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## Checklists Life and health insurance entities, with conforming changes as of May 1, 2011; Audit and accounting guide

American Institute of Certified Public Accountants. Life Insurance Audit Guide Task Force

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AUDIT & ACCOUNTING GUIDE

# Life and Health Insurance Entities

MAY 1, 2011



Audit & Accounting Guide: Life and Health Insurance Entities  
May 1, 2011



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AUDIT & ACCOUNTING GUIDE

# Life and Health Insurance Entities

WITH CONFORMING CHANGES AS OF  
MAY 1, 2011

This edition of the AICPA Audit and Accounting Guide *Life and Health Insurance Entities*, which was originally issued in 2000, 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 and other changes necessary to keep the guide current on industry and regulatory matters. The schedule of changes identifies all changes made in this edition of the guide. The changes do *not* include all those that might be considered necessary if the guide was subjected to a comprehensive review and revision.

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# Preface

## Purpose and Applicability

This AICPA Audit and Accounting Guide has been developed by the Insurance Companies Committee and the Life Insurance Audit Guide Task Force to assist management of life and health insurance entities in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and statutory accounting practices (SAPs) and to assist independent auditors in auditing and reporting on such financial statements.

This guide is intended to apply to all life and health insurance entities including stock, mutual, fraternal, and assessment entities. This guide is intended to be applied to all life and health entities that can issue life or accident and health insurance. This guide does not apply to governmental entities or to managed health care organizations.

The financial accounting and reporting guidance contained in this guide, when developed by the original task force or committee, was approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, now the Financial Reporting Executive Committee (FinREC). FinREC is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming updates made to the financial accounting and reporting guidance contained in this guide in years subsequent to the original development are reviewed by select FinREC members, among other reviewers where applicable.

This guide does the following:

- Identifies certain requirements set forth in Financial Accounting Standards Board (FASB) *Accounting Standards Codification*<sup>TM</sup> (ASC).
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter.
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them.
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in FASB ASC.

Accounting guidance for nongovernmental entities included in an AICPA Audit and Accounting Guide is a source of nonauthoritative accounting guidance. As discussed later in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Accounting guidance for governmental entities included in an AICPA Audit and Accounting Guide is a source of authoritative accounting guidance described in category *b* of the hierarchy of GAAP for state and local governmental entities,

and has been cleared by Governmental Accounting Standards Board (GASB). AICPA members should be prepared to justify departures from GAAP as discussed in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01).

Auditing guidance included in an AICPA Audit and Accounting Guide is recognized as an interpretive publication pursuant to AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of Statements on Auditing Standards (SASs) in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The members of the ASB have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If an auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

## Recognition

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Darrel R. Schubert  
*Chair*, Auditing Standards Board

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## Guidance Considered in This Edition

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued. Authoritative guidance issued through May 1, 2011, has been considered in the development of this edition of the guide. Authoritative guidance discussed in the text of the guide (as differentiated from the temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years *ending* on or before May 1, 2011. Authoritative guidance discussed only in temporary footnotes is not yet effective as of May 1, 2011, for entities with fiscal years ending after that same date.

This includes relevant guidance issued up to and including the following:

- FASB Accounting Standards Update (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*
- SAS No. 121, *Revised Applicability of Statement on Auditing Standards No. 100*, Interim Financial Information (AICPA, *Professional Standards*, AU sec. 722 par. .05)
- Statement on Standards for Attestation Engagements No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence is Impaired* (AICPA, *Professional Standards*, AT sec. 301 par. .23)
- Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 15, *Audit Evidence* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

Users of this guide should consider guidance issued subsequent to those items listed previously to determine their effect on entities covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in appendix E, "Schedule of Changes Made to the Text From the Previous Edition." The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

## Applicability of U.S. Generally Accepted Auditing Standards and PCAOB Standards

Audits of the financial statements of *nonissuers* (those entities not subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, private entities, generally speaking) are conducted in accordance with U.S. generally accepted auditing standards (GAAS) as issued by the ASB, the senior technical committee of the AICPA with the authority to promulgate auditing standards

for nonissuers. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in the AICPA's *Professional Standards*. Paragraph .03 of AU section 150 establishes that an AICPA member's failure to follow ASB standards for audits of nonissuers is a violation of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct.

Audits of the financial statements of *issuers*, as defined by the SEC (those entities subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, public entities, generally speaking), are conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the audits of issuers. The SEC has oversight authority over the PCAOB, including the approval of its rules, standards, and budget.

For audits of a nonissuer, in accordance with both GAAS and PCAOB standards, Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), provides reporting guidance applicable to such engagements.

## References to Professional Standards

In citing the professional standards, references are made to AICPA *Professional Standards*. In those sections of the guide that refer to specific auditing standards of the PCAOB, references are to the AICPA's *PCAOB Standards and Related Rules* publication. When referencing professional standards, this guide cites section numbers and not the original statement number, as appropriate. For example, SAS No. 54, *Illegal Acts by Clients*, is referred to as AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*).

## FASB ASC

### Overview

Released on July 1, 2009, FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by topically organizing the authoritative literature. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force, and the AICPA) to organize them under approximately 90 topics.

FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.

FASB published a notice to constituents that explains the scope, structure, and usage of consistent terminology of FASB ASC. Constituents are encouraged to read this notice to constituents because it answers many common questions about FASB ASC. FASB ASC, and its related notice to constituents, can be



accessed at <http://asc.fasb.org/home> and are also offered by certain third party licensees, including the AICPA. FASB ASC is offered by FASB at no charge in a Basic View and for an annual fee in a Professional View.

## Issuance of Amendments to FASB ASC

Amendments to FASB ASC are now issued through ASUs and will serve only to update FASB ASC. FASB does not consider the ASUs authoritative in their own right; such amendments become authoritative when they are incorporated into FASB ASC.

The ASUs issued are in the form of ASU No. 20YY-XX, in which "YY" is the last two digits of the year and "XX" is the sequential number for each update. For example, ASU No. 2010-01 is the first update in the calendar year 2010. The ASUs will include the amendments to the codification and an appendix of FASB ASC update instructions. ASUs also provide background information about the amendments and explain the basis for FASB's decisions.

## Pending Content in FASB ASC

Amendments to FASB ASC issued in the form of ASUs (or other authoritative accounting guidance issued prior to the release date of FASB ASC) that are not fully effective, or became effective within that last six months, for all entities or transactions within its scope are reflected as "Pending Content" in FASB ASC. This pending content is shown in text boxes below the paragraphs being amended in FASB ASC and includes links to the transition information. The pending content boxes are meant to provide users with information about how a paragraph will change when new guidance becomes authoritative. When an amended paragraph has been fully effective for six months, the outdated guidance will be removed, and the amended paragraph will remain without the pending content box. FASB will keep any outdated guidance in the applicable archive section of FASB ASC for historical purposes.

Because not all entities have the same fiscal year-ends, and certain guidance may be effective on different dates for public and nonpublic entities, the pending content will apply to different entities at different times. As such, pending content will remain in place within FASB ASC until the *roll off* date. Generally, the roll off date is six months following the latest fiscal year end for which the original guidance being amended or superseded by the pending content could be applied as specified by the transition guidance. For example, assume an ASU has an effective date for fiscal years beginning after November 15, 2010. The latest possible fiscal year end of an entity still eligible to apply the original guidance being amended or superseded by the pending content would begin November 15, 2010 and end November 14, 2011. Accordingly, the roll-off date would be May 14, 2012.

Entities cannot disregard the pending content boxes in FASB ASC. Instead, all entities must review the transition guidance to determine when the pending content is applicable to them. This Audit and Accounting Guide identifies pending content where applicable. As explained in the section of the preface "Guidance Considered in This Edition," pending content discussed in the text of the guide (as differentiated from the temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years ending on or before May 1, 2011. Pending content discussed only in temporary footnotes is not yet effective as of May 1, 2011, for entities with fiscal years ending after that same date.

## New AICPA.org Website

The AICPA encourages you to visit the new website at [www.aicpa.org](http://www.aicpa.org). It was launched in 2010 and provides significantly enhanced functionality and content critical to the success of AICPA members and other constituents. Certain content on the AICPA's website referenced in this guide may be restricted to AICPA members only.

## Select Recent Developments Significant to This Guide

### Summary of Significant Differences Between the PCAOB and AICPA Risk Assessment Standards

On August 5, 2010, the PCAOB issued Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). This release includes eight auditing standards (collectively referred to as the PCAOB risk assessment standards) as adopted by the PCAOB. The eight standards, which were approved by the SEC on December 23, 2010, and included in *PCAOB Standards and Related Rules* are as follows:

- Auditing Standard No. 8, *Audit Risk*
- Auditing Standard No. 9, *Audit Planning*
- Auditing Standard No. 10, *Supervision of the Audit Engagement*
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*
- Auditing Standard No. 14, *Evaluating Audit Results*
- Auditing Standard No. 15, *Audit Evidence*

The release also includes conforming amendments to other interim standards related to the PCAOB risk assessment standards. The effective date of the PCAOB risk assessment standards is for audits of financial statements of issuers with fiscal periods beginning on or after December 15, 2010.

In general, the PCAOB risk assessment standards are consistent with the AICPA SASs related to risk assessment (the AICPA risk assessment standards). Where differences exist, they are due to the PCAOB

- a. addressing audits of financial statements in conjunction with audits of effectiveness of internal control (often referred to as integrated audits). The AICPA risk assessment standards only address audits of financial statements.
- b. presenting content in standards different than the AICPA risk assessment standards. For example, the PCAOB
  - i. incorporated fraud risk assessment procedures into the PCAOB risk assessment standards

- ii. created Auditing Standard No. 10 to separately address supervision of the audit engagement,
- iii. created Auditing Standard No. 14 to separately address the evaluation of audit results,
- iv. moved content related to other audit areas such as analytical review procedures and audits of group financial statements.

The PCAOB risk assessment standards are not as voluminous as the AICPA risk assessment standards because the PCAOB standards do not contain as much application guidance as do the AICPA risk assessment standards. Appendix 11, "Comparison of the Objectives and Requirements of the Accompanying PCAOB Auditing Standards with the Analogous Standards of the International Auditing and Assurance Standards Board and the ASB of the American Institute of Certified Public Accountants," of the release contains a more detailed comparison of the differences between the PCAOB risk assessment standards and the AICPA risk assessment standards.

## **ASB's Clarity Project**

In an effort to make GAAS easier to read, understand, and apply, the ASB launched the Clarity Project. When completed, clarified auditing standards will be issued as one SAS that will supersede all prior SASs. The new audit standards are expected to apply to audits of financial statements for periods ending on or after December 15, 2012.

The foundation of the ASB's Clarity Project is the establishment of an objective for each auditing standard. These objectives will better reflect a principles-based approach to standard-setting. In addition to having objectives, the clarified standards will reflect new drafting conventions that include

- adding a definitions section, if relevant, in each standard.
- separating requirements from application and other explanatory material.
- numbering application and other explanatory material paragraphs using an A prefix and presenting them in a separate section (following the requirements section).
- using formatting techniques, such as bulleted lists, to enhance readability.
- adding special considerations relevant to audits of smaller, less complex entities.
- adding special considerations relevant to audits of governmental audits.

The project also has an international convergence component. The ASB expects that, upon completion of the project, nearly all the requirements of International Accounting Standards (IASs) will also be requirements of U.S. GAAS. AICPA Audit and Accounting Guides, as well as other AICPA publications, will be conformed to reflect the new standards resulting from the Clarity Project after issuance and as appropriate based on the effective dates.

## **International Financial Reporting Standards**

International Financial Reporting Standards (IFRSs) consist of accounting standards and interpretations developed and issued by the International

Accounting Standards Board (IASB), a London-based independent accounting standard-setting body. IASB began operations in 2001, when it succeeded the International Accounting Standards Committee (IASC). IASC was formed in 1973, soon after the formation of FASB. In 2001, when the IASB replaced the IASC, a new, independent oversight body, the IASC Foundation, was created to appoint the members of the IASB and oversee its due process. The IASC Foundation's oversight role is very similar to that of the Financial Accounting Foundation (FAF) in its capacity as the oversight body of FASB.

The term *IFRSs* has both a narrow and a broad meaning. Narrowly, IFRSs refer to the new numbered series of pronouncements issued by the IASB, as differentiated from IASs issued by its predecessor, the IASC. More broadly, however, IFRSs refer to the entire body of authoritative IASB pronouncements, including those issued by the IASC and their respective interpretive bodies. Therefore, the authoritative IFRSs literature, in its broadest sense, includes the following:

- Standards, whether labeled IFRSs or IASs
- Interpretations, whether labeled IFRIC (referring to the International Financial Reporting Interpretations Committee, the current interpretive body of the IASC Foundation) or SIC (Standing Interpretations Committee, the predecessor to IFRIC and former interpretive body of the IASC)
- IFRS framework

As of March 31, 2010, IFRIC formally changed its name to the IFRS Interpretations Committee and on July 1, 2010, the IASC Foundation formally changed its name to the IFRS Foundation.

The preface to the IFRS 2011 bound volume states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities including commercial, industrial, and financial entities regardless of legal form or organization. Included within the scope of profit-oriented entities are mutual insurance companies and other mutual cooperative entities providing dividends or other economic benefits to their owners, members, or participants.

IFRSs are not designed to apply to not-for-profit entities or those in the public sector, but these entities may find IFRSs appropriate in accounting for their activities. In contrast, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The AICPA governing council voted in May 2008 to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of Rules 202 and 203 gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As a result, private entities in the U.S. can prepare their financial statements in accordance with U.S. GAAP as promulgated by FASB; an other comprehensive basis of accounting, such as cash- or tax-basis; or IFRSs, among others. However, domestic issuers are currently required to follow U.S. GAAP and rules and regulations of the SEC. In contrast, foreign private issuers may present their financial statements in accordance with IFRSs as issued by the

IASB without a reconciliation to U.S. GAAP, or in accordance with non-IFRSs home-country GAAP reconciled to U.S. GAAP as permitted by Form 20-F.

The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession. Acceptance of a single set of high-quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years. See appendix D, "International Financial Reporting Standards," for a discerning look at the status of convergence with IFRSs in the United States and the important issues that accounting professionals need to consider now.

## Private Company Financial Reporting Blue Ribbon Panel

The Blue Ribbon Panel on Private Company Financial Reporting was established in December 2009 and is sponsored by the AICPA, the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA). This panel was formed to consider how U.S. accounting standards can best meet the needs of users of private company financial statements. Members of the panel represent a cross-section of financial reporting constituencies, including lenders, investors, owners, preparers, and auditors.

In late 2010, the Blue Ribbon Panel voted to recommend that FAF accept a new standard-setting model for private companies and the creation of a separate board to set those standards. Work continues related to changes being considered for private company financial reporting. For more information visit [www.accountingfoundation.org/home](http://www.accountingfoundation.org/home).

## Insurance Contracts Project

The IASB split its insurance contract project into two phases so that some components of the project were completed by 2005 without delaying the rest of the project. Phase I addresses the application of existing IFRSs to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts. The issuance of IFRS No. 4, *Insurance Contracts*, along with *Basis for Conclusions on IFRS 4* and *Implementation Guidance to IFRS 4*, brought to a close phase I of the international insurance project.

Effective for the aforementioned international insurers for annual periods beginning on or after January 1, 2005, IFRS No. 4 provides the framework for accounting for insurance contracts until the IASB completes phase II. IFRS No. 4 generally allows insurance contracts to be accounted for under the insurer's existing local accounting with some enhancements to those local standards. Although IFRS No. 4 permits the continuation of the existing local accounting for insurance contracts, the standard has imposed a requirement that the contract must contain significant insurance risk to qualify as an insurance contract under IFRS No. 4. The standard applies to reinsurance contracts as well as insurance contracts. IFRS No. 4 does not apply to other assets and liabilities of an insurer. Readers with international reporting situations should continue to be alert to potential developments in international accounting standards for insurance contracts.

In July 2010, the IASB issued the exposure draft *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. While the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement

approach; however, the majority prefers an alternative approach. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. GAAP to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.

## Limitations

This guide does not discuss the application of all U.S. GAAP, all GAAS, and all PCAOB auditing standards that are relevant to the preparation and audit of financial statements of life and health insurance entities. This guide is directed primarily to those aspects of the preparation and audit of life and health insurance entities' financial statements that are unique to those organizations or are considered particularly significant to them.

## Impact on Other Literature

GAAP for stock life entities was established by the AICPA Industry Audit Guide *Audits of Stock Life Insurance Entities* (the original guide). In June 1982, FASB issued Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (which is now FASB ASC 944, *Financial Services—Insurance*), which extracted the specialized principles and practices from the AICPA insurance industry Audit Guides and established financial accounting and reporting standards for insurance entities other than mutual life insurance entities, fraternal benefit societies, and assessment entities. This guide establishes expanded or new audit requirements in certain areas, including the following:

**Use of an actuary** (see paragraphs 5.81–.88). The guide requires the use of an outside qualified actuary (that is, an actuary who is neither an officer nor an employee of the entity whose financial statements are being audited) in connection with auditing reserves, deferred acquisition costs, and other actuarially determined amounts in all audit engagements to which the guide applies.

The insurance laws and regulations of the states require insurance entities domiciled in those states to comply with the guidance provided in the National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law. The NAIC codified SAP for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the manual). All states require insurers to comply with most, if not all, provisions of the manual. States have adopted the manual in whole, or in part, as an element of prescribed SAP in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed SAP applicable in each state. The NAIC publication *States' Prescribed Differences*

from *NAIC Statutory Accounting Practices* describes by state the differences from the manual.

Two other insurance specific auditing pronouncements not incorporated in the guide are important to specific individual state practice: Statement of Position (SOP) 01-3, *Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law* (AICPA, *Technical Practice Aids*, AUD sec. 14,370), and SOP 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code* (AICPA, *Technical Practice Aids*, AUD sec. 14,390).

## **Effective Date and Transition**

The accounting and financial reporting provisions of this guide that are carried forward from the AICPA Audit Guide *Audits of Stock Life Insurance Companies* retain their initial effective date. The accounting and financial reporting provisions that describe changes related by other new authoritative literature should be applied as provided for in the related literature using the effective dates specified in that literature.

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# Introduction

**I.1** This guide has been written with the assumption that readers are proficient in accounting and auditing in general but unfamiliar with the life and health insurance industries (hereinafter referred to as the life insurance industry or life insurance entities). Accordingly, the guide includes extensive life insurance industry background and explanatory material.

**I.2** Chapters 1–5 provide background information and terminology that is intended to help the reader to better understand the industry. The chapters also include comprehensive discussions of the life insurance business, product characteristics, and general auditing considerations and accounting practices—both statutory accounting practices (SAP) and U.S. generally accepted accounting principles (GAAP)—unique to the insurance industry.

**I.3** Chapters 6–14 focus on the major financial statement components that have unique accounting or auditing requirements for life insurance entities. The organization of chapters 6–14 is as follows:

- Introductory material
- Regulatory matters
- General descriptions of accounting practices, both SAP and U.S. GAAP
- Discussion of the auditor's understanding of internal control, including the following:
  - Understanding of the control environment
  - Assessment of the risks of material misstatement
  - Examples of control activities
  - Description of the related information system
  - Description of special audit considerations, if any
  - Charts of audit considerations with examples of specific audit objectives and control and auditing procedures

**I.4** Chapter 6, "Auditing Inforce Files," emphasizes the significance of the *inforce* files in the audit of a life insurance entity, and contains descriptions of control and audit procedures for inforce files. Chapters 7–14 concentrate on the major transaction cycles of a life insurance entity. Chapter 15, "Reports on Audited Financial Statements," discusses reports on audited financial statements and contains examples of various reports.

## Auditing

**I.5** The auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

- identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.

- relate the identified risks to what can go wrong at the relevant assertion level.
- consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- consider the likelihood that the risks could result in a material misstatement of the financial statements.

**I.6** The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed. When the risk assessment is based on an expectation that controls are operating effectively to prevent or detect material misstatement, individually or when aggregated, at the relevant assertion level, the auditor should perform tests of the controls that the auditor has determined to be suitably designed to prevent or detect a material misstatement in the relevant assertion to obtain audit evidence that the controls are operating effectively.

**I.7** The auditor should design and perform further audit procedures (tests of controls or substantive procedures) whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the risk assessments. In designing further audit procedures, the auditor should consider such matters as

- the significance of the risk.
- the likelihood that a material misstatement will occur.
- the characteristics of the class of transactions, account balance, or disclosure involved.
- the nature of the specific controls used by the entity, in particular, whether they are manual or automated.
- whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing or detecting material misstatements.

The nature of the audit procedures is of utmost importance in responding to the assessed risks. Because of the large volume of transactions associated with life and health insurance, the auditor often employs both audit sampling techniques (either statistical or nonstatistical) and computer-assisted auditing techniques in certain tests.

**I.8** Auditing guidance, including substantial guidance for each area regarding consideration of control environment, assessment of the risks of material misstatement, and selected control and audit procedures, is provided for each major financial statement component.

## **Audit Consideration Charts**

**I.9** The examples of specific audit objectives and control and audit procedures in the auditing sections of chapters 7–14 (in addition to the sections devoted to the consideration of internal control), illustrate how the auditor might assess control risk, perform audit procedures, and become familiar with

internal control. The charts following each chapter are arranged by broad audit objectives. These classifications may be useful in the evaluation process. There need not be a one-to-one relationship between audit objectives and the control or audit procedures. Some procedures may relate to more than one audit objective. On the other hand, a combination of procedures may be needed to achieve a single audit objective. The illustrations are not intended to be all-inclusive or to suggest that specific control procedures and audit procedures should be applied. In fact, some control and audit procedures may not be relevant to a particular life insurance entity because of the nature of its operations or the absence of certain kinds of transactions. Additionally, the absence of one or more of the illustrative internal control procedures would not necessarily suggest a weakness in internal control.

**I.10** Many of the illustrative control procedures are premised on certain essential characteristics of internal control as discussed in the control procedures section of each chapter. Control procedures include authorization of transactions, segregation of duties, documentation, supervision and independent review. These examples of characteristic control procedures have not been repeated in the audit consideration charts.

**I.11** *Transactions not unique to life insurance entities.* Many transactions occur in the normal course of business that are not unique to the life insurance industry. Such transactions include payroll, accounts payable, and cash disbursements. This guide does not address any accounting or auditing considerations regarding these business transactions for which the auditor should follow general guidance as it applies to any other industry.

**I.12** A glossary of terms and several appendixes have been included to provide the reader with additional sources of information regarding the life insurance industry. The appendixes are the following:

- a. Appendix A, "List of Industry Trade and Professional Associations, Publications, and Information Resources"
  - b. Appendix B, "Illustrative Financial Statements"
  - c. Appendix C, "Life Insurance Entity Specific Disclosures"
  - d. Appendix D, "International Financial Reporting Standards"
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## Chapter 1

# Overview of the Life and Health Insurance Industry

### Introduction

**1.01** The function of insurance is to pool the risks of many persons who are exposed to similar risks. For a payment known as a *premium*, insurance entities 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. One of the primary purposes of life insurance is to provide financial assistance to named beneficiaries at the time of the death of the insured. The long term nature of the coverage involving the risk of death—a risk that increases with age—is the distinguishing characteristic that sets life insurance apart from other forms of insurance. Traditionally, life insurance entities provided life and health products to protect against the loss of financial stability resulting from premature death or illness, and provided annuity products to protect against the risk of outliving one's financial resources. The primary emphasis was on meeting the customer's insurance needs.

**1.02** Recently, however, insurers have been providing a wide range of financial service products that meet more of the customer's investment and retirement savings needs. Although the mix of products has retained the traditional features of life and health insurance, there is an increased emphasis on interest sensitive products and investment related contracts with a combination of fixed and variable features.

**1.03** The Gramm-Leach-Bliley Act, enacted in 1999, removed restrictions on bank affiliations with insurers and permits mergers that combine commercial banks, insurers, and securities firms under one holding company. Until passage of the Gramm-Leach-Bliley Act, the Glass-Steagall Act of 1933 had limited the ability of banks to engage in securities related businesses, and the Bank Holding Company Act of 1956 had restricted banks from being affiliated with insurance entities.

### Legal Forms of Organization

**1.04** Life insurance entities may be grouped into the following four broad categories according to the legal form of their ownership:

- a. Stock entities
- b. Mutual entities
- c. Fraternal benefit societies
- d. Assessment entities

### Size and Composition of the Industry

**1.05** Approximately 95 percent of the life insurance entities in business are owned by stockholders. The remaining 5 percent are mutual entities,

fraternal benefit societies, and assessment entities. Mutual companies can convert to stock companies by a process of demutualization.

**1.06** In addition to the legal forms of organization, life insurance entities can be identified by the kinds of insurance products they offer and the markets they serve. For example, *reinsurance entities* do not serve the public directly, but assume portions of the risk underwritten by insurance entities for their contract holders. *Captive insurance entities* underwrite insurance exclusively for the members or customers of a group, typically the captive's parent. An example of a captive entity is a credit life insurance corporation that writes insurance on customers of its finance entity or bank parent.

## Stock Insurance Entities

**1.07** A stock insurance entity is a corporation organized for profit with ownership rights and control of operations vested in the stockholders. Generally, stockholders are not liable in the event of bankruptcy or the impairment of capital. In most states, stock insurance entities may issue both participating and nonparticipating contracts. *Participating contracts* are those contracts under which a portion of the associated earnings are returned to contract holders in the form of participating or contract holder dividends. *Nonparticipating contracts* are those contracts under which contract holders have no right to share in the associated earnings arising from their contracts. Stock insurance entities may also pay dividends to their shareholders; however, these payments are a return of profits and are reflected as a decrease in the retained earnings of the stock insurance entity. Stock insurance entities, like other stock corporations, are capitalized through the private or public sale of ownership shares.

## Mutual Insurance Entities

**1.08** A mutual insurance entity is an incorporated entity without private ownership interests that operates for the benefit of its contract holders and their beneficiaries. Mutual insurance entities issue participating contracts that pay participating dividends. In a mutual entity, participating contract holders are contractual creditors who have the right to vote for members of the entity's board of directors and trustees, as provided by law. In some states, the insurance laws provide that upon liquidation of a mutual insurance entity, the net assets are to be distributed among the existing contract holders, and prior contract holders have no right to a share of the net assets. The net assets and net income of a mutual insurance entity belong to the entity, and on the termination of their contracts contract holders lose their rights and interests in the mutual insurance entity.

**1.09** Mutual insurance entities commonly create wholly owned stock subsidiaries to issue nonparticipating contracts. The capital used to establish a mutual insurance entity is usually obtained from contributions by the original contract holders and the sale of interest bearing debt.

**1.10** Many mutual insurance entities are seeking enhanced financial flexibility and better access to capital to support long term growth and other strategies to accomplish strategic initiatives.

**1.11** Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-805 provides guidance on accounting by insurance enterprises for demutualizations and the formation of mutual insurance holding companies (MIHC). This guidance also applies to stock insurance



enterprises that apply FASB ASC 944, *Financial Services—Insurance*, to account for participating policies that meet the criteria of FASB ASC 944-20-15-3.

**1.12** FASB ASC 944-805 specifies the following:

- Financial statement presentation of the closed block (that is, the block of participating business operated for the exclusive benefit of the policies included therein for policy holder dividend purposes only)
- Accounting for predemutualization participating contracts after the demutualization date or formation of an MIHC
- Emergence of earnings
- Accounting for participating policies sold outside the closed block after the date of demutualization or formation of an MIHC
- Accounting for expenses related to a demutualization and the formation of an MIHC
- Accounting for retained earnings and other comprehensive income at the date of demutualization and formation of an MIHC
- Accounting for a distribution from an MIHC to its members

FASB ASC 944-805-05 applies to past and future demutualizations or formations of an MIHC. Readers may refer to FASB ASC 944-805-05 for a complete understanding of its provisions.

## **Fraternal Benefit Societies**

**1.13** A fraternal benefit society resembles a mutual insurance entity in that, although incorporated, it does not have capital stock, and it operates for the benefit of its members and their beneficiaries. Contract holders participate in the earnings of the society, and the contracts stipulate that the society has the power to assess its members if its legal reserves become impaired. Fraternal societies use contracts that incorporate their charter, constitution, and bylaws, in addition to the insurance contract. Any subsequent amendments to the entity's charter or bylaws automatically amend the insurance contract. The management of a fraternal benefit society is elected by member delegates to national conventions, who in turn elect the officers and directors. Fraternal benefit societies operating under a lodge system are exempt from federal income taxation.

## **Assessment Entities**

**1.14** An assessment entity is a group of insureds that share similar interests or characteristics, such as a religious denomination or a professional group. Assessment entities represent only a minor segment of the industry and, in many states, the organization of a new one is not permitted. Most existing assessment entities have been reorganized on a "legal reserve assessment entity basis," by which they charge fixed premiums and maintain the amount of reserves required by law, but retain the right to call for additional premiums. These entities are required by law to charge no less than the required minimum rates and have an assessment clause only until they accumulate surplus in excess of the legal minimum required. An assessment clause enables an assessment entity to collect assessments from members if funds are not sufficient to pay claims.

## Operations and Distribution Systems

### Operations

**1.15** The operations of life insurance entities are generally quite complex. Depending on the products offered and market segments served, life insurance entities can be organized into several departments or specialized areas, such as accounting, actuarial, administration, agency, claims, contract issue, contract holder services, information systems, investment, legal, marketing, product development, and underwriting. These areas can be centralized so that they assume entity wide responsibility, or they can be organized by product or line of business. Given the nature of the life insurance business, all departments may engage in activities that produce data that directly affect the financial statements.

**1.16** Life insurance entities offer a variety of products and may serve unique markets, but are also apt to share a number of characteristics. Operating functions that are basic to life insurance entities include the following:

- a. Underwriting and collection of premiums.* Underwriting is the process of establishing guidelines to evaluate and investigate applications for insurance, accepting or rejecting insurance risks, and classifying those risks to determine the proper premium for each. The proper selection and pricing of insurance risks are critical to a successful insurance entity. Billing and collection of premiums are significant operating activities of a life insurance entity.
- b. Investment of premium.* Once premiums for insurance coverage are received, the life insurance entity invests the funds. Assumptions regarding the use of investable funds and estimated maturities and returns on those investments are inherent in the profit planning and pricing policies of life insurance entities. Funds are invested so that the income from the investments, plus the maturities and anticipated renewal premiums, meet the cash flow needs of the life insurance entity. In most jurisdictions, regulatory standards and limitations on investment activities are intended to ensure adequate stability and liquidity. Regulations may also prescribe methods for valuing and reporting invested assets.
- c. Payment of benefits and claims.* The claim payment process in a life insurance entity begins with the receipt by the entity of a notice either to file a claim or fully or partially surrender a contract. However, before receiving requests for benefit payments, life insurance entities will have received premiums and recorded revenue. To properly match revenues and expenses, estimates of liabilities for future policy benefits (benefit and claim liabilities) and related expenses must be made. Contract liabilities for future policy benefits must be sufficient to provide for future promised benefits as they become due. These benefit and claim liabilities are estimated using generally accepted actuarial standards and methodologies based on factors that include mortality, morbidity, interest rate, withdrawal, and expense assumptions. Benefit and claim liabilities are usually the most significant liability of life insurance entities. Accurate databases, a good understanding of the industry environment, consistent application of acceptable approaches, and detailed

comparisons of actual to expected results are necessary to produce appropriate benefit and claim liability estimates.

## Distribution Systems

**1.17** Life insurance entities sell their products through various distribution systems. The choice of distribution systems is dependent on a number of factors, such as relative cost considerations, marketing strategies, and product processing requirements. Most life insurance entities employ either a general agency or branch office distribution system, or some combination thereof; however, they are increasingly relying on other third parties, such as brokers, to sell certain life insurance products.

**1.18** Some life insurance entities sell home service insurance in small amounts through door-to-door salespersons; these contracts may be issued on either ordinary or home service contract forms. Premiums on such insurance are generally collected by the agent on a weekly or monthly basis.

**1.19** Life insurance entities are increasingly obtaining new business through other channels, such as direct mail solicitation, advertising in the news media, the Internet, and telemarketing. Still, the general agent and branch office systems remain the most common distribution systems.

**1.20** Distribution systems, which are described in paragraphs 1.21–.23, are distinctive as a result of their relationship with the life insurance entity. However, distributors submit applications for insurance to the insurance entity; distributors not only accept or reject the applications, but generally hold the power to issue binding agreements.

**1.21** *General agencies.* General agents are usually independent contractors and often are granted an exclusive territory in which to produce business for a life insurance entity. However, this practice varies among entities and usually does not apply to agencies operating in large metropolitan areas. General agents agree to promote an entity's interests, pay their own expenses (although reimbursement may be provided by contract), maintain a satisfactory agency force, and secure subagents. They perform services associated with securing applications for insurance and the issuing of contracts. General agents are compensated primarily by commission, a percentage of the premiums they produce, plus certain allowances designed to cover related expenses. The allowance may be a gross percentage, out of which the general agents pay the subagents whom they appoint, or it may be a specific overriding commission, with the subagents' and brokers' commissions paid directly by the insurance entity. General agents typically represent only one life insurance entity, and they commonly have vested rights to renewal commissions, depending on their contractual agreement.

**1.22** *Branch offices.* Branch office salespersons may be employees of a life insurance entity, independent contractors, or employees of general agents. Offices are operated by managers, who are usually salaried employees of the life insurance entity. The manager's compensation may be based partly on production; however, the manager usually does not have vested rights to renewal commissions. The branch office's expenses are usually paid directly by the life insurance entity.

**1.23** *Brokers.* Brokers are independent agents who solicit business and place it with various life insurance entities. They represent the contract holder

and may write business with various life insurance entities. They submit applications for acceptance or rejection directly to the entity or through a general agent, subagent, or other broker. Generally, brokers do not have any contractual relationship with the life insurance entity and represent only the insureds. They are compensated on the basis of a commission, which is usually calculated according to the amount of premium on contracts placed with the life insurance entity. Brokers usually have vested rights to renewal commissions, depending on their contractual agreement.

## Major Lines of Business

**1.24** Typically, the products of life insurance entities can be grouped into seven broad lines of business. The majority of these insurance products are sold on either a group or individual basis and on either a participating or nonparticipating basis.

## Life Insurance Contracts

**1.25** Traditional life insurance contracts include whole life, term, and endowment contracts that provide a fixed amount of insurance either for a fixed term or over the life of the insured. The related benefits are payable only upon the insured's death except for those contracts that contain living benefit clauses. Premiums are paid over various periods as allowed under the terms of the contract.

**1.26** Universal life and similar contracts are contracts with terms that are not fixed or guaranteed relative to premium amounts, expense assessments, or benefits accruing to the contract holder.

**1.27** Variable life contracts are contracts with adjustable terms that are usually dependent on the investment performance of a specific separate pool of assets, usually a *separate account*. Separate accounts are discussed further in paragraph 2.21 and in chapter 14, "Other Assets and Liabilities, Lending and Financing, Surplus Notes, Separate Accounts, Insurance-Related Assessments and Equity—Contract Holders' Surplus."

**1.28** Some annuity and life contracts sold as general account or separate account products may combine fixed and variable features. The features of these nontraditional contracts may be complex, and are offered in different combinations, such that there are numerous variations of the same basic products being sold in the marketplace. FASB ASC 944-805 provides accounting guidance for and examples of some of these product features.

## Accident and Health Insurance Contracts

**1.29** Accident and health insurance contracts are generally classified as either medical indemnity contracts, which provide benefits for medical expenses, or disability income contracts, which provide for periodic benefit payments for a predetermined period (fixed or for life) in the event the insured is unable to work as a result of total or partial disability resulting from illness or injury.

## Annuity Contracts

**1.30** Annuity contracts are arrangements whereby a contract holder is guaranteed to receive benefits over a fixed or variable period commencing either

immediately or at some future date. As stated in paragraph 1.28, some of these products now may combine fixed and variable features.

## Investment Contracts

**1.31** Investment and similar contracts are those that do not subject the insurer to significant insurance risks of contract holder mortality or morbidity and are comparable to financial or investment products offered by other kinds of financial institutions.

## Fee-for-Service Contracts

**1.32** Fee based services, such as group plan administrative services, investment advisory services, and other back office services, are contracts that provide for services only, and do not contain significant elements of insurance or investment risks to the life insurance entity.

**1.33** In addition, life insurance entities commonly offer products through noninsurance subsidiaries, such as finance entities, broker-dealer operations, mutual funds, unit trusts, joint ventures, mortgage banks, and real estate trusts. These ancillary services are beyond the scope of this guide.

## Reinsurance

**1.34** Frequently, life insurance entities respond to market conditions or capital limitations by writing contracts on risks for amounts that exceed either their financial capacity or willingness to be at risk of loss. Such risks are spread among other insurance entities through reinsurance, which is the indemnification by one insurer (referred to as the *reinsurer* or the *assuming entity*) of all or part of a risk originally underwritten by another insurer (referred to as the *ceding entity* or the *direct writer*).

**1.35** All life insurance entities set limits on the amounts and kinds of risks they will retain. Such limits are referred to as *retention*, and may differ depending on the insured's age or the classification of the risk as standard or substandard. Amounts at risk in excess of the retention limit are generally reinsured for a negotiated fee arrangement. In reinsuring all or part of a risk, a ceding entity does not discharge its primary liability to its insured, but reduces its maximum exposure in the event of an unexpected loss by obtaining the right to reimbursement from the assuming entity for the reinsured portion of the loss. A ceding entity is also exposed to the possibility that the reinsurer will be unable to make the reimbursement to the ceding entity.

**1.36** Indemnity reinsurance transactions are between insurance entities, not insureds. The legal rights of the insureds generally are not affected by reinsurance except as described in paragraph 1.37 for assumption reinsurance. The entity issuing the contract remains liable for the payment of the contract benefits.

**1.37** Reinsurance also applies to the sale of all or part of an entity's insurance in force to another entity, commonly referred to as *assumption reinsurance*. If the original contract is novated, the assuming entity legally replaces the ceding entity as the primary obligor to the contract holder. Such a transaction may arise upon the insolvency or liquidation of an entity, or it may be instituted by a management decision (with regulatory approval) to sell a

portion of the business. (Regulators typically require the agreement of individual policyholders.)

## Regulation

**1.38** The insurance industry is deemed to be vested with the public interest because it acts in a fiduciary capacity and therefore requires regulation. In 1945, Congress passed the McCarran-Ferguson Act (Public Law 15), which states that although the federal government has the right to regulate the insurance industry, it will not exercise this right as long as state legislation provides for adequate supervision of the industry. Statutes in each state provide for the organization and maintenance of an insurance department responsible for supervising insurance entities and enforcing their compliance with the law. Although statutes vary among states, the common principal objectives are the development and enforcement of measures designed to preserve insurer solvency, promote uniform reporting, and promote fair and nondiscriminatory dealings with contract holders.

**1.39** In a majority of states, life insurance entities may not organize without the authorization of the state insurance department; in states in which such authorization is not required, approval by the state insurance department is necessary for the completion of organization. Life insurance entities can be licensed in one or more states to conduct business in those states, and although they are primarily subject to the regulations of their state of domicile, they are also subject to the regulations of each state of license.

**1.40** To preserve solvency, statutes generally

- a. restrict investments of insurance entities to certain amounts and kinds of assets.
- b. prescribe methods of valuation of securities and other assets.
- c. require maintenance of minimum reserves, capital, and surplus. Risk based capital (RBC) is one method required by statutes; see paragraph 1.50 for further discussion.
- d. define those assets not permitted to be reported as admitted assets in annual statements or audited statutory financial statements filed with the state insurance department.

**1.41** To promote uniform reporting, all states require that insurance entities operating within their boundaries submit to the insurance commissioner an annual and quarterly statement or *Blank* containing annual financial statements and other financial information. Annual statements are required to be filed on a calendar year basis and are prepared in accordance with accounting principles and practices that are prescribed or permitted by the insurance department of the state of domicile. (See chapter 3, "Sources of Accounting Principles and Reporting Requirements," for further discussion.) In addition, regulators require that insurance entities include with their annual statement an opinion of a *qualified actuary* regarding the adequacy of reserves and their conformity with statutory requirements. *Qualified actuary*, as used here and as defined in the National Association of Insurance Commissioners (NAIC) *Annual Statement Instructions*, is a member in good standing of the American Academy of Actuaries, or a person who has demonstrated his or her actuarial competence to the satisfaction of the insurance regulatory official of the domiciliary state.

**1.42** To promote fair and nondiscriminatory dealings with contract holders, state statutes provide for the incorporation of certain standard provisions in contracts, market conduct regulations, and certain pricing policies. State insurance departments review and approve contract forms and perform market conduct examinations involving pricing policies and notifications to contract holders as required by law. Insurance agents, brokers, and salespersons generally must qualify for and obtain licenses granted by a state insurance department before they may solicit business in that state.

**1.43** In general, premium rates for individual life insurance are regulated but may not need permission in advance for rate changes. Maximum premium limits are set for credit insurance. Premium rates for certain health insurance coverages are supervised. Rate making bureaus exist in the property and liability industry, but not in the life insurance industry. Controls are imposed on life insurance premium rates by means of reserve regulation. Definitive benefit liability requirements are a significant variable in the setting of premium rates that are high enough to maintain minimum statutory reserves and surplus levels.

**1.44** A state insurance department usually consists of an insurance commissioner or a superintendent in charge, as well as his or her deputies, examiners, accountants, actuaries, attorneys, and clerical assistants. The head of the state insurance department, generally referred to as the *commissioner*, is either appointed by the governor or elected. The state legislature is responsible for enacting laws and statutes; however, the commissioner usually holds many discretionary powers, including the authority to issue the rules and regulations necessary to ensure compliance with the state's statutes. A commissioner is not bound by precedent; that is, the commissioner may disregard his or her own previous decisions as well as the decisions made by predecessors. Formal acts of an insurance regulatory authority are set forth either as *adjudications* or *rulings*. Adjudications are a commissioner's decision in a particular situation, such as a denial of a provision in a certain contract form requested by an insurer. *Rulings* or *regulations* are regulatory decisions concerning situations that have widespread implications; they apply to all activities over which the state insurance department has jurisdiction. The insurance commissioner also has the power to take remedial action against any entity in noncompliance with the regulations of the affected state, including actions that would preclude the insurance entity from writing further business in a particular state.

**1.45** States generally conduct periodic financial examinations of life insurance entities. These examinations are conducted under the supervision of the state insurance department of the entity's state of domicile with the participation of other zones on request from other states in which the entity is licensed to write business. Examinations generally are conducted every three to five years, at the discretion of the state department of insurance. At the conclusion of the examination, a detailed report, including any adjustments to statutory surplus required by the state examiners, is issued. Generally, such adjustments are not retroactively recognized in an entity's financial statement. (See chapter 5, "General Auditing Considerations," paragraphs 5.116–.128 for further discussion.)

**1.46** Regulators may deem a life insurance entity unable to continue doing business as a result of inadequate statutory surplus levels, and force the entity into receivership, rehabilitation, or liquidation. (See chapter 4, "Audit Risk Considerations," paragraph 4.07 for further discussion.)

## National Association of Insurance Commissioners

**1.47** In 1871, to create greater uniformity in the laws and their administration and to recommend desirable legislation to state legislatures, the state commissioners of insurance organized an association known today as the NAIC. The primary activities of the NAIC include monitoring financial condition and providing guidance on financial reporting and state regulatory examinations. Over the years, the work of the NAIC has helped eliminate many conflicts in state law and promote more uniform and efficient regulation of insurance entities. In June 1989, the Financial Regulation Standards were adopted, which established baseline requirements for an effective regulatory system in each state. The NAIC Financial Regulation Standards and Accreditation Program was subsequently adopted to provide states with guidance regarding these standards. The standards are divided into three categories: (1) laws and regulations, (2) regulatory practices and procedures, and (3) organizational and personnel practices. Accounting, financial reporting, and auditing requirements are included in the standards. Mandating certain requirements and certifying that the states are in compliance, provides a degree of assurance that regulators have adequate authority to regulate insurers, have the resources to carry out that authority and have in place administrative practices designed for effective regulation.

**1.48** *NAIC codified statutory accounting.* 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 guide as *statutory accounting practices*. The insurance laws and regulations of the states generally require insurance entities domiciled in those states to comply with the guidance provided in the NAIC Accounting Practices and Procedures Manual except as otherwise prescribed or permitted by state law. The NAIC codified statutory accounting practices for certain insurance entities, resulting in a revised Accounting Practices and Procedures Manual. States generally require insurers to comply with most, if not all, provisions of the revised manual. Preparers of financial statements and auditors of an insurance entity should continually monitor the status of the new guidance adopted as part of the revised manual and the effects on the prescribed practices of the domiciliary state.

**1.49** *Insurance Regulatory Information System.*<sup>1</sup> States monitor the financial condition of insurance entities partially through the Insurance Regulatory Information System (IRIS), which is a series of 12 ratio tests based on statutory financial information. These ratios are intended to identify life insurance entities that may be experiencing or trending toward financial difficulty. Insurance entities that do not meet IRIS standards may be given a high priority for additional regulatory surveillance. (Note that *Commissions and Expenses to Premiums and Deposits* has been discontinued as a regular ratio.)

*a. Overall Ratios*

- i. *Net change in capital and surplus.* This measures the improvement or deterioration in an entity's financial condition during the year. It is calculated by dividing the change in capital and surplus between the prior and current year

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<sup>1</sup> From the National Association of Insurance Commissioners Insurance Regulatory Information System, Kansas City, Kansas.



(net of any capital and surplus paid in, including net increases in surplus notes) by the prior year capital and surplus. The usual range includes all results greater than -10 percent and less than 50 percent.

- ii. *Gross change in capital and surplus.* This ratio should be compared to ratio 1. Ratio 2 also measures the improvement or deterioration in an entity's financial condition during the year. Unlike ratio 1, it takes into account capital and surplus, including surplus notes, paid during the year. The ratio is calculated by dividing the change in capital and surplus from the prior year to the current year by the prior year capital and surplus. The usual range includes all results greater than -10 percent and less than 50 percent.
- iii. *Net income to total income (including realized capital gains and losses).* This ratio measures an entity's profitability and is calculated by dividing net income from operations (including realized capital gains and losses) by total income (including realized capital gains and losses). The usual range for this ratio includes all results greater than zero.

b. Investments

- i. *Adequacy of investment income.* This profitability ratio measures whether an insurer's investment income is adequate to meet the interest requirements of its reserves. It is calculated by dividing net investment income by interest required (tabular interest reported in the analysis of increase in reserves for policies and contracts involving life or disability contingencies, the tabular fund interest on accident and health policies and contracts, and the investment earnings credited to deposit type contract funds). The usual range includes all results greater than 125 percent and under 900 percent.
- ii. *Nonadmitted assets to admitted assets.* This ratio measures the degree to which an entity has acquired nonadmitted assets, which may represent either nonproductive assets or risky investments. To calculate, total nonadmitted assets are divided by total assets. The usual range includes all results less than 10 percent.
- iii. *Total real estate and total mortgage loans to cash and invested assets.* This ratio measures the percentage of cash and invested assets that are invested in real estate and mortgage loans, a potential area of financial difficulty. The ratio is calculated by dividing the sum of all mortgage loans, BA mortgages, total real estate (including properties occupied by the entity, properties held for the production of income, properties held for sale less encumbrances, and BA real estate) by cash and invested assets less amounts payable for securities. The usual range includes results less than 30 percent.

- iv. *Total affiliated investments to capital and surplus.* This ratio indicates potential risk from investments in affiliates. The ratio is calculated by dividing the sum of all receivables and investments in affiliates by total capital and surplus. The usual range includes all results less than 100 percent.
- c. **Surplus Relief**
  - i. *Surplus relief.* This ratio measures the adequacy of surplus. The ratio is calculated by dividing net commissions and expense allowances on reinsurance by capital and surplus. For entities with capital and surplus of \$5 million or less, the usual range is greater than -10 percent and less than 10 percent. For entities with capital and surplus in excess of \$5 million, the usual range includes those results which are greater than - 99 percent and less than 30 percent.
- d. **Changes in Operation**
  - i. *Change in premium.* This ratio measures the percentage change in premium from the prior to the current year. The ratio is calculated by dividing the annual change in total premiums, deposit type contract fund considerations and other considerations, by prior year total premiums, deposit type fund considerations and other considerations. The usual range includes all results less than 50 percent and greater than -10 percent.
  - ii. *Change in product mix.* This ratio measures the average change in the percentage of total premium from each product line during the year. The percentage of premium from each product line is first determined for current and prior year. Then the difference in the percentage of premium between the 2 years is determined for each product line. Finally, the total of these differences, without regard to sign, is divided by the number of product lines to determine the change in the percentage of premium for the average product line. If total premiums for either year are zero or negative, no result is calculated. The usual range includes results less than 5 percent.
  - iii. *Change in asset mix.* This ratio measures the average change in the percentage of total cash and invested assets for certain classes of assets. The change in asset mix is calculated in the same manner as the change in product mix ratio. The usual range includes all results less than 5 percent. Additionally, if total assets for either year are zero or negative, the result is automatically considered unusual.
  - iv. *Change in reserving ratio.* This ratio measures the number of percentage points of difference between the reserving ratio for current and prior years. The ratio is calculated by dividing the aggregate increase in reserves for individual life insurance by renewal and single premiums for individual life insurance. The usual range of the number

of percentage points of difference includes all results less than 20 percent but greater than a -20 percent. For entities with no industrial or ordinary life lines of business, a ratio value of zero is within the range of acceptability.

**1.50 Risk based capital.** RBC is a program developed by the NAIC that serves as a benchmark for the regulation of life insurance entities' solvency by state insurance regulators. RBC requirements set forth dynamic surplus requirements based on 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. The regulatory consequences of low capital and surplus are determined by the ratio of the entity's capital and surplus to its calculated RBC. (See chapters 4 and 5.) For life insurance entities, the RBC formula focuses on the following four general kinds of risk (which are fully discussed in paragraphs 4.03–.07):

- a. C-1—Asset risk (defaults)
- b. C-2—Insurance risk (underwriting)
- c. C-3—Interest rate risk (asset-liability matching)
- d. C-4—Business risk (management, regulatory action, and other contingencies)

## Federal Regulations

**1.51** Federal regulation of the life insurance industry has historically concerned itself with financial reporting as regulated by the Securities and Exchange Commission (SEC). Life insurance entities registered under Section 12 of the Securities Exchange Act of 1934 must comply with the SEC's periodic reporting requirements and generally must file, pursuant to Section 13 of the act, a Form 10-K annual report. Registered entities are also subject to proxy solicitation and insider trading rules. Insurance entities 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 Securities Exchange Act of 1934.

**1.52** Insurance entities required to file a Form 10-K annual report must comply with reporting requirements of Regulation S-X. Regulation S-X prescribes the form, content, and requirements for financial statements for all entities subject to the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and other federal laws governing the offering and sale of securities.

**1.53** According to SEC rules, public offerings of variable life insurance and annuity products (in which the benefits are based on the investment performance of a separate account) are not exempt from the securities acts as these are forms of investment contracts and are regulated by the SEC and must comply with the annual and periodic reporting requirements of the Investment Company Act of 1940.<sup>2</sup> If the life insurance entity or its designated subsidiary

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<sup>2</sup> In January 2009, the Securities and Exchange Commission (SEC) issued Release No. 33–8996, *Indexed Annuities and Certain Other Insurance Contracts*, that prospectively defines a class of indexed annuities that fall outside the scope of the exemption for certain "annuity contracts" or "optional annuity contracts" in Section 3(a)(8) of the Securities Act of 1933. The new definition

(continued)

is also the principal underwriter of the separate account, its distributors or agents typically must be qualified and licensed as registered representatives. In addition, the principal underwriter ordinarily must comply with reporting requirements of the Securities Exchange Act of 1934, including the filing of an annual report on Form X17a-5 and other filings required by broker-dealers.

**1.54** Publicly held insurance entities and other issuers are subject to the provisions of the Sarbanes-Oxley Act of 2002 and related SEC regulations implementing the act. Their outside auditors are also subject to the provisions of the act and to the rules and standards issued by the Public Company Accounting Oversight Board, subject to SEC oversight. For further information on these rules and regulations, see the preface, and chapters 3 and 5.

**1.55** In addition, the Federal Trade Commission regulates insurance entity mergers, mail order advertising, and other trade practices affecting competition. The U.S. Department of Labor and the IRS administer the Employee Retirement Income Security Act under which private pension plans are regulated. Life insurance entities (except for fraternal benefit societies exempt from federal income taxation) are also subject to the rules and regulations of the U.S. Department of the Treasury as specified in the Internal Revenue Code (IRC). Additionally, under the Gramm-Leach-Bliley Act, if the insurance entity is a member of a holding company system that includes banks or other financial institutions, the insurance entity may be subject to regulations passed by financial institution regulators.

**1.56** *The Dodd-Frank Wall Street Reform and Consumer Protection Act.* On July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law. The Dodd-Frank Act was approved by the House on June 30, before narrowly clearing the Senate on July 15. The Dodd-Frank Act will create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002, make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisers. Some of the highlights of the Dodd-Frank Act are summarized in the following paragraphs.

**1.57** The Dodd-Frank Act creates a new systemic risk regulator called the Financial Stability Oversight Council (FSOC). The FSOC will identify any company, product, or activity that could threaten the financial system. It will be chaired by the Treasury secretary, and members will be heads of regulatory agencies, including the chairmen of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the SEC, among others. For those large entities deemed a threat to the U.S. financial system, the FSOC can, under the authority of a new orderly liquidation authority, authorize the FDIC to close such entities under the supervision of the Federal Reserve. The FSOC, through the Federal Reserve, will also have the power to break up large firms; require increased reserves; or veto rules created by another new regulator, the Bureau of Consumer Financial Protection, with a two-thirds vote.

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*(footnote continued)*

applies if the amounts payable by the insurer under the contract are more likely than not to exceed the amounts guaranteed under the contract. The rule will apply prospectively to indexed annuities issued on or after January 12, 2011, and those meeting the definition will be required to register under the Securities Act of 1933, but will generally continue to be exempt from ongoing reporting under the Exchange Act of 1934. This topic has been the subject of litigation, readers should review the release on the SEC's website under the "Final Rules" section.

**1.58** The new Bureau of Consumer Financial Protection (BCFP) consolidates most federal regulation of financial services offered to consumers. The director of the BCFP replaces the director of the Office of Thrift Supervision on the FDIC board. Almost all credit providers, including mortgage lenders, providers of payday loans, refund anticipation loan providers, other nonbank financial companies, and banks and credit unions with assets over \$10 billion, will be subject to the new regulations. Functions currently handled by existing agencies are expected to be transferred to the BCFP, and the BCFP is expected to assume full authority for consumer financial protection no later than 1 year after enactment.

**1.59** The Dodd-Frank Act recognizes that CPAs providing customary and usual accounting activities (which include accounting, tax, advisory, or other services that are subject to the regulatory authority of a state board of accountancy) and other services incidental to such customary and usual accounting activities are already adequately regulated and, therefore, are not subject to the BCFP's authority.

**1.60** The Dodd-Frank Act amends the Sarbanes-Oxley Act to make permanent the exemption from its Section 404(b) requirement for nonaccelerated filers (those with less than \$75 million in market capitalization) that had temporarily been in effect by order of the SEC. Section 404(b) of Sarbanes-Oxley Act requires companies to obtain an auditor's report on management's assessment of the effectiveness of the company's internal control over financial reporting. In September 2010, the SEC issued Final Rule *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers* (Release Nos. 33-9142 and 34-62914), to conform its rules to this resulting change from the Dodd-Frank Act.

**1.61** The Dodd-Frank Act also provides for the PCAOB to create a program for registering and inspecting the auditors of broker-dealers, including standard setting and enforcement. Currently, all auditors of broker-dealers must be registered with the PCAOB. Covered auditors will now be required to follow PCAOB guidance. The Dodd-Frank Act allows the PCAOB, in its inspection rule, to differentiate among broker-dealer classes and to potentially exempt introducing brokers, such as those who do not engage in clearing, carrying, or custody of client assets.

**1.62** The Dodd-Frank Act requires standardized swaps to be traded on an exchange, or in other centralized trading facilities, to better promote transparency in this complex market. Standardized derivatives will also have to be handled by central clearinghouses. However, a measure requiring banks to spin off their swaps trading units was scaled back in the final version of the Dodd-Frank Act. Banks will still be able to trade swaps to hedge risk and trade interest rate or foreign exchange swaps, but dealing in riskier swaps transactions must still be moved into affiliates. Clearing and exchange trading requirements are expected to become effective 360 days following enactment.

**1.63** The Dodd-Frank Act gives the FSOC the duty to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress to make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets. The FSOC may submit comments to the SEC and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure.

**1.64** Currently, the Investment Advisers Act of 1940 requires investment advisers with over \$30 million in assets under management to register with the SEC. Under the Dodd-Frank Act, this threshold for federal regulation will be raised to \$100 million, with certain exceptions. This change will increase the number of advisers under state supervision.

**1.65** Because it lowers the legal standard from "knowing" to "knowing or reckless," the Dodd-Frank Act may make it easier for the SEC to prosecute aiders and abettors of those who commit securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Additionally, the Dodd-Frank Act authorizes two studies on these matters. One of the studies directs the Government Accountability Office to investigate the impact of authorizing private rights of action for aiding and abetting claims and to release its findings within 1 year. The second study directs the SEC to examine whether private rights of action should be authorized for transnational or extraterritorial claims, and that study is to be completed within 18 months.

**1.66** The Dodd-Frank Act eliminates the private adviser exemption under the Investment Advisers Act of 1940, which will consequently result in more advisers having to register with the SEC. Advisers to venture capital funds remain exempt from registration, as well as advisers to private funds if such an adviser acts solely as an adviser to private funds and has U.S. assets under management below \$150 million. The Dodd-Frank Act also amends the Investment Advisers Act of 1940 to specifically exclude family offices from registration as an investment adviser. The new registration requirement will become effective 1 year after enactment; however, any investment adviser may, at the discretion of the investment adviser, register with the SEC during that 1-year period.

**1.67** The Dodd-Frank Act requires a nonbinding shareholder vote on executive pay. At a public company's first shareholder meeting following the end of the six month period after enactment, management must give shareholders the opportunity to vote on how frequently shareholders will have a "say on pay" (that is, annually, every two years, or every three years). Compensation based on financial statements that are restated must be returned for the three years preceding the restatement in an amount equal to the excess of what would have been paid under the restated results. Listing exchanges will enforce the compensation policies. The Dodd-Frank Act also requires directors of compensation committees to be independent of the company and its management and requires new disclosures regarding compensation.

## Rating Agencies

**1.68** Insurance entities are rated by independent rating agencies for financial strength and claims paying ability. Insurance entity ratings are widely used by sales agents to compare entities, and are important to consumers who are buying insurance policies where claims may not be filed for years, or even decades. A rating agency bases its rating on financial reports, interviews with entity executives, data gathered through questionnaires, proprietary formulas for assessing financial strength and the agency's opinion about the entity's business prospects and quality of management. The major rating agencies include Moody's Investors Service (for financial strength), Fitch (for claims paying ability), Standard & Poor's (for claims paying ability), and A.M. Best (for financial strength).

## Taxation

### Federal Taxation

**1.69** Taxation of U.S. life insurance entities has become increasingly complex. Federal tax policies have a major effect, not only on the profitability of the life insurance industry, but also on product design and the viability of existing products. Paragraphs 1.58–.70 describe the major tax legislation that has affected the life insurance industry and that is discussed further in chapter 13, "Taxation of Life Insurance Entities."

**1.70** *The Revenue Act of 1921.* This act provided for the taxation of investment income, to the extent that it was not required in the contract reserves to liquidate present and future claims.

**1.71** *The Life Insurance Company Act of 1959.* This act continued taxation of the insurance entity's share of investment income, but added taxation of underwriting gains and introduced a complex three phase tax structure in which taxable income varied according to the relationship of taxable investment income and taxable gain from operations. In certain situations, a portion of otherwise taxable gain from operations was not currently taxed, but was accumulated in a tax basis *policyholders' surplus account*, subject to future tax if distributed, or if policyholders' surplus reached a specified maximum. In determining underwriting gain, a deduction was allowed for the increase in reserves. Tax basis reserves under the 1959 act were generally statutory reserves with an elective adjustment to increase reserves from *preliminary term* to appropriate *net level premium reserve*.

**1.72** *The Deficit Reduction Act of 1984.* This act replaced the 3 phase structure of the Life Insurance Company Act of 1959 with a simplified, single phase structure. Proration of investment income into the entity's share and contract holder's share was retained. A special deduction was provided equal to 20 percent of otherwise determined taxable income. Tax basis reserves were revised to be calculated using preliminary term methodology and prevailing statutory interest rates and mortality or morbidity tables. The excess of the tax reserves set by the 1959 act over those of the 1984 act were effectively forgiven, in that the excess was not included in taxable income. The 1984 act included a provision to reduce the deductibility of contract holder dividends of mutual entities. A portion of contract holder dividends of mutual entities was viewed as return of equity, somewhat similar to shareholder's dividends of stock life insurance entities. This provision was intended to result in equitable treatment of mutual and stock entities regardless of the differences in their form of ownership. The 1984 act also included a definitional test for life insurance products based on guideline premiums and cash value tests.

**1.73** *The Tax Reform Act of 1986.* This act introduced a new alternative minimum tax (AMT) that applies to all corporations, including life insurance entities. The AMT is a second tax calculation that determines the amount of tax a corporation ordinarily must pay if the AMT exceeds the regular tax calculation. This act also repealed the 20 percent special deduction enacted in 1984.

**1.74** *1987 Revenue Act.* This act was the first statute to create a requirement bringing many tax reserves below minimum statutory reserves by means of the initiation of the applicable federal interest rate.

**1.75 *The 1988 Tax Act.*** This act directly affected contract holders, in that contracts afforded tax treatment as life insurance contracts were more narrowly defined. Congress determined that certain contracts that resemble investment vehicles more than life insurance should not be afforded the same tax treatment as life insurance contracts. Under the 1988 tax act, certain classes of life insurance contracts were defined as modified endowment contracts, which alters the taxation of distributions to the contract holder for these contracts prior to death. This provision is applicable to contracts issued after June 20, 1988.

**1.76 *The Revenue Reconciliation Act of 1990.*** The act passed in 1990 increased the tax burden for life insurance entities by requiring changes in the capitalization and amortization of contract acquisition costs and the treatment of unearned and advance premiums, that will, in effect, defer certain tax deductions or accelerate taxable income or both.

**1.77 *The Omnibus Budget Reconciliation Act of 1993.*** This act enacted IRC Section 197, which requires that acquired intangible assets such as insurance in force, goodwill and going concern value, be amortized by the straight line method over 15 years. Additionally, specific rules apply to assumption reinsurance transactions and the Section 197 interplay with tax deferred acquisition costs.

**1.78 *The Small Business Job Protection Act of 1996.*** This act provided market value accounting for modified guaranteed contracts.

**1.79 *The Health Insurance Portability and Accountability Act of 1996 and the Taxpayer Relief Act of 1997.*** These acts modified the rules related to company owned life insurance (COLI) and limited the deductibility of interest on indebtedness with respect to COLI policies on employees.

**1.80 *The Job Creation and Worker Assistance Act of 2002.*** This act temporarily suspends IRC Section 809 for taxable years 2001, 2002, and 2003. Section 809 provides that mutual life insurance entities reduce deductions for policyholder dividends by an industry computed differential earnings amount. This reduction is an estimation of the distributed ownership equity component of the policyholder dividends that, in the case of a stock life insurance entity, would take the form of nondeductible stockholder dividends.

**1.81 *The Pension Funding Equity Act of 2004.*** This act contains significant changes to Section 501(c)(15) tax exempt insurance entities, modifies the definition of a property casualty insurance entity, and repeals the Section 809 differential earnings adjustment for mutual life insurance entities. Separate portions of the act have multiple effective dates, starting with tax years beginning after December 31, 2003.

**1.82 *The American Jobs Creation Act of 2004*** (Pub. L. No 108-357), effective October 2004, contains changes to a variety of areas. Areas of practice affecting insurance entities include but are not limited to, unfunded deferred compensation plans, new disclosure and penalty regimes for reportable transactions (tax shelters), distributions from policyholder and shareholder surplus accounts, foreign earnings taxation (including tax credits and repatriation), and transition repeal of the Foreign Sales Corporation/Extraterritorial regime. More specifically for insurance entities, the Senate amendment provision suspends for a stock life insurance entity's taxable years beginning after December 31, 2003, and before January 1, 2006, the application of rules imposing income tax on distributions to shareholders from the policyholder's surplus account of



a life insurance entity (IRC Section 815). The provision also reverses the order in which distribution reduces various accounts, so that distributions would be treated as first made out of the policyholder's surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts. Furthermore, because foreign related party reinsurance arrangements may be used as a technique for eroding the U.S. tax base, the act amends IRC Section 845(a) to clarify that the IRS has the authority to allocate, recharacterize, or make any other adjustment to items of each party to a reinsurance agreement, in order to reflect the proper amount, source, or character of the item.

**1.83** *The American Recovery and Reinvestment Act of 2009.* In February 2009, President Obama signed legislation designed to work hand in hand with the Emergency Economic Stabilization Act of 2008 to stimulate the U.S. economy. The Recovery Act is designed primarily to combat the rising unemployment trends, put more money in the hands of consumers, and reduce the likelihood that state and local governments will need to raise taxes significantly.

## State Taxation

**1.84** State taxation of life insurance entities is usually based on premium revenues received within each taxing authority in which the entity is licensed to write business. Tax rates vary among states, and some states may require the filing of income tax returns by both domestic and foreign insurers. Counties and municipalities may also levy taxes that are generally based on premiums and that are usually collected in lieu of other state income taxes.

## State Guaranty Funds

**1.85** The primary role of the state guaranty system is to provide protection for contract holders in the event that an insurance entity fails. Generally, a state's guaranty laws provide for the indemnification of losses suffered by contract holders through assessments against other solvent insurers licensed to sell insurance in that state. Assessments are based primarily on premium writings, whereby each insurance entity pays the same assessment rate based on the volume of business written. There are, however, state-by-state limits on the kinds of insurance and amounts of losses that the guaranty fund will pay. Losses generally are paid by the guaranty fund in the state in which a particular contract was written. In some cases, however, losses are paid in the state in which the contract holder currently resides, regardless of the state of domicile of the underwriter. In a number of states, an insurance entity may receive a partial or full reduction of premium taxes because of assessments paid. See chapter 14 for a further discussion.

**1.86** The National Organization of Life and Health Insurance Guaranty Associations assists in handling multistate insolvencies, acts as a clearinghouse for information, and provides a forum for resolution of issues and problems arising from the operation of the state guaranty funds.

## Industry Associations

**1.87** The life insurance industry has many industry associations to help with the multitude of issues affecting it. See appendix A, "List of Industry Trade and Professional Associations, Publications, and Information Resources."

## International Considerations

**1.88** The removal of trade barriers among members of the European Community in 1992, the stabilization of currencies in Central and South America, and the growing prosperity of the Pacific Rim nations give U.S. life insurance entities immense opportunities for international expansion. The large number of entities that already operate in the global marketplace is rapidly increasing as the ownership of the industry changes and as established insurance entities are purchased by overseas investors.

**1.89** Despite the growing trend toward globalization, there are persistently and widely different practices for the supervision and taxation of the industry throughout the world. In addition, accounting principles and practices vary widely. The European Union made International Accounting Standards Board (IASB) standards mandatory by 2005 for all listed entities in Europe and the U.K. The IASB and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts.

**1.90** The IASB split its insurance contract project into two phases so that some components of the project were completed by 2005 without delaying the rest of the project. Phase I addresses the application of existing International Financial Reporting Standards (IFRSs) to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts. The issuance of IFRS No. 4, *Insurance Contracts*, along with *Basis for Conclusions on IFRS 4* and *Implementation Guidance to IFRS 4* brought to a close phase I of the international insurance project.\*

**1.91** Effective for the aforementioned international insurers for annual periods beginning on or after January 1, 2005, IFRS No. 4 provides the framework for accounting for insurance contracts until the IASB completes phase II. IFRS No. 4 generally allows insurance contracts to be accounted for under

\* The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, the Financial Accounting Standards Board (FASB) issued the invitation to comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project.

In July 2010, the IASB issued the exposure draft *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. Although the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement model; however, the majority prefer an alternative model. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. generally accepted accounting principles to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.

the insurer's existing local accounting with some enhancements to those local standards. Although IFRS No. 4 permits the continuation of the existing local accounting for insurance contracts, the standard has imposed a requirement that the contract must contain significant insurance risk to qualify as an insurance contract under IFRS No. 4. The standard applies to reinsurance contracts as well as insurance contracts. IFRS No. 4 does not apply to other assets and liabilities of an insurer. Readers with international reporting situations should continue to be alert to potential developments in international accounting standards for insurance contracts. Additionally, for reporting, auditors can refer to Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .56–.59).

## Terrorism

**1.92** Life and health insurance entities with property and casualty lines of business need to follow the Terrorism Risk Insurance Act of 2002 (TRIA) and its amendment, the Terrorism Risk Insurance Extension Act of 2005, and the Terrorism Risk Insurance Program Reauthorization Act of 2007. The 2002 act created a federal backstop for property and casualty insurance entities covering acts of terrorism in excess of \$5 million. Insurance entities would pay a deductible equal to 7 percent, 10 percent, and 15 percent of prior year premiums in 2003, 2004, and 2005, respectively. The government would then cover 90 percent of everything exceeding the deductible with insurance entities liable for the other 10 percent. Federal payments would be capped at \$90 billion, \$87.5 billion and \$85 billion, in 2003, 2004, and 2005, respectively. Among other matters, the act also mandates that insurers shall make terrorism insurance available under all of its property and casualty insurance policies on the same terms and conditions as the underlying policy.

**1.93** Effective January 1, 2006, the Terrorism Risk Insurance Extension Act of 2005 adds new program years 4 and 5 (2006 and 2007, respectively) to the definition of *insurer deductible*. The insurer deductible is now set as the value of an insurer's direct earned premiums for (newly defined) commercial property and casualty insurance over the immediately preceding calendar year multiplied by 17.5 percent and 20 percent for 2006 and 2007, respectively. A newly added program trigger prohibits payment of federal compensation unless the aggregate industry insured losses from an act of terrorism exceeds \$50 million and \$100 million for 2006 and 2007, respectively. Additionally, subject to the program trigger, the federal share is 90 percent and 85 percent of an amount that exceeds the applicable insurer's deductible in 2006 and 2007, respectively.

**1.94** On December 26, 2007, the Terrorism Risk Insurance Program Reauthorization Act of 2007 was signed into law. This act extends TRIA through December 31, 2014. See [www.treasury.gov/about/organizational-structure/offices/Pages/Terrorism-Risk-Insurance-Program.aspx](http://www.treasury.gov/about/organizational-structure/offices/Pages/Terrorism-Risk-Insurance-Program.aspx) for recoupment provision revisions and other specifics not discussed here.

**1.95** In January 2006, the NAIC adopted two model disclosure forms to assist insurers in complying with the Terrorism Risk Insurance Extension Act of 2005. The model disclosure forms may be used by insurers to meet their

obligation under the rules and provide policy holders of the status of current coverage, and in some cases, make a selection regarding future insurance coverage for acts of terrorism. Insurers ordinarily must comply with state law and the act and are encouraged to review the disclosure forms in light of their current policy language, state legal requirements and the provisions of the act.

**1.96** Additionally, the NAIC's Terrorism Insurance Implementation Working Group adopted a model bulletin intended to help state insurance regulators advise insurers about regulatory requirements related to the recent extension of the TRIA. The model bulletin provides guidance to insurers related to rate filings and policy language that state regulators would find acceptable to protect U.S. businesses from acts of terrorism. The model bulletin describes important changes that are contained in the 2005 act and informs insurers regarding whether rate and policy form filings might be needed. For additional information see [www.naic.org/topics/topic\\_tria.htm](http://www.naic.org/topics/topic_tria.htm).

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## Chapter 2

# *Characteristics of Life and Health Insurance Products*

### Introduction

**2.01** Traditionally, life insurance entities provided primarily life and health insurance products. Today, life insurance entities provide a variety of financial service products that meet their customers' needs for services related to retirement and investment as well as their life and health insurance needs.

### Classification of Insurance Contracts

#### Broad Lines of Business

**2.02** Products offered by life insurance entities generally can be grouped into the following broad categories:

- a. Life insurance contracts
  - i. Traditional whole life
  - ii. Term life
  - iii. Endowments
  - iv. Universal life
  - v. Variable life
  - vi. Adjustable life
  - vii. Living benefit life
  - viii. Supplemental benefits (riders), including waiver of premium and accidental death benefit
  - ix. Supplementary contracts, including settlement options and dividend options
- b. Accident and health insurance contracts
  - i. Disability contracts, including short and long term disability contracts
  - ii. Medical expense insurance, including major medical plans, hospital indemnity plans, and dental
  - iii. Medicare supplemental contracts
  - iv. Long term care contracts
- c. Annuity (investment) contracts
  - i. Variable annuities
  - ii. Fixed annuities
- d. Other Investment contracts
  - i. Guaranteed investment contracts (GICs)
  - ii. Funding Agreements
  - iii. Other deposit contracts, including 401(k), 403(b), and 457 contracts
- e. Fee-for-service contracts, including administrative services only

## Participating or Nonparticipating Classification

**2.03** Life, accident, and health, or annuity insurance, contracts can be sold on a participating or nonparticipating basis. With participating contracts, the contract holder shares in the experience of the insurance entity either through direct reimbursement with participating dividends or through an increase in contract benefits, such as *paid-up additions* or *term additions*. With nonparticipating contracts, contract holders have no right to share in this experience.

## Group or Individual Classification

**2.04** All of the kinds of coverage discussed in this chapter are offered to persons as either individuals or members of a group. Individual insurance is characterized by single contracts that insure one person or one life. Group insurance is characterized by a group contract or master contract, an experience rating based on large groups, and group underwriting. Group insurance is generally issued without a medical examination to each member of a group of persons with related interests (for example, an employer group or a professional group), and is customarily written on a yearly renewable term (YRT) basis. However, group universal life, group variable life, as well as permanent group life insurance contracts are also sold.

**2.05** Each member of the group is covered by a master contract and is issued a certificate of insurance that describes the coverage provided under the master contract. Because the insured is not the owner of the contract, group members are often referred to as *third party beneficiaries* of the insurance contract.

## Accounting Classification

**2.06** Insurance contracts are also classified as either *short duration* or *long duration contracts*, and as *insurance contracts* or *investment contracts*, primarily for the purpose of prescribing U.S. generally accepted accounting principles as defined in Financial Accounting Standards Board *Accounting Standards Codification* 944-20. (See chapter 7, "Insurance Revenues," for a detailed discussion of accounting classification of contract types.)

**2.07** Insurance contracts are considered short duration contracts if the insurance protection is for a fixed period of short duration and the insurer can cancel or adjust the provisions of the contract at the end of any contract period. Contracts generally are considered long duration contracts if they require performance of various functions and services for an extended period of time and are not subject to unilateral changes in their provisions. *Limited payment contracts* are long duration contracts that have fixed and guaranteed terms, and require premium payments over a shorter duration than the period for which benefits are provided. Long duration contracts with terms that are not fixed or guaranteed are referred to as *universal life type contracts*. Participating contracts are specifically excluded from the universal life type category. Life insurance entities write both short duration contracts<sup>1</sup> (such as credit life and certain accident and health contracts) and long duration contracts (such

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<sup>1</sup> Technical Questions and Answers sections 1200.06–.16 (AICPA, *Technical Practice Aids*), provide information in the area of finite insurance products utilized by noninsurance enterprises. The guidance provides information to assist insurance customers and their practitioners in identifying the relevant literature to consider in addressing their specific facts and circumstances.

as whole life, guaranteed renewable accident and health, endowments, universal life, and annuity contracts with significant life contingencies). Unlike insurance contracts, investment contracts do not subject the life insurance entity to significant mortality and morbidity risks (referred to as *insurance risk*). For statutory purposes, investment contracts are those contracts that do not subject the life insurance entity to any insurance risks.

## Types of Contracts

### Life Insurance Contracts

**2.08** *Traditional whole life contracts.* Under these contracts, payment of the face value of the contract is made upon the death of the insured. These contracts are designed to provide a fixed amount of insurance coverage over the life of the insured. Whole life plans contain provisions for the accumulation of a savings element that is referred to as the *cash value*. The contract holder can terminate the contract by surrendering the contract and receiving the accumulated cash value as payment (also referred to as the *surrender value*). There may be a provision for *surrender charges*, which are penalties for early withdrawal of funds in the form of a withdrawal charge, a back end or front end charge, or some other contract charge. All states have *nonforfeiture* laws that define the minimum amount that must be returned to the contract holder upon surrender of a contract. Most contracts allow the surrender (nonforfeiture) value to be taken in cash, in a reduced amount of paid-up insurance of the same kind as the original contract, or in extended term insurance for a period of time for the full face amount of the contract.

**2.09** Premiums are paid over various periods according to the terms of the contract. Whole life contracts usually have a level premium, which can be paid annually or more frequently. With ordinary or straight life contracts, premiums are payable as long as the insured lives. Limited payment contracts are arranged so that premiums are paid for a limited number of payments or a single amount, after which the contract becomes paid up for its full amount. Payment limitations may be expressed in terms of the number of annual premiums (for example, a 20 payment life), or the age up to which premiums ordinarily must be paid (for example, 65). Because limited payment contracts require premium payments for a term that is shorter than the contract term, the annual level premium must be higher than that charged for comparable straight whole life plans.

**2.10** Single premium plans are available. These are characterized by a lump sum or one time premium payment at the inception of the contract, usually with some stated minimum premium amount.

**2.11** Most whole life contracts contain features that allow contract holders to borrow against the cash value. These loans are generally referred to as *policy loans*. The borrower generally must pay interest charges on the loan at a rate permitted by the regulations of the state of domicile. Many contracts contain provisions that allow the life insurance entity to generate an automatic policy loan to pay the premium if the insured does not make a premium payment. If the contract holder dies during the period that the loan is outstanding, the death benefit will be reduced by the amount of the loan plus accrued interest thereon.

**2.12 *Term life contracts.*** Under term life contracts, life insurance coverage is provided for only a specified period and usually does not include the accumulation of cash values. The amount of insurance coverage may be level for a specified period (level term), or decrease over the contract term (decreasing term). Level-term contracts frequently contain an option to renew the contract for a limited number of additional periods without a medical examination, regardless of the health of the insured, up to a maximum age, such as 60 or 65, and are generally referred to as YRT. The premium may increase with each renewal period and is based on the attained age of the insured. Rights to convert to a whole life contract or an endowment contract may also be contained in the term contract.

**2.13** In addition to traditional YRT contracts, many entities now issue *reentry or revertible term life contracts*, which give insureds the right to requalify for lower premiums after a few years (generally 10 years), provided they can satisfy underwriting standards for newly issued life contracts. For those who remain healthy, the resulting premium pattern is generally lower than that of YRT contracts. However, for those insureds who cannot requalify, the resulting premium pattern is generally higher than that of YRT contracts because reentry contracts will be priced as nonpreferred or substandard risks at the reissue date.

**2.14 *Credit life.*** Credit life insurance is another kind of term insurance that is issued to borrowers for the amount and term of the outstanding debt. Credit life insurance can be level or decreasing term insurance (the amount of life insurance coverage decreases in proportion to decreases in the amount of outstanding debt) and is usually associated with residential mortgages and consumer debt. Credit life contracts provide benefits should the borrower die before the debt is repaid or expire at the end of the term. Credit life contracts do not have the convertibility features of other term contracts.

**2.15 *Endowment contracts.*** These contracts are principally savings contracts that incorporate an element of life insurance protection so that if the insured dies before the contract matures, the face amount of the contract is paid to a beneficiary. If the insured is still living at the maturity date, he or she receives the face amount of the contract. Endowment contracts mature at a specified attained age of the insured or at the end of a specified period. Premium payments are made over this specified period, but may also be made under a single premium or limited payment plan.

**2.16 *Universal life contracts.*** Typically, universal life contracts are long duration contracts with terms that are not fixed or guaranteed with respect to premium amounts, expense assessments, or benefits accruing to the contract holder. Such contracts divide the pure insurance protection, the related expense charge, and the cash value accumulation into separate and distinct components.

**2.17** Considerable flexibility exists with respect to payment of premiums on universal life contracts; however, contracts may be issued with fixed or flexible premium payment schedules. Generally, most life insurers only require payment of the initial year's premium, after which the amount and incidence of the premium payments can be unilaterally varied by the contract holder within the contract's stated terms. Universal life contracts will remain in force as long as there is sufficient cash value or premium payments are made to cover the current cost of insurance and other related charges.



**2.18** Universal life contracts have an internal structure with investment, expense, and mortality elements that are separately and specifically defined. The amounts assessed by the life insurer for these elements are not fixed or guaranteed by the contract. The amounts accruing to the contract holder (such as interest credited on cash values) are not fixed or guaranteed; however, there is a minimum guaranteed interest rate that applies to the accumulation of cash values stated in the contract. Any interest credits in excess of the minimum guaranteed rates (referred to as *excess interest credits*) either are determined at the discretion of the life insurance entity, based on current and expected future investment performance or based on an external index such as the rates for U.S. Treasury Bills.

**2.19** Most universal life type contracts have a surrender charge designed to encourage persistency. Surrender charges may be in the form of a front end load on premium or a back end load on withdrawals of cash value. These surrender charges are intended to help recoup the initial costs of selling and issuing the contracts that do not persist; generally the charges decrease annually, the longer the contracts remain in force. There may be other forms of inducements, such as persistency bonuses or credited interest rate differentials for contracts that persist.

**2.20** As required by state law, universal life contracts also have policy loan provisions that are similar to those of traditional whole life contracts. The loan interest rates may be different from those credited to the contract; therefore, life insurance entities generally credit only the guaranteed rate or a lower rate to the portion of the contract value that represents an outstanding loan.

**2.21** *Variable life contracts.* Variable life contracts are those long duration contracts designed to give the contract holder the ability to choose the contract's underlying investment vehicle from among the investment options offered by the life insurance entity and to bear the risk of investment performance. These contracts have features whereby death benefits, cash surrender values, and premium amounts vary with the investment performance of a specific separate pool of assets, usually a separate account. A *separate account* is a legally restricted fund that is segregated from all other assets of the life insurance entity. State insurance laws provide that assets in separate accounts may be invested without regard to restrictions covering general investments of life insurance entities. Separate account assets generally are not available to cover general account liabilities except to the extent they are in excess of amounts necessary to satisfy separate account policyholder liabilities. Variable life contracts also contain provisions similar to those included in universal life-type contracts for surrender charges and policy loans.

**2.22** With variable life insurance, the contract holder has direct participation in the investment earnings of the separate account or asset pool. Most life insurance entities offer contract holders a choice of investment strategies. This is accomplished by specifying the separate account investment vehicles, which are typically a family of mutual funds regulated under the Investment Company Act of 1940. The family of mutual funds may or may not be sponsored by the life insurance entity and may be invested in various instruments, such as equity securities or high grade bonds. Cash values of variable life plans are not guaranteed, and actual investment experience will cause fluctuations in the cash values and the death benefit; however, the death benefit cannot fall below a contractually determined guaranteed minimum amount.

**2.23** Variable life insurance is subject to the Securities Act of 1933 and the Investment Company Act of 1940. Most variable life products can be sold only by appropriately licensed representatives under the Securities Act of 1933.

**2.24** *Adjustable life contracts.* Adjustable life contracts effectively allow contract holders to make changes in their insurance plans without the need for the life insurance entity to issue riders or replace the contract in order to more appropriately meet the contract holder's insurance needs or changing financial situation. This kind of contract includes features that, within limits, allow changes in the following contract elements:

- a. Face amount
- b. Premium amount and payment period
- c. Duration of coverage

**2.25** The flexibility of adjustable life contracts allows the contract holder to choose two of the three contract elements, and the third is determined by the choice of the first two.

**2.26** Increases in coverage generally require evidence of insurability, although some adjustable life contracts allow cost-of-living increases on a guaranteed issue basis.

**2.27** *Living benefit.*<sup>2</sup> Living benefit features allow contract holders who have whole life, term life, as well as universal life contracts and who can show proof of a terminal illness or deterioration in health condition, to collect portions of the face amount of their life insurance contract while they are still living. The rationale behind such products is that contract holders should be able to use the benefits promised by the contract before death. The payments made before death on these contracts are called *viatical settlements or life settlements*.\*

**2.28** *Supplemental benefits.* The basic death benefit for most life, accident and health, and endowment contracts can be supplemented by the use of riders. The most common riders are the following:

- a. *Waiver of premium* waives required premium payments in the event of disability of the insured.
- b. *Accidental death benefit* is often referred to as *double indemnity* and pays twice the face amount of the contract if the insured dies as a result of an accident. These supplemental benefits may be sold for additional premiums or are included in the basic contract premium.

**2.29** *Supplementary contracts.* Upon the death of the insured, the proceeds of the contract become payable to the named beneficiary. A *supplementary contract* is an agreement between the life insurance entity and either the insured or the beneficiary to provide for full or partial settlement of the amounts due

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<sup>2</sup> Financial Accounting Standards Board *Accounting Standards Codification* 325-30 provides initial and subsequent measurement guidance and financial statement presentation and disclosure guidance for investments by third party investors in life settlement contracts.

\* On June 4, 2007, amendments to the Viatical Settlements Model Act were adopted. The National Association of Insurance Commissioners (NAIC) Executive Committee decided on June 3, 2007, that this act met the necessary criteria to become a NAIC model law. This amendment addresses several issues in the life settlement marketplace, including an emerging type of life insurance practice known as Stranger-Originated Life Insurance (STOLI). The model strengthens several consumer protections and imposes a five year ban settling a life insurance policy with specified elements indicative of a STOLI transaction. Readers should remain alert to developments in this area.

under the original contract. Most life insurance entities allow the proceeds to be paid either in a lump sum in cash, or offer various *settlement options* that typically include payment options and interest options that allow a portion of the proceeds to remain with the life insurance entity to accumulate interest. Some payout options are similar to annuities in that they have contingencies on the beneficiary's life (referred to as *with life contingencies*). Other payout options are for a fixed period of time regardless of the beneficiary continuing to be alive (referred to as *without life contingencies*).

**2.30** Generally, life insurance entities that issue participating contracts allow the insured several *dividend options*. The five basic options are: cash, reduction of premiums, paid-up additions, accumulation at interest, and purchase of one year term insurance.

## Accident and Health Insurance Contracts

**2.31** *Disability income insurance contracts.* This coverage protects the insured against loss of income as a result of the partial or total inability to work as a result of illness, injury, or disease. The contracts are either short term contracts that provide benefits for a limited number of weeks or long term contracts that provide benefits for an extended period. Most long term disability contracts provide benefits to age 65 or for life. The long term contract is primarily characterized by an extensive elimination period, usually 30 to 180 days, before benefits begin.

**2.32** *Medical expense insurance.* This broad base of coverage is designed to indemnify the insured against incurred losses covering virtually all kinds of expenses associated with medical care and related services. Contracts differ widely among insurers as to total dollar limits and specific benefits covered. These generally contain some method of cost sharing of medical costs with the contract holder through either copayment plans, which specify a formula for the sharing of actual medical expenses between the insurer and the contract holder, or deductibles, which specify a dollar amount of medical expense the contract holder generally must pay before the insurance coverage begins, or both. Many plans have also introduced cost containment provisions, such as required use of preferred providers, or specified dollar amounts of coverage per injury or illness.

**2.33** Most medical benefit coverage is provided under group contracts. Medical expense contracts allow for assignment of benefits, and most benefit payments are assigned by the insured to go directly to the provider. Most medical expense plans are issued with various riders similar to those attached to life insurance contracts (for example, riders for waiver of premium in the event of disability and specific coverage riders such as childbirth).

**2.34** *Medicare supplement contracts.* As part of the Social Security Amendments of 1965 (Public Law 89-97), Congress enacted a three-part program for medical care for the aged and needy. The Social Security Act (*The Public Health and Welfare, U.S. Code 42*) provides health insurance protection to qualified individuals under part A (hospital insurance) and part B (voluntary supplementary medical insurance). Those two parts are collectively known as Medicare. The third part of the program, Medicaid, provides assistance to the needy. Pursuant to the Balance Budget Act of 1997, managed care plans and medical savings account plans have been added under an umbrella plan Medicare + Choice (part C), which also includes parts A and B.

**2.35** Medicare supplement contracts are used to provide coverage for amounts or services not covered under the current Medicare programs. These contracts may be purchased on a voluntary basis by those individuals who qualify for Medicare.

**2.36** The Medicare Prescription Drug Improvement and Modernization Act of 2003 established a new voluntary Medicare Prescription Drug Program (Medicare part D) for which benefits started January 1, 2006. Generally, the benefit had a \$250 deductible for 2006 with \$50 annual increases each year after. For 2006, the initial coverage limit was \$2,250 with \$10 annual increases for each year after. The coinsurance percentage associated with initial coverage is 25 percent. Finally, the benefit has an out-of-pocket threshold and an associated secondary coinsurance percentage. After total costs paid by the enrollee (including the deductible and the coinsurance under the initial coverage limit) exceed the out-of-pocket threshold, the enrollee is only responsible for a proportion (namely, the coinsurance percentage) of any further drug costs. Generally, for 2006, the out-of-pocket threshold was \$3,500, with \$50 annual increases for each year after. Note that the law has prior year considerations built into the calculations. The coinsurance percentage associated with the out-of-pocket threshold is 5 percent.

**2.37** There are provisions in the regulations that authorize certain types of alternative benefit designs, so long as the benefits provided are certified as being actuarially equivalent to the standard design. The regulations also permit a prescription drug plan sponsor (PDP sponsor) to offer enhanced alternative coverage, in which at least 1 key aspect of the benefit design (deductible, cost sharing, or initial coverage limit) is richer than the standard plan. Such additional benefits are referred to as *supplemental benefits* in the regulations. For additional information on Medicare part D, see [www.ssa.gov](http://www.ssa.gov). Many entities are expected to develop enhanced alternative coverages that provide insurance benefits for claims above the initial coverage limit, even though the standard out-of-pocket threshold may not have yet been satisfied. The Centers for Medicare & Medicaid Services (CMS) will reimburse PDP sponsors for 80 percent of all claims above the out-of-pocket threshold. To the extent that the PDP sponsor's adjusted allowable risk corridor costs vary in either direction from a target amount, there is risk sharing between the CMS and the PDP. No sharing occurs if actual costs are within 2.5 percent of the target; a 50/50 sharing occurs for costs between 2.5 and 5 percent; costs in excess of 5 percent are shared 20 percent and 80 percent by the PDP sponsor and the CMS, respectively.<sup>†</sup>

**2.38** National Association of Insurance Commissioners Interpretation No. 05-05, *Accounting for Revenues under Medicare Part D Coverage*, provides guidance to life and health insurers on how to present various funds to be received under the Medicare Part D Program. Interpretation No. 05-05 requires the application of existing statutory accounting principles (Statements of Standard Accounting Practice [SSAP]) No. 47, *Uninsured Plans*; SSAP No. 66, *Retrospectively Rated Contracts*; and SSAP No. 54, *Individual and Group Accident and Health Contracts*, depending upon the nature of the funds received).

**2.39** *Long term care contracts*. These are primarily contracts that provide coverage for nursing home or other continuing care services related to long term

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<sup>†</sup> Readers should be aware of the Health Care and Education Affordability Reconciliation Act of 2010 that was signed into law on March 30, 2010, and the Patient Protection and Affordable Care Act was signed into law on March 23, 2010.

disabilities or inability to perform activities of daily living (ADLs) without assistance. ADLs refer to the basic tasks of everyday life, such as eating, bathing, dressing, toileting, and transferring, and, although primarily a challenge for the elderly, there are significant numbers of persons not considered elderly who cannot perform ADLs without assistance. These contracts are relatively new to the industry and typically offer coverage based on a preset limit on per-day reimbursement for long term care. The contracts are generally guaranteed renewable, with an option that automatically adjusts the coverage level with inflation indexes. An option for return of premium after a contract has been in force continuously for a specified period without incurring one or more claims has also become increasingly common.

## Annuity Contracts

**2.40** An annuity contract is an arrangement under which the contract holder is guaranteed to receive benefits over a fixed or variable period, commencing either immediately or at some future date. For accounting purposes, annuity contracts can be classified as insurance or investment contracts depending on whether the terms of the contract incorporate significant insurance risks arising from contract holder mortality or morbidity. The premium paying period of an annuity contract is referred to as the *accumulation phase*. The date that benefit payments begin is referred to as the *annuitization date*, after which the contract is in the *payout phase*. Annuity contracts are issued on either a group or individual basis, with group annuities most commonly used to provide for pension benefits. Many life insurance entities offer annuity products that have flexible premiums and allow the contract holder to vary unilaterally the frequency and the amount of annual premium. Annuity contracts generally contain surrender provisions that contain some form of surrender charge for early withdrawals.

**2.41** Benefit payments of annuity contracts can begin immediately or be deferred. *Immediate annuities*, where the first benefit payment begins one interval after purchase, generally must be purchased with a lump sum premium. *Deferred annuities* can be purchased in a single installment (single premium) or by periodic payments, with the benefit payment set to commence at some future date after all the premium payments have been made.

**2.42** Annuities provide either for payment of benefits until the insured dies or for continued payments to a beneficiary until a specific number of periods are met. Annuity contracts are either fixed or variable. A traditional fixed deferred annuity provides for a fixed rate of interest over some specified period, with the insurance entity bearing the investment risk associated with the cash received and invested in the insurance entity's general account assets. A traditional variable annuity provides for the transfer of all investment risks to the policyholder, with no guarantees of return of principal, minimum interest rates, or minimum death benefits. Variable annuities are subject to Securities and Exchange Commission regulation, similar to variable life products.

**2.43** Annuity products with nontraditional terms have been and continue to be developed. These products may have both fixed and variable features, or other nontraditional features, such as the following:

- a. Variable annuity contracts with guaranteed return of principal, or guaranteed return of principal plus minimum stated interest rate

- b. Fixed annuity contracts with guaranteed minimum interest rate plus a contingent return based on some internal or external index, most often the Standard & Poor's 500 Stock Index (equity indexed annuities)
- c. Contracts that provide for return of principal and interest if held until maturity, or a specified "market adjusted value" if surrendered at an earlier date (market value adjusted annuity)
- d. Fixed annuities that provide a higher "teaser" rate in the first year of the contract, or a bonus interest rate if the contract is held for a specified period of time
- e. Variable annuity contracts that offer a minimum death benefit guarantee option that varies depending on the performance of the related separate account investments
- f. Variable annuity contracts that provide for potential benefits in addition to those provided by the account balance, payable only if annuitization is elected
- g. Variable annuity contracts that guarantee a minimum accumulation balance at a specific date
- h. Variable annuity contracts that guarantee that a minimum amount will be available for withdrawal over a specific period

## Investment Contracts

**2.44** Investment contracts are deposit type contracts that do not subject the insurer to significant insurance risks arising from contract holder mortality or morbidity and are comparable to financial or interest bearing instruments provided by other financial institutions. Under such contracts, the life insurance entity assumes varying degrees of investment risk.

**2.45** Life insurance entities hold assets underlying investment contracts in separate accounts, where preservation of principal is not guaranteed and contract holders share in the investment results of the separate account. The separate account assets are generally segregated from the general account assets of the life insurance entity and are only available to pay liabilities of the separate account.

**2.46** *Guaranteed investment contracts.* Contracts that provide for a stated rate of interest on all funds deposited with the insurer for a stated period are GICs. *Bullet GICs* provide that the funds must be deposited with the insurer in a single payment, whereas *window GICs* provide a stated period of time or window in which funds may be received. GICs generally are used by employee benefit plans, including 401(k) plans, to provide a fixed interest option for plan participants. GICs usually provide for a market value adjustment, and may have other surrender charge provisions for premature withdrawal of funds.

**2.47** *Other deposit contracts.* A *deposit administration* (DA) contract is a vehicle for group pension plan fund accumulations for an unspecified time, generally with annual interest guarantees. The accumulated value of the fund can be withdrawn at the anniversary date with no withdrawal penalties; however, the fund is charged an annual administration charge by the insurer. There are no specific allocations to individuals within the fund, but at the time of retirement a withdrawal is made from the fund to purchase an immediate annuity for the retiree. The insurer does not guarantee the adequacy of the DA contract to meet the contract holder's accrued liability under the provisions of

the employee benefit plan; however, once an immediate annuity is purchased for a participant, the annuity becomes a liability of the insurer, and the benefit payments are guaranteed.

**2.48** An *immediate participation guaranteed (IPG)* contract is a variation of the DA contract in which the contract holder shares in the mortality and investment experience of the insurer. Although assets are not specifically identified to individual contracts, an attempt is made to reflect the investment experience of the insurer on an allocation basis, for example, by the investment year method.

**2.49** *Funding agreements.* Funding agreements are investment contracts that pay a guaranteed rate of return. Funding agreements are not tax qualified insurance contracts and are issued to special purpose entities and a wide range of corporations, mutual funds and other institutional investors. Funding agreements usually have stated maturities. Some funding agreements with stated maturities may be renewed by mutual agreement. The guaranteed rate of return can be a fixed rate or a floating rate based on an external market index. Funding agreements may also have put and call features.

## Fee-for-Service Contracts

**2.50** *Administrative services.* Many life insurance entities provide administrative services only (ASO) contracts or Administrative Services Contracts (ASCs) for groups or other insurance entities. The life insurance entity is not at risk but only handles the administration of the insurance coverage or other services for a service fee. Insurance entities typically contract to provide services such as investment management, underwriting, group health claims administration, electronic data processing services, employee benefit plan administration, and mortgage services. Under an ASO plan, claims are paid from a bank account owned and funded directly by the uninsured plan sponsor; or, claims are paid from a bank account owned by the insurance entity, but only after the insurance entity has received funds from the uninsured plan sponsor that are adequate to fully cover the claim payments. Under an ASC plan, the insurance entity pays claims from its own bank accounts, and subsequently receives reimbursement from the uninsured plan sponsor. Life insurance entities that provide these services are frequently referred to as *third party administrators*.





## Chapter 3

# Sources of Accounting Principles and Reporting Requirements

## Introduction

**3.01** The life insurance industry, by the nature of its business, is endowed with fiduciary responsibility to its contract holders and, therefore, is generally subject to a high level of regulation in the accounting and reporting of its financial condition.

**3.02** All life insurance entities are required by state insurance regulations to prepare financial statements in accordance with statutory accounting practices (SAP). Furthermore, many life insurance entities prepare financial statements in accordance with generally accepted accounting principles (U.S. GAAP) to comply with Securities and Exchange Commission (SEC) regulations or for other reasons.

## Statutory Accounting Practices

**3.03** The National Association of Insurance Commissioners (NAIC) codified SAP for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual*. The insurance laws and regulations of the states require insurance enterprises domiciled in the states to comply with most, if not all, provisions of the revised manual. States may adopt the revised manual in whole, or in part, as an element of prescribed SAP in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed SAP applicable in each state. Additionally, see the information regarding permitted accounting practices starting in paragraph 3.11.

**3.04** The NAIC has taken into consideration Financial Accounting Standards Board (FASB) Statement No. 168, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, which reduced the U.S. GAAP hierarchy to two levels (one that is authoritative and one that is not). The preamble of the revised manual notes the following as the statutory hierarchy, which is not intended to preempt state legislative or regulatory authority:

### Level 1

- The Statements of Statutory Accounting Principles (SSAPs) including GAAP reference material to the extent adopted by the NAIC from the FASB *Accounting Standards Codification* (ASC)<sup>1</sup> (FASB ASC or GAAP guidance)

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<sup>1</sup> Effective September 15, 2009, the Financial Accounting Standards Board (FASB) *Accounting Standards Codification™* (ASC) is the source of authoritative U.S. generally accepted accounting

(continued)

*Level 2*

- Consensus positions of the Emerging Accounting Issues Working Group as adopted by the NAIC

*Level 3*

- NAIC annual statement instructions
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*

*Level 4*

- Statutory Accounting Principles Statement of Concepts<sup>2</sup>

*Level 5*

- Sources of nonauthoritative GAAP accounting guidance and literature, including: (a) practices that are widely recognized and prevalent either generally or in the industry, (b) FASB Concept Statements, (c) AICPA Issue Papers, (d) International Financial Reporting Standards, (e) pronouncements of professional associations or regulatory agencies, (f) Technical Questions and Answers included in AICPA *Technical Practice Aids*, and (g) accounting textbooks, handbooks, and articles.

If the accounting treatment of a transaction or event is not specified by the SSAPs, preparers, regulators, and auditors of statutory financial statements should consider whether the accounting treatment is specified by another source of established statutory accounting principles. If an established statutory accounting principle from one or more sources in level 2 or 3 is relevant to the circumstances, the preparer, regulator, or auditor should apply such principle. If there is a conflict between statutory accounting principles from one or more sources in level 2 or 3, the preparer, regulator, or auditor should follow the treatment specified by the source in the higher level—that is, follow level 2 treatment over level 3. Revisions to guidance in accordance with additions or revisions to the NAIC statutory hierarchy should be accounted for as a change in accounting principle in accordance with SSAP No. 3, *Accounting Changes and Corrections of Errors*.

**3.05** Traditionally, government regulation of the life insurance industry has been the responsibility of the individual states. The individual states have enacted laws, regulations, and administrative rulings governing the operations and reporting requirements of life insurance entities licensed to write business in their state. These laws and rulings, along with the *Accounting Practices and Procedures Manual* and permitted practices, constitute the body of SAP, which

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(footnote continued)

principles (GAAP). As of that date, FASB ASC superseded all then-existing non-Securities and Exchange Commission (SEC) accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in FASB ASC is nonauthoritative.

<sup>2</sup> The Statutory Accounting Principles Statement of Concepts incorporates by reference FASB Concept Nos. 1, 2, 5, and 6 to the extent they do not conflict with the concepts outlined in the statement. However, for purposes of applying this hierarchy, the FASB concepts statements shall be included in level 5 and only those concepts unique to statutory accounting as stated in the statement are included in level 4.

is currently considered a comprehensive basis of accounting other than GAAP. (See chapter 15, "Reports on Audited Financial Statements.")

**3.06** As discussed in the preceding paragraph, SAP are somewhat uniform from state to state, although some differences may exist. A life insurance entity may request special accounting consideration from the insurance department of its state of domicile for unusual or significant transactions that may materially affect statutory surplus. This practice, in addition to some variations in state statutes, precludes total uniformity and absolute definitions of SAP.

**3.07** All life insurance entities are required to maintain records in accordance with SAP prescribed or permitted by the insurance department of their state of domicile, and in some instances, by other states in which they are licensed to write business. SAP attempt to determine the entity's ability to satisfy its obligations to its contract holders and creditors at all times. Because of the focus on solvency, the statutory balance sheet represents assets and liabilities that generally are valued on a conservative basis. Accordingly, certain nonliquid assets, such as furniture and fixtures are assigned no value (referred to as *nonadmitted assets*). In addition, policy acquisition costs must be expensed as incurred under SAP. With respect to liabilities, SAP generally requires formula driven reserves relating to invested assets and benefit reserve liabilities using statutory tables or other conservative assumptions.

**3.08** In assessing a life insurance entity's financial condition under SAP, considerable emphasis is placed on the adequacy of the entity's surplus. This emphasis on surplus is based on state laws that require life insurance entities to maintain minimum levels of statutory surplus. Surplus provides protection to contract holders against adverse fluctuations in an entity's asset base, mortality and morbidity experience, and its expense and investment experience. Surplus also provides the financial strength to permit a life insurer to expand its operations or enter new lines of business. (See chapter 4, "Audit Risk Considerations," paragraphs 4.07–.12 for additional discussion of capital adequacy.)

**3.09** Life insurance entities prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile, that is, SAP. SAP are considered an other comprehensive basis of accounting as described in AU section 623, *Special Reports* (AICPA, *Professional Standards*).

**3.10** Prescribed SAP are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state.

### Permitted Statutory Accounting Practices<sup>3</sup>

**3.11** Permitted SAP includes practices not prescribed in paragraph 3.10 but allowed by the domiciliary state regulatory authority upon request. A life insurance entity may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of its statutory financial statements if either of the following occurs:

- a. The entity wishes to depart from the prescribed SAP.

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<sup>3</sup> For additional information, see the National Association of Insurance Commissioners manual's preamble and its section: "Permitted Practices Advance Notification Requirement Question and Answers."



including an analysis of operations by line of business (gain and loss exhibit), aggregate reserves for life and accident and health policies, detailed schedules of investments, and various other schedules and exhibits. The NAIC *Annual Statement Instructions* (the instructions) require that life insurance entities file, with their annual statement, an opinion by a qualified actuary regarding the adequacy of reserves and other actuarial items, and their conformity with statutory requirements. The instructions also require insurers to file a supplement to the annual statement titled *Management's Discussion and Analysis* by April 1 each year. (See chapter 5, "General Auditing Considerations," for additional discussion of the opinion by a qualified actuary.) See the instructions for a detailed listing of the exhibits.

**3.16** The NAIC has developed several kinds of annual statement forms to be used by particular life insurance entities and has assigned each a color cover for easy reference, such as the following:

- a. Life and health insurers (blue)
- b. Variable and separate accounts of Life and Health insurers (green)
- c. Health insurers (orange)

This is only a partial list. The nature of the insurer's business will dictate the annual statement form(s) to be filed.

**3.17** Software packages are available from third party vendors that produce annual statement exhibits, schedules, and financial statements based on input information from the reporting insurer. The NAIC and many state insurance departments now require filing of the annual statement via electronic medium.

**3.18** The NAIC annual statement and forms have been adopted by each state to promote uniformity in reporting, although requirements vary by state. The instructions require life insurance entities to file audited financial statements and a supplemental schedule of selected financial data, investment interrogatories and summary investment schedule with their state of domicile insurance department. The summary investment schedule is filed with the annual statement whereas the interrogatories are filed as a supplement to the annual statement by April 1 for the applicable reporting period. The Life, Accident, and Health and Fraternal Annual Statement Instructions include instructions for completing Schedule 1 *Selected Financial Data*. The supplemental schedule of selected financial data, investment interrogatories and summary investment schedule are required to be included in the annual audit report for Life, Accident and Health and Fraternal reporting entities.

**3.19** For most states, the audited statutory statements are to be filed as a supplement to the annual statement on or before June 1 for the year ended December 31, immediately preceding; however, the domiciliary commissioner may request an earlier filing date than June 1 with 90 days advance notice to the life insurance entity. These audit requirements generally apply to life insurance entities writing in excess of a stipulated amount of business or having in excess of a stipulated number of contract holders.

**3.20** The instructions, as adopted by the states, require the filing of audited statutory basis financial statements for each life insurance entity. An insurer may make written application to the insurance commissioner for approval to file audited consolidated or combined financial statements in lieu of separate annual audited financial statements if the insurer is part of a group of

insurance entities that utilizes a pooling or one hundred percent reinsurance agreement that affects the solvency and integrity of the insurer's loss reserves and such insurer cedes all of its direct and assumed business to the pool. In such case, a columnar consolidating or combining worksheet must be filed with the report. The NAIC Revised Model Audit Rule requires life insurance entities to have their auditors prepare and file a report on material weaknesses, if any, in the life insurance entity's internal controls, an accountant's awareness letter, and an accountant's letter of qualification. In addition, the NAIC Revised Model Audit Rule requires an entity's management to file a separate report on internal controls over financial reporting. (See chapter 5 for further discussion of communications between independent auditors and regulators.) In addition to the annual audit requirement, the insurance laws of the various states generally provide the commissioner with the authority to require an independent review or audit of the life insurer's financial condition whenever deemed necessary. Also, the insurance departments conduct their own financial and market conduct examinations of their domestic insurance entities on a periodic (generally, three to five year) basis.

## Disclosure Issues

**3.21** Financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used. That includes a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from U.S. GAAP. As noted in the preamble of the manual, paragraph 59 states,

To the extent that disclosures required by an SSAP are made within specific notes, schedules, or exhibits to the annual statement, those disclosures are not required to be duplicated in a separate note. Annual statutory financial statements which are not accompanied by annual statement exhibits and schedules (for example, annual audit report) shall include all disclosures required by the SSAPs based on the applicability, materiality and significance of the item to the insurer. Certain disclosures, as noted in individual SSAPs, are required in the annual audited statutory financial statements only.

Additionally, the provisions of the manual as well as the NAIC Emerging Accounting Issues Working Group Interpretation 04-1, *Applicability of New GAAP Disclosures Prior to NAIC Consideration*, state that GAAP pronouncements do not become part of Statutory Accounting Principles until and unless adopted by the NAIC. However, provisions of the manual or any other explicit rejection of a GAAP disclosure do not negate the requirements of AU section 623.\* For further information, see exhibit 3-1, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," which is reprinted from Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of AU section 623 (AICPA, *Professional Standards*, AU sec. 9623

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\* Footnote 13 of paragraph .68 in Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of AU section 623, *Special Reports* (AICPA, *Professional Standards*, AU sec. 9623 par. .60–.77), states that any explicit rejection of GAAP disclosures would not negate the requirements to include significant and relevant GAAP disclosures in statutory financial statements.

par. .60–.77).<sup>5</sup> That interpretation provides guidance in evaluating whether informative disclosures are reasonably adequate for financial statements prepared on a statutory basis, and has been modified as a result of the completion of the NAIC codification.

## U.S. GAAP Financial Statement Disclosures

**3.22** AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*), states that "the presentation of financial statements in conformity with U.S. GAAP includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their appended notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth. An independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time."

**3.23** Illustrative U.S. GAAP basis financial statements and related note disclosures typical of life and health insurance entities are included in appendix B, "Illustrative Financial Statements." However, financial statement disclosure requirements and practices are continually evolving and are subject to variations of business and materiality for each entity. Life insurance entity specific disclosures are discussed in appendix C, "Life Insurance Entity Specific Disclosures." Accordingly, this Audit and Accounting Guide does not attempt to present all possibilities for disclosure; rather, it attempts to present the auditor with sources and examples of financial statement disclosure that are generally applicable to life insurance entities. U.S. GAAP may require additional disclosures such as information concerning related party transactions, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, stock based compensation, lease commitments, accounting changes, derivative instruments, hedging activities, concentrations of credit risk, fair value of financial instruments, and other matters not unique to life insurance entities. The auditor needs to evaluate the need for disclosure on an entity-specific basis.

**3.24** FASB ASC 944, *Financial Services—Insurance*, and SEC Regulation S-X, Article 7, Insurance Companies should be consulted with respect to disclosures specific to life insurance activities.

## Certain Financial Statement Disclosures

**3.25** FASB ASC 944-505-50 requires insurance entities, where applicable, to make the following disclosures in their financial statements.

**3.26** As discussed in FASB ASC 944-505-50-2, the disclosures in FASB ASC 944-505-50-3 should be made if (a) the use of prescribed or permitted SAP (individually or in the aggregate) results in reported statutory surplus or risk based capital that is significantly different from the statutory surplus or risk based capital that would have been reported had NAIC SAP been followed and (b) either (i) state prescribed SAP differ from NAIC SAP or (ii) permitted state SAP differ from either state prescribed SAP or NAIC SAP. According to

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<sup>5</sup> The second amendment to this interpretation occurred in January 2005, subsequent to the Public Company Accounting Oversight Board adoption of the AICPA standards as interim, on April 16, 2003.

FASB ASC 944-505-50-6, if an insurance enterprise's risk based capital would have triggered a regulatory event had it not used a permitted practice, that fact should be disclosed in the financial statements. FASB ASC 944-505-50-3 states that insurance enterprises should disclose, at the date each financial statement is presented, a description of the prescribed or permitted SAP and the related monetary effect on statutory surplus of using an accounting practice that differs from either state prescribed SAP or NAIC SAP. As noted in FASB ASC 944-505-50-4, these disclosures should be applied by a U.S. insurance enterprise, a U.S. enterprise with a U.S. insurance subsidiary, or a foreign enterprise with a U.S. insurance subsidiary, if the enterprise prepares U.S. GAAP financial statements. As discussed in FASB ASC 944-505-50-5, if a foreign insurance enterprise that does not have a U.S. insurance subsidiary prepares U.S. GAAP financial statements or is included in its parent's consolidated U.S. GAAP financial statements, the notes to the financial statements should disclose permitted regulatory accounting practices that significantly differ from the prescribed regulatory accounting practices of its respective regulatory authority, and their monetary effects.

**3.27** Following are two examples of illustrative disclosures that an insurance enterprise could make to meet the requirements of paragraph 3.26 of this guide.

***Note X. Statutory Accounting Practices***

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [state of domicile] Insurance Department. [State of domicile] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [state of domicile] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by \$2.5 million and \$2.3 million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was \$30.0 million and \$27.9 million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the Company's capital and surplus would have been \$29.9 million and \$27.7 million at December 31, 20X2 and 20X1, respectively.

***Note X. Statutory Accounting Practices***

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [state of domicile] Insurance Department. [State of domicile] has adopted the National Association of Insurance Commissioners' statutory accounting practices (NAIC SAP) as the basis of its statutory accounting practices, except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.



In addition, the commissioner of the [state of domicile] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP.

The monetary effect on statutory capital and surplus of using accounting practices prescribed or permitted by the [state of domicile] Insurance Department is as follows:

	December 31	
	20X2 \$m	20X1 \$m
Statutory capital and surplus per statutory financial statements	\$30.0	\$27.9
Effect of permitted practice of recording home office property at estimated fair value	(2.5)	(2.3)
Effect of [state of domicile's] prescribed practice of immediate write-off of goodwill <sup>1</sup>	2.4	2.1
Statutory capital and surplus in accordance with the NAIC statutory accounting practices <sup>2</sup>	<u>\$29.9</u>	<u>\$27.7</u>

<sup>1</sup> This amount compared to the prior year reflects the net impact of an additional year's amortization and the fact that admitted goodwill is based on the level of statutory capital and surplus and thus can fluctuate.

<sup>2</sup> In the initial year of implementation of this disclosure, prior year amounts for the effect of permitted practices and prescribed practices should be disclosed as required under FASB ASC 944-505-50.

**3.28** In accordance with FASB ASC 944-40-50-3, 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
- d. Also, insurance enterprises should discuss the reasons for the change in incurred claims and claim adjustment expenses recognized in the income statement attributable to insured events of prior fiscal years and should indicate whether additional premiums or return premiums have been accrued as a result of prior year effects

## Risks and Uncertainties

**3.29** FASB ASC 275-10-50-1 requires entities to include in their financial statements information about the following:

- a. The nature of their operations
- b. The use of estimates in the preparation of financial statements
- c. Certain significant estimates
- d. Current vulnerability due to certain concentrations

FASB ASC 275-10-50-15 gives examples of items that may be based on estimates that are particularly sensitive to change in the near term. Examples of similar estimates that may be included in the financial statements of insurance entities include the following:

- a. Deferred policy acquisition costs of insurance entities
- b. Valuation allowances for commercial and real estate loans
- c. Claim liabilities for short duration business

Insurance entities could have concentrations that may be subject to disclosure if they meet the criteria of FASB ASC 275-10-50-16, for vulnerability due to certain concentrations, for example, reinsurance contracts with one reinsurer, or a significant amount of insurance written in one region or with one customer.

## Mutual Life Insurance Entities

**3.30** FASB ASC 944-30-50-2 and 944-40-50-8 require entities to disclose the following in the financial statements with respect to participating contracts:

- a. The methods and assumptions used in estimating the liability for future policy benefits
- b. The average rate of assumed investment yields used in estimating expected gross margins
- c. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period

## FASB ASC 820, *Fair Value Measurement*, and FASB ASC 825, *Financial Instruments*

**3.31** As noted in FASB ASC 820-10-05-1, FASB ASC 820 defines *fair value*, establishes a framework for measuring fair value, and requires certain disclosures about fair value measurements. The following paragraphs summarize FASB ASC 820 but are not intended as a substitute for reviewing FASB ASC 820 in its entirety.

## Definition of *Fair Value*

**3.32** FASB ASC 820-10-20 defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the

asset or transfer the liability either occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The FASB ASC glossary defines the *principal market* as "the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The principal market (and thus, market participants) should be considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities."

**3.33** FASB ASC 820-10-35-3 and FASB ASC 820-10-30-2 provide that the hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). Conceptually, entry prices and exit prices are different. However, FASB ASC 820-10-30-3 explains that, in many cases, at initial recognition a transaction price (entry price) will equal the exit price and, therefore, will represent the fair value of the asset or liability. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity should consider facts specific to the transaction and the asset or liability.

**3.34** Paragraphs 7–8 of FASB ASC 820-10-35 explain that the price should not be adjusted for transaction costs. If location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

## Application to Assets

**3.35** FASB ASC 820-10-35-10 provides that a fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

**3.36** FASB ASC 820-10-35-10 states that the highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be appropriate for a financial asset. According to paragraphs 12–13 of FASB ASC 820-10-35, an asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants. An asset's value in-exchange is determined based on the

price that would be received in a current transaction to sell the asset stand-alone.

## Application to Liabilities

**3.37** According to paragraphs 16–16A of FASB ASC 820-10-35, a fair value measurement assumes that both (a) the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled), and (b) the nonperformance relating to that liability is the same before and after its transfer. Further, it is also assumed that a liability is exchanged in an orderly transaction between market participants. Certain liabilities, such as debt obligations, are traded in the marketplace as assets. However, many liabilities are rarely transferred in the marketplace due to contractual or other legal restrictions.

**3.38** FASB ASC 820-10-35-16B states that if a quoted price in an active market for an identical liability is available, it represents a level 1 measurement. If that is not available, a reporting entity should measure fair value using one or more of the following techniques:

- a. A valuation technique that uses
  - i. the quoted price of the identical liability when traded as an asset or
  - ii. quoted prices for similar liabilities or similar liabilities when traded as assets
- b. Another valuation technique that is consistent with the principles of FASB ASC 820, such as an income or market approach

**3.39** According to FASB ASC 820-10-35-16D, when measuring the fair value of a liability using the quoted price of the liability when traded as an asset, the reporting entity should adjust the quoted price for factors specific to the asset that are not applicable to the fair value measurement of the liability. For example, the quoted price for the asset may relate to a similar, but not identical, liability traded as an asset or the unit of account for the asset may not be the same as for the liability.

**3.40** FASB ASC 820-10-35-16G explains that when measuring the fair value of a liability using a valuation technique, the reporting entity should ensure the fair value measurement is consistent with FASB ASC 820. For example, when using a technique based on the amount at the measurement date that the reporting entity would receive to enter into the identical liability, the inputs should reflect the assumptions that market participants would use (or the reporting entity's own assumption about the assumptions that market participants would use) in the principal or most advantageous market for issuance of a liability with the same contractual terms.

**3.41** When estimating the fair value of a liability, FASB ASC 820-10-35-16E states that the reporting entity should not include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability because the effect of that restriction is already either implicitly or explicitly included in the other inputs to the fair value measurement.

**3.42** Paragraphs 17–18 of FASB ASC 820-10-35 provide that a fair value measurement of a liability should reflect its nonperformance risk (the risk that

the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value.

## Valuation Techniques

**3.43** Paragraphs 24–35 of FASB ASC 820-10-35 describe the valuation techniques that should be used to measure fair value. Valuation techniques consistent with the market approach, income approach, cost approach, or all of the approaches, should be used to measure fair value, as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option pricing models, and the multiperiod excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost of a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

**3.44** FASB ASC 820-10-35-24 states valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit) and the respective indications of fair value should be evaluated and weighted, as appropriate considering the reasonableness of the range indicated by those results, example 3 (paragraphs 35–41) of FASB ASC 820-10-55 illustrates the use of multiple valuation techniques. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

**3.45** As explained by paragraphs 25–26 of FASB ASC 820-10-35, valuation techniques used to measure fair value should be consistently applied. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for as a change in accounting estimate in accordance with the provisions of FASB ASC 250, *Accounting Changes and Error Corrections*.

## Present Value Techniques

**3.46** Paragraphs 4–20 of FASB ASC 820-10-55 provide guidance on present value techniques. These paragraphs neither prescribe the use of one

specific present value technique nor limit the use of present value techniques to the three techniques discussed therein. It says that a fair value measurement of an asset or liability using present value techniques should capture the following elements from the perspective of market participants as of the measurement date: an estimate of future cash flows, expectations about possible variations in the amount or timing (or both) of the cash flows, the time value of money, the price for bearing the uncertainty inherent in the cash flows (risk premium), other case specific factors that would be considered by market participants, and in the case of a liability, the nonperformance risk relating to that liability, including the reporting entity's (obligor's) own credit risk.

**3.47** FASB ASC 820-10-55-6 provides the general principles that govern any present value technique, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use in pricing the asset or liability.
- Cash flows and discount rates should consider only factors attributed to the asset (or liability) being measured.
- To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using the contractual cash flows of a loan, but is not appropriate if the cash flows themselves are adjusted to reflect possible defaults.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effects of inflation) should be discounted at a rate that includes the effects of inflation.
- Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

**3.48** FASB ASC 820-10-55-9 describes how present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, method 1 of the expected present value techniques uses a risk-free rate and risk-adjusted expected cash flows. Method 2 of the expected present value technique uses a risk-adjusted discount rate (which is different from the rate used in the discount rate adjustment technique) and expected cash flows. In the expected present value technique, the probability weighted average of all possible cash flows is referred to as the expected cash flows. The traditional present value technique and two methods of expected present value techniques are discussed more fully in FASB ASC 820-10-55.

## The Fair Value Hierarchy

**3.49** FASB ASC 820-10-35-51D emphasizes that fair value is a market based measurement, not an entity specific measurement. Therefore, as stated by FASB ASC 820-10-35-9, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to in the statement as inputs). Paragraphs 37–58 of FASB ASC 820-10-35 establish a fair value hierarchy that distinguishes between (a) market participant assumptions developed based on market data

obtained from sources independent of the reporting entity (observable inputs) and (b) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

**3.50** The fair value hierarchy in FASB ASC 820-10-35 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are as follows:

- Paragraphs 40–41 of FASB ASC 820-10-35 state that level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market, as defined by the FASB ASC glossary, is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as discussed in paragraphs 42–43 of FASB ASC 820-10-35. FASB ASC 820-10-35-44 provides guidance on how the quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor), but rather would be measured within level 1 as the product of the quoted price for the individual instrument times the quantity held.
- Paragraphs 47–51 of FASB ASC 820-10-35 explain that level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the asset or liability. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability, and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. As discussed in paragraph 48 of FASB ASC 820-10-35, level 2 inputs include
  - quoted prices for similar assets or liabilities in active markets;
  - quoted prices for identical or similar assets or liabilities in markets that are not active;
  - inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates); and

- inputs that are derived principally from or corroborated by observable market data by correlation or other means (market corroborated inputs).
- According to FASB ASC 820-10-35-51, an adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall.
- As discussed in paragraphs 52–55 of FASB ASC 820-10-35, level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should be developed based on the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Assumptions about risk include the risk inherent in the inputs to the valuation technique. A measurement (for example, a mark-to-model measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability. The reporting entity should not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the entity's own data used to develop unobservable inputs should be adjusted if information is readily available without undue cost and effort that indicates that market participants would use different assumptions. FASB ASC 820-10-55-22 discusses level 3 inputs for particular assets and liabilities.

As explained in FASB ASC 820-10-35-37, in some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

**3.51** As discussed in FASB ASC 820-10-35-38, the availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within level 2 or level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

**3.52** As stated by FASB ASC 820-10-35-15, market participant assumptions should include assumptions about the effect of a restriction on the sale or use of an asset if market participants would consider the effect of the restriction in pricing the asset. Example 6 (paragraphs 51–55) of FASB ASC 820-10-55



explains that restrictions that are an attribute of an asset, and therefore would transfer to a market participant, are the only restrictions reflected in fair value.

### **Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)**

**3.53** Paragraphs 58–62 of FASB ASC 820-10-35 contains guidance intended to improve financial reporting by permitting the use of a practical expedient, with appropriate disclosures, when measuring the fair value of an alternative investment that does not have a readily determinable fair value.

**3.54** The practical expedient reduces complexity and improves consistency and comparability in the application of FASB ASC 820 while reducing the costs of applying FASB ASC 820. This guidance also improves transparency by requiring additional disclosures about investments within its scope to enable users of financial statements to understand the nature and risks of investments and whether the investments are probable of being sold at amounts different from net asset value per share.

**3.55** According to FASB ASC 820-10-15-4, this guidance only applies to an investment that meets both of the following criteria:

- a. The investment does not have a readily determinable fair value.
- b. The investment is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 (investment activity, unit ownership, pooling of funds, and reporting entity) or, if one or more of the attributes specified in FASB ASC 946-10-15-2 are not present, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies*.

**3.56** Examples of investments, to which this guidance applies, may include hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds.

**3.57** FASB ASC 820-10-35-58 states that classification within the fair value hierarchy of a fair value measurement of an investment that is measured at net asset value per share requires judgment. This guidance provides considerations for determining the level within the fair value hierarchy that a fair value measurement of an investment at net asset value per share (or its equivalent) should be categorized.

**3.58** Paragraphs 59–62 of FASB ASC 820-10-35 create a practical expedient to measure the fair value of an investment on the basis of the net asset value per share of the investment (or its equivalent) determined as of the measurement date. Therefore, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the fair value of the investment if the practical expedient is used.

### **Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased**

**3.59** Paragraphs 51A–51H of FASB ASC 820-10-35 clarify the application of FASB ASC 820 in determining fair value when the volume and level of

activity for the asset or liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, paragraphs 59A–59I of FASB ASC 820-10-55 include illustrations on the application of this guidance.

**3.60** This guidance does not apply to quoted prices for an identical asset or liability in an active market (level 1 inputs). For example, although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

**3.61** Consistent with FASB ASC 820-10-35-51D, when determining fair value when the volume and level of activity for the asset or liability has significantly decreased, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FASB ASC 820-10-35-51A lists a number of factors that may be evaluated to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability (or similar assets or liabilities) when compared with normal market activity. According to FASB ASC 820-10-35-51B, if, after evaluating the factors, the conclusion is reached that there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market conditions, transactions or quoted prices may not be determinative of fair value. Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with FASB ASC 820-10. According to FASB ASC 820-10-35-51C, the objective is to determine the point within the range of fair value estimates that is most representative of fair value under the current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

**3.62** FASB ASC 820-10-35-51D states that determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. The reporting entity's intention to hold the asset or liability is not relevant however, because fair value is a market-based measurement, not an entity-specific measurement.

**3.63** According to FASB ASC 820-10-35-51E, an entity should evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence. Circumstances that may indicate that a transaction is not orderly and guidance that should be considered in the determination are found in paragraphs 51E–51F of FASB ASC 820-10-35. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). In making the determination as to whether a transaction is orderly, an entity does not need to undertake all possible efforts, but should not ignore information that is available without undue cost and effort. The reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction. Refer to FASB ASC 820 for more information.

## Disclosures<sup>†</sup>

**3.64** FASB ASC 820-10-50 discusses the disclosures required for assets and liabilities measured at fair value. "Pending Content" in FASB ASC 820-10-50-1 explains that the reporting entity should disclose information that enables users of its financial statements to assess both (a) for assets and liabilities measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the valuation techniques and the inputs used to develop those measurements and (b) for recurring fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on earnings for the period.<sup>‡</sup>

## Fair Value Option

**3.65** FASB ASC 825, *Financial Instruments*, creates a fair value option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur. An election is made on a instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements. The fair value option need not be applied to all identical items, except as required by FASB ASC 825-10-25-7. Most financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain nonfinancial contracts.

**3.66** As explained by FASB ASC 825-10-15-5, specifically excluded from eligibility is an investment in a subsidiary that the entity is required to consolidate, an interest in a variable interest entity that the entity is required to consolidate, the employer and plan's obligations under postemployment, postretirement plans (including health care and life insurance benefits), and deferred compensation arrangements (or assets representing overfunded positions in those plans), financial assets and liabilities recognized under leases (this does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease), deposit liabilities of depository

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<sup>†</sup> In May 2011, FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820) Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*. According to FASB, the objective of this ASU is to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and International Financial Reporting Standards, by changing the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and disclosing information about fair value measurements. The amendments include those that clarify FASB's intent about the application of existing fair value measurement and disclosure requirements and those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. This ASU, which is to be applied prospectively, is effective during interim and annual periods beginning after December 15, 2011. Early application, which is not permitted for public entities, is permitted for nonpublic entities, but no earlier than for interim periods beginning after December 15, 2011.

<sup>‡</sup> In January 2010, FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. This ASU establishes new disclosure requirements and clarifies certain existing disclosures regarding level of disaggregation and inputs and valuation techniques. The amendments in this ASU became effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures in the level 3 fair value measurement roll forward. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Examples related to the guidance in this ASU were added to FASB ASC 820-10-55. The guidance referenced in this paragraph is amended by this ASU.

institutions, and financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including temporary equity).

**3.67** FASB ASC 825-10-45 and 825-10-50 also include presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Paragraphs 1–2 of FASB ASC 825-10-45 state that entities should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity should either (a) report the aggregate of both fair value and non-fair-value items on a single line, with the fair value amount parenthetically disclosed or (b) present separate lines for the fair value carrying amounts and the non-fair-value carrying amounts. As discussed in FASB ASC 825-10-25-3, upfront costs and fees, such as debt issue costs, may not be deferred for items which the fair value option has been elected.

## SEC Reporting Requirements

**3.68** The SEC imposes additional financial reporting rules for stock life insurance entities whose shares are publicly traded on a stock exchange and insurance holding companies. The SEC requires publicly traded entities to file an annual Form 10-K, to distribute an annual report to shareholders pursuant to the SEC's proxy rules, and to file a quarterly Form 10-Q. Article 7 of SEC Regulation S-X governs the form and content of financial statements of life insurance entities included in annual shareholders' reports and filings with the SEC. Both stock life insurance entities and mutual life insurance entities that issue other public securities (for example, debt) must also comply with certain SEC rules.

**3.69** *SEC Disclosure Information: General Recommendations.* SEC recommendations for improved disclosures include, but are not limited to, the following:<sup>6</sup>

- a. *Loss reserves.* The SEC staff desires improved explanations for changes in reserve estimates. More specifically, disclosure should show changes in estimates by line of business, improved explanations of the facts involved in the estimates, or new information since the last report date underlying the improved insight on estimates and a more robust discussion of the entity's remaining exposure to uncertainty. (The staff is concerned that investors place a higher degree of precision on loss reserve estimates than exists. Therefore, investors should be provided information relating to uncertainties inherent in the estimates.)
- b. *Other than temporary impairments of securities.*<sup>11</sup> Discussion should include the entity's policy for evaluating other than temporary

<sup>6</sup> In March and September 2008, the Division of Corporation Finance of the SEC sent out illustrative letters to public entities identifying a number of disclosure issues they may wish to consider in preparing Management's Discussion and Analysis for their upcoming quarterly reports on Form 10-Q. Readers should familiarize themselves with these letters that can be found on the SEC website.

<sup>11</sup> For the application of GAAP, refer to FASB ASC 320, *Investments—Debt and Equity Securities*. Statutory Interpretation No. 06-07, *Definition of the Phrase "Other Than Temporary,"* adopts, with modification, certain aspects of FASB ASC 320. For additional specifics, see chapter 11, "Investments."

impairments, the amount of impairment and whether those factors would affect other investments. The SEC staff expects this level of disclosure for each quarter for all material impairments given current market conditions.

- c. *Realized losses on investments.* Discussion should include the amount of loss and the fair value at the date of sale as well as the reasons for sales if the entity previously asserted the ability and intent to hold the investment to maturity, in order to justify the lack of an impairment loss. The SEC expects this level of disclosure each quarter for all material losses given current market conditions.
- d. *Unrealized losses on investments.* Discussion should include concentrations of securities with a loss. Additionally, disclosure should include the length of time that securities have been recorded with an unrealized loss, in table format, by class of security, and broken out between investment and noninvestment grade investments. The SEC staff expects this level of disclosure each quarter for all material losses given current market conditions.
- e. *Accounting policy disclosures.* Registrants should provide more specific information regarding critical accounting policies, especially if the policies are in areas where there is known diversity in practice.
- f. *Contractual obligations.* The SEC Staff recommended increased disclosures regarding insurance and investment contracts in the Contractual Obligations table in Form 10-K. Disclosures include variables such as mortality, morbidity, future lapse rates, and interest crediting rates.

**3.70 SEC Disclosures: Sarbanes-Oxley Implementation.** In response to passage of the Sarbanes-Oxley Act of 2002, the SEC and Public Company Accounting Oversight Board (PCAOB) have issued (or are issuing) additional rules and regulations specifying compliance. Additionally, in June 2006, state regulators adopted changes to the Model Audit Rule effective in 2010 by considering certain provisions of the act. For additional information, see chapter 5. Sections of the act that contain disclosure requirements include Sections 302, 401(a), 401(b), 404, 406, and 407.

- a. *Section 302—Certification of Disclosure in Companies Quarterly and Annual Reports.* CEOs and CFOs (or their equivalents) are now required to certify the financial and other information contained in quarterly and annual reports and make certain disclosures. Additionally, Department of Justice certifications (governed by Section 906 of the act) became effective upon enactment of the act.
- b. *Section 401(a)—Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations.* This section of the act requires that each annual and quarterly financial report disclose specific material transactions and relationships. See the preface of this guide for additional information.
- c. *Section 401(b)—Conditions for Use of Non-GAAP Financial Measures,* discusses the disclosure of pro forma financial information in any report filed with the SEC, or in any public disclosures or press releases. The term *non-GAAP financial measures* rather than *pro*

*forma financial information*, is used to eliminate confusion with pro forma disclosures that are required under existing SEC rules and regulations. As required by the act, whenever an entity presents a non-GAAP financial measure, Regulation G will require presentation of a numerical reconciliation to the most directly comparable measurement calculated using GAAP. Regulation G also explicitly prohibits the presentation of inaccurate or misleading non-GAAP financial measures. Rule 401(b) defines a *non-GAAP financial measure* as a numerical measure of an entity's historical or future financial performance, financial position, or cash flows that excludes (includes) amounts, or is subject to adjustments that have the effect of excluding (including) amounts, that are included (excluded) in the most directly comparable measure calculated in accordance with GAAP.

- d. Section 404—*Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*. See chapter 5 and the preface of this guide for additional information.
- e. Sections 406 and 407—*Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*. (Code of Ethics and Audit Committee financial expert disclosures, respectively). See the preface of this guide for additional information.

**3.71** *Additional Insurance Industry Information for Non-GAAP Financial Measures*. The definition of non-GAAP financial measures specifically excludes measures that are required to be disclosed by GAAP, SEC rules, or an applicable system of regulation imposed by a government, governmental authority or self-regulatory organization. Therefore, statutory basis financial ratios (for example, combined ratios) used by insurance registrants in SEC filings to describe the results of operations are considered outside the scope of the non-GAAP rules so long as those ratios are identical (in terms of both formula and result) to those presented in required filings with insurance regulators.

**3.72** In addition to Regulation G, the SEC also amended Regulations S-K and S-B to impose additional requirements and restrictions on the disclosure of non-GAAP financial measures in SEC filings. Among other things, the amendments to Regulations S-K and S-B prohibit the presentation of performance measures that exclude charges or gains identified as "nonrecurring, infrequent or unusual," unless the excluded items meet certain conditions. Many insurance entities use the term *operating earnings* (or similar non-GAAP terms) in discussing financial results within SEC filings. Insurance entities have defined *operating earnings* in a variety of different ways; however, the most common definition is net income excluding after tax realized investment gains and losses. Under the new non-GAAP rules, the term *operating earnings* is prohibited from being used in SEC filings because it is considered a performance measure that is adjusted to eliminate or smooth items (that is, realized investment gains and losses), which have either occurred in the prior two years or are likely to recur within two years from the balance sheet date.<sup>#</sup>

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<sup>#</sup> Readers should be aware of the revised SEC Non-GAAP Compliance and Disclosure Interpretations (specifically question 102.03, which addresses adjusting a non-GAAP financial performance measure) issued in January 2010, which can be found on the SEC website at [www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm](http://www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm).

## **Tax Basis Accounting Requirements**

**3.73** Life insurance entities, with the exception of most fraternal societies, are subject to tax, either individually or as part of a consolidated group. Therefore, the IRS influences accounting procedures by requiring special record keeping to comply with specific tax laws. Rules and regulations governing accounting methods that are used in the preparation of the income tax returns for a life insurance entity may be different in many respects from SAP and U.S. GAAP. These differences are discussed in chapter 13, "Taxation of Life Insurance Entities."

## **Comparison of U.S. GAAP and Statutory Accounting Practices**

**3.74** The objectives of U.S. GAAP reporting differ from the objectives of SAP. The primary focus of financial reporting in accordance with U.S. GAAP is information about earnings and its components. U.S. GAAP financial reporting assumes the continuation of an entity as a going concern in the absence of significant information to the contrary. Statutory financial statements are designed to address the concerns of the regulators, who are the primary users of statutory financial statements and emphasize the measurement of ability to pay all current and future contract holder obligations. For example, under SAP, contract acquisition costs are expensed in the period incurred because the funds are no longer available to pay future liabilities. However, under U.S. GAAP, in view of the long term nature of the life insurance contract, these same acquisition costs are capitalized and amortized over varying periods (such as the premium paying period of the contract) so that expenses and related revenues are recognized in the same accounting period (that is, matching revenue to expense). Table 3-1, "Summary of Statutory Accounting Practices and U.S. Generally Accepted Accounting Principles," presents a summarized comparison of the major difference in accounting treatment between U.S. GAAP and codified SAP for selected financial statement components. The reader ordinarily should, however, refer to the actual pronouncements for explicit guidance in accounting for transactions in each of the areas.

Table 3-1

Summary of Statutory Accounting Practices and U.S. Generally Accepted Accounting Principles

The following are highlights of significant differences in accounting treatment between codified statutory accounting practices (SAP) and U.S. generally accepted accounting principles (GAAP) for certain financial statement components. As described in paragraph 3.06, statutory accounting may vary by state. SAP and U.S. GAAP references pertaining to each area are not necessarily inclusive of all guidance applicable to the subject matter.

<i>Area</i>	<i>Codified Statutory Accounting Practices</i>	<i>U.S. Generally Accepted Accounting Principles<sup>(1)</sup></i>
Debt securities	Debt securities should be carried at amortized cost, except for those with a National Association of Insurance Commissioners (NAIC) designation of 6, which shall be reported at the lower of amortized cost or fair value. For reporting entities that do not maintain asset valuation reserve (AVR), debt securities with an NAIC designation of 1 or 2 shall be reported at amortized cost, whereas all other debt securities (NAIC designation 3–6) shall be reported at the lower of amortized cost or fair value. See Statement of Statutory Accounting Principles (SSAP) No. 26, <i>Bonds, Excluding Loan-backed and Structured Securities</i> and SSAP No. 43R, <i>Loan-backed and Structured Securities</i> , as amended.	Classified as trading securities or securities available for sale at fair value; classified as held-to-maturity at amortized cost, if positive intent and ability to hold to maturity exists. See Financial Standards Accounting Board (FASB) <i>Accounting Standards Codification</i> (ASC) 320, <i>Investments—Debt and Equity Securities</i> .
Common stock	Investments in unaffiliated common stock are generally reported at the fair value as stated by the NAIC's Securities Valuation Office. See SSAP No. 30, <i>Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)</i> .	Fair value. See FASB ASC 320, <i>Investments—Debt and Equity Securities</i> .
Nonredeemable preferred stock	Preferred stock <sup>(2)</sup> shall be valued based on the underlying characteristics of the security, the quality rating as designated by the NAIC, and whether an asset valuation reserve is maintained by the reporting entity. See SSAP No. 32, <i>Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)</i> .	Fair value. See FASB ASC 320.



<i>Area</i>	<i>Codified Statutory Accounting Practices</i>	<i>U.S. Generally Accepted Accounting Principles<sup>(1)</sup></i>
Mortgages	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. See SSAP No. 37, <i>Mortgage Loans</i> .	Unpaid balance plus unamortized loan origination fees less impairment as prescribed by FASB ASC 310, <i>Receivables</i> , Purchased loans with evidence of credit quality deterioration are accounted for under FASB ASC 310.
Real estate	Reported at depreciated cost less encumbrances. See SSAP No. 90, <i>Accounting for the Impairment or Disposal of Real Estate Investments</i> , as amended by SSAP No. 95, <i>Exchanges of Nonmonetary Assets A Replacement of SSAP No. 28—Nonmonetary Transactions</i> . Additional information can be found in SSAP No. 40, <i>Real Estate Investments</i> .	Depreciated cost, after impairment write-down as per FASB ASC 360, <i>Property, Plant, and Equipment</i> .
Real estate held for sale	Lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property. See SSAP No. 90, as amended by SSAP No. 95. Additional information can be found in SSAP No. 40.	Lower of carrying value or fair value less cost to sell. See FASB ASC 360.
Investments in affiliates	Investments in subsidiary, controlled or affiliated entities should be reported using either a market valuation approach or statutory equity methods. See SSAP No. 97, <i>Investments in Subsidiary, Controlled, or Affiliated Entities, A Replacement of SSAP No. 88</i> . <sup>(*)</sup>	Consolidated, equity basis, or cost as appropriate. See FASB ASC 970-323. <sup>(†)</sup>
Asset Valuation Reserve (AVR)	Formula driven reserve balance to offset potential credit or equity related investment losses. Changes reflected as a component of surplus. See SSAP No. 7, <i>Asset Valuation Reserve and Interest Maintenance Reserve</i> , and the NAIC Annual Statement Instructions.	Not applicable.
Interest Maintenance Reserve (IMR)	Interest-rate related net realized gains or losses, deferred and amortized to investment income (net of tax) over the remaining life of the investments sold. See SSAP No. 7 and the NAIC Annual Statement Instructions.	Not applicable.

(continued)

<i>Area</i>	<i>Codified Statutory Accounting Practices</i>	<i>U.S. Generally Accepted Accounting Principles<sup>(1)</sup></i>
Realized gains (losses)	Non-IMR gains and losses reported in income. Guidance comes from a variety of sources, including but not limited to, SSAP Nos. 7, 26, 30, 32, 43R, and 86, <i>Accounting for Derivative Instruments and Hedging Activities</i> .	Recorded in income statement. See FASB ASC 320 and FASB ASC 944, <i>Financial Services—Insurance</i> .
Unrealized gains (losses) for securities	For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus) net of income taxes. Guidance comes from a variety of sources, including but not limited to, SSAP Nos. 26, 30, 32, 43R, 46, <i>Investments in Subsidiary, Controlled, and Affiliated Entities, 72, Surplus and Quasi-Reorganization</i> , and 86.	Recorded in net income or other comprehensive income, as appropriate (except for held-to-maturity). See FASB ASC 320 and FASB ASC 220, <i>Comprehensive Income</i> .
Debt securities <sup>(‡)</sup>	<p>For debt securities, excluding loan-backed and structured securities, if it is determined that a decline in fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bonds carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made.</p> <p>The new cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value that are determined to be other than temporary, shall be recorded as realized losses. An impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the date of acquisition.</p> <p>See SSAP No. 26.</p> <p>For loan backed and structured securities, the impairment guidance within SSAP No. 43R, requires bifurcation of "interest"</p>	<p>If an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date.</p> <p>If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery</p>

Area	Codified Statutory Accounting Practices	U.S. Generally Accepted Accounting Principles <sup>(1)</sup>
	<p>and "non-interest" components for impairment recognition in situations when the entity does not have an intent to sell and has the intent and ability to hold the investment for a period of time sufficient to recover the amortized cost basis:</p> <ul style="list-style-type: none"> <li>• When an other than temporary impairment (OTTI) has occurred because the entity intends to sell or has assessed that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the OTTI recognized in earnings as a realized loss shall equal the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date.</li> <li>• When an OTTI has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the OTTI recognized as a realized loss shall equal the different between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security's effective interest rate.</li> </ul> <p>SSAP No. 43R has been amended to revise the definition of a loan-backed security. In June 2010, nonsubstantive revisions were also adopted to paragraphs 27 and 36 of SSAP No. 43R to clarify the accounting for gains and losses between AVR and IMR for SSAP No. 43R securities. Both revisions are effective for January 1, 2011.</p>	<p>of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be separated into both of the following:</p> <ol style="list-style-type: none"> <li>a. The amount representing the credit loss</li> <li>b. The amount related to all other factors</li> </ol> <p>The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.</p> <p>The previous amortized cost basis less the other-than-temporary impairment recognized in earnings shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. However, the amortized cost basis shall be adjusted for accretion and amortization as prescribed in FASB ASC 320-10-35-35.</p> <p>See FASB ASC 320.</p>

(continued)

Area	Codified Statutory Accounting Practices	U.S. Generally Accepted Accounting Principles <sup>(1)</sup>
Equity securities	For any decline in the fair value of unaffiliated common and preferred stocks, that is deemed other than temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. See SSAP No. 30, and No. 32. See also NAIC Interpretation 06-7, <i>Definition of Phrase "Other Than Temporary."</i>	If it is determined that the impairment is other than temporary, then an impairment loss shall be recognized in earnings equal to the entire difference between the investment's cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment shall not include partial recoveries after the balance sheet date. The fair value of the investment would then become the new cost basis of the investment and shall not be adjusted for subsequent recoveries in fair value. See FASB ASC 320.
Nonadmitted assets	Excluded from the statutory balance sheet and charged directly to unassigned surplus. See SSAP No. 4, <i>Assets and Nonadmitted Assets</i> ; No. 20, <i>Nonadmitted Assets</i> ; No. 29, <i>Prepaid Expenses</i> ; No. 87, <i>Capitalization Policy</i> ; and SSAP No. 96, <i>Settlement Requirements for Intercompany Transactions</i> .	Not applicable.
Liability for future policy benefits	Policy reserves determined using interest, morbidity, and mortality assumptions based on specified tables, formulas or both. See SSAP No. 51, <i>Life Contracts</i> , and applicable appendixes, SSAP No. 54, <i>Individual and Group Accident and Health Contracts</i> , and SSAP No. 59, <i>Credit Life and Accident and Health Insurance Contracts</i> . <sup>(11)</sup>	For traditional products—determined using expected expense, interest, morbidity, mortality, and voluntary withdrawal assumptions with provisions made for adverse deviation for contracts on a net level premium basis; for universal life-type contracts—retrospective deposit method of accounting is required. Additional liabilities for insurance and annuitization benefits may be required by FASB ASC 944.  For long duration insurance or investment contracts that are subject to FASB ASC 944 (paragraphs 15 and 17[a]) the accrued account balance equals

<i>Area</i>	<i>Codified Statutory Accounting Practices</i>	<i>U.S. Generally Accepted Accounting Principles<sup>(1)</sup></i>
		<ul style="list-style-type: none"> <li>a. deposits, net of withdrawals;</li> <li>b. plus amounts credited pursuant to the contract;</li> <li>c. less fees and charges assessed;</li> <li>d. plus additional interest accrued but not yet credited (for example, persistency bonus); and</li> <li>e. other adjustments (for example, appreciation or depreciation recognized in accordance with FASB ASC 944-40-25 to the extent not already credited and included in preceding step b).</li> </ul> <p>Additional liabilities for insurance and annuitization benefits may be required.</p>
Due and uncollected premiums	<p>Gross premium amounts that are due on or before the valuation date but have not been received. To the extent that there is no related unearned premium, any uncollected premium balances that are over ninety days due shall be nonadmitted.</p> <p>See SSAP No. 6, <i>Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers</i>; No. 51, and No. 54.</p>	Due and uncollected premiums are reported as assets. See FASB ASC 944.
Deferred premiums	<p>Deferred premiums are recorded as assets.</p> <p>See SSAP No. 51.</p>	Deferred premiums offset against liabilities for future policy benefits. See FASB ASC 944.
Contract holder dividend liability	<p>Provision for dividends expected to be paid over the year subsequent to the date of the financial statements, whether or not declared or apportioned.</p> <p>See SSAP No. 51.</p>	If limitations exist on the amount of net income from participating insurance contracts of life insurers that may be distributed to stockholders, provision is made for accumulated earnings expected to be paid to contract holders, including pro rata portion of dividends incurred to valuation date. If there are no net income restrictions, the future dividends are accrued over

(continued)

<i>Area</i>	<i>Codified Statutory Accounting Practices</i>	<i>U.S. Generally Accepted Accounting Principles<sup>(1)</sup></i>
		the premium paying period of the contract. See FASB ASC 944.
Reinsurance	Full credit generally given for authorized reinsurers; net reporting generally required; reinsurance recognized based on adequate risk transfer as defined by statutory guidance; changes in liability for unauthorized reinsurers in excess of approved collateral mediums recorded directly to surplus. See SSAP No. 61, <i>Life, Deposit-Type and Accident and Health Reinsurance</i> .	Reinsurance recognized based on adequate transfer of risk; <sup>(#)</sup> provision for uncollectible reinsurance and gross reporting of balance sheet amounts required under FASB ASC 944, net reporting is not allowed unless a right of offset exists as defined in FASB ASC 210-20. <sup>(#)</sup>
Deferred taxes	Balance sheet should include deferred income tax assets (DTAs) and liabilities, the expected future tax consequences of temporary differences generated by statutory accounting, as defined in FASB ASC 740, <i>Income Taxes</i> . The guidance in SSAP No. 10R, <i>Income Taxes—Revised, A Temporary Replacement of SSAP No. 10</i> , results in a two step process for determining DTAs. DTAs are calculated per the guidance in paragraph 6 of SSAP No. 10R, and are reduced by a statutory valuation allowance adjustment if, based on the weight of available evidence, it is more likely than not that some portion or all of the gross DTAs will not be realized. The statutory valuation allowance adjustment will reduce the gross DTAs to the amount that is more likely than not to be realized (the adjusted gross deferred tax assets). The adjusted gross DTAs are then admitted based on a calculation in paragraph 10 of SSAP No. 10R. See SSAP No. 10R. SSAP No. 10R is effective for 2009 annual financial statements, and 2010 and 2011 interim and annual financial statements only. In March 2011, the Statutory Accounting Principles Working Group (SAPWG) of the NAIC exposed SSAP No. 101, <i>Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10</i> . The proposed guidance would incorporate U.S. GAAP guidance	Provision made for temporary differences, net operating losses, and credit carryforwards under FASB ASC 740.

<i>Area</i>	<i>Codified Statutory Accounting Practices</i>	<i>U.S. Generally Accepted Accounting Principles<sup>(1)</sup></i>
	for uncertain tax positions and tax-planning strategies. It would also change how admitted deferred tax assets are calculated. The comment deadline was April 29, 2011. The SAPWG has scheduled several calls during the spring of 2011 to discuss the proposed guidance and intends to adopt a final standard at the summer NAIC meeting in August 2011.	
Leases	All leases, except leveraged leases should be considered operating leases. See SSAP No. 22, <i>Leases</i> .	Classified as capital or operating according to the provisions of FASB ASC 840, <i>Leases</i> . <sup>(**)</sup>
Liability for postretirement benefits other than pensions	An employer shall account for its postretirement benefits for vested employees only, on an accrual basis. See SSAP No. 14, <i>Postretirement Benefits Other Than Pensions</i> , which adopts FASB ASC 715, <i>Compensation—Retirement Benefits</i> with some modifications.	Expected postretirement benefit obligations are recognized over the working life of employees; liability based on vested and nonvested benefits under FASB ASC 715.
Pension benefits	For defined benefit plans, reporting entities should adopt FASB ASC 715, with a modification to exclude nonvested employees. The excess of plan assets over obligations should be treated as a nonadmitted asset. Net plan obligations must be accrued irrespective of funding.  For defined contribution plans, the reporting entity should expense contributions required by the plan over the period in which the employee vests in those contributions. Contributions to plan participants' accounts made prior to vesting shall be treated as a prepaid asset that is nonadmitted. Contributions required after participants terminate or retire shall be accrued and an expense shall be recorded over the working lives of the participants.  See SSAP No. 89, <i>Accounting for Pensions, A Replacement of SSAP No. 8</i> , which adopts FASB ASC 715 with some modifications.	Pension costs calculated based on the projected unit credit method under FASB ASC 715.

(continued)

<i>Area</i>	<i>Codified Statutory Accounting Practices</i>	<i>U.S. Generally Accepted Accounting Principles<sup>(1)</sup></i>
Universal life revenue	Premiums and cost of insurance, and other contract charges are recognized as revenue. See SSAP No. 51.	Premiums and deposits included in contract holder liabilities; revenues represent amounts assessed against policyholders and shall be reported in the period that the amounts are assessed unless evidence indicates that the amounts are for future periods, as per FASB ASC 944.
Contract acquisition costs	Charged to expense when incurred. See SSAP No. 71, <i>Policy Acquisition Costs and Commissions</i> .	Deferred and amortized (with interest) in relation to the revenue generated (premiums or estimated gross profit, as appropriate) if recoverable from such revenue. See FASB ASC 944.
Consolidation	Generally on an unconsolidated, individual reporting entity basis with subsidiaries on a modified equity method basis. See SSAP No. 97 <sup>(*)</sup>	Generally required in accordance with FASB ASC 810, <i>Consolidation</i> .

(1) FASB ASC 820, *Fair Value Measurements and Disclosures*, establishes a framework for measuring fair value that applies broadly to financial and nonfinancial assets and liabilities and improves the consistency, comparability, and reliability of the measurements. For further information, see <http://asc.fasb.org> and chapter 11, "Investments."

(2) The National Association of Insurance Commissioners (NAIC) Financial Condition Committee had previously adopted a short term resolution for hybrid securities classification. At the summer 2008 NAIC meeting, the NAIC decided not to adopt the short term "notching solution," but instead to adopt a 2007 report from the American Academy of Actuaries, and look for a long term solution to improve identification, classification, and accounting guidance for new structured investments. As of January 1, 2009, the notching solution will expire, and hybrid securities should be reported in Schedule D with a separate line number and the annual statement note disclosure for these holdings would be eliminated. A definition of hybrid securities was also added to the investment schedules instructions. For additional specifics, see chapter 11.

(\*) Per Statements of Statutory Accounting Principles (SSAP) No. 96, *Settlement Requirements for Intercompany Transactions, An Amendment of SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*, related party transactions are now required to be in the form of a written agreement that specifies a due date. Amounts receivable from related parties over 90 days passed due from the due date or if the due date is not specified in the agreement, are now nonadmitted.

(†) FASB ASC 810, *Consolidation*, addresses the topic of consolidation. The objective of which is to improve comparability and transparency of consolidated financial statements by establishing accounting and reporting standards and is effective fiscal years beginning on or after December 15, 2008. Early adoption is prohibited. For more information, see chapter 11.



(†) Substantive revisions in paragraphs 13–14, 57–81, and 98–101 of SSAP No. 91R regarding securities lending transactions and repurchase agreements and additional disclosures were adopted in May 2010 and are effective December 31, 2010. The substantive revisions adopted in SSAP No. 91R did not adopt or reject any new generally accepted accounting principles (GAAP) standards, but it did incorporate guidance regarding the determination of whether collateral is on balance sheet or off balance sheet, which is closer to the existing GAAP guidance.

(‡) The NAIC adopted various changes to appendix-010 and conforming changes to SSAP No. 59, *Credit Life and Accident and Health Insurance Contracts*. The changes modify the methodologies for establishing reserves for individual and group disability income claims incurred after January 1, 2007, contract reserves for single premium credit disability insurance policies and long-term care insurance individual policies or group certificates issued after January 1, 2007.

(#) FASB ASC 815-10-45-5 permits a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement that have been offset in accordance with that paragraph.

(\*\*) FASB and the IASB initiated a joint project to develop a new approach to lease accounting that would ensure that assets and liabilities arising under leases are recognized in the statement of financial position. On March 19, 2009, the boards published, for public comment the discussion paper *Leases: Preliminary Views*. The comment period for the discussion paper ended on July 17, 2009. The proposals in the discussion paper have been refined based on comment letters received and input from preparers, auditors, users, regulators, and other interested parties during other outreach activities. On August 17, 2010, the boards published, for public comment, the exposure draft *Leases*. The comment period for the exposure draft ended on December 15, 2010. The boards are currently redeliberating based on comments received. Readers should be aware that the boards plan to issue final standards by the end of the second quarter 2011.

**Exhibit 3-1****Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis<sup>1</sup>**

**Question.** Insurance enterprises issue financial statements prepared in accordance with accounting practices prescribed or permitted by insurance regulators (a "statutory basis") in addition to, or instead of, financial statements prepared in accordance with GAAP. Most states have adopted a comprehensively updated *Accounting Practices and Procedures Manual*, as revised by the NAIC's Codification project. The updated *Accounting Practices and Procedures Manual*, along with any subsequent revisions, is referred to as the revised manual. The revised manual contains extensive disclosure requirements. As a result, after a state adopts the new *Accounting Practices and Procedures* manual, its statutory basis of accounting will include informative disclosures appropriate for that basis of accounting. The NAIC Annual Statement Instructions prescribe the financial statements to be included in the annual audited financial report. Some states may not adopt the revised manual or may adopt it with significant departures. How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?<sup>2</sup>

**Interpretation.** Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to AU section 623, *Special Reports* (AICPA, *Professional Standards*), paragraph .04. AU section 623 paragraph .09 states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than GAAP, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the basis of accounting used. The auditor should apply essentially the same criteria to financial statements prepared on an other comprehensive basis of accounting as he or she does to financial statements prepared in conformity with GAAP. Therefore, the auditor's opinion should be based on his or her judgment regarding whether the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation as discussed in section AU section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, paragraph .04 (AICPA, *Professional Standards*)."

AU section 623 paragraph .02 states that generally accepted auditing standards (GAAS) apply when an auditor conducts an audit of and reports on financial statements prepared on an other comprehensive basis of accounting. Thus, in accordance with the third standard of reporting, "informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

**Question.** What types of items or matters should auditors consider in evaluating whether informative disclosures are reasonably adequate?

**Interpretation.** AU section 623 paragraphs .09–.10 indicate that financial statements prepared on a comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used. That includes a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. The provisions of the preamble of the revised manual that states,

"GAAP pronouncements do not become part of Statutory Accounting Principles until and unless adopted by the NAIC," do not negate the requirements of AU section 623 paragraph .10, which also states that when "the financial statements [prepared on an other comprehensive basis of accounting] contain items that are the same as, or similar to, those in financial statements prepared in conformity with GAAP, similar informative disclosures are appropriate."

**Question.** How does the auditor evaluate whether "similar informative disclosures" are appropriate for

- a. items and transactions that are accounted for essentially the same or in a similar manner under a statutory basis as under GAAP?
- b. items and transactions that are accounted for differently under a statutory basis than under GAAP?
- c. items and transactions that are accounted for differently under requirements of the state of domicile than under the revised manual?

**Interpretation.** Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially the same or in a similar manner under the statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP unless the revised manual specifically states the NAIC Codification rejected the GAAP disclosures.<sup>3</sup> Disclosures should also include those required by the revised manual.

Disclosures in statutory basis financial statements for items or transactions that are accounted for differently under the statutory basis than under GAAP, but in accordance with the revised manual, should be the disclosures required by the revised manual.

If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised manual for that item or transaction, but it is in accordance with GAAP or superseded GAAP, the disclosures in statutory basis financial statements for that item or transaction should be the applicable GAAP disclosures for the GAAP or superseded GAAP. If the accounting required by the state of domicile for an item or transaction differs from the accounting set forth in the revised manual, GAAP or superseded GAAP, sufficient relevant disclosures should be made.

Paragraph .10 of AU section 623 states that "when evaluating the adequacy of disclosures, the auditor should also consider disclosures related to matters that are not specifically identified on the face of the financial statements, such as (a) related party transactions, (b) restrictions on assets and owners' equity, (c) subsequent events, and (d) uncertainties." Other matters should be disclosed if such disclosures are necessary to keep the financial statements from being misleading.

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<sup>1</sup> Reprinted from *Special Reports: Auditing Interpretations of AU section 623* (AICPA, *Professional Standards*, AU sec. 9623). This exhibit reflects the amendments to Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of AU section 623, *Special Reports* (AICPA, *Professional Standards*, AU sec. 9623 par. .60–.77), as made by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, effective December 15, 2001 and by the Auditing Standards Board, effective January 2005—subsequent to the PCAOB adoption of the AICPA standards as interim, on April 16, 2003.

- <sup>2</sup> It is possible for one of three different situations to occur: The state adopted the revised manual without significant departures, adopted the revised manual with significant departures, or has not yet adopted the revised manual.
- <sup>3</sup> The provisions of the preamble of the revised manual that states, "GAAP pronouncements do not become part of Statutory Accounting Principles until and unless adopted by the NAIC" or any other explicit rejection of a GAAP disclosure does not negate the requirements of paragraph .10 of AU section 623. (Note that the Emerging Accounting Issues Working Group Interpretation 04-1, *Applicability of New GAAP Disclosures Prior to NAIC Consideration* is consistent with the revised manual.)
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## Chapter 4

# Audit Risk Considerations

### Introduction

**4.01** This chapter is intended to assist the auditor in identifying and assessing the effects of business and economic conditions on inherent risk. According to paragraph .01 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*):

The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

**4.02** Although life insurance entities exist to manage the insurance and investment risks of their contract holders, the principal risks are related to the risk that actual cash flows will be different from anticipated cash flows. Methodologies have been developed to estimate and measure this risk by segregating the elements into four broad categories. These categories are used in the National Association of Insurance Commissioners (NAIC) risk-based capital (RBC) formulas, which are discussed in paragraph 4.08, to quantify capital requirements for such risks. The categories are as follows:

- a. *Asset risk (C-1)*. Also referred to as asset quality risk, this is the risk of asset default or impairment of value. For equity investments such as common stock, equity real estate, and joint ventures, this is the risk of a decline in the value of the investment. For debt investments, such as debt securities and mortgage loans, this is the risk of default, which is defined as failure to make any payment of principal or interest on schedule, or any significant modification in the contract.
- b. *Insurance risk (C-2)*. Insurance rate risk is often referred to as underwriting risk, and is the risk of loss as a result of adverse mortality or morbidity experience and erroneous pricing assumptions other than asset and interest assumptions. This risk covers a wide range of adverse circumstances including unanticipated changes in fixed costs, mortality and morbidity experience, and *lapse rates*.
- c. *Interest rate risk and equity markets (C-3)*. Interest rate risk is often referred to as asset-liability risk, and is the risk of loss due to changes in interest rate levels. For example, it may not be possible to find suitable investments with sufficient returns and durations to satisfy the investment earnings assumptions for long-duration contracts common in the industry. Additionally, changes in general interest rates may prompt contract holders to withdraw funds prematurely (referred to as *disintermediation*) or result in prepayment of fixed income securities (referred to as *reinvestment risk*). *Equity markets risk* is the risk of loss due to changes in equity market levels on variable products with guarantees.

- d. *Business risk (C-4)*. This is general business and management risk common to most entities. Examples of such risks are changes in the regulatory or tax environment, regulatory intervention, technological change, fraud, mismanagement, and loss of reputation due to downgrading by rating agencies or negative publicity.

## Risk Indicators in the Life and Health Insurance Industry

**4.03** The adequacy of a life insurance entity's capital is an important consideration in assessing inherent risk. Strong earnings and capital positions provide more risk taking capacity and operational flexibility. A weak capital position or poor earnings outlook limits an entity's ability to address risks and increases financial exposure to risks that may materialize. Described in the following sections are the significant indicators that are usually the result of a combination of C-1, C-2, C-3, and C-4 risks that the auditor may consider when assessing inherent risk. For the purposes of this Audit and Accounting Guide, each item is listed under a specific risk, even though these categorizations may be somewhat arbitrary because a given indicator may relate to more than one risk category. Audit considerations are discussed in detail in chapter 5, "General Auditing Considerations."

### Asset Risk (C-1)

**4.04** The indicators of asset risk exposure the auditor may consider include the following:\*

- a. Large investments in noninvestment grade securities
- b. Significant investments in affiliates
- c. Concentration of investments in a single investee
- d. Equity stakes accepted in lieu of principal and interest as well as capitalization of interest
- e. Substantial unrealized investment losses
- f. Guarantees of publicly issued debt, such as collateralized mortgage obligations or municipal bonds
- g. Increasing delinquencies and nonperforming loans as well as little experience in modifications, workout programs, or restructuring
- h. Higher delinquency and foreclosure rates than industry averages or prior years' experience
- i. Refinancing or restructuring of significant amounts of bullet loans
- j. Significant exposure to individual real estate investments in concentrated markets or geographic regions
- k. Concentrations of mortgages with individual borrowers
- l. Significant high risk loans underwritten (such as high interest rates or second liens)
- m. Significant mortgages and other loans to affiliates, subsidiaries, joint ventures, limited partnerships, or other related parties

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\* The subprime market meltdown in 2008 and 2009 has had wide reaching financial implications for many entities, including life and health insurers. Specific asset risks include investments backed by residential and commercial mortgages or synthetic exposure to mortgages.

- n.* The acceptance of additional investment risk to support high interest crediting rates
- o.* Significant amounts of investments in derivatives and structured securities
- p.* Downgrading of securities by rating agencies
- q.* Significant changes in interest rates
- r.* Duration of portfolio may not match cash flow needs
- s.* Investment policies and procedures do not exist
- t.* Lack of defined strategy for investments
- u.* Significant amount of other than temporary impairment taken in prior years

## Insurance Risk (C-2)

**4.05** The auditor may consider indicators of insurance risk exposure, including the following:

- a.* Lack of conservatism in determining benefit liabilities
- b.* Sensitivity of benefit liabilities to management estimates
- c.* Extensive use of reinsurance arrangements with poorly rated reinsurers
- d.* Health insurance products affected by dramatic increases in medical costs
- e.* Little experience in underwriting and pricing new products such as long term care contracts
- f.* Relaxed underwriting standards
- g.* Trends toward *antiselection*, particularly in health care products, which may result in deteriorating margins
- h.* New forms of competition in the traditional life insurance market
- i.* Significant increases over prior years in the frequency and severity of claims
- j.* New events, such as the advent of acquired immune deficiency syndrome, that may result in deteriorating profits on existing contracts
- k.* Fixed costs that are increasing faster than inflation
- l.* Actual expenses that are substantially higher than those assumed in pricing
- m.* Product pricing assumptions that are based on competitive market pricing without regard to expected costs
- n.* Underwriting standards that are inconsistent with the mortality-morbidity assumptions used in product pricing
- o.* The use of credits to offset rate increases
- p.* Lack of approved underwriting guidelines and authorization limits
- q.* Lack of management monitoring concentration of risks
- r.* Lack of control over agents with binding authority
- s.* Policies, endorsements, cancellations may not be processed timely

## Interest Rate Risk and Equity Markets (C-3)

**4.06** The auditor may consider indicators of interest rate risk, including the following:

- a.* Significant increases in surrenders or lapses of contracts
- b.* Insufficient short term liquid investments
- c.* Negative spreads on investment contracts
- d.* Significant deposit contracts without surrender charges
- e.* Individually significant balances with single customers for pension or other deposit type products
- f.* Inadequate testing of cash flow or interest rate scenarios
- g.* Asset maturities that are not consistent with expected payouts of contract holder liabilities
- h.* Significant asset—liability mismatches
- i.* Significant long term liabilities (such as structured settlements), supported by assets with significant debtor optionality (such as residential mortgage backed securities)
- j.* Investment program does not provide adequate returns
- k.* Ineffective derivative hedging program

## Business Risk (C-4)

**4.07** The auditor may consider indicators of business risk exposure, including the following:

- a.* Capital and surplus that are below industry average
- b.* Poor or deteriorating results under the NAIC RBC model
- c.* A substantial portion of surplus that is attributable to gains resulting from nonrecurring transactions or other nonrecurring items
- d.* Transactions and changes in accounting treatment that enhance surplus, such as financial reinsurance or change in benefit and claim liability estimates
- e.* Asset transfers or other activities with affiliates that enhance surplus, such as expense allocations, reinsurance transactions, fronting, and nonadmitted assets transferred to a noninsurance subsidiary
- f.* Lack of profitability of new products that are subsidized by a profitable inforce
- g.* The possibility of large guaranty fund assessments
- h.* The risk of changes in the competitive structure of health insurers due to the Patient Protection and Affordability Act
- i.* Unexpected changes in the individual tax laws, such as those that affected single premium life insurance products and certain types of individual annuities
- j.* Explosive growth without adequate infrastructure and controls
- k.* Events or transactions that could cause regulators to assume control or supervision of the life insurance entity
- l.* The possibility of regulatory action to influence or change actions taken by management



- m. Downgrading by major rating agencies
- n. Recent negative publicity that could potentially causes a decline in current customer base and presents additional challenges in obtaining new customers
- o. Lack of corporate business plan, underwriting strategy, or both
- p. Lack of an enterprise risk management process
- q. Merger and acquisition activity

## Statutory Risk Based Capital

**4.08** The NAIC has developed an RBC model which provides for 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, and are set forth in the RBC instructions. Such formulas focus on the four general kinds of risk described in paragraph 4.02. The amount of risk determined under such formulas is called the authorized control level risk based capital (ACL RBC).

**4.09** RBC requirements establish a framework for linking various levels of regulatory corrective action to the relationship of a life insurance entity's total adjusted capital, which is equal to statutory capital, plus asset valuation reserve, plus 50 percent of dividend liability, capital notes, and certain other specified adjustments to the calculated ACL RBC. The levels of regulatory action, the trigger point, and the corrective actions are summarized in table 4-1, "Risk Based Capital Requirements."

**Table 4-1**  
**Risk Based Capital Requirements**

<i>Level</i>	<i>Trigger</i>	<i>Corrective Action</i>
Company action level (CAL) RBC	Total adjusted capital (TAC) is less than or equal to $2.0 \times \text{ACL}$ , or TAC is less than or equal to $-2.5 \times$ authorized control level (ACL) with negative trend.	The life insurance entity must submit a comprehensive plan to the insurance commissioner.
Regulatory action level (RAL) RBC	TAC is less than or equal to $1.5 \times \text{ACL}$ , or there is an unsatisfactory RBC Plan.	In addition to the previous action, the insurance commissioner is required to perform the examination or analysis deemed necessary, and issue a corrective order, specifying the corrective actions required.

(continued)

<i>Level</i>	<i>Trigger</i>	<i>Corrective Action</i>
Authorized control level (ACL) RBC	TAC is less than or equal to 1.0 x ACL.	In addition to the actions described previously, the insurance commissioner is permitted but not required to place the life insurance entity under regulatory control.
Mandatory control level (MCL) RBC	TAC is less than or equal to .7 x ACL.	The insurance commissioner is required to place the life insurance entity under regulatory control.

**4.10** Under the RBC requirements, the comprehensive financial plan should

- a. identify the conditions of the insurer that contribute to the failure to meet capital standards.
- b. contain proposals of corrective actions that the insurer intends to take and that would be expected to result in compliance with capital standards.
- 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 affecting the insurer's projections and the sensitivity of the projections to the assumptions.
- e. identify the quality of and the 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.

**4.11** RBC requirements require that the comprehensive financial plan be filed with the state's insurance commissioner within 45 days of the failure to meet RBC standards. Within 60 days of submission of the plan, the commissioner is required to notify the insurer whether the plan is accepted or is unsatisfactory.

**4.12** *Audit considerations.* In evaluating inherent risk,<sup>1</sup> auditors should develop an understanding of the statutory RBC calculation and its implications on the financial position of the life insurance entity. The audit considerations of RBC are discussed in detail in chapter 5.

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<sup>1</sup> As defined in AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), inherent risk is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related account balances, classes of transactions, and disclosures than for others.

## Chapter 5

# General Auditing Considerations

### Introduction

**5.01** An initial step in any audit is to become knowledgeable about the life insurance business and the competitive and economic environment in which the entity operates. Toward this end, chapter 1, "Overview of the Life and Health Insurance Industry;" chapter 2, "Characteristics of Life and Health Insurance Products;" and chapter 4, "Audit Risk Considerations," of this Audit and Accounting Guide discuss the general nature of the life insurance business, outlining the general risk characteristics and the most common products provided by the life insurance industry. Chapter 3, "Sources of Accounting Principles and Reporting Requirements," provides a general discussion of statutory accounting practices (SAP) and U.S. generally accepted accounting principles (GAAP) relating to the life insurance industry. Appendix A, "List of Industry Trade and Professional Associations, Publications, and Information Resources," provides sources for additional information on the life insurance industry.

**5.02** In accordance with AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), an independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. This chapter provides guidance, primarily on the application of the standards of fieldwork. Specifically, this section provides guidance on the risk assessment process (which includes, among other things, obtaining an understanding of the entity and its environment, including its internal control) and general auditing considerations for life and health insurance entities.

### Scope of the Audit Engagement<sup>1</sup>

#### General Considerations

**5.03** AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), states the auditor should establish an understanding with the life and health insurance entity regarding the services to be performed for each engagement. This understanding should be documented through a written communication with the life and health insurance entity in the form of an engagement letter. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and

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<sup>1</sup> A member performing an attest engagement must be *independent* pursuant to Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .01), of the AICPA Code of Professional Conduct. Other applicable independence rules and regulations may also apply to members and accountants while performing attest engagements (for example, Securities and Exchange Commission [SEC], Public Company Accounting Oversight Board [PCAOB], Government Accountability Office [GAO], and state licensing boards).

A member performing a statutory attest engagement must also be independent under state insurance independence requirements, as described in Section 7 of the National Association of Insurance Commissioners (NAIC) revised Model Audit Rule, *Qualifications of the Independent Certified Public Accountant*.

limitations of the engagement. The nature, timing, and extent of audit procedures to be performed and the kind of reports to be issued are based on the scope of the audit services required by the life insurance entity.

#### *Considerations for Integrated Audits*

For audits performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, paragraphs .05–.08 of AU section 310, *Appointment of the Independent Auditor* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), provides guidance about auditors establishing an understanding with the client regarding services to be performed when performing an audit of financial statements only, or when performing an integrated audit of financial statements and internal control over financial reporting.

**5.04** In defining the scope of audit services, the auditor may consider matters relating to specific reporting responsibilities of the engagement. These matters include the following:

- a. The legal structure or organization of the life insurance entity and the number and kind of entities that require separate reports on SAP or U.S. GAAP financial statements (or both), or that require consolidated statements
- b. Regulatory reporting and filing requirements for local, state, and federal regulatory authorities
- c. Reporting requirements—of a foreign parent or subsidiaries—such as those for which guidance is provided in AU section 534, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*), for the auditor practicing in the United States, who is engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles that are generally accepted in another country for use outside the United States

### **PCAOB Integrated Audit of Financial Statements and Internal Control Over Financial Reporting<sup>2</sup>**

**5.05** Many life and health insurance entities are public issuers; the scope requirements for audits of issuers have been expanded. As described in paragraph 5.115, pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley), the Securities and Exchange Commission (SEC) now requires a PCAOB registered public accounting firm's attestation report on management's assessment of the entity's internal control over financial reporting. PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards),<sup>3</sup> establishes requirements and provides directions that apply when an auditor is engaged to audit both an entity's financial statements and management's assessment of the effectiveness of internal control over financial reporting.

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<sup>2</sup> This service is referred to as an *integrated audit* throughout the guide. Certain areas of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), guidance that corresponds to guide topics discussed are indicated, but are not inclusive.

<sup>3</sup> PCAOB Auditing Standard No. 5 is effective for fiscal years ending on or after November 15, 2007.

**5.06** More specifically, for integrated audits, paragraph 3 of Auditing Standard No. 5 states that

the auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must<sup>4</sup> plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

**5.07** The PCAOB has issued Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards). The auditing standard includes two appendixes: one contains illustrative reports and the other includes the background and basis for conclusions. The standard establishes requirements and provides directions that apply when an auditor is engaged to report on whether a previously reported material weakness in internal control over financial reporting continues to exist as of a date specified by management. The engagement described by the standard is voluntary and the standards of the PCAOB do not require an auditor to undertake an engagement to report on whether a previously reported material weakness continues to exist.

**5.08** The PCAOB rule also amends the PCAOB's interim standards—paragraph .04(f) of AT section 101, *Attest Engagements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards)—to clarify that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than an entity's internal use.

## PCAOB Audit of Financial Statements Only

**5.09** Scope requirements have also changed if an auditor is performing audits of financial statements only for issuers or nonissuers in accordance with PCAOB standards and related rules. The PCAOB continues to issue new standards and rules and has also integrated certain requirements of PCAOB

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<sup>4</sup> For issuers, PCAOB Rule 3101, *Regarding Certain Terms Used in Auditing and Related Professional Practice Standards* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), states the following definition for imperatives used to describe different degrees of auditor responsibility:

- The terms *must*, *shall*, and *is required* indicate unconditional obligation. The auditor must accomplish obligations of this type in all cases in which the circumstances exist to which the obligation applies. Not to do so is a rule violation.
- The terms *should* and *should disclose* indicate obligations that are presumptively mandatory. The auditor must comply unless the auditor can demonstrate, by verifiable, objective, and documented evidence that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports. Failure to discharge is a violation of Rule 3101 unless specific circumstances are met. See Rule 3101 for the specifics.
- The terms *may*, *might*, *could*, and *should consider*, describe actions and procedures that auditors have a professional obligation to consider. Whether an auditor takes action or implements the procedure in question depends on an exercise of professional judgment in the circumstances.

Auditing Standard No. 5 by amending or superseding their interim standards through the issuance of *Conforming Amendments to PCAOB Auditing Standards Resulting From the Adoption of PCAOB Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements."*<sup>\*</sup> PCAOB audits of financial statements only may also occur for specific SEC registrants (for example, certain investment entities).

## Planning and Other Auditing Considerations

**5.10** The objective of an audit of a life insurance entity's financial statements is to express an opinion on whether they present fairly, in all material respects, the entity's financial position, results of operations, and cash flows in conformity with GAAP or an other comprehensive basis of accounting. To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to life and health insurance entities.

### Audit Planning

**5.11** The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311 (AICPA, *Professional Standards*), establishes requirements and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor; preliminary engagement activities; establishing an understanding with the client; preparing a detailed, written audit plan; determining the extent of involvement of professionals with specialized skills; and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity, and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control.

**5.12** Paragraph .03 of AU section 311 (AICPA, *Professional Standards*) states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

#### *Considerations for Integrated Audits*

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB standards, the auditor should refer to paragraphs 9–20 of Auditing Standard No. 5 regarding planning considerations in addition to the

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<sup>\*</sup> See the PCAOB website at [www.pcaob.org](http://www.pcaob.org) for information about the effective dates of these conforming amendments.

planning considerations discussed in AU section 311, *Planning and Supervision* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).

**5.13** Planning procedures usually include reviewing the auditor's files pertaining to the entity and holding discussions with audit personnel and entity personnel. The following are examples of those procedures. Some of these procedures may also be performed as risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control (see section titled "Understanding the Entity, Its Environment, and Its Internal Control"):

- a. Review correspondence files, the previous year's audit documentation, permanent files, financial statements, the last examination report, rating agency reports, and the auditor's reports.
- b. Review minutes of the meetings of those charged with governance.
- c. Review the relationship of affiliated organizations to the life insurance entity and determine the extent to which their financial information should be included in its financial statements.
- d. Review the status of unsettled claims reports—particularly for health insurance product lines.
- e. Discuss matters that may affect the audit with the audit firm's personnel responsible for any nonaudit services to the life insurance entity.
- f. Inquire about current business developments affecting the life insurance entity, such as the introduction of new products, new or amended reinsurance agreements, or changes in distribution systems.
- g. Review the current year's interim financial statements and filings with the SEC.
- h. Review periodic reports to other regulatory bodies.
- i. Discuss the nature, scope, and timing of the engagement with the entity's management, audit committee, or those charged with governance.
- j. Consider the effects of applicable accounting and auditing pronouncements, particularly new ones.
- k. Coordinate the assistance of life insurance entity personnel in data preparation.
- l. Determine the extent of involvement, if any, of consultants, specialists, and internal auditors, and identify situations in which accounting estimates are required and relevant factors that may affect these estimates.
- m. Determine examination status with regulatory authorities. Review correspondences with regulatory authorities. Review examination reports that have been issued.
- n. Consider the need to conduct audit procedures for third-party administrators such as underwriters, investment managers, and claims administrators.
- o. Consider the need to conduct audit procedures for reinsurers for material transactions or reinsurance agreements.

- p. Discuss conditions that may require extension or modification of audit procedures, for example, related-party transactions with the life insurance entity's management.
- q. Establish the timing of the audit work.

**5.14** The auditor may find it helpful to maintain a permanent file for each audit engagement that may include the following documents:

- a. Articles of incorporation
- b. Bylaws
- c. Chart of accounts
- d. Organization chart
- e. Contracts and agreements, such as leases, contract forms, agent contracts, agreements with third parties such as reinsurers, and agreements with affiliated and related organizations
- f. Description of the internal control, that is, the control environment, the risk assessment, control activities, information and communication, and monitoring
- g. Loan agreements, bond indentures, and other debt instruments
- h. Licensing status and examiner's reports
- i. Reinsurance agreements that continue to impact the current year under audit

## Audit Risk

**5.15** AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), states that *audit risk* is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

**5.16** At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (a) the risks of material misstatement (consisting of inherent risk and control risk) and (b) detection risk (see subsequent paragraphs for further discussion of these components). Paragraph .23 of AU section 312 (AICPA, *Professional Standards*) states that auditors should assess the risk of material misstatement at the relevant assertion level as a basis to design and perform further audit procedures (tests of controls or substantive procedures). It is not acceptable to simply deem risk to be *at the maximum*. This assessment may be in qualitative terms such as high, medium, and low, or in quantitative terms such as percentages.

**5.17** In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.



## ***Risk of Material Misstatement***

**5.18** AU section 312 (AICPA, *Professional Standards*) and other sections in AICPA *Professional Standards* describe the risk of material misstatement as the auditor's combined assessment of inherent risk and control risk; however, the auditor may make separate assessments of inherent risk and control risk. Inherent risk and control risk are the entity's risks, that is, they exist independently of the audit of financial statements. The assessment of the risk of material misstatement at the assertion level is a judgment rather than a precise measurement of risk; however, the auditor should have an appropriate basis for that assessment. This basis may be obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, including its internal control, and through the performance of suitable tests of controls to obtain audit evidence about the operating effectiveness of controls, where appropriate.

### ***Inherent Risk***

**5.19** *Inherent risk* is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related account balances, classes of transactions, and disclosures than for others. In determining the scope of audit procedures to be performed, the auditor is generally concerned with matters that could be material to the financial statements; the auditor also should generally consider certain aspects of the life insurance entity's operations that are usually subject to a greater level of inherent risk than others.

**5.20** The size, complexity, and ownership characteristics of the life insurance entity have a significant influence on the risk environment. In assessing inherent risk, the following factors may be considered; however, the presence of a number of factors in isolation would not necessarily indicate increased risk. See further discussion of risk in chapter 4.

**5.21** *Management characteristics.* The following management characteristics may indicate increased inherent risk:

- a. One person dominates management's operating and financing decision-making process.
- b. Management places undue emphasis on meeting earnings projections.
- c. Management's reputation in the business community is poor.
- d. Management compensation is significantly influenced by earnings.
- e. Management lacks experience in addressing the life insurance industry, emerging products and issues, noninsurance subsidiaries, or other complex matters.
- f. Staff turnover is high, or personnel are inexperienced, or staff levels are insufficient given the volume or kind of business processed.

**5.22** *Operating and industry characteristics.* The following characteristics pertaining to operations and the industry may indicate increased inherent risk:

- a. Key financial indicators of the life insurance entity significantly differ from industry averages or are inconsistent with the entity's operations.

- b. The life insurance entity is poorly rated by the rating agencies or has had a recent change in rating.
- c. Operating results significantly differ from projected results.
- d. Market share is changing.
- e. Operating results are highly sensitive to economic factors, such as interest rate fluctuations.
- f. The asset portfolio has changed significantly or product mix has changed in a way that may affect the appropriate matching of maturities for assets and liabilities.
- g. Asset quality is poor, or assets are highly concentrated by type or geographical areas.
- h. Significant off-balance-sheet risks exist.
- i. New, specialized products have been introduced, or there is rapid growth in previously limited product lines.
- j. Decision-making is decentralized and lacks adequate monitoring.
- k. Significant changes in regulation or taxation have occurred that may affect the profitability or marketability of a product line or affect general surplus requirements.
- l. Lapses and internal replacements are excessive, or the life insurance entity has a concentrated book of business in products that allow for immediate and significant surrenders.
- m. Significant changes have occurred in the entity's reinsurance programs, retention limits, or availability or cost of reinsurance.
- n. There are significant contracts with reinsurers whose financial strength is in doubt.
- o. The life insurance entity depends on a limited number of agents or brokers to generate new business.
- p. Internal or external circumstances raise substantial doubt about the life insurance entity's ability to continue as a going concern.
- q. Significant issues emerge that may adversely affect mortality or morbidity expectations and claims levels.

**5.23 Engagement characteristics.** The following characteristics pertaining to an engagement may signal increased inherent risk:

- a. Contentious or difficult accounting issues are present.
- b. The number and complexity of contract types have increased.
- c. The number or amounts of adjustments in prior periods have been significant, including significant deficiencies or material weaknesses.
- d. The life insurance entity has noninsurance subsidiaries such as finance entities, joint ventures, and mutual funds.
- e. The life insurance entity is significantly involved in international business that exposes it to many different regulatory authorities and accounting models.

### *Control Risk*

**5.24** *Control risk* is the risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.

### *Detection Risk*

**5.25** *Detection risk* is the risk that the auditor will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor does not examine 100 percent of an account balance or a class of transactions and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results. For a given level of audit risk, detection risk should bear an inverse relationship to the risk of material misstatement at the relevant assertion level. As the auditor's assessment of the risk of material misstatement decreases, the detection risk that the auditor can accept increases correspondingly.

### *Additional Audit Risk Considerations*

**5.26** The auditor should consider statutory calculated risk-based capital (RBC) in the planning stage of the audit when assessing risk. The auditor should obtain and review the entity's RBC reports and should understand the instructions and the actual regulations associated with RBC and the preparation of the reports. See paragraphs 5.44–.47 for discussion of the auditor's consideration of RBC for life insurance entities.

### *Planning Materiality*

**5.27** The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

**5.28** In accordance with paragraph .27 of AU section 312 (AICPA, *Professional Standards*), the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall strategy for the audit. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole.

#### *Considerations for Integrated Audits*

When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 20 of Auditing Standard No. 5 regarding materiality considerations.

### ***Tolerable Misstatement***

**5.29** The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Paragraph .34 of AU section 312 (AICPA, *Professional Standards*) defines *tolerable misstatement* (or *tolerable error*) as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

### ***Qualitative Aspects of Materiality***

**5.30** As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

**5.31** Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 (AICPA, *Professional Standards*) provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

### ***Use of Service Organizations***

**5.32** When planning and performing an audit of an entity that uses a service organization to process transactions, transactions that affect the user organization's financial statements are subjected to controls that are, at least in part, physically and operationally separate from the user organization. AU section 324, *Service Organizations* (AICPA, *Professional Standards*),<sup>5</sup> provides guidance on the factors and clarifies applicability that an independent auditor should consider when auditing the financial statements of an entity that obtains services from another organization that are part of its information system. The significance of the controls of the service organization to those of the user organizations depends on the nature of the services provided by the service organization, primarily the nature and materiality of the transactions it processes for the user organization and the degree of interaction between its activities and those of the user organization. To illustrate how the degree of interaction affects user organization controls, when the user organization initiates transactions and the service organization executes and does the accounting processing of those transactions, there is a high degree of interaction

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<sup>5</sup> The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, includes illustrative control objectives as well as interpretations that address responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers. Additionally, AU section 324, *Service Organizations* (AICPA, *Professional Standards*), amends Statement on Auditing Standards (SAS) No. 70 to expand subsequent event guidance with respect to audit responsibilities and management representations.

between the activities at the user organization and those at the service organization. In these circumstances, it may be practicable for the user organization to implement effective controls for those transactions. However, when the service organization initiates, executes, and does the accounting processing of the user organization's transactions, there is a lower degree of interaction, and it may not be practicable for the user organization to implement effective controls for those transactions.

#### *Considerations for Integrated Audits*

Note that when conducting an audit in accordance with PCAOB standards, when assessing a service organization's controls and how they interact with a user organization's controls, the user auditor may become aware of the existence of certain deficiencies. In such cases, the user auditor should consider the guidance provided in paragraphs 78–84 in Auditing Standard No. 5. Additionally, when conducting an integrated audit, refer to paragraphs B17–B27 of appendix B, "Special Topics," of Auditing Standard No. 5 regarding the use of service organizations.

## Use of Assertions in Obtaining Audit Evidence

**5.33** Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

### Categories of Assertions

<i>Description of Assertions</i>			
	<i>Classes of Transactions and Events During the Period</i>	<i>Account Balances at the End of the Period</i>	<i>Presentation and Disclosure</i>
Occurrence/Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.

(continued)

	<i>Description of Assertions</i>		
	<i>Classes of Transactions and Events During the Period</i>	<i>Account Balances at the End of the Period</i>	<i>Presentation and Disclosure</i>
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Under-standability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

**5.34** The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity, Its Environment, and Its Internal Control

**5.35** AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), establishes requirements and provides guidance about implementing the second standard of field work, as follows:

The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

**5.36** Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this

process, the auditor should also consider the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*).

**5.37** This section addresses the unique aspects of life and health insurance entities that may be helpful in developing the required understanding of the entity, its environment, and its internal control.

## Risk Assessment Procedures

**5.38** As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

**5.39** In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

- a. Inquiries of management and others within the entity
- b. Analytical procedures
- c. Observation and inspection

See paragraphs .06–.13 of AU section 314 for additional guidance on risk assessment procedures.

## Discussion Among the Audit Team

**5.40** In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 (AICPA, *Professional Standards*) to discuss the susceptibility of the entity's financial statements to fraud.

## Understanding of the Entity and Its Environment

**5.41** AU section 314 requires auditors to obtain an understanding of the entity and its environment, including its internal control. In accordance with paragraph .04 of AU section 314, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (a) to assess risks of material misstatement of the financial statements and (b) to design and perform further audit procedures (tests of controls and substantive tests).

**5.42** The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- a. Industry, regulatory, and other external factors
- b. Nature of the entity
- c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- d. Measurement and review of the entity's financial performance
- e. Internal control, which includes the selection and application of accounting policies (see subsequent section for further discussion)

Refer to appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (a)–(d).

**5.43** The next section discusses some unique characteristics of life and health insurance entities that the auditor would generally consider when obtaining an understanding of the entity and its environment in order to assess the risks of material misstatement.

### ***The Auditor's Consideration of Statutory Risk-Based Capital for Life Insurance Entities***

**5.44** Life insurance entities operate in a highly regulated environment. The regulation of life insurance entities is directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the life insurance system. One of the primary tools used by state insurance departments for ensuring that those objectives are being achieved is RBC.

**5.45** Regulators of life insurance entities have historically focused on capital. The National Association of Insurance Commissioners (NAIC) requires life insurance entities to disclose RBC in their statutory filings. The RBC calculation serves as a benchmark for the regulation of life insurance entities' 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 the following four general kinds of risk:

- a. The risk related to the insurer's assets (asset or default risk)
- b. The risk of adverse insurance experience with respect to the insurer's liabilities and obligations (insurance or underwriting risk)
- c. The interest rate risk from the insurer's business (asset/liability matching)
- d. All other business risks (management, regulatory action, and contingencies)

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

**5.46** RBC requirements establish a framework for linking various levels of regulatory corrective action to the relationship of a life insurance entity's total adjusted capital (equal to the sum of statutory capital and surplus and



such other items, if any, as the NAIC's RBC instructions<sup>6</sup> may provide) to the calculated ACL. The levels of regulatory action, the trigger point, and the corrective actions are summarized in paragraphs 4.08–.11.

**5.47** Because of the importance of RBC to life insurance entities, RBC should be considered in assessing the risks of material misstatement. 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.

### **Information Processing<sup>7</sup>**

**5.48** Because of the large number of transactions and the need to maintain accountability for individual contracts, most life insurance entities use some form of IT to maintain statistical and accounting records. Typically, contract master files (also referred to as *inforce files*), and agent master files are maintained on computerized systems. Examples of other common applications are benefit and claim liabilities, mortgage and securities records, premium billings, policy loans, investments, payroll, accounts payable, property and equipment records, and general ledger.

**5.49** The sophistication of a life insurance entity's IT systems is often a factor in an entity's ability to compete because it affects its ability to service insureds and introduce new products. The IT operations may be characterized by one or several large installations, the extensive use of telecommunications equipment (including direct access by agents and insureds), service bureau processing, and integrated data bases and operating systems that lack traditional audit trails.

**5.50** Although the use of IT systems does not affect the objectives of the audit, they affect the way the audit is planned and executed. However, the organizational and control procedures may differ from those used in manual data processing, and audit procedures applied to accounting records maintained on IT equipment may vary from those applied to records maintained manually.

### **Understanding of Internal Control<sup>8</sup>**

**5.51** AU section 314 states that the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to

- a. evaluate the design of controls relevant to an audit of financial statements and
- b. determine whether they have been implemented.

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<sup>6</sup> The NAIC's risk based capital (RBC) instructions may be amended by the NAIC from time to time in accordance with procedures adopted by the NAIC.

<sup>7</sup> AU section 324 provides guidance to auditors in auditing the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically.

<sup>8</sup> For additional nonauthoritative guidance pertaining to internal control and the risk assessment standards (SAS Nos. 104–111 [AICPA, *Professional Standards*]), refer to Technical Questions and Answers (TIS) sections 8200.05–.16 (AICPA, *Technical Practice Aids*) issued in March and April 2008.

**5.52** The auditor should use the understanding to

- identify types of potential misstatements,
- consider factors that affect the risks of material misstatement, and
- design tests of controls, when applicable, and substantive procedures.

**5.53** Obtaining an understanding of controls should be distinguished from testing the operating effectiveness of controls. The objective of obtaining an understanding of controls is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

**5.54** Paragraph .41 of AU section 314 defines internal control as "a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations." Internal control consists of five interrelated components:

- a. The control environment
- b. Risk assessment
- c. Information and communication systems
- d. Control activities
- e. Monitoring

Refer to paragraphs .40–.101 of AU section 314 for a detailed discussion of the internal control components.

**5.55** Certain characteristics of internal control, particularly in the control environment, may be unique to life insurance entities. AU section 314 states that auditors should obtain a sufficient knowledge of the control environment to understand the attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should consider both the substance of controls and their collective effect.

*Considerations for Integrated Audits*

Note that for an integrated audit, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, PCAOB Standards and Related Rules, Interim Standards]). Also refer to paragraph 54 of Auditing Standard No. 5 for a discussion on the extent of tests of controls and to paragraphs 52–53 of Auditing Standard No. 5 regarding the timing of tests of controls.

Additionally, when performing an integrated audit in accordance with PCAOB standards, paragraphs .65 and .83 of AU section 319 state that if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the

reasons for that conclusion. Paragraph .83 of AU section 319 also states that accordingly, if control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion.

### ***Use of Information Technology***

**5.56** An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. AU section 314 states that, in obtaining an understanding of internal control sufficient to assess the risk of material misstatement, the auditor considers how an entity's use of IT and manual procedures may affect controls relevant to the audit. Information technology encompasses automated means of originating, processing, storing, and communicating information, and includes recording devices, communication systems, computer systems, and other electronic devices. The auditor is primarily interested in the entity's use of IT to initiate, authorize, record, process, and report transactions or other financial data. An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. Life insurance entities have been leading users of advanced information technologies, and the control issues involving IT merit considerable attention.

**5.57** This guide does not address the major effects of IT on an audit. Guidance on auditing records for which IT is a significant factor is contained in the following:

- a. AU section 314
- b. AU section 324<sup>9</sup>
- c. *AICPA Audit Guide Assessing and Responding to Audit Risk in a Financial Statement Audit*

Other nonauthoritative guidance on auditing IT records is contained in the following AICPA Auditing Procedures Studies:

- a. Audit Implications of Electronic Data Interchange
- b. Auditing With Computers

## **Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures**

**5.58** As discussed previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environment, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides

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<sup>9</sup> The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*, includes illustrative control objectives as well as interpretations that address responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers. AU section 324 expands subsequent event guidance with respect to audit responsibilities and management representations.

guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

## Assessing the Risks of Material Misstatement

**5.59** Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

- a. identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements,
- b. relate the identified risks to what can go wrong at the relevant assertion level,
- c. consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements, and
- d. consider the likelihood that the risks could result in a material misstatement of the financial statements.

**5.60** The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

## Identification of Significant Risks

**5.61** As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. Refer to paragraphs .45 and .53 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), for further audit procedures pertaining to significant risks.

## Designing and Performing Further Audit Procedures

**5.62** Paragraph .01 of AU section 318 provides guidance about implementing the third standard of field work, as follows:

The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

**5.63** To reduce audit risk to an acceptably low level, the auditor (a) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (b) should design and perform further audit procedures whose nature, timing, and extent are responsive to the

assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risks of material misstatement.

### **Overall Responses**

**5.64** The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date.

### **Further Audit Procedures**

**5.65** Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing, and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risks of material misstatement at the relevant assertion level. In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach. Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

**5.66** The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. When, in accordance with paragraph .117 of AU section 314, the auditor has determined that it is not possible or practicable to reduce the detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion.

**5.67** Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period

under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

**5.68** Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

**5.69** The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records; and
- Examining material journal entries and other adjustments made during the course of preparing the financial statements.

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

## Evaluating Misstatements

**5.70** Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. Paragraph .42 of AU section 312 (AICPA, *Professional Standards*) states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial and communicate them to the appropriate level of management. Paragraph .50 of AU section 312 (AICPA, *Professional Standards*) further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.

**5.71** For detailed guidance on evaluating audit findings and audit evidence, refer to AU sections 312 and 326, respectively.

## Additional Audit Considerations

### Analytical Procedures<sup>10</sup>

**5.72** Analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible

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<sup>10</sup> The AICPA Audit Guide *Analytical Procedures* provides practical guidance to auditors on the effective use of analytical procedures. This Audit Guide includes a discussion of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), concepts and definitions, a series of questions and answers, and a case study illustrating trend analysis, ratio analysis, reasonableness testing, and regression analysis.

relationships among both financial and nonfinancial data. A basic premise underlying the application of analytical procedures is that it is reasonable to assume that plausible relationships among data exist and continue in the absence of known conditions to the contrary. Variations in these relationships may be caused by particular conditions such as unusual transactions or events, accounting changes, material business changes, random fluctuations, or misstatements.

**5.73** AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits. The purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions. To accomplish this, the analytical procedures should focus on (a) enhancing the auditor's understanding of the client's business and the transactions and events that have occurred since the last audit date, and (b) identifying areas that may represent specific risks relevant to the audit. Thus, the objective of the procedures is to identify such things as the existence of unusual transactions and events, as well as amounts, ratios, and trends that might indicate matters that have financial statement and audit planning ramifications. Also, in accordance with paragraph .09 of AU section 314, the auditor should also apply analytical procedures in planning the audit to assist in understanding the entity and its environment and to identify areas that may represent specific risks relevant to the audit. For example, analytical procedures may be helpful in identifying the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. Refer to paragraphs 5.38–39 for general guidance on risk assessment procedures.

**5.74** Analytical procedures may be effective and efficient tests for assertions even though an examination of detailed evidence fails to disclose potential misstatements, or detailed evidence is not readily available. Examples of sources of information for developing analytical expectations include prior-period financial information, Insurance Regulatory Information System ratio analysis (see paragraph 1.48), and rating agency reports. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), added documentation requirements when an analytical procedure is used as the principal substantive test of a significant financial statement assertion. AU section 339, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules, Interim Standards*), provides documentation guidance for audits performed in accordance with PCAOB standards.

**5.75** Examples of analytical procedures the auditor may find useful in planning or as a substantive procedure in an audit of a life insurance entity are as follows:

- a. Comparison of account balances with budget and prior period amounts
- b. Analysis of changes between periods for reinsurance activity, underwriting standards, reserve methodologies, and other related factors
- c. Analysis of related economic factors such as interest rate fluctuations

- d. Comparison, between periods, of the following:
- i. New business premiums and renewal premiums
  - ii. Amounts and kinds of insurance in force
  - iii. Contract counts
  - iv. Average premium per unit in force
  - v. Geographical concentration of revenues and assets
  - vi. Source of revenue by agent, broker, or other distribution system
  - vii. Investment income and yield comparison by asset category
  - viii. Composition of asset portfolio
  - ix. Benefits expense incurred to premiums collected for traditional life products
  - x. Assets and troubled assets to surplus ratio
  - xi. SAP to U.S. GAAP benefit and claim liabilities
  - xii. Taxes to pretax income
  - xiii. Capitalized costs to first year premium
  - xiv. Relationship between periods of replacement, lapse, reinstatement, and policy loan activity
  - xv. Premiums, related commission amounts, and operating expenses
  - xvi. Suspense account activity, ending balances, and aging of individual items

**5.76** The risk of management override of controls is an important consideration when designing substantive analytical procedures. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. In addition, before using results obtained from substantive analytical procedures, the auditor may either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.

*Considerations for Integrated Audits*

For integrated audits, paragraphs B6–B9 of appendix B of Auditing Standard No. 5 provides guidance on the effect of tests of controls on substantive procedures, including analytical procedures.

## Accounting Estimates

**5.77** In determining the scope of audit procedures to be performed, the auditor may recognize that as a result of the long-term nature of the products sold, certain areas of a life insurance entity's operations require accounting estimates that may be material in the preparation and presentation of financial statements. These areas may include, but are not limited to, benefit liabilities, claim liabilities, participating dividends, deferred acquisition costs (DAC) and related amortization, valuation of real estate and mortgage loan portfolios, and



income taxes. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), provides guidance on obtaining and evaluating sufficient appropriate audit evidence to support significant accounting estimates.

**5.78** In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate by using various approaches.

*Considerations for Integrated Audits*

When performing an integrated audit, in evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

- 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 the date of the auditor's report.

**Note:** When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.

(Paragraph .10 of AU section 342, *Auditing Accounting Estimates* [AICPA, *PCAOB Standards and Related Rules*, Interim Standards].)

## Use of Specialists

**5.79** The operations of life insurance entities can be quite complex, and in certain instances, the auditor will use the work of a specialist as an audit procedure to obtain sufficient appropriate audit evidence. Examples of such specialists might include actuaries, appraisers, attorneys, financial instrument valuation specialists, and IT specialists. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance to the auditor who uses the work of a specialist in performing the audit of financial statements.

## Nonattest Services

**5.80** Prohibitions and restrictions exist related to the performance of nonaudit services for audit clients, including actuarial services. Practitioners should be aware of and comply with these prohibitions and restrictions, including the AICPA independence rules (Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* [AICPA, *Professional Standards*, ET sec. 101 par. .05]), SEC independence rules, PCAOB independence rules, as well as rules passed by the Government Accountability Office, state licensing boards, and others. The NAIC adopted changes to the Annual

Financial Reporting Model Regulation (Model Audit Rule) related to Sarbanes-Oxley during its fall 2006 meeting, with the majority of the changes effective for 2010. Section 7, *Qualifications of the Independent Certified Public Accountant*, of the revised Model Audit Rule addresses what types of accounting and actuarial services the auditing firm is prohibited from providing.

### **Auditing Actuarially Determined Accounting Estimates**

**5.81** Actuarially determined accounting estimates may affect many elements of the financial statements of life and health insurance entities. Actuarially determined estimates that are usually significant to life and health insurance entities include benefit and claim liabilities and DAC and related amortization.

**5.82** *Use of specialists by management in making actuarially determined estimates.* Management is responsible for making the accounting estimates included in the financial statements. The process of estimating actuarially determined amounts, such as benefit and claim liabilities, DAC, and related amortization, is complex and involves many subjective judgments. Accordingly, the determination of such amounts should involve a qualified actuary with a sufficient level of competence and experience, including knowledge about the kinds of insurance for which liabilities are being estimated and an understanding of appropriate methods available for calculating the estimates. The actuary's qualification obligations are established by the *Code of Professional Conduct and Qualification Standards For Prescribed Statements of Actuarial Opinion* of the American Academy of Actuaries. The actuary's competence and experience should be commensurate with the complexity of the entity's business, which is affected by such factors as the kinds of contracts underwritten and the environment and risk considerations described in previous chapters in this guide.

**5.83** Many life insurance entities use actuaries who are employees or officers of the entity. In addition, many entities engage consulting actuaries to either assist in the determination of the benefit and claim liability estimates or to perform a separate review of the entity's benefits and claim liability estimates as well as other material actuarially determined amounts. The scope of work performed by the consulting actuary is a matter of judgment by the entity's management. Usually, the consulting actuary will issue a report summarizing the nature of the work performed and the results. The Annual Statement requires a *Statement of Actuarial Opinion*. The AICPA has issued a notice to practitioners, *Auditor's Responsibility Concerning Statement of Actuarial Opinion Required by Insurance Regulators*, which provides guidance on this subject.

**5.84** Because the process of determining benefit and claim liabilities as well as DAC and related amortization is based on actuarial principles and methods, the absence of involvement by a qualified actuary in the determination of management's estimates of these amounts may constitute a control deficiency and more, specifically, possibly a material weakness in the entity's internal control. See further discussion on the auditor's responsibility to communicate control deficiencies later in the chapter.

**5.85** *Use of specialists by auditors in evaluating actuarially determined estimates.* It is the auditor's responsibility to evaluate the reasonableness of the actuarially determined amounts established by management. The procedures that the auditor should consider in evaluating the reasonableness of

such amounts are described in AU section 342. Because of the significance of actuarially determined estimates to the financial statements of life and health insurance entities, the complexity and subjectivity involved in making such estimates, and because the process of determining these liabilities is based on actuarial principles and methods, the audit of such amounts requires the use of an outside qualified actuary, that is, one who is neither an employee nor an officer of the entity. If the auditor is a qualified actuary, he or she need not use the work of an outside qualified actuary. If the auditor does not possess the level of competence in actuarial methods to qualify as an actuary, the auditor should use the work of an outside qualified actuary.

**5.86** In accordance with AU section 336, whenever the auditor uses the work of a specialist such as an outside qualified actuary, the auditor should fulfill certain fundamental requirements. The auditor should satisfy himself or herself concerning the professional qualifications and reputation of the specialist. The auditor should consider the relationship, if any, of the outside qualified actuary to the entity whose financial statements are being audited. An understanding should be established between the auditor, the entity whose financial statements are being audited, and the outside qualified actuary as to the scope and nature of the work to be performed by the outside qualified actuary and the form and content of the outside qualified actuary's report. If the auditor is not a qualified actuary, the auditor has the responsibility to obtain an understanding of the methods and assumptions used by the outside qualified actuary to determine whether the findings of the outside qualified actuary are suitable for corroborating representations in the financial statements.

**5.87** The auditor may obtain the following:

- a. A written report from the outside qualified actuary who calculated or verified the benefit and claim liabilities
- b. A written representation from the in-house qualified actuary, as appropriate, just as he or she would obtain letters from counsel on legal matters and other representations from management on various matters

**5.88** The following are descriptions of situations involving the presence or absence of a qualified actuary in management's determination of benefit and claim liabilities, DAC and related amortization, and other material actuarially determined amounts and the recommended response by the auditor to each situation. The guidance in AU section 336 should be followed in each situation.

**Situation 1.** The entity has no qualified actuaries involved in the determination of benefit and claim liabilities, deferred acquisition costs and related amortization, or other material actuarially determined amounts.

**Auditor response.** As stated in paragraph 5.84, this situation may constitute a control deficiency and more, specifically, possibly a material weakness in the internal control. The auditor may be required to use an outside qualified actuary. See paragraph 5.80 for guidance about the performance of nonaudit services by auditors.

**Situation 2.** The entity has an in-house qualified actuary who is involved in the determination of benefit and claim liabilities, deferred acquisition costs and related amortization, or other material actuarially

determined estimates, and the entity does not use an outside qualified actuary.

**Auditor response.** The auditor would be required to use an outside qualified actuary, unless the auditor was a qualified actuary or had one on staff, to evaluate the reasonableness of the entity's material actuarially determined estimates.

**Situation 3.** The entity has no in-house qualified actuaries but involves an outside qualified actuary in the determination of benefit and claim liabilities, deferred acquisition costs and related amortization, or other material actuarially determined estimates.

**Auditor response.** The auditor should evaluate the extent to which the outside qualified actuary has served as a preparer in the determination of benefit and claim liabilities, deferred acquisition costs, or other material actuarially determined amounts. If the outside qualified actuary has prepared or assisted in the preparation of a matter that is material to the financial statements, and the auditor intends to use the outside qualified actuary's work, then the auditor should perform additional procedures with respect to some or all of the specialist's assumption, methods, or findings to determine that the findings are not unreasonable or should use an outside specialist for that purpose.

**Situation 4.** The entity involves an in-house qualified actuary in the determination of benefit and claim liabilities, deferred acquisition costs and related amortization, or other material actuarially determined amounts. The entity engages an outside qualified actuary to separately review those estimates.

**Auditor response.** The auditor could use the separate review performed by the outside qualified actuary.

## Use of Internal Auditors<sup>11</sup>

**5.89** If the life insurance entity has an internal audit function, the auditor should obtain a sufficient understanding of the internal audit function when obtaining an understanding of the internal control, to identify those activities that are relevant to planning the audit. If the auditor will be considering the work of, or receiving direct assistance from, the entity's internal auditors, guidance is provided in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*).

### *Considerations for Integrated Audits*

Additionally, when performing an integrated audit, refer to paragraphs 16–19 of Auditing Standard No. 5 for discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

## Audit Reports

**5.90** The decision about the appropriate form of audit report to issue in particular circumstances is often derived by a complex judgment that requires

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<sup>11</sup> See footnote 1 in the heading above paragraph 5.03.

considerable professional experience. The auditor may have to communicate with the regulator to assist with his or her assessment. See chapter 15, "Reports on Audited Financial Statements," for illustrative audit reports. Auditors of publicly held life insurance entities should consider the SEC's Financial Reporting Release No. 16, *Rescission of Interpretation Relating to Certification of Financial Statements*, which states, "... filings containing accountant's reports that are qualified as a result of questions about the entity's ability to continue existence must contain appropriate and prominent disclosure of the registrant's financial difficulties and viable plans to overcome these difficulties."

## Audit Documentation—Audits Conducted in Accordance With GAAS

**5.91** AU section 339 (AICPA, *Professional Standards*), superseded Statement on Auditing Standards (SAS) No. 96, *Audit Documentation*, and amended SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, AU sec. 530).

**5.92** As noted in AU section 339 (AICPA, *Professional Standards*), the auditor should prepare and maintain<sup>12</sup> audit documentation, the form and content of which should be designed to meet the circumstances of the particular audit engagement. Audit documentation is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment.

**5.93** AU section 339 (AICPA, *Professional Standards*) states that audit documentation serves mainly to

- a. provide the principal support for the auditor's report, including the representation regarding observance of the standards of fieldwork, which is implicit in the reference in the report to GAAS and<sup>13</sup>
- b. aid the auditor in the conduct and supervision of the audit.

**5.94** Paragraph .05 of AU section 339 (AICPA, *Professional Standards*) describes audit documentation as the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as *working papers* or *workpapers*, may be recorded on paper, electronically, or on other media. It is important that when transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document. Additionally, paragraph .06 of AU section 339 (AICPA, *Professional Standards*) states that examples of audit documentation include for example, audit plans,<sup>14</sup> analyses, issues, memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of work

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<sup>12</sup> TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), clarifies the completion and retention status of current year audit documentation contained in the permanent file.

<sup>13</sup> However, there is no intention to imply that the auditor would be precluded from supporting his or her report by other means in addition to audit documentation.

<sup>14</sup> See AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), for guidance regarding preparation of audit plans.

the auditor performed or commentaries prepared or obtained by the auditor. Audit documentation may be in paper form, electronic form, or other media.

**5.95** Audit documentation should be sufficient to (a) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained;<sup>15</sup> (b) indicate the engagement team member(s) who performed and reviewed the work; and (c) show that the accounting records agree or reconcile with the financial statements or other information being reported on.

**5.96** Paragraph .03 of AU section 339 (AICPA, *Professional Standards*) states that the auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusion reached. Audit documentation

- a. provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally acceptable auditing standards; and
- b. provides that principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

**5.97** Paragraph .23 of AU section 339 (AICPA, *Professional Standards*) to provide that the auditor's report date should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion. Among other matters, sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that it has taken responsibility for them. This ordinarily will result in a report date that is close to the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements (report release date). Delays in releasing the report may require the auditor to perform additional procedures to comply with the requirements of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*).<sup>16</sup>

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<sup>15</sup> A firm of independent auditors has a responsibility to adopt a system of quality control policies and procedures to provide the firm with reasonable assurance that its personnel comply with applicable professional standards, including generally accepted auditing standards, and the firm's standards of quality in conducting individual audit engagements. Review of audit documentation and discussions with engagement team members are among the procedures a firm performs when monitoring compliance with the quality control policies and procedures that it has established. (Also, see AU section 161, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* [AICPA, *Professional Standards*].)

<sup>16</sup> AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), will result in the extension of the auditor's report date to be closer to the Statutory Accounting report release date. The NAIC amended Statements of Statutory Accounting Principles No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses* to state:

Changes in estimates of the liabilities for unpaid claims or losses and loss/claim adjustment expenses resulting from the continuous review process between the March 1 filing deadline of the Annual Statement and the June 1 filing deadline for the audited financial statements are considered a change in estimate and shall be recorded in the statement of operations in the period the change becomes known.

(continued)

**5.98** As discussed in paragraph .04 of AU section 339 (AICPA, *Professional Standards*), audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit. The standard includes additional requirements related to the following topics that should be complied with

- content, ownership, extent, and confidentiality,
- significant findings and issues,
- identification of preparer and reviewer,
- documentation of specific items tested,
- documentation of departures from statements on auditing standards, and
- revisions to audit documentation.

Appendix A of AU section 339 (AICPA, *Professional Standards*) lists the audit documentation requirements contained in other areas of AICPA professional standards.

In addition, the practitioner may refer to AICPA, applicable government, and individual state licensing board requirements.

## **Audit Documentation—Audits Conducted in Accordance With PCAOB Standards**

**5.99** For audits conducted in accordance with PCAOB Standards, Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), superseded SAS No. 96 and establishes general requirements for documentation the auditor should prepare and retain in connection with engagements conducted pursuant to PCAOB standards. Audit documentation is the written record of the basis for the auditor's conclusions that provides the support for the auditor's representations, whether those representations are contained in the auditor's report or otherwise. Audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. Among other things, audit documentation includes records of the planning and performance of the work, the procedures performed, evidence obtained, and conclusions reached by the auditor.

**5.100** The auditor must prepare audit documentation in connection with each engagement conducted pursuant to the standards of the PCAOB. Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation should be appropriately organized to provide a clear link to the

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(footnote continued)

Additionally, the AICPA Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290), provides guidance to auditors of nonissuers regarding the application of certain AU section 339 (AICPA, *Professional Standards*) provisions, primarily relating to dating the auditor's report. The practice alert provides guidance with respect to the audit report date, evidence surrounding financial statement amounts and disclosures (including attorney letters, obtaining waivers and subsequent event evaluation), and financial statement preparation and management's assertions.

significant findings or issues. Examples of audit documentation include memoranda, confirmations, correspondence, schedules, audit plans, and letters of representation. Audit documentation may be in the form of paper, electronic files, or other media.

**5.101** As required by Sarbanes-Oxley the SEC rule *Retention of Records Relevant to Audits and Reviews* (SEC Release No. 33-8180), requires accounting firms to retain for seven years certain records relevant to their audits and reviews of issuers' financial statements. These records include workpapers and other documents that form the basis of the audit or review, and memoranda, correspondence, communications, other documents, and records (including electronic records), created, sent or received in connection with the audit or review, and contain conclusions, opinions, analyses, or financial data related to the audit or review. Auditing Standard No. 3 adopted this requirement and provides additional guidance on documentation of specific matters, and retention of and subsequent changes to audit documentation.<sup>17</sup>

**5.102** Auditing Standard No. 3 requires that in addition to the documentation requirements of AU section 339 (AICPA, *Professional Standards*), the auditor should document certain items related to their audit of internal control over financial reporting.

## Auditing Fair Value Measurements and Disclosures

**5.103** Fair value measurements of assets, liabilities, and components of equity may arise from both the initial recording of transactions and later changes in value. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, discussed are the following:

- Understanding the entity's process for determining fair value measurements and disclosures and the relevant controls, and assessing risk
- Evaluating conformity of fair value measurements and disclosures with GAAP
- Engaging the use of a specialist
- Testing the entity's fair value measurements and disclosures
- Disclosures about fair values
- Evaluating the results of audit procedures
- Management representations
- Communication with audit committees or others charged with governance

**5.104** Evidence obtained outside the scope of AU section 328 also may provide relevant information in regards to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset

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<sup>17</sup> If work papers support the audit of statutory financial statements, the retention period may be longer due to state requirements. Section 13 of the NAIC revised Model Audit Rule requires that the insurer require that the accountant retain the audit workpapers and communications until the insurance department has filed a report on examination covering the period of the audit, but no longer than seven years from the date of the audit report.



measured at fair value may provide relevant evidence about its valuation. Additionally, U.S. GAAP requires or permits a variety of fair value measurements and disclosures and varies in the level of measurement guidance it provides.

**5.105** AU section 328 provides overall guidance on auditing fair value measurements and disclosures. It does not, however, provide guidance on auditing specific assets, liabilities, components of equity, transactions, or industry-specific practices. That guidance will be developed in the future and is available in other standards, such as in AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*).

**5.106** Additionally, auditors can refer to Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 (AICPA, *Professional Standards*, AU sec. 9328 par. .01–.04) and Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 (AICPA, *Professional Standards*, AU sec. 9332 par. .01–.04), respectively.<sup>18</sup> These interpretations clarify that simply receiving a confirmation from a third party (including a trustee) does not in and of itself constitute adequate audit evidence with respect to the valuation assertion of interests in trusts or investments in securities. The interpretations also reiterate the responsibility of management to institute accounting and financial reporting processes for the determination of fair value measurements. According to the interpretations, if the auditor is unable to audit the existence or measurement of interests in investments in securities at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to qualify his or her opinion or disclaim an opinion.<sup>19</sup>

## Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule

**5.107** The NAIC's *Annual Statement Instructions Requiring Annual Audited Financial Report*, which incorporates the *January 1991 Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in October 1998) (herein after called the Model Audit Rule), requires auditors to communicate in a certain form and content with state insurance regulators. Though some states have laws or regulations that differ from the Model Audit Rule, this guide addresses only the requirements of the Model Audit Rule. The NAIC adopted revisions to the Model Regulation in June 2006 that considered certain provisions of Sarbanes-Oxley. Highlights of the significant changes to the current Model Audit Rule related to Sarbanes-Oxley include the following:

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<sup>18</sup> These interpretations were issued in 2005, subsequent to PCAOB adoption of AICPA standards as interim, on April 16, 2003.

<sup>19</sup> Additionally, the auditor can refer to nonauthoritative publications. The AICPA issued a practice aid titled *Alternative Investments Audit Considerations—A Practice Aid for Auditors* located at [www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/DownloadableDocuments/Alternative.Investments.Practice.Aid.pdf](http://www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/DownloadableDocuments/Alternative.Investments.Practice.Aid.pdf). This practice aid addresses challenges associated with auditing investments for which a readily determinable fair value does not exist. Additionally, the AICPA has issued an auditor's toolkit titled *Auditing Fair Value Measurements and Disclosures: Allocations of the Purchase Price Under FASB Statement of Financial Accounting Standards No. 141, Business Combinations, and Tests of Impairment Under FASB Statements No. 142, Goodwill and Other Intangible Assets, and No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets*.

- *Section 7:* The time allowed to serve in the capacity as the lead or coordinating audit partner was decreased from seven years to five consecutive years with a new five year break in service (previously two years), effective beginning with year 2010 statutory audits.
- *Section 7:* A list of nonaudit services that cannot be performed by the auditor (the prohibitions generally agree with those designated by the SEC), effective for the year 2010 statutory audits.
- *Section 11:* Auditors should prepare a written communication of any unremediated material weaknesses that the insurer will furnish the domiciliary commissioner, effective beginning with year 2010 statutory audits. The previous Model Audit Rule required the auditor to prepare a report of significant deficiencies and material weaknesses in the insurer's internal control structure noted by the auditor during the audit.
- *Section 14:* New specifications for the responsibilities of audit committees and the required qualifications of audit committee members is effective January 1, 2010. The adopted revisions require that insurance entities have an audit committee that is solely responsible for the appointment, compensation, and oversight of the entity's auditor. The guidance also indicates that some audit committees, based on the insurer's premium volume, would need to comprise a certain percentage of individuals who are independent from management.
- *Section 16:* Every insurer required to file an audited financial report that has an annual direct written and assumed premium of \$500 million or more shall prepare a report of the insurers' or group of insurers' internal control over financial reporting and file it with their insurance commissioner, effective December 31, 2010. The Model Audit Rule also includes a list of what should be included in management's report on internal control over financial reporting. This report is prepared by management and is not audited.
- *Section 17:* An insurer may make written application to the commissioner for waiver from any or all provisions of the model based upon financial or organizational hardship. For example, the commissioner could, under this section, grant a waiver of the Section 14B audit committee independence requirements to an entity exceeding the \$500 million premium threshold, even though the Section 14H waiver would not apply. This exemption is granted at the discretion of the commissioner and may be granted at any time for a specified period or periods.

**5.108 Awareness.** Section 6 of the revised 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 CPA, 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; and
- b. will issue a report on the financial statements in the terms of their conformity to the SAP prescribed or otherwise permitted by the

insurance department of the state of domicile, specifying exceptions as appropriate. See exhibit 5-1.

In addition, certain states require additional assertions. For most states, the awareness letter is only required to be filed once, in the first year engaged to perform the audit (within 60 days of becoming subject to the rules). The filing deadline for most states is December 31 of the year being audited. A few states require a letter to be filed annually. Some states have more specific requirements regarding contracts, licensure, and rules of domicile. Practitioners should check individual state regulations for the complete requirements of that state.

**5.109 *Change in auditor.*** Section 6 of the revised Model Audit Rule requires that insurers notify the insurance department of the state of domicile within 5 business days of the dismissal or resignation of the auditor for the immediately preceding filed audited statutory financial statements. Within 10 business days of that notification, the insurer also is required to provide a separate letter stating whether, in the 24 months preceding the 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 revised 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. The disagreements required to be reported in response to this section include both those resolved to the former accountant's satisfaction and those not resolved to the former accountant's satisfaction. Disagreements contemplated by this section are those that occur at the decision-making level, that is, between personnel of the insurer responsible for presentation of its financial statements and personnel of the accounting firm responsible for rendering its report. The insurer should also in writing request the former accountant to furnish a letter addressed to the insurer stating whether the accountant agrees with the statements contained in the insurer's letter and, if not, stating the reasons for which he or she does not agree; and the insurer should furnish the responsive letter from the former accountant to the commissioner together with its own. See exhibit 5-2, "Illustration of the Change in Auditor Letter."

**5.110 *Qualifications.*** Section 12 of the revised 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 of Professional Conduct and pronouncements of the AICPA and the Rules of Professional Conduct of the appropriate state board of public accountancy;<sup>20</sup>

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<sup>20</sup> A member performing an attest engagement must be *independent* pursuant to Rule 101 of the AICPA Code of Professional Conduct. Other applicable independence rules and regulations may also apply to members and accountants while performing attest engagements (for example, SEC, PCAOB, GAO, state licensing boards).

- b. the background and experience in general of the individuals used for an engagement and whether each is a certified public accountant. Nothing within this regulation shall be construed as prohibiting the auditor from utilizing such staff as he or she deems appropriate where use is consistent with the standards prescribed by GAAS;
- c. the auditor understands that the annual audited statutory financial statements and his or her opinion thereon will be filed in compliance with the requirements of the revised 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 working paper requirement contained in the revised Model Audit Rule and agrees to make the working papers and other audit documentation available for review by the domiciliary commissioner or the commissioner's designee under the auditor's control, the workpapers, as defined in Section 13 of the revised Model Audit Rule;<sup>21</sup>
- e. A representation that the auditor is properly licensed by an appropriate state licensing authority and is a member in good standing in the AICPA; and
- f. The auditor meets the qualifications and is in compliance with the "Qualifications of Independent Certified Public Accountant" section of the revised Model Audit Rule. (Section 7 of the NAIC revised Model Audit Rule, *Qualifications of Independent Certified Public Accountant*, has been revised effective for the year 2010 statutory audits. The list of nonaudit services that cannot be performed by the auditor has been revised to generally agree with those designated by the SEC). Readers can also refer to the *Implementation Guide for the Annual Financial Reporting Model Regulation*, located in appendix G of the NAIC *Accounting Practices and Procedure Manual*.)

See exhibit 5-3, "Illustrative Accountant's Letter of Qualifications."

**5.111 Notification of adverse financial condition.** Section 10 of the revised Model Audit Rule requires that the auditor notify the insurer's board of directors or audit committee in writing within five business days of determination of one of the following:

- a. The insurer has materially misstated its financial condition as reported to the domiciliary commissioner as of the balance-sheet date currently under examination.
- b. The insurer does not meet the minimum capital and surplus requirements of the state insurance statute as of the balance-sheet date.

The revised Model Audit Rule also requires the insurer to provide both of the following:

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<sup>21</sup> Refer to *Audit Documentation: Auditing Interpretations of Section 339* (AICPA, *Professional Standards*, AU sec. 9339; AICPA, *PCAOB Standards and Related Rules*, Interim Standards, AU sec. 9339).

- 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.
- b. To the auditor, evidence that the notification has been provided to the insurance commissioner.

If the auditor receives no such evidence, the revised Model Audit Rule requires the auditor to send the notification to the insurance commissioner directly within the next five business days. (Certain states require direct notification to the insurance commissioner from the auditor as a matter of course). See exhibit 5-4, "Illustration of Notification of Financial Condition Letter When the Audit Is Complete," which indicates adverse financial conditions.

**5.112** *Report on internal controls.*<sup>22</sup> Effective for 2010 statutory audits, Section 11 of the revised Model Audit Rule requires that insurers provide the commissioner with a written communication as to any unremediated material weaknesses in its internal control over financial reporting noted during the audit. Such communication should be prepared by the auditor within 60 days after the filing of the annual audited financial report, and should contain a description of any unremediated material weakness (as the term *material weakness* is defined by SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* [AICPA, *Professional Standards*], or its replacement) as of December 31 immediately preceding (so as to coincide with the audited financial report discussed in Section 4(A) of the revised Model Audit Rule) in the insurer's internal control over financial reporting noted by the auditor during the course of their audit of the financial statements. If no unremediated material weaknesses were noted, the communication should so state. The insurer is also required to provide a description of remedial actions taken or proposed to correct unremediated material weaknesses, if the actions are not described in the accountant's communication. The insurer is expected to maintain information about significant deficiencies communicated by the independent certified public accountant. Such information should be made available to the examiner conducting a financial condition examination for review and kept in such a manner as to remain confidential.

**5.113** PCAOB Auditing Standard No. 5 and AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), define a *significant deficiency* as deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the entity's financial reporting. AU section 325 defines a *material weakness* as a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

**5.114** For purposes other than satisfying Section 11 of the revised Model Audit Rule, the auditor also has to consider any additional reporting requirements of AU section 325, and AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*) or

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<sup>22</sup> Readers can refer to the *Implementation Guide for the Annual Financial Reporting Model Regulation*, located in appendix G of the NAIC Accounting Practices and Procedure Manual. The guide has been published prior to the 2010 effective date in order to assist entities in planning and preparing for compliance with the new requirements when they become effective.

AU section 380, *Communication With Audit Committees* (AICPA, PCAOB Standards and Related Rules, Interim Standards).

## SEC Requirements for Management's Report on Internal Control Over Financial Reporting

**5.115** As directed by Section 404 of Sarbanes-Oxley, the SEC adopted final rules requiring entities subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment entities, to include in their annual reports a report of management on the entity's internal control over financial reporting. See the SEC website at [www.sec.gov/rules/final/33-8238.htm](http://www.sec.gov/rules/final/33-8238.htm) for the full text of the regulation. In its Final Rule Release No. 33-8238, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, the SEC directs entities subject to the reporting requirements of the Securities Exchange Act of 1934 (the Exchange Act), other than registered investment entities, to include in their annual reports a report of management on the entity's internal control over financial reporting. Issued for the purpose of implementing Section 404 of Sarbanes-Oxley, this rule is effective August 14, 2003, and requires registrants to (a) take responsibility for establishing and maintaining adequate internal control structure and procedures for financial reporting and (b) assess their effectiveness at the end of each fiscal year. Moreover, the final rule requires an entity's annual report to include an internal control report of management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the entity.
- A statement identifying the framework used by management to evaluate the effectiveness of the entity's internal control over financial reporting.
- Management's assessment of the effectiveness of the entity's internal control over financial reporting as of the end of the entity's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective.
- Disclosure of any material weaknesses in internal control over financial reporting. Management is not permitted to conclude that the entity's internal control over financial reporting is effective if there are one or more material weaknesses.
- A statement that its auditor has issued an attestation report on management's assessment of the entity's internal control over financial reporting. The auditor's attestation report must be included in the entity's annual report.<sup>23</sup>

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<sup>23</sup> SEC Final Rule Release No. 33-8238, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, has been amended multiple times by subsequent final rules, primarily for purposes of extending the compliance dates and providing transition guidance for newly public entities.

Currently, with regard to compliance dates associated with Section 404 of the Sarbanes-Oxley Act of 2002 that are not yet effective on May 1, 2009, SEC Final Rule Release No. 33-8934, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, provides that a nonaccelerated filer will be required to file the auditor's attestation report on internal control

(continued)

With respect to the application of this rule to quarterly reporting required under the Exchange Act, management's responsibilities are less extensive than those required for annual reporting. Management must, with the participation of the principal executive and financial officers, evaluate any change in the entity's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

**5.116** Effective for year end 2010 statutory audits, Section 16 of the revised Model Audit Rule every insurer that is required to file an audited financial report (that has annual direct written and assumed premiums of \$500,000,000 or more) is required to prepare a report of the insurer's or group of insurers' internal control over financial reporting. The report should be filed with the commissioner along with the "Communication of Internal Control Related Matters Noted in an Audit" described under Section 11 of the revised Model Audit Rule (as discussed in paragraph 5.112). Management's Report of Internal Control over Financial Reporting shall be as of December 31 immediately preceding. An insurer or a group of insurers that is: (a) directly subject to Section 404; (b) part of a holding company system whose parent is directly subject to Section 404; (c) not directly subject to Section 404 but is a Sarbanes-Oxley Compliant Entity; or (d) a member of a holding company system whose parent is not directly subject to Section 404 but is a Sarbanes-Oxley Compliant Entity, may file its or its parent's Section 404 Report and an addendum in satisfaction of this Section 16 requirement provided that those internal controls of the insurer or group of insurers having a material impact on the preparation of the insurer's or group of insurers' audited statutory financial statements (those items included in Sections 5B–5G of this regulation) were included in the scope of the Section 404 report.

**5.117** Management's Report of Internal Control over Financial Reporting as required under Section 16 of the revised Model Audit Rule should include

- a. a statement that management is responsible for establishing and maintaining adequate internal control over financial reporting;
- b. a statement that management has established internal control over financial reporting and an assertion, to the best of management's knowledge and belief, after diligent inquiry, as to whether its internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles;
- c. a statement that briefly describes the approach or processes by which management evaluated the effectiveness of its internal control over financial reporting;
- d. a statement that briefly describes the scope of work that is included and whether any internal controls were excluded;

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*(footnote continued)*

over financial reporting when it files an annual report for a fiscal year ending on or after December 15, 2009.

PCAOB Auditing Standard No. 5 clarifies that the auditor's report must include the auditor's opinion on whether the entity maintained effective internal control over financial reporting. The standard eliminates the requirement that the auditor also include an opinion on whether management's assessment of the effectiveness of the entity's internal control over financial reporting is fairly stated.

- e. disclosure of any unremediated material weaknesses in the internal control over financial reporting identified by management as of December 31 immediately preceding. Management is not permitted to conclude that the internal control over financial reporting is effective to provide reasonable assurance regarding the reliability of financial statements in accordance with statutory accounting principles if there is one or more unremediated material weaknesses in its internal control over financial reporting;
- f. a statement regarding the inherent limitations of internal control systems; and
- g. signatures of the CEO and the CFO (or equivalent position or title).

Management should document and make available, upon financial condition examination, the basis upon which its assertions are made. Management may base its assertions, in part, upon its review, monitoring, and testing of internal controls undertaken in the normal course of its activities. Management has discretion regarding the nature of the internal control framework used, and the nature and extent of documentation, in order to make its assertion in a cost effective manner and, as such, may include assembly of or reference to existing documentation.

## Other Communication Between Auditors and Regulators

**5.118** *Auditor's consideration of state regulatory examinations.* The auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies." (AU section 342) "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 made available to the auditor." (AU section 317, *Illegal Acts by Clients* [AICPA, *Professional Standards*].) Accordingly, it is appropriate that the auditor review examination reports and related communications between regulators and the insurance entity to obtain appropriate evidential matter. Regulators are assessing changes to the current examination process with consideration being given to a risk-focused approach. The objective is to provide a more efficient process to monitor and assess an insurer's solvency. The process would include a risk-focused financial analysis along with a review of internal and external changes affecting the insurer. A proposed output of the process is a rating system that would assist regulators in developing the Supervisory Plan for the insurer.

**5.119** The auditor should review reports of examinations and communications between regulators and the insurance entity and make inquiries of the regulators. The auditor should

- a. request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions;
- b. read reports of examinations and related correspondence between regulators and the life insurance entity during the period under audit through the date of the auditor's report; and
- c. inquire of management and communicate with the regulators, with the prior approval of the life insurance entity, when the regulators' examination of the entity is in process or a report on an examination



has not been received by the insurance entity regarding conclusions reached during the examination.

**5.120** 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 (paragraphs .22–.34 of AU section 508, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*]). 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.

**5.121** In addition, the auditor may wish to attend—as an observer, with prior approval of the life insurance entity—the exit conference between the regulator and the entity's board of directors, trustees, or executive officers, or all three.

**5.122** *Permitted statutory accounting practices.* Prescribed SAP are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state.

**5.123** Permitted accounting practices include practices not prescribed in paragraph 5.120 but allowed by the domiciliary state regulatory authority, upon request. Insurance entities may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of their statutory financial statements under either of the following circumstances:

- a. If the entity wishes to depart from the prescribed SAP
- b. If prescribed SAP do not address the accounting for the transaction(s).

Accordingly, permitted accounting practices differ from state to state, may differ from entity to entity within a state, and may change in the future.

**5.124** 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 audit, auditors should obtain sufficient appropriate audit evidence to corroborate management's assertion that permitted SAP that are material to an insurance entity's financial statements are permitted by the domiciliary state insurance department.

**5.125** Sufficient appropriate audit evidence consists of any one or combination of the following:

- a. Written acknowledgment sent directly from the regulator to the auditor (This kind of corroboration includes letters similar to attorneys' letters and responses to confirmations.)
- b. Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client
- c. 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 kind of corroboration that is necessary in the circumstances.

**5.126** If the auditor is unable to obtain sufficient appropriate audit evidence to corroborate management's assertion regarding a permitted SAP 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 (AU section 508).

**5.127** *Availability of auditor's audit documentation to regulators.* Every life insurance entity required to file an audited financial report with the state insurance department requires the auditor to make available for review by department regulators all working papers and other audit documentation prepared in conducting his or her audit, and any audit-related communications between the auditor and the life insurance entity. Audit documentation may include audit planning documentation, audit plans, analyses, memoranda, letters of confirmation and representation, abstracts or copies of entity documents and schedules, or commentaries prepared or obtained by the auditor in the course of his or her audit of the life insurance entity's financial statements and that support the auditor's opinion thereon.<sup>24</sup>

**5.128** State regulations generally require the auditor to retain the audit documentation and communications until the state insurance department has filed a report on the examination covering the period of audit.

**5.129** *Supplemental schedule of selected financial data.* The NAIC Annual Statement and forms have been adopted by each state to promote uniformity in reporting, although requirements vary by state. The Instructions require life insurance entities to file audited financial statements and a supplemental schedule of selected financial data, investment interrogatories, and summary investment schedule with their state of domicile insurance department. The summary investment schedule is filed with the Annual Statement whereas the interrogatories are filed as a supplement to the annual statement by April 1 for the applicable reporting period. The Life, Accident and Health and Fraternal Annual Statement Instructions include instructions for completing Schedule 1, *Selected Financial Data*. The supplemental schedule of selected financial data, investment interrogatories, and summary investment schedule are required to be included in the annual audit report for Life, Accident and Health and Fraternal reporting entities.

**5.130** The auditor is required to issue a report on the supplemental information as to whether the information is fairly presented in relation to the financial statements taken as a whole. Because all of the information required to be included in the supplementary schedules is either directly related to the basic statutory financial statements or derived from accounting records that are tested by auditors, the guidance in AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*), should be followed when auditors report on supplemental information. AU section 551A provides guidance for both accounting and nonaccounting data.

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<sup>24</sup> See Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of AU section 339 (AICPA, *Professional Standards*, AU sec. 9339 par. .01–.15).

## Communications by Successor Auditors<sup>25</sup>

**5.131** AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*), provides guidance on communications between predecessor and successor auditors when a change of auditors has taken place or is in process.

## Communication of Matters Related to Internal Control<sup>26</sup>

**5.132** For audits conducted under GAAS, AU section 325 provides guidance on evaluating and communicating matters related to an entity's internal control over financial reporting identified during an audit of financial statements. It is contemplated that communication would generally be with the audit committee or others charged with governance with an equivalent level of authority and responsibility (such as the board of directors or trustees, an owner in an owner-managed entity, or in organizations that do not have an audit committee with others who may have engaged the auditor). AU section 325 provides that the communication should state that it is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made. For integrated audits performed in accordance with PCAOB standards, additional guidance is provided in paragraphs 78–84 of PCAOB Auditing Standard No. 5.

**5.133** AU section 325 requires that deficiencies identified during the audit that, upon evaluation, are considered significant deficiencies or material weaknesses under this section should be communicated, in writing, to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and the date of that communication.

**5.134** For audits performed in accordance with PCAOB standards, AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and paragraphs 78–84 of Auditing Standard No. 5 provide guidance on identifying and reporting deficiencies that relate to an entity's internal control for audits of financial statements only and integrated audits, respectively. The auditor must communicate *in writing* to management and the audit committee control deficiencies that are either *significant deficiencies* or *material weaknesses* as defined in paragraphs .02–.03 and .09–.10 of AU section 325

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<sup>25</sup> Additionally, the PCAOB has issued a staff question and answer titled *Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor*, available at [www.pcaob.org](http://www.pcaob.org).

<sup>26</sup> The NAIC adopted revisions to the Model Regulation in June of 2006. Changes to the Model Audit Rule considered certain provisions of the Sarbanes-Oxley Act of 2002. Changed provisions included requiring management to prepare a report on internal control over financial reporting per Section 16 of the Revised Model Audit rule effective December 31, 2010. This is required for every insurer required to file an audited financial report that has annual direct written and assumed premiums, excluding premiums reinsured with the Federal Crop Insurance Corporation and Federal Flood Program, of \$500 million or more. The NAIC has also incorporated AU section 325.

(AICPA, *PCAOB Standards and Related Rules*, Interim Standards). For integrated audits, all deficiencies in internal control with a lesser magnitude than a significant deficiency must be reported in writing to management and the audit committee notified when communication is made.

**5.135** Written communications should be best made prior to the issuance of the auditor's report on the financial statements for nonissuers and should be made prior to the issuance of the auditor's report for issuers. The auditor's communications should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses. (AICPA, *PCAOB Standards and Related Rules*, AU section 325 paragraph .04 and paragraph 78 of Auditing Standard No. 5.) The audit committee or other proper equivalent level of authority is defined in AICPA *PCAOB Standards and Related Rules*, AU section 325 paragraph .04 and footnote 8 in paragraph 9 of Auditing Standard No. 5. For additional information on internal control communications, see the applicable standard.

**5.136** Additionally, among other matters, Section 404 of Sarbanes-Oxley requires a report on management's assessment of internal control over financial reporting of the public accounting firm to be included in an issuer's annual report.<sup>†</sup> This report may or may not be combined with the audit opinion. Refer to paragraphs C16–C17 of appendix C, "Special Reporting Situations," of Auditing Standard No. 5, which provides direction when an auditor's report on internal control over financial reporting is included or incorporated by reference in filing under federal securities statutes. Finally, the insurance commissioner of the state of domicile requires that the auditor prepare for the client a written report describing any significant internal control deficiencies and provide a description of remedial actions taken or proposed to correct those deficiencies.

## Communication of Other Matters With Those Charged With Governance, Including Audit Committees<sup>27,†,28</sup>

**5.137** For audits performed in accordance with GAAS, AU section 380 (AICPA, *Professional Standards*) supersedes SAS No. 61, *Communication With*

<sup>†</sup> The SEC issued Final Rule 33-8934, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*; under the amendments, a nonaccelerated filer will be required to file the auditor's attestation report on internal control over financial reporting when it files an annual report for a fiscal year ending on or after December 15, 2009, which effectively extends the deadline by 12 months.

<sup>27</sup> A member performing an attest engagement must be independent pursuant to Rule 101. Other applicable independence rules and regulations may also apply to members and accountants while performing attest engagements (for example, SEC, PCAOB, GAO, state licensing boards).

A member performing a statutory attest engagement must also be independent under state insurance independence requirements, as described in Section 7 of the NAIC revised Model Audit Rule, *Qualifications of the Independent Certified Public Accountant*.

The PCAOB has issued Release No. 2005-014, *Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees*. Among other matters, the rules require registered public accounting firms to provide certain information to audit committees in connection with seeking preapproval to provide nonprohibited tax services. The PCAOB has also issued Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), that requires the registered public accounting firm to (1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence; (2) discuss with the audit committee of the issuer the potential effects of any relationships that could impact independence, should they be appointed as the issuer's auditor;

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*Audit Committees.* Whereas SAS No. 61 established communication requirements applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee, AU section 380 (AICPA, *Professional Standards*) broadens the applicability of the requirements to audits of the financial statements of all nonissuers and establishes a requirement for the auditor to communicate with those charged with governance certain significant matters related to the audit.

**5.138** Among other matters, the auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The new guidance defines *those charged with governance* as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. AU section 380 (AICPA, *Professional Standards*) establishes a requirement for the auditor to communicate certain matters relating to the audit. This includes, but is not limited to

- the auditor's responsibilities under GAAS (AICPA, *Professional Standards*, AU sec. 380 par. .26–.28).
- an overview of the planned scope and timing of the audit (AICPA, *Professional Standards*, AU sec. 380 par. .29–.33).
- significant finding from the audit (AICPA, *Professional Standards*, AU sec. 380 par. .34–.44).

Although the communication can be oral, it should be in writing when, in the auditor's judgment, oral communication would not be adequate. When matters required to be communicated by this section have been communicated orally, the auditor should document them. AU section 380 (AICPA, *Professional*

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(footnote continued)

and (3) document the substance of these discussions. These discussions should occur at least annually. The board also adjusted the implementation schedule for Rule 3523, *Tax Services for Persons in Financial Services Oversight Roles* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board) as it applies to tax services. The board agreed not to apply Rule 3523 to tax services provided on or before December 31, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. The amendments to Rule 3523 became effective August 28, 2008. The remaining provisions became effective September 30, 2008.

For additional information, see chapter 13, "Taxes." Additionally, PCAOB Rule 3525, *Audit Committee Pre-Approval of Non-Audit Services* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), relates to the auditor's responsibilities when seeking audit committee preapproval of internal control related nonaudit services.

<sup>‡</sup> Readers should be aware of PCAOB Release No. 2010-001, *Proposed Auditing Standards Related to Communications With Audit Committees* and look for its final release.

<sup>28</sup> Section 14(F)(1) of the NAIC revised Model Act Rule now requires the auditor to communicate to the audit committee specific requirements:

The Audit committee shall require the accountant that performs for an insurer any audit required by this regulation to timely report to the Audit committee in accordance with the requirements of SAS 61, *Communication with Audit Committees*, or its replacement, including:

- (a) All significant accounting policies and material permitted practices;
- (b) All material alternative treatments of financial information within statutory accounting principles that have been discussed with management officials of the insurer, ramifications of the use of the alternative disclosures and treatments, and the treatment preferred by the accountant; and
- (c) Other material written communications between the accountant and the management of the insurer, such as any management letter or schedule of unadjusted differences.

*Standards*) also contains information on the communication process, timing of communication and specific examples of what should be communicated. See paragraphs .23–.44 of AU section 380 (AICPA, *Professional Standards*) for examples of additional items to be communicated.

**5.139** For audits performed in accordance with PCAOB standards, AU section 380 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) establishes a requirement that the auditor determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process. The communications required are applicable to (a) entities that either have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and to (b) all SEC engagements. Communications required are located in paragraphs .06–.17 of AU section 380 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). Paragraph .12 of AU section 380 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) states that the audit committee often considers information prepared by management that accompanies the entity's financial statements such as the *Management's Discussion and Analysis of Financial Condition and Results of Operations* that certain SEC filers are required to present in annual reports to shareholders. The auditor should discuss with the audit committee his or her responsibility for other information in documents containing audited financial statements, any procedures performed, and the results. AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), discusses the auditor's responsibility for such information.

**5.140** Additionally, AU section 380 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) requires an auditor of SEC clients to discuss with audit committees the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles and underlying estimates in its financial statements. For integrated audits performed in accordance with PCAOB standards, additional guidance is provided in paragraphs 78–84 of Auditing Standard No. 5.

**5.141** *A significant finding—uncorrected misstatements.* Under GAAS, AU section 312 (AICPA, *Professional Standards*) requires the auditor to accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. Paragraph .59 of AU section 312 (AICPA, *Professional Standards*) clarifies that auditors should include both qualitative and quantitative considerations when evaluating misstatements and specifies the importance of individual and aggregate misstatement analysis. Consequently, paragraphs .40–.41 of AU section 380 (AICPA, *Professional Standards*) state that the auditor should communicate with those charged with governance uncorrected misstatements and the effect that they may have on the opinion in the auditor's report, and request their correction. In communicating the effect that material uncorrected misstatements may have on the opinion in the auditor's report, the auditor should communicate them individually. Where there are a large number of small uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the misstatements, rather than the details of each individual misstatement. The auditor should discuss with those charged with governance the implications of a failure to correct known and likely misstatements, if any, considering qualitative as well as quantitative

considerations, including possible implications in relation to future financial statements. The auditor should also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

**5.142** For audits performed in accordance with PCAOB standards, paragraph .10 of AU section 380 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) states that "the auditor should inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole." These misstatements are gathered from the evaluation of audit findings. Paragraph .34 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), clarifies that auditors should include both qualitative and quantitative considerations when evaluating misstatements and specifies the aforementioned importance of individual and aggregate misstatement analysis. Auditors should also consider SEC Staff Accounting Bulletin (SAB) No. 99, *Materiality* (Codification of Staff Accounting Bulletins, Topic 1-*Financial Statements*, Section M-*Materiality*), when assessing the materiality of misstatements, at least for public entities.

**5.143** On September 13, 2006, the SEC released SAB No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*.<sup>||</sup> The issuance provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement. The SEC staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The staff believes that this can be accomplished by quantifying errors under both a balance sheet and an income statement approach and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

**5.144** If, in correcting an error in the current year, an error is material to the current year's income statement, the prior year financial statements should be corrected, even though such a revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next

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<sup>||</sup> On January 29, 2008, the PCAOB adopted Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), and conforming amendments to the board's interim auditing standards. This standard was issued in light of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 250, *Accounting Changes and Error Corrections*, and replaces the board's current interim standard AU section 420, *Consistency of the Application of Generally Accepted Accounting Principles* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). While the key concepts of AU section 420 were retained, this standard updates and clarifies the auditor's responsibilities with respect to evaluating and reporting on matters relating to the consistency of financial statements. The standard also enhances auditor reporting on accounting changes and corrections of misstatements by more clearly distinguishing between these events. Readers should refer to the PCAOB website at [www.pcaob.org](http://www.pcaob.org) for more information.

time the registrant files the prior year financial statements. However, registrants electing not to restate prior periods should follow the disclosure requirements specified in the SAB. For additional specifics, see the issuance at [www.sec.gov/interp/account/sab108.pdf](http://www.sec.gov/interp/account/sab108.pdf).

**5.145** *Other Standards and Rules Requiring Communications.* In addition, communication with those charged with governance by the auditor on specific matters as they occur in the conduct of an audit is required by other standards, including AU sections 316, 317, and 325; AU section 333, *Management Representations*; and AU sections 380, and 722, *Interim Financial Information* (AICPA, *Professional Standards*).

**5.146** For audits performed in accordance with PCAOB standards, communication with those charged with governance by the auditor on specific matters as they occur in the conduct of an audit is required by other standards, including AU sections 316, 317, 325, 333, 380, 722 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and in Auditing Standard No. 5. Additionally, Title II of Sarbanes-Oxley adds Subsection K to Section 10A of the Securities Exchange Act of 1934 and requires specific communications for auditors of issuers. Each accountant that performs for an audit client that is an issuer any audit required under the securities laws must report prior to the filing of such audit report with the SEC, to the audit committee

- all critical accounting policies and practices to be used;
- all alternative treatments within GAAP "for policies and practices related to material items" that have been discussed with management of the issuer, including (a) the ramifications of the use of such alternative disclosures and treatments and (b) the treatment preferred by the registered public accounting firm; and
- other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

The SEC has not required that the communication be in writing; however, the SEC noted that it would expect that such communications would be documented by the accountant and the audit committee. However, note that the PCAOB has issued standards subsequent to this issuance that require additional written communications. See the section "Communication of Matters Related to Internal Control" for some examples.

## Consideration of Fraud in a Financial Statement Audit<sup>29</sup>

**5.147** There are risks inherent in all audit engagements, including the possibility of fraudulent acts that cause a material misstatement of financial

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<sup>29</sup> The PCAOB has released a report titled *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (PCAOB Release No. 2007-001). The report focuses on aspects of the board's interim auditing standards that address the auditor's responsibility with respect to fraud, principally AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). The PCAOB is not, in this report, changing or proposing to change any existing standard, nor is the report meant to provide a new interpretation of any aspect of existing standards. The PCAOB has, however, identified certain observations, made in the course of board inspections, that are sufficiently important or arise with sufficient frequency to warrant discussion in a public report, both for the purpose of generally focusing auditors on being diligent about these matters and for the purpose of providing information that audit committees may find useful in working with auditors. For additional information see [www.pcaob.org](http://www.pcaob.org).



statements. AU section 316 (AICPA, *Professional Standards*) is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 (AICPA, *Professional Standards*) establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in paragraph .02 of AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*).

#### *Considerations for Integrated Audits*

When performing an integrated audit in accordance with PCAOB standards, auditors are required to refer to paragraphs 14–15 of Auditing Standard No. 5 regarding fraud considerations, in addition to the fraud considerations set forth in AU section 316 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).

**5.148** There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Additionally, three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

**5.149** *The importance of exercising professional skepticism.* Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

**5.150** *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.*<sup>30</sup> Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs .14–.18 of AU section 316 (AICPA, *Professional Standards*). The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (a) create incentives or pressures for management and others to commit fraud, (b) provide the opportunity for fraud to be

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<sup>30</sup> The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), to discuss the potential of the risks of material misstatement.

perpetrated, and (c) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

**5.151** Factors that may increase the risk of material misstatement due to fraud as a result of the items described previously include, but are not limited to, the following:

- a. *Internal Factor.* A significant portion of management compensation (that is, bonuses, stock options, and earn-out arrangements) is contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow. Incentives specific to the insurance industry may include the following:
  - i. Pressures motivating the underwriting department to become more profitable
  - ii. The investment department is evaluated based upon investment yields
- b. *External Factor.* A slow economy. Because insurers have such a large number of investments, equity market declines and reduced market interest rates will significantly lower investment returns. Such conditions could result in insurers looking to new investment vehicles to secure sufficient investment margins including derivatives, real estate, mortgage loans, and joint venture arrangements. Insurers need to have controls in place to ensure adequate underwriting, due diligence, and accounting controls on new investments. Pressures exist in various forms including holding producers to historical sales expectations despite a slowing economy. Life insurers generally should have procedures in place to identify internal replacements, the use of the cash surrender value of a previous contract to pay a lump-sum premium for a new contract, and account for them properly. In addition, sales and other promotions material should be updated to avoid including misleading interest rate assumptions.
- c. *Internal Factor.* Significant dependency on information systems for support in day-to-day operations, and a lack of controls regarding access to information systems. For example, a risk of loss exists from employees who have access to the masterfile system. They could make unauthorized changes to policyholder account balances, death benefits, beneficiaries, surrenders, or loan balances.
- d. *Internal Factor.* Management ability to override internal controls in financial reporting related to
  - i. numerous manual adjustments required to determine amounts recorded in financial statements (that is, accrual entries booked to a cash-basis ledger or statutory-to-GAAP adjustments);
  - ii. correcting entries made by management, particularly at or near year-end;
  - iii. adjusting entries made directly to the financial statements.

The factors that may increase the risk of material misstatement due to fraud listed previously are general examples, and may be considered in conjunction

with table 5-1, "Fraud Risk Factors—Fraudulent Financial Reporting," and table 5-2, "Fraud Risk Factors—Misappropriation of Assets," which address risk factors related to fraudulent financial reporting and misappropriation of assets specific to the insurance industry. An auditor should use professional judgment in determining whether factors are present that could increase the risk of material misstatement due to fraud.

**5.152** *Insurance industry fraud risk factors.* Fraud risk factors relevant to fraudulent financial reporting and misappropriation of assets are described in tables 5-1 and 5-2, respectively. The risk factors are further classified based on the three conditions generally present when material misstatements due to fraud occur: incentives or pressures, opportunities, and attitudes or rationalizations. Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the auditor may wish to consider additional or different risk factors. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence. Finally, some of the risk factor related to misstatements arising from fraudulent financial reporting may also be present when misstatements arising from misappropriation of assets occur. For example, ineffective monitoring of management and weakness in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exist.

**5.153** An entity auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. Some of the following factors and conditions are present in insurance entities where specific circumstances *do not present a risk of material misstatement*. Also, specific controls may exist that mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, you should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements. The industry-specific fraud risk factors that follow include interpretations of some of the AU section 316 (AICPA, *Professional Standards*) example risk factors tailored to the insurance industry. Each section may be used to supplement, but not replace, the example risk factors included in AU section 316 (AICPA, *Professional Standards*). Tables 5-1 and 5-2 are not meant to be inclusive.

**Table 5-1**  
**Fraud Risk Factors—Fraudulent Financial Reporting**

<b>Incentive/Pressure</b> Financial stability or profitability is threatened by economic, industry, or entity operating conditions such as:	a. New accounting, statutory, or regulatory requirements.	<div><div>1. New criteria used by rating agencies to assign ratings to insurers.</div><div>2. Demutualization.</div><div>3. Changes in risk-based capital requirements.</div><div>4. Changes in consolidation criteria (for example, special purpose entities).</div><div>5. Changes in fair value measurement recognition.</div></div>
	b. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.	<div><div>1. Rapidly changing distribution network results in different sales vehicles without adequate controls (for example, possible use of the Internet).</div><div>2. Changes in interest rates may have a significant impact on the financial results of many life insurance entities.</div></div>
	c. Rapid growth or unusual profitability especially compared to that of other entities in the same industry.	<div><div>1. Unusual and considerable increases in the number of policyholders over a short period of time.</div><div>2. Loss ratios significantly different from entities offering similar insurance coverages.</div><div>3. Unusual or significant increases in fee income (for variable products where fees are a direct result of assets under management) in a period of market decline, as compared to other entities in the same industry.</div><div>4. Unusual increases in the number of policies in mature lines of business, potentially indicating inadequate pricing to gain business from competitors.</div></div>

- d. Emerging trends in claims settlement and litigation.
  - 1. Identification of emerging new classes of claims.
  - 2. Plaintiffs expanded theory of liability.
  - 3. Court coverage decisions and judicial interpretations.
  - 4. Expanded liability due to changes in legislation.
- e. High degree of competition or market saturation, accompanied by declining margins.
  - 1. Rapid development of new products reacting to the market environment without adequate review of long-term strategies.
  - 2. Volatility of earnings due to market environment that could cause an entity to manipulate earnings.
- f. Volatility of earnings due to catastrophic losses could cause the entity to manipulate earnings in other areas.

**Incentive/  
Pressure**

Excess pressure for management to meet the requirements or expectations of third parties due to the following:

- a. Profitability or trend expectations of investment analysts.
- b. Pressure to maintain or improve ratings from rating agencies.
- c. Close to tripping risk-based capital requirements.

**Opportunity**

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from:

- a. Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
  - 1. Unusual or complex intercompany reinsurance transactions.
  - 2. Transactions entered into with affiliates, the impact of which are to increase statutory surplus.
  - 3. Complex or inconsistent, or both, expense allocation agreements.

(continued)

- b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
  - 1. Estimates for loss and loss adjustment expenses, reinsurance recoverables, deferred acquisitions costs (DAC), reserves, and others based on unusually subjective judgments.
  - 2. Significant purchases and sales of securities that do not have an active market, which could indicate "parking losses."
  - 3. Aggressive policies related to revenue recognition for administrative-service type contracts.
  - 4. Improper classification of normal operating losses as "catastrophe-related" in financial reporting (for example, management discussion and analysis, footnote disclosure). Also, the diversion of an insurer's resources in dealing with a catastrophe could put a strain on internal controls.
- c. Significant, unusual, or highly complex transactions, especially those close to period end, that pose difficult "substance over form" questions.
  - 1. High yields on investments that appear to be low risk.
  - 2. Transactions that "convert" nonadmitted assets to admitted assets.
  - 3. Numerous and complex off-balance-sheet financing transactions.
  - 4. Reinsurance transactions that embody loss assumptions that are very different from industry or historical trends in order to pass the "transfer of risk" rules.
  - 5. Transactions that "convert" realized capital gains/losses to ordinary income or vice versa.
  - 6. Significant closing journal entries for insurers that maintain their books on a statutory basis of accounting, which requires the need to post several statutory-to-generally accepted accounting principles adjusting entries.

7. Significant or unusual amount of quarter-end or year-end manual entries posted after consolidation.
8. Estimates of the value of closely held securities.
9. Agreements accounted for as reinsurance transactions that do not transfer risk.

**Opportunity**  
Ineffective monitoring of management due to the following:

a. Domination of the board of directors because it is composed primarily of an entity's close business partners (for example, agents, bankers, and lawyers).

**Opportunity**  
There is a complex organizational structure as evidenced by the following:

a. Significant transactions included in noninsurance affiliates with the sole purpose of excluding such activity from the statutory-basis financial statements filed with insurance regulators.

**Opportunity**  
Internal control components are deficient as a result of:

a. Information systems which cannot account for complex features of insurance policies issued (for example, policies with complex deductible features).

*(continued)*

**Attitude/  
Rationalization**  
Excessive  
interest by  
management in  
maintaining or  
increasing the  
entity's stock  
price or earnings  
trend or  
statutory capital  
position.

- a. Risk transfer  
criteria for  
reinsurance  
transactions are  
rarely met.
- b. Use of  
discretionary  
reserves to  
manipulate  
earnings.

**Attitude/  
Rationalization**  
A failure by  
management to  
display and  
communicate an  
appropriate  
attitude  
regarding  
internal control  
and the financial  
reporting  
process.

- a. Lack of board or  
management  
oversight of  
critical processes.
  - 1. Underwriting-control risk,  
price risk.
  - 2. IT systems or resources to  
effectively administer complex  
insurance or reinsurance  
contract provisions.
  - 3. Monitoring of creditworthiness  
of reinsurers.
  - 4. Suspense account clearance.
  - 5. Treasury-securities/derivative  
valuation (selection of models,  
methodologies, and  
assumptions.
  - 6. Establishment of loss and loss  
adjustment expense reserves.
  - 7. Investment decisions.
  - 8. Understanding of critical  
accounting policies and  
significant estimates.
- b. No business risk  
management  
responsibility or  
function.
- c. No accounting  
policy  
responsibility or  
function.
- d. Management's  
inattention to  
establish  
independent  
reporting lines for  
key assurance  
functions (for  
example, internal  
audit and quality



control reviews of claims and underwriting).

- e. Lack of insurance-industry or finance experience on the audit committee.

**Attitude/  
Rationalization**

Management displaying a significant disregard for regulatory authorities.

- a. Existence of a regulatory enforcement action.
- b. Prior examination findings not addressed or inadequately addressed.
- c. Mandated restatements of regulatory financial reports due to inappropriate accounting treatment.
- d. Assessment of market conduct fines.

**Attitude/  
Rationalization**

A strained relationship between management and the current or predecessor auditor, as exhibited by the following:

- a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters such as the reasonableness of sensitive estimates (for example, loss and loss adjustment expense reserves, allowances for uncollectible reinsurance, DAC, and other amounts).

(continued)

- b. Issuance of reportable condition or material weakness letters.<sup>#</sup>
- c. Failure of management to address reportable condition, control deficiency, or more specifically, material weakness issues on a timely basis.

**Attitude/  
Rationalization**  
Nonfinancial management's excessive participation in or preoccupation with the selection of the accounting principles or the determination of significant estimates.

- a. Lack of management to establish controls over accounting policy issues.

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<sup>#</sup> For items (b). and (c), see *A Statutory Framework for Reporting Significant Deficiencies in Internal Control to Insurance Regulators*.

**Table 5-2****Fraud Risk Factors—Misappropriation of Assets****Incentive/  
Pressure**

Adverse relationships between the entity and employees with authority over cash and assets could motivate employees to misappropriate those assets).

- a. History of workforce reductions (for example, combining regional claims offices).

**Opportunity**

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation, for example, opportunities to misappropriate assets increase when there are the following factors:

- a. Significant activity or balances, or both, present in suspense accounts.
- b. Large volume premium checks received by the insurance entity rather than being sent to a lock box.
- c. Premiums are not directly remitted to the insurer but are instead collected by the agent.

**Opportunity**

Inadequate internal control your assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because of the following factors:

- a. Inadequate segregation of duties or independent checks.
  - 1. Lack of rotation or review of claim adjusters on long-term claims.
  - 2. Custodial reconciliations performed by an individual who records the amount to the ledger.
- b. Inadequate management oversight of employees responsible for assets.
  - 1. Lack of adequate monitoring of underwriting policies and procedures.

(continued)

2. Lack of management review or control processes over year-end or month-end transactions.
  3. Extensive use of managing general agents with little or no supervision by management.
  4. Lack of internal audit or claim quality review functions, or both.
  5. Inadequate payment approval process.
  6. Lack of review or inadequate controls over system overrides (for example, claim payments and commissions).
  7. Lack of strong custodial controls over cash/investments.
- c.* Loans requested on life policies occurring soon after large deposits on the policy are made. The loan could be issued before the deposit check clears, and then the check is returned for insufficient funds.
- d.* Large volume of duplicate claims processed.
- e.* Large volume of claims paid to post office boxes.
- f.* Large volume of claims paid to the same claimant.
- g.* Large volume of claims paid to employees.

**Attitude/  
Rationalization**

Failure to report all instances of fraud to the audit committee and others charged with governance.

**Attitude/  
Rationalization**

Failure to properly staff internal audit and other (claims/underwriting) quality control functions.

**Attitude/  
Rationalization**

Poor relationships between management, employees, and agents that may appear to justify misappropriations of assets.

**Attitude/  
Rationalization**

Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.

**5.154** *Obtaining the information needed to identify the risks of material misstatement due to fraud.* AU section 314 establishes requirements and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control for the purpose of assessing the risks of material misstatement. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used to identify the risks of material misstatement due to fraud:

- a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed (AICPA, *Professional Standards*, AU sec. 316 par. .20–.27).

- b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit (AICPA, *Professional Standards*, AU sec. 316 par. .28–.30).
- c. Consider whether one or more fraud risk factors exist (AICPA, *Professional Standards*, AU sec. 316 par. .85). (See tables 5-1 and 5-2 and paragraphs 5.149 and 5.153.)
- d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (AICPA, *Professional Standards*, AU sec. 316 par. .34).

In planning the audit, the life or health insurance auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. Measurements and fluctuations that can be indicative of potential fraudulent practice include the following:

- The average value of policy loan outstanding
- The average reserve per inforce amounts
- DAC as a percentage of reserves or inforce
- Deferred and uncollected premiums as a percentage of reserves or inforce
- Significant fluctuations in the average premium or reserve, per policy inforce
- Significant fluctuations in premiums written by agents or managing general agents (MGAs)

When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud. (AICPA, *Professional Standards*, AU section 318 paragraph .57; AICPA, *PCAOB Standards and Related Rules*, Interim Standards, AU section 329 paragraph .10.)

**5.155** *Considering fraud risk factors.* As indicated in item (c) in paragraph 5.152, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists. AU section 316 (AICPA, *Professional Standards*) provides fraud risk factor examples that have been written to apply to most enterprises. Even though tables 5-1 and 5-2 contain lists of fraud risk factors specific to the insurance industry, remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

**5.156** *Identifying risks that may result in a material misstatement due to fraud.*<sup>31</sup> In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs .19–.34 of AU section 316 (AICPA, *Professional Standards*). The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole.

- A. *Accounts, classes of transactions, and assertions.* The following items may involve a high degree of management judgment and subjectivity and may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.
1. Investments:
    - a. Fair market value for nonpublic securities and derivatives;
    - b. Recognition of impairment losses of investments; and
    - c. Yields assumed on mortgage backed and asset backed securities.
  2. Deferred Acquisition Costs:
    - a. DAC and whether there is consistent application and allocation techniques annually;
    - b. Assumptions utilized for amortizing DAC. Auditors may need to challenge management's persistency assumptions and future gross profits used in the analysis;
    - c. Recoverability of DAC; and
    - d. Determination of substantial change for internal replacements in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*.
  3. Reinsurance:
    - a. Evaluation of whether there is a transfer of risk because it must be reasonably possible that the reinsurer will realize a significant loss in order to record the reinsurance transaction;
    - b. Reinsurance transactions near year-end; and
    - c. Estimates due to time lags in the receipt of reports from the ceding company.

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<sup>31</sup> Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's consideration of fraud and assessment of risk, and the auditor's procedures in response to those assessed risks.

## 4. Reserves:

- a. Assumptions used to calculate policy reserves and premium deficiencies, including mortality and morbidity, interest credited, lapse rates, and surrender charges;
- b. Appropriateness of factors applied to the in force to estimate reserves for FASB ASC 944 traditional long-duration contracts; and
- c. The life insurer's reserves for future policy and contract benefits represents the largest estimate on the balance sheet. The auditor should be alert for changes to the assumptions (for example, discount rates, actuarial tables, reinsurance) as well as the establishment of new, nonspecific reserves that may significantly affect the reserve balance.

- B. *A presumption that improper revenue recognition is a fraud risk.* See paragraph .41 of AU section 316 (AICPA, *Professional Standards*). Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.

In the recent past, certain life insurers became party to investment transactions, generally with related parties that significantly inflated asset values or realized gains. Others failed to establish timely or sufficient, or both, valuation reserves against delinquent mortgage loans, real estate investments (including real estate acquired through foreclosure) and commitments to limited partnership and joint venture arrangements. Because premium income is generally known by policy, the more significant risks impacting revenue relate to cutoff or fictitious policies. Life insurance entities utilize suspense accounts extensively to record cash collections and recognize premium income when amounts are applied to a specific policy. Evaluation of the timing of entries booked to suspense accounts may be considered, as inappropriate adjustments or delays in recording adjustments to suspense accounts could impact revenue recognition. Suspense accounts may be analyzed and reviewed for large, old, or unusual items. In addition, policies written by agents or MGAs may be more susceptible to fraud if premiums are sent directly to the agent or MGA. High commission structures could also pose a risk regarding the volume of premiums written by agents or MGAs. Significant fluctuations regarding such balances may need to be investigated.

- C. *A consideration of the risk of management override of controls.* See paragraphs .57–.67 of AU section 316. Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk apart from any conclusions regarding the existence of more specifically



identifiable risks. Specifically, the procedures described in AU section 316 should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

In conjunction with the evaluation of risk factors that could result in material misstatements due to fraud, auditors should apply procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments (for example, entries posted directly to financial statement drafts) made in the preparation of the financial statements. An auditor may evaluate the types of entries that can be made by members of management and the related authorization levels that apply to consider the risk of management override of controls. Procedures should also focus on evaluating inappropriate or unauthorized entries, as well as consolidating adjustments or reclassifications in the financial statement that are not reflected in the general ledger. Inappropriate or unauthorized journal entries and adjustments often have unique identifying characteristics. Such characteristics may include entries made to unrelated, unusual, or seldom used accounts or business segments; entries recorded as the end of the period or as post closing entries; entries made before or during the preparation of the financial statements that do not have account numbers, and entries that contain round numbers; or a consistent ending number.

In addition to testing controls, auditors should perform substantive testing to further address the risk of management override of certain controls. Auditors should examine journal entries and other adjustments for possible material misstatement due to fraud.

- D. *Key Estimates.* Key estimates made by management that could be susceptible to material misstatement due to fraud include reserve calculations for future policy and contract benefits and related accounts, deferred taxes and the related valuation allowances, estimated gross profits and their impact on the amortization of DAC and investment valuation reserves, the assessment of securities for impairments that are other than temporary, and guarantee fund assessments. Auditors should challenge whether the assumptions used to amortize DAC are consistent with the assumptions used to estimate future policy benefits. See also *a* for a description of accounts, classes of transactions, and assertions that have an inherent risk because they involve a high degree of management judgment and subjectivity.

**5.157** *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls that address the risks.* See paragraphs .43–.45 of AU section 316 (AICPA, *Professional Standards*). Auditors should comply with the requirement of AU section 316 (AICPA, *Professional Standards*) concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. As part of the understanding of internal control sufficient to plan the audit, the life or health insurance auditor should evaluate whether entity programs and controls that address identified

risks of material misstatement due to fraud have been suitably designed and placed in operation. These programs and controls may involve:

- a. Specific controls designed to mitigate specific risks of fraud and may include controls to address specific assets susceptible to misappropriation. Examples of such controls include the following:
  - i. Use of a lock box for the remittance of premium receipts
  - ii. Management quality control review of claim payments
  - iii. Established authorization and approval levels for underwriters and claim adjusters
- b. Broader programs designed to prevent, deter, and detect fraud. Examples of such controls include the following:
  - i. Programs to promote a culture of honesty and ethical behavior. Directors and officers of the life and health insurance entity set the tone at the top, by establishing a code of conduct and promoting a strong value system.
  - ii. Evaluating and monitoring appropriate controls and monitoring activities. Because of the importance of information technology in supporting operations and the processing of transactions, management also needs to implement and maintain appropriate controls, whether automated or manual, over computer-generated information.

**5.158** The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

**5.159** *Responding to the results of the assessment.*<sup>32</sup> Paragraphs .46–.67 of AU section 316 (AICPA, *Professional Standards*) provide requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

- a. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned.
- b. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed.

The life or health insurance auditor's responses to address specifically identified risks of material misstatement due to

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<sup>32</sup> Paragraph .03 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that, to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. See paragraphs .04–.07 of AU section 318. This requirement provides a link between the auditor's consideration of fraud and assessment of risk and the auditor's procedures in response to those assessed risks.

fraud may include changing the nature, timing, and extent of auditing procedures in the following ways:

- The nature of auditing procedures performed may need to be changed to obtain evidence that is more reliable or to obtain additional corroborative information. For example, more evidential matter may be needed from independent sources outside the entity, such as confirmations regarding reinsurance transactions or policy holder account balances.
  - The timing of substantive tests may need to be modified. The auditor might conclude that substantive testing should be performed at or near the end of the reporting period to best address an identified risk of material misstatement due to fraud. Such accounts that could be tested at year-end may include reserves, DAC, and market value testing for investments.
  - The extent of the procedures applied should reflect the assessment of the risks of material misstatement due to fraud. For example, increasing sample sizes or performing analytical procedures at a more detailed level (that is, by product line) may be appropriate for premiums, reserves, or DAC. Also, computer assisted audit techniques may enable more extensive testing of electronic transactions and account files. Such techniques can be used to select sample transactions from key electronic files, to sort transactions with specific characteristics, or to test an entire population instead of a sample.
  - The auditor may wish to consider the controls in place to prevent unauthorized access and changes to policyholder information or the auditor may find it necessary to confirm certain policy information directly with the policyholder. The auditor may also consider the controls in place related to proper authorization, due diligence, and underwriting of new investments as well as accounting controls over investment valuation.
- c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see AU section 316 [AICPA, *Professional Standards*] and paragraph 5.155).

**5.160** *Evaluating audit evidence.* Paragraphs .68–.78 of AU section 316 (AICPA, *Professional Standards*) provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries

throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

**5.161** At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

**5.162** *Responding to misstatements that may be the result of fraud.* When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. Paragraphs .75–.78 of AU section 316 (AICPA, *Professional Standards*) contain requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

**5.163** If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

- a. attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon;<sup>33</sup>
- b. consider the implications for other aspects of the audit;
- c. discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved and with senior management and the audit committee; and
- d. if appropriate, suggest that the client consult with legal counsel.

The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

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<sup>33</sup> See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), for guidance on auditors' reports issued in connection with audits of financial statements. More specifically, referenced in AU section 508, *Reports on Audited Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), for reports issued in connection with an integrated audit of financial statements and internal control over financial reporting, the practitioner should refer to paragraphs 85–98 of PCAOB Auditing Standard No. 5 for guidance on reporting on internal control over financial reporting.

**5.164** *Communicating about possible fraud to management, the audit committee, and others.* Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs .79–.82 of AU section 316 (AICPA, *Professional Standards*) for further requirements and guidance about communications with management, the audit committee, and others.

**5.165** *Documentation and guidance.* AU section 316 (AICPA, *Professional Standards*) require certain items and events to be documented by the auditor. Auditors should comply with those requirements. Other sources of guidance include AU section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*), and AU section 333. Additionally, the AICPA practice aid *Fraud Detection in a GAAS Audit—Revised Edition* provides a wealth of additional information and help on complying with the provisions of the aforementioned AU sections. Moreover, this practice aid will assist auditors in understanding important fraud requirements and whether current audit practices effectively incorporate these requirements. This practice aid is an *other auditing publication* as defined in AU section 150. Other auditing publications have no authoritative status; however, they may help the auditor understand and apply SASs.

## Illegal Acts

**5.166** AU section 317 prescribes the nature and extent of the consideration an auditor should give to the possibility of illegal acts by a client. The term *illegal acts*, for purposes of AU section 317, relates to violations of laws or government regulations. It also provides guidance on the auditor's responsibilities when a possible illegal act is detected. Auditors should assure themselves that all illegal acts that have come to their attention, unless clearly inconsequential, have been communicated to those charged with governance in accordance with AU section 317.

**5.167** Illegal acts vary considerably in their relation to the financial statements. Generally, the further removed an illegal act is from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the act or to recognize its possible illegality.

**5.168** The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. For example, statutory requirements affect investment limitations for insurance entities. However, the auditor should consider such laws or regulations from the perspective of their known relationship to audit objectives that are derived from financial statement assertions rather than from the perspective of legality per se. The auditor's responsibility to detect misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors or fraud, as described in AU section 316 (AICPA, *Professional Standards*). That is, the auditor should design the audit to provide reasonable assurance of detecting illegal acts having a direct and material effect on the determination of financial statement amounts.

**5.169** In addition, life insurance entities may be affected by many other laws or regulations, including those related to occupational safety and health, market conduct, equal employment, and price fixing or other antitrust violations. Generally, these laws and regulations relate more to an entity's operating aspects than to its financial and accounting aspects, and their financial

statement effect is indirect. An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. Even when violations of such laws and regulations can have consequences material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.

**5.170** Normally, an audit in accordance with GAAS or PCAOB standards does not include audit procedures specifically designed to detect illegal acts such as those described in paragraph 5.166. However, other audit procedures may bring possible illegal acts to the auditor's attention. Such audit procedures might include the following:

- a. Inquiries of the client's management and legal counsel concerning litigation, claims, assessments, and violations of laws or regulations cited in regulatory examination reports
- b. Inquiries of the client's management or other appropriate personnel concerning compliance with the domiciliary state insurance department's laws and regulations and those of any other states in which the entity is licensed to write business
- c. Consideration of the adequacy of the client's procedures for monitoring regulatory and contractual compliance

**5.171** As a result of the licensing requirements and highly regulated nature of the life insurance industry, specific audit procedures should be considered regarding compliance with certain requirements of the life insurance entity's state of domicile.

**5.172** The auditor also ordinarily obtains written representations from management. The auditor should refer to AU section 333 for guidance concerning representations about violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency or which should be reported to the state regulatory authorities.

## Going-Concern Considerations \*\*

**5.173** AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), require auditors to evaluate—as part of every financial statement 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 exceeding one year beyond the date of the

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\*\* In October 2008, FASB issued Proposed Statement of Financial Accounting Standards *Going Concern* that would provide guidance on the preparation of financial statements as a going concern and on management's responsibility to evaluate a reporting entity's ability to continue as a going concern. It also would require certain disclosures when either financial statements are not prepared on a going concern basis or when there is substantial doubt as to an entity's ability to continue as a going concern. Readers should be alert to any final pronouncements. Currently, AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), contains the guidance about the going concern assessment. The PCAOB adopted AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), on an initial, transitional basis and has subsequently amended that interim standard.

financial statements being audited. The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at the time or have occurred prior to the date of the auditor's report. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited. The auditor's evaluation of a life insurance entity's ability to continue as a going concern may be one of the most complex and important portions of the audit. This section describes the unique issues that an auditor may encounter in evaluating a life insurance entity's ability to continue as a going concern. See paragraph 5.184 for additional documentation requirements.

**5.174** The auditor may identify information about certain conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the life insurance entity's ability to continue as a going concern for a reasonable period of time. The significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. The following are examples of such conditions and events that may be encountered in audits of life insurance entities:

- a.* Recurring operating losses
- b.* Indications of strained liquidity
- c.* Failure to meet minimum capital requirements
- d.* Failure to meet contractual requirements (for example, debt covenants, reinsurance agreements)
- e.* Concerns expressed or actions taken by regulatory authorities regarding alleged unsafe and unsound practices
- f.* Indications of strained relationships between management and regulatory authorities
- g.* Rating agency downgrade

**5.175** AU section 341 provides guidance to the auditors for meeting their responsibility to evaluate whether there is substantial doubt about a life insurance entity's ability to continue as a going concern for a reasonable period of time. (Documentation requirements pertaining to the following are discussed in paragraph 5.184.)

- a.* The auditor considers whether the results of the procedures performed in planning, gathering audit evidence relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. It may be necessary to obtain additional information about such conditions and events, as well as appropriate evidential matter to support information that mitigates the auditor's doubt.
- b.* If the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, then the auditor should (i) obtain information about management's plans that are intended to mitigate the effect of the conditions or events, and (ii) assess the likelihood that such plans can be effectively implemented.

- c. After the auditor has evaluated management's plans, the auditor concludes whether he or she has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, then he or she should (i) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (ii) include an explanatory paragraph (following the opinion paragraph) in the audit report to reflect that conclusion. If the auditor concludes that substantial doubt does not exist, then he or she should consider the need for disclosure.

**5.176** AU section 341 states that it is not necessary to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the ability of an entity to continue as a going concern for a reasonable period of time. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose. The following are examples of procedures normally performed in audits of life insurance entities that may identify such conditions and events:

- a. Analytical procedures
- b. Review of subsequent events
- c. Review of compliance with the terms of debt and loan agreements
- d. Reading of the minutes of meetings of those charged with governance
- e. Inquiry of an entity's legal counsel about litigation, claims, and assessments
- f. Confirmation with related and third parties of the details of arrangements to provide or maintain financial support
- g. Review of the financial strength and liquidity of the parent entity, if applicable
- h. Review of reports of significant examinations and related communications between examiners and the life insurance entity
- i. Review of asset/liability matching studies and reports
- j. Review of the life insurance entity's RBC calculations and development of an understanding of any implications on the financial position of the entity

**5.177** A significant consideration in the auditor's evaluation of a life insurance entity's ability to continue as a going concern is whether the entity complies with regulatory RBC requirements.<sup>34</sup> In view of the serious ramifications of noncompliance with regulatory RBC requirements for life insurance entities, 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 either the adverse effects of the

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<sup>34</sup> Auditors should evaluate a life insurance entity's ability to continue as a going concern even if the entity meets minimum risk-based capital (RBC) standards. There are other conditions and events that may indicate that there could be substantial doubt about a life insurance entity'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. See paragraphs 5.44–.47.



noncompliance with regulatory RBC capital requirements or the events that gave rise to the condition, assessing the likelihood of such plans being implemented. In evaluating management's plans, the auditor should consider the following:

- a. The life insurance entity's existing regulatory capital position
- b. Whether a comprehensive financial plan has been filed with the state insurance department and, if so, whether it has been accepted

**5.178** The auditor should consider the amount of any RBC capital deficiency. In general, the lower the ratio of total adjusted capital to ACL RBC, the greater the doubt about the entity's ability to continue as a going concern for a reasonable period. However, the auditor should also assess the likelihood of the life insurance entity's regulatory capital position improving or deteriorating in the next 12 months.

**5.179** The auditor should also consider the nature or source (asset quality, underwriting, asset/liability matching, or other) of the deficiency. Curing deficiencies from certain sources may be more within the control of the management of the life insurance entity than curing deficiencies from other sources.

**5.180** 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; the auditor should also identify and perform auditing procedures to obtain evidential matter about the significant elements. For example, the auditor may consider the adequacy of support regarding an entity'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 life insurance entity by the commissioner that are most difficult to achieve and consider the likelihood of the life insurance entity failing to implement the elements successfully.

**5.181** 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,<sup>35</sup> the auditor should review related communication between the commissioner and the life insurance entity and make inquiries of both management and regulatory officials to determine the current status of the comprehensive financial plan. If the life insurance entity has not filed a financial plan with the commissioner,<sup>36</sup> the auditor should make inquiries of management officials about their comprehensive financial plan and their plans for filing.

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<sup>35</sup> The RBC requirements require the commissioner to notify the insurer whether the comprehensive plan is accepted or is unsatisfactory within 60 days of submission of the plan.

<sup>36</sup> The RBC requirements require that a comprehensive financial plan be filed with the commissioner within 45 days of the failure to meet RBC standards.

**5.182** After the auditor has evaluated management's plans, the auditor should conclude whether substantial doubt about the life insurance entity'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.

**5.183** If the auditor concludes that substantial doubt about the life insurance entity'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 and (b) modify his or her report.

**5.184** When, after considering management's plans, the auditor concludes that substantial doubt about the life insurance entity's ability to continue as a going concern for a reasonable period of time is alleviated, he or she should consider the need for disclosure in the financial statements of the principal conditions and events that initially caused the auditor to believe there was substantial doubt. The auditor's consideration of disclosure should include the possible effects of such conditions and events and any mitigating factors, including management's plans. Some of the information that might be disclosed includes the following:

- a. Pertinent conditions and events giving rise to the assessment of substantial doubt about the life insurance entity's ability to continue as a going concern for a reasonable period of time
- b. The possible effects of such conditions and events
- c. Management's evaluation of the significance of those conditions and events and any mitigating factors
- d. Possible regulatory sanctions, including the discontinuance of operations
- e. Management's plans, including information about the life insurance entity's capital plan and relevant prospective financial information
- f. Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

**5.185** If the auditor concludes that substantial doubt remains about the life insurance entity's ability to continue as a going concern for a reasonable period of time, the audit report should include an explanatory paragraph (following the opinion paragraph) to reflect that conclusion.<sup>37</sup> The auditor's decision about whether modification of the standard report is appropriate may depend on the following:

- a. The life insurance entity's RBC position and the likelihood that this position will improve or deteriorate within the next 12 months
- b. The status of any plan filed with regulators and the auditor's assessment of the life insurance entity's ability to achieve its capital plan

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<sup>37</sup> The inclusion of an explanatory paragraph in the auditor's report should serve adequately to inform users of the financial statements. Nothing in this guide, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner, and the auditor's report should give all the substantive reasons for the disclaimer of opinion.

- c. The extent of recurring operating losses
- d. The financial strength and liquidity of the parent entity
- e. The consequences of defaults under debt and loan agreements

**5.186** AU section 341 states that the auditor should document all of the following:

- a. The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.
- c. The auditing procedures performed and evidence obtained to evaluate the significant elements of management's plans.
- d. The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the conclusion as to the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt.
- e. The auditor's conclusion as to whether he or she should include an explanatory paragraph in the audit report. If disclosures with respect to an entity's ability to continue as a going concern are inadequate, the auditor also should document the conclusions as to whether to express a qualified or adverse opinion for the resultant departure from GAAP.

**5.187** For audits performed in accordance with GAAS, paragraph .17 of AU section 341 states that, after considering identified conditions and events in the aggregate and after considering management's plans, if the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should communicate with those charged with governance

- a. the nature of the events or conditions identified.
- b. the possible effect on the financial statements and the adequacy of related disclosures in the financial statements.
- c. the effects on the auditor's report.

## Management Representations<sup>††</sup>

**5.188** AU section 333 provides guidance to the auditor about the representations to obtain from management as part of an audit. The specific written representations to obtain depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. (See exhibit 5-5, "Illustrative Management Representation Letter for Audits of Life and Health Insurance Entities.") Auditors of life insurance entities might also obtain representations, if applicable, whether

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<sup>††</sup> See paragraph 5.115 for additional information regarding management representations.

- a. information returns have been filed on a timely basis with the appropriate regulatory bodies.
- b. pending changes in the organizational structure, financing arrangements, or other matters that have a material effect on the financial statements of the entity have been properly disclosed.
- c. GAAP financial statements have benefit and claim liabilities, account values, deferred acquisition cost assets, and related financial statement items that are based on appropriate actuarial assumptions and presented in accordance with GAAP.
- d. SAP financial statements have aggregate reserves, account values, and related financial statement items that are based on appropriate actuarial assumptions and prepared in accordance with the prescribed or permitted SAP of the insurer's state of domicile.
- e. the auditor has been provided with information relating to all regulatory financial examinations that have been completed during the period covered by the financial statements being audited or that are currently in process.
- f. prescribed or permitted practices have been used in the preparation of the statutory financial statements.

Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, paragraph .09 of AU section 333 states that management representations should be made as of the date of the auditor's report. If the auditor "dual dates" his or her report, the auditor should consider whether obtaining additional representations relating to the subsequent event is appropriate. See also paragraph .05 of AU section 530.<sup>38</sup>

#### *Considerations for Integrated Audits*

Additionally, for integrated audits performed in accordance with PCAOB standards, refer to paragraphs 75–77 of Auditing Standard No. 5 for additional written representations to be obtained from management.

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<sup>38</sup> TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), clarifies timing effects surrounding the management letter and the independent auditor's report date.

**Exhibit 5-1****Illustration of the Accountant's Awareness Letter<sup>1</sup>**

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 auditing standards generally accepted in the United States of America 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 entities. 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*].

The letter is intended solely for the information and use of the Insurance Department of [*name of state of domicile*] and other state insurance departments in states in which the Company is licensed and is not intended to be and should not be used for anyone other than these specified parties.

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<sup>1</sup> See chapter 15, "Reports on Audited Financial Statements," for samples of PCAOB language.

**Exhibit 5-2****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, 20X4 and 20X3.<sup>1</sup> 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 may 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.]<sup>2</sup>

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<sup>1</sup> If the auditor had not reported on any financial statements, the first sentence may 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, 20X1.

<sup>2</sup> 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, 20X4 and 20X3, 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 (SAP) 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.

**Exhibit 5-3****Illustrative Accountant's Letter of Qualifications<sup>1</sup>**

To the Board of Directors of GHI Insurance Company:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the statutory financial statements of GHI Insurance Company (the Company) for the years ended December 31, 20X4 and 20X3, 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 *[number]* years and *[number]* years, respectively, of experience in public accounting and are experienced in auditing insurance entities. Members of the engagement team, most (some) of whom have had experience in auditing insurance entities and *[number]* 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 regulators. In this context, the Company and the insurance commissioners should understand that the objective of an audit of statutory financial statements in accordance with GAAS 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 GAAS, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform our audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional 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 misstatement resulting from fraud. Because of the characteristics of fraud, a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements caused by error or fraud 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 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 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 working papers<sup>2</sup> prepared in the conduct of our audit until the Insurance Department of [name of state of domicile] has filed a Report of Examination covering 20X4, but no longer than seven years. After notification to the Company, we will make the working papers available for review by the Insurance Department of [name of state of domicile] at the offices of the insurer, at our offices, at the Insurance Department or at any other reasonable place designated by the Insurance Commissioner. Furthermore, in the conduct of the aforementioned periodic review by the Insurance Department of [name of state of domicile], photocopies of pertinent audit working papers may be made (under the control of the accountant) and such copies may be retained by the Insurance Department of [name of state of domicile].<sup>3</sup>
- 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 *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

The letter is intended solely for the information and use of the Insurance Department of [name of state of domicile] and other state insurance departments



in states in which the Company is licensed and is not intended to be and should not be used for anyone other than these specified parties.

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- <sup>1</sup> See chapter 15, "Reports on Audited Financial Statements," for samples of PCAOB language.
- <sup>2</sup> Section 13 of the revised Model Audit Rule defines working papers as follows:
- Workpapers are the records kept by the independent certified public accountant of the procedures followed, the test performed, the information obtained, and the conclusions reached pertinent to the accountant's examination of the financial statements of an insurer. Workpapers, accordingly, may include audit planning documentation, work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents and schedules or commentaries prepared or obtained by the independent certified public accountant in the course of his or her examination of the financial statements of an insurer and which support the accountant's opinion.
- <sup>3</sup> Refer to *Audit Documentation: Auditing Interpretations of Section 339* (AICPA, *Professional Standards*, AU sec. 9339; AICPA, *PCAOB Standards and Related Rules*, Interim Standards, AU sec. 9339).

**Exhibit 5-4****Illustration of Notification of Financial Condition Letter When the Audit Is Complete<sup>1,2</sup>**

To the Board of Directors:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the statutory financial statement of MNO Insurance Company (the Company) as of December 31, 20X4 and 20X3, 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, 20X4, as reported on the 20X4 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 20X4 Annual Statement should be reduced by \$\_\_\_\_ as a result of the matter in the preceding sentence.<sup>3</sup>

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.

The letter is intended solely for the information and use of the Insurance Department of *[name of state of domicile]* and other state insurance departments in states in which the Company is licensed and is not intended to be and should not be used for anyone other than these specified parties.

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<sup>1</sup> 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 illustration letter may be modified depending on the relevant facts and circumstances.

<sup>2</sup> See chapter 15, "Reports on Audited Financial Statements," for samples of PCAOB language.

<sup>3</sup> 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 may 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.

**Exhibit 5-5****Illustrative Management Representation Letter for Audits of Life and Health Insurance Entities**

[Date of Auditor's Report]

[Independent auditor's address]

To [Independent Auditor]

We are providing this letter in connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [date] and for the [period of examination] for the purpose of expressing an opinion as to whether the [consolidated] financial statements present fairly, in all material respects, the financial position, results of operations, other comprehensive income, and cash flows of [name of entity] in conformity with accounting principles generally accepted in the United States of America [other comprehensive basis of accounting]. We confirm that we are responsible for the fair presentation of the [consolidated] financial statements of financial position, results of operations, other comprehensive income, and cash flows in conformity with GAAP (or admitted assets, liabilities, and capital and surplus, statutory income, capital and surplus, and cash flows in conformity with the accounting practices prescribed or permitted by the [state of domicile] Department of Insurance).

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

We confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

[Body of the representation letter generally applies to the audit of both SAP and GAAP financial statements except as indicated]

1. The financial statements referred to previously are fairly presented in conformity with accounting principles generally accepted in the United States of America (or with the accounting practices prescribed or permitted by the [state of domicile] Department of Insurance).
2. We have made available to your representatives all of the following:
  - a. Financial records and related data
  - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared
  - c. All significant contracts and agreements
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate to the financial statements taken as a whole.
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving
  - a. Management,
  - b. Employees who have significant roles in internal control, or
  - c. Others where the fraud could have a material effect on the [GAAP/SAP] financial statements
8. We have no knowledge of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.
9. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
10. The following have been properly recorded or disclosed in the financial statements:
  - a. Related-party transactions and related amounts receivable or payable, premiums and other revenues, claims and other expenses, loans, transfers, leasing arrangements, and guarantees
  - b. Capital stock repurchase options, or agreements or capital stock reserves for options, warrants, conversion, or other requirements
  - c. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements
  - d. Agreements to repurchase assets previously sold
  - e. Amount of credit risk and extent, nature, and terms of financial instruments with off-balance-sheet risk
  - f. All permitted accounting practices used in the preparation of our statutory financial statements for the year ended December 31, 20X4
11. There are none of the following:
  - a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure for [GAAP/SAP] financial statements or as a basis for recording a loss contingency.
  - b. Unasserted claims or assessments that our lawyers have advised us are probable of assertion and must be disclosed in accordance with FASB Statement No. 5, *Accounting for Contingencies*.
  - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed as defined in FASB Statement No. 5.

12. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
13. Provision, when material, has been made for the following:
  - a. Loss to be sustained in the fulfillment of, or from inability to fulfill, any sales commitments for securities or other assets
  - b. Loss to be sustained as a result of purchase commitments for securities or other assets at prices in excess of the prevailing market prices
  - c. Loss on those invested assets whose value has been impaired, or when required by the [state of domicile] Department of Insurance
14. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
15. The financial statements reflect accumulated liabilities for future policy benefits that, together with expected future gross premiums and expected future investment earnings, will be sufficient to cover expected future promised benefits, settlements, and maintenance expenses under reasonable assumptions as to future experience.
16. [For GAAP] The entity's benefit and claim liabilities, account values, deferred acquisition cost assets, and related financial statement items are based on appropriate actuarial assumptions, are prepared in accordance with the accounting principles that are generally accepted for life insurance entities, are fairly stated in accordance with sound actuarial principles applied on a consistent basis, and include provision for all actuarial reserves and related financial statement items that should be established. The deferred acquisition cost assets are recoverable based on appropriate assumptions, and no additional loss recognition is required as of [balance-sheet date]. In connection with this, the related master files and valuation listings and summaries represent a materially complete and accurate record of all contracts in force at [balance-sheet date].
17. [For SAP] The entity's aggregate reserves, account values, and related financial statement items are based on appropriate actuarial assumptions, are prepared in accordance with the accounting practices prescribed or permitted by the [state of domicile] Department of Insurance, are fairly stated in accordance with sound actuarial principles applied on a consistent basis, and include provision for all actuarial liabilities and related financial statement items that should be established. In connection with this, the related master files and valuation listings and summaries represent a materially complete and accurate record of all contracts in force at [balance-sheet date].
18. We have informed you of all regulatory financial examinations that have been completed in the past year or that are currently in process. We have reviewed with you all the proposed adjustments to the statutory financial statements arising from the [date] examinations by the [name of state] Department of Insurance and your

audit, and we concur with the disposition of those proposed adjustments in the statutory financial statements.

- 19. All information returns have been filed on a timely basis with the appropriate regulatory bodies.

To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

\_\_\_\_\_  
*[Name of Chief Executive Officer and Title]*

\_\_\_\_\_  
*[Name of Chief Financial Officer and Title]*

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## Chapter 6

# Auditing Inforce Files

### Introduction

**6.01** Information relating to an individual life insurance contract is typically recorded in an automated file, which is commonly referred to as the *inforce file* or the *contract holder master file*. The information contained in the inforce file is used by many different operations within the life insurance entity. For instance, it is typically used to generate premium billings and to calculate or control commissions, contract holder benefits, contract holder dividends, and policy loans. The inforce file is also a key source of data for actuarial estimates, such as valuation of benefit liabilities and other period end accruals and balances. In addition, the inforce files maintain historical data used in actuarial analysis and experience studies. Accordingly, exercising control over the related contract information files is of primary importance. A life insurance entity may have separate inforce files established for lines of business or even plans of insurance. For example, separate application systems may exist for life insurance contracts and annuity contracts that maintain separate inforce files. In addition, separate inforce files may exist for different plans of insurance, such as traditional whole life and universal life contracts.

**6.02** Access to the inforce file is usually limited to authorized individuals involved in contract holder service areas. These individuals may issue contracts, maintain files for change of addresses or beneficiaries, and so on. There generally should be an appropriate segregation of duties among all individuals with authorized access to the inforce files, and appropriate levels of independent reviews.

**6.03** In addition, the inforce file is commonly interfaced with many of the life insurance entity's financial systems. Consequently, a number of audit procedures related to the inforce file can often be more efficiently addressed by extending the tests on the related systems to ensure that transactions are appropriately reflected in the inforce file. For this reason, a number of the possible audit procedures directed at obtaining assurance as to the accuracy, completeness, and authenticity of the inforce file are described in other sections of this Audit and Accounting Guide.

**6.04** The information contained in the inforce file includes both *standing data* (set up when the contract is issued and maintained for any changes) and *transaction based data* (data based on financial transactions associated with the individual contract). The inforce file should indicate the date, reason, and source of changes to file data. Inforce files may include any or all of the data indicated in the following table.

<i>Standing Data</i>	<i>Transaction Data</i>
Contract number	Status of contract (such as in force, lapsed, paid up, claim filed, claim paid)
Contract holders' names and addresses	Agent or broker
Owner and beneficiary	Commission details
Name of the insured	Policy loans outstanding and interest thereon
Date of birth and age at issue	Accumulated cash surrender value
Gender	Dividend or participating profit accumulations
Smoker or nonsmoker	Paid-to-date and premiums outstanding
Kind of contract	Paid-up additions
Contract issue date	Benefit payments
Period of coverage	Interest credits
Benefits, face amount, or both, of the contract	Contract charges
Riders in force (for example, waiver of premium)	Account values
Reinsurance details	
Premium payment mode	
Stated premium amount, if any	
Investment options, if any	
Face amount option: A (level death benefits) or B (level amount at risk)	
Short term interest and mortality guarantees	

**6.05** The inforce file data are generally updated as a result of processing any one of the following:

- a. Transactions initially processed through other transaction cycles, as described elsewhere in this guide, such as premium payments, commission payments, benefit and claim liabilities, reinsurance, and policy loans
- b. Transactions initiated automatically by the other application systems, such as an automatic policy loan for nonpayment of premium and the calculation of interest credits for universal life contracts
- c. Transactions initiated by the contract holder such as surrenders

**6.06** Inforce file maintenance includes transactions such as issuing new contracts and the maintenance of existing contracts (for example, change of address, change of a beneficiary, or corrections of other contract data). These transactions typically do not affect other transaction cycles.



## Control Objectives

**6.07** *Controls over transactions affecting other transaction cycles.* Other transaction cycles may be completely integrated with the inforce files, or they may be stand alone systems that require a separate inforce file update for related transactions. In either case, controls typically should be in place to ensure that all transactions affecting inforce data are accurately and completely processed in the proper accounting period within the inforce system. In addition, controls should exist to ensure that transactions generated by the inforce system or other application systems, such as automatic policy loans or reinstatements, are completely and accurately processed in the proper accounting period.

**6.08** *Controls over inforce maintenance transactions.* Access to the inforce file for making changes generally should be restricted to authorized personnel, and all changes should be reviewed to protect the integrity of the file. For example, an incorrect change in age, contract issue date, or face amount could result in incorrect liability amounts or improper benefit payments.

**6.09** *General controls for inforce files.* Inforce files are used extensively for administrative, managerial, and financial applications. The total or partial loss or unauthorized alteration of inforce data could adversely affect a life insurance entity's profitability, the integrity of its financial statements, and the ability to service its contract holders or manage its business. Therefore, adequate controls ordinarily should be established concerning data security, and procedures should be in place for the recovery of data lost as a result of natural disaster, intentional acts of sabotage, or unintentional errors, accidents, or omissions. General and application controls on data security are directed toward ensuring that access to systems is limited to authorized individuals for purposes of executing their assigned duties. Data recovery procedures generally should provide for systematic backup and off-site storage of critical files as well as plans for the replacement of computer systems in case of total or partial destruction.

## Auditing Procedures

**6.10** Because the inventory of insurance contracts in force is not under general ledger control, it is essential to carefully examine the internal control policies and procedures over the inventory. Such a review may highlight the possible kinds of errors so that the auditor can then direct his or her attention to those areas. National Association of Insurance Commissioners (NAIC) *Life, Accident and Health Annual Statement Instructions* requires that insurers filing audited statutory financial statements in accordance with NAIC *Annual Statement Instructions* include a Supplemental Schedule of Selected Financial Data. The schedule, which is illustrated in the NAIC *Annual Statement Instructions*, includes inforce amounts used by actuaries in determining benefit liabilities. The NAIC *Annual Statement Instructions* require the auditor to issue a report on the supplemental schedule on whether the information is fairly presented in relation to the financial statements taken as a whole. Because all of the information required to be included in the supplementary schedule is either directly related to the basic statutory financial statements or derived from accounting records that are tested by auditors, the guidance in AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*), should be

followed when auditors report on supplemental schedules. AU section 551A provides guidance for both accounting and nonaccounting data.

**6.11** The inventory of contracts in force should be tested for inclusion and exclusion of all applicable contracts and for accuracy and completeness of the information included in each contract record (for example, plan, issue age, sex, face amount, and contract riders). In smaller life insurance entities, the auditor can often obtain a detailed listing of all insurance contracts in force. In larger entities or entities in which detailed listings are unavailable, the auditor may be able to obtain details supporting the accumulation of selected blocks or cells of contracts in the entity's inventory.

**6.12** The auditor should perform sufficient tests of controls, substantive procedures, or both, of insurance contracts in force to satisfy himself or herself that all contracts that should be included in the inventory are included. Such tests may be performed based on sampling techniques, including tests of data to and from sources independent of the inforce files, such as cash receipts, premium billing records, and contract registers. The auditor may also test data to and from the lapse files, claim registers, and cash disbursements to provide evidence that the proper deletions have been made from the inforce inventory. The accuracy of the coding shown on the detail of the insurance in force may be tested by comparing it with data shown on the original contract applications.

**6.13** The auditor should consider the following audit procedures (in addition to those audit procedures described previously and in other chapters) in auditing the accuracy, reliability, and completeness of a life insurance entity's inforce files (it should be noted that procedures would differ when auditing traditional long-duration contracts versus universal life-type or limited-payment contracts):

- a. Review variances between actual and estimated contract counts and inforce amounts of new and existing business by line of business or reserve category.
- b. Review or test changes between periods by appropriate classification of contracts, line of business, or reserve category. Obtain explanations for any large, unusual, or unexpected differences in the following:
  - i. Record counts and value of inforce file
  - ii. Additions and deletions to the inforce file
  - iii. Distribution of inforce file by geographic area, issue age, and gender
  - iv. Volume and number of automatic transactions, such as conversion to paid-up status
  - v. Unusual contract holder data, such as ages outside the normal ranges
  - vi. Individual contracts or groups of contracts that insure the same individual and exceed the entity's retention limits
  - vii. Surrenders, lapses, and death claims (number of contracts and value) relative to the value of insurance in force at the beginning of the period
  - viii. Duplicate contract numbers and missing contract holder data
  - ix. Summary of processing backlogs

- c. Review periodic reconciliations between inforce transactions and data from other application systems and the general ledger.
- d. Review details of any system failures, breaches in security, or other unauthorized access related to the inforce files or other interfaced application systems.
- e. Test cutoff procedures to assure appropriate period end reporting of inforce data with the general ledger, premium collection system, and other application systems.
- f. Determine the propriety of inforce file transactions by tracing back to other transaction processing systems, such as premium receipts and claims processing, as appropriate.

**6.14** Because of the size and complexity of the inforce file, computer assisted audit techniques are often used.

### Confirmation of Insurance Contracts in Force

**6.15** Under certain circumstances, the auditor may consider verification of the authenticity of contracts included in the inforce inventory by direct confirmation with the contract holders (see paragraph 6.18). In general, it would be unusual for a life insurance entity to overstate its liabilities by inflating the inventory of insurance contracts in force, because such an overstatement would generally result in decreased current earnings on a statutory basis. However, an overstatement of insurance contracts in force could result in increased current earnings for life insurance entities reporting on a U.S. generally accepted accounting principles (GAAP) basis.

**6.16** There could be additional motivation for overstating insurance contracts in force when reinsurance related to those contracts has the effect of materially increasing current earnings, which can occur when an entity reports on either a U.S. GAAP or statutory accounting principles (SAP) basis. The reinsurance of life insurance contracts may permit the elimination or reduction of the related liability for future contract holder benefits. Under certain circumstances for SAP, reinsurance may also result in increased current earnings to the extent that the proceeds received from reinsurance exceed expenses incurred in connection with the sale and servicing of reinsured contracts. (See chapter 12, "Reinsurance.")

**6.17** Satisfactory results of the comparison of insurance contracts in force with premium collections along with other ordinary audit procedures, discussed previously and in the *Auditing* sections of chapters 7–14 of this guide, generally will provide the auditor with sufficient appropriate audit evidence as to the validity of those contracts included in the inventory of insurance contracts in force. However, the auditor may consider confirming insurance contracts in force with contract holders if certain circumstances such as the following exist:

- a. Proper maintenance of the inventory of insurance in force may be materially deficient as a result of an absence of segregation of duties or other internal control structure policies and procedures.
- b. Trend analyses or ratios that measure insurance in force indicate erratic or unusual results that have not been satisfactorily explained.
- c. Additions to insurance in force cannot be related to the collection of premiums.

- d. Significant amounts of insurance in force result from related party transactions, and the related party's financial statements are not examined by the auditor.
- e. The life insurance entity markets insurance products, such as those with immediate cash value features or with unusual commission arrangements that would motivate the agent to submit fictitious contracts.
- f. Ceded reinsurance activities can materially increase earnings or investable funds.

**6.18** AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*), provides guidance for designing the confirmation request, performing the confirmation procedures, performing alternative procedures when necessary, and evaluating the combined results of the confirmation and alternative procedures. Additionally, for audits of nonissuers, Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330<sup>1</sup> (AICPA, *Professional Standards*, AU sec. 9330 par. .01–.06), provides guidance as to whether electronic confirmations can be considered to be reliable audit evidence.<sup>2</sup>

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<sup>1</sup> In November 2008, the Auditing Standards Board issued revised Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, AU sec. 9330 par. .01–.08). The interpretation clarifies, among other matters, that the use of an electronic confirmation process is not precluded by AU section 330. Although no confirmation process with a third party is without some risk of interception or alternation, including the risk that the confirmation respondent will not be the intended respondent, paragraph .05 of Interpretation No. 1 states that confirmations obtained electronically can be considered to be reliable audit evidence if the auditor is satisfied that (1) the electronic confirmation process is secure and properly controlled, (2) the information obtained is a direct communication in response to a request, and (3) the information is obtained from a third party who is the intended respondent. The interpretation also provides guidance to assist the auditor in assessing the confirmation process.

<sup>2</sup> Additionally, the AICPA has updated and revised the guidance in its Practice Alert No. 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240), to provide information regarding a number of topics, including but not limited to, the use of electronic confirmations, alternative procedures, and management requests not to confirm. Practitioners are encouraged to incorporate the information as soon as practicable. The alert is currently available at [www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/DownloadableDocuments/PracticeAlerts/pa\\_2003.1.pdf](http://www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/DownloadableDocuments/PracticeAlerts/pa_2003.1.pdf).

## Chapter 7

# Insurance Revenues

### Introduction

**7.01** Life and health insurance premiums and annuity considerations represent the largest portion of a life insurance entity's statutory revenue. Although life insurance entities have other sources of statutory revenue—such as investment income—maintaining sufficient contract revenues is crucial to their financial stability. Direct premium rates must

- a. be high enough to pay contract benefits,
- b. cover selling, operating, and maintenance expenses, and
- c. provide for an adequate profit.

To attract and maintain contract holders, those rates must also be competitive with the premium rates of other entities.

### Regulation of Premium Rates

**7.02** In general, the life insurance industry is not directly regulated in the amount of the premium charged except for certain health insurance contracts and maximum allowable rates on credit insurance. Controls are imposed on life insurance premium rates through reserve regulation. Definitive reserve requirements indirectly force premium rates that are high enough to maintain minimum statutory reserves.

### Taxation of Premiums

**7.03** In addition to federal income taxes and other taxes, such as real estate and payroll taxes, life insurance entities also are subject to state premium taxes. State premium taxes are generally levied on direct life and health premiums written in a particular state. However, each state has its own premium tax system, with unique rules governing the rate of tax and the definition of the tax base. Each state may charge different rates based on the kind of entity (for example, fraternal benefit societies are exempt), kind of contract, and the state of domicile of the life insurance entity. (See chapter 13, "Taxation of Life Insurance Entities," for additional discussion.)

### Accounting Practices\*

**7.04** As discussed in chapter 3, "Sources of Accounting Principles and Reporting Requirements," life insurance entities are subject to the filing

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\* The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, the Financial Accounting Standards Board (FASB) issued the invitation to comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*. That invitation to comment included a discussion paper issued by the IASB, *Preliminary*

(continued)

requirements of statutory accounting practices (SAP), and may also prepare financial statements in accordance with U.S. generally accepted accounting principles (GAAP). The following discussion of SAP and U.S. GAAP accounting for premium revenues is not a comprehensive source of authoritative accounting literature, but is intended to assist the preparers and auditors of financial statements in obtaining a general understanding of basic accounting practices for the contracts most commonly used by the life insurance industry. The authoritative sources cited in chapter 3 may be referred to in determining appropriate accounting and reporting treatment in all cases.

**7.05** A complete discussion of revenue recognition concepts for life insurance entities requires an understanding not only of premiums, but also of the calculation and accounting for related items such as benefit and claim liabilities, treatment of expense and surrender charges, contract acquisition costs, investment income, reinsurance, and other economic aspects of the underlying contracts. This chapter concentrates primarily on accounting concepts relating to the recognition of premium and deposit revenue. (See exhibit 7-1, "Excerpt of Exhibit 1 From the Annual Statement," for a diagram that illustrates a decision process for classifying products.)

## Statutory Accounting Practices

**7.06** *Premium revenue recognition.* Under SAP, premiums and annuity considerations are recognized as revenue on the gross basis (amount charged to the policyholder) when due from the policyholders under the terms of the insurance contract. Premium revenue will be adjusted for deferred, due and uncollected, and unearned premiums as required by the premium recognition assumptions used in computing contract reserves. (See chapter 8, "Liabilities for Future Policy Benefits (Statutory Benefit Reserves) and Other Contract Liabilities.") SAP premium amounts also include reinsurance assumed and are reduced by reinsurance ceded. (See chapter 12, "Reinsurance.")

**7.07** Classifying a policy as either a life insurance contract or a deposit contract determines the method for recognizing premiums and deposits under SAP. Statements of Standard Accounting Practice (SSAP) No. 50, *Classifications and Definitions of Insurance or Managed Care Contracts In Force*, and SSAP No. 52, *Deposit-Type Contracts*, provide guidance in determining the appropriate classification. Under SAP, contracts without any life or disability

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(footnote continued)

*Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project.

In July 2010, the IASB issued the exposure draft *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. Although the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement model; however, the majority prefer an alternative model. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. generally accepted accounting principles to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.

contingencies (that is, mortality or morbidity risk) should not be accounted for as life insurance contracts. The revenue recognition methodologies applied under SAP are as follows:

- a. *Life contracts.* Premiums are recognized as revenue when due from policyholders under the terms of the insurance contract.
- b. *Deposit type contracts.* Amounts received as payments are not recorded as revenue but instead are reported directly to an appropriate policy reserve account. This applies to certain types of structured settlements, guaranteed investment contracts (GICs), and other agreements.

**7.08** Life insurance entities generally record premiums as revenue when received or due, and make accrual adjustments to account correctly for earned revenues. The specific accrual adjustments needed to allocate premium revenue to the proper accounting period for statutory reporting depend on the premium revenue assumptions inherent in related reserve calculations and require an understanding of the following premium and related items.

- a. *Gross premium.* As per SSAP No. 51, *Life Contracts*, paragraph 2, "is the amount charged to the policyholder and taken into operations as premium income."
- b. *Net premium.* As per SSAP No. 51 paragraph 3, "is the amount calculated on the basis of the interest and mortality table used to calculate the reporting entity's statutory policy reserves."
- c. *Loading.* As defined in SSAP No. 51 paragraph 4, "this is the difference between the net premium and the gross premium. Loading generally includes allowances for acquisition costs and other expenses but also includes the differences in mortality and interest assumptions utilized for pricing and statutory reserving purposes."
- d. *Valuation date and policy anniversary date.* The valuation date is the financial period end date (also referred to as the balance sheet date). The contract anniversary date is the year-end of each individual contract, measured from the policy issue date. Generally, the valuation date and the policy anniversary date will be different.
- e. *Deferred premium.* As per SSAP No. 51 paragraphs 22–23:

Premiums are often received in installments more frequently than annually and because the calculation of mean reserves assumes payment of the current policy year's entire net annual premium, the policy reserve is overstated by the amount of net modal premiums not yet received for the current policy year as of the valuation date. As a result, it is necessary to compute and report a special asset to offset the overstatement of the policy reserve.

This special asset is termed *deferred premiums*. Deferred premiums are computed by taking the gross premium (or premiums) extending from (and including) the modal (monthly, quarterly, semiannual) premium due date or dates following the valuation date to the next policy anniversary date and subtracting any such deferred premiums that have actually been collected. Deferred premium assets should also be reduced by loading. Because the calculation of mean reserves assumes payment of the current policy year's entire

net annual premium, deferred premium assets are considered admitted assets to compensate for the overstatement of the policy reserve.

- f. *Due and uncollected premium.* These are gross premium amounts that are due on or before the valuation date but have not been received. As noted in SSAP No. 6, *Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts due from Agents and Brokers*, to the extent that there is no related unearned premium, any uncollected premium balances that are over 90 days due should be nonadmitted. If an installment premium is over 90 days due, the amount over 90 days due plus all future installments that have been recorded on that policy should be nonadmitted. These amounts are adjusted to a net premium basis, in a manner that is similar to the treatment of deferred premium. Accident and health premiums that are due and uncollected are identified separately as they generally are accrued to premium revenue and the balance sheet at the gross premium amount and are generally referred to as *due and unpaid*. Note that paragraph 6 of SSAP No. 25, *Accounting for and Disclosures about Transactions With Affiliates and Other Related Parties*, as amended by SSAP No. 96, *Settlement Requirements for Intercompany Transactions*, used SSAP No. 6 accounting as a basis for specifying an aging threshold for admission of receivables, loans, and advances to related parties outstanding as of the reporting date. Amounts receivable from related parties should be nonadmitted if they are over 90 days past due or if there is not a due date specified in the related party transaction agreement.
- g. *Unearned premium.* This is the portion of the modal premium amount that is due or has been received and that represents the period from the valuation date to the paid-to-date. The calculation of unearned premium depends on the reserve methodology used for the contract and generally is not needed for traditional life contracts. Accident and health contracts and *home service and credit life contracts* usually require unearned premium adjustments because there is usually not an assumption of a net annual premium payment because these contracts are generally reserved for using a midterminal reserve methodology. (See chapter 8 for discussion of reserve methodologies.)
- h. *Advance premium.* These are premiums received by the statement date that have still not reached their due date. Premium revenues ordinarily do not include more than one year's advance premium. The total amount of advance premiums, less any discounts as of the valuation date, is reported as a liability in the statutory financial statements and is not considered premium income until due. The gross premium, not the net valuation premium, is recorded as the advance premium in recognition of the reporting entity's liability to refund such premiums if the contract is terminated.

**7.09** Statutory earned premium revenue for products using the annual premium method and mean reserves includes actual premium received plus the change in both due and uncollected gross premiums and deferred gross premiums less the change in advance premiums. See exhibit 7-1.



**7.10** The recognition of deferred and due and uncollected gross premiums in revenues is required to maintain consistency with the mean reserve method of computing statutory reserves. This method assumes that a net annual premium has been collected on the contract anniversary date. Inclusion of the net annual premium in the determination of the reserve liability requires that deferred premiums and due and uncollected premiums be recorded to ensure the matching of related balance sheet and income statement amounts. The purpose of accruing due and deferred premiums is not to set up a premium receivable (as the life insurance entity has no legal right to due or deferred premiums) but, rather, to offset the overstatement in the reserve liability caused by the reserve calculation methodology. SAP requires that these amounts be recorded as assets rather than as adjustments to the reserve liability. Generally, if the loading portion of the due and deferred premium is estimated to be inadequate to cover the estimated expenses, a liability is established for the excess amount.

**7.11** Generally, flexible premium contracts, including most flexible premium universal life-type contracts and other similar products do not use reserve methodologies that require net annual premium assumptions. Consequently, the calculation of due and deferred premiums is not applicable for premium revenue recognition for these contracts.

## Generally Accepted Accounting Principles

**7.12** *Premium revenue recognition.* Under U.S. GAAP, the specialized industry accounting principles for revenue recognition for life insurance entities are specified in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*. The following is a brief discussion of the accounting principles relating to premium revenue recognition.

**7.13** As defined in the FASB ASC glossary, the definition of U.S. GAAP *gross premium* is the amount charged to the policyholder for an insurance contract. The FASB ASC glossary defines U.S. GAAP *net premium* as the portion of the gross premium needed to provide for all benefits and expenses.

**7.14** The underlying assumptions used in calculating the U.S. GAAP net premium are generally the same as those used in the U.S. GAAP liability and deferred acquisition costs (DAC) amortization calculations. Accordingly, the statutory concept of loading is not applicable to U.S. GAAP methodologies. For universal life-type and investment contracts, the amount of premium collected does not affect revenue recognition. As a result, the concepts of gross and net premium have little relevance to those contracts. Instead, revenue from those contracts represents amounts assessed against policyholders and is reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period. As a result, revenue may be recognized even if a policyholder chooses to pay no premium during the current period.

**7.15** *Contract classification.* For accounting purposes, contracts issued by life insurance entities are classified as either *insurance contracts* or *investment contracts*. (See exhibit 7-2, "Contract Classifications as Defined in FASB ASC 944, *Financial Services—Insurance*," at the end of this section for contract classification definitions.) Insurance contracts issued by life insurance entities are life, accident and health, and annuity contracts that subject the insurer to significant mortality or morbidity risks. Insurance contracts are classified as *long* or *short-duration contracts*, depending on whether the contract is expected

to provide insurance coverage for an extended period. In classifying contracts, the economic substance of the contract, in addition to the contract terms, should be evaluated.

**7.16 *Short duration insurance contracts.*** As discussed in FASB ASC 944-20-15-7, short duration insurance contracts provide insurance coverage for a fixed period of short duration, and the life insurance entity has the right to cancel the contract or adjust the contract provisions at the end of the contract period.

**7.17** Short duration contracts include contracts such as credit life and certain term life contracts. Accident and health insurance can be of either short or long duration, depending on whether the contracts are expected to remain in force for an extended period or have noncancelable or guaranteed renewable terms.

**7.18 *Long duration insurance contracts.*** As discussed in FASB ASC 944-20-15-10, long duration insurance contracts are expected to remain in force for an extended period and generally are not subject to unilateral changes in their provisions. They include contracts such as whole life and universal life. Long duration insurance contracts are categorized as follows:

- a. *Long duration contracts.* These are insurance contracts that have terms that are fixed and guaranteed and for which premiums are collected for the same period in which the benefits are provided. An example of such contracts is traditional whole life.
- b. *Limited payment contracts.* According to the FASB ASC glossary, *limited payment contracts* are long duration insurance contracts that have fixed and guaranteed terms, that require premium payments over a shorter period than the period for which benefits are provided. Limited payment contracts subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which premium is collected.

Limited payment contracts include such contracts as single premium whole life contracts; 20 payment whole life contracts; and single premium immediate annuity contracts, which include significant life contingencies.

- c. *Universal life-type contracts.* These are long duration insurance contracts that do not have fixed or guaranteed terms. Universal life-type contracts differ primarily from other long-duration contracts in the flexibility and discretion that is granted to the insurer, the contract holder, or both. Examples of these contracts are variable life insurance, universal life insurance, and other interest sensitive products.
- d. *Participating contracts issued by mutual life insurance entities and stock life insurance entities.* These are long duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurance entity. Annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the *contribution method*).

**7.19** *Investment contracts.* Per the FASB ASC glossary, *investment contracts* are long-duration contracts that do not subject the insurance entity to risks arising from policyholder mortality or morbidity. As discussed in FASB ASC 944-825-15-3, investment contracts issued by an insurance entity should be accounted for in a manner consistent with interest bearing or other financial instruments issued by other kinds of financial institutions.

**7.20** Examples of investment contracts include GICs and most deferred annuity contracts during the accumulation phase.

**7.21** *Premium and deposit revenue recognition.* The revenue recognition methodologies applied under U.S. GAAP are defined by the accounting classifications of the contracts. (See exhibit 7-3, "Revenue Recognition Methods as Defined in FASB ASC 944, *Financial Services—Insurance*," for revenue recognition methods under U.S. GAAP.) These classifications are as follows:

- a. *Short duration insurance contracts.* As discussed in FASB ASC 944-605-25-1, premiums from short duration contracts ordinarily are recognized as revenue over the contract term or period of risk, if different, in proportion to the amount of insurance protection provided.
- b. *Long duration insurance contracts and limited payment contracts.* As discussed in FASB ASC 944-605-25-3, premiums from long duration contracts, other than universal life-type contracts and limited payment contracts, are recognized as revenue when due from the contract holder.

**7.22** Statutory deferred premium amounts are a function of the premium payment assumptions used in calculating the policy reserves; accordingly, under U.S. GAAP, any deferred benefit premium amounts are netted against the liability for future policy benefits and are not recorded as an asset as is generally the case in statutory accounting. Likewise, any deferred acquisition expense premium amounts are added to the DAC asset, and not recorded as a separate asset.

**7.23** As discussed in FASB ASC 944-605-25, premiums collected on universal life-type contracts are not recorded as revenues. Revenue from those contracts represents amounts assessed against policyholders and should be reported in the period that the amounts are assessed unless those amounts compensate the life insurance entity for services to be provided in the future. Such amounts should be recognized as unearned revenue. Amounts assessed against the policyholder balance as consideration for the origination of the contract, often referred to as origination or front-end fees, should be recognized as unearned revenues. As discussed in FASB ASC 944-605-35-2, amounts recognized as unearned revenue should be recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs.

**7.24** Gross premium receipts, net of any front-end loads, are recorded as a liability. The deposit fund liability is increased by credits to the contract holder's account balance, such as credited interest, and decreased by amounts assessed against the contract, such as mortality or cost of insurance charges, surrender charges, and maintenance fees.

**7.25** The accounting model used for universal life contracts, as defined in the FASB ASC glossary, is referred to as the *retrospective deposit method*. (See

chapter 8, exhibit 8-1, "Benefit Liabilities—Prospective Reserve Method and Retrospective Reserve Method," for an example.)

**7.26** Limited payment contracts subject the insurance entity to mortality or morbidity risk over a period that extends beyond the premium collection period. As discussed in FASB ASC 944-605-25-15, any excess of the gross premium over the net premium should be deferred.

**7.27** Any excess of the gross premium over the net premium should be recognized in income in a constant relationship with insurance in force (life insurance contracts) or with the amount of expected future benefits (annuity contracts).

**7.28** *Investment contracts.* Premiums or deposits received for investment contracts are recorded as a deposit liability. The life insurance entity's revenue related to such contracts is comprised of investment income plus the surrender charges and contract maintenance expense charges.

## Auditing

### Inherent Risk Factors

**7.29** As part of the auditor's assessment of inherent risk, the auditor may consider those factors related to premium revenue recognition, including factors relating to underwriting policies, distribution channels, management, premium billing and collection operations, and product line characteristics. Such factors might encompass the following:

- a. The premium rates charged are significantly below the industry averages for similar kinds of products, or the analysis of contract pricing or profitability is inadequate.
- b. Relationships of cash receipts to recorded premiums are inconsistent with the kind or volume of contracts written.
- c. The life insurance entity's product lines include experience rated insurance arrangements.
- d. There are a significant number of *internal replacement transactions*.
- e. There are an increasing number of lapses and reinstatements.
- f. Third party billings are incomplete, or represent a composite of gross premium receipts, commissions, and premium adjustments that must be analyzed and allocated to individual contracts and appropriate accounts.
- g. Changes in tax legislation affect the life insurance entity's products.
- h. Regulations affect the life insurance entity's operations relative to its market conduct (for example, content of marketing material, licensing of sales force, and contract forms).
- i. Regulation of capital capacity restricts the life insurance entity's ability to write new business.
- j. The requirements for the licensing of agents or other intermediaries are not adhered to or require changes to agent contracts.

- k. Reinsurance agreements have been revised and are becoming more complex, or reinsurance has become unavailable at the life insurance entity's desired retention level or cost.
- l. New specialized products are introduced or rapid growth develops in previously limited product lines.
- m. Dependency on investment and similar contracts in which the fixed rate in the contract exceeds the rate of return on the related investments.
- n. Market trends indicate a saturated demand for the entity's product.

## Obtaining an Understanding of Internal Control for Premium Transactions

**7.30** As part of obtaining an understanding of internal control related to revenues, the auditor might consider the following factors. An entity's internal control consists of the following five components: the control environment, risk assessment, control activities, information and communication, and monitoring as stated in paragraph .41 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). As discussed in chapter 5, "General Auditing Considerations," the auditor should obtain a sufficient understanding of each of the five components of the entity's internal control to assess the risks of material misstatement of the entity's financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

### Control Environment

**7.31** The control environment, as related to premium revenue recognition of a life insurance entity, represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific control policies or procedures on the operations of the entity. Such factors that relate to premium revenue recognition include the following:

- a. There is a substantial increase in the volume of a particular product or a significant change in the mix of business that might adversely affect control design or operating effectiveness.
- b. New products or contracts are being written that require different revenue recognition policies or accounting procedures or that have unique processing requirements.
- c. The premium accounting system used by the life insurance entity or third party servicing agent is inadequate to meet the needs of the entity's financial or regulatory reporting requirements. There is a lack of coordination with key processing systems.
- d. There is a substantial increase in the suspense accounts or level of backlogs of premium transactions exists. The processing error rate is significant or increasing.
- e. Operations are highly decentralized, and there is a high reliance on third parties or agents for customer correspondence, premium billing, and collection.
- f. Significant staff turnover, inexperienced personnel, or insufficient staff for the volume of premium transactions processed result in the improper recording of transactions.

## Control Activities

**7.32** Control activities are those policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor should obtain an understanding of those control activities relevant to the audit.

**7.33** Examples of typical internal control policies and procedures relating to premium revenue recognition include the following:

- a. Proper authorization of transactions and activities.* Written underwriting standards are in place that assign the appropriate individuals with the responsibility to approve risks and the authority to approve premium rates used in product pricing, changes in rate structures, and reinsurance arrangements.
- b. Segregation of duties.* Underwriting approval, application processing, premium billing and collection, key information systems functions, inforce file maintenance, agent master file maintenance, and general accounting activities are appropriately segregated, and the work performed is independently reviewed.
- c. Design and use of adequate controls over documents and records.* There are procedures to ensure that fictitious or duplicate premium transactions are not included in the records and to prevent or detect the omission of valid premium transactions.
- d. Adequate safeguards of access to and use of assets and accounting records.* Data files and production programs have adequate safeguards against unauthorized access. Adequate safeguards exist over premium receipts.
- e. Independent checks on performance and proper valuation of recorded amounts.* Procedures are in place to ensure that premium registers are correctly summarized and accurately processed in the proper accounting period, that correct premium accounts (for example, by contract kind, agent, and state) are credited, and that appropriate rate schedules are used for the kind of contract and risk assumed.

Note that for an integrated audit performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (see paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, PCAOB Standards and Related Rules, Interim Standards]).

## Information and Communication

**7.34** AU section 314 paragraph .81 states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report an entity's transactions

(as well as events and conditions) and to maintain accountability for related assets, liabilities, and equity.

**7.35** For an insurance entity, the premium accounting cycle includes all phases of premium revenue recognition and premium related transactions by the life insurance entity from contract inception to expiration. The premium related functions performed include underwriting, reinsurance (see chapter 12), contract issue, billing, collection, recording, agency accounting and commission payments (see chapter 10, "Commissions, General Expenses, and Deferred Acquisition Costs"), and valuation.

**7.36** The premium cycle for new life and accident and health business generally begins with the submission of an application for insurance to the life insurance entity, either directly by the customer, or by the agent or broker. The initial premium is usually submitted with the application and deposited by the life insurance entity. The cash is recorded in a clearing (suspense) account, and the application is assigned a sequential number from the contract issue log (which generally becomes the contract number) and is forwarded to underwriting for evaluation. The suspense account is cleared either by refunding the deposit premium for rejected risks or recording the amounts in the proper premium accounts for accepted risks when contracts are issued.

**7.37** In general, the deposit (or investment) contract revenue cycle is driven by competitive interest crediting rates. Those rates are generally negotiated with the customer and do not necessarily involve the traditional underwriting process as applied to life and health contracts. Although many contracts are standardized, there are often amendments to larger contracts.

**7.38** *Underwriting and reinsurance.* Life insurance underwriting is the process of examining and evaluating applications that are subject to mortality or morbidity risks. The underwriting function includes evaluating the acceptability of the risk, selecting the applicable premium schedule, and evaluating the entity's capacity or desire to assume the entire risk. The determination of risk acceptance is based on the entity's underwriting standards and may include a review of the applicant's medical history, a medical examination, the agent's report, or other investigative reports or automatic issue in the case of smaller contracts. The risk is rated as standard or substandard based on the insured's medical history, occupation, family history, and habits, and the appropriate premium schedule is applied in accordance with the entity's approved underwriting guidelines. Not all products are subject to individual underwriting, such as auto-issue term life insurance, certain pension products, and group insurance products.

**7.39** All or part of the risk that is accepted may be reinsured under automatic reinsurance treaties, which usually cover some portion of the risk of a particular class of business that is underwritten and are usually in effect for long periods. Entities typically set maximum risk retention levels under automatic treaties. Life insurance entities may reinsure specific risks under facultative agreements that cover specific risks and require the insurer and the reinsurer to agree on terms and conditions of reinsuring each risk. (See chapter 12 for further discussion.)

**7.40** *Contract issue.* Once a risk is accepted, a contract form is prepared, and a sequential contract number is assigned from the contract register (typically the same number issued to the application). The contract is then issued,

and the contract documents are sent directly to the insured, or to the agent or broker for delivery.

**7.41** Most life and health insurance contracts contain a free look provision, which permits the applicant to rescind the application during a period specified in the contract. If the contract is declined by the life insurance entity or rescinded by the applicant during the free look period, the initial premium is returned. An explanation for the rejection by the life insurance entity is provided if one is required by the regulatory authorities.

**7.42** *Billing, collection, and recording.* For new business, the initial premium for a life insurance contract is usually submitted with the application. Thereafter, however, subsequent renewal premiums (except for home service life insurance) are billed by and remitted directly to the life insurance entity, third party intermediary, or the agent, depending on the billing and collection system employed. The insured may be able to select the mode of subsequent premium payments, which may be lump-sum, annual, semiannual, quarterly, monthly, or flexible payments and may be in fixed or variable amounts. Renewal billings are generated in accordance with the selected premium payment mode and are typically generated from the inforce file data. Renewal billings are usually mailed a specified number of days prior to the due date. For the life insurance products described earlier in this chapter, no accounts receivable or revenue transaction occurs at the time of billing because revenue is only recorded when due or received. However, the inforce file is updated to reflect that a premium notice was sent.

**7.43** Insurance premiums are payable prior to the date coverage commences. If the payment is not received by the due date, there is a grace period (usually 30 to 45 days) during which the premium can be received without causing the contract to lapse. Generally, life insurance entities delay processing lapses for 60 to 90 days after the grace period to reduce administrative costs because of the frequency of renewals or reinstatements during this period. (Losses that occur during the period beyond the grace period are generally not paid unless the premium amount in arrears was received by the life insurance entity prior to the loss date.)

**7.44** When a lapse or termination occurs, the nonforfeiture option selected by the contract holder or an automatic option provided by the contract goes into effect. Commonly, those options are automatic purchases of paid-up or extended term life, application of accumulated dividends, or automatic contract loans to cover the unpaid premium if there is sufficient cash value. If the contract has lapsed and the contract holder subsequently requests that the contract be reinstated, it may be necessary to provide evidence of insurability, and to pay the premium in arrears, with interest.

**7.45** Specific premium collection methods vary within the life insurance industry, depending on the kinds of products sold, the distribution system, and the processing methods employed. The collection function involves establishing controls over cash collected, matching the amount collected to the amount billed and accounting for any differences, updating the inforce file to reflect premiums collected and paid-to-date, and recording all payments in the cash receipts records, premium register, and general ledger. If a premium receipt cannot be immediately matched with the related contract, the premium receipt is credited to a clearing (suspense) account. A premium receipt generally cannot be matched if



- a. the contract has not yet been issued,
- b. the contract is past the grace period,
- c. the amount of the receipt is different from the amount billed, and
- d. the amount received cannot be readily identified with a specific contract.

Generally, the personnel responsible for premium accounting are responsible for maintaining aged trial balances of suspense accounts and clearing all items from the account to the appropriate general ledger premium account.

**7.46** Premiums are typically recorded on a cash basis and adjusted at the valuation date, when premiums are due and uncollected; premiums received in advance are generally determined on a contract-by-contract basis. The financial records are then updated to reflect these adjustments. If contract volumes are large and calculations are automated, the contract-by-contract details of the calculations are generally unavailable.

**7.47** Traditionally, *nonledger adjustments* refer to adjustments for premiums due and uncollected and for premiums received in advance. Nonledger adjustments are needed for statutory Annual Statement accrual accounting. (See chapter 14, "Other Assets and Liabilities, Surplus Notes, Separate Accounts, Insurance-Related Assessments, and Equity—Contract Holders' Surplus," for discussion of nonledger items.)

## Audit Consideration Chart

**7.48** The auditor may consider the following specific audit objectives and examples of selected control and auditing procedures in auditing premium and deposit revenue transactions of life insurance entities. The audit consideration chart that follows is intended to present examples only and is not all inclusive for any category.

Audit Consideration Chart—Insurance Revenues

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Existence or Occurrence and Rights and Obligations</i>		
Revenues recorded relate to the contracts issued or in force during the period.	Underwriting standards, premium rates, credited interest rates, and contract holder charges are regularly reviewed and monitored by appropriate levels of management.	Obtain and inspect evidence about proper contract issuance for selected new and inforce contracts as follows.
Cash or other consideration is received within the contract terms.	Contract applications are independently reviewed for compliance with the entity's underwriting standards prior to contract issuance.	1. Examine contract file for signed application, underwriting approval, and other applicable documents.
Premium deposits, return premium adjustments, and contract holder dividends are properly recorded.	Adequate procedures exist and are routinely monitored to achieve the following:	2. Trace to master file data such as contract number, sex, name, effective date, paid-to-date, inforce status, contract type, coverage limits, face amount, premium rate schedule, cash premium, payment mode, modal premium, distribution channel, agent or broker, and line of business.
Lapse and reinstatement policies are in accordance with the terms of the contract and properly recorded.	1. Physically control unissued contract forms.	3. Compare premiums register to cash receipts records, bank statements, and general ledger.
	2. Maintain numerical control over contracts issued.	4. Confirm that contract documents were issued to the contract holder.
	3. Properly register contract applications and control premium remittances received with applications.	5. Test that underwriting procedures were followed for underwriting approval, calculation of premiums and reinsurance, and proper recording of premium payments and reinsured amounts.
	4. Assure correct premium billing of inforce contracts.	Reconcile premiums and commissions to agents' reports.
	5. Assure that premium transactions recorded in the premium registers and the contract master file accurately reflect actual transactions dates.	
	6. Assure that deposit contract documentation and coverage details are reconciled on a timely basis.	

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	<p>Contract endorsements and cancellations or other changes are approved; determinations of additional or return premiums are also reviewed and approved.</p> <p>Contract holder dividends and experience rated premiums are reviewed and approved.</p> <p>Premium adjustments are compared with contract provisions, and dividends are compared with dividend declaration for compliance.</p> <p>Automatic transactions (for example, interest credits, contract charges, automatic lapse, automatic policy loans) are reconciled to master file changes and control accounts.</p>	<p>Reconcile monthly summary of premiums written (direct, assumed, and ceded) by line of business with the general ledger.</p> <p>Trace selected noncash premium transactions (such as an automatic contract loan) for renewal business to the premium register, and verify the transactions are in accordance with the contract terms.</p> <p>Test proper reporting of new business premiums that are the internal replacement of renewal premiums, and related transactions.</p> <p>Test that agents submitting applications are licensed, and inspect agency agreements.</p> <p>Test the propriety of return premiums by inspecting evidence of cancellation on contract face and by obtaining evidence about adherence to the contract terms regarding cancellation method.</p> <p>Test that contract holder dividends comply with authorization, and reconcile amounts with underlying contract records.</p>
<p><i>Completeness</i></p> <p>Contract revenues applicable to future periods are deferred.</p>	<p>Guidelines are established for coding contracts (for example, contract type, state code, premium payment mode, reinsurance) for master file input, and coding is reviewed for accuracy.</p>	<p>Test whether risks in excess of retention amounts are reinsured.</p> <p>Test the computation of reinsurance premiums and commissions; trace to reinsurance records.</p>

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	<p>Reconciliations of accounting records and the master file are performed on a timely basis to assure that all transactions are properly recorded, and proper cutoff procedures are established.</p> <p>Reconciliations of accounting records and master file information for investment selection for variable products are performed on a timely basis.</p> <p>Processing backlogs are independently monitored for significant fluctuations.</p> <p>Deletions of contract master file records (other than automatic lapses) are approved.</p>	<p>Test the cutoff by inspecting premium registers, premium billings, suspense account trial balances, and other supporting documentation to determine whether premium transactions were recorded in the proper period.</p> <p>Obtain and review or test reconciliations between the following:</p> <ol style="list-style-type: none"><li>1. The premium register and the general ledger</li><li>2. New contract data and the inforce file</li><li>3. Contracts issued and contract numerical control records</li><li>4. Cash receipts and the premium register</li><li>5. The premium and commission registers</li><li>6. The premium register and the inforce file</li></ol>
	<p>Contract loan values are reviewed and reconciled to either automatic premium loan amounts or the reduction of contract cash values.</p>	<p>Check calculation of premiums to premium rate tables.</p>
	<p>Edit and validation controls, batch balancing, data transmission controls, logging, and cash totals are used to provide assurance that all transactions have been completely and accurately processed and that systems interfaces are operating correctly.</p> <p>Adequate procedures exist for monitoring third parties involved in processing or calculating premium or deposit transactions.</p>	<p>For group contracts, perform the following.</p> <ol style="list-style-type: none"><li>1. Reconcile enrollments to premium receipts.</li><li>2. Test changes in enrollments to changes in master file records.</li><li>3. Conduct an independent review of the detailed records of self-administered groups and recalculate any rate adjustments.</li></ol>

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Suspense account balances are analyzed and reviewed for large, old, or unusual items by appropriate personnel.	Reconcile premium receipts to bank deposit slips, cash receipts journal, premium register, and general ledger.  Review premium suspense accounts and support for old, large, or unusual items.  Review premium revenue general ledger accounts for large or unusual items.
<i>Valuation or Allocation</i>		
Premium revenues, contract deposits, and related transactions are recorded in the appropriate accounts and correctly accumulated in the financial and inforce records in the proper period.	Suspense accounts are analyzed and reviewed regularly for large, old, or unusual items, by appropriate personnel.	Inquire about the method for recognizing contract revenue; check the application for its consistency with that of prior years. Test the revenue recognition methodology for its appropriateness for contract classification. Test the accounting classification of premium transactions.
Contract revenues are correctly calculated in accordance with the nature and terms of the contracts and applicable accounting principles.	Procedures for timely lapse of contracts for nonpayment of premium and reinstatement procedures are in place and monitored by the appropriate personnel.  Procedures are in place and appropriately monitored to ensure that premium revenue is correctly processed in the premium register, updated to the master files (for example, paid-to-date), and correctly reflected in the general ledger.	Compare current period amounts to previous periods and investigate unexpected or significant fluctuations. The following are examples:  1. Compare due premiums as a percentage of first year and renewal premium by line of business.  2. Compare the net deferred premiums as a percentage of gross deferred premiums for first year and renewal.  3. Compare premium revenue to the current year's budget and prior year's actual by line of business.

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	
	<i>Examples of Auditing Procedures</i>	
	Return premiums are reviewed for reasonableness by comparison to original premiums.	Test collectibility of premium receivables by inspecting subsequent collections or by inspecting history of receipts. Evaluate the adequacy of the allowance for doubtful accounts, including suspense items.
	Premium rates, including any changes to the rate tables, are current and are reviewed by the appropriate personnel.	Test calculations of due and deferred premium amounts.
	Delinquent accounts are investigated, and write-offs of bad debts and unreconciled items are approved.	For universal life-type contracts and other investments products, compare the cash received to the increase in the account balance.
	Processing controls ensure that current contract master file data is used in calculating premium billings, unearned premium, and due and deferred premium.	Compare cost of insurance to net amount at risk.
	<i>Presentation and Disclosure</i>	
Premiums, deposits, and other contract revenues are properly classified and disclosed in the financial statements, including notes, in conformity with applicable accounting principles.	Revenue recognition methods for all product lines are approved by appropriate personnel.	Test revenue recognition by contract type is in accordance with applicable accounting principles, including related disclosures.

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Comparisons of actual to expected premium revenue by line of business are prepared and significant or unexpected variances are identified and monitored by management.	<p>Test whether disclosures and classifications comply with applicable accounting principles.</p> <p>Identify and examine items that may require separate disclosure. Examples are discontinued operations, segment information, gains or losses on foreign currency transactions.</p> <p>Review board minutes, agreements, budgets, and plans for evidence of new sources of revenue that should be included in the financial statements. Examples are administrative services only (ASO) contracts or other kinds of service revenue. Investigate significant items.</p>

# Exhibit 7-1

## Excerpt of Exhibit 1 From the Annual Statement

Statutory direct and reinsurance ceded or assumed premiums for first year premiums, renewal premiums, and single premiums are accounted for and reported separately on exhibit 1—part 1 of the Annual Statement. In addition, these amounts are allocated to the appropriate lines of business, such as life insurance and accident and health insurance, for the entity.

For example, following is an excerpt from exhibit 1—part 1 of *Premiums and Annuity Considerations*, for first year premiums. The entire exhibit 1—part 1 contains first year premiums, renewal premiums, and single premiums. (See *Annual Statement Instructions* for full exhibit and line of business allocations.) The total column is shown for illustration only.

FIRST YEAR (Other Than Single)	TOTAL
1. Uncollected	133,000
2. Deferred	5,108,000
3. Deferred and Uncollected:	
A. Direct	5,246,000
B. Reinsurance Assumed	0
C. Reinsurance Ceded	5,000
D. Net Deferred and Uncollected (Line 1 + Line 2)	5,241,000
4. Advance	1,000
5. Net Deferred and Uncollected less Advance (Line 3D - Line 4)	5,240,000
6. Collected During the Year	
A. Direct	28,116,000
B. Reinsurance Assumed	0
C. Reinsurance Ceded	33,000
D. Net Collected	28,083,000
7. Current Year's Accrual plus Net Collected (Line 5 + Line 6D)	33,323,000
8. Previous Year's Accrual (Uncollected + Deferred – Advance)	4,448,000
9. First Year Premiums and Considerations:	
A. Direct	28,914,000
B. Reinsurance Assumed	0
C. Reinsurance Ceded	37,000
D. Net (Line 7 – Line 8)	28,875,000



**Exhibit 7-2****Contract Classifications as Defined in FASB ASC 944,  
Financial Services—Insurance**

Insurance contracts are defined and classified in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-20-15 and 944-20-55 as follows:

Per paragraph 2 of FASB ASC 944-20-15, insurance contracts, for purposes of this subtopic, should be classified as short duration or long duration contracts depending on whether the contracts are expected to remain in force for an extended period (in force refers to the period of coverage, that is, the period during which the occurrence of insured events can result in liabilities of the insurance entity).

Paragraph 7 of FASB ASC 944-20-15 discusses the factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are as follows for a short-duration contract:

- a. The contract provides insurance protection for a fixed period of short duration.
- b. The contract 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.

Paragraph 10 of FASB ASC 944-20-15 discusses that the following factors shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are as follows for a long-duration contract:

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

As noted in paragraph 1 of FASB ASC 944-20-55, examples of short duration contracts include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. As noted in paragraph 3 of FASB ASC 944-20-55, examples of long duration contracts include whole life contracts, guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts. Paragraph 5 of FASB ASC 944-20-55 discusses that, accident and health insurance contracts may be short duration or long duration depending on whether the contracts are expected to remain in force for an extended period. For example, individual and group insurance contracts that are noncancelable or guaranteed renewable (renewable at the option of the insured), or collectively renewable (individual contracts within a group are not cancelable), ordinarily are long duration contracts.

FASB ASC 944 establishes accounting for three classes of long-duration contracts, limited payment type, universal life-type, and investment contracts.

*Limited payment contracts* are defined by the FASB ASC glossary as follows: Long duration insurance contracts with terms that are fixed and guaranteed, and for which premiums are paid over a period shorter than the period over which benefits are provided. Limited-payment contracts subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which premiums are collected.

*Universal life-type contracts*, as discussed in FASB ASC 944-20-15-26, are as follows: Universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any of the following features:

- a. One or more of the amounts assessed by the insurer against the policyholder—including amounts assessed for mortality coverage, contract administration, initiation, or surrender—are not fixed and guaranteed by the terms of the contract.
- b. Amounts that accrue to the benefit of the policyholder—including interest accrued to policyholder balances—are not fixed and guaranteed by the terms of the contract.
- c. Premiums may be varied by the policyholder within contract limits and without consent of the insurer.

As discussed in FASB ASC 944-20-15-27, a participating or nonguaranteed premium contract is within the scope of the "Long-Duration" subsection of FASB ASC 944-20-15 if the terms of the contract suggest that it is, in substance, a universal life-type contract. The determination that a contract is in substance a universal life-type contract requires judgment and a careful examination of all contract terms.

As discussed in FASB ASC 944-20-15-29, a participating contract that includes any of the following features should be considered a universal life-type contract:

- a. The policyholder may vary premium payments within contract limits and without consent of the insurer.
- b. The contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed.
- c. The insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

This list is not intended to be all inclusive or limiting.

As discussed in FASB ASC 944-20-15-30, a nonguaranteed premium contract that includes either of the following features should be considered a universal life-type contract:

- a. The contract has a stated account balance that is credited with policyholder premiums and interest and against which assessments are made for contract administration, mortality coverage, initiation, or surrender, and any of the amounts assessed or credited are not fixed and guaranteed.
- b. The insurer expects that changes in any contract element will be based primarily on changes in interest rates or other market conditions rather than on the experience of a group of similar contracts or the enterprise as a whole.

*Investment contracts* are defined by the FASB ASC glossary, as long duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity. According to paragraphs 16–17 of FASB ASC 944-20-15, a mortality or morbidity risk is present if, under the terms of the contract, the entity is required to make payments or forego required premiums contingent on the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

As stated in FASB ASC 944-20-15-3, participating life insurance contracts have both of the following characteristics:

- a. They are long duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurance enterprise.
- b. Annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus (commonly referred to in actuarial literature as the contribution principle).

**Exhibit 7-3****Revenue Recognition Methods as Defined in FASB ASC 944,  
Financial Services—Insurance**

Premium revenue recognition as defined in paragraphs 1–2 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-605-25 is as follows:

*Short-Duration Contracts*

Premiums from short duration contracts should be recognized as revenue over the period of the contract in proportion to the amount of insurance protection provided. For those few types of contracts for which the period of risk differs significantly from the contract period, premiums should be recognized as revenue over the period of risk in proportion to the amount of insurance protection provided. That generally results in premiums being recognized as revenue evenly over the contract period (or the period of risk, if different), except for those few cases in which the amount of insurance protection declines according to a predetermined schedule.

If premiums are subject to adjustment (for example, retrospectively rated or other experience rated insurance contracts for which the premium is determined after the period of the contract 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), premium revenue should be recognized as follows:

- a. If the ultimate premium is reasonably estimable, the estimated ultimate premium should be recognized as revenue over the period of the contract. The estimated ultimate premium should be revised to reflect current experience.
- b. 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.

*Long Duration Contracts*

In accordance with FASB ASC 944-605-25-3, premiums from whole-life contracts, guaranteed renewable term life contracts, title insurance contracts, and participating life insurance contracts that meet the criteria in FASB ASC 944-20-15-3, should be recognized as revenue over the premium-paying periods of the contracts when due from policyholders.

Revenue recognition as defined in FASB ASC 944, is as follows:

*Investment Contracts*

As discussed in FASB ASC 944-20-15-14 and paragraphs 1–2 of FASB ASC 944-825-25, investment contracts issued by an insurance enterprise do not incorporate significant insurance risk as that concept is defined in the FASB ASC glossary, and should not be accounted for as insurance contracts. Amounts received as payments for such contracts should not be reported as revenues. Payments received by the insurance enterprise should be reported as liabilities and accounted for in a manner consistent with the accounting for interest bearing or other financial instruments.

*Limited Payment Contracts* (FASB ASC 944-605-25-4A and 944-605-35-1)

*Limited payment contracts* per the FASB ASC glossary subject the insurer to risks arising from policyholder mortality and morbidity over a period that extends beyond the period or periods in which premiums are collected. For those contracts, the liability for policy benefits should be established in accordance with the guidance beginning in paragraph 7 of FASB ASC 944-40-25. According to FASB ASC 944-605-25-4A, the collection of premium does not, however, represent the completion of an earnings process. Any gross premium received in excess of the net premium (the FASB ASC glossary defines *gross premium* as "the premium charged to a policyholder for an insurance contract." Per paragraphs 1 and 1A of FASB ASC 944-605-35, any gross premium deferred in accordance with FASB ASC 944-605-25-4A should be recognized in income in a constant relationship with insurance in force (if accounting for life insurance contracts) or with the amount of expected future benefit payments (if accounting for annuity contracts). The deferred profit liability should be amortized in relation to the discounted amount of the insurance in force or expected future benefit payments, and interest shall accrue to the unamortized balance. The use of interest in the amortization is consistent with the determination of the deferred profit using discounting.

*Universal Life-Type Contracts* (paragraphs 5–6 of FASB ASC 944-605-25 and 944-605-35-2)

According to paragraphs 16–19 of FASB ASC 944-40-30, the liability for policy benefits for universal life-type contracts should be equal to the sum of

- a. the balance that accrues to the benefit of policyholders at the date of the financial statements (accounting methods that measure the liability for policy benefits based on policyholder balances are known as retrospective deposit methods).
- b. any amounts that have been assessed to compensate the insurer for services to be performed over future periods (see paragraphs 6–7 of FASB ASC 944-605-25).
- c. any amounts previously assessed against policyholders that are refundable on termination of the contract.
- d. any probable loss (premium deficiency) as described in paragraphs 7–9 of FASB ASC 944-60-25.

Amounts that may be assessed against policyholders in future periods, including surrender charges, should not be anticipated in determining the liability for policy benefits. In the absence of a stated account balance or similar explicit or implicit contract value, the cash value, measured at the date of the financial statements, that could be realized by a policyholder upon surrender should represent the element of liability described in FASB ASC 944-40-30-16(a). Provisions for adverse deviation should not be made.

As noted in paragraph 5 of FASB ASC 944-605-25, premiums collected on universal life-type contracts should not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from

those contracts should represent amounts assessed against policyholders and should be reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period.

As discussed in paragraphs 6–7 of FASB ASC 944-605-25, amounts assessed that represent compensation to the insurance enterprise for services to be provided in future periods are not earned in the period assessed. Such amounts should be reported as unearned revenue and as noted in FASB ASC 944-605-35-2 recognized in income over the period benefited using the same assumptions and factors used to amortize capitalized acquisition costs. Amounts that are assessed against the policyholder balance as consideration for origination of the contract, often referred to as initiation or front-end fees, should be recognized as unearned revenues.

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## Chapter 8

# ***Liabilities for Future Policy Benefits (Statutory Policy Reserves) and Other Contract Liabilities***

**Note:** This chapter contains references to both financial and nonfinancial assets and liabilities that are subject to fair value measurement. As noted in chapter 3, "Sources of Accounting Principles and Reporting Requirements;" Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*; and FASB ASC 825, *Financial Instruments*, have significant implications for the concept of fair value. Please refer to chapter 3, beginning at paragraph 3.31, for further information.

## **Introduction**

**8.01** Insurance contracts are agreements to provide the future benefits in exchange for premiums or other consideration received. Life insurance contracts are fundamentally different from other forms of insurance in that the event insured against, death, is certain to occur as opposed to uncertain events, such as disability, fire, or floods that may or may not occur. In addition, life insurance contracts may contain cash accumulation benefits, where cash may be withdrawn at the election of the contract holder. This element of certainty of the life insurance contract, together with cash value accumulation features, requires the establishment of liabilities that provide for the benefits promised for future events that are certain to occur. This liability is based on assumptions with respect to future mortality, morbidity, investment earnings, expenses, amounts and frequency of premium payments, and withdrawals. The benefit liabilities are usually determined for groups of contracts with similar characteristics and are less than the sum of the contracts' face amount (that is, the benefits payable upon death or maturity) for those contracts. This is because the cash inflows (premiums) and cash outflows (benefits, expenses and withdrawals) for any large group of contracts can be modeled based on the preceding assumptions. Using these models, the ability to estimate the timing of those cash flows can be reliably measured, and the present value of those cash flows will be less than the sum of the face amounts. When an insured event occurs, the face amount of the contract becomes a "claim liability" and the previously recorded liability for future benefits is released. The liability for life, accident and health, and annuity benefits and claims is usually the most significant liability on the balance sheet of a life insurance entity. Liabilities for benefits and claims are referred to by regulators and in state insurance statutes as reserves. Throughout this Audit and Accounting Guide (the guide), the term reserves is used only in discussions of regulation and statutory accounting principles (SAP).

**8.02** *Liabilities for future policy benefits* are accrued obligations to policyholders that relate to insured events, such as death or disability. The liability for future policy benefits can be viewed as either actuarially determined

estimates of the present value of future benefits to be paid to or on behalf of policyholders and expenses, less the present value of future net premiums payable under the insurance contracts or the accumulated amount of net premiums already collected less the accumulated amount of benefits and expenses already paid to or on behalf of policyholders. (See chapter 7, "Insurance Revenues," for a definition of *net premium* and paragraph 8.57 for further explanation.)

**8.03** Traditional life insurance such as guaranteed renewable term life and whole life contracts generally provide guaranteed future benefits for a fixed premium, and in the case of whole life, a guaranteed future cash value. Liabilities for traditional life benefits represent the actuarially determined amount that is needed to provide for the future expected benefits to be paid to contract holders. (See paragraphs 8.02 and 8.57 for further discussion.)

**8.04** Generally, universal life and other similar interest sensitive life insurance contracts do not have guaranteed future cash values but do have cash surrender values that are based on a retrospective accumulation of premiums (which may be flexible or fixed), less mortality and expense charges, at a rate of interest based on either a specific index or declarations by the life insurance entity. For U.S. generally accepted accounting principles (GAAP), the benefit liability for these contracts is usually equal to the sum of the balance that accrues to the benefit of the policyholders at the date of the financial statement, any amount that has been assessed to compensate the insurer for services to be performed over future periods, any amounts previously assessed against policyholders that are refundable on termination of the contract, and any probable loss (premium deficiency). The statutory liability for universal life contracts is commonly the commissioners' reserve valuation method (CRVM) reserve as specified by the National Association of Insurance Commissioners (NAIC) Universal Life Model Regulation and no less than the cash surrender value.

**8.05** For deferred annuities in the accumulation phase and other investment related products, benefit liabilities are generally based on the accumulated value of the contracts or their cash surrender value. Benefit liabilities for individual deferred annuities, immediate annuities, allocated group deferred annuities, and other deferred annuities in their payout phase are equal to the present value of the estimated benefits.

**8.06** Claim liabilities are different from benefit liabilities in that they represent the estimated liability for events that have already occurred. Claim liabilities represent the liability for incurred losses, both reported and not reported, for contract benefits attributable to the occurrence of an insured event on or before the balance sheet date. Examples of such events are death, hospitalization, or maturity of an endowment contract.

**8.07** FASB ASC 815, *Derivatives and Hedging*, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those investments at fair value. Insurance entities should be aware that contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases may contain embedded derivative instruments that may need to be separated from the host contract and accounted for as a derivative instrument as noted in FASB ASC 815-15-05-1 and FASB ASC 815-15-25-1. As described in FASB ASC 815, equity indexed



annuities and nontraditional variable annuity contracts with minimum guarantees of the account value (as discussed in FASB ASC 944-815-25-5) are two of the products offered by life and health insurers likely to contain embedded derivatives.<sup>1</sup> Readers should refer to FASB ASC 815 when considering accounting and reporting issues related to derivative instruments and hedging activities.

## Regulation

**8.08** Under SAP, the aggregate policy reserves reported in the annual statement are required to equal or exceed minimum reserve amounts (referred to as legal reserves) that are calculated using certain specified assumptions and calculation methodologies. For traditional life and health insurance and annuities or pure endowment contracts, all states have adopted the NAIC Model Standard Valuation Law (MSVL) and its interpretations, which define the minimum level of reserves for most kinds of insurance contracts; however, variations by state do exist. For nontraditional life insurance, such as universal life-type products, the NAIC has issued model reserve laws that define the minimum reserve for these contracts; however, those model laws have not been adopted by all states. The required actuarial assumptions and calculation methodologies specified by the NAIC MSVL generally vary by line of business and by issue date of the contract.

**8.09** Recent revisions to the NAIC MSVL also require that the valuation actuary compare future insurance cash flows with cash flows from designated assets in an amount equal to the benefit reserves, under a variety of interest rate scenarios. This testing procedure is commonly referred to within the actuarial profession as cash flow testing or asset adequacy analysis. If assets equal to benefit reserves based on permitted actuarial assumptions and calculation methodologies are deemed to provide inadequate cash flow, the life insurance entity may be required to establish higher statutory reserves.

## Statement of Actuarial Opinion

**8.10** Each state requires a "Statement of Actuarial Opinion" in each life insurance entity's annual statement. The NAIC's *Annual Statement Instructions* require the actuary's reserve opinion to include statements with regard to the adequacy, consistency of assumptions, and appropriateness of calculation methodologies of the reserves and other actuarial items carried on the balance sheet. In addition, actuarial methods, considerations, and analyses used in forming the opinion should conform to the appropriate Standards of Practice as promulgated from time to time by the Actuarial Standards Board.

**8.11** The qualified actuary must give such a professional opinion, issue a qualified opinion, or refuse to issue a statement. The actuary rendering the statement of actuarial opinion is not required to be independent. The actuary is generally required by insurance regulatory authorities to be appointed by those charged with governance and to provide the actuarial opinion directly to those charged with governance in the capacity of appointed actuary.

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<sup>1</sup> As discussed in chapter 11, "Investments," hybrid instruments described in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 825-10-50-8, which include derivatives embedded in insurance contract hosts, are not eligible for the fair value election described in paragraphs 4–5 of FASB ASC 815-15-25.

## Calculation Methods

**8.12** Advances in data processing capabilities have made it possible to calculate the reserve for each contract on a *seriatim* basis (contract-by-contract basis), considering the exact day of issue, the actual premium payment modes, and the contract's provisions as to return of premium or other features. However, as a result of the historical impracticality of *seriatim* calculations, several life insurance entities continue to calculate reserves for traditional life and health products using simplified assumptions, such as midyear issue, annual, or continuous premium payment modes, and by grouping contracts with the same contract type, issue age, and duration into *valuation cells*.

## Reserve Definitions

**8.13** Benefit reserves are actuarially determined amounts that represent estimates of the present value of expected future cash flows for each contract or group of contracts. In understanding these calculations, the following definitions are required.

- a. *Terminal reserves.* Terminal reserves represent the contract reserves at the end of the contract year. A terminal reserve is calculated based on assumptions that all net premiums have been paid, all interest earned, and the benefits paid through the end of the contract year. (See paragraph 8.14 for a discussion of methods to calculate the terminal reserve.)
- b. *Initial reserves.* The SAP initial reserve is calculated by adding the SAP net premium for the current contract year to the terminal reserve of the preceding contract year.

**8.14** Terminal and initial reserves are not used as reserve liabilities in financial statements because the contract year-end (referred to as the *anniversary date*) and the financial reporting period-end (referred to as the *valuation date*) are usually different. These reserve amounts are used as a basis for calculating the following reserves that are used in estimating the financial statement amounts.

- a. *Mean reserve.* Most commonly used for SAP statements, the mean reserve is the arithmetic average of the initial reserve and the terminal reserve of the current contract year. This results in the mean reserve reflecting a full year's net premium and one-half year's interest and mortality costs. The mean reserve calculation is based on the assumption that the midpoint of the preceding 12 months is the average issue date for all contracts in force, and is intended to reflect the value of the contracts at the midpoint of the contract year. Accordingly, the validity of the mean reserve method depends on an even distribution of issues and terminations of contracts over the year. In practice, the mean reserve methodology assumes the receipt of all premiums, which in fact may not have been received, requiring the recording of offsetting deferred premiums. (See chapter 7 for a discussion of deferred premiums.)
- b. *Mid-terminal reserves.* Mid-terminal reserves represent the arithmetic average of the prior-year terminal reserve and the current year terminal reserve. These reserves are generally based on the

same assumptions as the mean reserve, the only difference being the premium assumption. Mid-terminal reserves assume that there are no unearned premiums outstanding as of the valuation date on which policyholders have prepaid coverage. It also assumes that on average the valuation date is halfway between policyholders' anniversaries. To the extent that premiums are collected more or less frequently than assumed, an unearned premium liability is needed to correct the understatement of the mid-terminal reserve. (See chapter 7 for a discussion of unearned premiums.) The mid-terminal reserve is commonly used for home service life business and certificates of fraternal benefit societies.

## Retrospective and Prospective Methods

**8.15** Two equivalent methods are used to calculate the terminal reserve: the retrospective method and the prospective method. The retrospective method views the terminal reserve looking backward at what has already occurred. Using this approach, the terminal reserve is the accumulated value of past net premiums minus the accumulated value of the assumed past benefits. The prospective method views the terminal reserve looking forward at future premiums and future benefits. Using this approach, the terminal reserve is the present value of future benefits minus the present value of the future net premiums. Both approaches will yield identical results. (Refer to exhibit 8-1, "Benefit Liabilities—Prospective Reserve Method and Retrospective Reserve Method.")

**8.16** There are several reserving methods currently in use to compute benefit reserves for financial statements of life insurance entities. The most common methods are the *net level reserve* and *modified or full preliminary term* methods that are defined as follows:

- a. *Net level reserve method.* The net level reserve method uses the valuation net premium (see chapter 7 for a discussion of net premium), which is a constant percentage of gross premium. This method usually produces the largest amount of reserves, as it requires a significant first year reserve, and is the only acceptable method for use in U.S. GAAP financial statements for traditional long duration insurance contracts as established by FASB ASC 944, *Financial Services—Insurance*.
- b. *Modified or full preliminary term method.* These methods are used only in SAP financial statements, and provide a smaller addition to reserves in the first contract year. This is intended to mitigate the effect of the higher first year expenses on a contract. The two most common preliminary term methods in use are the full preliminary term method (FPTM) and the CRVM. The CRVM produces the least amount of reserves allowed by the standard valuation law. The CRVM produces a first year terminal reserve of zero for many contract types, reducing the statutory surplus strain associated with new business. The NAIC Universal Life Model Regulation also sets forth minimum reserving methods to calculate CRVM reserves for universal life-type products. The two year FPTM is allowed for certain health products.

## Accounting Practices<sup>\*</sup>

**8.17** As discussed in chapter 3, life insurance entities are subject to the filing requirements of SAP and may also prepare financial statements in accordance with U.S. GAAP. The following discussion of SAP and U.S. GAAP accounting for benefit and claim liabilities is not a comprehensive source of authoritative accounting literature. It is intended to assist the preparers and auditors of financial statements in obtaining a general understanding of basic accounting practices for the most common kinds of benefit and claim liabilities within the life insurance industry. The authoritative sources cited in chapter 3 may be referred to in determining appropriate accounting and reporting treatment in all cases.

## Statutory Accounting Practices

**8.18** Statutory policy and claim reserves for life insurance entities are subject to limitations and calculation methods prescribed or permitted by regulatory authorities in the state of domicile. SAP policy reserves may be determined using either the net level reserve, the modified preliminary term, or FPTMs.

**8.19** *Mortality and morbidity.* Minimum legal standards for SAP policy reserves are based on published mortality and morbidity tables prescribed by the various states as recommended by the NAIC (per the provisions of appendixes A-585, A-010, A-815,<sup>†</sup> A-820, and A-822 and the actuarial guidelines found in appendix C of the revised manual).

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<sup>\*</sup> The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, FASB issued the invitation to comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project.

In July 2010, the IASB issued the exposure draft *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. Although the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement model; however, the majority prefer an alternative model. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. generally accepted accounting principles to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.

<sup>†</sup> Model Regulation 815, *Permitting the Recognition of Preferred Mortality Tables*, has been added as appendix A-815 to the manual (and Statement of Statutory Accounting Principles [SSAP] No. 80, *Life Contracts, Deposit-Type Contracts and Separate Accounts, Amendments to SSAP No. 51—Life Contracts, SSAP No. 52—Deposit-Type Contracts, and SSAP No. 56—Separate Accounts*.) This change permits the 2001 CSO Mortality Table to be split into preferred and residual classes; reporting entities can use the split based on their anticipated experience with a January 1, 2007, effective date. Model Regulation 815 primarily provides interim relief to term insurance providers that equals the interim relief provided to universal life providers in Actuarial Guideline 38.

**8.20 Interest.** As noted in paragraph 5 of appendix A-820, *Minimum Life and Annuity Reserve Standards*, of the revised manual, "the interest rates used in determining the minimum standard for the valuation of policies issued on or after the effective date of the Codification [January 1, 2001] shall be the calendar year statutory valuation rates" as defined in paragraph 5(a) of the appendix.

**8.21 Withdrawals.** Under SAP, estimated future withdrawals (terminations for reasons other than death or maturity) for life insurance contracts are not considered because statutory policy reserves are not permitted to be less than the cash surrender values or other nonforfeiture benefits on an individual contract basis. Investment contracts such as guaranteed investment contracts (GICs) can commonly be surrendered, therefore, there is no explicit consideration of a probability of withdrawal. For certain health products, estimated future voluntary termination or total termination assumptions are specifically allowed. See appendixes A-010, A-585, A-820, and A-821 of the revised manual for additional discussion of actuarial guidelines.

**8.22 Participating dividends.** Dividends are not usually considered in the calculation of statutory reserves. SAP does provide for participating dividend liabilities as a separate liability on the balance sheet. (See paragraphs 8.82–.91.)

**8.23 Change in valuation basis.** As stated in paragraph 32 or Statement of Statutory Accounting Principles (SSAP) No. 51, *Life Contracts*,

A change in valuation basis shall be defined as a change in the interest rate, mortality assumption, or reserving method (for example, net level and preliminary term, among others) or other factors affecting the reserve computation of policies in force and meets the definition of an accounting change as defined in SSAP No. 3, *Accounting Changes and Corrections of Errors*. Consistent with SSAP No. 3, any increase (strengthening) or decrease (destrengthening) in actuarial reserves resulting from such a change in valuation basis shall be recorded directly to surplus rather than as a part of the reserve change recognized in the summary of operations. The impact on surplus is based on the difference between the reserve under the old and new methods as of the beginning of the year. This difference shall not be graded in over time unless an actuarial guideline adopted by the NAIC prescribes a new method and a specific transition that allows for grading.

## Calculation of Reserve Liabilities by Contract Type<sup>2</sup>

**8.24 Life insurance contracts.** As described in SSAP No. 51 paragraphs 14–15,

Statutory reserves should be established for all unmatured contractual obligations of the reporting entity arising out of the provisions of the insurance contract. Where separate benefits are included in a

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<sup>2</sup> AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), resulted in the extension of the auditor's report date to be closer to the statutory accounting report release date. The National Association of Insurance Commissioners amended SSAP No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses*, to state:

Changes in estimates of the liabilities for unpaid claims or losses and loss/claim adjustment expenses resulting from the continuous review process between the March 1 filing deadline of the Annual Statement and the June 1 filing deadline for the audited financial statements are considered a change in estimate and shall be recorded in the statement of operations in the period the change becomes known.

(continued)

contract, a reserve for each benefit should be established as required in appendix A-820. These statutory reserves are generally calculated as the excess of the present value of future benefits to be paid to or on behalf of policyholders less the present value of future net premiums.

The reserving methodologies and assumptions used in computation of policy reserves should meet the provisions of Appendices A-820 and A-822 and the actuarial guidelines found in appendix C of this manual. Further, policy reserves should be in compliance with those Actuarial Standards of Practice promulgated by the Actuarial Standards Board.

**8.25** *Accident and health contracts.* Reserves for most accident and health contracts consist of the following:

- a. A policy reserve, which has been referred to as active life reserves and also includes unearned premium reserves.
- b. A claim reserve, which is an estimate of the present value of amounts not yet due on claims and related claim expenses. (Claim reserves are held for both reported and unreported claims.)

**8.26** Policy reserves, or *active life reserves*, are required on all inforce contracts meeting certain renewal criteria that are priced on a level premium concept and have an increasing incidence of claims costs over the duration of the contract. These renewal criteria are generally guaranteed renewable and noncancelable contract features. The relationship of the contract's morbidity costs and its premium structure dictate the need for active life reserves. In general, a requirement for an active life reserve exists if the timing of benefits lags the timing of premiums. For contract holders that are receiving benefits, such as disability claims, active life reserves are still required and are in addition to any claim reserves on those contracts. There are method, morbidity, and interest standards recommended by the NAIC for the calculation of the minimum reserve amounts.

**8.27** As noted in paragraph 12 of SSAP No. 54, *Individual and Group Accident and Health Contracts*:

Unearned premium reserves shall be required for all accident and health contracts for which premiums have been reported for a period beyond the date of valuation other than premiums paid in advance. The minimum unearned premium reserve that applies to the premium period beyond the valuation date shall be based on the valuation net modal premium if contract reserves are required and the gross modal unearned premium reserve if contract reserves are not required.

**8.28** As stated in SSAP No. 54 paragraph 19, "Claim reserves shall be accrued for estimated costs of future health care services to be rendered that

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(footnote continued)

Readers should be aware that only SSAP No. 55 was changed to indicate that it is a change in estimate reflected in the period the change becomes known, all other account balances must be reviewed for subsequent events relative to the period being audited.

Additionally, AICPA Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290), provides guidance to auditors of nonissuers regarding the application of certain AU section 339 provisions, primarily relating to dating the auditor's report. The practice alert provides guidance with respect to the audit report date, evidence surrounding financial statement amounts and disclosures (including attorney letters, obtaining waivers, and subsequent event evaluation) and financial statement preparation and management's assertions.

the reporting entity is currently obligated to provide or reimburse as a result of premiums earned to date and that would be payable after the reporting date under the terms of the arrangements, regulatory requirements or other requirements if the insured's or subscriber's illness or disability were to continue." By contrast, a claim liability is for an amount currently due and payable. Claim reserves consist of a reserve for claims incurred but not reported and a reserve for those reported claims not yet paid or settled. The present value of amounts not yet paid or settled relates to that portion of the liability for claims incurred on or before the valuation date that has not been accrued as of the valuation date. Claim reserves, which represent the present value of claims not yet due on disability contracts, are sometimes referred to as *disabled life reserves*. The claim reserves are usually computed by the application of actuarially determined factors based on mortality, morbidity, interest, and contract limitations or may be based on entity experience.

**8.29** *Annuity contracts.* Annuity reserves are determined based on whether the contract is in the *accumulation phase* (premium paying period or paid-up and deferred) or in the *payout phase* (benefit payments have commenced). The life insurance entity's obligation is different in each phase, and therefore, requires different reserve methodologies.

**8.30** Individual annuities in the accumulation phase are reserved under the NAIC MSVL, using the commissioners' annuity reserve valuation method (CARVM). Statutory annuity reserves in the payout phase are generally estimates of the present value of the future cash payments, based on statutory annuity mortality tables and prescribed interest rates. Annuity and pure endowment contracts with interest guarantees may require additional reserves as determined by the statutes and regulations of the states. As a result of the complexity of such contracts and the difficulties of applying the CARVM requirements, further guidance is provided through the NAIC Model Regulations and NAIC Actuarial Guidelines. A qualified actuary is needed to interpret these requirements to an entity's product. Additional guidance on the CARVM requirements can be found in appendix A-820 of the revised manual. The NAIC also has adopted proposed AG VACARVM as Actuarial Guideline 43 for Variable Annuities with regards to contracts issued on or after January 1, 1981, effective December 31, 2009. The purpose of Actuarial Guideline 43 for Variable Annuities is to interpret the standards for the valuation of reserves for variable annuity and other contracts involving certain guaranteed benefits similar to those offered with variable annuities. With the adoption of Actuarial Guideline 43 for Variable Annuities, the NAIC approved a modern, principles-based reserve methodology for variable annuities with guarantees that allows companies to set reserves that more accurately and appropriately reflect the risks of variable annuities with guarantees. It allows insurers to calculate their reserve requirements in a way that is more in line with calculations for risk based capital reserves and capital requirements from the NAIC. The guideline also retains a minimum formulaic value. Section V of Actuarial Guideline 43 for Variable Annuities provides, however, that where the application of Actuarial Guideline 43 for Variable Annuities produces higher reserves than a company had otherwise established by its previously used interpretation, the company may request a grade-in period, not to exceed three years, from the domiciliary insurance commissioner upon satisfactory demonstration of the previous interpretation, and that such a delay of implementation will not cause a hazardous financial condition or potential harm to policyholders.

**8.31 *Investment contracts.*** For investment contracts accounted for as other deposit funds, a liability is usually established for the account balance and accrued interest to the valuation date. The terms of the contract, including provisions for early surrender, must be considered in establishing the liability. The liability for GICs is subject to the NAIC MSVL. As noted in paragraph 9 of SSAP No. 52, *Disclosures for Funding Agreements Issued to a Federal Home Loan Bank*, "The policy reserves for contracts without life contingencies where the future benefits are fixed and guaranteed shall be based on the present value of the future guaranteed benefits discounted at the valuation interest rate."

**8.32 *Supplementary benefits.*** As noted in SSAP No. 51 paragraph 33, "supplemental benefits, include, but are not limited to, accidental death benefits and waiver of premium benefits."

**8.33 *Supplementary contracts.*** Policy reserves for supplementary contracts with life contingencies are determined in a manner similar to annuity contracts in a payout phase and are reported as part of the aggregate life reserves.

**8.34 *Deficiency reserves.*** Deficiency reserves (reserves for the excess of the valuation net premium over the gross premium) may be necessary when the entity charges a gross premium that is less than the minimum statutory valuation net premium. This can occur if the entity's interest or mortality assumptions used to calculate the gross premium are significantly different than the corresponding assumptions permitted in determining minimum statutory reserves (or gross premiums are significantly affected by outside market factors).

**8.35** The net valuation premium used in determining the deficiency reserve is not always the same as the net premium used in calculating the statutory contract reserve. For purposes of determining deficiency reserves, the calculation methodology is the same as the SAP reserve, but the minimum permitted interest and mortality valuation standards are used. There is a statutory maximum valuation interest rate and a valuation mortality that is prescribed for the determination of the minimum statutory reserve amount and for the determination of deficiency reserves.

**8.36 *Miscellaneous reserves.*** In addition, SAP requires the estimation of miscellaneous reserve items that may be reported as a separate item or as part of the aggregate life reserves as permitted by state laws and regulations. For example, miscellaneous reserves may be required for such items as a reserve for substandard extra premium, a reserve for extra mortality on group conversions, waiver of premium, accidental death and dismemberment, a reserve for guaranteed insurability options, and reserves required based on cash flow testing, asset-liability matching requirements, or both.

**8.37 *Reinsurance credits.*** Under SAP, a ceding life insurance entity records reinsurance recoverable on losses incurred as an admitted asset and records anticipated reinsurance recoverable on contracts in force as a reduction of the statutory reserve. These amounts are based on the terms of the reinsurance agreements, considering the assessment of collectability from the assuming entities. The NAIC and some jurisdictions limit credit for reinsurance recoverable if the reinsurance agreement does not provide an adequate transfer of risk and may require advance regulatory approval of certain reinsurance agreements. SSAP No. 61, *Life, Deposit-Type and Accident and Health Reinsurance*, paragraphs 36–38, further discusses credits for ceded reinsurance.



**8.38** For reinsurance transactions with entities not authorized to do business in the ceding entity's state of domicile, the assuming entity may be required to furnish evidence of its solvency or provide acceptable security, such as letters of credit or acceptable funds on deposit, to enable the ceding entity to take a credit against its reserves. (See chapter 12, "Reinsurance," for further discussion.)

## Participating Policies

**8.39** *Statutory accounting practices.* SAP for dividends on individual participating contracts generally requires a provision for dividends expected to be paid over the year subsequent to the date of the financial statements, whether or not declared or apportioned. Because of the impact of high initial contract acquisition costs, many life insurance entities issuing participating contracts do not provide for or declare dividends until two full annual premiums have been collected. For such entities, there is no charge to the financial statement for a dividend provision in the first year the participating contract is in force. Furthermore, undistributed earnings on participating business of stock life entities are included in unassigned surplus without regard to the fact that such earnings may not inure to the benefit of the stockholders.

## U.S. Generally Accepted Accounting Principles

**8.40** Under U.S. GAAP, the overall conceptual approach of the calculation of liabilities for future policy benefits for traditional life and health products is generally similar to SAP; however, the assumptions and methodologies used are usually different.

**8.41** The total profit over the life of the contract is identical on any block of business for both SAP and U.S. GAAP; however, the use of different assumptions and liability methodologies causes the incidence of these profits to be different. This different incidence of profits results from the differing objectives between SAP and U.S. GAAP reporting models (see chapter 3 for further discussion). The SAP model's primary objective is to assure solvency and the ability to pay contract holder benefits. The U.S. GAAP model's primary objective is to measure revenues and the related expenses in the proper accounting periods, reflecting the economic substance of the transactions and events that occurred during those periods and the long term nature of the insurance product.

**8.42** The assumptions used in determining benefit liabilities in U.S. GAAP financial statements attempt to provide a representationally faithful measure of the benefit, claim, and other contract liabilities, and profits reflecting the economic substance of the underlying contracts. For traditional long-duration insurance contracts described in FASB ASC 944, U.S. GAAP assumptions also provide for the *risk of adverse deviation*, which is the risk that the actual experience will be less favorable than that expected when the contract was issued.

**8.43** The primary differences between the computation of SAP reserves and U.S. GAAP benefit liabilities are as follows:

- a. U.S. GAAP liabilities for FASB ASC 944 traditional long duration insurance contracts include assumptions for withdrawals and nonlevel maintenance expenses; SAP reserves do not (except for a provision for early withdrawals on investment contracts).
- b. U.S. GAAP mortality, morbidity, and interest assumptions consider the life insurance entity's future expectations and trends,

considering historical experience. The SAP mortality and interest assumptions are those approved by the state insurance department.

- c. U.S. GAAP liabilities for FASB ASC 944 traditional long duration insurance contracts and limited payment contracts contain provisions for adverse deviation, whereas SAP reserves may have no such specific explicit provision. For those contracts, U.S. GAAP liabilities are based on best estimates of future experience at the time the contract is sold, with an adjustment for the risk of adverse deviation.
- d. Net level reserve methodology is required for U.S. GAAP liabilities for FASB ASC 944 traditional long duration insurance contracts. This causes profits from these contracts to emerge as a level percent of premium plus the effects of experience differences between the actual result and those assumed. SAP reserves may use other reserve methodologies. (See paragraph 8.15 for discussion.)

## Significant Actuarial Assumptions

**8.44** The selection of actuarial assumptions affects the incidence of reported profits for traditional life and health insurance products. If the U.S. GAAP assumptions are too optimistic, earnings could be overstated in the early years of the contract and understated in the later years. Conversely, if the U.S. GAAP assumptions are unduly pessimistic, the opposite could occur.

**8.45** The selection of actuarial assumptions for U.S. GAAP liabilities requires considerable judgment with due consideration given to reasonableness, consistency, and risk of adverse deviation. Because of the interrelationship of assumptions, pessimism with respect to one assumption may have the opposite effect on the results produced by other assumptions. Pessimism with respect to individual assumptions may not necessarily result in appropriate recognition of profit. For example, a higher mortality assumption may result in deferral of profit on an ordinary whole life contract and in accelerating profits on an endowment contract.

**8.46** In determining the collective adequacy of U.S. GAAP net liabilities, which is generally done by taking the benefit reserve minus the deferred acquisition cost (DAC) by line of business, the adequacy of the gross premium must be considered. If the U.S. GAAP valuation premium (the premium necessary to fund contract benefits and expenses) exceeds the actual gross premium charged, a gross premium deficiency may be indicated and future losses may be expected under the contract. If so, the recognition of these losses should be accelerated and recognized in the current period. (See paragraphs 10.57–.67.)

**8.47 Mortality.** The mortality assumptions reflect realistic expectations of future results, considering historical experience. The life insurance entity may use tables developed from its internal experience, or may modify published tables that are consistent with its own expected results.

**8.48** If there is adequate medical underwriting, a *select table* is generally appropriate. A select mortality table considers the effect of underwriting, and reflects better mortality experience for a period of time after underwriting (such as 5-25), referred to as the *select period*. For blocks of business that are subject to little or no underwriting selection, the use of aggregate or ultimate mortality

tables is appropriate. The *aggregate table* reflects the experience of all insured lives. The *ultimate table* reflects the experience following the select period.

**8.49 Morbidity.** Morbidity assumptions should be based on expected incidence and the severity of disability and claims experience at the time the contracts are issued or revised. Consideration should be given to these factors for various kinds of coverages, such as noncancelable provisions, and for such other factors as occupational class, elimination period, gender, age, and benefit period. Morbidity assumptions usually include a provision for the risk of anti-selection (the tendency for fewer terminations of poor risks) in renewal years.

**8.50** For accident and health contracts, assumptions may be based on the life insurance entity's own claims experience, or, if its own experience is unavailable or insufficient, an appropriate basis for claims cost assumptions is industry experience adjusted for the expected experience for a specific coverage, and the effect of the entity's underwriting practices. External trend factors, such as economic conditions and medical developments, should also be considered as they may create higher rates of morbidity by contract duration than are provided in the statutory or industry experience tables.

**8.51 Interest.** As noted in paragraphs 9–10 of FASB ASC 944-40-30, the interest assumption for these insurance contracts reflects the estimate of future investment yields (net of related investment expenses) expected when the contracts are issued. The investment yield expectations for each group of contracts are based on actual yields, trends in yields, portfolio mix and maturities, the quality of the investment portfolio, and the general investment experience of the entity.

**8.52** Selection of an interest rate assumption is a subjective judgment that must be made by the life insurance entity considering the long term nature of life insurance, the contractual obligation under the contracts, and the inherent inability to forecast the future with certainty.

**8.53 Terminations.** As discussed in paragraph 14 of FASB ASC 944-40-30, terminations affect anticipated premiums and death benefits; therefore, the liability computations generally should include provision for terminations, using anticipated termination rates and contractual nonforfeiture benefits. For insurance contracts that do not have termination or nonforfeiture benefits, termination assumptions are also generally appropriate because of the effects of terminations on anticipated premiums and claim costs.

**8.54** Termination assumptions are based on anticipated termination rates and contractual nonforfeiture benefits. The U.S. GAAP benefit liability will often be less than the aggregate cash values of all contracts outstanding. The DAC asset reduces the U.S. GAAP net liability further. As a result, a U.S. GAAP book loss often occurs on surrender.

**8.55** Termination rates used in determining U.S. GAAP liabilities usually vary by plan, issue age, mode of premium, duration, and other factors. If composite rates are used, they should reflect the entity's actual mix of business.

**8.56 Participating dividends.** See paragraphs 8.82–.91 for discussion.

**8.57 Expense.** As discussed in paragraph 15 of FASB ASC 944-40-30, expense assumptions are based on expected nonlevel costs, such as termination and settlement expenses and costs after the premium paying period. Maintenance costs are generally incurred in a level pattern from year to year and

are expensed as incurred. However, U.S. GAAP liabilities generally include a provision for maintenance expenses to reflect any significant changes in future maintenance expenses such as increases attributable to the effects of inflation.

## Calculation of Liabilities for Future Policy Benefits by Contract Type

**8.58** *Life insurance contracts.* As discussed in FASB ASC 944-40-30-7, for traditional long duration contracts and limited payment contracts, the liability for future policy benefits represents the present value of the future benefits to be paid to contract holders and related expenses less the present value of the related future U.S. GAAP net premiums. (See chapter 7 for a discussion of U.S. GAAP net premiums and exhibit 7-2, "Contract Classifications as Defined in FASB ASC 944, *Financial Services—Insurance*," for contract classification.) These amounts are estimated using a method that includes assumptions, such as interest, mortality, withdrawals, and settlement expenses, applicable at the time the insurance contracts are issued. These assumptions should also include a provision for adverse deviation.

**8.59** For limited payment contracts, the benefit liability includes the amount of gross premium that is received in excess of the net premium and accounted for as unearned premium revenue. (See chapter 7 for a discussion of limited payment contracts.)

**8.60** For traditional long duration contracts and limited payment contracts, FASB ASC 944-40-35-5 requires that the original assumptions used when the contracts are issued be locked in and that those assumptions be used in all future liability calculations as long as the resulting liabilities are adequate to provide for the future benefits and expenses under the related contracts. In the event that liabilities for future policy benefits need to be increased to recognize future losses, the DAC asset is reduced or the benefit liability is increased. See chapter 10, "Commissions, General Expenses, and Deferred Acquisition Costs," paragraphs 10.63–.67 for a discussion of loss recognition and paragraphs 10.40–.52 for a discussion of DAC. By locking in the original assumptions, the gains or losses attributable to actual experience that differs from the original assumptions flow through the income statement in the period in which the differences occur.

**8.61** In accordance with FASB ASC 944, universal life-type contracts are accounted for using a *retrospective deposit method*. Under that method, the benefit liability for universal life-type contracts that contain contract or account balances is equal to the sum of the following, as stated in FASB ASC 944-40-30-16:

- a. The balance that accrues to the benefit of policyholders at the date of the financial statements
- b. Any amounts that have been assessed to compensate the insurer for services to be performed over future periods against the contract holder that are accounted for as unearned revenue at the valuation date
- c. Any amounts previously assessed against policyholders that are refundable upon termination of the contract
- d. Any probable loss (premium deficiency) as described in paragraphs 7–9 of FASB ASC 944-60-25 (see also chapter 10, paragraphs 10.64–.67.)

Amounts that may be assessed against policyholders in future periods, such as surrender charges, are not anticipated in determining the liabilities for policy benefits. In the absence of a contract holder account balance or implicit or explicit contract value, the account balance element (see preceding item [a]) of the benefit liability is the cash value at the valuation date that could be realized by the policyholder if the contract were surrendered on that date. Benefit liabilities for universal life-type contracts do not contain provisions for adverse deviation or withdrawal assumptions.

**8.62** FASB ASC 944-40-25 provides guidance for determining the balance that accrues to the benefit of contract holders. As described in FASB ASC 944-40-25-13, the balance that accrues to the benefit of the contract holder for a long duration insurance or investment contract is the accrued account balance. As described in FASB ASC 944-40-25-14, the accrued account balance<sup>3</sup> equals

- a. deposit(s) net of withdrawals;
- b. plus amounts credited pursuant to the contract;
- c. less fees and charges assessed;
- d. plus additional interest (for example, persistency bonus); and
- e. other adjustments (for example, appreciation or depreciation recognized in accordance with paragraphs 18–21 of 944-40-25 to the extent not already credited and included in preceding item [b]).

For purposes of preceding item (d), additional interest is an amount that is required to be accrued under the liability valuation model that has not yet been credited to the contract holder's account. Additional interest, if any, should be accrued through the balance sheet date at the rate that would accrue to the balance available in cash, or its equivalent,<sup>4</sup> before reduction for future fees and charges, at the earlier of the date that the interest rate credited to the contract is reset or contractual maturity. The reset date is the date at which the existing contractually declared investment return expires.

**8.63** As discussed in paragraphs 18–21 of FASB ASC 944-40-25, some contracts, such as variable life and annuity and certain group pension participating and other experience rated contracts, provide for a return through periodic crediting rates, surrender adjustments, or termination adjustments based on the total return of a contractually referenced pool of assets owned by the insurance enterprise. Insurance enterprises should determine whether such contracts will be accounted for under the provisions of FASB ASC 815. To the extent the contract is not accounted for under the provisions of FASB ASC 815, the amount of other adjustments described in paragraph 8.62 of the guide should be based on the fair value of the referenced pool of assets at the balance sheet date, even if the related assets are not recognized at fair value, to the extent not already credited to the accrued account balance and included in paragraph 8.62(b). Amounts determined for other adjustments are not reduced for future fees and charges.<sup>5</sup>

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<sup>3</sup> The liability for the contract is the combination of amounts recorded in separate account liabilities and general account policyholder liabilities.

<sup>4</sup> For this purpose, an asset or contract is the equivalent of cash if it has a readily determinable fair value and can be converted to cash without incurring significant transaction costs.

<sup>5</sup> A loss should be recognized in the statement of operations to the extent an asset reported in the general account is designated as part of a contractually referenced pool of assets and on that designation date has an unrealized loss.

**8.64** As discussed in paragraph 22 of FASB ASC 944-40-25, for contracts that have features that may result in more than one potential account balance (for example, a contract that provides a return based on a contractually referenced pool of real estate assets owned by the insurance enterprise but also provides for minimum investment return guarantees), the accrued account balance should be based on the highest contractually determinable balance that will be available in cash or its equivalent at contractual maturity or the reset date, before reduction for future fees and charges. For contracts in which amounts credited as interest to the contract holder are reset periodically, the accrued balance should be based on the highest crediting rate guaranteed or declared through the reset date.

**8.65** As discussed in paragraph 25 of FASB ASC 944-40-25, the accrued account balance should not reflect surrender adjustments (for example, market value annuity adjustments,<sup>6</sup> surrender charges, or credits). Any changes in the accrued account balance resulting from the application of the guidance in paragraphs 8.62–.64 should be reflected in net income in the period of the changes.

**8.66** Also as noted in paragraph 12 of FASB ASC 944-40-25, sales inducements provided to the contract holder, whether for investment or universal life-type contracts, should be recognized as part of the liability for policy benefits over the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with paragraphs 13–16 of FASB ASC 944-40-25 (paragraph 8.62 of the guide). No adjustments should be made to reduce the liability related to the sales inducements for anticipated surrender charges, persistency, or early withdrawal contractual features. See chapter 10 of the guide for further discussion on sales inducements offered to contract holders. See chapter 9, "Benefit and Claim Payments," of this guide for a discussion of the FASB ASC 944 guidance relative to death and other insurance benefit features of universal life-type contracts and for annuitization guarantees.

**8.67** As noted in FASB ASC 944-40-25-29, a liability for future policy benefits relating to participating contracts should be equal to the sum of the following:

- a. The net level premium reserve for death and endowment policy benefits
- b. The liability for terminal dividends
- c. Any probable loss (premium deficiency) as described in paragraphs 7–9 of FASB ASC 944-60-25

FASB ASC 944-40-30-30 states that the net level premium should be calculated based on the dividend fund interest rate, if determinable, and mortality rates guaranteed in calculating the cash surrender values described in the contract. If the dividend fund interest rate is not determinable, the guaranteed interest rate used in calculating cash surrender values described in the contract should be used. If the dividend interest rate is not determinable and there

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<sup>6</sup> As defined in the FASB ASC glossary, a *market value annuity* is a contract that provides for a return of principal plus a fixed rate of return if held to maturity, or alternatively, a market-adjusted value if the surrender option is exercised by the contract holder before maturity. The market-adjusted value is typically based on current interest rates being offered for new market value annuity purchases.

is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the preceding rates exists, then the interest rate used to determine minimum cash surrender values—as set by the NAIC model standard nonforfeiture law—for the year of issue of the contract should be used. Regardless of the rate used, net premiums should be calculated as a constant percentage of the gross premiums.

**8.68** In accordance with FASB ASC 944-40-25-30, terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met:<sup>7</sup>

- a. Payment of the dividend is probable.
- b. The amount can be reasonably estimated.

In accordance with paragraphs 22–24 of FASB ASC 944-40-35, if the two conditions are met (and they ordinarily will be), the terminal dividends should be recognized as an expense over the life of a book of participating life insurance contracts, at a constant rate based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield (net of related investment expenses). If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing the expense amount to be recognized. (The base substituted in this calculation should be the same one substituted in the amortization of DACs discussed in FASB ASC 944-30-35-11.)

**8.69** See chapter 14, "Other Assets and Liabilities, Surplus Notes, Separate Accounts, Insurance Related Assessments, and Equity—Contract Holders' Surplus," for a discussion of separate accounts for variable life-type contracts.

**8.70** *Accident and health contracts.* The aggregate liabilities for short duration accident and health contracts usually consist of an unearned premium liability and a claim liability. These liabilities are usually set equal to the corresponding statutory amounts.

**8.71** Aggregate liabilities for long duration accident and health contracts (for example, noncancelable and guaranteed renewable) usually consist of a benefit liability (which includes an unearned premium liability and an active life liability) and a claim liability. U.S. GAAP claim liabilities (before discounting) are generally the same as the statutory claim reserve, although different interest assumptions may be used. Claim liabilities should be recognized as separate and distinct from claim reserves for statutory purposes, even though they are often calculated as one aggregate number for certain lines of business. Methods and concepts for calculating benefit liabilities are the same as those used in long duration life contracts. The present value of projected claim costs is calculated as a valuation premium that bears a constant percentage relationship to the gross premium. Liabilities are the difference between the present value of the future benefits and the present value of the future valuation net premiums. The valuation net premium is the constant percentage of the gross premium that, at issue, has the same present value as the expected claim costs. For guaranteed renewable, collectively renewable, and other long

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<sup>7</sup> These conditions should be used in the same sense that they are used in FASB ASC 450-20.

term contracts, estimates of future premium should, in some cases, consider anticipated premium increases and their effect on lapses and antiselection.

**8.72 *Annuity contracts.*** The benefit liability for an annuity contract depends on the kind of contract, the premium payment terms, and whether the contract is in the accumulation or payout phase. Provision for adverse deviation is included in the assumptions used in calculating benefit liabilities for annuity contracts that are classified as short or long duration insurance contracts or limited payment contracts.

**8.73** A liability for immediate annuities is recorded at the amount approximating the present value of future annuity payments and expenses based on expected mortality, costs, and interest assumptions; in accordance with the provisions of FASB ASC 944. Any gross premiums received in excess of the net premium should be deferred and recognized in income in a constant relationship with the amount of expected future payments. The process used to defer the excess premium is often accomplished by calculating a breakeven interest rate. This rate is calculated by finding the interest rate that causes the initial liability to be equal to the net consideration made (gross premium minus acquisition costs). Thus, the process of deferring the excess premium at issue often accomplishes the objective of providing provision for adverse deviations, inasmuch as the liabilities will be calculated using an interest rate lower than that used to calculate the premium. Generally, the immediate annuity deposit is invested immediately at a known rate of interest. When the liability is accrued, although the expected flow of investment cash is matched closely to the flow of anticipated benefits, a provision for adverse deviation for reinvestment and other risks in the investment assumption may be needed. An interest assumption based on the new money rate of the life insurance entity in the year of issue may be appropriate; however, reinvestment risks should be considered. The mortality assumption in annuity liabilities includes a significant risk of adverse deviation. Expense assumptions should provide for future expenses. Because withdrawals under single premium immediate annuities are usually not permitted, withdrawal assumptions are generally not applicable.

**8.74** Liabilities for deferred annuities, both single premium and periodic premium contracts, are considered in two phases. The first phase is the accumulation or deferred phase, during which the contract is an investment contract, and premium payments (deposits) or consideration received by the life insurance entity are accumulated at the credited interest rate and the cash surrender value generally may be withdrawn. The primary risks to the life insurance entity are the following:

- a. The entity fails to earn the spread between interest earned (which is not guaranteed) and the rate credited to the annuity (which is guaranteed at a minimum rate).
- b. Liquid assets of sufficient value may not be available to fund requests for surrender.

Annuity liabilities during the accumulation phase are computed on deposits received accumulated at interest under the guidance of FASB ASC 944-40-25, as described in paragraphs 8.62–.65 of this guide.

**8.75** The second phase, at the election of the policyholder, is the payout or liquidation phase, during which annuity payments are made to the annuitant and the mortality risks are introduced. Annuity liabilities during the payout phase are similar to liabilities for the immediate annuities discussed



previously. Not all annuities have mortality risk, such as period certain contracts, and therefore are required to be accounted for as investment contracts.

**8.76 *Investment contracts.*** Investment contracts include GICs and other investment contracts as described in chapter 2, "Characteristics of Life and Health Insurance Products." For most investment contracts, the benefit liability or the amount that accrues to the benefit of the contract holder should be accounted for under the guidance of FASB ASC 944-40-25, as described in paragraphs 8.62–.65 of this guide.

**8.77 *Other liabilities.*** In addition to the benefit and claim liabilities previously discussed, miscellaneous liabilities may be necessary for items such as waiver of premium, accidental death and dismemberment, and conversion options under term or group contracts.

**8.78 *Reinsurance accounting.*** According to the provision of FASB ASC 944-310-25-2, a ceding life insurance entity generally records anticipated reinsurance recoveries on the contracts in force as a reinsurance receivable asset.

**8.79** The anticipated reinsurance receivable amounts are calculated in the same way as the benefit liabilities, and are based on the terms of the reinsurance agreement. (See chapter 12 for further discussion.) Reinsurance contracts that do not provide for adequate transfer of risk as prescribed by FASB ASC 944 are treated as deposits.

**8.80** FASB ASC 340-30 provides guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. The transfer of insurance risk requires transferring both timing risk and underwriting risk. As discussed in FASB ASC 340-30-15, these concepts apply to all entities and all insurance and reinsurance contracts that do not transfer insurance risk, except for long duration life and health insurance contracts. The method used to account for insurance and reinsurance contracts that do not transfer insurance risk is referred to as *deposit accounting*. Refer to FASB ASC 340-30-05 for a discussion of deposit arrangements.

**8.81** FASB ASC 340-30-25-1 requires that, at inception, a deposit asset or liability should be recognized for insurance and reinsurance contracts accounted for under deposit accounting. FASB ASC 340-30-30-1 states that at inception, a deposit asset or liability should be measured based on the consideration paid or received, less any explicitly identified premiums or fees to be retained by the insurer or reinsurer, irrespective of the experience of the contract. Accounting for such fees should be based on the terms of the contract. According to FASB ASC 340-30-45-1, deposit assets and liabilities should be reported on a gross basis, unless the right of setoff exists as defined in FASB ASC 210-20.<sup>8</sup> The accounting by the insured and insurer are symmetrical, except as noted in paragraphs 6–7 of FASB ASC 340-30-35.

**8.82** FASB ASC 340-30-35 provides guidance about the measurement of the deposit asset or liability at subsequent reporting dates. The subsequent measurement of the deposits is based upon whether the insurance or reinsurance contract (a) transfers only significant timing risk, (b) transfers only

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<sup>8</sup> FASB ASC 815-10-45-5 permits a reporting entity to offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from derivative instruments recognized at fair value executed with the same counterparty under the same master netting arrangement.

significant underwriting risk, (c) transfers neither significant timing nor underwriting risk, or (d) has indeterminate risk.

## Participating Dividends

**8.83** *U.S. generally accepted accounting principles.* To determine the appropriate accounting in conformity with U.S. GAAP for participating business, first determine whether the insurance entity and the contract meet the criteria in paragraphs 3–4 and 11 of FASB ASC 944-20-15. This guidance applies to all mutual life insurance enterprises and stock life insurance subsidiaries of mutual life insurance enterprises, that issue long duration participating life insurance contracts that are expected to pay dividends to policyholders based on the actual experience of the insurance entity and where annual policyholder dividends are paid in a manner that identifies divisible surplus and distributes that surplus in approximately the same proportion as the contracts are considered to have contributed to divisible surplus. As described in FASB ASC 944-20-15-11, stock life insurance enterprises with participating life insurance contracts that meet the conditions listed previously, are permitted to account for those contracts in accordance with the long duration contracts subsection of FASB ASC 944-20. If the contract meets the criteria in item (b) of FASB ASC 944-20-15-3, annual policyholder dividends should be reported separately as an expense in the statement of earnings, and should be based on estimates of amounts incurred for the policies in effect during the period. If the contract does not meet the criteria in item (b) of FASB ASC 944-20-15-3 consider any restrictions on the amount of earnings of participating contracts that can inure to the benefit of the stockholders. Such restrictions may be imposed by law, charter, or contract.

**8.84** FASB ASC 944-50-25-3 states that for life insurance entities for which there are no net income restrictions and that use life insurance dividend scales unrelated to actual net income, policyholder dividends should be accrued over the premium-paying periods of the contracts. As stated in FASB ASC 944-740-25-1, although payment is not required, this dividend is considered a planned contractual benefit in computing U.S. GAAP liabilities. However, it may be necessary to identify the amount of this dividend to calculate deferred income taxes in those cases in which there is a question as to whether the dividend provision in the liabilities, together with the dividends paid or declared, may exceed the amount of dividends otherwise deductible for federal income tax purposes.

**8.85** Some stock life insurance entities that issue participating contracts may have limitations on the amount of earnings on business that may inure to the stockholders. As discussed in FASB ASC 944-50-25-2, the contract holders' share of earnings on business, which cannot be expected to inure to the stockholders, is excluded from stockholders' equity by a charge to operations and a credit to an appropriate liability account relating to participating policyholder funds. Dividends declared or paid to participating policyholders are charged to that liability account. Dividends declared or paid on such business, in excess of the liability account, are charged to operations.

**8.86** Currently, there are several states with insurance regulations that restrict the amount of profits on participating contracts that may inure to the benefit of the stockholders. These limitations are generally based on one of the following:

- a. A percentage of income on participating business

- b. An amount per \$1,000 of insurance in force of participating business
- c. The greater of items (a) or (b)

In some states, the limitation applies only to domestic entities, or it can apply to all business written in that state.

**8.87** In establishing provisions for contract holders' share of earnings, consideration must be given to whether earnings applicable to contract holders and stockholders are determined based on earnings or whether they are determined on a basis unrelated to earnings. In instances in which earnings applicable to contract holders and stockholders are determined based on earnings before provision for the contract holders' share, adjustments to conform to U.S. GAAP create reconciling items between the inclusion of items in income and expense in U.S. GAAP and SAP financial statements. For the purposes of computing a provision for the contract holders' share of earnings, these reconciling items should be considered. For example, a life insurance entity may by law determine that 90 percent of earnings on participating contracts must inure to the benefit of participating contract holders. If earnings before dividends on its participating business, determined in conformity with U.S. GAAP, are \$1 million, provision should be made for contract holders' share of earnings by a charge to operations for \$900,000 (90 percent of \$1 million). Actual dividends should be treated as previously described.

**8.88** A second example relates to a legal restriction that limits the amount that may inure each year to stockholders from certain participating contracts to the greater of the following:

- a. 10 percent of statutory earnings before contract holder dividends
- b. 50-cents-per-1,000 dollars of participating life insurance in force

**8.89** For a life insurance entity whose statutory earnings on participating business are subject to the 10 percent limitation, and who is expected to continue to be in that situation, reconciling items and their reversal will affect contract holders' and stockholders' share of participating earnings. For an entity whose statutory earnings on participating business is subject to the 50-cents-per-1,000 limitation, and who is expected to continue to be in that situation, reconciling items and their reversal will not affect the amount of earnings that can inure to stockholders. In the former case, a provision for the contract holders' share of participating earnings should be made by a charge to operations based on 90 percent of reported predividend earnings. In the latter case, a provision should be made by a charge to operations for all reported predividend income in excess of 50-cents-per-1,000.

**8.90** Financial statements prepared in accordance with U.S. GAAP may reflect predividend income, which would produce an apparent basis of calculation of the contract holders' share of participating earnings that differs from the basis used in the SAP statements. Such a change in basis of calculation should be recognized only under circumstances indicating that the reconciling items, which create the change in basis, are likely to produce the same results for statutory purposes when such reconciling items reverse.

**8.91** A third example relates to stock life insurance entities that issue participating contracts that follow FASB ASC 944 traditional long duration contract accounting, which are substantially similar to participating contracts of mutual life insurance entities in that all or substantially all of the earnings

on such contracts inure to the benefit of the contract holders. As in the other examples, earnings that cannot inure to the stockholders should be excluded from stockholders' equity by a charge to operations and a credit to a liability account. Stock life insurance entities with qualifying contracts are permitted to follow the accounting guidance in FASB ASC 944 for long duration contracts.

**8.92** For participating businesses for which all or substantially all of the profits inure to the contract holders, or for which amounts that may inure to the stockholders are limited to 50-cents-per-1,000, adjustments to conform to U.S. GAAP will not affect net income or stockholders' equity. However, they will affect individual items within the financial statements. The auditor should determine whether the adjustments to individual items within the financial statements are necessary for fair presentation.

**8.93** The demutualization process described in FASB ASC 944-805 is applicable to all insurance enterprises that demutualize or form a mutual insurance holding company (MIHC).

**8.94** *Accounting for predemutualization participating contracts after the demutualization date or formation of an MIHC.* FASB ASC 944-805-15-5 states that the accounting guidance in FASB ASC 944-20 is the appropriate accounting method for participating policies that meet the conditions of FASB ASC 944-20-15-3 and, therefore, an insurance enterprise should continue to apply that guidance to demutualized insurance enterprises' participating contracts issued before the date of demutualization or formation of an MIHC. However, the segregation of undistributed accumulated earnings on participating contracts is meaningful in a stock life insurance entity because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, after the date of demutualization or formation of an MIHC, the provisions of FASB ASC 944-50-25-2 and FASB ASC 944-50-30-2 relating to dividends on participating contracts should apply to those contracts sold before the date of demutualization or formation of an MIHC.

**8.95** *Accounting for participating policies sold after the date of demutualization or formation of an MIHC and for stock insurance enterprises that adopted FASB ASC 944-20.* FASB ASC 944-805-35-15 requires that the accounting guidance in FASB ASC 944-20 be applied to demutualized insurance enterprise participating contracts within its scope that are issued after the date of demutualization or formation of an MIHC. The segregation of undistributed accumulated earnings on participating contracts in excess of amounts that inure to stockholders is meaningful in a stock life insurance entity because the objective of such presentation is to identify amounts that are not distributable to stockholders. Therefore, the provisions of FASB ASC 944-50-25-2 and FASB ASC 944-50-30-2 relating to dividends on participating contracts should apply to contracts that are sold after the date of demutualization or formation of an MIHC and meet the requirements of FASB ASC 944-20. Those provisions should also be applied by stock insurance enterprises that adopted FASB ASC 944-20 with respect to participating contracts for which limitations exist on the amount of net income that may be distributed to stockholders. If there is a limitation on the amount of income from participating contracts issued after the date of demutualization or formation of an MIHC that may be distributed to stockholders, the policyholders' share of income on those contracts that may not be distributed to stockholders should be charged to operations with a corresponding credit to a liability. Dividends paid to participating policyholders reduce that liability.

## Auditing

### Inherent Risk Factors

**8.96** In obtaining an understanding of benefit liabilities to assess the risks of material misstatement, the auditor may want to consider inherent risk factors related to benefit liabilities, including factors relating to management, liability assumptions, product characteristics, underwriting approach, marketing strategies, and the competitive, economic, and regulatory environment. Such factors might encompass the following:

- a.* Management's selection of actuarial assumptions for pricing and liability calculations are unduly influenced by considerations other than realistic expectations of future performance.
- b.* The entity has a history of introducing new products if actual performance is less favorable than the original assumptions used for pricing and expected gross profit projections.
- c.* Actual investment results are lower or likely to become lower than assumed, causing potential premium deficiency or loss recognition situations.
- d.* Actual lapse or surrender rates are higher than assumed, causing potential premium deficiency and loss recognition, including the potential effects of antiselection.
- e.* Economic conditions exist that increase contract holders' expectations of dividend scales or interest crediting rates that may affect benefit liability assumptions.
- f.* Volatility in the financial markets or other economic conditions makes assessment of appropriate investment returns or expense levels difficult.
- g.* Unforeseen risks or events significantly affect the adequacy of liabilities for future policy benefits and mortality or morbidity assumptions.
- h.* Increased competition or changes in tax legislation affect the lapse and surrender assumptions used in benefit liability calculations.
- i.* Changes in reinsurance availability or agreements affect actuarial assumptions.
- j.* Changes in regulations or application of accounting principles (SAP or U.S. GAAP) alter benefit liability requirements, assumptions, or calculation methodologies. Changes in tax regulations require benefit liabilities to be calculated on a different basis.
- k.* Changes in the entity's underwriting standards or marketing strategy result in the acceptance of substandard risks or a change in business practices.
- l.* The entity's surplus position is weak in comparison to the industry standard or close to minimum statutory levels.
- m.* The life insurance entity has international operations, and benefit liabilities for operations outside the United States must conform to accounting principles and regulations in the country of domicile.
- n.* Unqualified actuaries are involved in the calculation and review of the benefit and claim liabilities.

- ## Obtaining an Understanding of Internal Control for Auditing Liabilities for Future Policy Benefits and Other Contract Liabilities

## Control Environment

- a. New products have been introduced that require changes to the benefit liability calculation systems, or the degree of complexity of product design or benefit liability calculations is increasing.
- b. Operations are highly decentralized or there is significant reliance on third parties to provide necessary data to calculate significant benefit liabilities.
- c. Existing systems are inadequate to cope with changes in benefit liability calculation methodologies or increases in business volume. There are inadequate interfaces with other key processing systems.
- d. There is heavy reliance on manual processes or on one individual for benefit liability calculations.
- e. Staff is inexperienced or insufficient in relation to the complexity and volume of transactions involved in the calculation of benefit liabilities.

## Control Activities

**8.99** Control activities are those policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor should obtain an understanding of those control activities relevant to the audit.

**8.100** The following are examples of typical internal control procedures and policies relating to benefit liability transactions:

- a. *Proper authorization of transactions and activities.* Written guidelines are in place that assign appropriate individuals the responsibility for initial approval and subsequent changes of actuarial assumptions and calculation methodologies. (For example, for benefit liabilities, changes in underwriting standards, dividend scales, special reinsurance arrangements, or compensation arrangements may affect the validity of the actuarial assumptions used in calculations of liabilities for future policy benefits.)
- b. *Segregation of duties.* Product pricing and development, benefit liability processing, premium billing and collection, key information systems functions, inforce file maintenance, and general accounting activities are appropriately segregated, and independent reviews of the work performed are conducted.
- c. *Design of adequate controls over documents and records.* There are procedures to ensure that fictitious or duplicate inforce file records or benefit liability records are not included in the records and to prevent or detect the omission of valid transactions.
- d. *Adequate safeguards of access to and use of assets and accounting records.* Benefit liability data files and production programs have adequate safeguards against unauthorized access.
- e. *Independent checks on performance and proper valuation of recorded amounts.* Qualified actuaries are used in actuarial calculations of liability amounts, and policies and procedures are in place for the appropriate personnel to evaluate those calculations and the resulting liability amounts.

Note that for an integrated audit performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit. (see paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, PCAOB Standards and Related Rules, Interim Standards]). Also refer to paragraph 54 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, PCAOB Standards and Related Rules, Auditing Standards) for a discussion on the extent of tests of controls (see paragraph .97 of AU section 319).

## Information and Communication

**8.101** AU section 314 paragraph .81 states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report an entity's transactions (as well as events and conditions) and to maintain accountability for related assets, liabilities, and equity.

**8.102** For insurance entities, the flow of accounting records for benefit and claim liability transactions usually encompasses all functions relating to the selection of valuation assumptions, the calculation of liability factors and

aggregate liability amounts, the evaluation of the adequacy of benefit liabilities, and the financial statement presentation. The accounting systems for these functions are necessarily complex, and significant manual adjustments may be required. They also may use multiple inforce files and usually encompass multiple automated systems. In general, benefit liability systems generate amounts that are analyzed as of the valuation date and recorded in the financial records by manual journal entries.

**8.103** Contract benefit liabilities for life contracts and active life benefit liabilities for accident and health contracts may be calculated on a seriatim (policy-by-policy) basis. It is also common to use a model of the inforce that consists of valuation cells representing groups of contracts with similar characteristics. Contracts that are grouped into a valuation cell typically share 1 or more of the following attributes: issue age, gender, issue year, and risk category (smoker—nonsmoker) to reflect appropriate mortality and morbidity experience. For minor plans (that is, contracts with relatively few policies in force), there may be a *mapping* to a major plan. An example of this would be a life contract paid up to the age of 95 with relatively few policies in force, which may be modeled as a whole life contract. Valuation cell issue ages may be quinquennial, with a male issue age of 35 cell representing policies sold to males ages 33–37. The accuracy of the model is typically validated by comparing the replication of aggregate face amounts, gross premiums, and the statutory reserve of grouped policies to the representative valuation cell. The inforce amount of each valuation cell is matched with the appropriate reserve factor, in a fashion analogous to seriatim inforce files. Appropriate reserve factors reflect a common set of actuarial assumptions of the valuation interest rate(s), mortality and morbidity tables, benefit costs, and maintenance expenses. In a number of life insurance entities, factors are applied directly to the inforce files, and in others to separately maintained files of cell data. If inforce files are particularly large, the details of these calculations may not be readily available either electronically or in hard copy.

**8.104** A general summary of the process of calculating benefit reserve factors for traditional life and annuity contracts (for both SAP and U.S. GAAP) is as follows:

- a. The selected mortality assumptions (and withdrawal assumptions for U.S. GAAP liabilities) are used to calculate the estimated number of contracts that will remain in force, and those that are expected to terminate at each future valuation date.
- b. The estimated gross premium expected to be collected on contracts remaining in force, and the expected contract benefits payable on terminating contracts is then calculated using the previously estimated number of contracts in all future periods.
- c. The net premium is then calculated using the entity's selected method (for U.S. GAAP liabilities, the net level method is required). The net premium is based on the present value of the estimated contract benefits expected to be paid for all future periods, which, for SAP reserves, considers mortality and interest assumptions. Net premiums for U.S. GAAP liabilities, also referred to as the *valuation premium*, are based on assumptions for mortality, interest, dividends, withdrawal, and expenses.



- d. The contract benefit liability is equal to the excess of the present value of the future benefits over the present value of future net premiums.
- e. The calculated estimated contract benefit liability at each future valuation date is generally expressed in terms of units of insurance in force to obtain reserve factors that are then applied to the units in force at the valuation date, for all contract durations (for an example, see exhibit 8-1).

## Special Considerations

**8.105** In auditing aggregate benefit liabilities of life insurance entities, the auditor may consider the following matters regarding the utilization of actuaries and liability assumptions for new and established life insurance entities, as well as matters in the audit consideration chart provided at the end of this chapter.

**8.106** As discussed in chapter 5, the use of an outside qualified actuary is required for audits of benefit and claim liabilities of life insurance entities.

## Auditing Statutory Reserve Adequacy

**8.107** As described earlier in this chapter, the NAIC has established minimum levels of reserves for most kinds of insurance contracts. The required actuarial assumptions and calculation methodologies generally vary by line of business and by the issue date of the contract. Statutory regulations also require that the valuation actuary compare future cash flows from designated assets in an amount equal to the benefit reserves to the expected future cash flows of the liabilities, under a variety of interest rate scenarios called cash flow testing. If designated assets based on permitted actuarial assumptions and calculation methodologies are deemed to provide inadequate cash flow, the life insurance entity may be required to establish higher statutory reserves.

**8.108** In performing an audit of statutory financial statements, the auditor should

- a. discuss the cash flow testing with management to obtain an understanding of the entity's cash flow testing procedures and analyses.
- b. based on the auditor's evaluation of risk, review and test the reasonableness of assumptions and calculations where necessary.
- c. determine whether any additional statutory reserves required as a result of the cash flow testing have been recorded by the entity.

## Auditing U.S. GAAP Benefit Liabilities—Reviewing Assumptions Used

**8.109** In reviewing the reasonableness and appropriateness of the assumptions used in the calculations of the U.S. GAAP benefit liabilities, the auditor may find the following guidelines helpful.

**8.110** *Audit guidelines for an established life insurance entity.* Unlike statutory reserves, for which the factors for most contracts are published or regulated, a life insurance entity calculating U.S. GAAP benefit liabilities uses its own actuarial factors based on assumptions developed using the entity's own historical, present, and projected experience.

**8.111 *Mortality and morbidity.*** The auditor should determine whether the entity properly considers its underwriting practices in its selection of assumed mortality and morbidity rates, assumes an appropriate degree of conservatism, and includes provisions for adverse deviation if appropriate.

**8.112** For current issues, the life insurance entity generally uses its own experience, if such experience is credible or, if appropriate, data from recently published tables or industry studies in the case of claims costs. Some entities compare their experience with published tables and express their own experience in terms of a modified table.

**8.113** For contracts issued in previous years, the entity's experience or published experience used in gross premium calculations is used if the subsequent gross premium calculations do not result in benefit liability deficiencies requiring adjustment.

**8.114 *Interest.*** In estimating yields for current contract issues, the entity considers its current and historical portfolio yields, trends in such yields, kinds of contracts, asset-liability relationships of yields and maturities, new money rates and cash flow projections for the particular mix of the investment portfolio, and general investment experience. Some entities may use a level interest assumption, whereas others use scaled down or graded interest assumptions because it is difficult to estimate yields so far into the future. Any anticipated effects of economic conditions on the interest assumption are also similarly applicable to the expense assumptions. Interest assumptions for short or long duration insurance contracts must include a provision for adverse deviation.

**8.115** For contracts issued in previous years, gross premiums or asset-share studies, if available, can be reviewed as a part of the test of reasonableness of interest rates and yields experienced at the time the contracts were issued.

**8.116** In testing interest assumptions, the adequacy of the gross premium should be considered, as discussed in the preceding paragraph. As a test of interest assumptions for the inforce business, the auditor may use the average new money rate or the average portfolio yield rate for a reasonable period. For an entity not having sufficient experience, the average rate on U.S. government bonds or other high quality fixed income investments may be substituted for its new money rate and the industry yield for the portfolio rate for each year that the entity did not have any experience during the period being considered.

**8.117** In testing the accumulation of interest to the account balances of universal life-type contracts, the auditor should consider all provisions of the contracts to determine whether the ultimate interest crediting rates, including amounts such as those credited as persistency bonuses, are accumulated. The auditor should also evaluate the interest spreads (that is, earned interest rate after consideration for investment expenses and credit losses less credited rate) projected for future periods with actual interest spreads in recent periods.

**8.118** Although it is not possible to establish a precise guideline that will apply in all circumstances, the interest rates used should be reasonable and conservative. For example, from time to time, marketplace demands have resulted in some life insurance entities seeking higher investment returns through the use of high yield bonds, real estate related investments, and other investments that generally entail higher risks. Although early yields on such investments are generally greater than rates on more conservative investments,

subsequent credit losses may tend to reduce the ultimate yield. The auditor has an additional burden when the rate used varies significantly from historic rates measured, as described previously.

**8.119 *Withdrawals.*** Withdrawals are affected by factors such as agent quality, underwriting, conservation efforts, marketing methods, premium collection methods, characteristics of the insureds, premium levels, cash value scales, dividend scales (in the case of participating contracts), inflation, interest rates, market competition, contract types, and many other factors. To determine the reasonableness of withdrawal assumptions used, the auditor may review the historical lapse rates and recent data or studies of the entity's termination rate experience and evaluate whether there have been any significant changes in factors that may affect the validity of the historical data.

**8.120** Established entities generally should use accepted withdrawal tables, such as those published by professional or industry organizations, only if the results produced by using such tables are comparable with the entity's actual withdrawal experience. The Linton tables are examples of published tables.

**8.121** Different kinds of contracts have different termination experience. In addition, nonannual mode contracts often experience termination rates that are higher than those of annual mode contracts. Accordingly, withdrawal rates used in calculating U.S. GAAP benefit liabilities may vary by plan, age, mode of premium payment, age, duration, and other appropriate factors. If composite rates are used, they should represent the entity's actual mix of business. A provision for adverse deviation should be included in withdrawal rates for short or long duration insurance contracts. The determination of the provision for adverse deviation rates can be complex.

**8.122** For all contracts, the entity's actual cash value scale should be used in the U.S. GAAP benefit liability calculation.

**8.123 *Expenses.*** For current contract issues the life insurance entity's current and historical maintenance expense levels and ratios as well as estimates of future inflation in such measurements, and the kinds of contracts may be considered in evaluating the reasonableness of expense assumptions. (See chapter 10 for discussions of expenses.)

**8.124 *Audit guidelines for a new life insurance entity.*** Because of the lack of reliable experience for a new life insurance entity, the auditor may have difficulty in forming an opinion as to the reasonableness of the assumptions to be used in calculating the U.S. GAAP contract benefit liabilities and the related recoverability of acquisition expenses. In a number of instances, the auditor may use industry data or data for entities similar to the one being audited as a test of the reasonableness of the assumptions and the recoverability of costs. Such data should be used only as a test and should not be used as a substitute for professional judgment. In exercising judgment about new life insurance entities, the auditor will probably need to be more conservative than if considering an established entity. If the auditor cannot be satisfied as to the adequacy of the benefit liabilities and the recoverability of the acquisition costs, modification of the audit report should be considered.

**8.125** New life insurance entities should use conservative provisions for adverse deviations for short or long duration insurance contracts, principally for interest and mortality, to make the valuation premium approximate the

gross premium until the entity has demonstrated consistent experience over a reasonable period. In such instances, the auditor may review projections and be satisfied that the implicit factors—including interest, expenses, mortality, withdrawals, dividends, and other benefits—resulting from the use of gross premium as the valuation premium can be attained by the entity.

**8.126** For a new entity to depart from regulatory practices, or to use a valuation premium that is less than the gross premium, the auditor may consider each assumption as described in the following paragraphs. In considering these assumptions, the assistance of an outside qualified actuary is required. (See chapter 5 for a discussion of use of specialists.)

**8.127 *Mortality.*** The auditor may be satisfied with the use of an accepted published table if it typifies the entity's experience and underwriting practices. In some cases, the auditor may only be satisfied with the use of commissioners' tables or other more conservative tables.

**8.128 *Interest.*** For entities having little or no investment experience, the auditor may find it helpful to compare the interest rate assumption used by the entity with benchmarks, such as the current average industry yield rate, or other investment measures that are consistent with management's investment philosophy. In some instances, the auditor may be satisfied if the entity uses the maximum rate permitted by the state in which the entity is domiciled.

**8.129 *Withdrawals.*** For an entity with little experience, the auditor may review industry data or data for entities similar to the one being audited. The auditor may be satisfied with the use of published tables if such tables are conservative and produce results that are not more favorable than industry experience or the entity's experience to date.

**8.130 *Expenses.*** For current contract issues, the life insurance entity's current and historical maintenance expense levels and ratios, and estimates of future inflation in such measurements, and the kinds of contracts are considered in estimating expense assumptions. (See chapter 10 for discussions of expenses.)

## Audit Consideration Chart

**8.131** The auditor may consider the following specific audit objectives and examples of selected control and auditing procedures in auditing benefit and claim liability transactions of life insurance entities. The audit consideration chart is intended to present examples only, and is not all-inclusive for any category. Additionally, AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU section 328 applies to liabilities, as well as to assets and components of equity contained in financial statements.

**Audit Consideration Chart—  
Benefit and Other Contract Liabilities**

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Existence or Occurrence and Rights and Obligations</i>		
All benefit and claim liabilities, and other contract liabilities recorded on the balance sheet are actual liabilities of the life insurance entity and relate to obligations incurred under the contracts in force.	Actuarial assumptions are individually documented regardless of aggregate applications in liability calculations.	Review the results of regulatory examinations.
	Procedures exist to ensure that appropriate files (for example, inforce, reserve factors, and mortality tables) are used in calculating the liability amounts.	Reconcile the inforce file to the liability and deferred premium valuation detailed output to ascertain that all contracts in force were properly included in the liability valuation.
	The following reconciliations are performed on a timely basis and reviewed by appropriate personnel:	For participating contracts, perform the following:
	<ol style="list-style-type: none"> <li>1. Benefit liability valuation file and inforce file.</li> <li>2. Unearned premiums (including reinsurance credits), to inforce file, reinsurance records, and general ledger records.</li> <li>3. Prior and current year statutory accounting practices (SAP) and U.S. generally accepted accounting principles (GAAP) liability and in force amounts.</li> <li>4. SAP reserves and U.S. GAAP benefit liabilities.</li> </ol>	<ol style="list-style-type: none"> <li>1. Review contract holder dividend liability calculation to determine that it was calculated in accordance with authorized entity practice, contract terms, and statutory requirements.</li> <li>2. Review the computation of restrictions on earnings from participating business.</li> </ol>

*(continued)*

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Adjustments to valuation records are reviewed and approved by appropriate personnel.	For unearned premium liabilities, perform the following:  1. Review the composition and calculation of the unearned premium liability balance for appropriateness.  2. Reconcile beginning and ending balances, and obtain explanations of any unusual reconciling items.  For accident and health contracts, determine that resisted and litigated claims are reviewed, evaluated, and properly considered in establishing the claims liability.

*Completeness*

All benefit and claim liabilities and other contract liabilities for contracts in force at the valuation date are included in the balance sheet, and the profit and loss statement reflects the changes therein.

Cutoff procedures for the inforce file and the benefit and claim liability system are applied at period end.

The entity maintains records of processing backlogs for reported claims and evaluates the effect on claim liabilities.

Review reserve valuation records for unusual items such as contracts with zero or negative liability amounts, and contracts with liability amounts larger than the amount of insurance. Ascertain the appropriateness of such items.

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	<p>Edit and validation controls, batch balancing, data transmission controls, logging, and cash totals are used to provide assurance that all transactions have been completely and accurately processed and that systems interfaces are operating correctly.</p> <p>Adequate procedures exist for monitoring third parties involved in processing or calculating benefit and claim liability data.</p> <p>Adequate procedures exist with respect to experience rated contracts to ensure the following:</p> <ol style="list-style-type: none"> <li>1. The data used in refund calculations are reconciled to actual premium and claim records.</li> <li>2. The proper cutoff of activity is established.</li> </ol> <p>Adequate procedures exist with respect to investment contracts to ensure that proper cutoff of activity is established.</p>	<p>For inforce models, review client prepared test results and evaluate how adequately the models reproduce the actual inforce and actual results such as gross premium, expenses, and statutory reserves.</p> <p>Review model tests under varying conditions to determine whether they are properly responsive to changes in experience.</p> <p>Review the calculation of liabilities for U.S. GAAP-deferred premium amounts for the propriety of calculation and proper recording (deduction of U.S. GAAP-deferred benefit premiums from U.S. GAAP benefit liabilities).</p> <p>Review SAP reserves to determine that all special reserves, such as deficiency reserves on guaranteed interest products, have been properly recorded.</p>
<b><i>Valuation or Allocation</i></b>		
Benefit and claim liabilities and other contract liabilities recorded on the balance sheet are adequate and reasonable estimates of contract obligations	Qualified actuaries are involved in the calculation and review of the benefit and claim liabilities.	Evaluate the need for utilization of an outside qualified actuary (based on the criteria discussed in chapter 5, "General Auditing Considerations").

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
incurred, and are correctly computed using methodologies and assumptions that are appropriate for the underlying contracts.	<p>Actuarial assumptions and methodologies are formally documented and approved by the appropriate level of management, including any subsequent revisions.</p> <p>Any manual calculations or adjustments, in addition to automated calculations of benefit and claim liabilities, are reviewed by appropriate personnel.</p> <p>Procedures are in place to assure that actuarial assumptions and methodologies are in accordance with regulatory guidelines.</p>	<p>Analyze and obtain explanations for changes between periods for the following:</p> <ol style="list-style-type: none"><li>1. Actuarial assumptions and methodologies</li><li>2. Benefit liabilities by line of business</li><li>3. Mortality, investment, or persistency gains and losses by reserve basis</li><li>4. Claim liabilities by kind of coverage</li><li>5. Ratio of claim liabilities and unearned premium</li><li>6. Loss ratios by line of business for short duration contracts</li></ol> <p>Evaluate the claim methodology, and determine that it is appropriate for the underlying contracts, consistently applied and periodically reviewed by management.</p> <p>For U.S. GAAP liabilities, evaluate whether assumptions and valuation practices are reasonable in relation to the underlying contracts in force and the operating characteristics of the entity, and review to ensure that they are consistently applied.</p>



<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
		For changes in assumptions and valuation practices, evaluate the appropriateness of the changes in light of the entity's experience studies, kind of contracts, and other relevant factors.
	A formal review process exists to assess the following:	Review results of interest, mortality, morbidity, withdrawal, and expense studies relating to liability assumptions, and compare to current assumptions being used for benefit liabilities.
	1. The underlying assumptions utilized in the calculation of the reserve factors, including the provisions for adverse deviation, where applicable, are reasonable and appropriate in relation to the underlying contracts and the entity's actual and projected experience.	Review correlation of investment policy and related interest liability assumptions to the kind of products being sold, the design of the products being sold, and how and to whom the products are being marketed.
	2. The benefit and claim calculation methodologies are appropriate.	For SAP reserves, perform the following.
	3. The factors resulting from the application of the methodology or formulas to the assumptions, and the resulting liability amounts are accurate.	1. Test that the appropriate reserve and premium factors are applied to inforce amounts (for example, test that reserve and premium factors agree with published tables, client developed reserve factors, or, for universal life contracts, amounts of contract funds).
	Studies are conducted of the entity's actual experience for mortality, morbidity, investment yield, persistency and expense, and compared to the benefit liability assumptions. Comparisons are analyzed and documented.	2. Consider whether contract benefit and premium patterns coincide with actual contract specifications.

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
		<div>3. Consider the need to perform tests of the computation of client reserve and premium factors.</div> <div>4. Perform tests to determine whether deferred premiums are properly computed and included in the reserve calculations.</div> <div>5. Perform tests to determine whether the benefit and claim reserve summaries are clerically accurate and complete.</div>
	Detailed records of reinsurance assumed or ceded are compared to the reinsurance liability records, including any adjustments, and are reviewed by appropriate personnel.	<div>Test inforce contracts as follows:</div> <div>1. Determine whether all inforce contracts are included in the proper liability and premium valuation cells (for example, plan, issue date, issue age, interest rate) for the appropriate amount of insurance.</div> <div>2. Ensure that unusual or unexpected additions or deletions are identified, and compare valuation cells at the beginning and end of the reporting period.</div> <div>Test universal life-type contracts, annuity contracts, and investment contracts inforce to determine the following:</div> <div>1. Premium payments, cost of insurance, and other contract charges and interest credits are properly applied to individual account balances or investment contracts.</div>

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
		<ol style="list-style-type: none"> <li>2. The contract account balance summary is clerically accurate and complete.</li> <li>3. The proper cutoff is established to ensure that the liability calculations consider all premium or contract deposit amounts received.</li> </ol>
<i>Presentation and Disclosure</i>		
Benefit and claim liabilities and other contract liabilities are properly classified, described, and disclosed in the financial statements, including notes, in conformity with applicable accounting principles.	<p>Actuarial reviews of reserving assumptions, methodologies, and liability amounts are reviewed for adequacy and monitored by management.</p> <p>Management reports are prepared and reviewed that may include the following:</p> <ol style="list-style-type: none"> <li>1. Benefit and claim liabilities by line of business</li> <li>2. Changes in actuarial assumptions or calculation methodologies</li> <li>3. Analysis of gains and losses by source of earnings such as mortality, investment, expense, and persistency by reserve basis</li> </ol>	<p>Review methodology of premium and liability calculations and summarizations for consistency and reasonableness.</p> <p>Review minutes, agreements, contract forms, and correspondence with state insurance departments to gain an understanding of items such as new contracts being issued and benefits associated with various contracts.</p> <p>Review recent state insurance department examination reports for evidence of compliance with statutory benefit and claim reserve levels.</p>

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	4. Reserve deficiency if any (SAP and U.S. GAAP), if applicable	Review minutes, agreements, contracts, invoices, and other documents for evidence of other liabilities that should be accrued.
	5. Yearly comparative ratios of benefit liabilities to insurance in force, by line of business, type, or grouping of contracts	Test whether disclosures comply with U.S. GAAP or SAP as applicable.
	6. Ratio of deferred premiums to liabilities	
	7. Ratio of claims incurred to claim liabilities by coverage type	

**Exhibit 8-1****Benefit Liabilities—Prospective Reserve Method and Retrospective Reserve Method**

This exhibit demonstrates how contract holder benefit liabilities are determined using both prospective and retrospective methodologies. In addition, an example of the calculation of reserve factors is included.

The following example is based on a five-year endowment policy. Under an endowment policy, if a contract holder survives to the end of the endowment period, he or she will receive the face amount of the contract; if a contract holder dies before the end of the endowment period, the beneficiary will receive the face amount of the contract at the date of the insured's death. For simplicity, it is assumed that all surviving contract holders will persist (continue making annual premium payments) through the end of the endowment period. In practice, a contract such as this one would likely provide nonforfeiture benefits (cash surrender values), and some of the contract holders would lapse before the end of the endowment period.

The example contract has a face value of \$1,000 and an annual gross premium of \$180. All premiums are collected annually at the beginning of the year, and all benefits are paid at the end of the year. The assumed number of contracts issued is 10,000. The assumed mortality rate, persisting contract holders, and investment earnings rate are as follows:

**Assumptions**

<i>Contract Year</i>	<i>Mortality Rate</i>	<i>Persisting Lives End of Year</i>	<i>Investment Earnings Rate</i>
1	.004	9,960	5 percent
2	.005	9,910	5 percent
3	.006	9,851	5 percent
4	.007	9,782	5 percent
5	.008	9,704	5 percent

In addition to contract holder benefits, assumptions as to expenses are required; however, for purposes of these examples, expenses have been ignored. In addition, for FASB ASC 944, *Financial Services—Insurance*, long duration contracts, provisions for adverse deviation are required, but those have also been ignored for purposes of these examples. Note that all of the assumptions have been arbitrarily chosen for the purpose of illustration and do not necessarily represent reasonable assumptions.

**Prospective Reserve Method**

The net level method required by FASB ASC 944 is a prospective reserve method. Contract holder benefit liabilities are established equal to the estimated present value of future benefits to be paid, less the estimated present value of future net premiums that will be collected. Net premiums represent the portion of gross premiums required to provide for all benefits and expenses. Net premiums are a calculated amount.

The present value of future benefits (and expenses) at the contract inception (issue date) are calculated. Then the amount of net premium necessary to provide for those benefits is calculated. If a product is a single premium product, the net premium is simply the present value of future benefits divided by the number of contracts.<sup>1</sup> For products with annual premium payments, such as the example endowment contract, if premiums are collected annually from surviving contract holders, the calculation is more complex. The number of contracts surviving at each contract anniversary is calculated based on the mortality assumptions (and withdrawal assumptions, if applicable) used for estimating benefits. The net premium is then calculated as the level amount<sup>2</sup> needed to be collected from the surviving contract holders such that the present value of the net premiums at the inception of the contracts is equal to the present value of future benefits at the inception of the contract. The net premium ratio may be determined at the issue date as follows:

Present Value of Future Policy Benefits divided by Present Value of Future Gross Premiums

The resulting net premium ratio multiplied by the annual gross premium represents the annual net premium.

The following table shows the calculation of the present value of future benefits at the inception of the contract and at each anniversary of the contract. At contract inception, the benefits of \$40,000 to be paid in year 1 are discounted for 1 year because they are assumed to be paid at the end of the year. Similarly, the benefits to be paid in year 2 are discounted for 2 years, and so on.<sup>3</sup> Note that in year 5, the death benefits are assumed to be incurred prior to payment of the endowment benefit.

Policy Benefits  
Present Value of Contract Benefits at End of Year

Year	Death Benefits	Endowment Benefits	Total Benefits	Issue Date	Year 1	Year 2	Year 3	Year 4	Year 5
1	\$ 40,000		\$ 40,000	\$ 38,095					
2	49,800		49,800	45,170	\$ 47,429				
3	59,461		59,461	51,365	53,933	\$ 56,630			
4	68,955		68,955	56,730	59,566	62,544	\$ 65,672		
5	78,255	\$9,703,529	9,781,784	7,664,283	8,047,498	8,449,872	8,872,366	\$9,315,984	—
Total	\$296,471	\$9,703,529	\$10,000,000	\$7,855,643	\$8,208,426	\$8,569,046	\$8,938,038	\$9,315,984	—

The following table shows the calculation of the present value of future gross premiums at the inception of the contract and at each anniversary of the contract. At contract inception, the gross premiums of \$1,800,000 to be collected in year 1 are not discounted, because they are assumed to be collected at contract inception. The gross premiums of \$1,792,800 for year 2 are discounted for 1 year because they are assumed to be collected on the first anniversary, 1 year after the contract inception. Similar present value calculations are done for gross premiums at each anniversary date, adjusting the data to remove past transactions and applying the then-appropriate present value factors.

**Gross Premiums**  
**Present Value of Gross Premiums at End of Year**

<i>Year</i>	<i>Total</i>	<i>Issue Date</i>	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>	<i>Year 5</i>
1	\$1,800,000	\$1,800,000					
2	1,792,800	1,707,429	1,792,800				
3	1,783,836	1,617,992	1,698,891	1,783,836			
4	1,773,133	1,531,699	1,608,284	1,688,698	1,773,133		
5	1,760,721	\$1,448,550	1,520,977	1,597,026	1,676,877	1,760,721	—
Total	\$8,910,490	\$8,105,670	\$6,620,952	\$5,069,560	\$3,450,010	\$1,760,721	—

From the preceding calculations, it has been determined that the present value at issue of future contract benefits is \$7,855,643, and the present value at issue of future gross premiums is \$8,105,670. The net premium ratio is thus .96915 (present value of future benefits divided by present value of future gross premiums). Thus, the net premium is 96.915 percent of the gross premium or \$174.45 (annual gross premium of \$180 multiplied by net premium ratio).

The present value of the net premiums at issue date and at each anniversary of the contract is as shown in the following table:

<b>Present Value of Net Premiums at End of Year</b>						
<i>Year</i>	<i>Issue Date</i>	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>	<i>Year 5</i>
1	\$1,744,478					
2	1,654,762	1,737,500				
3	1,568,084	1,646,488	1,728,812			
4	1,484,452	1,558,675	1,636,609	1,718,439		
5	\$1,403,868	1,474,061	1,547,764	1,625,153	1,706,410	—
Total	\$7,855,644	\$6,416,724	\$4,913,185	\$3,343,592	\$1,706,410	—

Using the prospective method the benefit reserve at each valuation date is equal to the excess of the present value of future benefits over the present value of future net premiums. The benefit reserve at each valuation date is as follows:

**Prospective Reserve**

	<i>Issue Date</i>	<i>Year 1</i>	<i>Year 2</i>	<i>End of Year Year 3</i>	<i>Year 4</i>	<i>Year 5</i>
Present Value of Future:						
Benefits	\$7,855,643	\$8,208,425	\$8,569,046	\$8,938,038	\$9,315,984	
Net Premiums	7,855,643	6,416,724	4,913,185	3,343,592	1,706,410	—
Contract holders' benefit reserve	\$ —	\$1,791,701	\$3,655,861	5,594,446	\$7,609,574	—

The liabilities increase over time as the large future benefits (in this case, predominately the endowment benefit in year 5) come closer to maturity while fewer net premiums are left to be collected. After increasing for a period of time, the liabilities decrease as benefits are paid and fewer future benefits are left. In this example, the decline is abrupt and dramatic when the endowment benefits

are paid in year 5. For a block of ordinary whole life insurance contracts, the decline would be somewhat more gradual and would start before the last year.

**Retrospective Reserve Method**

Although contract holder benefit liabilities under FASB ASC 944 and for statutory accounting purposes are usually defined and described in prospective terms (present value of future benefits less present value of future net premiums) as discussed in paragraph 8.14, the following demonstrates that liabilities calculated retrospectively by accumulating past transactions will yield identical results. Thus, the reserve at the end of a year is the sum of the beginning-of-year reserve, the net premiums collected, and interest accrued on the opening balance plus net premium collected (assumed to be collected at the beginning of the year), less the gross amount of benefits paid (assumed to be paid at the end of the year).

**Retrospective Reserve**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Beginning of year reserve	\$ —	\$1,791,701	\$3,655,862	\$5,594,446	\$7,609,574
Net premiums collected	1,744,478	1,737,500	1,728,812	1,718,439	1,706,410
Interest accrued (5 percent)	87,223	176,461	269,233	365,644	465,800
Benefits paid	(40,000)	(49,800)	(59,461)	(68,955)	(9,781,784)
End of year reserve	<u>\$1,791,701</u>	<u>\$3,655,862</u>	<u>\$5,594,446</u>	<u>\$7,609,574</u>	<u>\$ —</u>

**Reserve Factors**

The following table shows the calculation of the end of year reserve factors. The reserve factors are found by dividing the reserve balance by the number of contracts remaining in force, and represent the reserve required for each contract at the applicable date.<sup>4</sup>

**Reserve Factors**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Reserve at end of year	\$1,791,701	\$3,655,862	\$5,594,446	\$7,609,574	—
Number of contracts in force	9,960	9,910	9,851	9,782	—
Reserve factor per contract	\$ 179.89	\$ 368.91	\$ 567.91	\$ 777.92	—

In practice the actual number of contracts at the end of the year is multiplied by the reserve factor per contract to calculate the reserve amount. When actual contract persistency is significantly different than assumed, the reader may refer to chapter 10 for guidance.

<sup>1</sup> The product used in this example has a single face amount for all contracts, \$1,000. In practice, products are sold with varying face amounts chosen by the contract holder from those made available by the life insurance entity. Accordingly, benefit reserve calculations are not performed by contract, but by a uniform unit of measurement that can be applied to all contracts, usually \$1,000 of face amount purchased, in force, or both.

<sup>2</sup> A level amount is used in the *net level premium method* of determining benefit reserves. Nonlevel net premiums are used in other methods, such as the commissioners' reserve valuation method (CRVM). With CRVM, the net premium in the first year is lower than the net premium in subsequent



years; subsequent years' net premiums are level and are higher than the net level premium determined using the net level premium method.

- <sup>3</sup> Discount factors are calculated as: 1.05 for year 1; 1 1.052 for year 2; 1 1.053 for year 3; and so on.
- <sup>4</sup> The product used in this example has a single face amount for all contracts, \$1,000. In practice, products are sold with varying face amounts chosen by the contract holder from those made available by the life insurance entity. Accordingly, benefit reserve calculations are not performed by contract, but by a uniform unit of measurement that can be applied to all contracts, usually \$1,000 of face amount purchased, in force, or both. Reserve factors usually represent, at a given point in time, the amount of reserve required for each \$1,000 of insurance in force.
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## Chapter 9

# Benefit and Claim Payments

**Note:** This chapter contains references to both financial and nonfinancial assets and liabilities that are subject to fair value measurement. As noted in chapter 3, "Sources of Accounting Principles and Reporting Requirements," Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, have significant implications for the concept of fair value. Please refer to chapter 3, beginning at paragraph 3.31, for further information.

### Introduction

**9.01** Life and health insurance and annuity contracts provide benefits promised under the contract terms in return for premiums or other consideration received from the contract holders.

### Kinds of Benefit and Claim Payments

**9.02** Contract benefit and claim payments generally can be categorized as follows:

- a. Death benefits (including benefits paid under living benefit provisions)
- b. Matured endowments
- c. Annuity benefits
- d. Surrender benefits
- e. Accident and health benefits
- f. Disability benefits (including waivers of premium)
- g. Participating dividends
- h. Experience rated refunds

**9.03** *Death benefits.* Death benefits are normally the face amount of the contract, or for certain contract types—such as variable life contracts—an amount determined based on the performance of related assets or guaranteed return. A common feature in variable annuities is a minimum guaranteed death benefit (MGDB), such as a death benefit equal to the total deposits made by the contract holder less any withdrawals, referred to as "return of premium" or "basic" MGDB. Although the return of premium MGDB has become increasingly common in variable annuities, the trend has been for insurers to offer MGDBs with more extensive benefit guarantees, such as the following:

- a. A death benefit equal to the total of deposits made to the contract less an adjustment for partial withdrawals, accumulated at a specified interest rate, often referred to as *roll-up*
- b. A death benefit equal to the account balance on a specified anniversary date adjusted for deposits less partial withdrawals since the specified anniversary date, often referred to as *reset*

- c. A death benefit equal to the highest account balance among prior specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date, often referred to as *ratchet*

This amount may be reduced by outstanding policy loans and accrued interest or any partial withdrawals and increased by any advanced premiums, unpaid participating dividends, and interest from the date of death to the date the benefit payment is made.

**9.04** Death benefits are paid to designated beneficiaries. Benefit payments may be made in a lump sum or under another arrangement as elected by the beneficiary or contract holder. When death benefits are payable, the original contract is complete; if the proceeds are to be paid under arrangements other than a lump sum or returned to the life insurance entity for investment, a new contract—called a *supplementary contract*—is entered into with the beneficiary. (See chapter 2, "Characteristics of Life and Health Insurance Products," for further discussion.)

**9.05** It is necessary to determine the significance of mortality and morbidity risk as well as to classify contracts that contain death or other insurance benefit features. FASB ASC 944, *Financial Services—Insurance*, provides guidance on accounting for contracts with death or other insurance benefit features. As discussed in paragraphs 20–23 of FASB ASC 944-20-15, to determine the accounting for a contract that contains death or other insurance benefit features, the insurance enterprise should first determine whether the contract is an investment or insurance contract. Classification of a contract as an investment contract or as an insurance contract should be made at contract inception, and the classification should not be reassessed during the accumulation phase of the contract. If the mortality and morbidity risk associated with insurance benefit features offered in a contract is deemed to be nominal, that is, a risk of insignificant<sup>1</sup> amount or remote<sup>2</sup> probability, the contract should be classified as an investment contract; otherwise, it should be considered an insurance contract. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility. If the mortality or morbidity risk is other than nominal and the fees assessed or insurance benefits are not fixed and guaranteed, the contract should be classified as a universal life-type contract by the insurance enterprise. If the fees assessed on a contract and insurance benefits provided by the contract are fixed and guaranteed or if the contract is short duration, the contract should be classified as a traditional long duration or short duration contract, respectively.

**9.06** As discussed in paragraphs 24–25 of FASB ASC 944-20-15, the determination of significance of mortality or morbidity risk should be based on a comparison of the present value of expected excess payments to be made under insurance benefit features (that is, insurance benefit amounts and related incremental claim adjustment expenses in excess of the account balance, herein referred to as the *excess payments*) with the present value of all amounts expected to be assessed against the contract holder (revenue). For contracts that

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<sup>1</sup> The terms *nominal* and *insignificant* are as used in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-20-55-9.

<sup>2</sup> The term *remote* is as defined in the FASB ASC glossary.

include investment margin<sup>3</sup> in their estimated gross profits,<sup>4</sup> the investment margin should be included with any other assessments for purposes of determining significance. In performing the analysis, an insurance enterprise should consider both frequency and severity under a full range of scenarios that considers the volatility inherent in the assumptions, rather than making a best estimate using one set of assumptions. For example, if the annuity contract is a variable annuity contract, the insurance enterprise should consider a range of fund return scenarios. When considering a range of scenarios, the insurance enterprise should consider historical investment returns, the volatility of those returns, and expected future returns, as applicable.

**9.07** As discussed in paragraphs 8–9 of FASB ASC 944-605-25, for a contract determined to meet the definition of an *insurance contract* as described in paragraphs 9.05–.06 (universal life contracts with death or other insurance benefit features),<sup>5</sup> if the amounts assessed against the contract holder each period for the insurance benefit feature are assessed in a manner that is expected to result in profits in earlier years and losses in subsequent years from the insurance benefit function, a liability for unearned revenue should be established in addition to the account balance (to recognize the portion of such assessments that compensates the insurance enterprise for benefits to be provided in future periods). An insurance entity should not record a liability for unearned revenue if the purpose is an attempt to inappropriately level the contract's gross profit over the life of the contract or if the accrual would serve to produce a level gross profit from the mortality benefit over the life of the contract. As discussed in paragraphs 20–25 of FASB ASC 944-40-30, the amount of the additional liability should be determined based on the ratio (benefit ratio) of (a) the present value of total expected excess payments over the life of the contract, divided by (b) the present value of total expected assessments over the life of the contract. The benefit ratio may exceed 100 percent, resulting in a liability that exceeds cumulative assessments. Total expected assessments are the aggregate of all charges, including those for administration, mortality, expense, and surrender, regardless of how characterized. For contracts in which the assets are reported in the general account and that include investment margin in their estimated gross profits, the investment margin should be included with any other assessments for purposes of determining total expected assessments. The insurance enterprise should calculate the present value of total expected excess payments and total assessments and investment margins, as applicable, based on expected experience. Expected experience should be based on a range of scenarios rather than a single set of best estimate assumptions. In calculating the additional liability for the insurance benefit feature, assumptions used, such as the interest rate, discount rate, lapse rate, and mortality, should be consistent with assumptions used in estimating gross profits for purposes of

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<sup>3</sup> The term *investment margin* is as defined in FASB ASC 944-30-35-5(c).

<sup>4</sup> The term *estimated gross profit* is as defined in FASB ASC 944-30-35-5.

<sup>5</sup> FASB ASC 944-605-25-9 clarifies practice for recording unearned revenue accruals. Moreover, practitioners can refer to the following Technical Questions and Answers (TIS) (AICPA, *Technical Practice Aids*) for additional information:

- TIS section 6300.08, "Definition of an Insurance Benefit Feature"
- TIS section 6300.09, "Definition of an Assessment"
- TIS section 6300.10, "Level of Aggregation of Additional Liabilities Determined Under FASB ASC 944"
- TIS section 6300.11, "Losses Followed by Losses"
- TIS section 6300.12, "Reinsurance"

amortizing capitalized acquisition costs. For contracts in which assessments are collected over a period significantly shorter than the period for which the contract is subject to mortality and morbidity risks, the assessment would be considered a front-end fee as defined in the FASB ASC glossary and accounted for under FASB ASC 944-605-25-6 and 944-605-35-2. The amounts recognized in income should be considered assessments for purposes of these paragraphs.

**9.08** As discussed in paragraph 9 of FASB ASC 944-40-35, the insurance enterprise should regularly evaluate estimates used and adjust the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. In making such revised estimates, both the present value of total excess payments and the present value of total expected assessments and investment margins, should be calculated as of the balance sheet date using historical experience from the issue date to the balance sheet date and estimated experience thereafter.

**9.09** As described in paragraphs 10–11 of FASB ASC 944-40-35, the additional liability for death or other insurance benefit features at the balance sheet date should be equal to

- a. the current benefit ratio multiplied by the cumulative assessments.<sup>6</sup>
- b. less the cumulative excess payments (including amounts reflected in claims payable liabilities).
- c. plus accreted interest.

However, in no event should the additional liability balance be less than zero. The change in the additional liability should be recognized as a component of benefit expense in the statement of operations.

**9.10** The estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect the recognition of the liability in accordance with paragraph 9.09.

**9.11** As discussed in paragraphs 35–41 of FASB ASC 944-40-25, if a reinsurer assumes the insurance benefit feature, the reinsurer should assess the significance of mortality and morbidity risk within the reinsurance contract according to the guidance in paragraphs 20–25 of FASB ASC 944-20-15 (paragraphs 9.05–.06 of the guide), regardless of whether there is an account balance. The reinsurer should determine the classification of the reinsurance contract as an investment contract or as an insurance contract at the inception of the reinsurance contract. For reinsurance contracts, the mortality or morbidity risk could be deemed other than nominal even if the original issuer did not determine mortality or morbidity to be other than nominal. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility. Similarly, the issuer of a contract that provides only an insurance benefit feature that wraps<sup>7</sup> a noninsurance contract, for example, a guaranteed minimum death benefit related to a mutual fund balance, should

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<sup>6</sup> The term *cumulative assessments* refers to actual cumulative assessments, including investment margins, if applicable, recorded from contract inception through the balance sheet date.

<sup>7</sup> The term *wrap* refers to the practice of adding an insurance benefit feature to a separate noninsurance contract generally from a different issuer.

evaluate its contract in the same manner. A reinsurer or issuer of the insurance benefit features of a contract should calculate a liability for the portion of premiums collected each period that represents compensation to the insurance enterprise for benefits that are assessed in a manner that is expected to result in current profits and future losses from the insurance benefit function. That liability should be calculated using the methodology described in FASB ASC 944-605 and 944-40 (paragraphs 9.07–.09 of the guide). For example, a reinsurance contract that assumes only the risk related to the MGDB feature for a fee that varies with the account balance rather than with the insurance coverage provided would be a universal life-type contract and the contract should be accounted for in accordance with FASB ASC 944-605 and 944-40 (paragraphs 9.07–.09 of the guide).

**9.12 *Matured endowments.*** Matured endowments are amounts payable to the contract holder at the conclusion of the endowment period. If the insured dies before the endowment period expires, a death claim is paid to the designated beneficiary. The amount payable is generally the face amount of the contract, plus unpaid participating dividends that have accrued; or, depending on the contract terms, the amount payable may be determined based on the performance of the related assets.

**9.13 *Annuity benefits.*** Annuity benefits include payments on either immediate or deferred annuities, and usually include any death benefits paid under the terms of annuity contracts. The main kinds of immediate annuities are the following:

- a. *Straight life annuities* provide for periodic payments to the annuitant as long as he or she lives. Death of the annuitant completes the contract, and no further payments are made by the life insurance entity.
- b. *Life annuities with period certain (annuities certain)* work essentially the same way as straight life annuities except that if the annuitant dies before the end of a specified period, payments continue to a designated beneficiary until the specified number of payments is completed.
- c. *Refund annuities* are similar to annuities certain. There are two common kinds of refund annuities. Under *cash refund annuities*, a lump sum payment is made at the death of the annuitant equal to the excess, if any, of the purchase price of the annuity over the sum of the annuity payments made to date of death. Under *installment refund annuities*, payments continue to be made to a designated beneficiary after the death of the annuitant until the sum of all payments equals the purchase price.
- d. *Joint and survivorship annuities* provide for the continuation of payments after the death of one of the annuitants during the lifetime of the surviving annuitant.
- e. *Variable annuities* provide for benefit payments in amounts that vary in accordance with investment experience. The consideration for a variable annuity is usually invested in a separate account in which the value of the contract share varies according to the performance of the separate account or guaranteed minimum return. (See chapter 14, "Other Assets and Liabilities, Surplus Notes, Separate Accounts, Insurance Related Assessments, and Equity—Contract Holders' Surplus," for a discussion of separate accounts.)

**9.14** Contracts may also provide for potential benefits in addition to the account balance that are payable only upon annuitization, such as annuity purchase guarantees, guaranteed minimum income benefits (GMIBs) and two tier annuities.<sup>8</sup> Under the guidance of FASB ASC 944, insurance enterprises should determine whether such contract features should be accounted for under the provisions of FASB ASC 815, *Derivatives and Hedging*.<sup>9</sup> As discussed in paragraph 27 of FASB ASC 944-40-25, if the contract feature is not accounted for under the provisions of FASB ASC 815, an additional liability for the contract feature should be established if the present value of expected annuitization payments at the expected annuitization date exceeds the expected account balance at the expected annuitization date. As discussed in paragraphs 26–29 of FASB ASC 944-40-30, the amount of the additional liability should be determined based on the ratio (benefit ratio) of (a) the present value of expected annuitization payments to be made and related incremental claim adjustment expenses, discounted at estimated investment yields expected to be earned during the annuitization phase of the contract, minus the expected accrued account balance at the expected annuitization date (the *excess payments*), divided by (b) the present value of total expected assessments during the accumulation phase of the contract. Total expected assessments are the aggregate of all charges, including those for administration, mortality, expense, and surrender, regardless of how characterized. For contracts whose assets are reported in the general account and that include investment margin in their estimated gross profits, the investment margin should be included with any other assessments for purposes of determining total expected assessments. The insurance enterprise should calculate the present value of total expected excess payments and total assessments and investment margins, as applicable, based on expected experience. Expected experience should be based on a range of scenarios that considers the volatility inherent in the assumptions rather than a single set of best estimate assumptions. In calculating the additional liability for the additional benefit feature, assumptions used, such as the interest rate, discount rate, lapse rate, and mortality, should be consistent with assumptions used in estimating gross profits for purposes of amortizing capitalized acquisition costs. When determining expected excess payments, the expected annuitization rate is one of the assumptions that needs to be estimated. In calculating the additional liability for the additional benefit feature, assumptions used, such as the interest rate, discount rate, lapse rate, and mortality, should be consistent with assumptions used in estimating gross profits for purposes of amortizing capitalized acquisition costs under the "Long-Duration Contracts" subsection of Section 944-30-35.

**9.15** As discussed in paragraphs 12–13 of FASB ASC 944-40-35, the insurance enterprise should regularly evaluate estimates used and adjust the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. In making such revised estimates, both the present value of total excess payments and the present value of total expected assessments or investment margins should be calculated as of the balance sheet date using historical

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<sup>8</sup> AICPA TIS section 6300.13, "Accounting for Contracts That Provide Annuitization Benefits" (AICPA, *Technical Practice Aids*), clarifies the scope for contracts under the provisions of FASB ASC 944-40 (paragraphs 9.14–.18) of this guide.

<sup>9</sup> Refer to FASB ASC 815-15-55 paragraphs 57–61 for discussion of deferred variable annuity contracts.



experience from the issue date to the balance sheet date and estimated experience thereafter.

**9.16** As discussed in paragraphs 14–16 of FASB ASC 944-40-35, the additional liability for annuitization benefits at the balance sheet date should be equal to

- a. the current benefit ratio multiplied by the cumulative assessments.
- b. plus accreted interest.
- c. less, at time of annuitization, the cumulative excess payments determined at annuitization.

However, in no event should the additional liability balance be less than zero. The change in the additional liability should be recognized as a component of benefit expense in the statement of operations. "Cumulative excess payments determined at annuitization" represent the amount that should be deducted at the actual date of annuitization. That amount should be calculated as the present value of expected annuity payments and related claim adjustment expenses discounted at expected investment yields minus the accrued account balance at the actual annuitization date. On the date of annuitization, the additional liability related to the cumulative excess benefits will be zero and the amount deducted will be used in the calculation of the liability for the payout annuity.

**9.17** As discussed in FASB ASC 944-30-35-10, the estimated gross profits used for the amortization of deferred acquisition costs should be adjusted to reflect the recognition of the liability determined in accordance with paragraph 9.15. Capitalized acquisition costs should continue to be amortized over the present value of estimated gross profits (as adjusted in paragraph 9.16) over the expected life of the book of contracts. For purposes of amortization of deferred acquisition costs, the life of the book of contracts excludes the annuitization phase.

**9.18** As discussed in FASB ASC 944-40-25-40, a reinsurer may agree to reinsure all or a portion of the additional annuitization benefits described in paragraph 9.14. Both the ceding entity and the reinsurer should determine whether such a reinsurance contract should be accounted for under the provisions of FASB ASC 815. For example, unlike many of the direct contracts that contain GMIB benefits, contracts to reinsure GMIB benefits often meet the definition of a derivative under FASB ASC 815. If the reinsurance contract should not be accounted for under the provisions of FASB ASC 815, the guidance in FASB ASC 944 should be followed (paragraphs 9.14–.17 of the guide.)

**9.19** *Surrender benefits.* Surrenders occur when the contract holder terminates the contract and requests payment of any cash surrender value that has accumulated. Surrender benefits are paid net of any outstanding policy loans and related accrued interest as well as any surrender charges, plus any unpaid participating dividends. Surrender benefits are applicable to any contract that has a guaranteed cash value or nonforfeiture benefit.

**9.20** *Accident and health benefits.* Accident and health contracts generally provide benefits such as reimbursement for hospital and medical costs, disability payments (see paragraph 9.21), and payments under accidental death and dismemberment contracts. Claims on accident and health contracts for medical costs are usually paid in a lump sum after the loss is incurred either to the insured or directly to the provider to whom the insured may have assigned

the benefit payments. Such benefits are commonly subject to limitations such as deductibles, copayments, contract maximum limits, and the coordination of benefits with other insurers. If an annuity contract provided that if during the accumulation phase, the contract holder has an insurable event (for example, disability, loss of "activities of daily living") that meets the criteria specified in the contract, additional benefits in excess of the account balance will be available, the feature should be evaluated and accounted for in accordance with FASB ASC 944 (paragraphs 9.05–.11 of the guide).

**9.21 *Disability benefits.*** Disability contracts, or riders, generally provide specified benefits, for a stated period or for life, in the event the insured is unable to work as a result of total or partial disability caused by illness or injury. Most disability contracts specify a waiting or elimination period beginning at the time the disability occurs. Benefit payments commence on the expiration of the elimination period. Disability benefits also include waiver of premium during the disability period.

**9.22 *Participating dividends.*** Both mutual and stock life insurance entities may write contracts that have participating dividend features. If a contract is sold with a participating feature, the amount of the participating dividend generally is not stated in the contract. Generally, there is no legal or contractual obligation to declare contract holder dividends; however, once a dividend is declared, it is a legal obligation of the life insurance entity. Participating dividends are typically declared and approved each year by those charged with governance of the life insurance entity and paid or credited according to the payment option selected by the contract holder. Some contracts also provide for the payment of a *terminal dividend* if a contract terminates as a result of death, maturity, or surrender. Terminal dividends are usually paid when the contract terminates after some minimum period in force, usually between ten and twenty years. The terminal dividend generally represents a return to the contract holder of an estimated equitable portion of the increase in surplus over the period that the contract was in force. Terminal dividends may be paid on all terminating contracts or only if certain conditions are met.

**9.23 *Experience refunds.*** Nonparticipating group life, health, and annuity contracts are sometimes sold with features that provide for premium adjustments or refunds through certain experience rating arrangements. The group contract generally states the experience rating formula used to determine the refund or premium adjustments. The experience refund is generally calculated at specified dates, such as the contract anniversary date or at the end of the calendar year. If the balance sheet date is different from the experience refund formula date, the experience is calculated to the valuation date and an appropriate liability is recorded.

## Regulation

**9.24** Most states have provisions to regulate the payment of benefits. These regulations are generally designed to protect contract holders, and usually apply to requirements for notice of claims, proof of loss, and payment of claims.

**9.25** Payment of contract holder dividends on participating contracts may be subject to limitations imposed by state regulatory authorities. Some states regulate the amount of surplus attributable to participating contracts that may be transferred to the stockholders. For example, in Illinois, no more than

10 percent of the profit on participating business issued by a stock life entity can inure to the stockholders, and New York has maximum and minimum surplus requirements, depending on when the entity was organized. (See chapter 8, "Liabilities for Future Policy Benefits (Statutory Benefit Reserves) and Other Contract Liabilities," for further discussion of participating dividends.)

## Accounting Practices \*

**9.26** As discussed in chapter 3, life insurance entities are subject to the filing requirements of statutory accounting practices (SAP) and may also prepare financial statements in accordance with U.S. generally accepted accounting principles (GAAP). The following discussion of SAP and U.S. GAAP accounting for benefit and claim payments is not a comprehensive source of authoritative accounting literature, but is intended to assist the preparers and auditors of financial statements in obtaining a general understanding of basic accounting practices for the most common kinds of benefit and claim payments within the life insurance industry. The authoritative sources cited in chapter 3 may be referred to in determining appropriate accounting and reporting treatment in all cases.

### Statutory Accounting Practices—Benefit and Claim Payments

**9.27** Contract benefits and claims are reported on an incurred basis in the National Association of Insurance Commissioners Annual Statement. They include benefits and claims paid, adjusted for the following:

- a. Benefit and claim payments due but unpaid
- b. Reported claims in the course of settlement
- c. Claims contested
- d. An estimate of claims incurred but not reported as of the valuation date

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\* The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, FASB issued the invitation to comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project.

In July 2010, the IASB issued the exposure draft *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. Although the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement model; however, the majority prefer an alternative model. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. generally accepted accounting principles to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.

In addition, benefits paid consist of amounts left with the life insurance entity to purchase supplementary contracts, and surrender benefits including withdrawals of the accumulated account balance on universal life-type contracts, annuity contracts, and investment contracts.

**9.28** Benefits reported in the summary of operations are those related to direct business, plus reinsurance assumed, reduced by reinsurance ceded.

**9.29** *Participating policies.* As noted in paragraphs 26–29 of Statement on Statutory Accounting Principles No. 51, *Life Contracts*, an entity shall accrue the following items related to participating policies: dividends due and unpaid, dividends apportioned (or not yet apportioned) for payment in the following twelve months, and dividends left on deposit to accumulate interest.

Dividends due and unpaid represent dividends payable to the policyholder in the current year but which have not been disbursed or otherwise applied at the reporting date. Dividends payable in the following calendar year represent the estimated amount of all dividends declared by a reporting entity's board of directors (for example, those charged with governance) prior to the end of the statement year which are not yet paid or due at the end of the year (dividends apportioned for payment) as well as all dividends payable in the following calendar year that have not been declared (dividends not yet apportioned for payment). Dividends left on deposit with the reporting entity shall be recorded in the amount of the deposit and accrued interest thereon.

Annual dividends are generally payable on contract anniversary dates. The dividend formula, commonly referred to as dividend scales, must be approved by those charged with governance, and the dividend must be formally declared before any legal obligation exists. The resolution of those charged with governance authorizing the payment of dividends is usually made annually for contracts reaching anniversaries within the following calendar year.

## Generally Accepted Accounting Principles—Benefit and Claim Payments

**9.30** In general, the principal differences between U.S. GAAP and SAP accounting for benefit payments and related liabilities are attributable to the following:

- a. *Return of accumulated values for universal life-type contracts and investment contracts.* Paragraphs 1–2 of FASB ASC 944-20-45 state the following: "Payments to policyholders that represent a return of policyholder balances are not expenses of the insurance enterprise and shall not be reported as such in the statement of earnings. Amounts reported as expenses shall include all of the following:
  - i. Benefit claims in excess of the related policyholder balances
  - ii. Expenses of contract administration
  - iii. Interest accrued to policyholders
  - iv. Amortization of capitalized acquisition costs (see subtopic 944-30)."
- b. *Participating dividends.* The accounting for participating dividends is described in chapter 8.

See chapters 8 and 10, "Commissions, General Expenses, and Deferred Acquisition Costs," of this guide for a discussion of the FASB ASC 944 guidance relative to sales inducements.

## Auditing

### Inherent Risk Factors

**9.31** As part of the auditor's assessment of inherent risks, the auditor may consider those factors related to benefit and claim payments, including factors relating to management, product characteristics, underwriting approach, marketing strategies, and the economic and regulatory environment. Such factors might encompass the following:

- a. Economic or environmental factors exist such as change in credit rating or changes in interest rates, which are likely to increase the incidence of claims or surrenders.
- b. Unforeseen risks or events require benefit payments if the risk was not considered covered or if the risk significantly affects mortality or morbidity assumptions.
- c. The life insurance entity's claims adjudication process is relatively unsophisticated.
- d. The life insurance entity has international operations and benefit payments for those operations that need to conform to local accounting principles or whose payments are made in foreign currencies.
- e. The life insurance entity employs aggressive claims settlement practices with respect to denying or contesting benefits due under related contracts.
- f. Changes in tax regulations affect the volume of claims or surrenders for certain kinds of contracts.

### Obtaining an Understanding of Internal Control for Contract Benefit and Claim Transactions

**9.32** As part of obtaining an understanding of internal control related to contract benefit and claim transactions, the auditor might consider the following factors. An entity's internal control consists of five elements: the control environment, risk assessment, control activities, information and communication, and monitoring systems as stated in paragraph .41 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). As discussed in chapter 5, "General Auditing Considerations," the auditor should obtain a sufficient understanding of each of the five elements of the entity's internal control to assess the risks of material misstatement of the entity's financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

### Control Environment

**9.33** The control environment as related to benefit and claim payment transactions of a life insurance entity represents the collective effect of various factors on establishing, enhancing, or maintaining the effectiveness of specific

control policies or procedures of the entity. Such factors that relate to benefit and claim transactions include the following:

- a. Benefit operations are highly decentralized or there is significant reliance on third parties to provide necessary data to process benefit amounts due.
- b. New products have been introduced that require changes to the benefit processing systems, or the degree of complexity of benefits in the product design is increasing.
- c. Existing systems are inadequate to cope with changes in benefit processing or increases in business volume. There are inadequate interfaces with other key processing systems.
- d. There is heavy reliance on manual processes for benefit processing.
- e. Staff is inexperienced or insufficient in relation to the complexity and volume of transactions involved in the benefit processing area.

## Control Activities

**9.34** Control activities are those policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor should obtain an understanding of those control activities relevant to the audit.

**9.35** The following are examples of typical internal control procedures and policies relating to benefit and claim payments and other related contract liability transactions.

- a. *Proper authorization of transactions and activities.* Written guidelines for claim processing are in place, assigning appropriate individuals the responsibility for approval of benefit payments and determinations of amounts.
- b. *Segregation of duties.* Claims processing, benefit payments, premium billing and collection, key information systems functions, master file maintenance, and general accounting activities are appropriately segregated, and independent reviews are conducted of the work performed.
- c. *Design of adequate controls over documents and records.* There are procedures to prevent or detect the omission of valid transactions and the inclusion of fictitious or duplicate claims or benefit payments in the records.
- d. *Adequate safeguards of access to and use of assets and accounting records.* Data files and production programs have adequate safeguards against unauthorized access.
- e. *Independent checks on performance and proper valuation of recorded amounts.* Recorded benefit payments are subject to independent testing or other quality control checks; benefit payments are periodically confirmed directly with contract holders; and reviews are performed to determine that continuous benefit payments, such as annuity or disability payments, are valid and supported by the appropriate documentation.

Note that for an integrated audit performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (see paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, PCAOB Standards and Related Rules, Interim Standards]). Also refer to paragraph 54 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, PCAOB Standards and Related Rules, Auditing Standards), for a discussion on the extent of tests of controls (see paragraph .97 of AU section 319).

## Information and Communication

**9.36** Paragraph .81 of AU section 314 states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report an entity's transactions (as well as events and conditions) and to maintain accountability for related assets, liabilities, and equity.

**9.37** The flow of accounting records for benefit and claim payment transactions encompasses all functions relating to claims processing, inforce master file updating, dividend processing, and benefit payments.

**9.38** The processing procedures for benefit payments generally begin with the receipt of a notification of intent to file a claim. A claim file is then established, assigned a sequential number, and recorded in the claim register. Claims processing personnel then determine whether the contract is in force and whether the claim is covered under the contract. The inforce master file is then updated to show that a claim has been filed. Once the claim is validated, the amount of the benefit is calculated. Such calculations can be complex and are often automated. The use of actuaries and other specialists, such as medical doctors, is often necessary. All relevant contract data are considered in calculating the benefit amount, including surrender charges, deductibles and copayments for accident and health contracts, policy loans, advance premiums, dividends on participating contracts, and any contract riders. Contracts involving reinsurance require submission of information regarding the contract to the reinsurer to obtain proper recoveries. (See chapter 12, "Reinsurance," for a discussion.)

**9.39** Once the benefit amount has been determined, the appropriate benefit recipient is identified. The recipient could be the contract holder in the case of investment contracts, surrenders, or annuities; or the recipient could be a designated beneficiary, estate, or trustee in the case of life insurance contracts.

**9.40** When the benefit claim is either paid or denied, the claim file is canceled or otherwise annotated to indicate that payment was made. The claim register is updated to show that the claim has been closed, and other applicable systems, such as statistical data relating to claims data bases, inforce master files, benefit liabilities and related systems files, are updated.

**9.41** *Life insurance contracts.* If a death claim is presented, a determination is made as to whether the contract was in force at the time of death. If so, the life insurance entity obtains proof of death, usually in the form of a death

certificate and a statement from a physician or medical examiner. The physician's statement as to the cause of death may be significant if the contract is in the *contestable period*, usually within two years of its issuance. If death occurs during this period and death is by suicide, or there is a material misstatement in the contract application by the insured (for example, past illnesses, occupation, or current health status), the life insurance entity is usually not required to pay the face amount of the contract; however, in such cases, premiums paid are usually returned.

**9.42** Cause of death may be an important consideration in determining the amount of the death benefit in contracts with *double indemnity* clauses. In addition, the provisions of the contract may exclude the risk that caused the death. For example, the contract may stipulate that coverage is not provided in the event the insured dies while piloting a private plane.

**9.43** Once it is determined that a death claim is payable, the entity determines the amount to be paid to the appropriate beneficiary, payment is made, and the contract is complete. However, if the proceeds are to be paid under arrangements other than a lump sum or returned to the life insurance entity for investment, a new contract called a *supplementary contract* is entered into with the beneficiary. (See chapter 2 for a discussion.)

**9.44** *Accident and health contracts.* When accident and health or disability claims are presented, proof of loss is obtained. This proof may include such documents as hospital bills and physicians' reports; however, other proof may be required with varying levels of supporting evidence depending on the kind of illness or disability related to the claim.

**9.45** In the case of disability contracts or riders, life insurance entities generally obtain statements from physicians or hospitals as proof that the insured has been totally or partially disabled, and whether the disability is permanent or temporary. If the disability is temporary, ongoing benefit payments are contingent on proof of the continuance of the disability. In addition, disability payments usually do not commence until a required elimination period has been completed.

**9.46** *Annuity contracts.* Immediate annuities generally provide for regular automated payments to begin at some interval after the annuity consideration has been received. Generally, payments for deferred annuities and maturing endowment contracts are identified by claims-processing personnel or automatically by the inforce master file system before the date payments are to begin. The contract holder is notified of the pending maturity and generally has several options for payout of the proceeds.

**9.47** *Participating dividends.* Participating contracts generally provide for the payment of annual dividends after the contract has been in force for two or three contract years. Annual dividends are generally payable on contract anniversary dates. Resolutions by those charged with governance authorizing the payment of dividends are usually made annually for contracts reaching anniversaries within the following calendar year. The amount apportioned for distribution to contract holders as the annual dividend is commonly referred to as *divisible surplus* and represents the excess of the funds on hand over the amount that the entity determines it should hold to meet future needs. A life insurance entity must determine that the level of its surplus and other entity goals can be satisfied before determining the final amount of divisible surplus.



Some contracts provide for terminal dividends. Such dividends are payable if contracts terminate by maturity, surrender, or death.

**9.48** Dividends can be

- a. paid in cash,
- b. applied to pay premiums,
- c. applied to provide *paid-up additions*,
- d. applied to shorten the endowment or premium paying period, or
- e. left on deposit at interest.

Other dividend options may also be available.

**9.49** A life insurance entity having both participating and nonparticipating contracts in force usually must file a separate statement of operations for each class of business, unless a large portion of the contracts in force (generally 90 percent in most states) is either participating or nonparticipating.

## Audit Consideration Chart

**9.50** The auditor may consider the following specific audit objectives and examples of selected control and auditing procedures in auditing benefit and claim payments of life insurance entities. The audit consideration chart is intended to present examples only, and is not all-inclusive for any category. Additionally, AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. AU section 328 applies to liabilities, as well as to assets and components of equity contained in financial statements.

**Audit Consideration Chart—Benefit and Claim Payments**

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Existence or Occurrence and Rights and Obligations</i>		
All benefits or claims paid or incurred represent valid obligations incurred by the life insurance entity under the contracts in force.	Procedures for benefit or claim payments, including any changes thereon, are established and monitored by appropriate levels of management.	Confirmation of benefits or claims paid to contract holders or beneficiaries in the period under review.
	Individual benefit or claim payments are approved by appropriate personnel.	For benefit or claim payment transactions, the auditor may consider the following general procedures and additional procedures for specific transaction types.
	Procedures are adequate for identifying and investigating suspicious or contestable claims. Periodic audits are performed by the life insurance entity of third-party disbursements, or third-party processing operations.	General procedures typically include the following: <ol style="list-style-type: none"><li>1. Verify that the contract was in force at transaction date.</li><li>2. Determine that the transaction was recorded and processed on the benefits processing and insurance in force systems.</li><li>3. Determine the authenticity of the claim.</li><li>4. Recalculate the benefit.</li><li>5. Determine that reinsurance recovery has been identified and accurately calculated and subsequently received.</li><li>6. Trace to the claims register.</li><li>7. Review prior year's values against actual experience of paid claims in later periods.</li></ol>

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
		<p>Procedures for death benefits, disability and accident, and health typically include the following:</p> <ol style="list-style-type: none"> <li>1. Determine that the claim is acceptable under the terms of the contract coverage.</li> <li>2. Determine that independent investigative reports were obtained in appropriate circumstances.</li> </ol> <p>For matured endowments, determine that the benefit is in accordance with the contract terms.</p> <p>For annuity benefits, determine the following:</p> <ol style="list-style-type: none"> <li>1. The contract has fulfilled its fixed accumulation period, or an annuitization request was submitted by contract holder.</li> <li>2. The contract has been properly set up for repetitive payments, if appropriate.</li> </ol> <p>For surrender benefits, perform the following:</p> <ol style="list-style-type: none"> <li>1. Determine that the transaction was allowable.</li> <li>2. Recalculate the surrender value, agree surrender values, or both, to established cash surrender value tables.</li> <li>3. Test that policy loans, interest, terminal dividends, and any other contract charges or credits have been properly reflected.</li> </ol>

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
		<p>For earnings credits on universal life, investment, and similar contracts, determine the propriety of the contract data and the factors used to calculate the earnings credits, expense deductions, or both. For contract holder dividends and profit sharing participations, perform the following:</p> <ol style="list-style-type: none"><li>1. Determine that participating benefit is due in accordance with contract terms.</li><li>2. Agree dividend and profit sharing participation rates to rate files.</li></ol>
<p><i>Completeness</i></p> <p>All benefits or claims incurred or paid in the current period are appropriately included in the financial statements.</p>	<p>Edit and validation controls, batch balancing, data transmission controls, logging, and cash totals are used to provide assurance that all transactions have been completely and accurately processed and that systems interfaces are operating correctly.</p> <p>Inquiry and observation is undertaken to determine that management has established adequate procedures for monitoring third parties involved in processing or calculating benefit or claim payments.</p>	<p>Test the clerical accuracy of the books of original entry (for example, claims register), historical claim databases, and key statistical data summary reports.</p> <p>Review the reconciliations of claim statistical databases to detail accounting records and the general ledger. Investigate significant or unusual reconciling items and determine the appropriate treatment of the reconciling items.</p>

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	<p>Inquiry and observation is undertaken to determine that management has established adequate procedures with respect to experience rated contracts to ensure that</p> <ol style="list-style-type: none"> <li>1. the data used in refund calculations are reconciled to actual premiums and claims records.</li> <li>2. proper cutoff of activity is established.</li> </ol>	<p>Review experience rated refund calculations to determine that</p> <ol style="list-style-type: none"> <li>1. the data used in the calculations are reconciled to actual premium and claim records.</li> <li>2. actual activity through end of the reporting period is considered.</li> <li>3. experience rated refunds are calculated in accordance with the contract provisions and are recorded correctly as to account, amount, and period.</li> </ol>
	<p>Inquiry and observation is undertaken to determine that management has established adequate procedures with respect to benefit and claim payment transactions to ensure that</p> <ul style="list-style-type: none"> <li>• proper cutoff of activity is established and</li> <li>• significant variances between expected and actual payments are analyzed and monitored by appropriate personnel.</li> </ul> <p>Processing backlogs are monitored and large or unusual fluctuations are investigated by appropriate personnel.</p>	<p>Review claim activity immediately before and after the valuation date, and perform detailed reviews of processing backlogs and incurred-but-not-reported (IBNR) balances to determine the adequacy of the period end cutoff.</p> <p>Review the balances in claim-related suspense accounts at year end and, if material balances are in suspense, obtain and review the client's reconciliations of the suspense account details to the general ledger control accounts. Ensure that an appropriate cutoff was achieved.</p>
	<p>Suspense account balances are analyzed and reviewed by appropriate personnel for large, old, or unusual items.</p>	

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<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Valuation or Allocation</i>	<p>Adequate procedures exist to identify and pursue reinsurance recoveries for benefit and claim payments. Benefit and claim payments are calculated using the appropriate contract data.</p> <p>Loss development techniques are used to establish IBNR for accident and health claims.</p>	<p>Compare ratios for prior periods and obtain explanations for any unexpected or significant changes as to the following:</p> <ol style="list-style-type: none"> <li>1. Average death claims to average contract size</li> <li>2. Benefits or claims incurred to premium income</li> <li>3. Cash surrender benefits paid to reserve amount at the last valuation date</li> <li>4. Contract holder dividends to participating premium income and to income before contract holder dividends</li> </ol> <p>Compare recorded reinsurance amounts to assumed or ceded detail records and evaluate whether reinsurance amounts relating to benefit or claim payments are properly calculated and recorded</p>
<i>Presentation and Disclosure</i>	<p>Benefit and claims paid or incurred are properly classified, described, and disclosed in the financial statements, including notes, in conformity with applicable accounting principles.</p> <p>Management reports are prepared and reviewed, which may include the following:</p> <ol style="list-style-type: none"> <li>1. Ratio of claims incurred to claims liabilities by coverage type</li> <li>2. Life insurance claims incurred to insurance in force</li> </ol>	<p>Review minutes, agreements, contracts, contested claims files, and other documents for evidence of other liabilities that should be accrued.</p> <p>Review minutes, agreements, contract forms, and correspondence with</p>

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	3. Contract holders' dividends to participating premium income and to income before contract holder dividends	state insurance departments to gain an understanding of items such as new contracts being issued and benefits associated with various contracts.
	4. Actual withdrawals to expected withdrawals	
	5. Numbers and total amounts of claims or benefit payments due and unpaid by line of business or coverage type	Test whether disclosures comply with U.S. generally accepted accounting principles or statutory accounting principles, as applicable.





## Chapter 10

# ***Commissions, General Expenses, and Deferred Acquisition Costs***

### **Introduction**

**10.01** For life and health insurance entities, expenses incurred in the normal course of business are generally associated with activities relating to the acquisition of new contracts, the maintenance or termination of existing contracts, and general overhead and administrative functions. Commissions or other kinds of selling or distribution expenses are typically the principal operating expenses of life insurance entities.

**10.02** For statutory reporting purposes, the operating expenses of life insurance entities are classified as either commissions; general expenses; or taxes, licenses, and fees. Statutory accounting principles (SAP) require that all costs be charged to expense as incurred. In many instances, because of the long term nature of life insurance contracts, commissions and other costs of acquiring business are greater than related premiums during the initial year that a contract is in force. In periods of increasing production, the results of operations are depressed as acquisition expenses are charged against current income, whereas related premium revenue is recognized over the term of the contract as it is received. Conversely, in periods of decreasing production, the results of operations are benefited by renewal premiums recorded as income whereas the related acquisition costs were expensed in prior periods.

**10.03** Under U.S. generally accepted accounting principles (GAAP), the costs attributed to the acquisition of contracts are deferred and amortized to match these costs with the related future revenue stream. Other costs are generally reported as expenses in the period incurred.

**10.04** The primary reason for the difference in reporting methods is that SAP and U.S. GAAP reporting models have different principal objectives. The SAP model's principal objectives emphasize the measurement of ability to pay claims in the future; the income statement effect is a secondary concern. As noted in paragraph 9 of the preamble to the revised manual, "SAP attempts to determine at the financial statement date an insurer's ability to satisfy its obligations to its policyholders and creditors." The primary focus of U.S. GAAP financial reporting is information about earnings and its components. U.S. GAAP is designed to meet the varying needs of different users of financial statements, whereas SAP is primarily focused on the needs of the regulators who are the main users of the statutory financial statements.

### **Regulation**

**10.05** In general, commission rates are not regulated except in certain states in which the maximum commission rate on certain contract types is specified (for example, credit insurance contracts). Allowances to agents may be designed to reimburse agents for expenses, such as office expenses, or may be in the form of *overriding commissions* and represent additional compensation to the agent. In certain states, there are restrictions regarding the amount of

expenses that may be reimbursed under allowance agreements. Commissions and allowances for certain accident and health and credit insurance contracts may also be indirectly controlled by regulatory restraints on the amount of premium that can be charged.

## Accounting Practices \*

**10.06** As discussed in chapter 3, "Sources of Accounting Principles and Reporting Requirements," life insurance entities are subject to the filing requirements of SAP and may also prepare financial statements in accordance with U.S. GAAP. The following discussion of SAP and U.S. GAAP accounting for commissions, general expenses, and deferred acquisition costs (DAC) is not a comprehensive source of authoritative accounting literature; rather it is intended to assist the preparers and auditors of financial statements in obtaining a general understanding of basic accounting practices related to commissions, general expenses, and DAC within the life insurance industry. The authoritative sources cited in chapter 3 may be referred to in determining appropriate accounting and reporting treatment in all cases.

## Statutory Accounting Practices

**10.07** Agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees that are primarily related to the acquisition of insurance contracts, are referred to as acquisition costs. All amounts paid or accrued as due are included, and no deferral is allowed. As noted in paragraph 11 of the preamble of the NAIC *Accounting Practices and Procedures Manual*, "policy acquisition costs are expensed as incurred under SAP because the funds so expended are no longer available to pay future liabilities." Commission amounts are reported as first year, single, renewal, as well as reinsurance ceded, assumed, or both, and are classified by line of business.

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\* The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, the Financial Accounting Standards Board (FASB) issued the invitation to comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project.

In July 2010, the IASB issued the exposure draft *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. Although the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement model; however, the majority prefer an alternative model. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. generally accepted accounting principles to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.

**10.08** General expenses include general operating costs of the entity for items such as salaries, costs of employee benefit plans, legal fees, postage, supplies, and field office operating expenses and also include imputed rent for owner occupied real estate and the related tenant costs associated with occupancy, such as electricity. As noted in Statement of Statutory Accounting Principles (SSAP) No. 40, *Real Estate Investments*, paragraph 15, "A reporting entity shall include in both its income and expenses an amount for rent relating to its occupancy of its own buildings. The amount recorded shall be at a rate comparable to rent received from others, rental rates, or both, of like property in the same area. If this is unavailable, it shall be derived from consideration of the repairs, expenses, taxes and depreciation incurred, plus interest added at an average fair rate on the book value of the reporting entity's investment in its home office building."

**10.09** General expenses allocated to the investment activities are allocated and categorized to investment-related expenses. Examples of investment related expenses generally include the salaries of employees involved in general investment functions, such as securities and mortgage loan administration, fees paid for real estate management, and all expenses related to the entity's owned real estate (excluding imputed rent and related tenant type expenses described previously), except depreciation and real estate taxes. Investment expenses are deducted from gross investment income to report net investment income in the revenue section of the Summary of Operations.

**10.10** Commissions and premium taxes are generally incurred as premiums are received. At the end of any reporting period, amounts are accrued for incurred commissions and premium taxes that have not been paid. Commissions and premium taxes related to due and deferred premiums are not explicitly accrued. These amounts are implicitly recognized in the calculation of *loading*, and the income statement effect is reflected in the *increase in loading on deferred and uncollected premiums* (see chapter 7, "Insurance Revenues"), which is reported separately as an expense in the Summary of Operations.

**10.11** Prepaid expenses can be defined as an amount that has been paid in advance of receiving future economic benefits anticipated by the payment (see chapter 14, "Other Assets and Liabilities, Surplus Notes, Separate Accounts, Insurance Related Assessments, and Equity—Contract Holders' Surplus"). As noted in SSAP No. 29, *Prepaid Expenses*, paragraph 2, "Prepaid expenses shall be reported as nonadmitted assets and charged against unassigned funds (surplus). They shall be amortized against net income as the estimated economic benefit expires."

## Generally Accepted Accounting Principles<sup>†</sup>

**10.12** Under U.S. GAAP, commissions, allowances, and other costs that vary with and are primarily related to the acquisition of new and renewal

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<sup>†</sup> In October 2010, FASB issued Accounting Standards Update (ASU) No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*. The objective of this update is to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The amendments in this ASU should be applied prospectively upon adoption. Retrospective application to all prior periods presented upon the date of adoption also is permitted, but not required. Early adoption is permitted, but only at the beginning of an entity's annual reporting period.

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business are generally deferred and amortized. These deferred amounts, referred to as *deferred acquisition costs* or *DAC*, are recorded as an asset on the balance sheet and amortized to income in a systematic manner based on related contract revenues or gross profits (or gross margins) as appropriate. (See exhibit 10-1, "Accounting for Deferred Acquisition Costs.")

**10.13** As stated in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-720-25-2, other costs incurred during the period—such as those relating to investments, general administration, policy maintenance, product development expenses, market research expenses, and general overhead—that do not vary with and are not primarily related to the acquisition of new and renewal insurance contracts should be charged to expense as incurred.

**10.14** *Determination of deferrable costs.* Acquisition costs are defined in the FASB ASC glossary. FASB ASC 944-30-25-4 identifies certain acquisition costs related to universal life-type insurance contracts and investment contracts that are not deferrable.

- a.* For all contracts, the FASB ASC glossary and FASB ASC 944-30-55-1 state the following:

All of the following costs vary with and are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred and shall be considered acquisition costs:

- a.* Agent and broker commissions

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(footnote continued)

FASB ASU No. 2010-26 specifies that the following costs incurred in the acquisition of new and renewal contracts should be capitalized in accordance with the amendments in the ASU:

1. Incremental direct costs of contract acquisition. Incremental direct costs are those costs that result directly from and are essential to the contract transaction(s) and would not have been incurred by the insurance entity had the contract transaction(s) not occurred.
2. The portion of the employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:
  - Underwriting
  - Policy issuance and processing
  - Medical and inspection
  - Sales force contract selling
3. Other costs related directly to the insurer's acquisition activities that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred.
4. Advertising costs that meet the capitalization criteria in FASB ASC 340-20.

All other acquisition-related costs—including costs incurred by the insurer for soliciting potential customers, market research, training, administration, unsuccessful acquisition or renewal efforts, and product development—should be charged to expense as incurred. Administrative costs, rent, depreciation, occupancy, equipment, and all other general overhead costs are considered indirect costs and should be charged to expense as incurred.

The amendments in this ASU modify the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal contracts. This revised definition may represent a significant change in practice for many insurance entities. For example, many insurance entities capitalize costs relating to unsuccessful contract acquisitions. The amendments in this ASU specify that the costs must be based on successful efforts (that is, acquiring a new or renewal contract).

- b. Salaries of certain employees involved in the underwriting and policy issue functions
  - c. Medical and inspection fees
- b. *For universal life-type contracts*, paragraphs 4–5 of FASB ASC 944-30-25-4 state the following:

Acquisition costs that have any of the following characteristics shall be considered maintenance and other period costs and be charged to expense in the period incurred:

- a. Acquisition costs that vary in a constant relationship to premiums or insurance in force
- b. Acquisition costs that are recurring in nature
- c. Acquisition costs that tend to be incurred in a level amount from period to period

Costs such as recurring premium taxes and ultimate level commissions, which vary with premium revenue, should be charged to expense in the periods incurred.

**10.15** The identification of acquisition costs requires considerable judgment; in making these judgments, due consideration should be given to the concepts of consistency, and recoverability. Individual expense categories should be analyzed to determine their relationship to the acquisition of business in the period incurred.

**10.16** In general, there are two broad kinds of acquisition expenses. The first is related to the actual sale of insurance, for example, commissions. The second is related to processing business submitted by agents and setting up the necessary records.

**10.17** Paragraphs 2–4 of FASB ASC 944-720-05 state that in a number of life insurance entities, virtually all sales expense is composed of compensation paid to agents. Such compensation relates directly to the amount of business produced by an agent. In other entities, considerably less compensation will be paid to agents; however, additional sums will be paid to salaried employees, such as branch managers and employees, or to field representatives, who call on and assist the agents. There are also entities that do not sell through agents. Some entities use mail, the Internet, and other mass marketing methods to sell their products. Regardless of the method used by a particular entity to sell insurance, according to FASB ASC 944-30-25-1,<sup>†</sup> costs that are acquisition costs should be capitalized. According to the FASB ASC glossary, acquisition costs are costs incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts.

**10.18** Issue expenses, as opposed to selling expenses, are generally incurred in the home office of a life insurance entity. In a number of entities, issue functions are partly performed in regional or branch offices. Issue costs that may be deferred are those expenses of the underwriting and contract issue departments that are primarily related to and vary with new business.

**10.19** *Nondeferrable expenses.* Some portions of a life insurance entity's expenses, such as investment expenses, product development expenses, market research expenses, contract maintenance expenses, and general overhead,

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<sup>†</sup> See footnote † in the heading preceding paragraph 10.12.

are not associated directly with acquiring business, nor are they appropriate for separate deferral. As is the case with other business entities, such expenses are charged to operations in the period incurred. In addition, for certain long-duration contracts level renewal expenses in the premium paying period are not capitalized as they are considered nondeferrable period expenses; however, the expense portion of the gross premium must be adequate to cover such expenses as well as the deferred costs. For other short or long-duration contracts, capitalized acquisition costs are amortized in proportion to premium revenue recognized. Acquisition costs such as recurring premium taxes and ultimate level commissions, which vary with premium revenue, are effectively charged to expense in the period incurred.

**10.20** *Allocation of deferred acquisition costs.* Contract acquisition costs are allocated to or directly identified with contract types or lines of business so that those costs can be amortized over the life of the related contracts. The allocation basis for acquisition costs should be reasonable and applied on a consistent basis from period to period.

**10.21** FASB ASC 944-30-25-1 requires the following:

To associate acquisition costs with related premium revenue, acquisition costs should be allocated by groupings of insurance contracts consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts.

## Accounting for DAC in Connection With Contract Modifications or Exchanges

**10.22** FASB ASC 944-30-35 and FASB ASC 944-30-40 provide specific guidance on accounting for DAC on internal replacements and modifications of insurance and investment contracts.

**10.23** *Internal replacements defined.* The FASB ASC glossary defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the legal extinguishment of one contract and the issuance of another contract (a contract exchange); by amendment, endorsement, or rider to a contract; or by the election of a benefit, feature, right, or coverage within the contract.<sup>1</sup>

**10.24** *Traditional life contracts replaced by universal life contracts.* Paragraphs 11–12 of FASB ASC 944-30-25 provide guidance on internal replacements that occur when a traditional life contract is replaced by a universal life-type contract. For these transactions, life insurance entities are required to expense the remaining unamortized acquisition costs associated with the replaced contracts and any difference between the cash surrender value and the previously recorded liability at the time of replacement.

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<sup>1</sup> AICPA Technical Questions and Answers (TIS) section 6300.32, "Premium Changes to Long Duration Contracts in Applying FASB ASC 944-30" (AICPA, *Technical Practice Aids*), contains discussion on whether changes in premiums to FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, long-duration insurance contracts for which the insurer has the right to make changes in premium rates are considered modifications as discussed in paragraph 8 of Statement of Position (SOP) 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts*.

**10.25** *All other contract modifications or exchanges.* FASB ASC 944-30 applies to all entities<sup>2,3,4</sup> and is applicable to modifications and replacements made to short duration and long duration contracts, including *investment contracts* as defined in the FASB ASC glossary. The AICPA also issued a series of Technical Question and Answers (TISs) on accounting and financial reporting issues related to FASB ASC 944-30 (TIS sections 6300.25–.36 [AICPA, *Technical Practice Aids*]).

**10.26** *Determining if the internal replacement is subject to FASB ASC 944-30 guidance.* An insurance enterprise must determine if the modification (other than partial withdrawals, surrenders or reductions in coverage that are addressed in FASB ASC 944-30-35-29) results from the election by the contract holder of a benefit, feature, right, or coverage that was within the original contract. If so, the modification is not an internal replacement subject to FASB ASC 944-30 as long as all of the following conditions are met (as discussed in paragraphs 25–28 of FASB ASC 944-30-35):

- a. The election is made in accordance with terms fixed or specified within narrow ranges in the original contract.
- b. The election of the benefit, feature, right, or coverage is not subject to any underwriting.<sup>5</sup>
- c. The insurance enterprise cannot decline to provide the coverage or adjust the pricing of the benefit, feature, right, or coverage.
- d. The benefit, feature, right, or coverage had been accounted for since the inception of the contract. For example, the option to elect the feature is an embedded option within the contract that is required to be accounted for under FASB ASC 815-15 (or would have been accounted for under this guidance if the "grandfathering" provisions of the statement, for embedded derivatives, had not been elected) or the existence of the option to elect a feature was assessed in the classification of and accounting for the contract, such as the classification of the contract as an insurance contract under FASB ASC 944-30-15.

The annuitization phase of a contract is separate and distinct from and cannot be accounted for as a continuation of the accumulation phase, even if annuitization is in accordance with terms fixed in the original contract.

**10.27** As discussed in FASB ASC 944-30-35-29, partial withdrawals, surrenders, or reductions in coverage (for example, reduced face amount on a life insurance contract or higher deductibles on a property casualty contract), as allowed by terms that are fixed and specified at contract inception either in the

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<sup>2</sup> FASB *Accounting Standards Codification* (ASC) 944-30 applies to life insurance enterprises, property and liability insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, and fraternal benefit societies. Modifications and exchanges of debt issued by insurance enterprises should follow the guidance in FASB ASC 470-50.

<sup>3</sup> FASB ASC 944-20 governs the determination of the implications of modifications to insurance and reinsurance contracts on risk transfer assessment and the classification of short-duration contracts as either retroactive or prospective.

<sup>4</sup> TIS section 6300.36, "Prospective Unlocking" (AICPA, *Technical Practice Aids*), discusses whether an insurance entity can "unlock" its original FASB Statement No. 60 assumptions for certain long-duration insurance contracts, after contract inception for collected, approved, or expected premium rate increases.

<sup>5</sup> TIS section 6300.28, Definition of Reunderwriting for Purposes of Applying FASB ASC 944-30" (AICPA, *Technical Practice Aids*), provides additional discussion on reunderwriting.

contract or other information available to the contract holder or, if required by state law or regulation, at terms in effect when the reduction is made for that benefit, feature, right, or coverage, whether or not surrender charges or other termination charges are assessed, are not internal replacements subject to this guidance, as long as there are no reunderwriting or other modifications to the contract, at that time, that would require evaluation under FASB ASC 944-30-35-37.

**10.28** *Integrated versus nonintegrated contract features.*<sup>6</sup> If the modification or replacement is subject to the guidance in FASB ASC 944-30, the insurance enterprise should then determine if the contract change involves the addition of or changes to a nonintegrated contract feature as discussed in paragraphs 30–31 of FASB ASC 944-30-35.

	<i>Long Duration</i>	<i>Short Duration</i>
Integrated	Benefits provided by the feature can be determined only in conjunction with the account value or other contract holder balances related to the base contract.	Contract features for which there is explicit or implicit reunderwriting or repricing of existing components of the base contract.
Nonintegrated	The determination of benefits provided by the feature is <i>not</i> related or dependent on the account value or other contract holder balances of the base contract. Underwriting and pricing for nonintegrated contract features typically are executed separately from other components of the contract, and it is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided.	Contract features that provide coverage that is underwritten and priced only for that incremental insurance coverage, and do not result in the explicit or implicit reunderwriting or repricing of other components of the contract. It is inherent in this concept that the premium charged is not in excess of an amount that is commensurate with the incremental insurance coverage provided. Additional coverage provided by a nonintegrated contract feature would be considered nonintegrated even though the entire coverage provided by the short duration contract may be subject to only one deductible or limit in the event of an insured loss.

<sup>6</sup> Paragraphs 7(d) and 8 of FASB ASC 825-10-25 state that if the fair value option is elected for an insurance contract (base contract) for which integrated or nonintegrated contract features or coverages are issued either concurrently or subsequently, the fair value option also must be applied to those features or coverages. The fair value option cannot be elected for only the nonintegrated contract features or coverages, even though those features or coverages are accounted for separately under FASB ASC 944-30.



**10.29** For contract modifications involving a nonintegrated contract feature or coverage, FASB ASC 944-30-35-32 states that the addition or election of that feature or coverage, in and of itself, does not change the existing base contract and, as a result, further evaluation of the base contract under FASB ASC 944-30-35-37 is not required. In accordance with FASB ASC 944-30-35-33, the nonintegrated contract feature or coverage should be accounted for in a manner similar to a separately issued contract. FASB ASC 944-30-35-34 states that subsequent modifications made only to the nonintegrated contract feature or coverage should be evaluated under paragraphs 26–37 of FASB ASC 944-30-35 separately from the base contract, and any DAC related to the nonintegrated contract feature or coverage accounted for accordingly. In accordance with FASB ASC 944-30-35-35, subsequent termination of a nonintegrated contract feature or coverage should be accounted for as an extinguishment of only the balances related to the nonintegrated contract feature or coverage. FASB ASC 944-30-35-36 states that for contract modifications involving integrated contract features or coverages (other than those contract modifications described in paragraphs 26–29 of FASB ASC 944-30-35), the insurance enterprise should review the conditions set forth in FASB ASC 944-30-35-37 to determine whether the contract has changed substantially as a result of the modification.<sup>7</sup>

**10.30** *Determining substantial changes.* As per the guidance in FASB ASC 944-30-35-37, an internal replacement (other than those described in paragraphs 26–29 of FASB ASC 944-30-35) is determined to involve contracts that are substantially unchanged only if all the following conditions exist:

- a. The insured event, risk, or period of coverage of the contract has not changed, as noted by no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any.<sup>8</sup>
- b. The nature of the investment return rights (for example, whether amounts are determined by formulae specified by the contract, pass through of actual performance of referenced investments, or at the discretion of the insurer), if any, between the insurance enterprise and the contract holder has not changed.<sup>9</sup>
- c. No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, the deposit,

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<sup>7</sup> Further discussion on integrated versus nonintegrated contract feature classification can be found in TIS section 6300.25, "Integrated/Nonintegrated Contract Features in Applying FASB ASC 944-30" (AICPA, *Technical Practice Aids*), which discusses the application of the flowchart in appendix C of SOP 05-1.

<sup>8</sup> Readers can refer to TIS section 6300.26, "Evaluation of Significance of Modification in Applying FASB ASC 944-30" (AICPA, *Technical Practice Aids*), for additional discussion on how the significance of the change in the degree of mortality risk, morbidity risk, or other insurance risk can be determined. Additionally, TIS section 6300.33, "Evaluation of Changes Under FASB ASC 944-30-35-37(a)" (AICPA, *Technical Practice Aids*), provides discussion on how changes in the period of coverage or insured risk under paragraph 15(a) of SOP 05-1 can be evaluated.

<sup>9</sup> Readers can refer to TIS section 6300.27, "Changes in Investment Management Fees and Other Administrative Charges in Applying FASB ASC 944-30" (AICPA, *Technical Practice Aids*), for SOP 05-1 applicability and TIS section 6300.34, "Nature of Investment Return Rights in FASB ASC 944-30-35-37(b)" (AICPA, *Technical Practice Aids*), for additional discussion on the nature of the investment return rights in paragraph 15(b).

premiums, or charges are reduced by an amount at least equal to the corresponding reduction in benefits or coverage.

- d. Other than distributions to the contract holder or contract designee or charges related to newly purchased or elected benefits or coverages, there is no net reduction in the contract holder's account value or, for contracts not having an explicit or implicit account value, the cash surrender value, if any.
- e. There is no change in the participation or dividend features of the contract, if any.
- f. There is no change to the amortization method or revenue classification of the contract.

If any of the preceding conditions are not met, an internal replacement is determined to involve a replacement contract that is substantially changed from the replaced contract.

**10.31** *Accounting for substantially unchanged contracts.* As discussed in paragraphs 38–40 of FASB ASC 944-30-35, a contract modification that is determined to result in a replacement contract that is substantially unchanged from the replaced contract (that is, by meeting all of the conditions in FASB ASC 944-30-35-37) should be accounted for as a continuation of the replaced contract. Unamortized DAC,<sup>10</sup> unearned revenue liabilities, and deferred sales inducement assets associated with the replaced contract should continue to be deferred and amortized or earned in connection with the replacement contract. Other balances associated with the replaced contract, such as any liability for minimum guaranteed death benefits (MGDBs) or guaranteed minimum income benefits (GMIBs), should be accounted for in a similar manner, that is, as if the replacement contract is a continuation of the replaced contract.<sup>11</sup>

**10.32** However, paragraphs 55–56 of FASB ASC 944-30-35 state that costs incurred in connection with an internal replacement that results in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as policy maintenance costs and charged to expense as incurred. The portion of renewal commissions paid on the replacement contract that meets the criteria for deferral in accordance with the provisions of FASB ASC 944, *Financial Services—Insurance*, limited to the amount of the future deferrable renewal commissions on the replaced contract that would have met the deferral criteria, continues to be deferrable under those provisions.<sup>12</sup>

**10.33** *Accounting for substantially changed contracts.* A contract modification that is determined to result in a replacement contract that is substantially changed from the replaced contract (that is, failure any of the conditions in FASB ASC 944-30-35-37) should be accounted for as an extinguishment of the replaced contract. As discussed in paragraphs 1–4 of FASB ASC 944-30-40,

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<sup>10</sup> If the replaced contract was acquired in a purchase business combination, any present value of future profits should be accounted for in a similar manner as unamortized deferred acquisition costs.

<sup>11</sup> Readers can refer to paragraphs 38–54 of FASB ASC 944-30-35 for guidance on accounting for contract modifications that result in replacement contracts that are substantially unchanged from the replaced contract to contract accounted.

<sup>12</sup> Readers can refer to the TIS section 6300.30, "Commissions Paid on an Increase in Insurance Coverage or Incremental Deposits in Applying FASB ASC 944-30" (AICPA, *Technical Practice Aids*), for further discussion.

unamortized DAC,<sup>13</sup> unearned revenue liabilities, and deferred sales inducement assets from the replaced contract in an internal replacement transaction that results in a substantially changed contract should not be deferred in connection with the replacement contract. Other balances associated with the replaced contract, such as any liability for MGDBs or GMIBs, should be accounted for in a similar manner; that is, accounted for based on an extinguishment of the replaced contract and issuance of a new contract. Acquisition costs related to the replacement contract should be evaluated for deferral in accordance with the provisions of FASB ASC 944.

**10.34** An enterprise's accounting policy may change for certain internal replacements, due to industry practice prior to the issuance of internal replacement guidance in FASB ASC 944-30. Changes in unamortized DAC,<sup>14</sup> unearned revenue liabilities, and deferred sales inducement assets that result from the impact on estimated gross profits of changes in accounting policy due solely to the adoption of the Statement of Position, as applied to previously anticipated future internal replacements, and any related income tax effects, should be reported in a manner similar to the cumulative effect of a change in accounting principle with offsetting adjustments to the opening balance of retained earnings as of the date of adoption, per FASB ASC 250-10.

## Sales Inducements to Contract Holders

**10.35** As defined in the FASB ASC glossary, *sales inducements* are contractually obligated inducements that are identified explicitly in a contract and are in excess of current market conditions. A sales inducement to contract holders enhances the investment yield to the contract holder. The three main types of sales inducements are an immediate bonus, a persistency bonus, and an enhanced-yield bonus.

**10.36** These types of sales inducements may be offered with fixed and variable life insurance and annuity contracts.

**10.37** FASB ASC 944-40-25-12 discusses that sales inducements provided to the contract holder, whether for investment or universal life-type contracts, should be recognized as part of the liability for policy benefits over the period in which the contract must remain in force for the contract holder to qualify for the inducement or at the crediting date, if earlier, in accordance with paragraphs 13–16 of FASB ASC 944-40-25 (paragraph 8.62 of the guide). No adjustments should be made to reduce the liability related to the sales inducements for anticipated surrender charges, persistency, or early withdrawal contractual features. See the discussion in chapter 8, "Liabilities for Future Policy Benefits (Statutory Policy Reserves) and Other Contract Liabilities," for further information on contract holder liabilities.

**10.38** As discussed in paragraph 7 of FASB ASC 944-30-25, sales inducements that (a) are recognized as part of the liability under FASB ASC 944-40-25-12 (paragraph 10.36), (b) are explicitly identified in the contract at inception, and (c) meet the criteria in the following sentence should be deferred and amortized using the same methodology and assumptions used to amortize capitalized acquisition costs. As discussed in paragraph 6 of FASB ASC

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<sup>13</sup> If the replaced contract was acquired in a purchase business combination, any present value of future profits should be accounted for in a similar manner.

<sup>14</sup> See footnote 13.

944-30-25, the insurance enterprise should demonstrate that such amounts are (a) incremental to amounts the enterprise credits on similar contracts without sales inducements and (b) higher than the contract's expected ongoing crediting rates for periods after the inducement, as applicable; that is, the crediting rate excluding the inducement should be consistent with assumptions used in estimated gross profits, contract illustrations, and interest crediting strategies. Due to the nature of day-one and persistency bonuses, the criteria in the preceding sentence are generally met. As stated in FASB ASC 944-30-45-2, the deferred amount should be recognized on the statement of financial position as an asset, and amortization should be recognized as a component of benefit expense. As discussed in paragraph 18 of FASB ASC 944-30-35, the annuitization phase is viewed as a separate contract under and should not be combined with the accumulation phase for amortization of deferred sales inducements.

**10.39** FASB ASC 944-30-35-57 states that in certain situations, an insurance enterprise may assess a surrender charge on the replaced contract that is offset by an immediate sales inducement to a contract holder on the replacement contract. In this situation, the insurance enterprise should offset any surrender charges assessed against the contract holder's account balance under the replaced contract against any stated immediate sales inducement to determine whether there has been a net reduction in the contract holder's account value in accordance with FASB ASC 944-30-35-37.

**10.40** FASB ASC 944-30-35-58 states that the liability for a sales inducement to a contract holder offered in conjunction with an internal replacement of a long duration contract that is determined to result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for from the date of its addition to the replacement contract in accordance with the guidance in FASB ASC 944-40-25-12 (see paragraph 10.36 of the guide). The criteria in paragraphs 6–7 of FASB ASC 944-30-25 for recognition of a related sales inducement asset cannot be satisfied in these circumstances because the sales inducement was not specifically identified in the original contract.

## Amortization of DAC

**10.41** The principal purpose of amortization is to systematically match costs with related revenues or gross profits, as appropriate. Amortization differs by type of contract.

**10.42** *Traditional long and short duration contracts and limited-payment contracts.* Amortization methods for long duration contracts and short duration contracts, as well as for limited payment contracts, are described by FASB ASC 944-30-30, 944-30-35, and 944-30-45; such costs are amortized in proportion to earned premium. (Refer to paragraphs 7.13–16 of this guide for contract classifications.)

**10.43** As described in FASB ASC 944-30-25-1 and FASB ASC 944-30-35-1, acquisition costs should be capitalized and charged to expense in proportion to premium revenue recognized. As described in FASB ASC 944-30-45-1, unamortized acquisition costs should be classified as assets.

**10.44** As described in FASB ASC 944-30-30-1, if acquisition costs for short-duration contracts are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined,

should be applied to applicable unearned premiums throughout the period of the contracts.

**10.45** As described in FASB ASC 944-30-30-2, actual acquisition costs for long-duration contracts should be used in determining acquisition costs to be capitalized as long as gross premiums are sufficient to cover actual costs.

**10.46** However, estimated acquisition costs may be used if the difference is not significant. Capitalized acquisition costs should be charged to expense using methods that include the same assumptions used in estimating the liability for future policy benefits.

**10.47** *Universal life-type contracts.* DAC balances for universal life-type contracts are amortized in proportion to gross profits as defined in paragraphs 4–5 of FASB ASC 944-30-35.

Capitalized acquisition costs should be amortized over the life of a book of universal life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of the book of contracts. The present value of estimated gross profits should be computed using the contract rate. If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force should be substituted as the base for computing amortization.

Estimated gross profit, as the term is used in the preceding paragraph, should include estimates of the following elements, each of which should be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation:

- a. Cost of insurance less benefit claims in excess of related policyholder balances
- b. Amounts expected to be assessed for contract administration less costs incurred for contract administration including acquisition costs not included in capitalized acquisition costs, the latter of which consists of both of the following:
  1. Policy-related costs that are not primarily related to the acquisition of business, such as policy administration, settlement, and maintenance costs
  2. Policy-related acquisition costs that are not capitalized under paragraphs 3–4 of FASB ASC 944-30-25, such as ultimate renewal commission and recurring premium taxes.
- c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances
- d. Surrender charges
- e. Other expected assessments and credits, however characterized.

Nonpolicy-related expenses, such as certain overhead costs, and costs that are related to the acquisition of business that are not capitalized under FASB ASC 944-30-25, such as certain advertising costs, should not be included in estimated gross profit.

**10.48** In general, for universal life-type contracts accounted for under FASB ASC 944, costs are amortized in proportion to the present value of the estimated future gross profit from mortality, interest, expense, and surrender margins. The estimation of future gross profits uses similar kinds of assumptions used in short and long duration contracts, for example, persistency and mortality; however, the gross profit estimate does not include any provision for adverse deviation.

**10.49** Estimates of expected gross profits used as a basis for amortization should be evaluated regularly, and adjustments to the total amortized amounts should be made in the period when actual experience or other evidence suggests that significant revisions to previous expected gross profit estimates are necessary. When adjustments are made to the total amortized amount due to changes in expected gross profit estimates, the original assumptions are revised and the resulting change in the accumulated amortization is reported in the income statement in the period in which the revision occurs. Changes in the assumptions used to calculate the expected gross profits require careful consideration of actual and expected future experience and considerable judgment. A common reason for changes in the estimate of gross profits relates to realized gains and losses from investment securities.

**10.50** In estimating expected gross profits, FASB ASC 944-30-35-5(b) (paragraph 10.47) requires that gross profit estimates include amounts expected to be assessed for contract administration less costs incurred for contract administration including acquisition costs not included in capitalized acquisition costs. Contract administration costs included in the calculation of estimated gross profits should consist of the following:

- a. Policy related costs that are not primarily related to the acquisition of business, such as policy administration, settlement, and maintenance costs
- b. Policy related acquisition costs that are not capitalized under paragraphs 3–4 of FASB ASC 944-30-25, such as ultimate renewal commissions and recurring premium taxes

**10.51** *Long-duration participating life insurance contracts that meet the criteria in FASB ASC 944-20-15-3 as participating life insurance contracts.* FASB ASC 944-30-35-11 states that capitalized acquisition costs should be amortized over the life of a book of participating life contracts at a constant rate, based on the present value of the estimated gross margin amounts expected to be realized over the life of the book of contracts. The present value of estimated gross margins should be computed using the expected investment yield. If significant negative gross margins are expected in any period, then the present value of gross margins before annual dividends, estimated gross premiums, or the balance of insurance in force should be substituted as the base for computing amortization.

**10.52** In computing amortization, FASB ASC 944-30-35-12, requires interest to be accrued to the unamortized balance of capitalized acquisition costs at the rate used to discount expected gross margins. Estimates of expected gross margins used as a basis for amortization should be evaluated regularly, and the total amortization recorded to date should be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised. The interest rate used to compute the present value of revised estimates of expected gross margins should be either

the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates should be applied consistently in subsequent revisions to computations of expected gross margins.

**10.53** In accordance with FASB ASC 944-30-35-13, estimated gross margin, as the term is used in FASB ASC 944-30-35-11, should include estimates of

- a. amounts expected to be received from premiums, *plus*
- b. amounts expected to be earned from investment of policyholder balances (that is, the net level premium reserve described in FASB ASC 944-40-25-29), *less*
- c. all benefit claims expected to be paid, *less*
- d. costs expected to be incurred for contract administration (including acquisition costs not included in capitalized acquisition cost), *less*
- e. expected change in the net level premium reserve for death and endowment benefits, *less*
- f. expected annual policyholder dividends, *plus or less*
- g. other expected assessments and credits, however characterized.

As discussed in paragraphs 14–15 of FASB ASC 944-30-35, estimated gross margins should be determined on a best estimate basis, without provision for adverse deviation. Several dividend options may be available to the policyholder, in which instances the options generally can be changed during the life of the contract. In estimating gross margins, life insurance entities should use the best estimate of the dividend options that policyholders will elect.

**10.54** *Alternative basis for DAC amortization.* As discussed in FASB ASC 944-30-35-4, for universal life-type contracts, if significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force should be substituted as the base for computing amortization.

**10.55** A change in the basis for amortizing DAC that is required as a result of significant unanticipated negative gross profits involves a change in the method of applying an accounting principle. However, because the cumulative effect attributable to the change in accounting principle cannot be separated from the current or future effects of the change in estimate, the change is reported as a change in accounting estimate, as defined by the FASB ASC glossary. Following the change, the new basis of amortization should be consistently applied in future periods.

**10.56** FASB ASC 944-30-35 discusses the methods to determine the revised estimate of expected gross profits, and the resulting cumulative adjustment to DAC as discussed in paragraph 10.44–49 of this guide. Once the revised expected gross profits are determined, either the retrospective approach, which is based on a new effective interest rate, or the catch up approach, which is based on the original effective interest rate, may be used to determine the discounted amounts.

**10.57** *Interest charges on DAC.* FASB ASC 944-30-35 requires that interest be accrued on the unamortized DAC balance and on any unearned revenues at the same interest rate used to discount the estimated gross profits. The interest rate is the credited rate used in the contracts; however, it can be the rate

in effect at the inception of the contracts or adjusted each period to the current credited rate. Once an interest rate method is selected, it must be consistently applied through the remaining life of the contract, including any subsequent revisions to the gross profit estimates. Any subsequent change in applying the interest rate method is considered a *change in accounting principle*, as defined by the FASB ASC glossary.

**10.58** *Investment contracts.* As discussed in paragraphs 19–23 of FASB ASC 944-30-35, for investment contracts accounted for under FASB ASC 944, DAC is amortized using an accounting method that recognizes acquisition and interest costs as expenses at a constant rate applied to the net contract liabilities and that is consistent with the interest method under FASB ASC 310-20. For investment contracts that include significant surrender charges or that yield significant revenue from sources other than the investment of contract holder funds, the amortization methods described for universal life-type contracts are generally used.

## Calculation Methodologies

**10.59** There are two basic methods of calculating amortization of DAC balances: the work sheet method and the expense reserve factor method. Both methods amortize costs over the period that benefits are provided in proportion to recognized revenues or gross profits (or gross margins for participating life insurance contracts), as appropriate, in that period. (See exhibit 10-1 for examples of calculation methodologies. Additionally, examples of calculation methodologies for internal replacements are located in FASB ASC 944-30-55.)

**10.60** *Work sheet method.* There are two kinds of work sheet methods, referred to as the *static work sheet method* and the *dynamic work sheet method*. The static work sheet method does not give effect to actual persistency, but uses an amortization schedule based on original estimates of persistency. The more commonly used dynamic work sheet method adjusts for persistency by using the inforce adjusted for actual terminations while using the same expense factors as the static work sheet methodology. The dynamic work sheet method is required for investment, limited-payment, and universal life-type contracts, and generally preferred for other long duration and short duration contracts; however, the static work sheet method may produce acceptable results in certain situations. The auditor should consider the continuing acceptability of using the static work sheet method in situations in which actual persistency materially differs from expected. Careful consideration should be given to persistency assumptions when using either method.

**10.61** *Expense reserve factor method.* The expense reserve factor method calculates an expense reserve for each *duration* using the same methods and assumptions as the benefit reserve calculations. The resulting expense reserve factor is then multiplied by the actual inforce. The expense reserve factors can be either standard cost factors or adjusted factors for cost variances. If the actual acquisition expenses do not vary greatly from the assumed expenses used to generate the expense reserve factors, it is appropriate to use the standard cost factors. If there is a significant difference, either adjusted factors for cost variances are used to recalculate the factors using actual costs, or a separate adjustment can be made to the DAC balance resulting from the original standard cost factors.

**10.62** The expense reserve factor method and the dynamic work sheet method should each yield approximately the same DAC balance. Careful



consideration should be given to persistency assumptions and actual experience under either method.

## Recoverability Testing and Loss Recognition

**10.63** *Recoverability testing (year of issue).* Recoverability tests are generally defined as profitability tests of a group of insurance contracts issued in a given year. Recoverability tests are performed only in the year of issue; thereafter, the year's issues may be merged with all other similar inforce contracts. In subsequent years, gains and losses are typically evaluated with respect to the entire group of contracts, except with respect to changes in persistency that may require the recalculation of amortization schedules.

**10.64** Recoverability testing of certain long and short duration contracts consists of determining whether all the expected gross premiums collected over the life of a certain group of insurance contracts are sufficient to recover all DAC as well as provide for expected future benefits and future maintenance costs. The amount of the DAC asset recorded on the balance sheet must be recoverable from future revenues of the related contracts. The expense portion of the gross premium must be adequate to provide for amortization of deferred costs and to cover level renewal expenses as well as nonlevel costs such as termination and settlement expenses. In addition, all renewal expense assumptions should take into account the possible effects of inflation on these expenses.

**10.65** Recoverability is usually demonstrated by determining that the present value of the contract related future cash flows, less the current benefit reserve, reduced by the current unamortized DAC balance, is a positive amount. If this amount is negative, a premium deficiency may exist. If the recoverability tests indicate a deficiency in the ability to pay all future benefit costs and expenses including the DAC, the loss is recognized and charged to expense as an adjustment to the current year's DAC balance, or if the loss is greater than the DAC balance, by an increase in the benefit reserve.

**10.66** As discussed in FASB ASC 944-60-15-5, the loss recognition requirements also should be applied to limited-payment and universal life-type contracts. In practice, the recoverability test for universal life type-contracts is sometimes satisfied demonstrating that the present value of the expected gross profits equals or exceeds the present value of the capitalized acquisition costs. As discussed in FASB ASC 944-30-35-22, DAC related to investment contracts described in FASB ASC 944-30-35-19, should be written off if it is determined that the amount at which the asset is stated is probably not recoverable. FASB ASC 944-60-35 states that a provision for loss recognition (premium deficiency), by which an additional liability is established for anticipated losses should not be applied to investment contracts described in FASB ASC 944-30-35-19.

**10.67** *Loss recognition tests (issues of all years).* Recoverability testing or profitability tests of insurance contract groups in years subsequent to issue should be performed periodically as deemed necessary. Overall consideration should be given to circumstances indicating that actual experience for a block of business, regardless of the issue year, is significantly different from the originally expected experience for each primary assumption. In circumstances in which actual experience is significantly worse than the originally assumed experience, loss recognition testing is required using revised assumptions that reflect actual experience and revised estimates of future experience, where appropriate. Significant assumptions generally include mortality, morbidity, persistency, expense levels, and interest rates. Insurance contracts should be

grouped to be consistent with the entity's manner of acquiring, servicing, and measuring the profitability of the insurance contracts to determine whether a premium deficiency exists.

**10.68** Annual tests of premium deficiencies are generally appropriate for short-duration contracts.

**10.69** *Loss recognition (premium deficiency).* The provisions in FASB ASC 944-60 addressing loss recognition (premium deficiency) apply to short duration and long duration contracts, including limited payment and universal life-type contracts, and participating contracts. For these contracts (except for universal life-type contracts), it is anticipated that the original assumptions for measurements of liabilities for future policy benefits will continue to be used during the period in which liabilities are accumulated, as long as liabilities are maintained at a level sufficient to provide for future benefits and expenses (a premium deficiency does not exist). This approach results in the recognition of variances from the original estimates in the accounting periods in which such variances occur.

**10.70** It is possible that actual experience with respect to expenses, interest, mortality, morbidity, and withdrawals may indicate that accumulated liabilities, together with the present value of future gross premiums, will not be sufficient (a) to cover the present value of future benefits and settlement and maintenance expenses related to the block of business and (b) to recover the unamortized portion of deferred acquisition expenses. The computation of such a deficiency would take the form illustrated in the following table

*Calculation of Premium Deficiency*

Present value of future payments for benefits and related settlement and maintenance expenses, determined using revised assumptions based on actual and anticipated experience	\$xxx
Less the present value of future gross premiums, determined using revised assumptions based on actual and anticipated experience	xxx
Liability for future policy benefits using revised assumptions	xxx
Less the liability for future policy benefits at the valuation date, reduced by unamortized acquisition costs	xxx
Premium Deficiency	\$(xx)

**10.71** This deficiency represents a loss that, in conformity with U.S. GAAP, should be recognized immediately by a charge to earnings and either a reduction of unamortized acquisition costs or an increase in the liability for future policy benefits. Future annual reserve additions should be based on the revised assumptions. No charge should be made to record currently an indicated loss that will result in the creation of an apparent profit in the future. The liability for future policy benefits using revised assumptions based on actual and anticipated experience should be estimated periodically for comparison with the liability for future policy benefits (reduced by unamortized acquisition costs) at the valuation date, particularly if the entity has experienced or anticipates adverse deviations from original assumptions that could materially affect the liabilities.

**10.72** Although the computation can be made only by individual blocks of business, a provision for premium deficiency at a minimum should be recognized if the aggregate liability on an entire line of business is deficient. In a number of instances, the liabilities on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits will be recognized in early years, and losses in later years. In such situations, appropriate adjustments should be made to liabilities to eliminate the recognition of losses in later years. Adjustments should always be made when losses first become apparent.

**10.73** *Loss recognition tests for investment contracts.* FASB ASC 944-60 related to the application of loss recognition (premium deficiency), does not address investment contracts. The practice of noninsurance financial institutions is to record losses only as negative margins are realized. Accordingly, an additional liability should not be established for anticipated losses on investment contracts; however, the DAC asset should be reduced to the level that can be recovered.

## Special Considerations

**10.74** *Participating contracts.* For participating insurance contracts, the treatment of dividends in loss recognition tests requires special consideration. Generally, the current dividend scale is used to project future dividend benefits. However, if a loss is indicated, the entity should consider whether it has the ability to reduce or eliminate dividends. In such situations, it is reasonable to consider that option in testing for premium deficiencies. When dividend scale reductions are included in the recoverability testing of participating contracts, considerable judgment is required to assess the consequences of any dividend reduction (for example, increased withdrawals). Conversely, if the life insurance entity indicates its intention to maintain the dividend scale and absorb the related losses, careful consideration should be given to the benefits expected to accrue as a result of maintaining the scale, such as additional contract holder persistency. However, when profits on participating contracts issued by stock entities are restricted (see chapter 8, the stockholders' share of any loss is recognized).

## Auditing

**10.75** *Audit guidelines for a new life insurance entity or a new product type.* For all life insurance entities, only those acquisition expenses that are recoverable should be deferred and amortized. The auditor should pay special attention in testing recoverability of expenses to be deferred by new entities or in connection with new product types. The auditor should be satisfied that the entity or new product can retain a sufficient volume of business to recover such costs. (See chapter 8 for further discussion.)

**10.76** *Use of specialists.* Amortization calculations and the related recoverability testing can require complex and subjective estimates that may have a significant effect on the life insurance entity's financial statements. Because of the significance of these actuarially determined estimates, the use of an outside qualified actuary is required. (See chapter 5, "General Auditing Considerations," paragraphs 5.82–.88, for guidance on the use of actuaries.)

## Inherent Risk Factors

**10.77** As part of the auditor's assessment of inherent risks, the auditor may consider those factors related to commissions, general expenses, and DAC, including factors relating to management, commission processing, cost allocation, and expense management. Such factors might encompass the following:

- a.* Management's philosophy toward deferral and amortization of contract acquisition costs, evaluation of the kind of costs that are deferred, including product development costs, and tests for premium deficiencies are considered aggressive in comparison to the industry.
- b.* Management tends to change its philosophy toward the deferral and amortization of contract acquisition costs from year to year.
- c.* The life insurance entity has commission structures with varied tiers and complex formulas. Commission patterns are not predictable.
- d.* Products have features combining high commission payments and early cash value accumulations.
- e.* Commission rates are significantly above industry averages for similar products and distribution systems.
- f.* Regulatory restrictions on agent compensation and allowances and other acquisition costs may exist.
- g.* The entity has changed distribution methods or compensation and incentive arrangements with agents and brokers.
- h.* Agent and broker turnover is high or there are flexible policies with regard to advances to agents.
- i.* Requirements for licensing agents or other intermediaries are not adhered to or require changes in compensation contracts.
- j.* Experienced lapse or surrender rates are higher than assumed, causing potential premium deficiency and possible loss recognition situations.
- k.* For credit insurance lines, the entity has had rate increases disapproved by the state or demonstrates inability to obtain future rate increases, which may affect the recoverability of DAC balances.
- l.* The entity's DAC amortization methodology is not sensitive to changes in persistency.
- m.* Qualified actuaries are not used in the calculation of DAC balance, recoverability testing, loss recognition evaluation, or gross profit tests.
- n.* The entity markets universal life-type products with tiered interest rate structures, making gross profit calculations complex for amortization of DAC for those products.
- o.* The entity has a history of introducing new contracts where actual performance does not meet the original profit projections affecting the recoverability of DAC balances.

## Obtaining an Understanding of Internal Control for Commissions, General Expenses, and Deferred Acquisition Costs

**10.78** As part of obtaining an understanding of internal control related to commissions, general expenses, and DAC, the auditor might consider the following factors. An entity's internal control consists of five elements: the control environment, risk assessment, control activities, information and communication, and monitoring as described in paragraph .41 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). As discussed in chapter 5, the auditor should obtain a sufficient understanding of each of the five elements of the entity's internal control to assess the risks of material misstatement of the entity's financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

**10.79** Discussions of specific control procedures and the evaluation of the control environment regarding general expenses are not included in this guide because they are substantially the same as those that apply in any other industry.

### Control Environment

**10.80** The control environment, as related to commissions and DAC transactions of a life insurance entity, represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific control policies or procedures of the entity. Such factors that relate to commissions and DAC transactions include the following:

- a. There is a heavy reliance on third parties or agents for premium collection. Premiums submitted net of commissions are incomplete, or require additional analysis to be applied to individual agents, contracts, and proper accounts.
- b. A substantial increase in volume or level of backlog for premium, related commission, or both, transactions exists. The processing error rate is significant or increasing.
- c. Existing systems are inadequate to cope with changes in commission calculations or increases in business volume. There are inadequate interfaces with other key processing systems.
- d. New products have been introduced that require changes to the commission processing systems, or the degree of complexity of commission processing is increasing.
- e. The entity does not have accounting systems that provide sufficient detail to accurately identify deferrable costs, or the ability to allocate costs to groups of contracts or lines of business. Cost studies are not periodically performed to validate allocation methodologies.
- f. The entity does not have sophisticated cost allocation systems in place that allow year-to-year comparisons of acquisition costs and other expenses by appropriate contract groupings or by line of business.
- g. The entity does not have systems in place or other sophisticated calculation methodologies available to estimate expected gross profit

used to determine amortization for products accounted for under FASB ASC 944 (or gross margins for participating contracts).

- h.* There is excessive reliance on one individual for DAC calculations.

## Control Activities

**10.81** Control activities are those policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor should obtain an understanding of these control activities relevant to the audit.

**10.82** The following are examples of typical internal control procedures and policies relating to commissions and DAC transactions:

- a. Proper authorization of transactions and activities.* Written commission guidelines are in place assigning appropriate individuals the responsibility for the approval of compensation rates and the authority to approve the compensation rates used in product pricing and changes in the current rate structures. Procedures are in place for the approval of special compensation arrangements with agents or brokers, including monitoring for regulatory compliance.
- b. Segregation of duties.* Commission processing, premium billing and collection, accounting for advances to agents, key information systems functions, master file maintenance, and general accounting activities should be appropriately segregated. For example, independent reviews of the work performed may be conducted. Also, functions of issuing, authorizing, and signing checks may be separate from those involved in processing vendor invoices and maintaining accounts payable or commissions payable records.
- c. Design and use of adequate controls over documents and records.* There are procedures to ensure that fictitious or duplicate commission payments are not included in the records and to prevent or detect the omission of valid commission transactions. Supporting documents for expense transactions are canceled to ensure against duplicate payments. There are procedures in place to ensure that signed commission and expense checks are not returned to the preparer or originating area.
- d. Adequate safeguards over access to and use of assets and accounting records.* Data files and production programs have adequate safeguards against unauthorized access. Access to wire transfer codes is restricted to authorized personnel, and wire transfers are monitored for authorization.
- e. Independent checks on performance and proper valuation of recorded amounts.* There are procedures in place to ensure that commission registers, accounts payable, and cash disbursement registers are correctly summarized and accurately processed in the proper accounting period. There are procedures in place to ensure that correct commission accounts (for example, by contract type, agent, and first year or renewal) are credited, and appropriate rate schedules are used for the kind of contract and distribution system.

There are procedures in place to ensure the use of correct exchange rates for payments made in foreign currency. Account codes and the existence of supporting documentation are reviewed prior to expense payments.

Note that for an integrated audit performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, *PCAOB Standards and Related Rules*, Interim Standards]). Also refer to paragraph 54 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for a discussion on the extent of tests of controls (AICPA, *PCAOB Standards and Related Rules*, Interim Standards, AU sec. 319 par. .97).

## Information and Communication

**10.83** Paragraph .81 of AU section 314 states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report an entity's transactions (as well as events and conditions) and to maintain accountability for related assets, liabilities, and equity.

## Commissions and Allowances

**10.84** The flow of accounting records for commissions transactions includes all phases of agent and broker compensation and is closely related to the premium accounting cycle. (See chapter 7.) Agents and brokers are generally compensated for their services with commissions. General agents may receive allowances to reimburse them for all or part of their expenses incurred in generating business for the life insurance entity. Allowances are usually reported as general expenses; however, allowances that represent additional compensation to the agent may be reported as commissions.

**10.85** Life insurance entities usually enter contractual arrangements with agents and brokers that cover commission structures and rates, contract periods, and credit terms for settlement of agent advance accounts, vesting rights in future renewal commissions upon termination of contracts, and responsibility for premium collection. Contracts are generally standard; however, special contract arrangements may exist for certain agents or brokers.

**10.86** The commission rate structure generally depends on the products being marketed and the distribution system employed. Most life products with periodic premiums have large first year commissions (for example, 50 percent of first year premium) and renewal commissions at a reduced rate for a specified period or the life of the contract (for example, 10 percent in years 2–5 and 2 percent thereafter). Accident and health products generally have lower first year commission scales than life products. The commission structure may also include a persistency bonus or service fee, which depends on the renewal and persistency of an agent's book of business.

**10.87** When an agent or broker is authorized to write business for a life insurance entity, details of the commission contract are set up in the agent's records. When an insurance contract is sold, the appropriate information relating to the agent or broker is set up in the inforce master file and in the agent records. As premiums are received, the inforce master file and agent's record are updated to record commissions due and related persistency information. When the life insurance entity directly bills and collects the premiums, the related commissions are periodically paid to agents on premiums collected. If the agents are responsible for collecting the premiums, as in home service contracts, the agents submit premiums of commissions due to the insurance entity and the premiums and related commissions are recorded in the financial records. For statutory purposes, the uncollected agent's receivable on a policy-by-policy basis that is over 90 days due is classified as a nonadmitted asset. Amounts classified as nonadmitted assets collected subsequent to the date of the statutory financial statements should not be used to adjust the nonadmitted asset recorded at the financial statement date.

**10.88** In addition to commission payments, many life insurance entities make advances to new agents to supplement their commission income in the early years of their careers. Advances are generally made against future commissions and are intended to be repaid out of such future commissions. If the agent terminates his or her contract before the advances are repaid, he or she is obligated to repay the advances. In practice, all or part of the advances are often not collected, except to the extent that they can be offset against future commission payments that otherwise would have been paid to the terminating agent. Accordingly, all states require that agents' advances be classified as a nonadmitted asset for statutory purposes.

**10.89** Agents credit balances that include commissions and allowances incurred, but not yet paid, are recorded as liabilities on the balance sheet.

## General Expenses

**10.90** The flow of accounting records for most general expenses and tax transactions is typically the same as those found in other kinds of industries. However, the reporting process that requires the allocation of expenses to Annual Statement categories for statutory purposes, and to acquisition and maintenance expenses for U.S. GAAP purposes, is unique to insurance entities (described earlier in this chapter).

## Deferred Acquisition Costs

**10.91** The methods used to identify, record, and amortize DAC vary among life insurance entities from periodic cost studies using elementary work sheet methodologies to sophisticated cost allocation systems. Whatever the methodology employed, the inclusion of any expense amount as an acquisition cost requires considerable judgment. In making those judgments, due consideration should be given to reasonable conservatism,<sup>15</sup> maintaining consistency across contract types and between periods, and recoverability from future revenue. The auditor should examine the results of the methods used to identify, defer, and amortize acquisition costs to obtain satisfaction that the following steps have been taken:

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<sup>15</sup> See paragraph 10.15.



- a. Acquisition costs are properly identified, and vary with and are primarily related to the production of business regardless of the distribution system used. Variability is generally classified as linear, step variable, or semi variable, and may differ depending on the measurement base used to measure production (for example, per contract, per unit in force, per \$1,000 face value). Once variability is determined, evidence should exist to show that the costs relate to the production of business in the period the costs are incurred.
- b. Acquisition costs, as previously described, are identified or allocated to lines of business or other groupings of insurance contracts in the same manner that the life insurance entity acquires, services, and measures the profitability of its insurance contracts. This allocation is necessary to relate the costs to the related contract revenues or gross profits (or gross margins for participating contracts) for recoverability testing. In addition, U.S. GAAP amortization methodologies may differ by contract classification.
- c. The preceding two steps described produce factors or expense levels that can be compared with the expense assumptions used to set premium rates as one test of the reasonableness of allocation methodologies and deferral levels.

**10.92** Acquisition expenses actually incurred, as distinguished from expense levels assumed at issue, are used in the deferral and amortization calculations. However, as a practical matter, most actuarial techniques use estimates to calculate amounts deferred. Such estimates are generally made as part of the pricing process before the costs are actually incurred. It is not necessary to adjust such estimates to actual if they do not vary significantly from acquisition costs actually incurred. Regardless of the methodology used to defer and amortize costs, unamortized acquisition costs must be subject to recoverability and loss recognition testing.

## Audit Consideration Chart

**10.93** The auditor may consider the following specific audit objectives and examples of selected control and auditing procedures in auditing commission, general expense, and DAC balances and amortization transactions of life insurance entities. Control procedures and auditing procedures related to auditing general expenses are typically the same as those applied in audits of general expenses of other industries and, accordingly, are not included in the following examples of control and audit procedures.

**10.94** The audit consideration chart is intended to present examples only for areas that are unique to life insurance entities and is not all-inclusive for any category.

**Audit Consideration Chart—  
Commissions, General Expenses, and Deferred Acquisition Costs**

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Existence or Occurrence and Rights and Obligations</i>		
<u>Commissions</u>	<u>Commissions</u>	<u>Commissions</u>
Commissions and other contract related expenses and taxes relate to contracts issued or in force during the period.	Formal procedures and guidelines exist with respect to following:  <ol style="list-style-type: none"><li>1. Agent compensation contracts</li><li>2. Special compensation arrangements</li><li>3. Changes in commission rate structures</li><li>4. Contingent commission arrangements</li><li>5. Bonuses and awards</li><li>6. Expense reimbursement agreements</li><li>7. Compliance with regulatory restrictions, which is monitored by appropriate levels of management</li></ol>	Review agent compensation contracts, expense reimbursement agreements, and any other special compensation arrangements, as follows:  <ol style="list-style-type: none"><li>1. Test that commission payments are made in accordance with the related contract.</li><li>2. Test that expense reimbursements are in accordance with agreements and applicable state insurance law.</li><li>3. Review selected expense reports and supporting details submitted by agents.</li></ol>
	Procedures exist to ensure proper adjustments to commission accounts for contracts that are lapsed or canceled.	Test proper recording of agents' balances.
	Adjustments to commission records are approved by appropriate personnel.	Test canceled or lapsed contracts to ensure that commission records are properly adjusted on a timely basis.
	Commissions are only paid on receipt of premium or deposit.	
		<u>Taxes</u>
		Test coding of premium transactions to determine that premiums are allocated to the appropriate state for proper premium tax calculations.  Test calculations for selected transactions to ensure that appropriate state tax rates are used.

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<u>DAC and Other Expenses</u>	<u>DAC and Other Expenses</u>	<u>DAC and Other Expenses</u>
All general expenses recorded in the income statement are properly supported as charges against the entity and relate to the period under review.	Formal procedures or accounting systems exist to <ol style="list-style-type: none"> <li>1. identify expenses that meet the entity's criteria for deferral and</li> <li>2. appropriately allocate acquisition costs to contract groupings or lines of business.</li> </ol>	Review the current criteria and nature of contract acquisition costs deferred. Compare to prior periods for consistency and analyze effects of any accounting policy changes. Evaluate reasonableness and consistency of cost allocations to lines of business or contract types. Obtain explanations for unusual items.
Recorded DAC balances represent actual costs that meet the entity's criteria for deferral.	Changes in agents' contracts and reinsurance agreements that may affect commissions are reviewed for any adjustments that may be required in deferral calculations. Any related adjustments are approved by appropriate personnel.	Test contract master file data used to calculate DAC balances (for example, age, sex, contract type, payment mode, issue date, and current status of contract). Test that transactions are correctly recorded in the inforce files.
<i>Completeness</i>	<u>Commissions</u>	<u>Commissions</u>
All commission data and related payments are appropriately recorded and accumulated in the proper accounts and master file records. For statutory financial statements, all expenses incurred in the current period are included in the Statement of Operations.	Edit and validation controls, batch balancing, data transmission controls, logging, and cash totals are used to provide assurance that all transactions have been completely and accurately processed and recorded to the financial records.	Review reconciliations between commission register, premium register, general ledger, and master file data. Obtain explanations for any discrepancies or significant adjustments.
For U.S. GAAP financial statements, all expenses related to the current period's revenue are included in the income statement.	Suspense account balances are analyzed and reviewed for large, unusual, or old items by the appropriate personnel.	Test that commission data are correctly recorded in the appropriate individual agents' accounts.

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
All contract acquisition costs available for deferral are appropriately deferred, in accordance with the entity's accounting policies.	<p>Reconciliations are carried out between the following:</p> <ol style="list-style-type: none"><li>1. Commission register and premium register</li><li>2. Commission register and the general ledger</li><li>3. Commission register and commission payment listing, which are reviewed and approved by appropriate personnel</li></ol> <p>Proper cutoff is established to ensure commissions, allowances, and premium taxes are accrued for premiums collected at period end.</p>	<p>Test proper cutoff of commission register. Test clerical accuracy of commission payment amounts.</p> <p>Review commission suspense accounts for overall changes from period to period and for old or unusual items. Obtain explanations for significant items.</p> <p>Confirm selected amounts of commissions paid and balances unpaid as of a specific date, as appropriate.</p>
	<p><u>DAC and Other Expenses</u></p> <p>Systems exist to identify acquisition costs properly and are monitored by appropriate personnel.</p> <p>Reconciliations of expenses used in DAC calculations to total entity expenses are regularly prepared and reviewed by appropriate personnel.</p> <p>Estimated expenses used in DAC calculations are compared to actual expenses meeting the entity's deferral criteria on a routine basis. Significant differences or adjustments are approved by management.</p>	<p><u>DAC and Other Expenses</u></p> <p>Compare changes between periods for the following:</p> <ol style="list-style-type: none"><li>1. General expenses levels to premium income</li><li>2. Exhibit 2 categories as a percentage of total expense</li><li>3. General expenses accrued to total expense levels</li><li>4. Functional or departmental budgets or estimated expenses to actual expense</li></ol> <p>Review general ledger balances and test that all expenses meeting the criteria for deferral have been included in the DAC calculations. Obtain explanations for unusual items or discrepancies.</p> <p>Test the clerical accuracy of the accumulation of DAC and related amortization calculations.</p>

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Reinsurance expense allowances are reviewed and appropriately included in acquisition cost. Any adjustments are approved by appropriate personnel.	<p>Test adjustment of acquisition expenses for deferred premiums.</p> <p>Compare changes between periods in total and by component for the following:</p> <ol style="list-style-type: none"> <li>1. Composition of acquisition costs by expense category</li> <li>2. Allocation methodologies of acquisition costs and other expenses</li> <li>3. Ratio of DAC to premium revenue</li> <li>4. DAC per contract and per unit of insurance in force</li> <li>5. Grouping of lines of business</li> <li>6. Actual acquisition costs to budgeted amounts</li> <li>7. Actual to assumed experience for mortality, morbidity, persistency, expense levels, investment yields, or gross profit</li> <li>8. Acquisition costs to general insurance expenses</li> <li>9. Ratio of amortized DAC to DAC asset balance</li> <li>10. Loss ratios (historical and prospective) and results of operations for accident and health and credit contracts</li> <li>11. Amounts of unamortized DAC by contract grouping or cell used in amortization calculation</li> </ol>

*(continued)*

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Valuation or Allocation</i>		
<u>Commissions</u>	<u>Commissions</u>	<u>Commissions</u>
Commissions are correctly calculated in accordance with the entity's rate structure. All costs and expenses are stated in the income statement in the proper amount.	Commission rates and special compensation arrangements with agents or brokers are approved by appropriate levels of management.	Test agent or broker expense reimbursements to determine whether they are in accordance with agreements or contracts and the applicable state insurance laws. Review expense reports submitted by agents and supporting documentation.
DAC are included on the balance sheet at the appropriate amounts and are being amortized to the statement of operations in a manner that appropriately matches the revenues, or expected gross profits, as appropriate, generated by the related contracts in accordance with applicable accounting principles applied on a consistent basis.	Commission rates and agent statements are periodically tested for accuracy and agreement with the rate schedule or other written approval. Discrepancies are promptly resolved and reviewed by appropriate personnel.	Review detailed reconciliations of the amounts due to or from agents. Obtain explanations of any unusual, old, or disputed amounts.
	<u>DAC and Other Expenses</u>	<u>DAC and Other Expenses</u>
		As described in FASB ASC 944-30-35, check the allocation of the unamortized DAC prior to the internal replacement between the replaced contracts and contracts remaining in the original book of business, and then amortize appropriately.
Recorded DAC are appropriately deferred and recoverable from related contract revenues or expected gross profits, as appropriate.	Allocations of contract related expenses and acquisition costs, by line of business or contract type, are reviewed by appropriate personnel.	Review the recoverability of DAC by comparing U.S. GAAP net premium with gross premiums. For unfavorable results, review loss recognition studies by line of business or contract type for possible loss recognition situations.

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Periodic reconciliations are performed between actual costs incurred meeting the criteria for deferral and estimates used in calculating DAC balances.	Review studies comparing actual and projected experience (gross profits, mortality, morbidity, persistency, investment yields, and expenses) with those assumed for adverse deviation from the original assumptions that may indicate potential loss recognition situations.
	Deferral and amortization calculations are independently reviewed and approved by appropriate levels of management.	<p>For identified loss recognition situations, determine that DAC balances are appropriately reduced or that premium deficiency liabilities are accrued.</p> <p>For life insurance entities using a factor approach, perform the following:</p> <ol style="list-style-type: none"> <li>1. Review the entity's analysis of persistency, investment yields, mortality, morbidity, and expenses to test the reasonableness of DAC assumptions.</li> <li>2. Test that the assumptions used to develop DAC factors are consistent with those used for benefit liabilities and that the DAC factors are calculated in accordance with an appropriate methodology.</li> <li>3. Test the factor calculations and determine whether contracts are included in the proper DAC valuation cells to which the factors are applied.</li> </ol>

*(continued)*

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
		<div><div>4. For contracts or lines of business that have lapse experience that is substantially different from expected, test that the results of the entity's experience (or industry experience when industry studies are used) are used to develop DAC factors.</div><div>5. Review reconciliations of actual acquisition cost incurred and estimates used in expense assumptions.</div><div>For universal life-type contracts and investment contracts, perform the following:</div><div><div>1. Review the present value of expected future gross profit calculations in relation to present value of DAC balances to determine recoverability.</div><div>2. Compare the assumptions or original projections used to develop gross profit calculations with actual experience.</div><div>3. Test that interest rate assumptions are consistently applied.</div></div></div>



<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<p><i>Presentation and Disclosure</i></p> <p>Commissions, other contract and general expenses, DAC, and related amortization amounts are properly classified, described, and disclosed in the financial statements, including notes, in conformity with applicable accounting principles.</p> <p>This includes disclosure and review of the entity's accounting policy for internal replacements, including whether the entity has taken the practicability exception in FASB ASC 944-30-35-44.</p>	<p><u>General</u></p> <p>Formal management review policies and guidelines exist with respect to the following:</p> <ol style="list-style-type: none"> <li>1. Agent compensation contracts</li> <li>2. Contingent or nonstandard compensation arrangements</li> <li>3. Compliance with regulatory environment</li> <li>4. Expense reimbursement agreements</li> </ol> <p>Procedures for the calculation and amortization of DAC, including allowable kinds of cost and allocation methodologies, are reviewed and approved by appropriate levels of management.</p>	<p><u>General</u></p> <p>Test whether disclosures comply with GAAP or SAP as applicable.</p> <p>For statutory financial statements, test whether classifications and disclosures comply with applicable state regulations.</p> <p>Review finance committee minutes, agent compensation contracts, rate books, and contract forms to ascertain that deferral policies are appropriate and adequately disclosed and described.</p>

Exhibit 10-1

Accounting for Deferred Acquisition Costs<sup>16</sup>

As discussed earlier in this chapter, contract acquisition costs are deferred and charged against revenue in proportion to recorded premium revenue or estimated gross profits recognized as appropriate for the contract types. Examples of methods for amortizing such costs are set forth in the following section.

For short duration and certain long duration contracts, including limited payment-type contracts, costs are amortized in proportion to the premium revenues recognized. Some amortization techniques will tend to produce unacceptable results. For example, the amortization of costs on the basis of "average contract life," involving straight-line charge-off of a fixed sum per contract per year plus an immediate charge-off of the unamortized amounts related to terminated contracts, will not result in a reasonable association of expenses with related revenues.

Assume 1,000 contracts are issued with a total acquisition cost of \$60,000 and that the average contract life of the block of contracts is estimated at 3 years, so that \$20 per contract in force would be written off each year with the unamortized balances for each contract charged off for terminated contracts.

Under this approach amortization would occur as shown in the following table.

Year	Contracts in Force at the Beginning of the Year (1)	Terminations (2)	Contracts in Force at the End of the Year (3)	Annual Amortization for Contracts in Force (Col. 3 × \$20) (4)	Writeoff of Unamortized Balances on Termination (5)	Total Amortization (6)	Expected Premium Income (7)	Amortized as a Percentage of Premium (7) ÷ (6) (Percent) (8)
1	1,000	200	800	\$16,000	(a) \$12,000	\$28,000	\$100,000	28%
2	800	200	600	12,000	(b) 8,000	20,000	80,000	25%
3	600	200	400	8,000	(c) 4,000	12,000	60,000	20%
4	400	200	200	—	—	—	40,000	—
5	200	200	—	—	—	—	20,000	—
						\$60,000		

Legend:

- (a) 200 × \$60
- (b) 200 × \$40
- (c) 200 × \$20

Such a method does not result in amortizing costs in proportion to premium revenues. It is also inconsistent with the concept that the aggregate acquisition costs for each year's blocks of business are expected to be recovered from the aggregate premium revenue over the life of each block. Stated otherwise, the costs of each individual contract issued are not expected to be recovered from each individual contract's premium revenue because the original assumptions at issue anticipate that terminations will begin almost immediately with respect to any year's block of business.

<sup>16</sup> Examples of accounting for internal replacements are located in FASB ASC 944-30-55.

A more acceptable approach involves the use of an amortization schedule adopted for each major block of business or group of contracts in the year of issue. Amortization would be prescheduled to coincide with the expected premium revenue. The following tables illustrate amortization under this method. For simplicity, the first table illustrates amortization without regard to interest accruals on the unamortized deferred acquisition cost (DAC) balance. The second table reflects an actuarially sound amortization method and incorporates an interest accrual element on the unamortized DAC balance.

**DAC Amortization**  
**Without Interest Accruals on Unamortized Balances**

<i>Year</i>	<i>Premium Revenue (1)</i>	<i>Ratio of Annual to Total (2)</i>	<i>Prescheduled Amortiza- tion (3) (<math>\epsilon(3) \times (2)</math>)</i>	<i>Ratio of Amortiza- tion to Premiums (4) (<math>(3) \div (1)</math>)</i>
1	\$100,000	33.3%	\$20,000	20%
2	80,000	26.7%	16,000	20%
3	60,000	20.0%	12,000	20%
4	40,000	13.3%	8,000	20%
5	20,000	6.7%	4,000	20%
	<u>\$300,000</u>	<u>100.0%</u>	<u>\$60,000</u>	<u>20%</u>

DAC Amortization  
With Interest Accruals on Unamortized Balances

PREMIUM						DAC				
Year	Expected Premium Rate (1)	Interest Rate Assumption (2)	Present Value Factor (3)	Discounted Premium (4)	Amortization Factor (5)	Beginning DAC Balance (6)	Interest on Beginning DAC Balance (7)	Prescheduled DAC Amortization (8)	Prescheduled Ending Balance (9)	Ratio of Annual DAC to Total DAC (10)
1	100,000	6%	1.000	100,000	0.2156	60,000	3,600	22,853	40,747	33.3%
2	80,000	6%	0.943	75,471	0.2156	40,747	2,445	18,283	24,909	26.7%
3	60,000	6%	0.890	53,400	0.2156	24,909	1,494	13,712	12,691	20.0%
4	40,000	6%	0.840	33,585	0.2156	12,691	762	9,141	4,312	13.3%
5	20,000	6%	0.792	15,842	0.2156	4,312	259	4,571	0	6.7%
Total	300,000			278,298			8,560	68,560		

Legend:  
Column Formula

- (4) (1) × (3)
- (5) Beginning DAC ÷ Sum of (4) (60,000 ÷ 278,298 = 0.2156)
- (6) Prior Year (9)
- (7) (6) × (2)
- (8) [(1) × (5)] × [1 + (2)]
- (9) (6) + (7) - (8)
- (10) (8) ÷ Sum of (8)

This method results in amortizing costs in proportion to premium revenues (referred to as sum-of-the-premiums method). If actual persistency experience differs from expected, actual premium revenues will differ from those estimated (column 1). Accordingly, the amount of prescheduled amortization in any year will be disproportionate to premium revenues. The method can be modified so that annual or periodic adjustments are made to give effect to actual terminations. This technique may be impractical, however, as schedules would need revision for each year of issue and group of contracts.

An alternative method approximates the technique used in the determination of reserve valuation factors under the single-valuation reserve method. This method uses a *standard unamortized cost factor* or *expense reserve factor*, which is applied to the insurance in force at the end of each period. For simplicity, using the prescheduled amortization schedule (without regard to interest) from the previous example, the expense reserve factor is determined as shown in the following table.

<i>Year</i>	<i>Planned Amortization</i>	<i>Planned Unamortized Cost End of Year</i>	<i>Expected Insurance in Force End of Period (000)</i>	<i>Planned Unamortized Cost per M of Insurance In Force</i>
1	\$20,000	\$40,000	\$800	\$50
2	16,000	24,000	600	40
3	12,000	12,000	400	30
4	8,000	4,000	200	20
5	4,000	—	—	—
	<u>\$60,000</u>			

Assume that actual experience emerges as shown in the following table.

<i>Planned Amortization</i>				<i>Amortization</i>		
<i>Year</i>	<i>Actual Premium Revenue</i>	<i>In Force End of Period (000)</i>	<i>Cost per M of Insurance in Force</i>	<i>Unamortized Cost End of Period</i>	<i>Amount</i>	<i>Ratio of Premiums Collected (Percent)</i>
1	\$100,000	\$700	\$50	\$35,000	\$25,000	25%
2	70,000	600	40	24,000	11,000	16%
3	60,000	500	30	15,000	9,000	15%
4	50,000	300	20	6,000	9,000	18%
5	30,000	—	—	—	6,000	20%
	<u>\$310,000</u>				<u>\$60,000</u>	

Under this method, if persistency is higher or lower than assumed, the unamortized cost factors (or expense reserve factors) are multiplied by higher or lower in force amounts. Thus, the method tends to provide some degree of self-correction in that it causes the rate of amortization to increase or decrease as

actual persistency is lower or higher than initially estimated. If actual experience differs significantly from that assumed, the factors should be recomputed. To be fully consistent with actuarial concepts, the rate of amortization in this method should be refined to give effect not only to estimated persistency but also to the interest assumed in benefit reserve calculations. In the previous examples, an amount of \$20 per thousand would have to be included in the gross premium to recover first-year acquisition costs based on expected persistency. This may be determined as follows:

<i>Year</i>	<i>Policies Expected to Be in Force at Beginning of Each Year</i>
1	1,000
2	800
3	600
4	400
5	200
Total expected premium payments	3,000
Acquisition costs	60,000

Amount required per premium payment  $\$60,000 \div 3,000 = \$20$

This \$20 may be considered as the present value of expected future expense premiums. The expense premium actually calculated and charged should be increased by the time cost of the funds expended. An interest rate, which coincides with the basic interest assumption, is used to determine an annuity factor. This factor is used to determine the expense portion of the gross premium in the following tabulation.

<i>Year</i> <i>(1)</i>	<i>Expected in Force Beginning of Year</i> <i>(2)</i>	<i>Interest Rates (Percent)</i> <i>(3)</i>	<i>Present Value Factor</i> <i>(4)</i>	<i>Present Value of 1 (Due at the Beginning of Each Year) at the Beginning of Year 1</i> <i>(2) × (4)</i> <i>(5)</i>
1	1.0	.06	1.000	1.000
2	.8	.06	.943	.755
3	.6	.06	.890	.534
4	.4	.06	.840	.336
5	.2	.06	.792	.158
				2.783

The annuity present value factor for the premium paying period is 2.783. By dividing this factor into the initial acquisition cost of \$60 per policy, an interest adjusted expense premium of \$21.56 is computed. In other words, the total of \$21.56 paid at the beginning of each year by the expected in force is equivalent to \$60 at the time of issuance of the policy plus interest thereon at the assumed

rates for the collection period indicated. This example demonstrates how premiums are theoretically determined and the basis upon which the expense portion of a single valuation premium factor would be determined. Any *work sheet* approach to amortization should be based on the fact that interest affects the rate of recovery of costs. This is a refinement of the previous example and results in a work sheet determination of an expense reserve factor that would be identical to the expense portion of the single reserve valuation factor.

The following tabulation summarizes this method.

<i>Year</i>	<i>Expected in Force Begin- ning of Year (1)</i>	<i>Interest Rate (Percent) (2)</i>	<i>Unamor- tized Cost Begin- ning of Year (3)</i>	<i>Expense Premium Payment <math>\\$21.56 \times (1)</math> (4)</i>	<i>Interest <math>[(3)-(4)] \times 2</math> (5)</i>	<i>Cost (4)-(5) (6)</i>	<i>Unamor- tized Cost End of Period (3)-(6) (7)</i>	<i>Per In Force At End of Year (8)</i>
1	1.0	6%	\$60.00	\$21.56	\$2.31	\$19.25	\$40.75	\$50.93
2	.8	6%	40.75	17.25	1.41	15.84	24.91	41.51
3	.6	6%	24.91	12.94	.72	12.22	12.69	31.73
4	.4	6%	12.69	8.62	.24	8.38	4.31	21.55
5	.2	6%	4.31	4.31	—	<u>4.31</u>	—	—
						\$60.00		

The factors shown in column 8 would be applied to the insurance in force at the end of each year in the manner shown in the previous example. If amortization is determined by this method, a result is produced that is identical to the result that would be produced by a single reserve valuation factor used to determine a single sum representing the aggregate amount of policy benefits and unamortized acquisition costs.

**Exhibit 10-2****Computation of Estimated Gross Profit***Illustration of Accounting for Capitalized Acquisition Costs for Universal Life-Type Contracts*

Schedules 1–3 from the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944-30-55 are reprinted in this exhibit to illustrate the accounting for capitalized acquisition costs incurred in connection with a portfolio or book of universal life-type contracts, projected over a 20-year period. The exhibits display the computations involved in (a) amortizing that amount as gross profits and surrender charges are realized, and one (b) revising estimates of gross profit expected to be realized. During year 1, actual experience is assumed to be the same as management's estimate. During year 2, 20 percent of policyholders surrender their contracts. Management's original estimate was that 12 percent of policyholders would surrender their contracts in year 2. Interest is credited to policyholder balances at 9 percent.

***Illustration of Computation of Gross Margins for Long-Duration Participating Contracts***

Schedules 1–3 from FASB ASC 944-30-55 are reprinted in this exhibit to illustrate the accounting for capitalized acquisition costs incurred in connection with a portfolio or book of participating contracts, projected over a 55-year period. The exhibits display the computations involved in (a) amortizing that amount as gross profits and surrender charges are realized, and (b) revising estimates of gross profit expected to be realized. During year 1, actual experience is assumed to be the same as management's estimate. During year 2, 20 percent of policyholders surrender their contracts. Management's original estimate was that 12 percent of policyholders would surrender their contracts in year 2. Interest is credited to policyholder balances at 9 percent.



**FASB ASC 944-30-55-4**  
**Schedule 1—Computation of Estimated Gross Profit**

Year	Surrender Charges	Mortality Assessments	Mortality Cost Incurred	Expense Assessments	Recurring Expenses Incurred	Investment Income		Interest Credited to Policy Balances	Estimated Gross Profit	Revised Gross Profit at Year 2
						Related to Policy Balances				
1	(a) \$13,298	(b) \$17,300	(c) \$(3,685)	(d) \$11,700	(e) \$(12,176)	(f) \$6,405		(g) \$(5,490)	\$27,352	\$27,352
2	13,169	15,099	(3,541)	9,356	(9,669)	10,571		(9,061)	25,924	34,637
3	7,314	14,104	(3,627)	8,229	(8,476)	14,436		(12,374)	19,606	17,822
4	4,656	13,604	(3,866)	7,566	(7,781)	18,356		(15,734)	16,801	15,273
5	3,645	13,199	(4,107)	7,108	(7,309)	22,405		(19,204)	15,737	14,304
6	2,739	12,791	(4,330)	6,676	(6,866)	26,286		(22,531)	14,765	13,422
7	1,929	12,950	(4,513)	6,270	(6,449)	29,957		(25,677)	14,467	13,151
8	1,208	12,905	(4,690)	5,888	(6,057)	33,447		(28,669)	14,032	12,756
9	567	12,755	(4,865)	5,529	(5,688)	36,779		(31,525)	13,552	12,320
10	0	12,593	(5,003)	5,191	(5,340)	39,965		(34,256)	13,150	11,954
11-20	0	108,164	(55,512)	37,183	(38,270)	551,879		(473,039)	130,405	118,543
21-50	0	140,607	(88,883)	32,577	(33,712)	2,618,726		(2,244,632)	424,743	386,112
Total	\$48,525	\$386,071	\$(186,572)	\$143,273	\$(147,793)	\$3,409,212		\$(2,922,182)	\$730,534	\$677,646
Present Value									\$180,944	\$176,087

Legend:

- (a) Surrender charges realized on termination of contracts.  
(b) Amounts assessed against policyholder balances for mortality coverage.  
(c) Benefit claims less the amount in the related policyholder balances.  
(d) Amounts assessed against policyholder balances for contract administration on either a percentage or a fixed amount per contract basis.  
(e) Recurring expenses not included in capitalized acquisition costs.  
(f) Investment income earned on policyholder deposits, computed by multiplying policyholder balances by the expected asset earning rate of 10.5 percent.  
(g) Interest that is accrued to contract holder account balances at the expected crediting rate of 9 percent.

FASB ASC 944-30-55-5  
Schedule 2—Computation of Amortization Rate

Present value of estimated gross profit, years 1 to 50 (from Schedule One)	(x)	<u>\$180,944</u>	<u>\$176,087</u>
Present value of capitalized acquisition costs	(y)	<u>\$90,986</u>	<u>\$90,986</u>
Amortization rate = (y) ÷ (x)	(z)	<u>50.284%</u>	<u>51.671%</u>

**FASB ASC 944-30-55-6**  
**Schedule 3—Illustration of Amortization**

	<i>Original Estimate</i>	<i>Revised Estimate</i>
Capitalized costs, year one	\$77,780	\$77,780
Interest accrual at 9 percent	7,000	7,000
Amortization, year one Gross profit of \$27,352 (from Schedule One) at rate (z) above	(13,754)	(14,133)
Balance, end of year one	71,026	70,647
Additional capitalized costs, year two	14,394	14,394
	85,420	85,041
Interest accrual at 9 percent	7,688	7,654
Amortization, year two Gross profit of \$34,637 (from Schedule 1) at 51.671% (revised rate from Schedule 2)	(17,897)	(17,897)
	<u>\$75,211</u>	<u>\$74,798</u>
Balance based on Original Estimate	\$75,211	
Balance based on Revised Estimate	<u>74,798</u>	
Adjustment required	<u>\$(413)</u>	
Net amortization recognized		
In year one	<u>\$6,754</u>	
In year two	<u>\$10,622</u>	

FASB ASC 944-30-55-8: Illustration of Computation of Gross Margins  
Schedule 1—Computation of Estimated Gross Margins

Year	Premium (a)	Interest on NLPR (b)	Interest on Current Activity (c)	Death Benefits Incurred (d)	Surrender Benefits Incurred (e)	Recurring Expenses Incurred (f)	Decrease in NLPR (g)	Dividends Incurred (h)	Postdividend Gross Margins	Revised Gross Profit at Year 2
1	\$210,000	\$0	\$16,244	\$(9,000)	\$0	\$(18,900)	\$(126,103)	\$(18,857)	\$53,384	\$53,384
2	184,611	10,719	14,280	(10,549)	0	(16,615)	(109,116)	(21,399)	51,931	50,546
3	169,621	19,994	13,120	(13,731)	(7,148)	(15,266)	(93,669)	(24,230)	48,691	47,419
4	155,763	27,955	12,048	(14,835)	(14,984)	(14,019)	(79,754)	(26,574)	45,600	44,432
5	142,990	34,735	11,060	(15,661)	(21,760)	(12,869)	(67,117)	(28,509)	42,869	41,797
6	131,222	40,440	10,150	(15,622)	(17,237)	(11,810)	(73,236)	(30,043)	33,864	32,880
7	124,333	46,665	9,617	(16,578)	(20,989)	(11,190)	(66,499)	(32,301)	33,058	32,126
8	117,768	52,317	9,109	(16,824)	(24,427)	(10,599)	(60,005)	(34,367)	32,972	32,089
9	111,526	57,417	8,627	(17,526)	(27,566)	(10,037)	(53,706)	(36,230)	32,505	31,669
10	105,582	61,982	8,167	(18,603)	(30,406)	(9,502)	(47,485)	(37,915)	31,820	31,028
11–20	779,517	760,283	60,296	(311,112)	(398,831)	(70,157)	(162,077)	(424,092)	233,827	227,980
21–55	589,392	1,222,685	45,589	(1,187,632)	(686,079)	(53,041)	938,767	(669,668)	200,013	195,591
Total	\$2,822,325	\$2,335,192	\$218,307	\$(1,647,673)	\$(1,249,427)	\$(254,005)	\$0	\$(1,384,185)	\$840,534	\$820,941

Present values at an earned rate of 8.5%:

Legend:

- (a) Gross premiums.
- (b) Interest, at 8.5 percent earned rate, on net level premium reserve (NLPR) at the end of the previous year. The NLPR is based on guaranteed mortality and the dividend fund interest rate.
- (c) Interest, at the 8.5 percent earned rate, on current-year cash flow. This illustration assumes premiums are received, and all expenses incurred, at the start of the year. This illustration assumes death benefits, surrender benefits, and dividends are all at the end of the year.
- (d) Death benefits, not reduced by related NLPR.
- (e) Surrender benefits, not reduced by related NLPR.
- (f) Recurring expenses not included in capitalized acquisition costs.
- (g) Net decrease (increase) in aggregate NLPR in the year.
- (h) Policyholder dividends for the year.
- (i) Sum of (a)–(h) inclusive.

**FASB ASC 944-30-55-9: Illustration of Computation of Gross Margin  
Schedule 2—Computation of Amortization Rate**

		<i>Original Estimate</i>	<i>Revised Estimate</i>
Present value of estimated gross profit, years 1–55 (from Schedule 1)	(a)	<u>\$371,261</u>	<u>\$362,945</u>
Present value of capitalized acquisition costs, years 1–55, evaluated at issue	(b)	<u>\$263,309</u>	<u>\$263,309</u>
Amortization rate = (b) ÷ (a)	(c)	<u>70.923%</u>	<u>72.548%</u>

FASB ASC 944-30-55-10  
Schedule 3—Illustration of Amortization

	<i>Original Estimate</i>	<i>Revised Estimate</i>
Capitalized costs, year 1	\$241,500	\$241,500
Interest accrual at 8.5% (d)	20,528	20,528
Amortization, year 1		
Gross profit of \$53,384 (from Schedule 1) at rate (c) above (e)	(37,862)	(38,729)
Balance, end of year 1 (f)	224,166	223,299
Additional capitalized costs, year 2	9,231	9,231
	233,397	232,530
Interest accrual at 8.5% (g)	19,839	19,765
Amortization, year 2		
Gross margin of \$50,546 (from Schedule 1, revised column) at (revised rate (c) above) (h)	(36,670)	(36,670)
Balance, end of year 2	\$216,566	\$215,625
Balance based on original estimate	\$216,566	
Balance based on revised estimate	215,625	
Adjustment required	\$(941)	
Net amortization recognized		
In year 1 (d + e)	\$17,334	
In year 2 (g + h based on revised estimates + difference between (f) at original estimate and at revised estimate)	\$17,772	

## Chapter 11

### *Investments*

**Note:** This chapter contains references to both financial and nonfinancial assets and liabilities that are subject to fair value measurement. As noted in chapter 3, "Sources of Accounting Principles and Reporting Requirements"; Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820-10; and FASB ASC 825-10, have significant implications for the concept of fair value. Please refer to chapter 3, beginning at paragraph 3.31, for further information.

### Introduction

**11.01** The investment operations of life and health insurance entities are an integral part of their overall operations. Life and health insurance entities collect premiums from contract holders, primarily for protection against untimely death, disability, or illness, and invest the funds until benefit payments are due. Premium rates, contract benefit liabilities, and certain contract features (such as credited interest rates on interest sensitive products) are determined based on specific assumptions regarding the use of investable funds and rates of return earned on those funds. Differences in the assumed yields on investable funds and actual yields have a significant effect on life insurance entities' profits or losses.

**11.02** Recognizing the importance of managing investment risks, life insurance entities plan their investment strategies to complement the cash flow requirements of their insurance businesses. Funds are invested with the intent that the income from investments, plus proceeds from maturities, will meet the ongoing cash flow needs of the life insurance entity. This approach of matching asset and liability durations and yields requires an appropriate mix of long term and short term investments and is generally referred to as *asset-liability management*.

**11.03** A typical life insurance entity's portfolio consists of debt securities, equity securities, mortgage and other loans, real estate investments, contract loans, and, to a lesser degree, derivative instruments. Most life insurance entities have separate investment departments responsible for investable funds; however, they may also use outside advisers or portfolio managers. The evaluation and subsequent acquisition and disposition of investments are based on the judgment of the life insurance entity's investment and finance committees. Typically, the finance committee, which usually consists of top level management and members of the board of directors or trustees, is responsible for authorizing and monitoring all investment activity. An investment committee of the entity's investment department typically evaluates investment transactions and recommends actions to the finance committee for approval. The evaluation of investments includes consideration of the life insurance entity's internal investment strategies, profitability goals, current and projected cash flow needs, regulatory requirements, and tax considerations as well as

external factors, such as market conditions, risk-reward relationships, interest rates, and hedging opportunities. Although some entities may not have a formal finance committee or investment committee, certain individuals at the entity will be responsible for carrying out similar duties as a finance or investment committee.

## Regulation

**11.04** Because life insurance entities have a fiduciary responsibility to meet their obligations to contract holders, state insurance statutes and regulations prescribe standards and limitations on investment activities and set requirements relating to the location and safeguarding of invested assets. Regulatory requirements and restrictions vary from state to state. However, most state statutes and accompanying regulations define the kinds of investments life insurance entities are permitted to make, limit the amount of investments in each kind of investment and in any one issuer, and establish requirements for valuing admitted assets in the statutory financial statements.

**11.05** Limitations on assets can be both quantitative and qualitative. Quantitative limitations are those that pertain to the total holdings of any kind of investment relative to some independent variable, such as total admitted assets or unassigned surplus. For example, a life insurance entity cannot have more than 5 percent of its invested assets in any one entity. Qualitative limitations are those such as earnings history, minimum capital, or financial rating that pertain to the economic condition of the investee.

**11.06** Investments not qualifying as admitted assets attributable to qualitative or quantitative limitations, or not specifically authorized by state insurance laws, are commonly permitted by state codes under a basket clause or provision. Generally, the amounts of otherwise nonadmitted assets permitted by the basket provisions are limited to an amount defined as a function of admitted assets, or surplus, or both.

**11.07** The National Association of Insurance Commissioners (NAIC) issued two Model Investment Laws. One law (Defined Limits Version) provides guidelines for insurers to follow regarding investment limitations and the other (Defined Standards Version) provides guidelines concerning investment standards. Some states may have adopted one of the NAIC Model Investment Laws. Therefore, state insurance laws and regulations have varying investment restrictions and limitations. The regulations of the state of domicile generally have precedence. However, several states, such as New York, have substantial compliance provisions that must also be followed by any life insurance entity authorized to write business in that state.

## Accounting Practices\*

**11.08** As discussed in chapter 3, life insurance entities are subject to the filing requirements of statutory accounting practices (SAP) and may also

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\* The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have a joint project on accounting for financial instruments. The objective of this project is to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The project will replace FASB and the IASB's respective financial instruments standards with a common standard. The boards believe that simplification of the accounting requirements for financial instruments should be an outcome of this improvement.

(continued)



prepare financial statements in accordance with U.S. generally accepted accounting principles (GAAP). The following discussion of SAP and U.S. GAAP accounting for invested assets is not a comprehensive source of authoritative accounting literature, but is intended to assist the preparers and auditors of financial statements in obtaining a general understanding of basic investment accounting practices for the most common classes of invested assets within the life insurance industry. The authoritative sources cited in chapter 3 may be referred to in determining appropriate accounting and reporting treatment in all cases.

## Security Investments

### Debt Securities

**11.09** Debt securities are obligations issued by business entities, governmental entities, and certain not-for-profit entities that have a fixed schedule for one or more future payments of money at specified future dates. Debt securities may include U.S. Treasury obligations, government or municipal bonds (direct obligations of any state, territory, possession, or local government unit), bonds (including commercial paper), and negotiable certificates of deposit. Additionally, Statement of Statutory Accounting Principles (SSAP) No. 26, *Bonds, excluding Loan-backed and Structured Securities*, paragraph 2, states that the definition of bonds includes Exchange Traded Funds that qualify for bond treatment and Class 1 Bond Mutual Funds, as identified in the NAIC Purposes and Procedures of the Securities Valuation Office (SVO). Some other investments that may be classified as debt securities include redeemable preferred stock, guaranteed investment contracts (GICs), and asset backed securities, such as collateralized mortgage obligations (CMOs), mortgage participation certificates, credit tenant mortgages, interest only (IO) and principal only (PO) certificates, and equipment trust certificates. Such investments may be public issues or private placements. Debt securities are purchased at a discount, a premium, or par value and generate interest income to the holder. Their sale may result in a realized gain or loss.

**11.10** *U.S. generally accepted accounting principles.* Under U.S. GAAP, investments in debt securities (including redeemable preferred stocks) are classified at acquisition into one of three categories, as prescribed by FASB ASC 320-10-25-1 and accounted for as follows as discussed in FASB ASC 320-10-35-1:

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(footnote continued)

On May 26, 2010, FASB issued the proposed Accounting Standards Update (ASU) *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. The comment period ended on September 30, 2010.

On February 9, 2011, FASB issued the discussion paper *Invitation to Comment—Selected Issues about Hedge Accounting (Including IASB Exposure Draft, Hedge Accounting)* to solicit input on the IASB's exposure draft *Hedge Accounting*, in order to improve, simplify, and converge the financial reporting requirements for hedging activities. The comment period ended April 25, 2011. On January 31, 2011, FASB and the IASB proposed a common solution for impairment accounting: the supplementary document *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Impairment*. The comment period ended April 1, 2011.

The boards continue to develop a comprehensive model for accounting for financial instruments, including hedge accounting. The boards plan to deliberate certain issues relevant to this project separately and then meet subsequently to reconcile differences in their technical decisions.

- a. *Trading securities.* Investments in debt securities that are classified as trading and equity securities that have readily determinable fair values that are classified as trading shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for trading securities shall be included in earnings.
- b. *Available-for-sale securities.* Investments in debt securities that are classified as available for sale and equity securities that have readily determinable fair values that are classified as available for sale shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge, pursuant to paragraphs 1–4 of FASB ASC 815-25-35.
- c. *Held-to-maturity securities.* Investments in debt securities classified as held to maturity shall be measured subsequently at amortized cost in the statement of financial position. A transaction gain or loss on a held-to-maturity foreign-currency-denominated debt security shall be accounted for pursuant to FASB ASC 830-20.

FASB ASC 320-10-25-3 states that amortized cost is relevant only if a security is actually held-to-maturity. The use of the held-to-maturity category is restrictive because the use of amortized cost must be justified for each investment in a debt security. At acquisition, an entity shall determine if it has the positive intent and ability to hold a security to maturity, which is distinct from the mere absence of an intent to sell. If management's intention to hold a debt security to maturity is uncertain, it is not appropriate to carry that investment at amortized cost. In establishing intent, an entity shall consider pertinent historical experience, such as sales and transfers of debt securities classified as held-to-maturity. A pattern of sales or transfers of those securities is inconsistent with an expressed current intent to hold similar debt securities to maturity.

FASB ASC 320-10-25-5(a) states that a security may not be classified as held-to-maturity if that security can contractually be prepaid or otherwise settled in such a way that the holder of the security would not recover substantially all of its recorded investment. A debt security with these characteristics should be evaluated in accordance with FASB ASC 815-15 to determine whether it contains an embedded derivative that must be accounted for separately.<sup>1</sup>

**11.11** Amortization of premium or discount is calculated using the interest method, which results in a constant effective yield, typically using the

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<sup>1</sup> For further information, see paragraph 11.51.

contractual maturity date in accordance with FASB ASC 310-20. The prepayment method, as described in FASB ASC 310-20-35-26, may also be used, particularly for asset backed securities such as CMOs, IO, and PO certificates. Amortization calculations may require the use of estimates, such as prepayment assumptions on CMOs or interest and return of investment allocations on IO and PO certificates. The current year's amortization or accretion is recorded as a charge or credit to interest income. FASB ASC 320, *Investments—Debt and Equity Securities*, provides guidance on accounting and reporting for all investments in debt securities. FASB ASC 310-20 provides guidance on the application of the interest method and other amortization matters. FASB ASC 325, *Investments—Other*, provides guidance on the recognition of interest income and impairment on purchased and beneficial interests that continue to be held by a transferor in securitized financial assets. FASB ASC 310-30 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes such loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. The guidance does not apply to loans originated by the entity or loans purchased that do not show evidence of credit quality deterioration where the acquirer does not expect to collect all contractual cash flows. For further discussion of FASB ASC 310-20 and FASB ASC 310-30, see the section "Mortgage Loans."

**11.12** Interest and dividend income, including amortization of premium and discount, are included in earnings, for all three categories of investments under FASB ASC 320.

**11.13** As a result of inquiries and comments by Securities and Exchange Commission (SEC) registrants and their auditors, the SEC staff made an announcement regarding the effects of FASB ASC 320-10 on certain assets and liabilities. The FASB staff believes that both public and nonpublic entities should comply with the guidance in this announcement. FASB ASC 320-10 provides guidance on the reporting of unrealized gains or losses. The text of this announcement is as follows and is also located at FASB ASC 320-10-S99-2 for reference.

- The SEC staff has been asked whether certain assets and liabilities, such as noncontrolling interests, certain life insurance policyholder liabilities, deferred acquisition costs, and intangible assets arising from insurance contracts acquired in business combinations, should be adjusted with a corresponding adjustment to other comprehensive income at the same time unrealized holding gains and losses from securities classified as available-for-sale are recognized in other comprehensive income. That is, should the carrying value of these assets and liabilities be adjusted to the amount that would have been reported had unrealized gains and losses been realized?
- Paragraph 11b of FASB ASC 740-20-45 addresses specifically the classification of the deferred tax effects of unrealized holding gains and losses reported in other comprehensive income. Paragraph 11b of FASB ASC 740-20-45 requires that the tax effects of those gains and losses be reported as charges or credits directly to

other comprehensive income. That is, the recognition of unrealized holding gains and losses in equity may create temporary differences for which deferred taxes would be recognized, the effect of which would be reported in accumulated other comprehensive income along with the related unrealized holding gains and losses. Therefore, deferred tax assets and liabilities are required to be recognized for the temporary differences relating to unrealized holding gains and losses as though those gains and losses actually had been realized, except the corresponding charges or credits are reported in other comprehensive income rather than as charges or credits to income in the statement of income.

- By analogy to paragraph 11b of FASB ASC 740-20-45, the SEC staff believes that, in addition to adjusting deferred tax assets and liabilities, registrants should adjust other assets and liabilities that would have been adjusted if the unrealized holding gains and losses from securities classified as available-for-sale actually had been realized. That is, to the extent that unrealized holding gains or losses from securities classified as available-for-sale would result in adjustments of noncontrolling interest, policyholder liabilities, deferred acquisition costs that are amortized using the gross-profits method, or intangible assets arising from insurance contracts acquired in business combinations that are amortized using the gross-profits method had those gains or losses actually been realized, the SEC staff believes that those balance sheet amounts should be adjusted with corresponding credits or charges reported directly to other comprehensive income. As a practical matter, the staff, at this time, would not extend those adjustments to other accounts such as liabilities for compensation to employees. The adjustments to asset accounts should be accomplished by way of valuation allowances that would be adjusted at subsequent balance sheet dates.
- For example, certain policyholder liabilities should be adjusted to the extent that liabilities exist for insurance policies that, by contract, credit or charge the policyholders for either a portion or all of the realized gains or losses of specific securities classified as available-for-sale. Further, asset amounts that are amortized using the gross-profits method, such as deferred acquisition costs accounted for under paragraph 4 of FASB ASC 944-30-35 and certain intangible assets arising from insurance contracts acquired in business combinations, should be adjusted to reflect the effects that would have been recognized had the unrealized holding gains and losses actually been realized. Further, capitalized acquisition costs associated with insurance contracts covered by paragraph 4 of FASB ASC 944-30-35 should not be adjusted for an unrealized holding gain or loss unless a "premium deficiency" would have resulted had the gain or loss actually been realized.
- This announcement should not affect reported net income. It addresses only the adjustment of certain assets and liabilities and the reporting of unrealized holding gains and losses from securities classified as available-for-sale.

**11.14** *Statutory accounting practices.*<sup>†</sup> Under SAP, qualifying debt securities are subject to the valuation standards of the NAIC, as described in the NAIC's Purposes and Procedures Manual of the NAIC SVO. For reporting entities that maintain an asset valuation reserve (AVR), debt securities should be carried at amortized cost, except for those with an NAIC designation of 6, which should be reported at the lower of amortized cost or fair value. As with U.S. GAAP, amortization or accretion under SAP is calculated by the interest method. As discussed in paragraph 6 of SSAP No. 26, amortization of bond premium or discount should be calculated using the scientific (constant yield) interest method taking into consideration specified interest and principal provisions over the life of the bond. Bonds containing call provisions (where the issue can be called away from the reporting entity at the issuer's discretion) should be amortized to the call or maturity value/date which produces the lowest asset value (yield to worst). An acquisition or disposal of a debt security should be recorded on the trade date, except for private placement bonds that should be recorded on the funding date.

**11.15** As noted in paragraphs 9–10 of SSAP No. 26:

An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of a debt security in effect at the time of acquisition. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a security prior to its maturity at an amount below carrying value. If it is determined that a decline in fair value of a bond is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the bonds carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7, *Asset Valuation Reserve and Interest Maintenance Reserve*. Credit related other-than-temporary impairment losses shall be recorded through AVR; interest related other-than-temporary impairments shall be recorded through IMR.

In periods subsequent to the recognition of an other-than-temporary impairment loss for a bond, the reporting entity shall account for the other-than-temporary impaired security as if the security had been purchased at the measurement date of the other-than-temporary impairment. The fair value of the bond on the measurement date shall become the new cost basis of the bond and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future

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<sup>†</sup> In June 2007, the National Association of Insurance Commissioners (NAIC) Emerging Accounting Issues Working Group finalized Interpretation No. 07-01, *Application of the Scientific (constant yield) Method in Situations of Reverse Amortization*. The interpretation reached decisions on accounting for reverse amortization for loan backed or structured securities, securities purchased at discounts and premiums and mortgage backed securities purchased at small premiums.

estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

**11.16** As noted in paragraph 10 of SSAP No. 26, "Interest income for any period consists of interest collected during the period, the change in the due and accrued interest between the beginning and end of the period as well as reductions for premium amortization and interest paid on acquisition of bonds, and the addition of discount accrual." Interest income determined to be uncollectible should be written off through the summary of operations, and an evaluation should be made to determine nonadmitted amounts (see chapter 14, "Other Assets and Liabilities, Surplus Notes, Separate Accounts, Insurance Related Assessments, and Equity—Contract Holders' Surplus"). Insurers are required to submit newly acquired unlisted securities, not subject to the provisional exemption filing rule, to the NAIC SVO for valuation. Under the provisional exemption rule, an insurer determines if a security is eligible for exemption based upon a three part test. If the insurer claims the security is eligible, it may list the security on the statutory investment schedule as an NAIC 1 or 2 with a PE symbol.<sup>‡</sup>

**11.17** Paragraph 15 of SSAP No. 32, *Investments in Preferred Stock (including investments in preferred stock of subsidiary, controlled, or affiliated entities)*, states that redeemable preferred stock should be classified into six quality categories (designations RP1–RP6) in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. As noted in paragraph 16 of SSAP No. 32, "Preferred stock shall be valued based on (a) the underlying characteristics of the security, (b) the quality rating of the security as defined in the NAIC *Purposes and Procedures of the Securities Valuation Office* (Purposes and Procedures of the SVO) and assigned in the NAIC *Valuations of Securities* product, and (c) whether an AVR is maintained by the reporting entity." For reporting entities that maintain an AVR, redeemable preferred stocks designated highest quality, high quality and medium quality (NAIC designations RP1–RP3) should be reported at book value; redeemable preferred stocks that are designated low quality, lowest quality and in or near default (NAIC designations RP4–RP6) should be reported at the lower of book value or fair value. For reporting entities that do not maintain an AVR, redeemable preferred stocks designated RP1–RP2 should be reported at book value; redeemable preferred stocks that are designated RP3–RP6 should be reported at the lower of book value or fair value. Paragraph 17 of SSAP No. 32 states that for reporting entities required to maintain an AVR, the accounting for unrealized gains and losses should be in accordance with SSAP No. 7, *Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an AVR, unrealized gains and losses should be recorded as a direct credit or charge to unassigned funds (surplus).

**11.18** As further noted in SSAP No. 32 paragraph 18, for reporting entities that do not maintain an AVR "Highest-quality or high-quality redeemable

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<sup>‡</sup> The NAIC is currently discussing modifications to the provisional exemption rule. There is now a process that exempts certain securities rated by nationally recognized statistical rating organizations from filing with the NAIC Securities Valuation Office. Additionally, there are discussions in process to allow authorized entities to self-rate nonrated securities. The NAIC Valuation of Securities Task Force issued a proposed revision to the Securities Valuation Office manual addressing the methodology for self rating. Readers should be alert to new developments.

preferred stock (NAIC designations 1–2) which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (with NAIC designations 3–6) shall be reported at the lower of cost, amortized cost or fair value." See SSAP No. 32, SSAP No. 99, and paragraphs 11.42–46 of this guide for impairment guidance.

**11.19** Guidance for accounting for loan backed and structured securities, including CMOs, is provided in SSAP No. 43R, *Loan-backed and Structured Settlements*,<sup>2,||</sup> the NAIC's *Purposes and Procedures of the Securities Valuation Office* manual, and the designation assigned in the NAIC *Valuations of Securities* product prepared by the NAIC SVO. At purchase, loan-backed and structured securities are recorded at cost, including brokerage and related fees, but not at an amount in excess of fair value. Discount or premium is recorded for the difference between the purchase price and the principal amount. The discount or premium is amortized using the interest method and is recorded as an adjustment to investment income. The interest method results in the recognition of a constant rate of return on the investment equal to the prevailing rate at the time of purchase or at the time of subsequent adjustments of book value. Paragraph 12 of SSAP No. 43R states that prepayments are a significant variable element in the cash flow of loan backed securities because they affect the yield and determine the expected maturity against which the yield is evaluated. As noted in paragraphs 13–14 of SSAP No. 43R,

Prepayment assumptions shall be applied consistently across portfolios to all securities backed by similar collateral (similar with respect to coupon, issuer, and age of collateral). . . . Loan-backed securities shall be revalued using the currently estimated cash flows, including new prepayment assumptions, using either the prospective or retrospective adjustment methodologies, consistently applied by type of securities. However, if at anytime during the holding period, the reporting entity determines it is no longer probable that they will collect all contractual cashflows, the reporting entity shall apply the accounting requirements in paragraphs 17 through 19.

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<sup>2</sup> The NAIC Statutory Accounting Principles Working Group has developed Statement of Statutory Accounting Principles (SSAP) No. 43R, *Loan-backed and Structured Settlements*, Question and Answer Implementation Guide, that is available on the NAIC website.

<sup>||</sup> At the fall 2010 NAIC meeting, SSAP No. 43R was amended to revise the definition of loan-backed securities effective January 1, 2011. In June 2010, nonsubstantive revisions were also adopted to paragraphs 27 and 36 of SSAP No. 43R to clarify the accounting for gains and losses between asset valuation reserve (AVR) and interest maintenance reserve (IMR) for SSAP No. 43R securities. As illustrated within paragraph 36, the AVR and IMR analysis required and provision to allocate gains and losses between AVR and IMR is the same regardless whether the security is written down as a result of an impairment analysis or whether the security was sold. Although the revisions to paragraphs 27 and 36 are considered nonsubstantive and are in accordance with the communicated intent provided in the *Question and Answer Implementation Guide*, it was identified that some entities had not correctly interpreted the *Question and Answer Implementation Guide* and such entities would need to make significant system changes to comply with the AVR and IMR bifurcation requirements for sale transactions. As a result, the revisions to paragraphs 27 and 36 adopted in June 2010 have an effective date of January 1, 2011, with early application allowed. Entities that have previously bifurcated gains and losses between AVR and IMR for sale transactions should not reverse previous bifurcations, and shall not revert to a process that does not bifurcate gains and losses between AVR and IMR when conducting future sales transactions before the January 1, 2011, effective date. Thus, if an entity bifurcated gains and losses from sale transactions between AVR and IMR anytime after the adoption of SSAP No. 43R (September 2009), that entity must continue to bifurcate gains and losses resulting from sale transactions for SSAP No. 43R securities in accordance with the nonsubstantive revisions to paragraphs 27 and 36 adopted in June 2010.

**11.20** Paragraphs 26–27 of SSAP No. 43R state the following:

The *Purposes and Procedures Manual of the NAIC Securities Valuation Office* identifies which method loan-backed securities are subject to in determining NAIC designation. Securities within the scope of this statement will determine the NAIC designation as follows:

*a.* For loan-backed securities subject to a single designation:

The NAIC designation is a single designation assigned to a particular CUSIP in the Valuation of Securities product (either assigned by the NAIC Securities Valuation Office, or determined by the Filing Exempt process). This designation establishes the carrying value method as described in paragraph 25 and is reported in Schedule D, or

*b.* For loan-backed securities subject to multiple designations:

Securities subject to multiple designations shall use a two-step process for determining the carrying value method and final NAIC designation;

*i.* Step 1: The current amortized cost of a loan-backed security is compared to the range of values assigned to the six (6) NAIC designations for each CUSIP to establish the **initial** NAIC designation. The carrying value method, either the amortized cost or the lower of amortized cost or fair value, is then determined as described in paragraph 25 based upon the **initial** NAIC designation.

*ii.* Step 2: The final NAIC designation that shall be used for reporting is determined by comparing the carrying value of a security (based on paragraph 26 b.i.) to the range of values assigned to the six (6) NAIC designations for each CUSIP. This final NAIC designation shall be applicable for all statutory accounting and reporting purposes (including establishing the AVR charges), except for establishing the appropriate carrying value method in Step 1 (paragraph 26 b.i.).

For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with paragraph 36 of SSAP No. 43R. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

**11.21** For impairments of loan backed and structured securities, paragraphs 28–37 of SSAP No. 43R state the following:

The application of this reporting requirement resulting from NAIC designation (i.e., lower of cost or fair value) is not a substitute for other-than-temporary impairment recognition (paragraphs 32–36). For securities reported at fair value where an other-than-temporary impairment has been determined to have occurred, the realized loss recognized from the other-than-temporary impairment shall first be applied towards the realization of any unrealized losses previously



recorded as a result of fluctuations in the security's fair value due to the reporting requirements. After the recognition of the other-than-temporary impairment, the security shall continue to report unrealized gains and losses as a result of fluctuations in fair value.

If the fair value of a loan-backed or structured security is less than its amortized cost basis at the balance sheet date, an entity shall assess whether the impairment is other than temporary. Amortized cost basis includes adjustments made to the cost of an investment for accretion, amortization, collection of cash, previous other-than-temporary impairments recognized as a realized loss (including any cumulative-effect adjustments recognized in accordance with paragraphs 56 through 58 of SSAP No. 43R).

If an entity intends to sell the loan-backed or structured security (that is, it has decided to sell the security), an other-than-temporary impairment shall be considered to have occurred.

If an entity does not intend to sell the loan-backed or structured security, the entity shall assess whether it has the intent and ability<sup>3</sup> to retain the investment in the security for a period of time sufficient to recover the amortized cost basis. If the entity does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost basis, an other-than-temporary impairment shall be considered to have occurred.

If the entity does not expect to recover the entire amortized cost basis of the security, the entity would be unable to assert that it will recover its amortized cost basis even if it does not intend to sell the security and the entity has the intent and ability to hold. Therefore, in those situations, an other-than temporary impairment shall be considered to have occurred. In assessing whether the entire amortized cost basis of the security will be recovered, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If present value of cash flows expected to be collected is less than the amortized cost basis of the security, the entire amortized cost basis of the security will not be recovered (that is, a non-interest related decline<sup>4</sup> exists), and an other-than-temporary impairment shall be considered to have occurred. A decrease in cashflows expected to be collected on a loan-backed or structured security that results from an increase in prepayments on the underlying assets shall be considered in the estimate of the present value of cash flows expected to be collected. In determining whether a non-interest related decline exists, an entity shall calculate the present value of cash flows expected to be collected based on an estimate of the expected future cash flows of the impaired loan-backed or structured security, discounted at the security's effective interest rate.

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<sup>3</sup> This assessment shall be considered a high standard due to the accounting measurement method established for the securities within the scope of SSAP No. 43R (amortized cost).

<sup>4</sup> A noninterest related decline is a decline in value due to fundamental credit problems of the issuer. Fundamental credit problems exist with the issuer when there is evidence of financial difficulty that may result in the issuer being unable to pay principal or interest when due. An interest related decline in value may be due to both increases in the risk-free interest rate and general credit spread widening.

- a. For securities accounted for under paragraphs 12 through 16—the effective interest rate of the loan-backed or structured security is the rate of return implicit in the security (that is, the contractual interest rate adjusted for any net deferred fees or costs, premium, or discount existing at the origination or acquisition of the security).<sup>5</sup>
- b. For securities accounted for under paragraphs 17 through 19—the effective interest rate is the rate implicit immediately prior to the recognition of the other-than-temporary impairment.
- c. For securities accounted for under paragraphs 20 through 24—the reporting entity shall apply the guidance in paragraph 22.b.

When an other-than-temporary impairment has occurred because the entity intends to sell the security or has assessed that they do not have the intent and ability to retain the investments in the security for a period of time sufficient to recover the amortized cost basis, the amount of the other-than-temporary impairment recognized in earnings as a realized loss shall equal the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized.)

When an other-than-temporary impairment has occurred because the entity does not expect to recover the entire amortized cost basis of the security even if the entity has no intent to sell and the entity has the intent and ability to hold, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment's amortized cost basis and the present value of cash flows expected to be collected, discounted at the loan-backed or structured security's effective interest rate in accordance with paragraph 32. (This guidance includes loan-backed securities previously held at lower of cost or market. For these securities, upon recognition of an other-than-temporary impairment, unrealized losses would be considered realized for the non-interest related decline. Hence, unrealized losses could continue to be reflected for these securities due to the reporting requirements.)

For reporting entities required to maintain an AVR or IMR, the accounting for unrealized gains and losses shall be in accordance with paragraph 36.a. For realized gains and losses, the AVR and IMR analysis required and provision to allocate gains and losses between AVR and IMR is the same regardless whether the realized loss results from an impairment write-down or whether there was a gain or loss upon sale. Guidance on specific scenarios resulting in realized gains and losses are addressed in paragraphs 36.b through 36.f below:

- a. **Unrealized Gains and Losses**—Record all unrealized gains and losses through AVR. At the time an unrealized gain or

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<sup>5</sup> Securities classified within the type of paragraph 6.a. or 6.b. may be required to change classification to type 6.c. when it becomes probable that the reporting entity will be unable to collect all contractually required payments receivable.

loss is realized, the accounting shall follow the premise in paragraph 36, as detailed in paragraphs 36.b through 36.f for specific transactions. Unrealized gains or losses that are realized shall be reversed from AVR before the recognition of the realized gain or loss within AVR and IMR. Gains and losses shall only be reflected in IMR when realized and as appropriate based on the analysis of interest and non-interest factors.

- b. **Other-Than-Temporary Impairment—Non-interest related other-than-temporary impairment losses** shall be recorded through the AVR. If the reporting entity wrote the security down to fair value due to the intent to sell or does not have the intent and ability to retain the investment for a period of time sufficient to recover the amortized cost basis, the non-interest related portion of the other-than-temporary impairment losses shall be recorded through the AVR; the interest related other-than-temporary impairment losses shall be recorded through the IMR. The analysis for bifurcating impairment losses between AVR and IMR shall be completed as of the date when the other-than-temporary impairment is determined.
- c. **Security Sold at a Loss Without Prior OTTI—An entity** shall bifurcate the loss into AVR and IMR portions depending on interest and non-interest related declines in accordance with the analysis performed as of the date of sale. As such, an entity shall report the loss in separate AVR and IMR components as appropriate.
- d. **Security Sold at a Loss With Prior OTTI—An entity** shall bifurcate the current realized loss into AVR and IMR portions depending on interest and non-interest related declines in accordance with the analysis performed as of the date of sale. An entity shall not adjust previous allocations to AVR and IMR that resulted from previous recognition of other-than-temporary impairments.
- e. **Security Sold at a Gain With Prior OTTI—An entity** shall bifurcate the gain into AVR and IMR portions depending on interest and non-interest factors in accordance with the analysis performed as of the date of sale. The bifurcation between AVR and IMR that occurs as of the date of sale may be different from the AVR and IMR allocation that occurred at the time of previous other-than-temporary impairments. An entity shall not adjust previous allocations to AVR and IMR that resulted from previous recognition of other-than-temporary impairments.
- f. **Security Sold at a Gain Without Prior OTTI—An entity** shall bifurcate the gain into AVR and IMR portions depending on interest and non-interest factors in accordance with the analysis performed as of the date of sale.

For situations where an other-than-temporary impairment is recognized pursuant to paragraphs 34 and 35 of this Statement, the

previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. Therefore, the prospective adjustment method shall be used for periods subsequent to loss recognition.

**11.22** Paragraph 38 of SSAP No. 43R states the following:

in periods subsequent to the recognition of an other than temporary impairment loss for a loan-backed or structured security, the reporting entity shall account for the other-than-temporarily impaired security as if the security had been purchased on the measurement date of the other-than-temporary impairment at an amortized cost basis equal to the previous amortized cost basis less the other-than-temporary impairment recognized as a realized loss. The difference between the new amortized cost basis and the cash flows expected to be collected shall be accreted as interest income. A reporting entity shall continue to estimate the present value of cash flows expected to be collected over the life of the loan-backed or structured security.

- a. For securities accounted for under paragraphs 12 through 19, if upon subsequent evaluation, there is a significant increase in the cash flows expected to be collected or if actual cash flows are significantly greater than cash flows previously expected, such changes shall be accounted for as a prospective adjustment to the accretable yield in accordance with paragraphs 17 through 19. The security shall continue to be subject to impairment analysis for each subsequent reporting period. The new amortized cost basis shall not be changed for subsequent recoveries in fair value. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.
- b. For beneficial interests accounted for under paragraphs 20 through 24, a reporting entity shall apply the guidance in paragraphs 21 through 22 to account for changes in cash flows expected to be collected.

**11.23** Requirements for carrying debt securities as admitted assets vary at the discretion of the states. A debt security may be classified as a nonadmitted asset to the extent that it fails a qualitative or quantitative limitation test or is otherwise not authorized by the applicable state code.

## Securities Lending Transactions<sup>#</sup>

**11.24** Life insurance entities may also lend debt securities (referred to as *securities lending*)<sup>6</sup> or enter into other agreements such as repurchase

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<sup>#</sup> In March 2010, the Securities and Exchange Commission (SEC) sent the an illustrative letter to certain public companies requesting information about repurchase agreements, securities lending transactions, or other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets. The letter can be found at the SEC website: [www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm](http://www.sec.gov/divisions/corpfin/guidance/cforepurchase0310.htm).

<sup>6</sup> Life insurance entities may also lend equity securities, although it is not as common as lending debt securities.

agreements (repos), reverse repurchase agreements (reverse repos), or dollar repurchase and dollar reverse repos. Those kinds of transactions are generally short term in nature, ranging from 1 to 30 days; however, longer terms are possible. When a debt security is loaned, collateral consisting of cash, cash equivalent, or both is pledged and maintained in an escrow account. If the collateral is cash, the transferor typically earns a return by investing that cash at a rate higher than the rate paid or rebated to the transferee. If the collateral is other than cash, the transferor typically receives a fee. Because of the protection of collateral (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, many securities lending transactions do not pose significant credit risks on either party. However, the parties may be subject to other risks, such as interest rate and liquidity risks.

**11.25** *U.S. generally accepted accounting principles.* FASB ASC 860-10-55-48, notes that in some securities lending transactions, the criteria in paragraph 5 of FASB ASC 860-10-40 are met, including the effective control criterion in paragraph 5(C) of FASB ASC 860-10-40, and consideration other than beneficial interests in the transferred assets is received. Those transactions shall be accounted for as follows:

- a. By the transferor as a sale of the loaned securities for proceeds consisting of the cash collateral and a forward repurchase commitment. If the collateral in a transaction that meets the criteria in paragraph 5 of FASB ASC 860-10-40 is a financial asset that the holder is permitted by contract or custom to sell or repledge, that financial asset is proceeds of the sale of the loaned securities.
- b. By the transferee as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment.

According to FASB ASC 860-10-55-49, during the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment.

**11.26** However, FASB ASC 860-30-25-7 states that many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity. FASB ASC 860-10-40-24 requires that an agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintain the transferor's effective control over those assets under FASB ASC 860-10-40-5(c)(1), and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the conditions in FASB ASC 860-10-40-24 are met. Those transactions should be accounted for as secured borrowings, in which either cash or securities that the holder is permitted by contract or custom to sell or repledge received as collateral are considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed and reclassified as set forth in FASB ASC 860-30-25-5(a), and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed.

**11.27** FASB ASC 860-30-25-8 states that the transferor of securities being loaned accounts for cash received in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash received should be recognized as the transferor's asset—as should investments made with that

cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash. If securities that may be sold or replighted are received, the transferor of the securities being loaned accounts for those securities in the same way as it would account for cash received.

**11.28** *Statutory accounting practices.* Under SAP, the collateral received is reflected in the appropriate investment section and the liability is reflected on the balance sheet as a write in line. Specific collateral requirements for securities lending, repurchase and reverse repurchase transactions are set forth in SSAP No. 91R, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.<sup>\*\*</sup> The collateral requirement varies based upon the type of transaction (securities lending, repurchase, reverse repurchase) or denomination of the collateral. SSAP No. 91R adopts portions of FASB ASC 860, *Transfers and Servicing*, with the following modifications as noted in paragraphs 103–104 of SSAP No. 91R:

- a. Servicing rights assets are to be nonadmitted.
- b. Sales treatment is not permitted for transactions where recourse provisions or removal-of-accounts provisions exist on the transferred assets whereas GAAP would permit the recognition of the transfer as a sale under some circumstances.
- c. As statutory financial statements are prepared on a legal entity basis, special purpose entities should not be consolidated in a reporting entity's statutory financial statements.
- d. Leases should be accounted for in accordance with SSAP No. 22, *Leases*.
- e. Reporting entities required to maintain an interest maintenance reserve (IMR) should account for realized and unrealized capital gains and losses in accordance with SSAP No. 7.
- f. The concepts of revolving period securitizations, banker's acceptances and risk participation in banker's acceptances are not applicable for statutory accounting purposes.
- g. This statement does not adopt the accounting for collateral as outlined in FASB ASC 860.

This statement adopts with modification FASB ASC 860:

- a. This statement adopts FASB ASC 860 guidance indicating that all servicing assets and servicing liabilities should initially be measured at fair value.
- b. This statement adopts FASB ASC 860 guidance requiring the inclusion of separately recognized servicing assets and servicing liabilities in the calculation of proceeds from the sale of assets.
- c. This statement rejects the optionality provided within FASB ASC 860 for subsequent measurement of servicing assets and servicing liabilities using either fair value or an amortization method. This

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<sup>\*\*</sup> Substantive revisions in paragraphs 13–14, 57–81, and 98–101 of SSAP No. 91R regarding securities lending transactions and repurchase agreements and additional disclosures were adopted in May 2010 and are effective December 31, 2010.

The substantive revisions adopted in SSAP No. 91R did not adopt or reject any new generally accepted accounting principles (GAAP) standards but it did incorporate guidance regarding the determination of whether collateral is on balance sheet or off balance sheet, which is closer to the existing GAAP guidance.

statement requires application of a fair value method for subsequent measurement.

- d. This statement adopts guidance in FASB ASC 860 regarding servicing assets and servicing liabilities established from the transfer of financial assets to a qualifying SPE in a guaranteed mortgage securitization in which the transferor retains all of the resulting securities.
- e. This statement adopts revisions in FASB ASC 860 replacing the term 'retained interests' with 'interests that continue to be held by the transferor' with amendments to the definition to exclude servicing assets and servicing liabilities from this definition.

Substantive revisions in paragraphs 13–14, 57–81, 98–101 of SSAP No. 91R regarding securities lending transactions and repurchase agreements and additional disclosures are effective December 31, 2010, and incorporate guidance regarding the determination of whether collateral is on balance sheet or off balance sheet. Readers should familiarize themselves with the new collateral requirements in these paragraphs of SSAP No. 91R.

## Repurchase Agreements and Wash Sales

**11.29** Repos and reverse repos, including dollar repurchase and dollar reverse repurchase agreements, are contracts to sell and repurchase or to purchase and sell back the same or similar instrument (same issuer). In addition, these transactions often involve mortgage backed securities (MBS), also referred to as *pass through certificates* or *mortgage participation certificates*.

**11.30** *Dollar repurchase agreements* (also called *dollar rolls*) are agreements to sell and repurchase similar but not identical securities. The dollar roll market consists primarily of agreements that involve MBS. Dollar rolls differ from regular repurchase agreements in that the securities sold and repurchased, which are usually of the same issuer, are represented by different certificates, are collateralized by different but similar mortgage pools (for example, single family residential mortgages), and generally have different principal amounts. The most common type of dollar rolls are fixed coupon and yield maintenance agreements.

**11.31** In a fixed coupon agreement, the securities repurchased have the same stated interest rate as, and maturities similar to, the securities sold and are generally priced to result in substantially the same yield. The seller-borrower retains control over the future economic benefits of the securities sold and assumes no additional market risk.

**11.32** In a yield maintenance agreement, the securities repurchased may have a different stated interest rate from that of the securities sold and are generally priced to result in different yields as specified in the agreement.<sup>7</sup> The seller-borrower surrenders control over the future economic benefits of the securities sold and assumes additional market risk. Yield maintenance

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<sup>7</sup> The price spread relationship between securities with different contract interest rates does not move in tandem. The existence of yield and price disparities provides opportunities for the buyer-lender to deliver, within the terms of the agreement, certificates providing the greatest benefit to the buyer-lender.

agreements may contain par cap provisions<sup>8</sup> that could significantly alter the economics of the transactions.

**11.33 Rollovers and extensions.** Occasionally, securities involved in repos are not delivered on the settlement date of the agreement and the contract may be rolled over or extended upon mutual agreement of the buyer-lender and seller-borrower.

**11.34 Breakage.** Securities repurchased under repos commonly have a principal amount that differs from the principal amount of the security originally sold under the agreement. This is particularly common to dollar rolls, which involve MBS. That difference is referred to as breakage and occurs because the principal amounts of MBS generally differ as a result of the monthly amortization of principal balances of mortgages collateralizing the MBS. The amount of the breakage is a factor in determining whether substantially the same security is reacquired in the repo transaction, that is, whether good delivery (one in accordance with the terms of the agreement) has been met on repurchase of the MBS.

**11.35 U.S. generally accepted accounting principles and statutory accounting practices.**<sup>††</sup> FASB ASC 860-10-55-55 states that if the conditions in FASB ASC 860-10-40-5 are met, the transferor shall account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee shall account for the agreement as a purchase of financial assets and a forward resale commitment. Other transfers that are accompanied by an agreement to repurchase the transferred financial assets that would be accounted for as sales if the conditions in FASB ASC 860-10-40-5 are met include transfers with agreements to repurchase at maturity and transfers with repurchase agreements in which the transferor has not obtained collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets.

**11.36** Paragraph 66 of SSAP No. 91R notes that if the transferor has surrendered control over transferred assets (*sales criteria* as discussed in paragraph 5 of SSAP No. 91R) the transferor should account for the repurchase agreement as a sale of financial assets and a forward repurchase commitment, and the transferee should account for the agreement as a purchase of financial assets and a forward resale commitment. As discussed in paragraph 67 of SSAP No. 91R, repurchase agreements that do meet the sales criteria (in paragraph 5 of SSAP No. 91R) should be treated as secured borrowings.

**11.37** Furthermore, wash sales that previously were not recognized if the same financial asset was purchased soon before or after the sale should be accounted for as sales under FASB ASC 860. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets. Under SAP, SSAP No. 91R, adopts FASB ASC 860 for accounting for wash

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<sup>8</sup> A par cap provision limits the repurchase price to a stipulated percentage of the face amount of the certificate. Fixed coupon agreements do not contain par cap provisions.

<sup>††</sup> On November 3, 2010, FASB published, for public comment, the proposed ASU *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. The comment period ended on January 15, 2011. The objective of this project is to improve the accounting for repurchase transactions by amending the *effective control* criteria for transactions involving repurchase agreements or other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity within FASB Accounting Standards Codification (ASC) 860, *Transfers and Servicing*. Readers should be aware of any final pronouncements.



sales to permit sales recognition, but also requires expanded disclosures (see SSAP No. 91R paragraph 98 for listing of information to be disclosed).

**11.38** The prior prohibition on a qualifying special purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument has been eliminated and in doing so, has clarified the status of qualified special purpose entity passive derivative instruments that pertain to beneficial interests issued or sold to parties other than the transferor, its affiliates, or its agents. This is not a move away from conservatism but is instead now allowed due to a FASB ASC 815, *Derivatives and Hedging*, requirement to evaluate interests in securitized financial assets that are freestanding derivatives or hybrids that contain an embedded derivative requiring bifurcation. For additional specifics, see paragraph 11.54.

## Equity Securities

**11.39** Equity securities represent units of ownership in a corporation or the right to acquire or dispose of an ownership interest in a corporation at fixed or determinable prices and may include common and nonredeemable preferred stocks, mutual fund shares, warrants, and options to purchase stock. Generally, equity securities generate cash dividends or dividends paid in the form of additional shares of stock. The sale of shares of equity securities usually results in a realized gain or loss.

**11.40** *U.S. generally accepted accounting principles.* Under U.S. GAAP, equity securities that have readily determinable fair values as defined by FASB ASC 320-10-35-1 are classified as either trading or available-for-sale securities and reported at fair value. Temporary changes in the fair value of those securities are recognized as unrealized gains and losses and are accounted for as described in paragraph 11.10. Investments in equity securities that are not addressed by FASB ASC 320 or do not have readily determinable fair values should be consolidated or accounted for under FASB ASC 323, *Investments—Equity Method and Joint Ventures*. Additionally, FASB ASC 944-325-30-1, states that investments in equity securities that are not within the scope of FASB ASC 320-10 or FASB ASC 958-320, because they do not have readily determinable fair values should be reported at fair value. As stated in FASB ASC 320-10-35-1, unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) should be excluded from earnings and reported in other comprehensive income until realized except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge should be recognized in earnings during the period of the hedge, pursuant to paragraphs 1 and 4 of FASB ASC 815-25-35.

**11.41** *Statutory accounting practices.* Under SAP, unaffiliated common stock is generally reported at the fair value. Paragraphs 7–8 of SSAP No. 30, *Investments in Common Stock (excluding Investments in common stock of subsidiary, controlled, or affiliated entities)*, state that, in those instances where unit price is not available from the SVO, it is the responsibility of management to determine fair value based on analytical or pricing mechanisms. For reporting entities required to maintain an AVR, the accounting for unrealized capital gains and losses should be in accordance with SSAP No. 7. For reporting entities not required to maintain an AVR, unrealized capital gains and losses should be recorded as a direct credit or charge to surplus.

**11.42** Preferred stock should be classified into six quality categories in accordance with the *Purposes and Procedures Manual* of the NAIC SVO.<sup>‡‡</sup> As noted in paragraph 16 of SSAP No. 32 (including investments in preferred stock of subsidiary, controlled, or affiliated [SCA] entities),

Preferred stock shall be valued based on (a) the underlying characteristics of the security, (b) the quality rating of the security as defined in the NAIC *Purposes and Procedures of the Securities Valuation Office* (Purposes and Procedures of the SVO) and assigned in the NAIC *Valuations of Securities* product, and (c) whether an AVR is maintained by the reporting entity. For reporting entities that maintain an AVR, perpetual preferred stocks designated highest quality, high quality and medium quality (NAIC designations P1–P3) shall be reported at book value; perpetual preferred stocks that are designated low quality, lowest quality and in or near default (NAIC designations P4–P6) shall be reported at the lower of book value or fair value. For reporting entities that do not maintain an AVR, perpetual preferred stocks designated P1–P2 shall be reported at fair value; and perpetual preferred stocks that are designated P3–P6 shall be reported at the lower of book value or fair value. Paragraph 17 of SSAP No. 32 states that for reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7. For reporting entities not required to maintain an AVR unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).

**11.43** As further noted in SSAP No. 32 paragraph 19 for reporting entities that do not maintain an AVR, "Perpetual preferred stock which are of highest or high quality (designation 1–2) and have characteristics of equity securities, shall be valued using unit prices as reported in the NAIC *Valuations of Securities Manual* (at cost). All other perpetual preferred stocks (with designations 3–6) shall be reported at the lower of cost, amortized cost or fair value."

**11.44** Interpretation No. 06-07, *Definition of the Phrase "Other Than Temporary,"* adopted with modification, certain aspects of FASB ASC 320. Interpretation No. 06-07 nullified Interpretation No. 02-7, *Definition of "Other Than Temporary Impairments,"* but adopted certain aspects of its consensus. The NAIC codified new SAP disclosure requirements based upon FASB ASC 320 into SSAP Nos. 26, 30, 32, and 43.

**11.45** Interpretation No. 06-07 includes a three step framework for other than temporary impairment analysis. In summary, steps 1 and 3 state that the determination of an investment impairment and valuation methodology, respectively, are governed by the relevant SSAP. Note that step 2 (in paragraph 5) states that an interest-related impairment should be deemed other than temporary when an investor has the intent to sell an investment, at the reporting date, but before recovery of the cost of the investment. These interest

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<sup>‡‡</sup> The NAIC Financial Condition Committee had previously adopted a short term resolution for hybrid securities classification. At the Summer 2008 NAIC meeting, the NAIC decided not to adopt the short term "notching solution," but instead to adopt a 2007 report from the American Academy of Actuaries, and look for a long term solution to improve identification, classification, and accounting guidance for new structured investments. As of January 1, 2009, the notching solution expired, and hybrid securities should be reported in Schedule D with a separate line number and the annual statement note disclosure for these holdings would be eliminated. A definition of hybrid securities was also added to the investment schedules instructions.

related declines in value, which now include changes in general credit spreads, are only recognized when the insurer has the intent to sell the security.

**11.46** SSAP No. 99 paragraphs 8–11 discuss accounting for other-than-temporary impairments for preferred stock:

**Impairment of Redeemable Preferred Stock**

"An other-than-temporary impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the security in effect at the time of acquisition. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a security prior to its maturity at an amount below carrying value (i.e. amortized cost). If it is determined that a decline in fair value of a redeemable preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7, *Asset Valuation Reserve and Interest Maintenance Reserve*.

In periods subsequent to the recognition of an other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporary impaired security as if the security had been purchased at the measurement date of the other-than-temporary impairment, and in accordance with paragraph 18 or paragraph 20 of SSAP No. 32, as applicable. The fair value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the security, based on the new cost basis, shall be amortized over the remaining life of the security in the prospective manner based on the amount and timing of future estimated cash flows. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses."

**Impairment of Perpetual Preferred Stock**

"If it is determined that a decline in the fair value of a perpetual preferred stock is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR/IMR, the accounting for the entire amount of the realized capital loss shall be in accordance with SSAP No. 7, *Asset Valuation Reserve and Interest Maintenance Reserve*.

In periods subsequent to the recognition of an other-than-temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other-than-temporary impaired security as if the security had been purchased at the measurement date of the other-than-temporary impairment, and in accordance with paragraph 19 or paragraph 21 of SSAP No. 32, as applicable. The fair value of the redeemable preferred stock on the measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses."

**11.47** Equity securities not listed in the NAIC *Purposes and Procedures of the Securities Valuation Office* or listed with no value that can be substantiated to the appropriate NAIC subcommittee or regulatory agency. The life insurance entity is required to submit sufficient information on these securities to the NAIC SVO for a determination of fair value.

**11.48** SSAP No. 97, *Investments in Subsidiary, Controlled, or Affiliated Entities, A Replacement of SSAP No. 88*, requires that investments in SCA entities be reported using either a market valuation approach or equity method. There are specific requirements to use the market valuation approach, including the requirement to record at a discount to market (the requirements can be found in SSAP No. 97 paragraph 8(a)). Under the equity method, investments in insurance SCA entities should be recorded based on audited statutory equity of the respective entity's financial statements. Investments in noninsurance SCA entities that are engaged in specific transactions or activities (as defined in SSAP No. 97 paragraph 8(b)(ii)) and have 20 percent or more of the SCA's revenue generated from the reporting entity and its affiliates, are valued based on the underlying equity of the respective entity's audited U.S. GAAP financial statements adjusted to a statutory basis of accounting (as explained in paragraph 9 of SSAP No. 97). Investments in noninsurance SCA entities that do not qualify under paragraph 8(b)(ii) of SSAP No. 97 should be recorded based on the audited U.S. GAAP equity of the investee. Investments in foreign insurance SCA entities should be recorded based on the underlying audited U.S. GAAP equity of the respective entity adjusted to a statutory basis of accounting in accordance with paragraph 9 of SSAP No. 97 and adjusted for reserves of the foreign insurance SCA with respect to business it assumes directly and indirectly from a U.S. insurer using the SAP promulgated by the NAIC in the manual. Note however, that the admissibility of assets may be limited when a qualified opinion is provided. Interpretation No. 03-03 of the Emerging Accounting Issues Working Group, *Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee When a Qualified Opinion is Provided*, sets forth the adjustment criteria. As defined in SSAP No. 97 paragraph 13(d), "if financial statements of an investee are not sufficiently timely for the reporting entity to apply an equity method to the investee's current results of operations, the reporting entity shall record its share of the earnings or losses of an investee from the most recent available financial statements. A lag in reporting shall be consistent from period to period." Investments in U.S. insurance SCA entities accounted for under the equity method (recorded based on the underlying audited statutory equity as noted in paragraph 8(b)(i) in SSAP No. 97), should record the investments on at least a quarterly basis, and should

base the investment value on the most recent quarterly information available for the SCA. Under the equity method (as described in paragraphs 8(b)(i)–8(b)(iv) of SSAP No. 97, the share of undistributed earnings and losses of an investee shall be included in unrealized gains and losses of the reporting entity. Other changes in the investee's surplus are also recorded as a component of unrealized capital gains and losses on investment. Dividends or distributions received should be recognized in income when declared. The carrying amount of the investment should be reduced to the extent dividends declared are in excess of undistributed accumulated earnings.

**11.49** Under the U.S. GAAP equity method, the amount to be recorded should be defined as the initial investment in the investee at cost (excluding any investments in an investee's preferred stock). As discussed in paragraph 12 of SSAP No. 97, the carrying amount of the investment should be adjusted to recognize the reporting entity's share of the audited GAAP basis earnings or losses of the investee after the date of acquisition, adjusted for any dividends received. As noted in paragraph 14 of SSAP No. 97, once the reporting entity elects to use a valuation approach for a particular subsidiary, the reporting entity may not change the valuation method without approval of the domiciliary commissioner. Paragraph 31(e) of SSAP No. 97 requires that for SCA entities that elected or were required to change its valuation method, a description of the reason for the change and the amount of adjustment recorded as unrealized gains or losses should be disclosed. The entity should also disclose whether commissioner approval was obtained.

**11.50** Realized and unrealized gains and losses for assets classified as equity securities are included in the AVR calculation (see paragraphs 11.62–.67) in the equity component except for certain preferred stock assets that may be included in the default component.

## Derivative Instruments

**11.51** Recent years have seen a growing use of innovative financial instruments, commonly referred to as *derivatives*, that often are complex and can involve a substantial risk of loss. Because interest rates, commodity prices, and other market rates and indices from which certain instruments (derivatives) derive their value may be volatile, the fair value of those instruments may fluctuate significantly and entities may experience significant gains or losses because of their use. With the introduction of interest sensitive products and the globalization of markets, life insurance entities increasingly use interest rate futures contracts, options, interest rate swaps, foreign currency options, equity indexed derivatives, and other similar derivative financial instruments to manage and reduce risks related to market changes in interest rates and foreign currency exchange rates. Financial transactions entered for purposes of minimizing price or interest rate risk are called *hedges* (in an economic, not necessarily an accounting, sense).

**11.52** Options and futures contracts can also be entered into for speculative purposes, but most insurance regulators prohibit life insurance entities from these kinds of speculative transactions. Although the criteria to qualify for hedging<sup>9</sup> transactions may differ from state to state, at a minimum the item to be hedged must expose the life insurance entity to price, interest rate,

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<sup>9</sup> The term *hedging*, as used in this paragraph, does not mean hedging for accounting purposes, but rather hedging in an economic or regulatory sense.

or currency exchange risk, and the financial instrument used as a hedge must reduce the specific risk exposure.

**11.53** *U.S. generally accepted accounting principles.* FASB ASC 815 establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives), and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those investments at fair value. If certain conditions are met, a derivative may be specifically designated as (a) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (b) a hedge of the exposure to variable cash flows of a forecasted transaction, or (c) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security, or a foreign currency denominated forecasted transaction. The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. FASB ASC 815-10-50 contains certain disclosure requirements. Readers should refer to the full text of FASB ASC 815 when considering accounting and reporting issues related to derivative instruments and hedging activities.

**11.54** The following is a list of insurance specific derivative issues:

- Paragraphs 9–15 of FASB ASC 815-10-05 discuss the definition of a derivative as it relates to synthetic GICs.
- Paragraphs 1–4 of FASB ASC 944-815-25 discuss embedded derivatives related to variable annuity products and policyholder ownership of the assets.
- Paragraphs 24–25 of FASB ASC 944-20-05 and paragraphs 5–6 of FASB ASC 944-815-25 discuss embedded derivatives as it relates to the identification of the host contract in a nontraditional variable annuity contract.
- Paragraphs 120–127 of FASB ASC 815-15-55 discuss embedded derivatives related to clearly and closely related criteria for market adjusted value prepayment options.
- Paragraphs 73–76 of FASB ASC 815-15-55 discuss embedded derivatives as it relates to equity indexed life insurance contracts.
- Paragraphs 57–61 of FASB ASC 815-15-55 discuss embedded derivatives related to deferred variable annuity contracts with payment alternatives at the end of the accumulation period.
- FASB ASC 815-10-55 discusses embedded derivatives related to dual trigger property and casualty insurance contracts.
- Paragraphs 32–36 of FASB ASC 815-10-55 discuss embedded derivatives related to dual trigger financial guarantee contracts.
- Paragraphs 1–4 of FASB ASC 815-15-55 discuss embedded derivatives related to foreign currency elements of insurance contracts.
- Paragraphs 62–72 of FASB ASC 815-15-55 discuss embedded derivatives related to equity indexed annuity contracts with embedded derivatives.

- Paragraphs 227–238 of FASB ASC 815-15-55 discuss embedded derivatives related to the application of FASB ASC 944, and FASB ASC 815, to equity indexed annuity contracts.
- Issue B31—Embedded Derivatives: Accounting for Purchases of Life Insurance.
- Issue B34—Embedded Derivatives: Period Certain Plus Life Contingent Variable Payout Annuity Contracts With a Guaranteed Minimum Level of Periodic Payments. (Refer to section B Issue B25.)
- Paragraphs 101–109 of FASB ASC 815-15-55 and FASB ASC 815-15-25-47 discuss modified coinsurance arrangements and debt instruments that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the obligor under those instruments.<sup>10</sup>
- Paragraphs 33–36 of FASB ASC 815-15-25 and paragraphs 137–159 of FASB ASC 815-15-55 discuss the application of FASB ASC 815-15-25-26(b) to securitized interests in prepayable financial assets.
- Paragraphs 136–141 of FASB ASC 815-10-55 and FASB ASC 815-10-55-44 discuss the scope exceptions related to physical variables.
- Paragraphs 1–5 of FASB ASC 944-815-55 discuss cash flow hedges related to hedging voluntary increases and interest credited on an insurance contract liability.
- Paragraphs 42–43 of FASB ASC 815-20-55 and FASB ASC 815-20-25-43 discuss hedging interest cash flows on variable rate assets and liabilities that are not based on a benchmark interest rate.

#### **11.55 Additional guidance in FASB ASC 815 that should be reviewed:**

- FASB ASC 815 allows financial instruments containing embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis (with changes in value recognized in earnings). However, hybrid financial instruments that are elected to be accounted for in their entirety at fair value cannot be used as a hedge instrument in a

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<sup>10</sup> The guidance in paragraphs 101–109 of FASB ASC 815-15-55 and FASB ASC 815-15-25-47 should be applied to all arrangements that incorporate credit risk exposures that are unrelated or only partially related to the creditworthiness of the issuer of an instrument. The issue may apply directly to modified coinsurance arrangements (modco arrangements) and coinsurance with funds withheld arrangements. An instrument that incorporates credit risk exposures that are either unrelated or only partially related to the creditworthiness of that instrument's obligor has an embedded derivative that is not considered "clearly and closely related" to the economic characteristics and risks of the host contract. B36 affects the accounting for credit linked notes that incorporate a third party's credit (or default) risk and modified coinsurance and coinsurance with funds withheld arrangements between reinsurers and ceding insurance entities and similar arrangements. The scope of B36 encompasses any receivable or payable where the interest is determined by reference to an actual pool of assets (unless the pool were comprised entirely of risk free debt securities, real estate, or both) or determined by any index other than a *pure* interest rate index. Under the implementation of B36, ceding entities were allowed a one time reclassification of securities from the held-to-maturity and available-for-sale categories into the trading category during the fiscal quarter B36 became effective (the first fiscal quarter beginning after September 15, 2003). This reclassification was limited to the amount and type of securities related to the embedded derivatives that were being newly accounted for under B36.

FASB ASC 815 hedge.<sup>11</sup> Financial guarantees and investment contracts are allowed the fair value election. However, hybrid instruments described in FASB ASC 825-10-50-8 are not within the scope. Therefore, derivatives embedded in insurance contract hosts, such as equity indexed annuities or nontraditional variable annuity contracts with minimum guarantees, would not be eligible for the fair value measurement election.

- FASB ASC 815-10-15-72 states that IO strips and PO strips are not subject to the requirements of FASB ASC 815.
- FASB ASC 815-10-15-11 requires a holder of interests in securitized financial assets to evaluate interests in order to identify those interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation.
- FASB ASC 815-15-15-9 clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives.

However, this does not in anyway negate other FASB ASC 815 credit risk requirements, including the identification of credit risk that continues to represent credit risk that is not clearly and closely related to the host contracts such as with modified coinsurance arrangements and debt instruments.

**11.56** *Statutory accounting practices.* The NAIC has incorporated certain concepts of FASB ASC 815, its related amendments, and DIG issues, in SSAP No. 86, *Accounting for Derivative Instruments and Hedging, Income Generation and Replication (Synthetic Asset Transactions)*. SSAP No. 86 superseded SSAP No. 31, *Derivative Instruments*, and is effective for derivative transactions entered into or modified on or after January 1, 2003. Alternatively, an insurer was able to choose to apply this statement to all derivatives to which the insurer was a party as of January 1, 2003. In either case, the insurer had to disclose the transition approach that was being or is still being used.

**11.57** Under SSAP No. 86, derivatives are defined as swaps, options, futures, caps, floors, and collars. SSAP No. 86 provides definitions for these terms. The more significant differences between SSAP No. 86 and FASB ASC 815 include the following:

- Embedded derivatives should not be accounted for separately from the host contract as derivative instrument. (Under SSAP No. 86, the definition of a derivative continues to be based upon SSAP No. 31 that is, its legal form or contractual rights and obligations, in contrast with FASB ASC 815 where the definition is based upon instrument characteristics. Consequently, certain contracts that may not meet the definition of a derivative may contain embedded derivative instruments.)
- Reporting entities should not separately account for the effectiveness and ineffectiveness of hedging derivatives. (A derivative instrument is either classified as an effective hedge or an ineffective hedge). Entities must account for the derivative using fair value accounting if it is deemed to be ineffective or becomes ineffective.

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<sup>11</sup> For those hybrid financial instruments measured at fair value under the practicability exception, FASB ASC 825-10-50-28 requires that the entity disclose specific information.



- Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge are required to be accounted for using hedge accounting. A reporting entity cannot choose to utilize fair value accounting.
- Changes in the fair value of a derivative that does not meet the hedging criteria should be recorded as unrealized gains and losses.

**11.58** SSAP No. 86 generally adopted the FASB ASC 815 framework for fair value and cash flow hedges. It allows derivatives to be designated as hedging exposure to changes in fair value, variability in expected cash flows or foreign currency exposures. Hedge accounting is permitted for derivatives to hedge a portfolio of similar assets or similar liabilities but macro hedging (hedging of an entire portfolio with dissimilar risks) does not qualify for hedge accounting. Firm commitments and forecasted transactions are eligible for designation as hedged transactions. Forecasted transactions must meet additional specific criteria to be designated in a cash flow hedge.

**11.59** To qualify for hedge accounting, a fair value, cash flow and foreign currency hedge must be highly effective. *Highly effective* is specifically defined within SSAP No. 86 as where the change in the derivative hedging instruments is within 80 percent to 125 percent of the change in the hedged item. The concept within FASB ASC 815 of identifying and separately accounting for effective and ineffective portions of a single hedge was rejected; therefore, for statutory, the ineffective portion of an effective hedge need not be separately recognized in income. An entity either has an effective hedge and follows hedge accounting or an ineffective hedge and uses fair value accounting (recognition in unrealized gains and losses).

**11.60** Under SSAP No. 86, derivatives used in hedging activities should be accounted for in a manner consistent with the item hedged (that is, if the item being hedged is accounted for at amortized cost, the hedging derivative is also accounted for at amortized cost). SSAP No. 86 paragraph 15 states the following:

Derivative instruments used in hedging transactions that meet the criteria of a highly effective hedge shall be considered an effective hedge and valued and reported in a manner that is consistent with the hedged asset or liability (referred to as hedge accounting). For instance, assume an entity has a financial instrument on which it is currently receiving income at a variable rate but wishes to receive income at a fixed rate and thus enters into a swap agreement to exchange the cash flows. If the transaction qualifies as an effective hedge and a financial instrument on a statutory basis is valued and reported at amortized cost, then the swap would also be valued and reported at amortized cost. For derivatives that do not qualify for hedge accounting derivatives are accounted for at fair value. Derivative instruments used in hedging transactions that do not meet or no longer meet the criteria of an effective hedge shall be accounted for at fair value and the changes in the fair value shall be recorded as unrealized gains or unrealized losses (referred to as fair value accounting).

**11.61** Under SSAP No. 86, for a gain or loss upon termination, paragraph 17 states the following:

Upon termination of a derivative that qualifies for hedge accounting, the gain or loss shall adjust the basis of the hedged item and be

recognized in income in a manner that is consistent with the hedged item. Alternatively, if the item being hedged is subject to IMR, the gain or loss on the hedging derivative may be realized and shall be subject to IMR upon termination. Entities who choose the alternative method shall apply it consistently thereafter.

Additionally, SSAP No. 86, appendix C guidance, is provided for redesignation of a derivative from a currently effective hedging relationship. The redesignation of an item carried at amortized cost to another effective hedging relationship with an item carried at amortized cost, should continue to be recorded at amortized cost with no gain or loss on the derivative recognized.

## Interest Maintenance Reserve and Asset Valuation Reserve

**11.62** IMR and AVR are required for statutory financial statements only. The NAIC's objectives with IMR and AVR were to develop an AVR that included all classes of assets, and to develop a practical calculation methodology that recognizes current experience and potential future experience (both adverse and favorable) in the valuation of the assets. The methodology was intended to be consistent with (a) the basis used in determining the statutory value of the liabilities, and (b) the accounting basis used to determine the statutory value of the assets.

**11.63** The IMR, for all kinds of debt securities, captures interest related realized gains and losses, net of applicable income taxes, and amortizes the capital gains or losses into investment income over the approximated remaining period to maturity of the assets sold. The IMR is not subject to any maximum or minimum value; however, the IMR balance cannot be less than zero at any valuation date. The IMR began at zero on January 1, 1992; all interest related realized gains and losses began accumulation with transactions on or after that date.

**11.64** The AVR calculation includes all invested asset classifications. The AVR contains two components (each of which has two subcomponents), each intended to address specific areas of asset risk:

- a. The *default component* contains provisions for future credit related losses on most kinds of securities. Its two subcomponents are the following:
  - i. The bond and preferred stock component other than the mortgage loan subcomponent, which contains default provisions for long term bonds, preferred stock, short term bonds and derivative instruments, corporate debt securities, and MBS
  - ii. The mortgage subcomponent, which contains default provisions for farm, commercial, and residential mortgages
- b. The *equity component* contains provisions for credit related losses for all kinds of equity investments. Its two subcomponents are the following:
  - i. The common stock subcomponent, which includes affiliated, unaffiliated, and all other investments in the nature of common stock

- ii. The real estate and other invested asset subcomponent, which contains provisions for real estate and other invested assets reported in Schedule BA of the Annual Statement

**11.65** The AVR is subject to maximum amounts. Voluntary contributions and limited transfers between subcomponents are permitted. AVR rules do not prohibit specific reserves in addition to the AVR (for example, reserves for specific real estate investments).

**11.66** Assets carried in segregated separate accounts at market value and used to support variable contracts and other separate account contracts are specifically excluded from the IMR and AVR.

**11.67** The NAIC Annual Statement Instructions and the NAIC *Accounting Practices and Procedures Manuals*, should be referred to for specific guidance on the IMR and AVR rules and calculations.

## **Realized and Unrealized Gains and Losses on Debt and Equity Securities**

**11.68** *U.S. generally accepted accounting principles.* Under U.S. GAAP, as discussed in FASB ASC 944-325-45-3 and FASB ASC 944-325-40-1 realized gains and losses on all investments (except investments that are classified as trading securities and those that are accounted for as either hedges of net investments in foreign operations or cash flow hedges), should be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses should be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. According to FASB ASC 944-325-40-1, realized gains and losses should not be deferred to future periods either directly or indirectly.

**11.69** *Unrealized holding gains and losses.* As discussed in FASB ASC 320-10-35-1, unrealized holding gains and losses for securities categorized as trading securities are included in earnings. Unrealized holding gains and losses for securities categorized as available-for-sale securities (including those classified as current assets) are excluded from earnings and reported in other comprehensive income until realized, except as indicated in the following sentence. All or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge should be recognized in earnings during the period of the hedge, pursuant to paragraphs 1–4 of FASB ASC 815-25-35. FASB ASC 740-20-45-11 provides guidance about reporting the tax effects of unrealized holding gains and losses reported as a separate component of other comprehensive income.

**11.70** *Fair value declines that are other than temporary.* FASB ASC 320-10-35 provides guidance regarding determining whether an investment is impaired, and whether an impairment is other-than-temporary. Securities classified as either available-for-sale or held-to-maturity should be evaluated to determine whether a decline in fair value below the amortized cost basis is other than temporary. If a security has been the hedged item in a fair value hedge, the security's amortized cost basis should reflect the effect of the adjustments of its carrying amount made pursuant to FASB ASC 815-25-35-2. (Paragraphs 20–29 of FASB ASC 320-10-35 discuss the steps to be taken in determining whether an investment is impaired. Paragraphs 30–32 of FASB ASC 320-10-35 describes how to evaluate whether an impairment is other-than-temporary

for both debt and equity securities. Paragraph 33 of FASB ASC 320-10-35 provides additional guidance for evaluating whether an impairment of a debt security is other than temporary.

**11.71 *Equity securities.*** FASB ASC 320-10-35-34 notes that for equity securities, if it is determined in step 2 that the impairment is other than temporary, then an impairment loss shall be recognized in earnings equal to the entire difference between the investment's cost and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment shall not include partial recoveries after the balance sheet date. The fair value of the investment would then become the new amortized cost basis of the investment and shall not be adjusted for subsequent recoveries in fair value.

**11.72 *Debt securities.*** Paragraphs 34A–34E of FASB ASC 320-10-35 discusses how to determine the amount of an other-than-temporary impairment recognized in earnings and other comprehensive income for debt securities (if it is determined that the impairment is other-than-temporary):

If an other-than-temporary impairment has occurred, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. In assessing whether the entity more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit losses, the entity shall consider the factors in paragraph 320-10-35-33F. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be separated into both of the following:

- a. The amount representing the credit loss.
- b. The amount related to all other factors.

The amount of the total other-than-temporary impairment related to the credit loss shall be recognized in earnings. The amount of the total other-than-temporary impairment related to other factors shall be recognized in other comprehensive income, net of applicable taxes.

The previous amortized cost basis less the other-than-temporary impairment recognized in earnings shall become the new amortized cost basis of the investment. That new amortized cost basis shall not be adjusted for subsequent recoveries in fair value. However, the amortized cost basis shall be adjusted for accretion and amortization as prescribed in paragraph 320-10-35-35.

**11.73** AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*; PCAOB

*Standards and Related Rules, Interim Standards*),<sup>12</sup> provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities as well as for investments in debt and equity securities as defined in FASB ASC 320 and investments accounted for under FASB ASC 323. Additionally, AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards; PCAOB Standards and Related Rules, Interim Standards*), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. For additional guidance, refer to Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 (AICPA, *Professional Standards*, AU sec. 9328 par. .01–.04), and Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 (AICPA, *Professional Standards*, AU sec. 9332 par. 01–.04).<sup>13</sup>

**11.74** Additionally, paragraphs 2–3 of FASB ASC 944-325-35 address accounting for unrealized gains and losses that are considered other than temporary for certain equity securities, as follows:

If a decline in the fair value of an equity security that is not within the scope of Subtopic 320-10 because it does not have a readily determinable fair value is considered to be other than temporary, the investment should be reduced to its net realizable value, which becomes its new cost basis. The amount of the reduction should be reported as a realized loss.

A recovery from the new cost basis should be recognized as a realized gain only at sale, maturity, or other disposal of the investment.

**11.75** Abstract Topic D-44 provides additional guidance on what is meant by an other than temporary decline in fair value in certain situations. In addition, the SEC's Staff Accounting Bulletin (SAB) No. 59, Topic 5M, *Noncurrent Marketable Securities*, sets forth the staff's interpretation of the phrase *other than temporary*. The SEC staff indicated that the phrase *other than temporary* should not be interpreted to mean permanent. In evaluating whether a realized or unrealized loss should be recognized resulting from a decline in market value below cost, many factors need to be considered, including the following:

- a. The length of time and extent to which the market value has been less than book value
- b. The financial condition and near term prospects of the issuer, including any specific events that may influence its operation
- c. The intent and ability of the life insurance entity to retain its investment for a period of time sufficient to allow for any recovery in market value

**11.76** *Transfers between FASB ASC 320 categories.* Changes in circumstances may cause a change in the life insurance entity's intentions to hold or trade certain debt and equity securities. A change in intent may require a transfer between categories. In accordance with FASB ASC 320-10-35-10 the

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<sup>12</sup> The companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides practical guidance for implementing AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*).

<sup>13</sup> These interpretations were issued in 2005, subsequent to Public Company Accounting Oversight Board (PCAOB) adoption of AICPA standards as interim, on April 16, 2003.

transfer of a security between categories is accounted for at fair value at the date of the transfer. As discussed in FASB ASC 320-10-35-16, for a debt security transferred into the held-to-maturity classification, the use of fair value may cause a premium or discount that is amortized as an adjustment of yield in accordance with FASB ASC 310-20. Transfers from the held-to-maturity category should be rare, except for transfers due to changes in circumstances identified in FASB ASC 320-10-25-6(a–f). Given the nature of a trading security, transfers into or from the trading category also should be rare. As discussed in FASB ASC 320-10-35-10, the date of transfer of the unrealized holding gains or losses are accounted for as follows:

- a. For a security transferred from the trading securities category, the unrealized holding gain or loss at the date of transfer will have already been recognized in earnings and should not be reversed.
- b. For a security transferred into the trading category the portion of the unrealized holding gain or loss at the date of the transfer that has not been previously recognized in earnings should be recognized in earnings immediately.
- c. For a debt security transferred into the available-for-sale category from the held-to-maturity category, the unrealized holding gain or loss at the date of transfer should be reported in other comprehensive income.
- d. For a debt security transferred into the held-to-maturity category from the available-for-sale 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 such as accumulated other comprehensive income, but should be amortized over the remaining life of the security as an adjustment to yield in a manner consistent with the amortization of any premium or discount. The amortization of an unrealized holding gain or loss reported in equity will offset or mitigate the effect on interest income of the amortization of the premium or discount (as described in paragraph 11.12) for that held-to-maturity security.

**11.77** *Statutory accounting practices.* Under SAP, realized gains or losses, net of applicable income taxes, are classified as interest related or credit related according to the rules for calculating the AVR and the IMR. See discussion on impairment in paragraphs 11.15–.16 for bonds, paragraphs 11.21–.22 for loan backed and structured securities, and paragraph 11.46 for preferred stock.

## Investments Other Than Securities

### Mortgage Loans

**11.78** In general, mortgage loan investments represent obligations secured by first or second mortgages on industrial, commercial, residential, or farm real property, and short term construction loans. Mortgages generally provide periodic interest payments generating interest income to the holder. The principal is generally paid back on a specified schedule or on a specific date.

**11.79** *U.S. generally accepted accounting principles.* Under U.S. GAAP, mortgages are reported at outstanding principal if acquired at par value, or

at amortized cost if purchased at a discount or premium, with a valuation allowance for any impairment. Premiums or discounts are generally amortized over the mortgage loan contract (or in some, limited cases, a shorter period based on estimated prepayment patterns; see FASB ASC 310-20-35-26) in a manner that will result in a constant effective yield. Interest income and amortization amounts and other costs that are recognized as an adjustment of yield are included as components of interest income.

**11.80** A life insurance entity 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 for the impaired loan with a corresponding charge or credit to bad-debt expense. Measuring impaired loans requires judgment and estimates, and the eventual outcomes may differ from those estimates. FASB ASC 310-10-35-13 provides four situations that identify those loans that are not included in the scope of the statement. Life insurers that engage in mortgage banking activities should apply the provisions of FASB ASC 948, *Financial Services—Mortgage Banking*, to those operations. Therefore, mortgage loans held for sale should be reported at the lower of cost or market value in conformity with FASB ASC 948.

**11.81** If a mortgage loan has been the hedged item in a fair value hedge, the loan's cost basis used in lower-of-cost-or-market accounting should reflect the effect of the adjustments of its carrying amount made pursuant to FASB ASC 815-25-35-1(b). As discussed in FASB ASC 815-10-15-71, loan commitments relating to the origination of mortgage loans held for sale should be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). If mortgage loans held for sale are securitized, an entity engaged in mortgage banking activities should classify the resulting MBS or other retained interests in conformity with FASB ASC 948.

**11.82** For issuers as prescribed by the rules of the SEC and entities subject to depository and lending institution agency regulatory requirements, SEC SAB No. 105, *Application of Accounting Principles to Loan Commitments* (Codification of Staff Accounting Bulletins, Topic 5—Miscellaneous Accounting, Section DD—*Loan Commitments Accounted for as Derivative Instruments*), provides guidance on loan commitments accounted for as derivatives.<sup>14</sup>

**11.83** Note that FASB ASC 825-10-50 requires disclosures of the fair values of all financial instruments for which it is practicable to estimate fair value and of significant concentrations of credit risk arising from financial instruments.

**11.84** If an entity accounts for mortgage servicing rights, FASB ASC 860-50 provides guidance for the disclosure of and accounting for servicing assets and servicing liabilities, including mortgage servicing rights. In general, it requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract if certain facts and circumstances exist. Additionally, all separately recognized servicing rights must be initially measured at fair value, if practicable. For each class of separately recognized servicing assets and liabilities, FASB ASC 860-50 permits an entity to choose either of the following

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<sup>14</sup> The AICPA Practice Aid *Illustrative Disclosures on Derivative Loan Commitments* provides illustrations of disclosures of derivative loan commitments in accordance with the reporting and disclosure guidance cited in Staff Accounting Bulletin No. 105.

subsequent measurement methods: (a) the amortization of servicing assets or liabilities in proportion to and over the period of estimated net servicing income or net servicing loss or (b) the reporting of servicing assets or liabilities at fair value at each reporting date and reporting changes in fair value in earnings in the period in which the changes occur. FASB ASC 860-50 also requires changed and additional disclosures for all separately recognized servicing rights.

**11.85 *Interest income.*** Interest income on all loans should be accrued and credited to interest income as it is earned, using the interest method. FASB ASC 310-40-50 requires disclosure of information about the recorded investment in certain impaired loans that fall within its scope and how a creditor recognizes interest income related to those impaired loans.

**11.86 *Amortization of discounts on certain acquired loans.*** The Financial Reporting Executive Committee (formerly the Accounting Standards Executive Committee) issued AICPA Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans* (AICPA, *Technical Practice Aids*, PB sec. 12,060), in 1989 to provide guidance on the accounting and reporting by purchasers of certain acquired loans or other debt securities (as defined). For acquired loans or other debt securities within its scope, Practice Bulletin No. 6 includes guidance on (a) amortization of discounts that reflect impairment due to credit risk, (b) initial and subsequent recognition of principal and interest, and (c) assessing collectibility. Practice Bulletin No. 6's provisions on these issues are inconsistent with certain provisions of FASB ASC 310-30 and ASC 320-10. FASB ASC 310-30-35 and ASC 320-10-35 take precedence for loans and debt securities within their scope.

**11.87** FASB ASC 310-30 applies to loans within the scope acquired individually, in a portfolio, or in acquisition. FASB ASC 310-30 does not apply to any entity originated loans, or acquired loans without evidence of credit quality deterioration.<sup>15</sup> FASB ASC 310-30 should be applied to loans individually to meet the scope criteria and individual loans are not to be aggregated for determining whether they, as a group, are within the scope. Because the use of aggregation may result in different scope applicability, aggregation is only allowed for recognition, measurement and disclosure purposes.

**11.88** FASB ASC 310-30 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment (purchase price) in loans or debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality. FASB ASC 310-30-35-2 describes that cash flows expected in excess of the initial investment should be recognized as yield. Yield that may be accreted (accretable yield) is limited to the excess of the investor's estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor's initial investment in the loan. FASB ASC 310-30-35 also requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable differences) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. FASB ASC 310-30-45-1 prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment.

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<sup>15</sup> See FASB ASC 310-30-15-2 for the list of scope exceptions.



**11.89** FASB ASC 310-30-30-1 states that valuation allowances should reflect only those losses incurred by the investor after acquisition—that is, the present value of all cash flows expected at acquisition that ultimately are not to be received.

**11.90** *Loan fees, costs, discounts, and premiums.* FASB ASC 310-20 establishes the accounting for loan origination fees and costs.<sup>16</sup> In general, loan origination fees net of direct loan origination costs should be deferred and recognized over the contractual life of the loan as an adjustment of yield using the interest method. However, for certain homogeneous pools consisting of a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the entity may consider estimates of prepayments in the calculation of the constant effective yield necessary to apply the interest method. Direct loan origination costs include incremental direct costs incurred in transactions with independent third parties for that loan and certain costs directly related to specified activities performed by the lender for that loan. Deferred costs include only the direct costs of completed loans and must be deferred irrespective of the existence of related loan fees. Direct costs of unsuccessful loan origination efforts and all indirect costs are charged to expense as incurred.

**11.91** Fees received for a commitment to purchase a loan, or group of loans or originate loans not held for sale by the issuer, should be deferred except for certain retrospectively determined fees. If the commitment is exercised, the commitment fee should be recognized as an adjustment of yield over the related loan's life. If the commitment expires unexercised, the commitment fee should be recognized in income upon expiration of the commitment. However, commitment fees, for which the entity's experience with similar arrangements indicates that the likelihood of exercise is remote, should be recognized over the loan commitment period on a straight line basis as service fee income. For originated loans held for sale by the issuer of the loan, commitments should be accounted for as derivatives under the scope of FASB ASC 815. (See paragraphs 11.77–.82.) Derivative accounting is required by the issuer of the loan commitment (the writer of the option) but not the holder of the loan commitment (the potential borrower under the contract). All other commitments to originate loans are excluded from the scope of FASB ASC 815 and are accounted for under FASB ASC 310-20 and 310-30, as appropriate.

**11.92** For purchased loans, the initial investment includes the amount paid to the seller, net of fees paid or received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. For purchased loans without evidence of credit quality deterioration, this difference should be recognized as an adjustment of yield over the life of the loan. See paragraphs 11.84–.87 for specifics on loans within the scope of FASB ASC 310-30. All other costs related to the purchase of loans are charged to expense as incurred (designation of a fee or cost as an origination fee or cost for a loan that is purchased is inappropriate because a purchased loan has already been originated by another party). (See paragraph 11.88.)

**11.93** FASB ASC 310-20 addresses fees and costs in refinancings or restructurings other than a troubled debt restructuring (TDR) and requires that

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<sup>16</sup> FASB staff has also published a FASB special report, *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases: Questions and Answers*.

the accounting for net fees or costs related to refinancing or restructuring be based on whether the terms of the new loan represent more than minor modifications and are at least as favorable to the lender (based on effective yield) as the terms of comparable loans. FASB ASC 310-20 also discusses a variety of other amortization issues, including the treatment of increasing, decreasing, and variable rate loans as well as demand loans and revolving lines of credit.

**11.94** *Statutory accounting practice.* The amount recorded as the initial investment in a loan is the principal of the loan, net of deferred loan origination and commitment fees. If purchased, the loan is recorded at the amount paid. 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, at the current valuation date, or both.

**11.95** Procedures for amortizing discounts and premiums on mortgage loans are included in SSAP No. 37, *Mortgage Loans*. Loan commitment fees are deferred, and should be amortized over the life of the loan if the commitment is exercised. If the commitment is not exercised, the fee should be recognized in income on the commitment expiration date. Nonrefundable loan origination fees that represent points should be deferred and amortized over the life of the loan. Nonrefundable loan origination fees, other than points, should not be recorded until received in cash. All costs related to loan origination, acquisition and commitments should be charged to expense as incurred.

**11.96** As noted in paragraph 16 of SSAP No. 37,

A mortgage loan shall be considered to be impaired when, based on current information and events, it is probable that a reporting entity will be unable to collect all amounts due according to the contractual terms of the mortgage agreement. A reporting entity shall measure impairment based on the fair value (as determined by acceptable appraisal methodologies) of the collateral less estimated costs to obtain and sell. The difference between the net value of the collateral and the recorded investment in the mortgage loan shall be recognized as an impairment by creating a valuation allowance with a corresponding charge to unrealized loss or by adjusting an existing loan valuation allowance with a corresponding charge or credit to unrealized gain or loss. Mortgage loans for which foreclosure is probable shall be considered permanently impaired.

For mortgages that are in default, being voluntarily conveyed, 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.

**11.97** Interest income on mortgage loans is recorded as earned, and contingent interest may be recorded when received or as earned. As noted in paragraph 14 of SSAP No. 37, "If a loan in default has any investment income due and accrued which is 180 days past due and collectible, the investment income shall continue to accrue, but all interest related to the loan is to be reported as a nonadmitted asset. If accrued interest on a mortgage loan in default is not collectible, the accrued interest shall be written off immediately and no further interest accrued."

**11.98** Realized gains and losses on mortgage loans are accounted for as required by the calculation rules of the IMR and AVR reserve, depending on the classification of the gain or loss as either interest related or credit related.

**11.99** SSAP No. 83 provides accounting and reporting guidance for mezzanine real estate loans. Loans that meet the definition of a MREL are admitted assets and follow the accounting and reporting guidelines for mortgage loans contained within SSAP No. 37.

## Troubled Debt Restructurings<sup>|| ||</sup>

**11.100** *U.S. generally accepted accounting principles.* FASB ASC 310-40-15 establishes the accounting for the TDRs. A restructuring of a debt constitutes a TDR if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. For creditors, TDRs include certain modifications of terms of loans and receipt of assets from debtors in full or partial satisfaction of loans. Other useful information can be found in FASB ASC 310-40-55.

**11.101** *Modifications of terms.* Modifications of terms for TDRs include one or a combination of the following (as noted in FASB ASC 310-40-15-9):

- a. Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt
- b. Extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk
- c. Reduction (absolute or contingent) of the face amount or maturity amount of the debt
- d. Reduction (absolute or contingent) of accrued interest

Creditors should account for modifications of terms of loans in accordance with FASB ASC 310-40-15 and FASB ASC 310-10-35.

**11.102** *Receipts of assets.* If assets, including equity interests, are acquired in full satisfaction of a loan, the creditor should report the receipt of such assets at their fair value at the time of the restructuring. Any excess of the recorded investment in the loan satisfied over the fair value of the assets received (less cost to sell if required by FASB ASC 310-40-15) should be recognized as a loan loss. If assets are received in partial satisfaction, the carrying amount of the loan is reduced and FASB ASC 310-10-35 is applied. Losses, to the extent they are not offset against allowances for uncollectible amounts or other valuation accounts, should be included in measuring net income for the period.

**11.103** *In-substance foreclosures.* FASB ASC 310-40-40-6 requires that the accounting for receipts of assets be applied when a TDR is in substance a repossession or foreclosure by the creditor, that is, the creditor receives physical possession of one or more of the debtor's assets in place of all or part of the receivable regardless of whether formal foreclosure proceedings take place.

**11.104** FASB ASC 310-10-35 requires a creditor to measure impairment based on the fair value of the collateral when a creditor determines that foreclosure is probable. A creditor should consider estimated costs to sell, on a

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<sup>|| ||</sup> In April 2011, FASB issued ASU No. 2011-02, *Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which provides clarification on whether a restructuring is a troubled debt restructuring. The amendments in this ASU are effective for the first interim or annual period beginning on or after June 30, 2011, and should be applied retrospectively to the beginning of the period of adoption.

discounted basis, in the measure of impairment if those costs are expected to reduce cash flows available to repay or otherwise satisfy the loan.

**11.105** *Statutory accounting practice.* Under SAP, TDRs should be accounted for according to the type of the restructuring (transfer of assets in full settlement, grant of equity interest in full settlement, modification of terms or combination of types) that has occurred. As noted in SSAP No. 36, *Troubled Debt Restructuring*, "Generally, troubled debt restructuring involving the transfer of assets or the grant of an equity interest should be accounted for at the fair value of the assets transferred or the equity interest granted." Restructurings involving only modifications of terms are accounted for at fair value. If the restructuring is for a collateral dependent loan, the asset is written down to the fair value of the underlying collateral. If the loan is not collateral dependent, the fair value should be determined in accordance with the *Purposes and Procedures Manual* of the NAIC SVO, if applicable, or at the present value of expected future cash flows (see SSAP No. 36 paragraphs 10–12). A mortgage loan in which the title to the asset is being obtained should be reclassified to real estate at the beginning of the redemption period unless it is probable that the loan will be redeemed. Nonrecoverable costs should be expensed in the period incurred.

**11.106** Additionally, statutes and regulations of the domicile state may contain provisions that require the disposal of foreclosed properties within a certain period of time. SSAP No. 36 adopts certain provisions of FASB ASC 310-40-15 and FASB ASC 310-10-35 (see SSAP No. 36 paragraphs 19–23 for discussion of the literature adopted).

## Real Estate Investments

**11.107** Real estate is classified either as investment real estate, real estate used in the entity's operations (depending on its predominant use), or real estate acquired in settlement of debt. Some real property investments produce rental income, whereas others may incur an operating loss and may result in a gain or loss at disposal.

**11.108** *U.S. generally accepted accounting principles.* In accordance with paragraphs 4–6 of FASB ASC 944-360-35, real estate investments (except those held for sale) are recorded at cost less accumulated depreciation. Depreciation and other related charges or credits should be charged or credited to investment income. Reductions in the carrying amount of real estate investments resulting from FASB ASC 360-10 should be included in realized gains and losses.

**11.109** Accounting guidance related to real estate acquisition, development, or construction arrangements is provided by FASB ASC 970-323, FASB ASC 810-20, FASB ASC 360-20, and FASB ASC 310-10.

**11.110** *Statutory accounting practices.* Under SAP, SSAP No. 40, *Real Estate Investments*, paragraph 4 states "Real estate investments shall be reported net of encumbrances in the following balance sheet categories, with parenthetical disclosure of the amount of the related encumbrances: a. Properties occupied by the company; b. Properties held for the production of income; and c. Properties held for sale." Properties occupied by the company and properties held for the production of income should be reported at depreciated cost. Properties held for sale should be reported at the lower of depreciated cost or fair value less encumbrances and estimated costs to sell the property. As noted in paragraph 11 of SSAP No. 40, "The current fair value of real estate shall be

determined on a property by property basis . . . and shall be defined as the price that a property would bring in a competitive and open market under all conditions requisite to a fair sale . . . If market quotes are unavailable, estimates of fair value shall be determined by an appraisal (internal or third party), which is based upon all relevant data about the market . . ." Appraisals are required to be no more than five years old, and a current appraisal should be obtained if there has been a significant decline in fair value. Any realized or unrealized gains or losses on real estate transactions are recognized as a component of net income after net gain from operations and included in the calculation of the AVR reserve in the equity component under the real estate and other invested assets subcomponent.

**11.111** SSAP No. 90, *Accounting for the Impairment or Disposal of Real Estate Investments*, as amended by SSAP No. 95, *Exchange of Nonmonetary Asset, A Replacement of SSAP No. 28—Nonmonetary Transactions*, incorporates the FASB ASC 360-10 concepts of the recognition and measurement of an impairment loss with certain SAP modifications. For example under SSAP No. 90, estimates of cash future cash flows used to test the reasonability of a long lived asset should only use their best estimate in testing. Real estate properties classified as held for sale are disallowed from recognizing increases in fair value less cost to sell until the asset is sold. The concept of grouping the asset for impairment purposes is rejected for SAP.

## Joint Ventures and Partnerships<sup>17</sup>

**11.112** Life insurance entities may invest indirectly in real estate or other investments, such as mining or oil drilling, high yield security partnerships, CMO partnerships, venture capital or leveraged buyout partnerships, or government backed mortgage partnerships, through participation in joint ventures or partnerships. These investments may differ in legal form and economic substance, but the most common forms are corporate joint venture, general partnership, limited partnership, and an undivided interest. Generally, joint venture arrangements have formal agreements that specify key terms of the arrangement such as profit or loss allocations, cash distributions, liquidation distributions, and capital infusions for each participant.

**11.113** The terms of these agreements, and the accounting model applied by the venture or partnership may affect the life insurance entity's investment valuation, accounting treatment, and income recognition. It is not uncommon to find transactions between the life insurance entity and the venture or partnership that may affect the carrying value and income recognition of other investments such as mortgage loans and debt securities. Joint ventures generally remit dividends to venture partners, and may result in a gain or loss upon

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<sup>17</sup> The AICPA issued a Practice Aid titled *Alternative Investments Audit Considerations—A Practice Aid for Auditors*, located at [www.aicpa.org/download/members/div/auditstd/Alternative-Investments.Practice.Aid.pdf](http://www.aicpa.org/download/members/div/auditstd/Alternative-Investments.Practice.Aid.pdf). This practice aid addresses challenges associated with auditing investments for which a readily determinable fair value does not exist (that is, investments not listed on national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System). These investments include private investment funds meeting the definition of an investment entity under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, as amended, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common and collective trust funds. Alternative investments may be structured as limited partnerships, limited liability corporations, trusts, or corporations.

disposal of their interest in the venture or partnership. In many cases, life insurance entities do not take an active role in the management of the venture.

**11.114** *U.S. generally accepted accounting principles.* Under U.S. GAAP, the ownership percentage in and the degree of control over the joint venture or partnership determine whether the cost, equity, or consolidation method applies with respect to the accounting and reporting of the investment. Many of the standards for the accounting and reporting of joint venture investments are established in FASB ASC 323, FASB ASC 835-20, and FASB ASC 840, *Leases*. The life insurance entity should disclose any contingent obligations or commitments for additional funding or guarantees of obligations of the investee in the notes to the financial statements.

**11.115** Insurance entities may participate in variable interest entities through investing in structured investments, such as asset backed securities, synthetic asset backed securities and catastrophe bonds, certain structured reinsurance transactions, joint ventures without substantive operations, financial guarantees, debt issuance vehicles, synthetic leases, collateralized bond obligation issuances, or limited partnerships.

**11.116** *Statutory accounting practices.* Except for entities within the scope of SSAP No. 93, *Accounting for Low Income Housing Tax Credit Property Investments*, SSAP No. 48, *Joint Ventures, Partnerships and Limited Liability Companies*, provides that joint ventures, partnerships and limited liability companies, except those with a minor ownership interest (that is, less than 10 percent), should be accounted for in accordance with an equity method as defined under SSAP No. 97. Refer to the discussion of SSAP No. 97 in paragraphs 11.44–45 of this chapter for discussion of equity method as defined under SSAP No. 97. Investments in joint ventures, partnerships, and limited liability entities in which the entity has a minor ownership interest or lacks control as stipulated in paragraphs 9–10 of SSAP No. 48, should be accounted for based on the audited U.S. GAAP equity. As discussed in paragraph 8 of SSAP No. 48, if audited U.S. GAAP basis financial statements of the investee are not available, joint ventures, partnerships, and limited liability companies in which the entity has a minor ownership interest or lacks control may be recorded based on either the U.S. GAAP basis equity as set forth in the audited footnote reconciliation of the investee's equity and income to U.S. GAAP within the investee's audited foreign GAAP prepared financial statements, or the International Financial Reporting Standards (IFRS) basis equity as set forth in the investee's audited IFRS financial statements prepared in compliance, both quarterly and annually, with IFRS as issued by the International Accounting Standards Board, or the underlying audited U.S. tax basis equity. These kinds of investments should be reported in "Other Invested Assets" in the financial statements. A nonsubstantive change to SSAP No. 48 allows the grand fathering of investments made prior to January 1, 2001, for GAAP audits. If the reporting entity (together with all other investors) does not have sufficient voting power (pursuant to the joint venture, partnership, or limited liability agreement) to force the preparation of audited GAAP financial statements, the reporting entity may then value its investment based on unaudited GAAP or audited tax basis financial statements. Note that the admissibility of assets may be limited when a qualified opinion is provided. Interpretation No. 03-03 of the Accounting Issues Working Group, *Admissibility of Investments Recorded Based on the Audited GAAP Equity of the Investee When a Qualified Opinion is Provided*, sets forth the adjustment criteria.

**11.117** Any realized gains or losses and unrealized losses are recognized as a component of net income after net gain from operations and included in the calculation of the AVR reserve in the equity component under the real estate and other invested assets subcomponent.

**11.118** Effective for reporting periods beginning on or after January 1, 2006, SSAP No. 93 establishes SAP for investments in federal and certain state sponsored low income housing tax credit properties. SSAP No. 93 adopts FASB ASC 323-740, with modifications. SSAP No. 93 requires the amortized cost method of FASB ASC 323-740 with a modification to include tax benefits during the holding period.

## Policy Loans

**11.119** Policy loans are loans made to contract holders using their life insurance contract's cash value as collateral. There are no statutory restrictions applicable to this kind of investment other than that the loan taken by contract holders may not exceed the cash surrender value of the policy. In addition, the loan interest rate is regulated in most states. If the contract holder stops paying premiums after a policy loan equals the surrender value, the contract is terminated.

**11.120** Many whole life contracts carry automatic policy loan provisions that allow for automatic policy loans from cash values to pay scheduled premium payments. For universal life-type contracts, the cost of insurance and other charges paid from cash values are not considered policy loans.

**11.121** Policy loans are unique to life insurance entities and are carried on the balance sheet at the unpaid principal balance. Additionally, under SAP, as noted in SSAP No. 49, *Policy Loans*, accrued interest that is collectible can be included in the balance of policy loans, as noted in SSAP No. 49. For policy loans that are considered uncollectible, the amount in excess of the cash surrender value should be written off as a reduction of investment income in the statement of operations during the period it is deemed uncollectible. The amount in excess of the cash surrender value, for all loans other than collateral assignment loans, are considered nonadmitted assets. The change in these nonadmitted assets should be recorded as a change in nonadmitted assets, as applicable.

**11.122** SSAP No. 91R provides statutory guidance for asset securitizations and securitizations of policy acquisition costs. This statement adopts portions of FASB ASC 860, with certain modifications (see SSAP No. 91R for listing of modifications and further guidance.)

## Investment Income Due and Accrued

**11.123** *Investment income due* represents certain amounts of income that are legally owed to the entity as of the statement date but have not yet been received. Investment income should not be accrued if collectibility is doubtful. For statutory purposes, uncollectible amounts should be written off through the statement of operations.

**11.124** *Accrued investment income* represents interest that would be collectible if the obligation were to mature as of the statement date. The amounts that are shown as accrued for preferred stocks and common stocks are

dividends on stocks declared to be exdividend on or prior to the statement date and payable after that date.

**11.125** Under SAP, as explained in SSAP No. 34, *Investment Income Due and Accrued*, as amended by SSAP No. 99, a collectibility test similar to that required under U.S. GAAP is used to determine whether an impairment of the investment income exists. If the interest is deemed uncollectible, the amount should be written off and charged against investment income in the current period. Interest not relating to mortgage loans even if deemed collectible, is considered nonadmitted if 90 days or more past due. Mortgage loan interest 180 days past due that is deemed collectible, should be considered a nonadmitted asset. Also as discussed in paragraph 3 of SSAP No. 34, as amended by SSAP No. 99, immediate amortization of premium which occurs upon recognition of an other-than-temporary impairment loss for a debt security with a recorded premium should be reported as a realized loss and should not be included in investment income.

## Auditing

### Debt and Equity Securities

**11.126** AU section 332 (AICPA, *Professional Standards*) is the primary source of guidance when auditing assertions about securities, derivatives, and hedging activities. In addition, the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides extensive guidance on auditing securities, derivatives, and hedging activities, including the assessment of the risks of material misstatement (inherent risk and control risk assessment) and the design of substantive procedures. Additionally, AU section 328 (AICPA, *Professional Standards*) establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. For additional guidance, refer to Interpretation No. 1 of AU section 328 and Interpretation No. 1 of AU section 332.<sup>18</sup>

### Inherent Risk

**11.127** As part of the auditor's assessment of inherent risks, the auditor may consider those factors related to investments, including factors relating to management, investment operations, and portfolio characteristics. Such factors might encompass the following:

- a. *Investments in general.* These include the following:
  - i. The entity's general investment policy is very aggressive and encourages the use of new and innovative kinds of securities or other investment vehicles that are susceptible to investment valuation adjustments.
  - ii. The kinds of investments, length to maturity, rates of return, and other investment strategies are not well matched to the kind of products sold or the cash flow needs of the entity.

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<sup>18</sup> These interpretations were issued in 2005, subsequent to PCAOB adoption of AICPA standards as interim, on April 16, 2003.



- iii. Changing regulations, including those concerning related party transactions, current tax rules, and reporting requirements, may establish specific practices allowed in the valuation and diversification of an investment portfolio.
  - iv. Investments are concentrated either by certain kinds (for example, high yield securities), issues (for example, specific industry bonds), geographical areas (for example, regional concentrations of mortgage loans or real estate projects), or single issuer.
  - v. There is a high concentration of investments in securities subject to prepayment risk, such as CMOs, IOs, POs, and Government National Mortgage Association (GNMA, also known as Ginnie Mae) securities.
  - vi. Foreign investments are threatened by actions of foreign governments (for example, foreign exchange controls).
  - vii. The amount of higher risk or unusual investment vehicles has increased (for example, joint ventures, interest rate swaps, or securities lending).
  - viii. The competitive environment requires the use of investment strategies that seek high rates of return.
  - ix. Turnover in the investment portfolio, other than that caused by the maturity of securities, has increased and may affect the balance sheet classification and carrying value of certain assets.
  - x. The cash flow expectations of the parent entity or the subsidiaries' needs for surplus are high.
  - xi. Compensation of investment personnel is closely linked to investment returns.
  - xii. The entity uses subsidiaries, limited partnerships, or other legal organization forms as vehicles for higher risk investments.
- b. *Debt and equity securities.* These include the following:
- i. The life insurance entity places substantial reliance on outside investment managers, brokers, and traders, who have significant discretionary authority over investment decisions.
  - ii. The life insurance entity uses sophisticated cash management techniques, or cash flow projections presume utilization of float.
  - iii. Various economic factors cause rapid fluctuations in market interest rates and securities prices.
  - iv. There is a high concentration of investments classified as held-to-maturity under FASB ASC 320.
- c. *Futures, options, and other derivatives.* These include the following:
- i. The entity uses sophisticated investing techniques such as hedging of interest rate and foreign currency exposure or computerized or programmed trading that may affect investment risk.
  - ii. There is a high use of structured notes.

- iii. There is uncertainty regarding the financial stability of a counterparty.
  - iv. High volatility in interest rates, currencies or other factors are affecting the value of derivatives and possibly their continued accounting for as a hedge.
- d. *Mortgage loans and real estate.* These include the following:
- i. Existing liens, imperfect deeds, or title positions exist that prevent the life insurance entity from having clear title to real property or collateral.
  - ii. Adverse environmental conditions are caused by materials used in construction (for example, asbestos) or the location of the site (for example, a site located near a toxic dump or contaminated water supply).
  - iii. Adequate casualty insurance is not maintained on the property to protect the value of the collateral or real estate investment in the event of a catastrophe.
  - iv. There are master leases on mortgaged or owned real estate properties.
  - v. Government regulations are becoming more prohibitive in relation to rent controls, mandated upgrading to comply with new or existing building codes, or foreclosure ability.
  - vi. There is a significant decline in the market values of real properties or collateral.
  - vii. Significant doubt exists regarding the collection of rent (for example, tenants in bankruptcy), the ability to dispose of foreclosed property, or the ability to refinance bullet mortgage loans.
  - viii. Troubled mortgage loans are restructured without due consideration given to the value of the underlying collateral.
  - ix. Significant doubt exists regarding the financial solvency or stability of private mortgage insurers, loan servicers or title insurers utilized by the entity.
- e. *Joint ventures and other investments.* The nature of the joint venture exposes the insurance entity to large or unusual risks, such as guarantees for future contributions of capital and other contingent liabilities that may exist. The entity has a complex organizational structure with diverse, restructured, or both, investment transactions leading to potential variable interest entities.
- f. *Policy loans.* Policy loan activity is increasing.

## Obtaining an Understanding of Internal Control for Investment Transactions

**11.128** As part of obtaining an understanding of internal control related to investment transactions, the auditor might consider the following factors. An entity's internal control consists of five elements: the control environment, risk assessment, control activities, information and communication, and monitoring as described in paragraph .41 of AU section 314, *Understanding the*

*Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). As discussed in chapter 5, "General Auditing Considerations," the auditor should obtain a sufficient understanding of each of the five elements of the entity's internal control to assess the risks of material misstatement of the entity's financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. Paragraphs .09–.17 of AU section 332 (AICPA, *Professional Standards*) and chapter 5 of the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, are primary sources of guidance and requirements on control risk assessment when auditing securities and derivatives.

**11.129** When performing an integrated audit of financial statements and internal control over financial reporting, paragraph 39 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), states "the auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if there are relevant assertions related to the entity's investment in derivatives and securities, the auditor's understanding of controls may include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and may encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system (AICPA, *PCAOB Standards and Related Rules*, Interim Standards, AU sec. 332 par. .11).

## Control Environment

**11.130** The control environment related to the invested assets of a life insurance entity represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific control policies or procedures on the investment operations of the entity. Such factors that relate to the invested assets transactions include the following:

*a. Investments in general.* These include the following:

- i. Formal investment policies do not exist or are limited in scope.
- ii. Periodic reviews of investments for other than temporary impairments are not performed or are inadequate.
- iii. There are frequent or unusual interentity or related party transactions.
- iv. Forecasts and analysis of investment operations results are limited.
- v. An independent valuation specialist is not used to value certain investments.
- vi. The investment information systems used by the life insurance entity or third party managers are unsophisticated or inadequate to meet the needs of the life insurance entity's financial reporting or asset management

requirements. Systems cannot cope with the diverse reporting required by regulatory agencies.

- vii. Investment department personnel are unsophisticated or given limited training in relation to the investment portfolio managed.

b. *Debt and equity securities.* These include the following:

- i. Holding of securities exists in-house rather than at an independent third-party custodian.
- ii. The entity does not take physical control of the underlying collateral for reverse repurchase agreements or other forms of borrowed securities.
- iii. Formal policies do not exist that would provide for a review of all reverse repo and dollar reverse repo contracts to determine whether they have been appropriately reported as financing or sales transactions.
- iv. The entity does not periodically assess the appropriateness of debt and equity classifications as held-to-maturity, trading, or available-for-sale.
- v. The entity does not properly monitor transfers between the three debt and equity security categories.

c. *Futures, options, and other derivatives.* These include the following:

- i. The entity depends on one individual for all organizational expertise on derivatives activities.
- ii. There is inadequate information available to effectively monitor derivatives transactions, including inadequate or untimely information about derivatives values.
- iii. There is significant use of derivatives without relevant expertise within the entity.

d. *Mortgage loans and real estate.* These include the following:

- i. There are no formal policies established and monitored regarding interest rates, mortgage terms, property appraisal preparation and review, foreclosure proceedings, or creditworthiness of borrowers or major tenants.
- ii. There are no periodic appraisals of wholly owned real estate or real estate supporting mortgage loans.
- iii. Troubled mortgage loans are restructured without due consideration given to the value of the underlying collateral.

e. *Joint ventures and other investments.* These include the following:

- i. Joint venture management fails to provide appropriate information to the life insurance entity regarding financial transactions or valuation of the related assets in the venture.
- ii. Significant audit adjustments are reported by joint venture management.

- iii. Subsidiary or equity investee financial statements are not available or are not reliable (for example, audited financial statements are not prepared or do not have an unqualified opinion).
- iv. Investment department personnel provide poor documentation for evaluation of substance over form analysis for accounting treatment of joint venture transactions.
- f. *Policy loans.* New products or processes have been introduced that do not adequately support policy loan activity and reporting requirements.

## Control Activities

**11.131** Control activities are those policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor should obtain an understanding of those control activities relevant to the audit.

**11.132** The following are examples of internal control procedures and policies relating to investment operations.

- a. *Proper authorization of transactions and activities.* Written policy statements detailing investment guidelines, objectives, hedging techniques, asset-liability matching policies, authorization levels, and limitations are adopted and monitored by the those charged with governance and designated levels of management. Potential investment transactions and investment policy changes are reviewed and approved by those charged with governance and recorded in the minutes. System security violations and failures are adequately monitored.
- b. *Segregation of duties.* Different individuals or areas are responsible for authorizing investment transactions, recording transactions, and maintaining custody of asset records. Different individuals are responsible for authorizing mortgage loans and current valuations and appraisals of those loans.
- c. *Design and use of adequate controls over documents and records.* Authorized lists of signatures, brokers, and other third parties exist, are adhered to, and are reviewed and updated on a timely basis.
- d. *Adequate safeguards over access to and use of assets and accounting records.* Securities, property deeds, and other evidence of ownership are safeguarded in vaults with limited access or with third-party custodians. Documentation for evidence of ownership is made out in the name of the life insurance entity.
- e. *Independent checks on performance and proper valuation of recorded amounts.* Accounting entries and supporting documentation for investment transactions are periodically reviewed by supervisory personnel to ensure accurate classification and proper recording. Recorded amounts of investments are periodically compared and reconciled to custodial ledgers and third party custodial confirmations; differences are investigated and resolved on a timely

basis; appropriate personnel review and approve reconciliations. Adjustments to investment accounts are reviewed and approved by authorized personnel.

Note that for an integrated audit performed in accordance with PCAOB standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, *PCAOB Standards and Related Rules*, Interim Standards]). Also refer to paragraph 54 of Auditing Standard No. 5 for a discussion on the extent of tests of controls (paragraph .97 of AU section 319).

## Information and Communication

**11.133** Paragraph .81 of AU section 314 states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report an entity's transactions (as well as events and conditions) and to maintain accountability for related assets, liabilities, and equity.

**11.134** The flow of accounting records for investment transactions encompasses all functions relating to the purchase and sale of investments, the recording of investment income, and realized and unrealized investment gains and losses, as well as the custody and safekeeping of invested assets. The functions within this cycle may be segregated into areas for each major investment category because of the different activities and expertise required for each.

**11.135** Security acquisitions or disposals are generally initiated by the preparation of trading slips either by investment department personnel or automated trading systems. Once approved, they are forwarded to a broker or automated trading system to execute the transaction. The investment transactions and related purchase premium or discount, or gain or loss, are matched against third party documentation (for example, brokers' advices) and recorded in the investment systems and accounting records.

**11.136** Mortgage and construction loans may be acquired and serviced by outside loan correspondents, whose reports serve as original documents for accounting transactions for these loans, or the life insurance entity may perform these functions itself. Once a mortgage loan has been approved and executed, mortgage loan accounting primarily consists of recording principal and interest payments and amortizing any premium or discount associated with the loan.

**11.137** Historically, life insurance entities have maintained their financial records on a cash basis, with end-of-period adjustments for accrual accounting. At the valuation date, due and unpaid amounts, accruals, and unearned income amounts are calculated and recorded for interest, dividend, and real estate income receivables. Adjustments may also be necessary for acquisition or disposal transactions that have trade dates before and settlement dates after the balance sheet date.

**11.138** Investment income and realized gains and losses generally comprise interest and dividend payments, amortization or accretion of premiums and discounts, and deferred loan fees, real estate income, and gains and losses

on sales and impairment of assets. These amounts are generally recorded as received, on a cash basis, in both the investment systems and the accounting records. Cash transactions should be compared with amounts expected and any difference should be evaluated and adjusted when necessary, as differences may arise because of the nature of some investments (for example, variable rate instruments and prepayments of mortgage principal).

**11.139** An insurance entity's treasury department is usually responsible for the safekeeping of securities, deeds, mortgage notes, and other related documents. Such documents are either stored in an entity vault where access is limited to authorized personnel, or held in the custody of third party custodians such as banks, securities depositories, or state departments of insurance.

**11.140** Accounting transactions may also arise from changes in fair values or regulatory valuations of the investment portfolio. In numerous jurisdictions investment valuation adjustments made for regulatory reporting purposes may differ in many respects from those made in accordance with GAAP.

**11.141** *Special considerations.* The investment community regularly develops new kinds of securities or other investment vehicles (for example, asset backed products or other derivative products). The auditor should obtain an understanding of the kinds of investments in the life insurance entity's portfolio and the related risks in designing appropriate audit procedures and tests as deemed necessary under the circumstances. In addition, the auditor may consider using a specialist, as appropriate. (Guidance on use of a specialist is provided in chapter 5.)

## Audit Consideration Chart

**11.142** The auditor may consider the following specific audit objectives and examples of selected control and auditing procedures in auditing investment transactions of life insurance entities. The audit consideration chart is intended to present examples only, and is not all-inclusive for any category. Additionally, AU section 332 (AICPA, *Professional Standards*) provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities as well as for investments in debt and equity securities as defined in FASB ASC 320, and investments accounted for under FASB ASC 323. Practitioners applying AU section 332 (AICPA, *Professional Standards*) may refer to the guidance in the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* for information about planning and performing audit procedures related to investments. Additionally, AU section 328 (AICPA, *Professional Standards*) establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements.

Audit Consideration Chart—  
Investments

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Existence or Occurrence and Rights and Obligations</i>		
	<u>General</u>	<u>General</u>
Investments included in the balance sheet physically exist.	Evidence of ownership exists, is adequately safeguarded, with access limited to authorized personnel or third party custodians, and is periodically inspected and reconciled to investment ledgers by appropriate personnel.	Obtain and inspect evidence of investment ownership held on the client's premises as of the date that the asset amounts are reconciled to general ledger control accounts.
Recorded investment acquisitions and disposals have occurred during the period under examination.		
The entity has legal title or similar rights of ownership to all recorded invested assets.	Custodial functions are independent of investment and accounting functions, and provide security commensurate with the risks involved.	Obtain confirmations from third parties for investments or collateral held for the client. Compare the confirmed lists with the trial balance or subledgers, and investigate discrepancies.
	The internal control environment, financial condition, and capabilities of third party custodians or servicing agents, property managers, and others with access to the entity's assets are evaluated periodically by the appropriate personnel.	Compare the face amounts and cost of investments recorded in the investment ledger with supporting documents created at the time of purchase. Examine supporting documents for proper completion and authorization. Compare cost data to published or other independent source.
	Reports and confirmations of investments held by third parties are periodically reconciled to entity records. Discrepancies are promptly resolved.	Confirm significant or unusual transactions for interest, dividend, or other investment income transactions.
	Questions concerning compliance with regulatory restrictions are referred to the legal department before transactions are executed.	Review legal department compliance records concerning statutory requirements and limitations.



<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Recorded investment transactions are supported by proper documentation and reviewed by authorized personnel.	Obtain and read custodial and servicing agreements and available reports regarding the adequacy of the custodians' internal controls and financial stability, including auditors' reports.
	Investment instruments are regularly inspected and reconciled to control ledgers by internal auditors or personnel not responsible for investment functions.	Confirm policy loan balances. Test loan balances to determine that they do not exceed cash surrender value. Read the finance committee minutes and test whether investment transactions have been properly authorized.
	<u>Securities</u> Transactions settled after year-end are evaluated or analyzed for recording in the proper period (as of the trade date). Electronic movement of funds requires the use of code words, number codes, callbacks, or other security procedures. Daily transaction reports are independently analyzed.	<u>Securities</u> Obtain confirmations that securities purchased under repurchase (repo) agreements, but not delivered, are being held by the sellers or the sellers' custodian on the entity's behalf. Confirm with brokers the status of securities in transit. Examine securities to determine whether they are registered or payable to the entity, an authorized nominee, or the bearer.
	<u>Mortgages and Other Loans and Real Estate Investments</u> Underwriting policies exist requiring real property appraisals, title searches, title insurance, limitations in the amounts and types of acceptable liens against properties, and are periodically evaluated and monitored by the appropriate personnel.	<u>Mortgages and Other Loans and Real Estate Investments</u> Examine evidence of insurance and property tax payments for mortgage collateral and real estate investments. Review adequacy of insurance coverage.

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Perfection of the deed, title positions, status of existing liens, insurance coverage, and tax payments are periodically monitored by appropriate personnel.	Examine mortgage notes and title deeds to real property to determine whether they are registered in the entity's name.
	Routine and periodic site inspections are conducted by internal auditors or appropriate personnel.	Physically inspect selected mortgage collateral and real estate investments.
		Examine real estate and mortgage files for loan applications, appraisal reports, deeds, title position and existing liens, and evidence that applicable property taxes and insurance are paid. Determine that loan terms (for example, interest rate) and the description of collateral are formally documented and approved by authorized personnel.
<i>Completeness</i>	<u>General</u>	<u>General</u>
Investment asset accounts include all investments of the entity.	Written policy statements detailing investment guidelines, hedging techniques, asset-liability matching procedures, and limitations are prepared and monitored by designated levels of management. New, current, and restructured transactions are reviewed for completeness.	Review selected transactions to test whether all significant terms were specified and documented, and whether the amounts and terms are consistent with those established by the entity's formal investment guidelines, hedging techniques, and asset-liability matching policies. Review mortgages, real estate, leases, and other loans and investments for significant controlling interests.
Investment income accounts include all transactions during the period.		

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
Investment records are properly compiled, and totals are properly included in the investment accounts.	<p>Potential investment transactions are reviewed by an investment advisory committee and approved by a finance committee.</p> <p>Investment systems permit forecasting of expected investment income and the forecasts are compared with actual amounts and reviewed by designated levels of management.</p> <p>Edit and validation controls, batch balancing, data transmission controls, logging, and cash totals are used to provide assurance that all investment transactions have been completely and accurately processed and recorded to investment master files.</p> <p>Investment master file data are independently reviewed and tested. Errors are investigated and resolved. Requested changes to master file data (for example, interest rate, CUSIP numbers) are authorized and approved.</p> <p>Suspense accounts (including clearing accounts) are reconciled and reviewed by the appropriate personnel for large, unusual, or old items.</p>	<p>Compare investment yields during the period with expected yields based on previous results and current market trends; investigate significant discrepancies.</p> <p>Examine input and output data and balances in individual investment accounts to test whether transactions are properly recorded and authorized.</p> <p>Compare investment totals to the client's reconciliation of the investment ledgers to the general ledger control accounts. Investigate significant discrepancies and any large or unusual reconciling items.</p> <p>Review suspense account trial balances for large, unusual, and old items.</p> <p>Test accruals of investment income for appropriate cutoff date, and proper exclusion of overdue amounts.</p> <p>Test clerical accuracy of subsidiary ledgers for policy loans. Agree balances to general ledger accounts.</p>
	<u>Securities</u>	<u>Securities</u>
	Buy-and-sell orders to brokers are compared to brokers' advices.	Inspect and count securities held by the client. Obtain confirmation from the custodian of securities held for the account of the client.

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Securities processing systems are monitored to ensure correct processing and period-end income accruals of complex financial instruments.	Determine that only securities dealers approved by the finance committee are used.  Test transactions settled after the end of the period for recording in the proper period (as of the trade date).
	Recorded amounts of investments are periodically compared with custodial ledgers and to current market values.	Review accruals for interest and dividends. Test selected calculations.
	<u>Mortgages and Other Loans</u>  Pertinent loan information entered into the processing systems (for example, loan type, loan amount, interest rate, maturity, collateral) is independently monitored to ensure accuracy and completeness.	<u>Mortgages and Other Loans</u>  Confirm significant loan terms (for example, outstanding principal, interest rate, maturity).  Review the proper treatment of escrow amounts.  Review accruals for mortgage loan interest. Test selected calculations.  Review asset reclassifications and mortgage loan restructuring for appropriateness.
	<u>Real Estate Investments</u>  Written policies detailing restructuring, refinancing, foreclosure guidelines, and underwriting standards are current and monitored by appropriate levels of management.	<u>Real Estate Investments</u>  Review asset reclassifications for appropriateness. Test compliance with underwriting standards.  Review lease agreements for contingent rental agreements. Test calculations where appropriate.
	Reclassifications between investment categories (for example, foreclosed mortgage loan to investment real estate) are reviewed and approved by appropriate levels of management.	

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Master leases are periodically reviewed by appropriate personnel.	
<i>Valuation or Allocation</i>	<u>General</u>	<u>General</u>
Invested assets are included in the financial statements in the appropriate amounts.	Investment valuation methodologies and procedures are established and monitored by designated levels of management.	Test determination of income collected, due, accrued, unearned, and nonadmitted for dividends, interest, amortization of discount or premium, rental income, and depreciation.
Investment income and expense, and gains and losses are recorded in the appropriate amounts.	Valuations for statutory reporting purposes are reviewed for conformity with NAIC published values.	Examine summaries of interest, dividend, and principal payments for indications of impairment.
	Unrealized gains and losses are reconciled with prior values, and are properly segregated as to accounting category of the securities.	Test computations and the statutory classifications of realized gains and losses.
	Allowances for the valuation of investments are substantiated by evidential matter.	Determine whether any decline in market value reflects an impairment in value that is other than temporary, and determine a new cost basis if applicable.
	Adjustments of investment accounts and master file information are reviewed and approved by authorized personnel.	Review debt securities and mortgage loans in default for proper exclusion of uncollectible amounts.
	Interest and dividends are reviewed for accuracy by reference to independent sources.	Review consistency of accounting methodologies between parent and any subsidiary or joint venture. Determine appropriate adjustments, if any.
		Obtain financial reports of joint ventures or limited partnerships, and compare reported amounts of dividends, net rentals, and so on, to the records.

(continued)

Life and Health Insurance Entities

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	<p>Investment income amounts due but not received are reconciled to estimated income lists and compared to subsequent income received.</p> <p>Calculation methodologies for premium or discount amortization, depreciation, and investment income accruals are reviewed and approved by the appropriate personnel.</p> <p>Proper records are maintained regarding calculation of the AVR and IMR.</p>	<p>Test calculation of the asset valuation revenue (AVR) and interest maintenance reserve (IMR).</p>
	<p><u>Securities</u></p> <p>Formal policies and procedures are in place to categorize securities at acquisition as to the appropriate accounting classifications as prescribed in FASB ASC 320, <i>Investments—Debt and Equity Securities</i>. Periodic reviews of categorizations are performed and appropriate documentation is prepared for any category transfers.</p> <p>Securities are monitored for other-than-temporary impairment and are written down to fair value when required. Periodic reviews of fair values are performed for other than temporary impairments.</p> <p>Securities valuations are obtained from outside brokers.</p>	<p><u>Securities</u></p> <p>Compare recorded costs of investments to published market quotations at the trade date. Consider reasonableness of commission rates, taxes, and other fees.</p> <p>Review dispositions of securities categorized as held-to-maturity to determine that disposals are consistent with the category. Assess the impact of sales or transfers on classification of remaining portfolio. Review sales activity to determine whether securities are classified in the appropriate FASB ASC 320 categories.</p>

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Market prices for purchases and sales are compared with independent sources.	Review the documentation for FASB ASC 320 categorizations of securities, including documentation for transfers between categories.
	Income amounts are compared with cash receipts records and are reconciled to the securities master listings.	Review hedging transactions to determine that they are consistent with the category hedged.
	Assumptions for projecting future cash flows relating to mortgage derivative or asset backed securities are reviewed and monitored by appropriate personnel.	Compare the recorded market values of investments to published market quotations at the end of the period.
	Formal policies are established and monitored to determine the appropriate accounting treatment of reverse repurchase agreements and related transactions as financing or purchase or sale transactions.	Examine past due bonds and notes for endorsements or evidence of reductions in principal through the receipt of partial payments.  Test dividend income by referring to published dividend records.
		Analyze yield by the type of mortgage derivative or asset backed security, such as collateralized mortgage obligations, for indications of unusually high or low yields or yields that differ significantly from expectations. Analyze amortization schedules using appropriate prepayment and default assumptions.
	<u>Mortgages and Other Loans</u>	<u>Mortgages and Other Loans</u>
	Collateral valuation, loan-to-value ratios, and the adequacy of insurance coverage are monitored by appropriate personnel.	Review current property appraisals and insurance coverage on collateral for mortgage loans.

(continued)

Life and Health Insurance Entities

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	Collateral valuation policies provide for current appraisals on troubled mortgage loans.	Review delinquent loan reports, testing for both the accuracy of the reports and the appropriateness of the aging of such loans.
	Underwriting policies are consistently applied for all loan applications and reviewed by the appropriate personnel.	Analyze loan agreements to determine whether acquisition, development, and construction arrangements exist, and review their classification and valuation.
	Formal policies exist for the identification of assets qualifying as in-substance foreclosures or loan restructures, and appropriate loss recognition is monitored by designated personnel.	Test the accuracy of loan-to-value ratios, and review compliance with statutory regulations and internal underwriting standards.
	Restructured mortgage loans are reviewed for compliance with in-substance foreclosure criteria.	Test mortgage loan prepayment assumptions and amortization methodologies for proper valuation.
	<u>Real Estate Investments</u>	<u>Real Estate Investments</u>
	Comprehensive investment and appraisal policies are established and monitored by appropriate levels of management.	Review current property appraisals (both internal and external), insurance coverage and income forecast for investment real estate.
	Effective reporting systems exist that track the performance of complex real estate deals and identify problem investments.	For joint ventures involving real estate assets, review formal agreements specifying key terms such as the allocation of profit and loss, cash distribution, and capital infusion provisions, which may affect investment valuations.
	Internal and external appraisals are periodically reviewed by appropriate levels of management as to methodology, review of assumptions, capitalization rate, and consistency across properties.	Review management's determination of fair value or net realizable value for real estate acquired in foreclosure or in substance foreclosure. If deemed necessary, obtain valuations from an independent appraiser.



<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
		<p>Review depreciation methodologies and test calculations.</p> <p>Review sale leaseback transactions for appropriate accounting treatment.</p>
<i>Presentation and Disclosure</i>		
	<u>General</u>	<u>General</u>
Investments are properly classified, described, and disclosed.	<p>Management reviews and monitors investment transactions and related results for compliance with authorized limits, yield and maturity requirements, and regulatory requirements.</p> <p>Management reviews and monitors invested assets with off balance sheet risks and concentrations of credit risks for appropriate disclosure.</p>	<p>Test whether disclosures comply with GAAP.</p> <p>For statutory financial statements, test whether classifications and disclosures comply with applicable regulations.</p> <p>Inquire about pledging, assignment, or other restrictions.</p> <p>Review finance committee minutes.</p> <p>Examine loan agreements.</p> <p>Obtain financial statements for joint venture partnerships and other investments in which the entity has a significant interest. Examine the opinion of the independent auditors and related disclosure to ensure that the items that affect the audit are properly considered.</p> <p>Compare changes in each category of the investment portfolio between periods.</p> <p>Review asset reclassifications for appropriateness.</p>
	<u>Futures, Options and Derivatives</u>	<u>Futures, Options and Derivatives</u>
	Financial reporting policies include adherence to FASB ASC 815, <i>Derivatives and Hedging</i> , as amended, which has extensive accounting and disclosure requirements for derivative instruments.	Determine whether appropriate disclosures are made for derivative instruments.



## Chapter 12

### Reinsurance

**Note:** This chapter contains references to both financial and non-financial assets and liabilities that are subject to fair value measurement. As noted in chapter 3, "Sources of Accounting Principles and Reporting Requirements," Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820-10 and FASB ASC 825-10 have significant implications for the concept of fair value. Please refer to chapter 3, beginning at paragraph 3.31, for further information.

### Introduction

**12.01** Reinsurance is a means by which the original or direct insurer, called the *ceding entity*, transfers all or part of its risk on a contract or group of contracts to another insurance entity, called the *assuming entity* or the *reinsurer*.

**12.02** Life insurance entities enter reinsurance agreements primarily to

- a. spread the risk of its insurance contracts;
- b. reduce exposure on particular risks or classes of risks;
- c. provide the financial capacity to accept risks and contracts with larger face amounts than those that could otherwise be accepted;
- d. help stabilize operating costs, which may be sensitive to fluctuations in claims experience, or stabilize mortality costs;
- e. improve its statutory surplus position by reducing the total liability for promised benefits to an appropriate level in relation to the life insurance entity's statutory surplus;
- f. facilitate the growth of new business written by reducing the net loss associated with statutory accounting principles (SAP) that occurs because of acquisition expenses and reserve requirements (*statutory surplus strain*);
- g. protect against accumulations of losses arising out of catastrophes such as unanticipated death claims in geographic areas that have suffered natural disasters;
- h. assist in financial and tax planning strategies;
- i. obtain underwriting assistance with respect to risk classification, or broaden the ability to market products with which the life insurance entity has little experience; and
- j. exit a line of business.

**12.03** Most life insurance entities set limits on the amounts and kinds of risks they will retain. These limits are referred to as *retention* and may differ depending on factors such as the age and sex of the insureds, the duration of the contracts, and the underwriting classification of the risk (standard or

substandard). Amounts at risk in excess of the retention limit are generally reinsured. In reinsuring all or part of a risk, the ceding entity does not ordinarily discharge its primary liability to its contract holders, but reduces its maximum potential exposure in the event of a loss by obtaining the right to reimbursement from the assuming entity for the reinsured portion of the loss. Life insurance contracts generally are expected to be profitable when written, so the original insurers generally desire to retain as much risk as possible. However, life insurance entities also want to avoid exposure to large losses that may jeopardize their financial position.

**12.04** For reasons similar to those described in paragraph 12.02, reinsurers also may transfer a portion of the risks they assume to other insurance entities, a procedure referred to as *retrocession*. A retrocession commonly occurs when the amount of reinsurance assumed is greater than the reinsurer's retention limit.

## Reinsurance Transactions

**12.05** Reinsurance transactions occur between insurance entities, not contract holders or insureds. In *indemnity reinsurance transactions*, the ceding entity remains primarily liable to the contract holder for the contract's promised benefits. In addition, the ceding entity bears the risks that the reinsurer may be unable to meet its obligations for the benefits assumed under the reinsurance agreement. The contract holder is generally unaware of any indemnity reinsurance transactions that may occur and continues to hold the original contract.

**12.06** In *assumption reinsurance transactions* (also referred to as *novations*), the assuming entity legally replaces the ceding entity as the primary obligor to the contract holder. The transactions usually involve a certain group or block of contracts (usually the sale of an entire block of business). In these transactions, the contract holder service responsibilities (for example, premium collection) are transferred to the assuming entity, and all relations with the original insurer are terminated. Generally, new contracts are issued by the assuming entity, or the contract holders are contacted for permission to transfer their contracts to the new entity, and assumption certificates are issued. In either case, the ceding entity is no longer liable to the contract holder. When an insurer, licensed in a state that has adopted the National Association of Insurance Commissioners (NAIC) Assumption Reinsurance Model Act or similar provisions, has entered into an assumption reinsurance transaction, the auditor should consider those provisions. Because the regulation gives policyholders up to two years to ratify or reject the transfer and novation, the reinsurance agreement may contain an indemnity reinsurance provision for contracts that have not transferred. See Statement of Statutory Accounting Principles (SSAP) No. 61, *Life, Deposit-Type and Accident and Health Reinsurance*, for additional information on SAP for reinsurance.

**12.07** *Fronting* is an arrangement between two or more insurers whereby the fronting entity will issue insurance 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. (See chapter 5, "General Auditing Considerations," for a discussion of the auditor's responsibility for

detection of illegal acts.) As with other indemnity reinsurance agreements, the fronting entity remains primarily liable for the benefits promised to the contract holders.

**12.08** *Reinsurance commissions.* Reinsurance agreements generally provide for a basic ceding commission, which is intended to reimburse the ceding entity for the costs it incurred selling and underwriting contracts. The ceding commission may include a profit factor. In addition, reinsurance agreements may also provide for contingent commissions, which are intended to allow the ceding entity to share in the profits realized by the assuming entity on the business subject to the reinsurance agreements. Contingent commissions may be in the form of volume commissions, sliding scale commissions, or commission adjustments or other adjustments that allow increasing commissions as losses decrease and vice versa, subject to maximum and minimum limits. Determining whether contracts with such provisions eliminate the indemnification of risks that may be inherent in the reinsurance agreement is a matter that generally requires a high degree of audit judgment.

**12.09** In addition to the reinsurance transactions that transfer excess risk, some life insurance entities enter into reinsurance agreements (usually some form of coinsurance) for the purpose of increasing their statutory surplus position to meet capital or surplus requirements, or both, to improve risk based capital ratios or to create enough taxable income to utilize a tax operating loss carryforward prior to the expiration of the carryforward period. These contracts are commonly referred to as *surplus relief agreements*. To accomplish this, an entity will seek a reinsurer with sufficient surplus or taxable income that is willing to assume a portion of the risk on a large block of business. In general, under SAP such reinsurance agreements result in current income to the ceding entity representing recovery of the acquisition costs and an element of profit. The corresponding amount is treated as a current expense by the assuming entity. Most states have rules or regulations that can prohibit the accounting treatment described previously for surplus relief transactions that do not transfer adequate risk.

## Types of Reinsurance Entities

**12.10** The following are the three common kinds of reinsurance entities.

- a. *Professional reinsurers* engage almost exclusively in reinsurance, although they are usually permitted by their charters and licenses to operate as direct insurers.
- b. *Reinsurance departments of direct insurers* function as units of direct insurance writers and engage in reinsurance.
- c. *Reinsurance pools or associations* are groups or syndicates of insurance entities organized to provide members with reinsurance protection and management for specialized high risk coverage (such as individual health insurance for those with diagnosed illnesses).

**12.11** In addition, *reinsurance intermediaries* facilitate reinsurance by bringing together ceding and assuming entities. Reinsurance intermediaries may underwrite, design, and negotiate the terms of the reinsurance arrangement. They may also place reinsurance, accumulate and report transactions, distribute premiums, and collect and settle claims.

## Bases of Reinsurance Agreements

**12.12** Reinsurance can be arranged on the following bases.

- a. *Facultative reinsurance* whereby each risk or portion thereof is reinsured individually, with the reinsurer having the option to accept or reject each individual insurance contract.
- b. *Automatic reinsurance* whereby an agreed upon portion of business written (generally all contracts in a specified class in excess of the ceding entity's retention limit, or a percentage of all contracts issued) is automatically reinsured, thereby eliminating the need to submit each risk to the reinsurer for acceptance or rejection. The ceding entity agrees to reinsure all qualified business and the assuming entity agrees to accept. This avoids the possibility of antiselection against the assuming entity. Automatic reinsurance is also referred to as *treaty reinsurance*.

## General Reinsurance Agreements

**12.13** Variability is the one common characteristic of the reinsurance business. Reinsurance agreements are individually negotiated to meet the needs of the assuming and ceding entities and, in practice, no two are exactly alike. The following are the most common kinds of agreements.

- a. *Yearly renewable term*. When reinsurance is ceded on a year renewable term (YRT) basis, the ceding entity purchases from the reinsurer one YRT insurance for the net amount at risk (face amount of the contract less the related reserve) on the portion of the contract reinsured, at annual premium rates specified in the agreement. The reinsurance premium depends on factors such as the age and sex of the insured, the duration of the contract, and the underwriting classification (standard or substandard). The YRT method transfers only mortality risk to the reinsurer, and generally does not contain any investment elements. These types of agreements may also be referred to as *annual renewal term* or *risk premium reinsurance*, and are usually designed to protect the ceding entity from large unanticipated mortality losses.
- b. *Coinurance*. When reinsurance is ceded on a coinsurance basis, the assuming entity shares in substantially all aspects of the original contract, including risks relating to mortality, persistency, investment, and other risks of the reinsurer's portion of the contract. The ceding entity pays the reinsurer a proportional share of the gross premium (based on the ceding entity's premium rate structure), less an allowance for commissions and other expenses as defined in the agreement. The reinsurer is liable for its proportional share of the contract holder dividends on participating contracts (as declared by the ceding entity), surrender benefits, death claims, and any other benefits covered by the premium. The assuming entity accepts a greater share of the persistency risk by reimbursing the ceding entity for a portion of the acquisition costs, and accepts an investment risk for adverse performance on the assets transferred to support the reinsured liabilities. The effect of coinsurance is to transfer a portion of the statutory surplus strain of the reinsured portion of new issues to the reinsurer (in addition to the mortality

and persistency risk). A direct writing entity may experience a strain on its surplus in the first policy year because premiums received by the direct writer during the first policy year usually are insufficient to pay the high first year commissions and other costs associated with issuance and to establish the initial benefit liability.

- c. *Modified coinsurance (Mod Co)*. This kind of reinsurance differs from coinsurance in that the statutory reserves and the supporting assets are retained by the ceding entity. (See chapter 8, "Liabilities for Future Policy Benefits (Statutory Benefit Reserves) and Other Contract Liabilities," for a discussion of mean reserves.) In addition to the transactions associated with coinsurance, a reserve adjustment payment between the assuming and ceding entities.

The reserve adjustment may be positive (payable to the ceding entity) or negative (payable to the reinsurer). The reserve adjustment is calculated as the increase in reserves from one valuation date to the next, less interest on the initial reserve because the ceding entity held the assets supporting the reserve for one year and earned interest thereon. The interest rate used is a negotiated rate determined according to a specified formula stated in the reinsurance agreement, such as a fixed rate or a rate related to the interest earnings of the ceding entity. Depending on the interest formula, the investment risk may be borne by the ceding entity, the assuming entity, or both entities. However, due to regulatory risk—transfer requirements, is it most common for the investment risk to be borne by the assuming entity. As with coinsurance, the assuming entity ordinarily participates in the mortality, persistency, and other risks.

- d. *Nonproportional reinsurance*. Life insurance entities may also purchase nonproportional reinsurance on all or part of their business. One form of nonproportional reinsurance is stop-loss reinsurance, under which the assuming entity agrees to reimburse the ceding entity for aggregate losses that exceed a specified amount. Another form is catastrophe reinsurance, under which the assuming entity agrees to reimburse the ceding entity for losses in excess of a specified amount from a single accident or event. The terms of these contracts generally vary considerably.

**12.14** Reinsurance agreements often provide for participation by the ceding entity in the profits generated under the reinsurance agreement, generally referred to as *experience rated contracts*. The reinsurance agreements specify the method of computing the profit and the formula for profit sharing.

## Regulation

**12.15** Life insurance entities and reinsurers are usually required to file copies of reinsurance agreements with their domiciliary state insurance department. In addition, in a number of states, advance approval of the reinsurance agreement by the domiciliary state insurance department is required. Generally, a reinsurer must be authorized to do business in the ceding entity's state of domicile. If the reinsurer is not authorized, the reinsurance is generally considered *unauthorized*, and the ceding entity is generally not permitted and may not be allowed to take a reserve credit for the related reinsurance

transaction in its statutory financial statements unless the balance is collateralized by funds held, assets in a trust account, or a letter of credit.

**12.16** Most states have specific requirements for the level or kind of risk transfer necessary for reinsurance reserve credits to be allowed. These requirements generally prohibit reserve credits for reinsurance agreements that provide little or no transfer of risk as defined by statutory guidance. In addition, the amount of the reserve credit cannot be greater than the gross reserves ceded.

**12.17** Generally, reinsurance premiums are not subject to premium taxes; however, under the terms of the agreement, the ceding entity may be reimbursed by the reinsurer for the premium taxes paid on the portion of direct premiums reinsured.

## Accounting Practices \*

**12.18** As discussed in chapter 3, life insurance entities are subject to the filing requirements of SAP and may also prepare financial statements in accordance with U.S. generally accepted accounting principles (GAAP). The following discussion of SAP and U.S. GAAP accounting for reinsurance transactions is not a comprehensive source of authoritative accounting literature, but is intended to assist the preparers and auditors of financial statements in obtaining a general understanding of basic accounting practices for the most common kinds of reinsurance transactions within the life insurance industry. The authoritative sources cited in chapter 3 may be referred to in determining appropriate accounting and reporting treatment in all cases.

**12.19** To properly account for reinsurance agreements, it is necessary to determine whether the agreements are constructed to transfer economic risk. Many coinsurance type reinsurance agreements entered into for surplus relief may, in essence, be financing arrangements rather than reinsurance

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\* The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, the Financial Accounting Standards Board (FASB) issued the invitation to comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project.

In July 2010, the IASB issued the exposure draft *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. Although the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement model; however, the majority prefer an alternative model. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. generally accepted accounting principles to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.



agreements. Financing type agreements often result in little, if any, transfer of economic risk. Such agreements usually call for the ceding entity to agree that the contract will not be canceled until the reinsurer has recovered all money advanced, and may provide that, in the event of cancellation, the ceding entity must refund the amount of surplus relief with interest. These agreements frequently call for a large provisional commission and accomplish the desired payback through subsequent adjustments of the provisional commission based on experience.

## Statutory Accounting Practices

**12.20** In general, the accounting treatment by ceding entities for reinsurance transactions is the opposite of that for 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 decreased for premiums related to insurance ceded). Refer to SSAP No. 61, which establishes SAP for life, deposit type, and accident and health reinsurance for additional guidance.

**12.21** Reinsurance agreements must transfer risk from the ceding entity to the reinsurer in order to receive reinsurance accounting treatment as discussed in SSAP No. 61. Appendix A-791, "Life and Health Reinsurance Agreements," of the NAIC *Accounting Practices and Procedures Manual*, outlines the criteria that must be met for risk transfer qualification. If the agreement violates the risk transfer criteria in SSAP No. 61, it will be subject to deposit accounting (see SSAP No. 61 paragraph 51 for discussion of deposit accounting). Indications of nontransfer of economic risk may include the following:

- a. Ceding of business solely to generate statutory surplus for the ceding entity, with a corresponding drain on the statutory surplus of the assuming entity, agreements that are generally referred to as *surplus relief treaties*
- b. Refund of the amount of surplus relief plus interest by the ceding entity in the event of cancellation of the reinsurance agreement
- c. Noncancellation of the contract by the ceding entity until the assuming entity has received funds advanced plus an insurance charge
- d. Large provisional commissions with payback through subsequent adjustments of the commissions based on experience
- e. Experience rated refunds, recapture clauses, or automatic buy-back provisions

Appendix A-791 primarily addresses risk transfer requirements primarily for coinsurance. Assumption reinsurance, certain nonproportional reinsurance arrangements, such as stop loss and catastrophe reinsurance, and YRT reinsurance are exempt from appendix A-791 except that certain provisions of A-791 apply to YRT reinsurance as described in Interpretation No. 02-08 of the Emerging Accounting Issues Working Group, *Application of A-791 to YTR Reinsurance of a Block of Business*. Under appendix A-791, reinsurance contract terms are evaluated to assess whether they transfer significant risk to the reinsurer. The guidance identifies six types of risks, and determines which ones are significant by product type. Additionally, appendix A-791 provides statutory accounting guidance for the treatment of gains on reinsurance transactions. For reinsurance of in-force blocks of business, gains that occur in the

initial calendar year are accounted for in accordance with appendix A-791 paragraph 3. Losses that occur in any year of an indemnity reinsurance contract are immediately recognized. If a retrocession of all or a portion of an in-force block of assumed business occurs contemporaneously with assuming the in-force block of business, any resulting net gain from assuming the in-force block of business and the retrocession should be accounted for in accordance with appendix A-791. Any resulting net loss should be recognized immediately in earnings. Appendix A-791 paragraph 3 states

any increase in surplus net of federal income tax resulting from reinsurance agreements entered into or amended after the effective date of the codification which involve the reinsurance of business issued prior to the effective date of the agreements shall be identified separately on the insurer's statutory financial statements as a surplus item and recognition of the surplus increase as income should be reflected on a net of tax basis as earnings emerge from the business reinsured.

**12.22 *Unauthorized reinsurers.*** Reinsurance with unauthorized reinsurers may be recognized under SAP if the ceding entity holds cash, securities, a letter of credit, or other forms of collateral of the unauthorized assuming entity, at least equal to the amount of reduction in benefit reserves to be recorded. If the security requirements are not met, the ceding entity must establish a separate liability to offset reductions recorded in various balance sheet accounts for reinsurance ceded to unauthorized reinsurers (see SSAP No. 61 paragraph 43 for discussion of unauthorized reinsurers). The change in the liability for unauthorized reinsurance from one valuation date to the next is a direct charge or credit to surplus, as appropriate.

**12.23 *Experience refunds.*** Some reinsurance agreements provide for experience rated refunds. As is the case with most experience rated contracts, the reinsurance agreement will have stated terms for any calculation formulas and other relative factors. For experience rated refund reinsurance agreements, the ceding entity records as an asset the amount of the refund reduced by the amount that is contingent on future experience at the balance sheet date. The assuming entity records as a liability the amount of the refund calculated at the balance sheet date, without regard to any effects of future experience (see SSAP No. 61 paragraphs 34–35 for discussion of experience rated refunds).

## Generally Accepted Accounting Principles

**12.24** As with SAP, the U.S. GAAP accounting for reinsurance ceded transactions is the opposite of accounting for direct business, however, the amounts for reinsurance ceded transactions are not netted against the related accounts in the balance sheet. FASB ASC 944, *Financial Services—Insurance*,<sup>1</sup> provides accounting guidance for reinsurance of long and short-duration contracts.

**12.25 *Conditions for qualifying for reinsurance accounting.*** In general, FASB ASC 944 requires a determination process of whether or not the reinsurance agreement, despite its form, transfers risk. Paragraphs 40–41, 46, 49–54,

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<sup>1</sup> Clarification as to how a ceding entity should account for reinsurance contracts that meet the risk transfer criteria of FASB *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*, and that also reinsure the insurance benefit features accounted for under paragraphs 20–25 of FASB ASC 944-40-30, can be found in the AICPA Technical Questions and Answers section 6300.12, "Reinsurance" (AICPA, *Technical Practice Aids*). See also chapter 9, "Benefit and Claim Payments."

and 59–61 of FASB ASC 944-20-15, which are reprinted in exhibit 12-1, "FASB ASC 944—Criteria for Qualifying for Accounting as Reinsurance," identify the conditions necessary for a contract to be accounted for as reinsurance. If these conditions are not met, the contract is accounted for as a deposit.<sup>2</sup>

**12.26** The accounting treatment for those transactions identified as reinsurance also depends on the underlying insurance contract classification as long duration or short duration, which is a matter of judgment. In addition, for short duration insurance contracts the reinsurance must be classified as prospective or retroactive. For reinsurance of long duration contracts, this accounting also depends on whether the reinsurance contract is long or short duration (see chapter 7, "Insurance Revenues," and exhibit 7-2, "Contract Classifications as Defined in FASB ASC 944," for a description of long duration and short duration contracts). Determining whether an agreement that reinsures a long duration insurance contract is long duration or short duration is a matter of judgment and must take all facts and circumstances into consideration.

## Reporting Reinsurance Assets and Liabilities

**12.27** *Assumption reinsurance.* Reinsurance agreements that are legal replacements of one insurer by another (for a discussion of assumption reinsurance, see paragraph 12.06), extinguish the ceding entity's liability to the contract holder and result in the removal of the related assets and liabilities from the financial statements of the ceding entity. Assumption reinsurance transactions may result in the immediate recognition of a gain or loss.

**12.28** *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 entity's records. For these agreements, the ceding entity should report estimated reinsurance receivables arising from those agreements separately as assets. Amounts paid to the reinsurer relating to the unexpired portion of reinsured contracts (prepaid insurance premiums) also should be reported separately as assets. Amounts receivable and payable between ceding entities and assuming entities are offset only when a right of setoff exists, as defined in the FASB ASC glossary.

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

**12.30** The amounts of earned premiums ceded and the recoveries recognized under reinsurance agreements should be reported (a) in the income statement in a separate line item or a parenthetical note, or (b) the footnotes to the financial statements.

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<sup>2</sup> See chapter 8, "Liabilities for Future Policy Benefits (Statutory Benefit Reserves) and Other Contract Liabilities," for a discussion of FASB ASC 340-30.

## Reporting Reinsurance Revenues and Costs

**12.31** *Short duration prospective reinsurance.* As discussed in FASB ASC 944-605-25-20 and FASB ASC 944-605-35-8, amounts paid for prospective reinsurance should be reported as prepaid reinsurance premiums and amortized over the remaining contract period in proportion to the amount of insurance protection provided. If the amounts paid are subject to adjustments that can be reasonably estimated, the amortization basis should be the estimated ultimate amount to be paid.

**12.32** In practice, prospective reinsurance agreements are more common than retroactive short duration contracts in the life insurance industry.

**12.33** *Short duration retroactive reinsurance.* As discussed in paragraphs 22–23 of FASB ASC 944-605-25 and FASB ASC 944-605-35-9, amounts paid for retroactive reinsurance should be reported as reinsurance receivables to the extent that they do not exceed the recorded liabilities relating to the underlying reinsured contracts. If the recorded liabilities exceed the amounts paid, the reinsurance receivables should be increased to reflect the difference and the resulting gain deferred. If the amounts paid for retroactive reinsurance for short-duration contracts exceed the recorded liabilities relating to the underlying reinsured short-duration contracts, the ceding entity shall increase the related liabilities or reduce the reinsurance receivable or both at the time the reinsurance contract is entered into, so that the excess is charged to earnings. The deferred gain should be amortized over the estimated remaining settlement period.

**12.34** For short duration retroactive reinsurers, the guidance in paragraphs 11–13 of FASB ASC 944-605-35 should be followed:

- a. Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts should be recognized in earnings in the period of the change.
- b. Reinsurance receivables should reflect the related change in the amount recoverable from the reinsurer, and a gain to be deferred and amortized, as described in the preceding paragraph, should be adjusted or established as a result. Decreases in the estimated amount of the liabilities should reduce the related amount recoverable from the reinsurer and accordingly reduce previously deferred gains.
- c. When changes in the estimated amount recoverable from the reinsurer or in the timing of receipts related to that amount occur, a cumulative amortization adjustment should be recognized in earnings in the period of the change so that the deferred gain reflects the balance that would have existed had the revised estimate been available at the inception of the reinsurance transaction. However, if the revised estimate of the liabilities is less than the amounts paid to the reinsurer, a loss should not be deferred. The resulting difference should be recognized in earnings immediately, as described in FASB ASC 944-605-25-23.

**12.35** For short duration prospective and retroactive reinsurance, FASB ASC 944-605-25-21 should be followed:

If practicable, prospective and retroactive provisions included within a single contract should be accounted for separately. The "Reinsurance

Contracts" subsections of this subtopic do not require any specific method for allocating reinsurance premiums to the prospective and retroactive portions of a contract. However, separate accounting for the prospective and retroactive portions of a contract may take place only when an allocation is practicable. Practicability requires a reasonable basis for allocating the reinsurance premiums to the risks covered by the prospective and retroactive portions of the contract, considering all amounts paid or deemed to have been paid regardless of the timing of payment. If separate accounting for prospective and retroactive provisions included within a single contract is impracticable, the contract should be accounted for as a retroactive contract provided the conditions for reinsurance accounting are met. Impracticable is used in the sense used in FASB ASC 825-10-50-17 to mean that the prospective and retroactive provisions can be accounted for separately without incurring excessive costs.

**12.36** *Long duration reinsurance.* As discussed in paragraphs 14–15 of FASB ASC 944-605-35, amortization of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long-duration or short-duration. The cost should be amortized over the remaining life of the underlying reinsured contracts if the reinsurance contract is long-duration, or over the contract period of the reinsurance if the reinsurance contract is short-duration. Determining whether a contract that reinsures a long-duration insurance contract is long-duration or short-duration in nature is a matter of judgment, considering all of the facts and circumstances. The assumptions used in accounting for reinsurance costs should be consistent with those used for the reinsured contracts.

**12.37** In general, the amounts recorded for those reinsurance agreements that qualify for reinsurance accounting under FASB ASC 944 are as follows:

- a. Liabilities and reinsurance recoveries related to future contract holder benefits are calculated using the GAAP benefit policy liability assumptions. (See chapter 8 for a discussion of GAAP benefit policy liability assumptions.) The benefit policy liability credits calculated for reinsurance ceded should be based on the GAAP assumptions of the ceding entity.
- b. Acquisition costs are capitalized regardless of whether the business is reinsured. Under certain kinds of reinsurance agreements (coinsurance and Mod Co), the acquisition expenses that are reimbursed by the assuming entity are offset against the ceding entity's deferred acquisition costs (DAC). The assuming entity should perform recoverability tests on expense allowances, which is DAC from the ceding entity.
- c. If renewal expense reimbursements are not sufficient to cover projected costs of servicing business, the ceding entity establishes a liability for the estimated excess future expenses over the expense allowance in the contract.

**12.38** Under the guidance of paragraphs 20–25 of FASB ASC 944-20-15, if a reinsurer assumes an insurance benefit feature (such as, a minimum guaranteed death benefit [MGDB]), the reinsurer should assess the significance of mortality and morbidity risk within the reinsurance contract, regardless of whether there is an account balance. The reinsurer should determine the

classification of the reinsurance contract as an investment contract or as an insurance contract at the inception of the reinsurance contract. For reinsurance contracts, the mortality or morbidity risk could be deemed other than nominal even if the original issuer did not determine mortality or morbidity to be other than nominal. There is a rebuttable presumption that a contract has significant mortality risk where the additional insurance benefit would vary significantly in response to capital markets volatility. Similarly, the issuer of a contract that provides only an insurance benefit feature that wraps<sup>3</sup> a noninsurance contract, for example, a guaranteed minimum death benefit related to a mutual fund balance, should evaluate its contract in the same manner. A reinsurer or issuer of the insurance benefit features of a contract should calculate a liability for the portion of premiums collected each period that represents compensation to the insurance enterprise for benefits that are assessed in a manner that is expected to result in current profits and future losses from the insurance benefit function. That liability should be calculated using the methodology described in paragraphs 20–25 of FASB ASC 944-40-30 (paragraphs 9.07–.09 of the guide). For example, a reinsurance contract that assumes only the risk related to the MGDB feature for a fee that varies with the account balance rather than with the insurance coverage provided would be a FASB ASC 944 universal life-type contract and the contract should be accounted for in accordance with paragraphs 20–25 of FASB ASC 944-40-30. See chapter 9, "Benefit and Claim Payments," of the guide for additional discussion about contract holder liabilities for insurance benefit features.

**12.39** A reinsurer may also agree to reinsure all or a portion of the annuitization benefits described in FASB ASC 944-40-25-26 (paragraph 9.14 of the guide). Both the ceding entity and the reinsurer should determine whether such a reinsurance contract should be accounted for under the provisions of FASB ASC 815, *Derivatives and Hedging*. For example, unlike many of the direct contracts that contain guaranteed minimum income benefits (GMIBs), contracts to reinsure GMIB often meet the definition of a derivative under FASB ASC 815. If the reinsurance contract should not be accounted for under the provisions of FASB ASC 815, the guidance in FASB ASC 944-40-25, FASB ASC 944-40-35, and FASB ASC 944-40-45 for contracts that provide annuitization benefits (paragraphs 9.14–.18 of the guide), should be followed.

**12.40** *Reinsurance agreements not qualifying for reinsurance accounting under FASB ASC 944.* FASB ASC 944 does not specifically address accounting for reinsurance agreements that do not meet the conditions for reinsurance accounting, other than to incorporate the following provisions:<sup>4</sup>

- 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 should be accounted for as a deposit by the ceding enterprise. A net credit resulting from the contract should be reported as a liability by the ceding enterprise. A net charge resulting from the contract should be reported as an asset by the reinsurer.

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<sup>3</sup> The term *wrap* refers to the practice of adding an insurance benefit feature to a separate noninsurance contract generally from a different issuer.

<sup>4</sup> See chapter 8 for a discussion of reporting on management's assessment pursuant to the life insurance ethical market conduct program of the Insurance Marketplace Standards Association.

- b. FASB ASC 944-30-35-64 states that proceeds from reinsurance transactions that represent recovery of acquisition costs should 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. FASB ASC 944-405-25-1 states, if the ceding enterprise has agreed to service all of the related insurance contracts without reasonable compensation, a liability should be accrued for estimated excess future servicing costs under the reinsurance contract. FASB ASC 944-30-25-13 states the net cost to the assuming enterprise should be accounted for as an acquisition cost.

**12.41** *Unauthorized reinsurers.* For GAAP financial statements, transactions with unauthorized reinsurers and transactions with authorized reinsurers are treated the same way.

**12.42** *Experience rated refunds.* Some reinsurance agreements provide for experience rated refunds, which allow the ceding entity to participate in the profits of the reinsured business. In general, experience rated refunds are determined by the assuming entity by deducting from premiums assumed benefits 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.

## Auditing

### Inherent Risk Factors

**12.43** As part of the auditor's assessment inherent risk, the auditor may consider those factors 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 encompass the following:

- a. The life insurance entity is involved in a significant amount of international reinsurance, or reinsurers are in jurisdictions with foreign exchange controls.
- b. The ceding entity's reinsurers are in financial difficulty.
- c. Reinsurance has become unavailable at the life insurance entity's desired retention levels and costs.
- d. There are significant or unexpected changes in the entity's reinsurance programs.
- e. Risk assumed under treaty arrangements is excessive.
- f. Financial information is inadequate or is not received on a timely basis.
- g. Regulations may not permit the treatment of certain reinsurance agreements as reinsurance.
- h. Significant reinsurance agreements involve wholly owned subsidiaries or other related parties.

## Obtaining an Understanding of Internal Control for Reinsurance Transactions

**12.44** As part of obtaining an understanding of internal control related to reinsurance transactions, the auditor might consider the following factors. An entity's internal control consists of five elements: the control environment, risk assessment, control activities, information and communication, and monitoring as stated in paragraph .41 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). As discussed in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

### Control Environment

**12.45** The control environment as related to reinsurance transactions of a life insurance entity represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific control policies or procedures of the entity. Such factors that relate to reinsurance transactions include the following:

- a. Use by the entity of complex reinsurance transactions at or near the end of the period to achieve financial performance goals or improve its surplus position
- b. The absence of executed contractual agreements between the ceding entity and the reinsurer
- c. Reinsurance coverage that is inadequate, does not meet the business needs of the entity, or does not reflect management's intended reinsurance program
- d. Reinsurance agreements that do not transfer adequate economic risk even though doing so was the intent of the parties

### Control Activities

**12.46** Control activities are those policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor should obtain an understanding of those control activities relevant to the audit.

**12.47** The following are examples of typical internal control procedures and policies relating to reinsurance transactions.

- a. *Proper authorization of transactions and activities.* Written guidelines for reinsurance transactions are in place assigning the responsibility for approval to appropriate individuals.
- b. *Segregation of duties.* Reinsurance transactions, claims processing, benefit payments, premium collection, key information systems functions, master file maintenance, and general accounting



activities are appropriately segregated, and independent reviews are conducted of the work performed.

- c. *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.
- d. *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.
- e. *Independent checks on performance and proper valuation of recorded amounts.* Recorded reinsurance 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.

Note that for an integrated audit performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (see paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, PCAOB Standards and Related Rules, Interim Standards]). Also refer to paragraph 54 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, PCAOB Standards and Related Rules, Auditing Standards) for a discussion on the extent of tests of controls (see paragraph .97 of AU section 319).

## Information and Communications

**12.48** Paragraph .81 of AU section 314 states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report an entity's transactions (as well as events and conditions) and to maintain accountability for related assets, liabilities, and equity.

**12.49** The flow of accounting records for reinsurance transactions usually encompasses all functions relating to underwriting, premium collection, commission processing, master file update, dividend processing, and benefit payments.

**12.50** *Reinsurance ceded.* As part of the underwriting process (see chapter 7 for a discussion), in accordance with the terms of the reinsurance agreements and predetermined retention limits, each contract is considered for reinsurance.

- a. *For automatic reinsurance,* a contract is automatically reinsured upon acceptance of the risk by the ceding entity. For contract-by-contract reporting, referred to as *bulk reporting*, a cession form

outlining basic contract data is generally completed for each contract and provided to the reinsurer as acknowledgment of assumption of the risk. For business that requires only summarized reporting, net summaries are completed for each reporting period.

- b.* For *facultative reinsurance*, the reinsurer has the right to accept or reject each risk in accordance with its own underwriting standards. Therefore, each contract application requiring reinsurance is submitted to the reinsurer for consideration. Upon acceptance, a facultative contract or certificate is issued to the ceding entity that usually contains the details of the contract.

**12.51** Most ceding entities have a separate reinsurance unit or department that maintains reinsurance records. For those risks that are reinsured, each premium, commission, and benefit transaction relating to the reinsured contract is evaluated and accounted for under the terms of the related contract. The related reinsurance records are updated, and summarized statements of reinsurance activity are sent periodically to the reinsurer. In addition, the ceding entity updates its financial records and inforce files for the related reinsurance activity. Settlements of net amounts due to or from reinsurers are periodically made as required by the contract. Reinsurance premiums are generally paid by the ceding entity on an annual premium basis regardless of the mode of premium payment selected by the contract holder.

**12.52** *Reinsurance assumed.* As in the case of reinsurance ceded, the transaction begins with the underwriting process, in accordance with the terms of the agreement, as follows:

- a.* For *automatic reinsurance*, the assuming entity will receive periodic summaries outlining the details of the reinsurance activity, such as premiums, commissions, and benefits, as defined by the contract, and cash settlement statements detailing the net amount due to or from the ceding entity. The assuming entity should review the information submitted and record its share of the assumed business. In addition, the assuming entity should receive periodic analysis of unpaid benefits and reserve increases or decreases from the ceding entity.
- b.* For *facultative reinsurance*, the assuming entity performs its normal underwriting process on each contract, and records its share of the business assumed on accepted risks. Periodic statements from the ceding entity are generally the same as under treaty reinsurance.

## Reinsurance Ceded

**12.53** The auditor of a ceding life insurance entity should obtain an understanding of the ceding entity's procedures for (a) evaluating the financial responsibility and stability of assuming entities (whether the assuming entities are domiciled in the United States or foreign countries) and (b) providing reasonable assurance of the accuracy and reliability of information reported to the assuming entities, including amounts due to or from assuming entities.

**12.54** The ceding entity's control procedures for evaluating the financial responsibility and stability of assuming entities may vary, depending on the

kind of agreements (such as YRT and coinsurance) and other factors, and may include

- a. obtaining and analyzing recent financial information of the assuming entities, such as financial statements and, if the statements are audited, the independent auditor's report; financial reports filed with the Securities and Exchange Commission (SEC) or similar authorities in other countries; and financial statements, including the actuary's opinion, filed with insurance regulatory authorities, with particular consideration of the quality and liquidity of the assuming entity's invested assets, and the amount of the entity's capital.
- b. obtaining and reviewing available sources of information related to the assuming entities, such as insurance industry reporting and rating services; insurance department examination reports; reports on internal control over financial reporting filed with regulatory authorities; and Insurance Regulatory Information System (IRIS) results filed with regulatory authorities.
- c. inquiring about the assuming entities retrocessional practices and experience.
- d. inquiring about the general business reputation of the assuming entities and the background of its owners and management.
- e. ascertaining whether the assuming entities are authorized to transact reinsurance within the ceding entity's state of domicile or whether letters of credit or other means of security are provided if the reinsurer is not so authorized.
- f. considering the need for and evaluating the adequacy of collateral from the assuming entities on certain reinsurance agreements.

**12.55** The ceding entity's control procedures relating to the accuracy and reliability of information reported to the reinsurer and amount due to or from the reinsurer are generally similar in nature to other control procedures for the recording of insurance transactions, and are described in the appropriate chapters of this guide.

**12.56** The absence of adequate procedures, or the failure to apply adequately designed procedures, may constitute a material weakness or control deficiency<sup>5</sup> in the ceding entity's internal control. Material weaknesses are discussed further in chapter 5.

## Planning Substantive Tests of Reinsurance Ceded

**12.57** Under certain circumstances, reinsurance may also result in increasing current earnings or investable funds to the extent that the proceeds received from the assuming entity exceed the expenses incurred in connection

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<sup>5</sup> The AICPA and Public Company Accounting Oversight Board (PCAOB) use the term *control deficiency* as encompassing all levels of deficiencies, from those less serious than a significant deficiency, up to and including material weaknesses. Control deficiencies that are significant deficiencies or material weaknesses are reportable in writing to management and those charged with governance (AICPA), audit committee (PCAOB). Note that for an integrated audit, the PCAOB considers control deficiencies that are less serious than a significant deficiency reportable in writing to management with the audit committee being notified of the communications. For further information, see chapter 5, "General Auditing Considerations," including paragraph 5.84.

with the sale and servicing of the reinsured contracts. The auditor should perform procedures to evaluate the collectability of amounts recorded in the financial statements as receivables or reductions of liabilities that are recoverable from assuming entities. The auditor of a ceding entity also ordinarily should confirm insurance contracts in force with contract holders if ceded reinsurance activities can materially increase current earnings or investable funds. (See paragraphs 6.15–.18 for a discussion of confirmation of insurance contracts in force.)

**12.58** To obtain reasonable assurance that reinsurance transactions are appropriately accounted for, the auditor of the ceding entity ordinarily should perform procedures for selected contracts, selected transactions, and related balances, which may include the following:

- a.* Read the reinsurance agreement and related correspondence to obtain an understanding of the business objective of the reinsurance agreement, and determine whether the accounting treatment of the transaction under the agreement is in conformity with SAP or U.S. GAAP, as appropriate.
- b.* Trace entries arising from selected reinsurance agreements to the appropriate records.
- c.* Trace selected transactions to supporting documents and test the related receivables and payables.
- d.* Test or recalculate balances and transactions in accordance with the agreement terms.
- e.* Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may also be appropriate.

## Reinsurance Assumed

**12.59** The auditor of an assuming entity should obtain an understanding of the assuming entity's procedures for assessing the accuracy and reliability of data received from ceding entities.

**12.60** The assuming entities' control procedures may vary depending on the type of contracts (such as YRT and coinsurance) and other factors, and may include the following:

- a.* Maintaining information relating to the business reasons for entering reinsurance agreements and anticipated results of the agreements, such as actuarial studies of the business assumed; anticipated profitability; anticipated termination rates; prior business experience with the ceding entity; the assuming entities experience on similar business; information regarding pricing and ceding commissions; and an indication of the frequency and content of reports from the ceding entity.
- b.* Monitoring the actual results reported by the ceding entity and investigating the reasons for and the effects of significant deviations from anticipated results.
- c.* Visiting the ceding entity and reviewing and evaluating its sales, underwriting, benefits processing, and actuarial policies and procedures.

- d. Obtaining from the ceding entity a service auditors report on policies and procedures placed in operation and, if he or she intends to seek audit evidence to support an assessment of control risk at low or moderate, a report on policies and procedures placed in operation and tests of operating effectiveness. See AU section 324, *Service Organizations* (AICPA, *Professional Standards*). If the ceding entity's auditor confirmed life insurance contracts in force, the reinsurer might also consider obtaining a special report from the ceding entity's auditor regarding the results of those confirmation procedures. When performing an integrated audit of financial statements and internal control over financial reporting, refer to appendix B, "Special Topics," paragraphs .B18–.B29, "Use of Service Organizations," of Auditing Standard No. 5 regarding the use of service organizations.

**12.61** Additional control procedures of the assuming entity may include the following:

- a. Obtaining and analyzing recent financial information of ceding entities, such as financial statements and, if the statements are audited, the independent auditor's report; financial reports filed with the SEC or similar authorities in other countries; and financial statements, including the actuary's opinion, filed with insurance regulatory authorities.
- b. Obtaining and reviewing available sources of information related to ceding entities, such as insurance industry reporting and rating services; insurance department examination reports; reports on internal control over financial reporting filed with regulatory authorities; and IRIS results filed with regulatory authorities.
- c. Inquiring about the general business reputation of ceding entities and the background of their owners and management.

**12.62** The absence of adequate procedures, or the failure to apply adequately designed procedures, may constitute a control deficiency in the assuming entity's internal control. Control deficiencies are discussed further in chapter 5.

## Planning Substantive Tests of Reinsurance Assumed

**12.63** The auditor of an assuming entity should perform procedures to obtain assurance regarding the accuracy and reliability of the data received from the ceding entity. The auditor's extended procedures should ordinarily include, but would not necessarily be limited to, one or more of the following:

- a. Perform procedures such as certain of the procedures specified in paragraphs 12.60–.61.
- b. Meet with and review the audit documentation of the ceding entity's auditor. See AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*). For integrated audits, refer to appendix C, "Special Reporting Situations," paragraphs C8–C11, "Opinions Based, in Part, on the Report of Another Auditor," of Auditing Standard No. 5, which provides direction with respect to opinions based, in part, on the report of another auditor.

- c. Perform auditing procedures at the ceding entity or request the auditor of the ceding entity to perform agreed-upon procedures.
- d. Obtain a special purpose report from the ceding entity's auditor on design and compliance tests of the entity's internal controls relating to ceded reinsurance. See AU section 324.

To obtain reasonable assurance that reinsurance transactions are appropriately accounted for, the auditor of the assuming entity ordinarily should perform procedures for selected contracts, selected transactions, and related balances, which may include the following:

- a. Read the reinsurance agreement and related correspondence to obtain an understanding of the business objective of the reinsurance agreement; determine whether the accounting treatment of the transactions under the agreement is in conformity with SAP or U.S. GAAP, as appropriate.
- b. Trace entries arising from selected reinsurance agreements to the appropriate records.
- c. Trace selected transactions to supporting documents and test the related receivables and payables.
- d. Test or recalculate balances and transactions in accordance with the agreement terms.
- e. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may also be appropriate.

### Audit Consideration Chart: Reinsurance Transactions in General

**12.64** The auditor may consider the following specific audit objectives and examples of selected control and auditing procedures in auditing reinsurance transactions of life insurance entities. The audit consideration chart is intended to present examples only, and is not all-inclusive for any category.

**Audit Consideration Chart—  
Reinsurance**

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Existence or Occurrence and Rights and Obligations</i>		
All amounts due to or from reinsurers recorded in the financial statement are actual receivables or liabilities of the life insurance entity.	All reinsurance contract terms and amendments are reviewed by appropriate personnel for compliance with entity guidelines.	For selected risks covered by reinsurance agreements, test that contracts are properly identified and designated as reinsured, recorded in the premium billing and inforce files, and reported to the assuming entity.

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	<p>Cumulative reports of reinsurance activity are reviewed to evaluate risk exposure and compliance with the terms of the agreement.</p> <p>For ceded risks, adequate procedures exist to determine the assuming entity's ability to honor its obligations under the reinsurance contract. Financial stability is periodically evaluated by the appropriate levels of management.</p> <p>Adequate procedures are in place to ensure the following:</p> <ul style="list-style-type: none"> <li>• Reinsurance transactions are recorded in accordance with the contract terms and supported by insurance contracts in force.</li> <li>• Special provisions of reinsurance contracts are properly computed and recorded.</li> </ul> <p>Criteria and procedures for ceding and assuming reinsurance are established.</p>	<p>Test the propriety of reinsurance balances payable by reference to reinsurance agreements and contract records.</p> <p>Confirm significant reinsurance balance and contract terms with assuming and ceding entities, as appropriate.</p> <p>Compare account balances and aged listing of reinsurance recoverables on paid claims with those of prior periods and investigate any significant changes on the following:</p> <ul style="list-style-type: none"> <li>• Major reinsurers</li> <li>• Balances per major reinsurer</li> <li>• Percentage of past due receivables</li> </ul> <p>Compare recorded reinsurance reserve amounts to assumed and ceded detail records and evaluate whether reinsurance amounts are properly calculated and recorded.</p>

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Completeness</i>		
All amounts due to or from reinsurers are recorded in the financial statements in the proper accounting period.	Edit and validation controls, batch balancing, data transmission controls, logging, and cash totals are used to provide assurance that all transactions have been completely and accurately processed and that systems interfaces are operating correctly.	Compare reported with expected results for significant reinsurance agreements. Investigate any unexpected results (or absence of expected changes).
Reinsured contracts are properly identified, and premiums on ceded reinsurance are properly recorded and reported to the assuming entity.	Suspense account balances are analyzed and reviewed by appropriate personnel for large, old, or unusual items.	Test reconciliations of reinsurance transactions to detailed inforce file records and general ledger accounts. Review treatment of reconciling items.
	Cutoff procedures for the inforce file and the reinsurance files are applied at period end.	Test period end cutoff of reinsurance transactions.
	Adequate procedures exist for monitoring third parties involved in processing or calculating reinsurance transactions.	Review reinsurance suspense account activities and reconciliations for large or unusual entries and subsequent clearance. Obtain explanations for unusual transactions.
	Periodic reviews are made of internal control and accounting records of ceding entities, other third parties, or both, to ensure the reliability and accuracy of reported transactions.	For entities <i>ceding</i> reinsurance risks, perform the following: <ol style="list-style-type: none"><li>1. Obtain and analyze financial information of assuming entities such as financial statements, the</li></ol>



<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
	<p>Ceded reinsurance information is reconciled to reinsurance premium and commission detailed records and general ledger accounts.</p> <p>Periodic reviews are made of detailed reports received from ceding entities.</p>	<p>independent auditor's report, Securities and Exchange Commission reports, and reports filed with regulatory authorities.</p> <ol style="list-style-type: none"> <li>2. Obtain and review other available sources of information such as life insurance industry rating services, insurance department examination reports, and letters relating to the design and operation of internal control policies and procedures filed with the regulatory authorities.</li> <li>3. Evaluate the need for an on-site review of the assuming entities' controls and accounting records.</li> </ol> <p>For entities <i>assuming</i> reinsurance risks, perform the following:</p> <ol style="list-style-type: none"> <li>1. Analyze the ceding entities' financial stability.</li> <li>2. Evaluate the need for an on-site review of the ceding entities' controls, accounting records, and compliance with underwriting standards.</li> <li>3. Trace recorded transactions to reports from ceding entities.</li> </ol>

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
<i>Valuation or Allocation</i> Amounts due to or from reinsurers are properly computed in accordance with the provisions of the reinsurance agreements.	Periodic reviews of the financial condition of assuming and ceding entities, including audits of account balances and operations, are performed. Results under assumed reinsurance treaties are regularly compared to expected results and deviations are reported and monitored by the appropriate personnel.	Review reinsurance agreements and related correspondence, as follows. <ol style="list-style-type: none"><li>1. Obtain an understanding of the business objective of the contract.</li><li>2. Determine the proper accounting treatment.</li><li>3. Review documentation of required management review and approval.</li></ol>
Amounts due from reinsurers are carried at their net realizable amount, and amounts due to reinsurers are recorded as owed at the balance sheet date.	Detailed records of reinsurance assumed or ceded are compared to the reinsurance reserve records, including any adjustments, and are reviewed by appropriate personnel. Write-offs of amounts due from reinsurers are approved by appropriate personnel.	For reinsurance <i>ceded</i> , perform the following: <ol style="list-style-type: none"><li>1. Test the calculations of premiums, claims, and expense allowances by reference to the terms of the contracts and the entity's accounting records.</li><li>2. Test computation of contingent reinsurance commissions and experience rating refunds.</li></ol>

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Auditing Procedures</i>
		<p>Evaluate the collectability of amounts recorded as recoverable from assuming entities, including the following:</p> <ol style="list-style-type: none"> <li>1. Adequacy of collateral.</li> <li>2. Financial condition of the assuming entity.</li> <li>3. Adequate fulfillment of the ceding entity's obligations under the contract (for example, underwriting standards).</li> </ol> <p>For reinsurance <i>assumed</i>, perform the following:</p> <ol style="list-style-type: none"> <li>1. Determine compliance of ceding entity with underwriting guidelines.</li> <li>2. Test calculations of expense allowances, experience refunds, and contingency reserves, and compare with contract terms.</li> </ol>

**Exhibit 12-1****Financial Accounting Standards Board *Accounting Standards Codification* 944 Criteria for Qualifying for Accounting as Reinsurance**

Several paragraphs from Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 944, *Financial Services—Insurance*, relating to accounting for reinsurance are reprinted here in their entirety.

**Indemnification Against Loss or Liability Relating to Insurance Risk**

FASB ASC 944-20-15-40:

Determining under subpoint *a* of 944-20-15-37 whether a contract with a reinsurer provides indemnification against loss or liability relating to insurance risk requires a complete understanding of that contract and other contracts or agreements between the ceding entity and related reinsurers. A complete understanding includes an evaluation of all contractual features that do either of the following:

- a.* Limit the amount of insurance risk to which the reinsurer is subject (such as through experience refunds, cancellation provisions, adjustable features, or additions of profitable lines of business to the reinsurance contract).
- b.* Delay the timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

This risk transfer assessment shall be made at contract inception, based on facts and circumstances known at the time.

**Reinsurance of Short-Duration Contracts**

FASB ASC 944-20-15-41:

Unless the condition in paragraph 944-20-15-53 is met, indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of short-duration contracts exists under paragraph 944-20-15-37(a) only if both of the following conditions are met

- a.* Significant insurance risk. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts. Implicit in this condition is the requirement that both the amount and timing of the reinsurer's payments depend on and directly vary with the amount and timing of claims settled under the reinsured contracts.
- b.* Significant loss. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

The conditions are independent and the ability to meet one does not mean that the other has been met. A substantive demonstration that both conditions have been met is required for a short-duration contract to transfer risk.

FASB ASC 944-20-15-46:

A reinsurer shall not be considered under subpoint *a* of 944-20-15-37 to have assumed significant insurance risk under reinsured short-duration contracts if the probability of a significant variation in either the amount or timing of payments by the reinsurer is remote. Contractual provisions that delay timely

reimbursement to the ceding entity would prevent this condition from being met because they prevent the reinsurer's payments from directly varying with the claims settled under the reinsured contracts.

*(Additional guidance on significant insurance risk can be found in paragraphs 47–48 of FASB ASC 944-20-15)*

Paragraphs 49–54 of FASB ASC 944-20-15:

The ceding entity's evaluation of whether it is reasonably possible for a reinsurer to realize a significant loss from the transaction shall be based on the present value of all cash flows between the ceding and assuming entities under reasonably possible outcomes, without regard to how the individual cash flows are characterized. The same interest rate shall be used to compute the present value of cash flows for each reasonably possible outcome tested. To be reasonable and appropriate, that rate shall reflect both of the following:

- a. The expected timing of payments to the reinsurer
- b. The duration over which those cash flows are expected to be invested by the reinsurer

All cash flows are included in the calculation in the preceding paragraph because payments that effectively represent premiums or refunds of premiums may be described in various ways under the terms of a reinsurance contract. The way a cash flow is characterized does not affect whether it should be included in determining the reinsurer's exposure to loss. Only cash flows between the ceding and assuming entities are considered, therefore precluding consideration of other expenses of the reinsurer (such as taxes and operating expenses) in the calculation.

Significance of loss shall be evaluated by comparing the following:

- a. The present value of all cash flows (determined as described in paragraph 944-20-15-49)
- b. The present value of the amounts paid or deemed to have been paid to the reinsurer

Determining (for purposes of [b]) the amounts paid or deemed to have been paid for reinsurance requires an understanding of all contract provisions. For example, payments and receipts under a reinsurance contract may be settled net. The ceding entity may withhold funds as collateral or may be entitled to compensation other than recovery of claims. Gross premiums shall be used—expenses shall not be deducted from premiums in evaluating the significance of a reasonably possible loss.

Because the present value of cash flows shall be determined over the period in which cash flows are reasonably expected to occur, unless commutation (termination) is expected in the scenario being evaluated, commutation shall not be assumed in the calculation. Further, the assumptions used in a scenario shall be internally consistent and economically rational for that scenario's outcome to be considered reasonably possible.

If, based on the comparison in paragraph 944-20-15-51, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding entity shall be considered indemnified against loss or liability relating to insurance risk only if substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts has been assumed by the reinsurer. That condition is met only if insignificant insurance risk is retained by the ceding entity on the reinsured portions of the underlying insurance contracts.

The assessment of that condition shall be made by comparing both of the following:

- a.* The net cash flows of the reinsurer under the reinsurance contract
- b.* The net cash flows of the ceding entity on the reinsured portions of the underlying insurance contracts

If the economic position of the reinsurer relative to the insurer cannot be determined, the contract shall not qualify under the exception in this paragraph.

The extremely narrow and limited exemption in the preceding paragraph is for contracts that reinsure either an individual risk or an underlying book of business that is inherently profitable. To qualify under that exception, no more than trivial insurance risk on the reinsured portions of the underlying insurance contracts may be retained by the ceding entity. The reinsurer's economic position shall be virtually equivalent to having written the relevant portions of the reinsured contracts directly.

### **Reinsurance of Long-Duration Contracts**

Paragraphs 59–61 of FASB ASC 944-20-15:

Indemnification of the ceding entity against loss or liability relating to insurance risk in reinsurance of long-duration contracts requires the reasonable possibility that the reinsurer may realize significant loss from assuming insurance risk.

Consistent with the definition of investment contract, a contract that does not subject the reinsurer to the reasonable possibility of significant loss from the events insured by the underlying insurance contracts does not indemnify the ceding entity against insurance risk.

The evaluation of mortality risk or morbidity risk in contracts that reinsure universal life-type policies shall be consistent with the criteria in paragraphs 944-20-15-16–15-19. Evaluation of the presence of insurance risk in contracts that reinsure other long-duration contracts (such as those that reinsure ordinary life contracts or contracts that provide benefits related only to illness, physical injury, or disability) also shall be consistent with those criteria.

**Exhibit 12-2****Financial Accounting Standards Board Staff Announcements  
Regarding Accounting by the Purchaser for a Seller's Guarantee  
of the Adequacy of Liabilities for Losses and Loss Adjustment  
Expenses of an Insurance Enterprise Acquired in a Purchase  
Business Combination<sup>1</sup>****November 14, 1996**

On November 14, 1996, a FASB representative made the following announcement at the EITF meeting.

The Insurance Companies Committee of the AICPA has notified the FASB staff that questions have been raised regarding whether FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, or APB Opinion No. 16, *Business Combinations*, should be applied to guarantees of the adequacy of liabilities existing at the acquisition date of a business combination, whether or not they are identified, for losses and loss adjustment expenses of short-duration insurance or reinsurance contracts of insurance enterprises (reserve guarantees) when the insurance enterprise is acquired in a business combination accounted for as a purchase. It appears that certain provisions of Statement 113 and Opinion 16 conflict with regard to accounting for those reserve guarantees.

Reserve guarantees may be provided by a seller to indemnify a purchaser for unanticipated increases in the liabilities for losses and loss adjustment expenses of the subject insurance enterprise. They are most often provided with regard to liabilities for losses and loss adjustment expenses for coverages with long payout periods (long-tail coverages) for which the ultimate liability and/or the timing of the payout is difficult to estimate (for example, liabilities for losses and loss adjustment expenses relating to environmental and asbestos exposures). The selling and purchasing enterprises may, or may not, be insurance enterprises, and similar guarantees are provided in a business combination accounted for as a purchase that does not involve an insurance enterprise.

The scope of this announcement is limited to the accounting by a purchaser for reserve guarantees relating to the adequacy of liabilities existing at the acquisition date of a business combination, whether or not they are identified, for short-duration insurance contracts of an insurance enterprise when provided by a seller in a business combination accounted for as a purchase in accordance with the provisions of Opinion 16. This announcement should not be applied to a business combination accounted for as a pooling of interests or to other transactions that are not within the scope of Opinion 16, such as spin-offs or initial public offerings.

The FASB staff believes that a purchaser, when accounting for reserve guarantees provided by a selling enterprise in a business combination accounted for as a purchase under the provisions of Opinion 16, should *not* apply paragraphs 22–24 of Statement 113, which address retroactive reinsurance arrangements. Reserve guarantees may be, and often are, provided between enterprises that are not insurance enterprises. The staff does not view reserve guarantees as being different from other guarantees of the existence of assets or the adequacy of liabilities often provided by the seller in a business combination accounted for as a purchase. The staff therefore believes that guarantees should be accounted

for consistently regardless of whether or not the seller or purchaser is an insurance enterprise.

The FASB staff believes that changes in the liabilities for losses and loss adjustment expenses of the purchaser resulting from the continuous review process and the differences between estimates and payments for claims should be recognized in income by the purchaser in the period in which estimates are changed or payments are made in accordance with FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; this includes those liabilities acquired in a business combination and subject to the reserve guarantee. The purchaser should at the same time recognize a receivable for the amount due from the seller under the reserve guarantee, subject to management's assessment of the collectability of that amount, with a corresponding credit to income. Changes in the balance of the receivable that occur subsequent to recording the business combination should be included in income in the period that the estimates are changed (or payments are received, if resulting from differences between estimates and payments) and should not affect the acquiring enterprise's accounting for the business combination.

The Task Force observed that this announcement should be applied either as a change in accounting principle in accordance with APB Opinion No. 20, *Accounting Changes*, or prospectively to new business combinations entered into after November 14, 1996.

The SEC Observer noted that the SEC staff believes it is preferable to present the effects of the loss guarantee on a gross rather than net basis. The SEC Observer noted that any receivable from the seller should not be netted against the related liability in the balance sheet or in supporting information such as footnotes or SEC Industry Guide 6 disclosures. The SEC Observer also expressed a preference that (a) any expense associated with increased reserves be reported as a component of other claim losses and loss adjustment expenses, and (b) other claim losses and loss adjustment expenses not be reduced by the effect of the reserve guarantee.

However, after discussion of these preferences with the Task Force, the SEC staff indicated that it would not object to claim losses and loss adjustment expenses being reported net of the effect of the reserve guarantee in the income statement. A net presentation is appropriate only if the effects of the reserve guarantee are disclosed separately in the notes to the financial statements, in the SEC Industry Guide 6 disclosures including the reconciliation of claims reserves, and in the loss ratio information. In addition, the SEC staff believes the effects of such an arrangement on operations and cash flows should be clearly disclosed in management's discussion and analysis.

### **November 20, 1997**

On November 20, 1997, a FASB representative made the following announcement at the EITF meeting:

A FASB representative announced that the FASB staff has received questions about whether *EITF Abstracts*, Topic No. D-54, "*Accounting by the Purchaser for a Sellers Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses of an Insurance Enterprise Acquired in a Purchase Business Combination*," applies to the purchasers accounting for an arrangement in which the seller obtains reinsurance from a *third-party* reinsurer who agrees to directly indemnify the purchaser for increases in the liabilities for losses and loss adjustment expenses that existed at the acquisition date of a purchase business combination. The staff believes that the applicability of Topic



D-54 to that and other arrangements that have circumstances that are similar to, but not the same as, the circumstances addressed in Topic D-54 should be determined based upon the specific facts and circumstances.<sup>2</sup> In order for the purchaser to apply the provisions of Topic D-54:

1. The seller must agree to participate in increases in the liabilities for losses and loss adjustment expenses that existed at the acquisition date of the purchase business combination. The seller may agree to indemnify the purchaser without remaining directly obligated for increases in the liabilities (for example, by funding its obligation through a reinsurance arrangement).
2. The guarantee arrangement between the purchaser and the seller must be contemporaneous with, and contingent on, the purchase business combination. The specific facts and circumstances should be considered in determining whether the guarantee arrangement is contemporaneous with the purchase business combination. The staff observes that to be contemporaneous, the guarantee arrangement should commit to *all* significant terms simultaneous with the consummation date of the purchase business combination. The absence of agreement on the significant terms, or the intention to establish or amend those terms at a later date, would result in the application of the provisions of FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, to that guarantee arrangement. The fact that the purchaser is at risk for the subject increases in the liabilities for losses and loss adjustment expenses for any period after the effective date of the purchase business combination would indicate that the guarantee arrangement was not contemporaneous with that combination.

### Illustrations

Following are explanations of how the previously mentioned factors would be applied to illustrative guarantee arrangements between the seller and the purchaser, or between the seller, the purchaser, and one or more third parties:

1. Topic D-54 applies to a guarantee arrangement that is entered into contemporaneously with a purchase business combination in which the seller obtains a third-party indemnification (for example, a reinsurance arrangement) to reimburse the purchaser directly for unexpected increases in the liabilities for losses and loss adjustment expenses. However, the purchaser should apply the provisions of Statement 113 to an arrangement entered into directly by the purchaser with a third-party reinsurer because such an arrangement cannot be viewed as being contingent on the purchase business combination and because the seller has not participated in the arrangement.
2. The purchaser should apply Statement 113 to a guarantee arrangement that the seller and the purchaser enter into after the purchase business combination (regardless of whether the guarantee arrangement is in the form of a reinsurance arrangement) because that guarantee arrangement would not be contemporaneous with the purchase business combination.

**Observation Related to Sellers Accounting**

The staff also observes that the *selling* enterprise should apply the provisions of Statement 113 (assuming that the seller is an insurance enterprise to which the provisions of Statement 113 apply) to a reinsurance arrangement that it enters into before or after a purchase business combination, even if the *purchaser* is identified as the direct beneficiary of that reinsurance arrangement.

**Business Combinations**

FASB Statement No. 141, which supersedes Opinion 16, was issued in June 2001. FASB Statement No. 141 prohibits the use of the pooling-of-interests method for all business combinations initiated after June 30, 2001.

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<sup>1</sup> This exhibit is taken from the FASB EITF Abstracts. FASB Statement No. 141, *Business Combinations*, as amended, addresses financial accounting and reporting for business combinations and supersedes APB Opinion No. 16. FASB Statement No. 141 prohibits the use of the pooling-of-interests method. The provisions of FASB Statement No. 141 apply to all business combinations initiated after June 30, 2001. FASB Statement No. 141 also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. FASB Statement No. 141 does not apply, however, to combinations of two or more mutual enterprises.

In December 2007, FASB issued FASB Statement No. 141 (revised 2007), which applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply FASB Statement No. 141 (revised) before that date. The objective of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. To accomplish that, this statement establishes principles and requirements for how the acquirer

- a. recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree;
- b. recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and
- c. determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

FASB Statement No. 141(R) defines the key terms associated with a business combination, for example acquiree. The statement also requires entities to record assets acquired and liabilities assumed as a result of a business combination at fair value, as defined by FASB Statement No. 157, *Fair Value Measurements*. The effective date of FASB Statement No. 141(R) is for fiscal years beginning on or after December 15, 2008, with early adoption prohibited.

<sup>2</sup> This announcement is combined with Topic D-54 in *EITF Abstracts*.

## Chapter 13

# Taxation<sup>1</sup> of Life Insurance Entities

## Introduction

### Federal Income Taxes

**13.01** In general, life insurance entities are subject to the same federal income tax laws that apply to other commercial entities. There are, however, additional sections of the Internal Revenue Code (IRC) and related U.S. Treasury regulations that apply specifically to life insurance entities. Sections 801–818 and 841–848 of the IRC applies to all business entities that meet the definition of a *life insurance company* as described in paragraph 13.03. This chapter is intended to familiarize the reader with significant and unique features of life insurance taxation.

**13.02** The taxation of life insurance entities has changed substantially as the result of a series of tax law changes enacted since 1984. From 1958 to 1983, life insurance companies, as defined by the IRC, were taxed under the Life Insurance Company Income Tax Act, which prescribed a complex three phase structure. The Deficit Reduction Act of 1984 eliminated the three phase taxation structure of the 1959 code and mandated a simpler single phase system based on total *life insurance company taxable income* (LICTI). Under the Deficit Reduction Act of 1984, life insurance companies are taxed on all sources of income at ordinary corporate tax rates. The Deficit Reduction Act of 1984 was modified in 1986 and again in 1990; however, the single phase system has been retained. Although the three phase taxation structure has been eliminated, the *phase III income tax*, as discussed in paragraph 13.14, remains from the prior law for many stock life companies.

**13.03** *Definition of a life insurance company for federal income tax purposes.* For a life insurance entity to be taxed as a *life insurance company* by IRC definition, it must meet the following requirements on an annual basis:

- a. More than half of its business activity during the year is the issuing of life insurance or annuity contracts or the reinsuring of such risks underwritten by other insurance companies.

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<sup>1</sup> For audits of issuers, as defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the Securities and Exchange Commission (SEC) (collectively referred to as *issuers*), Section 202 of the act and the SEC Rule *Strengthening the Commission's Requirements Regarding Auditor Independence* require that an issuer's audit committee preapprove all audit and nonaudit services provided to the issuer by the auditor. This includes tax services. On July 26, 2005, the Public Company Accounting Oversight Board (PCAOB) issued Release No. 2005-014, *Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees* (AICPA, PCAOB Standards and Related Rules, Select PCAOB Releases). Subsequently, a number of related releases and a concept statement are addressing technical amendments and implementation schedules. Finally, a question and answer document was issued to provide further application clarity. For specifics, see the PCAOB website at [www.pcaobus.org](http://www.pcaobus.org). Among other matters, the rules treat a registered firm as not independent of a public company audit client if the firm, or an affiliate of the firm, provided any service or product to an audit client for a contingent fee or a commission, or received from an audit client, directly or indirectly, a contingent fee or commission. The rules also treat such a firm as not independent if the firm, or an affiliate of the firm, provided assistance in planning, or provided tax advice on, certain types of potentially abusive tax transactions to an audit client or provided any tax services to certain persons employed by an audit client. Further, the rules require registered public accounting firms to provide certain information to audit committees in connection with seeking preapproval to provide nonprohibited tax services.

- b. The company's life insurance statutory reserves, plus unearned premiums and unpaid losses on noncancellable life, accident, or health policies not included in life insurance tax basis reserves, must comprise more than 50 percent of its total statutory reserves.

As a result, entities that are organized as life insurance companies under applicable state insurance laws may not qualify as *life insurance companies* for federal income tax purposes. For purposes of this chapter, the term *life insurance company* is used as defined at the beginning of this paragraph. In addition, other terms referred to in this chapter may have unique meaning under the IRC.

## Election to File a Consolidated Return

**13.04** For taxable years beginning after December 31, 1980, the common parent of an affiliated group that has 1 or more life insurance companies may elect to treat such companies as includable corporations and include them in the filing of a consolidated return. The election must apply to all life insurance companies that otherwise qualify as members of the affiliated group. Once the election is made, the group must continue to file consolidated returns unless the group obtains permission from the commissioner of the IRS to revoke its election. If the election is not made, the life insurance companies will continue to be treated as nonincludable corporations; however, two or more life insurance companies may elect to file a consolidated return with each other provided the requisite 80 percent stock ownership test is satisfied. (See IRC Section 1504(a)(2).)

## Five Year Affiliation Requirement

**13.05** A life insurance company cannot be treated as an includable corporation in a consolidated return with nonlife companies unless it has been a member of the affiliated group for the five taxable years of the common parent entity immediately preceding the taxable year for which the consolidated return is filed. The term *eligible corporation* is defined by the IRC as a corporation (life or nonlife) that has satisfied the various tests of the five year requirement. An ineligible life insurance company may not be included; however, if an ineligible nonlife insurance company is includable in the consolidated group, its losses may not reduce the income of the life members. If the ineligible life insurance company is also the parent of the group, the life-nonlife consolidated return election cannot be made.

**13.06** Consolidation rules for life and nonlife consolidated tax returns are complex, and the auditor may retain the services of life insurance tax specialist for advice in these matters. There are limitations to fully offsetting nonlife losses against life insurance related income.

## Elements of Life Insurance Company Taxable Income

**13.07** The following discussion of the elements of LICTI focuses on the elements of statutory gain from operations as adjusted to arrive at taxable income. LICTI tends to follow statutory accounting practices (SAP) rather than U.S. generally accepted accounting principles (GAAP).

## Life Insurance Gross Income

**13.08** Life insurance gross income consists of all of the items of income earned by the life insurance company, both in its underwriting and investment capacities. The elements of income are gross premium income, decrease in tax basis reserves, gross investment income, net capital gains, and other amounts. Components of life insurance gross income are as follows:

- a. *Gross premium income.* Gross premium income should include the following (as found on page 4 of the annual statement):
  - i. Premiums and annuity considerations
  - ii. Annuity and other fund deposits
  - iii. Consideration received for supplementary contracts involving life contingencies and those not involving life contingencies
  - iv. Commissions and expense allowances on reinsurance ceded
- b. Tax adjustments to gross premium income should be made as follows:
  - i. *Advance premiums and premium deposit funds.* These items are usually excluded from gross premiums for annual statement purposes. However, for tax purposes, these amounts should be included in gross premiums and should be adjusted accordingly.
  - ii. *Deferred and uncollected premiums.* For annual statement purposes, life insurance companies include deferred and uncollected premiums in gross premiums and related statutory benefit reserves. For tax purposes, gross premiums do not include deferred and uncollected premiums. Accordingly, gross premium and related statutory benefit reserve account adjustments are required for the changes in the balances of this account.
  - iii. *Experience rated refunds.* Annual statement experience rated refunds are often netted against gross premiums. For tax purposes, experience rated refunds are deductible items. Therefore, the netted experience rated refunds should be added back to arrive at taxable gross premiums.
    - (1) *Decrease in tax basis reserves.* Generally, tax basis reserve decreases are classified as part of "Gross Income." See paragraph 13.09(b) for a discussion of tax basis reserves.
    - (2) *Gross investment income.* Generally, the gross investment income of a life insurance company is treated for tax purposes in a manner similar to that used for other business entities. However, there are some areas of unique treatment as discussed in the following list. The items of gross investment income include the following:

- (a) Interest income, which includes the following:
    - (i) Tax exempt interest income (For statutory purposes, tax exempt interest income is included in the annual statement computation of gain from operations. For tax purposes, it should be excluded. However, part of the excluded tax exempt interest is later included in the LICTI through the *proration mechanism* discussed in paragraph 13.09c.)
    - (ii) Amortization of bond premium and accrual of market discount (Market discount is only accrued currently if the taxpayer makes an election to do so.)
    - (iii) Original issue discount
  - (b) Dividend income that is taxed when received rather than earned
  - (c) Rental income (Adjustments may be necessary for rents received in advance. In addition, the annual statement may include charges for occupying company owned real estate (referred to as imputed rent). These amounts should be reversed for tax purposes.)
  - (d) Royalty income
  - (e) Leases, mortgages, and other instruments (Various timing differences exist with respect to the recognition of income relating to mortgages and leases. In addition, there are timing differences relating to the write-offs of nonperforming leases and mortgages. Generally, for tax purposes, write-offs are deductible only on a specific write-off method where worthlessness can be demonstrated, as defined by the IRC.)
  - (f) Capital gains and losses
  - (g) Wash sales
- c. *Other amounts included in gross income.* This category would include all other amounts of income that are not reportable as part of premium or investment income. An example of this would be ordinary gains derived from the sale of assets used primarily in trade or business (for example, computers, furniture, and IRC Section 1231 assets), or income from nonlife trade or business. An analysis should be made of all miscellaneous income items of the company.

## Life Insurance Company Deductions Allowed

**13.09** The annual statement deductions are generally allowed for tax purposes, subject to tax modifications (for example, the calculation of life insurance tax basis reserves and discounting of certain other statutory reserves). In addition to the deductions appearing on the annual statement, special deductions, such as the dividends received deduction (DRD) and the operations loss deduction (OLD), are generally available. The following are deductions allowed for life insurance companies:

- a. *Death benefits.* Payments to contract holders under insurance contracts (for example, death benefits and annuity benefits) are generally deductible. In addition, incurred but not reported (IBNR) liabilities represent matured liabilities that for tax purposes should no longer be a part of life insurance tax basis reserves as these amounts represent future unaccrued claims. Therefore, reasonably estimated IBNR liabilities as of the end of the taxable year should be included in the death benefits deduction. Corresponding IBNR adjustments should be made to the life insurance statutory benefit reserves.
- b. *Deduction for increase in tax basis benefit reserves.* If the tax basis benefit reserves at the end of the year are larger than at the beginning of the year, the increase is included as a deduction. If tax basis benefit reserves at the end of the year are less than tax basis benefit reserves at the beginning of the year, the decrease is included as income. The following items are included in computing the change in a life insurance company's tax basis benefit reserves: (i) life insurance tax basis reserves; (ii) unearned premiums and unpaid losses; (iii) the discounted amounts necessary to satisfy obligations under insurance or annuity contracts not involving life, health, or accident contingencies; (iv) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (v) premiums received in advance and liabilities for premium deposit funds; and (vi) reasonable special contingency liabilities under contracts of group term life insurance or group accident and health insurance that are established and maintained for the provision of insurance on retired lives, for premium stabilization, or for a combination thereof.
  - i. *Computing tax basis reserves for life insurance benefits.* Tax basis reserves for life insurance benefits are determined under special provisions of the tax law, which specify the calculation method, interest rate, and morbidity and mortality tables to be used. Generally, life insurance contracts should be valued by the statutory commissioners' reserve valuation method, and annuity contracts should be valued by the statutory commissioners' annuity reserve valuation method. Both methods are prescribed by the National Association of Insurance Commissioners. A 2 year full preliminary term method is used for noncancellable accident and health insurance statutory reserves. Beginning in 1988, the interest rate used should be the greater of the *applicable federal interest rate* as prescribed by the IRS or the *prevailing state assumed interest rate*,

which is the highest interest rate for statutory reserves permitted by at least 26 states. The IRC also provides that the *prevailing commissioners' standard tables for mortality and morbidity*, which is the table permitted by at least 26 states, should be used in calculating tax basis statutory reserves for life insurance benefits. The tax basis benefit reserves for life insurance benefits are the greater of the reserves computed as described at the beginning of this paragraph or the net surrender value. However, the tax basis benefit reserve for life insurance benefits may not exceed the statutory reserve amounts. This calculation should be done on a contract-by-contract basis.

- ii. *Tax adjustments for nonlife statutory reserves.* Cancelable and nonrenewable accident and health insurance contracts are subject to the statutory unearned premium reserve reduction and the unpaid loss discounting tax rules related to property and casualty insurance companies. For taxable years after 1990, the statutory unearned premium reserve of such contracts must be reduced by 20 percent.
- c. *Proration of tax exempt interest and dividends received deduction.* Normally, tax exempt interest and dividends are excluded or partially excluded from taxable income. Congress concluded that life insurance companies receive a double benefit through an increase in reserves that may be partially funded by tax exempt interests and dividends or both, and introduced the *proration mechanism* into the tax law. The proration mechanism requires that a portion of the tax exempt interest and the DRD be added back to taxable income.
- d. *Policyholder dividends.* For tax purposes, the term policyholder dividends is broadly defined as a dividend or similar distribution to contract holders in their capacity as such, regardless of whether the contract is participating or not. Policyholder dividends may include the following: (i) amounts paid or credited (including an increase in benefits) where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management, (ii) premium adjustments, (iii) excess interest, and (iv) experience rated refunds.

Life insurance companies are entitled to deduct policyholder dividends paid or accrued during the taxable year. The liability for policyholder dividends is not taken into account in determining the deduction. Policyholder dividends are defined by the IRC, as described in step (iv), and may include amounts that are not treated as policyholder dividends under statutory accounting rules, and may apply to nonparticipating contracts.

- e. *Other deductions.* Life insurance companies are allowed deductions generally available to other nonlife companies. Almost all general insurance expenses, including those listed in exhibits 5–6 of the annual statement, are deductible as other deductions. The following limitations and adjustments should apply to certain deductions:



- i. No deduction is allowed for additions to an allowance for bad debts. Insurance companies are permitted a deduction on bad debts only on a specific charge-off basis.
- ii. Charitable contributions are limited to 10 percent of the LICTI before a deduction of such contributions, or of loss carrybacks, dividends to policyholders, dividend received deduction, and the small life insurance company deduction.
- iii. In addition, a loss from a noninsurance business is limited by the IRC to the lesser of 35 percent of the life insurance taxable income or 35 percent of the nonlife loss.

## Adjustments Unique to Life Insurance Companies

**13.10** *Deferred contract acquisition costs.* In 1990, Congress enacted a tax law change requiring life insurance companies to capitalize contract acquisition costs. As a result of the complexity of determining contract acquisition costs and the amortization methods, the tax law requires the use of a proxy method. Under this approach, the *deemed contract acquisition cost* is determined by multiplying the net premiums on *specified insurance contracts* by a fixed capitalization rate. Specified insurance contracts are defined in the IRC as any life insurance, annuity, or noncancellable or guaranteed renewable accident and health insurance contract (or any combination thereof). The capitalized amounts generally will be amortized over 120 months on a straight line basis. Certain small life companies may qualify to accelerate to a 60 month amortization period.

**13.11** In applying the proxy method, under existing tax law, the following percentages of net premiums of the specified insurance contracts, written directly or through reinsurance, are capitalized:

<i>Contracts</i>	<i>Percent</i>
Annuities	1.75
Group Life	2.05
Other life (including noncancellable or guaranteed renewable accident and health)	7.70
Qualified pension plans (not subject to DAC tax)	0

The capitalized amount is limited to the company's total *general deduction* for that year. General deductions include the deductions allowed as general trade or business deductions, interest and taxes, depreciation, and so on. It does not include death benefits paid, policyholder dividends, the dividend received deduction, and the OLD.

**13.12** *Operations loss deduction.* Whereas nonlife insurance companies may generate net operating losses (NOLs), a life insurance company with a net taxable loss will generate an OLD. OLDs are generally subject to a 3 year carryback and a 15 year carryforward limitation, except for those companies that qualify as new life insurance companies, which are permitted an additional 3 years. The Taxpayer Relief Act of 1997 (h2014) modified the NOL carryback and carryforward rules under IRC Section 172 from a 3 year carryback and a 15 year carryforward to a 2 year carryback and a 20 year carryforward. Although there is no change to the OLD rules under IRC Section 810, companies should

be mindful of the NOL change and watch for a potential technical correction to bring the OLD rules in line with the NOL rules.

**13.13 *Small life insurance company deduction.*** A small life insurance company deduction is allowed to life insurance companies with gross assets of less than \$500 million determined at year end on a controlled group basis. The deduction is equal to 60 percent of the first \$3 million of tentative LICTI. The deduction is phased out at the rate of 15 percent of the amount in excess of \$3 million and is completely phased out when tentative LICTI equals \$15 million.

**13.14 *Phase III income.*** Under pre-1984 law, a portion of stock LICTI was tax-deferred indefinitely, and accumulated in a tax memorandum account referred to as *policyholders' surplus account* or *phase III income*. As a result of the 1984 changes, stock life insurance companies no longer defer taxation of any portion of their taxable income; however, the previously deferred pre-1984 income remains tax deferred to the extent that (a) the life insurance company does not distribute such income to its shareholders, (b) the company retains its status as a life insurance company, and (c) the company maintains minimum levels of tax basis reserves or premiums. Reductions in the policyholders' surplus accounts (phase III income) are included in taxable income in the year in which such a reduction occurs. Phase III income cannot be offset by NOLs. The American Jobs Creation Act of 2004 suspends the application of the rules imposing income tax on distributions to shareholders from the policyholder's surplus account of a stock life insurance company for taxable years beginning after December 31, 2003, and before January 1, 2006. The provision also reverses the order in which distributions reduce the various accounts, so that distributions would be treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

**13.15 *Dividends-received deduction.*** As with nonlife insurance companies, life insurance companies are generally entitled to a DRD, however this deduction is subject to proration as described in paragraph 13.09(c). This deduction is determined in part on the life insurance company's ownership of the dividend paying company.

## Computation of Federal Income Tax Liability

**13.16** The computation of federal income taxes is generally the same as in other industries. The IRC provides two systems of income taxation for all taxpayers including life insurance companies, the regular tax (taxable income is determined as described in paragraph 13.14 and the tax is determined by applying the regular income tax rates to such taxable income) and the alternative minimum tax (AMT). An entity's federal income tax liability is the greater of regular income tax or the AMT.

**13.17** The AMT is a tax system that parallels the regular income tax system. It is intended to tax those entities with little current taxable income but significant financial reporting earnings. For the purpose of calculating the AMT, taxable income is adjusted by certain amounts as specified by the IRC to arrive at alternative minimum taxable income (AMTI). The tentative AMT is generally 20 percent of the AMTI. The AMT is the excess of tentative minimum tax over the regular tax liability.

**13.18 *Tax payments.*** As is the case with other business entities, a life insurance company must make estimated tax payments on April 15, June 15,

September 15, and December 15. A life insurance entity that does not base its estimated tax payments on 100 percent of its tax liability for the preceding year (the safe harbor) will have to base its estimated tax payment on 100 percent of the amount of tax shown on its current year's return. Large life insurance entities (those with taxable income of \$1 million or more in any of the 3 preceding years) may continue to compute first quarter estimated tax payments based on the preceding year's tax liability.

## State Taxes

**13.19** Various state governments tax life insurance entities on premiums written and on income. Taxation methods and tax rates vary widely among the states. Many states apply different rates to different lines of business and differentiate between domestic insurers and foreign insurers.

**13.20** *State premium taxes.* All states tax premiums. These taxes usually apply both to the life insurance entities that are domiciled in the state, called domestic insurers, and to the entities 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. (Statement of Statutory Accounting Principles [SSAP] No. 94, *Accounting for Transferable State Tax Credits*, provides guidance for credits that are consistent with the SAP statement of concepts—excluded from its scope are certified capital gain companies and investments in low income housing per SSAP No. 93, *Accounting for Low Income Housing Tax Credit Property Investments*.) 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.

**13.21** Most states require premium tax payments and require the balance of any premium taxes due to be paid in February of the year following the year that the premiums were written (along with the filing of the annual return). Rather than computing the liability on a state by state basis, most life insurance entities 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 life insurance entities should evaluate the ratio annually, because shifts in the concentration of the entity's business from state to state and changes in state tax laws can significantly affect an insurer's premium tax liability.

**13.22** *State income taxes.* In addition to taxing premiums, some states tax the net income of domestic insurers; 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.

**13.23** The prior year apportionment percentage is generally indicative of the current year for computing the accrual. Significant changes in the places in which the entity 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.

## Accounting Practices

**13.24** As discussed in chapter 3, "Sources of Accounting Principles and Reporting Requirements," life insurance entities are subject to the filing requirements of SAP and may also prepare financial statements in accordance with U.S. GAAP. The following discussion of SAP and U.S. GAAP accounting for federal income taxes and other related amounts is not a comprehensive source of authoritative accounting literature, but is intended to assist the preparers and auditors of financial statements in obtaining a general understanding of basic accounting practices for federal income tax provisions within the life insurance industry. The authoritative sources cited in chapter 3 may be referred to in determining appropriate accounting and reporting treatment in all cases.

## Statutory Accounting Practices

**13.25** A life insurance company's federal income tax liability is the greater of its regular tax liability or its AMT liability. Under SSAP No. 10R, *Income Taxes—Revised, A Temporary Replacement of SSAP No. 10*,\*

only adjusted gross deferred tax assets that are more likely than not (a likelihood of more than 50 percent) to be realized shall be considered in determining admitted adjusted gross deferred tax assets.

SSAP No. 10R, paragraphs 5 and 7 note that, under SAP,

A reporting entity's balance sheet should include deferred income tax assets (DTAs) and liabilities (DTLs), the expected future tax consequences of temporary differences generated by statutory accounting, as defined in paragraph 11 of Financial Accounting Standards Board (FASB) Statement No. 109 . . . Changes in DTAs and DTLs, including changes attributable to changes in tax rates and changes in tax status, if any, shall be recognized as a separate component of gains and losses in unassigned funds (surplus). Admitted adjusted gross DTAs and DTLs shall be offset and presented as a single amount on the statement of financial position.

Under SAP the adjusted gross DTA is also subject to an additional admissibility test to determine how much of the gross deferred tax asset may be admitted (see paragraph 13.38).

**13.26** *Subsequent true-up.* Generally, life insurance companies are calendar year taxpayers. Income tax returns are due on March 15 of the following tax year; however, most insurance companies elect to extend the due date to September 15. At year end, a tax accrual is performed to determine the expected tax liability for the year. However, the tax liability actually reported on the tax return may be different from the expected tax determined in the accrual. As a result, a true-up is performed, which compares the actual tax

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\* Statement of Statutory Accounting Principles (SSAP) No. 10R, *Income Taxes—Revised, A Temporary Replacement of SSAP No. 10*, is effective for 2009 annual financial statements and 2010 interim and annual financial statements only.

In March 2011, the Statutory Accounting Principles Working Group (SAPWG) of the National Association of Insurance Commissioners (NAIC) exposed SSAP No. 101, *Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10*. The proposed guidance would incorporate U.S. generally accepted accounting principles guidance for uncertain tax positions and tax-planning strategies. It would also change how admitted deferred tax assets are calculated. The comment deadline was April 29, 2011. The SAPWG has scheduled several calls during the spring of 2011 to discuss the proposed guidance and intends to adopt a final standard at the summer NAIC meeting in August 2011.

liability with the current tax provision. If the actual tax due is different (either greater or lesser) than the current provision, an additional book entry is recorded. Federal income taxes incurred during the year relating to prior period adjustments generally are included with current year taxes.

**13.27** *Tax return accounting.* In general, tax return accounting follows statutory accounting with several exceptions that have been discussed in the preceding paragraphs of this section. These exceptions are summarized in table 13-1, "Comparison of Tax Return Accounting Rules and Statutory Accounting Practices."

**13.28** Financial statements should recognize current and deferred income tax assets and liabilities. Under U.S. GAAP, the accounting principles for income taxes for life insurance entities as well as other business entities are specified in FASB *Accounting Standards Codification* (ASC) 740, *Income Taxes*. The sections of FASB ASC 740 that have a significant effect on life insurance entities are paragraphs 1–14 of FASB ASC 740-20-45, relating to intraperiod tax allocation, subpoint a(4) of FASB ASC 740-10-25-3, and FASB ASC 944-740-50-1. Under SAP, SSAP No. 10R has adopted FASB ASC 740 with modifications for state income taxes, the realization criteria for deferred tax assets, and the recording of the impact of changes in its deferred tax balances.

**Table 13-1**  
**Comparison of Tax Return Accounting Rules and Statutory Accounting Practices**

	<i>Statutory Accounting Practices</i>	<i>Tax Return Accounting</i>
Qualification	Organized as a life insurance entity under state insurance law	Meets the Internal Revenue Code definition of life insurance company on an annual basis
Premiums	Recorded as collected, or for some contract types, when due	Gross premium income generally follows annual statement definition
• Deferred Uncollected Premiums	Included in premiums and reported as assets on balance sheet	Excluded from gross premium income
• Advance Premiums and Premium Deposit Funds	Excluded from premiums and reported as liabilities on balance sheet	Included in gross premium income
• Experience Rated Refunds	Often netted against premium and annuity considerations	Deductible as policyholder dividends
Investment Income		
• Interest Income	• Included in gain from operations income	• Tax exempt income of the policyholder's share is included in life insurance company taxable income (LICTI) via decrease of ending tax basis reserves
— Tax Exempt Interest Income	• Not applicable	• The percentage of tax exempt interest income and dividends received subject to tax is increased
— Proration		
— Market Premium and Discount on Bond Obligations	Amortized and accrued currently	• Option is available not to accrue market discount currently • Unaccrued market discount realized upon disposition may be ordinary income for certain obligations
— Original Issue Discount	Same as Market Premium	Must accrue original issue discount currently
• Dividend Income	Included in gain from operations	Generally included in taxable income as received, except some amounts, which may be reclassified as return of capital or capital gain depending on the paying entity's circumstances

	<i>Statutory Accounting Practices</i>	<i>Tax Return Accounting</i>
• Rental Income	Included in operations income; may include an amount for occupying company owned real estate (imputed rent)	Imputed rent is eliminated
• Royalty Income	Included in operations income	Various adjustments may be required depending on the nature of the activity that generates the income
• Leases, Mortgages, and Other Instruments	Included in operations income	<ul style="list-style-type: none"> <li>• Tax return accounting rules may require an item be reported in a different period than statutory accounting practices</li> <li>• Only the specific charge-off method is allowed on worthless mortgages</li> </ul>
• Capital Gains and Losses	Included in gain from operations, to the extent not included in the interest maintenance reserve	Taxed when realized
General Deductions	Charged to gain from operations as incurred	<ul style="list-style-type: none"> <li>• Subject to tax accounting rules generally applicable to other nonlife entities</li> </ul>
Computation of Life Insurance Statutory Benefit Reserves	Determined using statutory interest, morbidity and mortality assumptions, and calculation methods as prescribed or permitted by the state insurance department	<ul style="list-style-type: none"> <li>• These are determined using interest rates, morbidity and mortality tables, and calculation methods as provided in the Internal Revenue Code</li> <li>• Liabilities not qualifying as life insurance statutory benefit reserves are discounted using IRS rates</li> </ul>
Statutory Unearned Premium Reserve on Nonlife Insurance Contracts	Treated generally the same as other statutory reserves	Subject to 20 percent reduction of beginning and ending statutory unearned premium reserves
Incurred But Not Reported	Included in statutory benefit reserves	Estimate deductible as benefits
Policyholder Dividends	Change in liability for policyholder dividends is charged to operations income	Amounts paid or accrued during the taxable year are deductible

(continued)

	<i>Statutory Accounting Practices</i>	<i>Tax Return Accounting</i>
Other Adjustments are the following:		
<ul style="list-style-type: none"><li>Contract Acquisition Costs</li></ul>	These are charged to gain from operations when incurred	<ul style="list-style-type: none"><li>Capitalization of a fixed percentage of net premiums on certain insurance contracts</li><li>Amortized over 120 months</li></ul>
<ul style="list-style-type: none"><li>Operations Loss Deduction</li></ul>	Not applicable	<ul style="list-style-type: none"><li>Operations loss deductions may be carried back 3 years and forward 15 years to offset past or future taxable income, if any</li><li>New life insurance companies may qualify for 18 year carryforward</li></ul>
<ul style="list-style-type: none"><li>Small Life Insurance Company Deduction (available to life insurance companies having end-of-year total assets of \$500 million or less)</li></ul>	Not applicable	<ul style="list-style-type: none"><li>Deduction is equal to 60 percent of the LICIT under \$3 million</li><li>Deduction is phased out for LICIT over \$3 million and eliminated for LICIT in excess of \$15 million</li></ul>
<ul style="list-style-type: none"><li>Phase III tax</li></ul>	Not applicable	<ul style="list-style-type: none"><li>The balance of the policyholder surplus account at December 31, 1983, which may become taxable</li><li>Independent of operations gain or loss of the company</li></ul>
<ul style="list-style-type: none"><li>Dividends Received Deduction</li></ul>	Not applicable	<ul style="list-style-type: none"><li>70 percent of dividends received from corporations where ownership is less than 20 percent</li><li>80 percent of dividends received from corporations where ownership is 20 percent or more but less than 80 percent</li><li>100 percent of dividends received from corporations where ownership is more than 80 percent</li></ul>

**13.29** Under FASB ASC 740, the asset and liability method accounts for deferred income taxes by applying provisions of the enacted tax law 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.

**13.30** *Determine current tax liability or asset.* Under U.S. GAAP, subpoint (b) of FASB ASC 740-10-25-2 states that a deferred tax liability or asset should be recognized for the estimated future tax effects attributable to temporary differences and carryforward (discussed starting at paragraph 13.33). Under FASB ASC 740, the contingency concepts no longer applies to recognition. Under SAP, a current tax liability or asset is recognized for the estimated taxes payable or refundable on tax returns for the current year, as discussed in paragraphs 13.01–23. Under SAP, SSAP No. 10R paragraph 3 defines *current income taxes* as follows:

- a. Current year estimates of federal and foreign income taxes (including the equity tax of a mutual life insurer and the 'true-up' of such tax), based on tax returns for the current year, and tax contingencies for current and all prior years, to the extent not previously provided, computed in accordance with SSAP No. 5, *Liabilities, Contingencies and Impairments of Assets*;
- b. Amounts incurred or received during the current year relating to prior periods, to the extent not previously provided, as such amounts are deemed to be changes in accounting estimates as defined in SSAP No. 3, *Accounting Changes and Corrections of Errors*.

**13.31** *Determine temporary differences.* To determine each year's deferred taxes, the first step is to identify temporary differences and operating loss and tax credit carryforwards. Temporary differences are differences between the tax return bases of assets and liabilities, under U.S. GAAP, computed pursuant to FASB ASC 740, and their financial reporting amounts. Some temporary differences cannot be identified with a particular asset or liability for financial reporting, but those temporary differences result from events that have (a) been recognized in the financial statements and (b) will result in taxable or deductible amounts in future years based on provisions of the tax law. Taxable temporary differences will result in taxable income in future years when the related asset or liability is recovered or settled. Conversely, deductible temporary differences will result in deductible amounts in future years. For life insurance companies, the most common temporary differences include the following:

- a. Deferred acquisition costs
- b. Life insurance statutory benefit reserves
- c. Statutory unearned premium reserves (generally for accident and health contracts)
- d. Certain discounted accident and health liabilities

Basic differences that will never have a tax consequence are not considered temporary differences.

**13.32** *Determine deferred tax asset or liability.* The total deferred tax assets and liabilities for temporary differences and carryforwards are then measured by applying the applicable tax rate, which is the enacted tax rate to taxable income, in the periods in which the deferred tax items are expected

to be settled or realized. Deferred tax assets are measured for each type of temporary difference and carryforward.

**13.33** A tax position could result in or affect the measurement of a current or deferred tax asset or liability in the statement of financial position. Organizations adopt many tax positions relative to tax laws, including those adopted in determining whether tax is due, a refund is owed, or if a tax return needs to be filed. A company's tax positions can change over time from a myriad of variables, for example, IRS developments, state taxing authorities, or tax court cases.

**13.34** Paragraph 6 of FASB ASC 740-10-25 notes that an entity should initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. For example, if an entity determines that it is certain that the entire cost of an acquired asset is fully deductible, the more-likely-than-not recognition threshold has been met. The more-likely-than-not recognition threshold is a positive assertion that an entity believes it is entitled to the economic benefits associated with a tax position. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold should consider the facts, circumstances, and information available at the reporting date. The level of evidence that is necessary and appropriate to support an entity's assessment of the technical merits of a tax position is a matter of judgment that depends on all available information.

**13.35** Paragraph 9 of FASB ASC 740-10-25 notes that a tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an entity should make the assessment on a position-by-position basis, but an entity could conclude that all positions in a particular tax year are effectively settled.

**13.36** In addition to the aforementioned guidance, FASB ASC 740 clarifies a number of other areas surrounding the uncertainty in income taxes, including derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

**13.37** Additionally, under U.S. GAAP, it is necessary to determine if a deferred tax asset valuation allowance is needed. Deferred tax assets are then reduced by a valuation allowance if, based on all available evidence (both positive and negative), it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the tax benefit will not be realized. The weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified. The valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

**13.38** *Valuation allowances—sources of evidence.* Realization of the deferred tax asset in the future depends on the existence of sufficient future taxable income of the appropriate character within the carryback or carryforward period available under the tax law. The following four possible sources of

taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

- a. Future reversals of existing taxable temporary differences
- b. Future taxable income in future taxable years, exclusive of reversing temporary differences and carryforwards
- c. Taxable income in prior carryback years if carryback is permitted under the tax law
- d. Tax planning strategies, provided the strategy is
  - i. prudent and feasible;
  - ii. an action that a life insurance company would normally not take in the ordinary course of business, but would take, if necessary, to prevent a tax benefit from expiring unused; and
  - iii. an action that would result in the realization of deferred tax assets. Paragraph 98 of FASB ASC 740-10-55 states that only tax planning strategies that meet the more likely than not recognition threshold would be considered in evaluating the sufficiency of future taxable income for realization of deferred tax assets.

However, if after all four sources as described in the preceding steps are examined, it is still more likely than not that some or all of the deferred tax asset will not be realized, then a valuation allowance should be established. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets. Significant expenses to implement a tax planning strategy or any significant losses that would be recognized if the strategy were implemented (net of any recognizable tax benefits associated with those expenses or losses) should be included in the valuation allowance.

**13.39** Under SAP, a valuation allowance adjustment and an admissibility test is used to determine how much of the gross deferred tax assets should be admitted. Paragraph 6 of SSAP No. 10R, notes

A reporting entity's deferred tax assets and liabilities are computed as follows:

- a. Temporary differences are identified and measured using a 'balance sheet' approach whereby statutory and tax basis balance sheets are compared;
- b. Temporary differences include unrealized gains and losses and nonadmitted assets but do not include asset valuation reserve (AVR), interest maintenance reserve (IMR), Schedule F penalties and, in the case of a mortgage guaranty insurer, amounts attributable to its statutory contingency reserve to the extent that "tax and loss" bonds have been purchased;
- c. Total DTAs and DTLs are computed using enacted tax rates; and
- d. A DTL is not recognized for amounts described in paragraph 31 of FAS 109.
- e. Reduce gross DTAs by a statutory valuation allowance adjustment 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 gross DTAs will not be realized. The statutory valuation allowance adjustment, determined in a manner consistent with paragraphs 20 through 25 of FAS 109,<sup>2</sup> shall reduce the gross DTAs to the amount that is more likely than not to be realized (the adjusted gross deferred tax assets).

The statutory valuation allowance adjustment is utilized strictly to calculate the "adjusted gross DTA." (Admittance criteria in paragraph 10 of SSAP No. 10R are applied to the "adjusted gross DTA.") The application of the statutory valuation allowance adjustment in SSAP No. 10R does not result in a statutory valuation allowance reserve within the statutory financial statements and does not go through net income.

**13.40** SSAP No. 10R paragraph 10, notes the

adjusted gross DTAs should be admitted in an amount equal to the sum of paragraphs 10.a, 10.b, and 10.c, or the amount determined in paragraphs 10.d. and 10.e.:

- a. federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year; and
- b. the lesser of
  - i. the amount of adjusted gross DTAs, after the application of paragraph 10 a., expected to be realized within one year of the balance sheet date; or
  - ii. 10 percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system software and any net positive goodwill; and
- c. the amount of adjusted gross DTAs, after application of paragraphs 10a–10b, that can be offset against existing gross DTLs. An entity must consider the character

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<sup>2</sup> For purposes of determining the amount of adjusted gross deferred income tax assets (DTAs) and the amount admitted under paragraph 10, the admission calculation shall be made on a separate company, reporting entity basis. A reporting entity that files a consolidated federal income tax return with its parent should look to the amount of taxes it paid (or were allocated to it) as a separate legal entity in determining the admitted DTA under paragraphs 10.a. and 10.e.i. Furthermore, the DTA under these paragraphs may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent. The taxes paid by the reporting entity represent the maximum DTA that may be admitted under paragraphs 10.a. or 10.e.i., although the amount could be reduced pursuant to the group's tax allocation agreement. The amount of admitted adjusted gross DTAs under paragraphs 10.b.i. and 10.e.ii.(a) is limited to the amount that the reporting entity expects to realize within the applicable realization period, on a separate company basis. The reporting entity must estimate its separate company taxable income and the tax benefit that it expects to receive from reversing deductible temporary differences in the form of lower tax payments to its parent. A reporting entity that projects a tax loss in the applicable realization period cannot admit a DTA related to the loss under paragraph 10.b. and 10.e.ii., even if the loss could offset taxable income of other members in the consolidated group and the reporting entity could expect to be paid for the tax benefit pursuant to its tax allocation agreement.

(i.e., ordinary versus capital) of the DTAs and DTLs such that offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations.

- d. if the reporting entity is subject to risk-based capital requirements or is required to file a risk-based capital Report with the domiciliary state, and the reporting entity's financial statements, after reflecting admitted adjusted gross DTAs calculated from the sum of paragraphs 10.a., 10.b., and 10.c. results in the company's risk-based capital level being above the following thresholds:
  - i. The risk-based capital trend test for those entities that are subject to a RBC trend-test; or
  - ii. For those entities not subject to a risk-based capital trend test, a risk-based capital above the maximum risk-based capital level where an action level could occur as a result of a trend test (i.e. 250% for life and fraternal entities; 300% for property/casualty entities and health entities;

then the reporting entity may elect to admit a higher amount of adjusted gross DTAs as calculated in paragraph 10.e.

If the reporting entity is not subject to risk-based capital requirements and is not required to file a risk-based capital Report with the domiciliary state, then the reporting entity shall not admit a higher amount of adjusted gross DTAs as calculated in paragraph 10.e. and shall calculate admitted adjusted gross DTAs equal to the sum of paragraphs 10.a., 10.b., and 10.c.

- e. If the thresholds in paragraph 10.d. are exceeded, then adjusted gross DTAs, if elected by the reporting entity, shall be admitted in an amount equal to the sum of:
  - i. Federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse during a time-frame corresponding with IRS tax loss carryback provisions, not to exceed three years; and
  - ii. The lesser of:
    - (1) The amount of adjusted gross DTAs, after the application of paragraph 10.e.i., expected to be realized within three years of the balance sheet date; or
    - (2) Fifteen percent of statutory capital and surplus as required to be shown on the statutory balance sheet of the reporting entity for its most recently filed statement with the domiciliary state commissioner adjusted to exclude any net DTAs, EDP equipment and operating system

software and any net positive goodwill;  
and

- iii. The amount of adjusted gross DTAs, after application of paragraphs 10.e.i. and 10.e.ii., that can be offset against existing gross DTLs. An entity must consider the character (i.e., ordinary versus capital) of the DTAs and DTLs such that offsetting would be permitted in the tax return under existing enacted federal income tax laws and regulations.
- f. the increased amount (admitted adjusted gross DTA calculated from 10.e. less the sum of admitted adjusted gross DTA calculated from 10.a., 10.b., and 10.c.) of admitted assets and statutory surplus resulting from the use, if applicable, of paragraph 10.e. to calculate admitted adjusted gross DTAs:
  - i. Shall be separately reported in the *Aggregate write-ins for gains and losses in surplus* line of the Summary of Operations, Statement of Income or Statement of Revenue, as applicable.
  - ii. Shall be separately reported in the *Aggregate write-in for special surplus funds* line of Liabilities, Surplus and Other Funds; Liabilities, Capital and Surplus or Liabilities and Surplus, as applicable.

**13.41** Paragraph 11 of SSAP No. 10R states,

in computing a reporting entity's admitted adjusted gross DTA pursuant to paragraph 10;

- a. Existing temporary differences that reverse by the end of the subsequent calendar year, within three years or during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years, shall be determined in accordance with paragraphs 228 and 229 of FAS 109;
- b. In determining the amount of federal income taxes that can be recovered through loss carrybacks, the amount and character (i.e., ordinary versus capital) of the loss carrybacks and the impact, if any, of the Alternative Minimum Tax shall be determined in accordance with the provisions of the Internal Revenue Code, and regulations thereunder;
- c. The amount of carryback potential that may be considered in calculating the admitted adjusted gross DTAs of a reporting entity in subparagraph 10.a. or 10.e.i. above, that files a consolidated income tax return with one or more affiliates, may not exceed the amount that the reporting entity could reasonably expect to have refunded by its parent; and
- d. The phrases 'reverse by the end of the subsequent calendar year,' 'reverse during a timeframe corresponding with IRS tax loss carryback provisions, not to exceed three years,' 'realized within one year of the balance sheet date' and

'realized within three years of the balance sheet date' are intended to accommodate interim reporting dates and reporting entities that file on an other than calendar year basis for federal income tax purposes.

## Auditing

### Inherent Risk Factors

**13.42** As part of the auditor's assessment of inherent risk, the auditor may consider those factors related to federal and state taxes, including factors relating to management, product characteristics, and economic and regulatory environment. Such factors might encompass the following:

- a. The life insurance entity has historically underprovided for its federal income tax liability.
- b. Management places undue emphasis on meeting projected tax liabilities on earnings projections.
- c. Significant changes in regulation or taxation have occurred.
- d. The entity is a member of a tax consolidated group, and its tax provisions are dependent on amounts from affiliates.

## Obtaining an Understanding of Internal Control for Auditing Income Tax Transactions

**13.43** As part of obtaining an understanding of internal control related to income tax transactions, the auditor might consider the following factors. An entity's internal control consists of the following five elements: the control environment, risk assessment, control activities, information and communication, and monitoring as stated in paragraph .41 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). As discussed in chapter 5, "General Auditing Considerations," the auditor should obtain a sufficient understanding of each of the five elements of the entity's internal control to assess the risks of material misstatement of the entity's financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

### Control Environment

**13.44** The control environment, as related to federal and state taxes of a life insurance entity, represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific control policies or procedures of the entity. Such factors that relate to federal and state tax transactions include the following:

- a. A single person dominates the decision making process with regard to tax issues and tax planning strategies.
- b. The entity does not use a life insurance tax specialist in determining its federal income tax provision.

### Control Activities

**13.45** Control activities are those policies and procedures that help ensure that management directives are carried out; for example, that necessary

actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. The auditor should obtain an understanding of those control activities relevant to the audit. The following are examples of typical internal control procedures and policies relating to federal and state tax payments, deferred tax amounts, and other related liabilities transactions:

- a. Proper authorization of transactions and activities
- b. Segregation of duties
- c. Design of adequate controls over documents and records (there is adequate control over records of temporary differences)
- d. Adequate safeguards of access to and use of assets and accounting records
- e. Independent checks on performance and proper valuation of recorded amounts

Note that for an integrated audit performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit (paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, PCAOB Standards and Related Rules, Interim Standards]). Also refer to paragraph 54 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, PCAOB Standards and Related Rules, Auditing Standards) for a discussion on the extent of tests of controls.

## Information and Communication

**13.46** Paragraph .81 of AU section 314 states that the information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report an entity's transactions and to maintain accountability for related assets, liabilities, and equity.

**13.47** The transaction flow of accounting records for income tax payments and related liabilities encompasses all functions relating to components of taxable income and related deductions. In general, the life insurance entity's general accounting system should provide adequate levels of information to determine the entity's federal and state income tax liabilities. Life insurance entities will maintain detailed accounting records for any items relating to temporary differences. In addition, separate tax memorandum accounts are required for stock life entities to account for the phase III income that has been deferred.

## Audit Consideration Chart

**13.48** The auditor may consider the following specific audit objectives and examples of selected control and auditing procedures in auditing income taxes of life insurance entities. The audit consideration chart is intended to present examples only, and is not all-inclusive for any category.



**Auditing Consideration Chart—Taxes**

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Substantive Auditing Procedures</i>
<b>Taxes—Current Provision</b>		
<i>Existence or Occurrence and Rights and Obligations</i>		
All liabilities for income taxes payable on the balance sheet represent amounts owed to governmental entities for income taxes.	Entries to deferred tax accounts are reviewed and approved by appropriate tax personnel.	Review the provisions of any applicable intercompany tax sharing arrangements and ensure that tax calculations are appropriately recorded.
	Movements in deferred tax balances are reviewed for reasonableness by management.	Compare the various tax account balances with those of prior periods and investigate any unexpected changes (or the absence of expected changes).
	Reconciliations between tax returns and payable or receivable balances are performed and reviewed for reasonableness.	Compare the relationships of current income tax expense to pretax income with such relationships for prior periods.
	Components of the year-end balances are analyzed and reviewed for reasonableness.	Review changes in reserves for reasonableness and consistency with prior years.
	Management reports regarding accrued tax liabilities for life insurance benefits are prepared and reviewed. These reports may include the following: 1. Changes in insurance statutory benefit reserves from prior year	

*(continued)*

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Substantive Auditing Procedures</i>
	<div>2. Comparison of insurance statutory benefit reserves on a policy by policy basis versus the aggregate on a statutory basis</div> <div>3. Impact of new policy issues on statutory reserves</div> <div>4. A review of changes in statutory assumptions to determine whether an accounting change has taken place</div>	
<i>Completeness</i>		
All current taxes payable and current expenses that should be accrued at the balance sheet date have been recorded.	<div>Management review of financial statements, with comparison of prior year financial statements, and prior year tax returns to ascertain the reasonableness of the following:<div>1. Book and tax differences</div><div>2. Effective tax rate</div></div> <div>Income tax filings and assessments are addressed promptly and are reviewed, approved, and compared to the financial records by management.</div>	<div>Compare the various tax account balances with those of prior periods and investigate unexpected changes (or the absence of expected changes).</div> <div>Compare the relationships of current income tax expense to pretax income with such relationships for prior years.</div>
<i>Valuation or Allocation</i>		
Current income taxes payable or receivable, deferred tax assets, and current income tax expense are recorded at appropriate amounts.	Management reviews statutory guidelines to determine that proper tax rates are utilized.	Reconcile prior year financial statement activity with the prior year tax return to true up prior year amounts.

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Substantive Auditing Procedures</i>
	Management reviews movements in policyholder surplus account for the calculation of Phase III tax. If applicable, management considers the implications of differential earning rate and finalization of prior year differential earnings rate.	Analyze and compare premiums written with the calculation of the deferred acquisition costs' (DAC) capitalization.
	Management reviews the impact of deferred acquisition cost capitalization as compared with line of business reporting.	Obtain financial statements for joint venture partnerships and other investments in which the entity has a significant interest.
	Management reviews recent legislative developments for their impact on tax calculation.	Examine the opinion and related disclosures to ensure that items that affect the audit are properly considered in the entity's tax accounting.
	Management investigates differences between the return and provisions to mitigate similar differences in current year.	
<i>Presentation and Disclosure</i>		
Current income taxes payable and current income tax expense and related amounts are properly classified, described, and disclosed in the financial statements, including notes, in conformity with applicable accounting principles.	Management reports are prepared and reviewed. These reports may include the following: <ol style="list-style-type: none"> <li>1. Analysis of all differences between financial and taxable income</li> <li>2. Analysis of all differences between statutory and taxable income</li> </ol>	Review whether disclosures comply with U.S. GAAP.  For audits of statutory financial statements, test whether classifications and disclosures comply with applicable regulations.  Read finance committee minutes.

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Substantive Auditing Procedures</i>
	<div>3. Analysis of federal, foreign, and state and local taxes</div> <div>4. Analysis of federal ordinary and capital gains tax</div> <div>5. Effective tax rate analysis</div> <div>6. The ratio of income tax expense to pretax income, operating earnings, budget, and so on</div> <div>Management determines whether footnotes are in accordance with company policy.</div>	<div>Review income tax accruals and provisions, the status of unresolved tax matters, and related financial statement disclosures with the entity's legal counsel and other appropriate personnel.</div>

**Taxes—Deferred Taxes**

*Existence or Occurrence and Rights and Obligations*

<div>All deferred liabilities for income taxes payable on the balance sheet represent amounts owed to government entities for income taxes.</div>	<div>Entries to deferred tax accounts are reviewed and approved by appropriate tax personnel.</div> <div>Movements in deferred tax balances are reviewed for reasonableness by management.</div> <div>Reconciliation between current tax calculation of temporary differences and the tax basis of the balance sheet at the beginning and end of the year is performed and reviewed for reasonableness.</div>	<div>Review the provisions of any applicable intercompany tax sharing arrangements and ensure that tax calculations are appropriately made and consistently applied and all settlements have been appropriately recorded.</div> <div>Review to ensure that return to provision reconciliation is reflected in the period end tax basis balance sheet.</div>
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*Completeness*

<div>All deferred taxes payable and deferred tax expense that should be accrued at the balance sheet date have been recorded.</div>	<div>Management prepares a review of financial statements, with comparison to prior year financial statements and prior year tax returns to ascertain the</div>	<div>Compare the various tax account balances with those of prior periods and investigate unexpected changes (or the absence of expected changes).</div>
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<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Substantive Auditing Procedures</i>
	<p>reasonableness of temporary differences as compared to movements in the tax basis balance sheet.</p> <p>Management reports are prepared and reviewed reconciling the difference between the beginning-of-year book and tax bases of assets and liabilities to the year end difference between book and tax bases of assets and liabilities.</p> <p>Income tax filings and assessments are addressed promptly and are reviewed, approved, and compared to the financial records by management.</p>	<p>Reconcile the changes in the deferred income tax balances between the current and prior periods with the provision for deferred income taxes.</p> <p>Compare the relationships of deferred income tax expense to pretax income with such relationships for prior years.</p> <p>Reconcile the current year book and tax timing differences to the change in balance sheet account balances.</p>
<i>Valuation or Allocation</i>		
Deferred income taxes payable and current income tax expense are recorded at appropriate amounts.	<p>Review reasonableness and necessity for valuation allowances.</p> <p>Management reports are prepared and reviewed detailing positive and negative evidence with respect to realizability of deferred tax assets.</p>	<p>Schedule a reversal of temporary differences in conjunction with projected return results.</p> <p>Review positive and negative evidence for determining the realizability of deferred tax assets.</p>

(continued)

<i>Audit Objectives</i>	<i>Examples of Selected Control Procedures and Techniques</i>	<i>Examples of Substantive Auditing Procedures</i>
<i>Presentation and Disclosure</i>		
Deferred income taxes payable and deferred income tax expense and related amounts are properly classified, described, and disclosed in the financial statements, including notes, in conformity with applicable accounting principles.	Management reports are prepared and reviewed. These reports may include the following:  <ol style="list-style-type: none"><li>1. Details of the differences between the statutory and effective rates of tax on pretax income</li><li>2. Components of the net deferred tax provision</li><li>3. Components of the year end deferred tax liability (asset) and reconciliation to year-end balance sheet</li><li>4. Calculation of deferred tax asset valuation</li></ol>	Compare the relationship of the current year effective tax rate to prior years.  Reconcile components of deferred tax provision to movements in tax basis balance sheet.  Schedule reversal of temporary differences in conjunction with projected future income to determine the reasonableness of valuation allowances.

## Chapter 14

# ***Other Assets and Liabilities, Lending and Financing, Surplus Notes, Separate Accounts, Insurance Related Assessments and Equity—Contract Holders' Surplus***

**Note:** This chapter contains references to both financial and nonfinancial assets and liabilities that are subject to fair value measurement. As noted in chapter 3, "Sources of Accounting Principles and Reporting Requirements," Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, has significant implications for the concept of fair value. Please refer to chapter 3, beginning at paragraph 3.31, for further information.

### **Introduction\***

**14.01** This chapter provides a brief description of statutory accounting practices (SAP) and U.S. generally accepted accounting principles (GAAP) and examples of suggested audit procedures for other assets and liabilities unique to life insurance entities, lending and financing, separate accounts, insurance related assessments, guarantees, and shareholders' equity or contract holders' surplus. For those areas in which auditing procedures may be unique to life insurance entities, examples of selected auditing procedures are included in

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\* The International Accounting Standards Board (IASB) and its predecessor organization have been working for several years to develop guidance on accounting for insurance contracts. The project was split into two phases. Phase I addressed the application of existing International Financial Reporting Standards to entities that issue insurance contracts. Phase II, initiated in September 2004, is a comprehensive project on accounting for insurance contracts.

On August 2, 2007, the Financial Accounting Standards Board (FASB) issued the invitation to comment *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders*. That invitation to comment included a discussion paper issued by the IASB, *Preliminary Views on Insurance Contracts*, setting forth its preliminary views on the main components of an accounting model for an issuer's rights and obligations (assets and liabilities) under an insurance contract. FASB issued the invitation to comment to gather information from its constituents to help decide whether there was a need for a comprehensive project on accounting for insurance contracts and whether FASB should undertake such a project jointly with the IASB.

In October 2008, FASB decided to join the IASB's insurance contract project.

In July 2010, the IASB issued the exposure draft *Insurance Contracts*. In developing the IASB's exposure draft, most of the discussions about the proposed insurance accounting approaches were held jointly with FASB. Although the boards reached common decisions in many areas, they reached different conclusions in others. Some FASB members prefer the IASB's proposed measurement model; however, the majority prefer an alternative model. Regardless of FASB members' individual views and uniform commitment to convergence, FASB determined that additional information was needed about whether the possible new accounting guidance would represent a sufficient improvement to U.S. generally accepted accounting principles to justify issuing new guidance. On September 17, 2010, FASB issued, for public comment, the discussion paper *Preliminary Views on Insurance Contracts*.

The boards are redeliberating significant issues based on feedback received on the IASB exposure draft and FASB discussion paper. The IASB is expected to issue a final standard and FASB is expected to release an exposure draft by the end of 2011. Readers should remain alert to any final pronouncements.

the "Auditing" section. In general, the audit objectives and internal control considerations are the same as those for any other business entities for similar asset and liability accounts; therefore, the sections addressing the auditor's understanding of internal control and the relevant chart have been omitted.

## Other Assets

**14.02** *Other assets* may include some or all of the following:

- a. Life insurance premiums and annuity considerations deferred and uncollected (See chapter 7, "Insurance Revenues," for a discussion.)
- b. Accident and health premiums due and unpaid (See chapter 7 for a discussion.)
- c. Amounts recoverable from reinsurers (See chapter 12, "Reinsurance," for a discussion.)
- d. For SAP, Statement of Statutory Accounting Principles (SSAP) No. 21, *Other Admitted Assets*, also includes the following as other admitted assets:
  - i. Collateral loans
  - ii. Cash value of life insurance when the reporting entity is the owner and beneficiary
  - iii. Receivables for securities
  - iv. Guaranteed investment contracts
  - v. State insurance guarantee association promissory notes
- e. Nonadmitted assets (See paragraph 14.03 for a discussion.)

## Nonadmitted Assets, Statutory Financial Statements Only

**14.03** *Nonadmitted assets* include all assets, or some portion thereof, that do not conform to the laws and regulations of the various states to qualify as admitted assets in the annual statement. These items are accounted for as charges to surplus. Examples of nonadmitted assets, as noted in SSAP No. 20, *Nonadmitted Assets*, paragraph 4, are the following:

- a. Deposits in suspended depositories
- b. Bills receivable (other than premium receivables) and loans either unsecured or secured by assets that do not qualify as investments
- c. Loans on personal security, cash advances to, or in the hands of, officers or agents and travel advances
- d. All "nonbankable" checks
- e. Trade names and other intangible assets
- f. Automobiles, airplanes, and other vehicles
- g. Entity's stock as collateral for loan

**14.04** SAP specifically designates certain assets as nonadmitted and requires other assets not specifically designated as admissible assets in the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual* (manual) to be nonadmitted. SSAP No. 4, *Assets and Nonadmitted Assets*, provides a definition and accounting treatment for *nonadmitted assets* as follows, "As stated in the Statement of Concepts, 'The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due.



Assets having economic value other than those that can be used to fulfill policyholder obligations, or those assets that are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet,' and are, therefore, considered nonadmitted." If an asset is considered to be nonadmitted, it should be reported as a nonadmitted asset and charged against surplus unless specifically addressed within the revised manual. The asset should be depreciated or amortized against net income as the estimated economic benefit expires.

**14.05** Under U.S. GAAP, the concept of nonadmitted assets does not exist. These assets should be included in the balance sheet, if appropriate. Any receivables must be subject to the usual review as to collectability, and appropriate valuation allowances should be established by a charge to income. Any amounts capitalized and amortized or depreciated should be reviewed for appropriate calculations and recoverability where applicable.

## Other Liabilities

**14.06** Other liabilities (including employee benefit obligations) generally consist of accrued expenses, taxes, licenses, and fees. (See chapter 10, "Commissions, General Expenses, and Deferred Acquisition Costs," for a discussion.) Additional other liabilities unique to life insurance entities may include the following:

- a. Amounts withheld or retained by the life insurance entity as an agent or trustee, such as payroll withholdings and amounts held in escrow for the payment of taxes and insurance under mortgage loans.
- b. Amounts held for agents, which generally represent credit balances in agents' accounts.
- c. Remittances and items not allocated, which represent cash clearing accounts and other suspense accounts.
- d. Commissions to agents due or accrued, including *levelized commission* agreements.
- e. Reinsurance in unauthorized entities. (See chapter 12 for a discussion.)
- f. Liabilities for amounts held under uninsured accident and health plans (referred to as *administrative services only*). Liabilities relating to one plan may not be offset by assets relating to a different plan.
- g. For SAP, SSAP No. 67, *Other Liabilities*, also includes the following as other liabilities:
  - i. Self-insurance
  - ii. Interest payable
  - iii. Payable to parent, subsidiaries and affiliates

## Lending and Financing

**14.07** FASB ASC 942, *Financial Services—Depository and Lending*, provides accounting guidance to any entity that lends to or finances the activities

of others. Additionally, FASB ASC 310, *Receivables*,<sup>†</sup> requires various disclosures. Among other matters, entities must disclose the basis for accounting for loans, the method for recognizing interest income on loans, including a statement about the entity's policy for treatment of related fees and costs, including the method of amortizing net deferred fees or costs. In addition, paragraph 9 of FASB ASC 310-10-50 requires

a description of the accounting policies and methodology the entity used to estimate its liability for off-balance sheet credit exposures and related charges for those credit exposures. Such a description should identify the factors that influenced management's judgment and a discussion of risk elements relevant to particular categories of financial instruments.

**14.08** FASB ASC 310-10-50-6 requires that the entity's summary of significant accounting policies for financing receivables should include all of the following:

- a. the policy for placing financing receivables, if applicable, on nonaccrual status (or discontinuing accrual of interest).
- b. the policy for recording payments received on nonaccrual financing receivables, if applicable.
- c. the policy for resuming accrual of interest.
- d. the policy for determining past due or delinquency status.

Paragraph 7 of FASB ASC 310-10-50 requires both the following disclosures related to nonaccrual and past due financing receivables as of each balance sheet date:

- a. The recorded investment in financing receivables on nonaccrual status
- b. The recorded investment in financing receivables past due 90 days or more and still accruing

FASB ASC 310-10-50-7A requires that an entity provide an analysis of the age of the recorded investment in financing receivables at the end of the reporting period that are past due, as determined by the entity's policy.

FASB ASC 310-10-50-7B notes that the guidance in FASB ASC 310-10-50-7A does not apply to the following financing receivables:

- a. Receivables measured at fair value with changes in fair value reported in earnings
- b. Receivables measured at lower of cost or fair value
- c. Except for credit card receivables, trade account receivables that have both of the following characteristics:
  - i. They have a contractual maturity of one year or less.
  - ii. They arose from the sale of goods or services.

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<sup>†</sup> In July 2010, FASB Accounting Standards Update (ASU) 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, was issued to provide greater transparency about an entity's allowance for credit losses and the credit quality of its financing receivables. For public entities the disclosures are effective for interim and annual reporting periods ending on or after December 15, 2010. For nonpublic entities, the disclosures are effective for interim and annual reporting periods ending on or after December 15, 2011.

For trade receivables that do not accrue interest until a specified period has elapsed, nonaccrual status would be the point when accrual is suspended after the receivable becomes past due. FASB ASC 310 contains other presentation and disclosure requirements that may apply to the financial statements of insurance entities.

## Surplus Notes

**14.09** FASB ASC 944-470 provides U.S. GAAP guidance on accounting for surplus notes. *Surplus notes*<sup>1</sup> are financial instruments issued by insurance entities that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations.

**14.10** SSAP No. 41, *Surplus Notes*, paragraphs 3–4 state the following about surplus notes,

Surplus notes issued by a reporting entity that are subject to strict control by the commissioner of the reporting entity's state of domicile and have been approved as to form and content should be reported as surplus and not as debt only if the surplus note contains the following provisions:

- a. Subordination to policyholders;
- b. Subordinations to claimant and beneficiary claims;
- c. Subordination to all other classes of creditors other than surplus note holders; and
- d. Interest payments and principal repayments require prior approval of the commissioner of the state of domicile.

Proceeds received by the issuer must be in the form of cash or other admitted assets having readily determinable values and liquidity satisfactory to the commissioner of the state of domicile.

**14.11** Mutual insurance entities are owned by their policyholders and cannot raise capital by issuing shares of common or preferred stock; thus, many mutual insurance entities have issued surplus notes. Early issuances of surplus notes were generally by financially troubled mutual insurance entities in need of raising capital with limited alternatives to do so. The recent issuance of surplus notes in the private placement market by the mutual life insurance industry and, to a lesser extent, stock life insurance entities coincided with the implementation of regulatory risk based capital (RBC) requirements in 1993. To improve RBC ratios and for other competitive reasons, numerous financially stable mutual and stock life and health and property and casualty insurance entities have issued surplus notes. SSAP No. 41 paragraph 2 notes that surplus notes are used for various reasons, including but not limited to

- a. providing regulators with flexibility in dealing with problem situations to attract capital to reporting entities whose surplus levels are deemed inadequate to support their operations;
- b. providing a source of capital to mutual and other types of non stock reporting entities who do not have access to traditional equity markets for capital needs; and

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<sup>1</sup> The term *surplus notes* is the most common term applied to these financial instruments. Some jurisdictions refer to these financial instruments as certificates of contribution, surplus debentures, or capital notes.

- c. providing an alternative source of capital to stock reporting entities, although not for the purpose of initially capitalizing the reporting entity.

**14.12** *U.S. GAAP balance sheet classification of outstanding surplus notes.* Surplus notes should be accounted for as debt instruments and presented as liabilities in the financial statements of the issuer. Equity treatment for surplus notes is inappropriate.

**14.13** Consistent with FASB ASC 405-20-40-1, a debtor should derecognize a surplus note if and only if it has been extinguished. According to FASB ASC 405-20-40-1, a liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
  - i. Delivery of cash.
  - ii. Delivery of other financial assets.
  - iii. Delivery of goods or services.
  - iv. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

**14.14** *Accrual of interest.* Under U.S. GAAP, interest should be accrued over the life of the surplus note, irrespective of the approval of interest and principal payments by the insurance commissioner, and recognized as an expense in the same manner as other debt. Under SAP, SSAP No. 41 paragraph 5 states,

Interest shall not be recorded as a liability nor an expense until approval for payment of such interest has been granted by the commissioner of the state of domicile. All interest, including interest in arrears, shall be expensed in the statement of operations when approved for payment. Unapproved interest shall not be reported through operations, shall not be represented as an addition to the principal or notional amount of the instrument, and shall not accrue further interest, that is, interest on interest.

**14.15** *Disclosure.* Issuers of surplus notes should comply with existing disclosure requirements for debt instruments. In addition, disclosure is required regarding the commissioner's role and ability to approve or disapprove any interest and principal payments. Under SAP there are additional disclosure requirements for the notes to the financial statements of a reporting entity that issues surplus notes. See paragraph 12 of SSAP No. 41 for a complete list.

## Separate Accounts

**14.16** Separate accounts represent assets and liabilities that are maintained by an insurance entity and are established primarily for the purpose of

funding variable annuity contracts, variable life insurance contracts, modified guaranteed annuity contracts, modified guaranteed life insurance contracts, or other various group contracts under pension or other employee benefit plans where funds are held in a separate account to support a liability. SSAP No. 56, *Separate Accounts*, paragraph 2 states, "When separate accounts are established and filed accordingly, they may be used to fund guaranteed benefits. Separate account contracts may also be used to accumulate funds which are intended to be applied at some later time to provide life insurance or to accumulate proceeds applied under settlement or dividend options."

**14.17** Individual state laws govern the structure of separate accounts and the NAIC has developed certain Model Laws and Regulations (including the Model Variable Contract Law) that states may adopt or modify with respect to separate accounts. The individual state laws generally indicate that a separate account is legally segregated from the insurer's general account and the assets in the separate account are generally restricted from being chargeable with liabilities arising out of any other business of the insurer. The various state laws governing a particular form of separate account should be reviewed for regulations and restrictions.

**14.18** The following is a discussion of various products utilizing separate accounts and different separate account structures.

## **Variable Annuity Contracts and Variable Life Insurance Contracts**

**14.19** Separate accounts are used to support variable annuity contracts and variable life insurance policies (hereafter referred to together as *variable contracts*). Separate accounts supporting variable annuity and life insurance contracts are registered investment entities under the Investment Company Act of 1940, without an applicable exemption. A variable contract is both a security registered under the Securities Act of 1933 and an insurance policy filed with and approved and regulated by state insurance departments.<sup>2</sup>

**14.20** A *variable annuity or life insurance contract* is a contractual arrangement that combines some features of an investment entity (the contract holder assumes the risk of investment gain or loss) with certain traditional insurance features (the insurance entity assumes the risk of mortality and administrative expenses). A significant difference between a fixed annuity and a variable annuity is that, in sponsoring a fixed annuity, the insurance entity assumes the risk of investment gain or loss and guarantees the contract holder a specified interest rate. In a variable annuity, the contract holder assumes the risk of investment gain or loss because the fair value of the contract holder's account varies with the investment experience of the specific portfolio of securities (that is, the securities held in the separate account). In both fixed annuities and variable annuities, the insurance entity (rather than the separate account) assumes the mortality risk and administrative expenses.<sup>3</sup>

## **Separate Account Structures**

**14.21** A separate account is not a legal entity, but an accounting entity with accounting records for variable contract assets, liabilities, income,

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<sup>2</sup> See chapter 10, "Variable Contracts—Insurance Companies," of the AICPA Audit and Accounting Guide *Investment Companies*.

<sup>3</sup> See footnote 2 in paragraph 14.19.

and expenses segregated as a discrete operation within the insurance entity. The insurance entity's other separate accounts and its general account do not affect the results of the variable contract separate account. The insurance entity must file an annual statement on the combined separate accounts with state insurance regulatory authorities. The separate account is not taxed separately for federal and state tax purposes; it is included with the operations of the insurance entity. However, under federal regulation, variable annuity and variable life products are securities. For purposes of the Investment Company Act of 1940, a separate account is an independent entity, separate from the insurance entity, and cannot rely on the Investment Company Act of 1940's exemption for insurance entities.<sup>4</sup>

**14.22 *Managed accounts.*** One structure for a separate account is a separate account that can invest directly in a portfolio of securities. This kind of separate account is typically called a managed account because it is classified as an open-end management entity under the Investment Company Act of 1940. An open-end management account that is not in the form of an insurance entity separate account is commonly known as a mutual fund. A management account invests directly in a portfolio of investment securities or other investments that are actively managed. Like other open-end management entities, a management account has a board of directors or managers that performs the function imposed under the Investment Company Act of 1940 on the board of directors or trustees of a management entity.

**14.23 *Unit investment trust.*** Alternatively, a separate account, in lieu of investing directly in an actively managed portfolio of securities, can invest in the securities of another investment entity whose portfolio in turn may be actively managed. This kind of separate account is classified as a unit investment trust (UIT) under the Investment Company Act of 1940. The underlying investment entity can be either an open-end management entity or another UIT. Similar to an open-end investment entity organized as a series fund, separate accounts are frequently structured with multiple subaccounts. Each subaccount has a unique investment strategy, and in the case of a separate account organized as a UIT, individual subaccounts will invest in different underlying investment entities. This structure allows contract holders to allocate their amount invested among various investment choices. Financial position and results of operations are maintained separately for each subaccount within the separate account.

## Group Annuity Contracts

**14.24** Separate accounts are used to support certain group annuity contracts, guaranteed investment contracts, and funding agreements. Separate accounts may also be established as investment vehicles for pension plans, such as deposit administration and immediate participation guarantee products, as described in the AICPA Audit and Accounting Guide *Employee Benefit Plans* chapter 7, "Auditing Investments." The financial statements of those separate accounts are generally prepared in accordance with the practices established by the AICPA Audit and Accounting Guide *Investment Companies*, FASB ASC 946-210-50, and Statement of Position 06-1, *Reporting Pursuant to the Global Investment Performance Standards* (AICPA, *Technical Practice*

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<sup>4</sup> See footnote 2 in paragraph 14.19.

*Aids*, AUD sec. 14,420).<sup>5</sup> Chapter 7, "Auditing Investments and Loans to Participants," of the Audit and Accounting Guide *Employee Benefit Plans* states the following:

Separate accounts were developed to allow insured plans to compete with trust funds in making investments and in funding variable annuity plans. The assets of a separate account plan are assets of the insurance company but are not commingled with the insurance company's general assets. The purpose of a separate account is to provide flexibility in the investment of the plan's funds. A separate account may be established solely for one plan or, more commonly, may be pooled with the funds of several plans.

A separate account in which only one plan participates is generally referred to as an *individual separate account* or as a *separate-separate account*. The investments in the account must be separately identified, and the account is operated similarly to a bank trust fund, although it is included in the insurance company's financial statements.

A separate account in which several plans participate generally is referred to as a *pooled separate account*. Each plan's share of a pooled separate account is determined on a participation-unit or variable-unit basis. The plan's equity account provides a cumulative record of the number of participation units credited to the account and the number of units allocated or withdrawn from the account. The balance of participation units credited to the account multiplied by the current participation-unit value equals the amount of equity account assets held on behalf of the policyholder at any given time. The participation-unit value is adjusted periodically, usually each business day, to reflect investment results under the separate account.

## Statutory Accounting Practices—Separate Accounts

**14.25** Under SAP, separate account assets and liabilities represent summary totals of details contained in the separate account's annual statement (green cover). Separate accounts constitute a separate record of fiduciary responsibility for assets (owned by the life insurance entity) that fund liabilities for variable or fixed benefit annuity contracts, variable life contracts, pension funds, and other variable contracts. The life insurance entity's surplus includes the surplus, if any, of the separate account. Net gains from operations of a separate account are recorded as a summary total in the income statement of the life insurance entity's general account.

**14.26** The separate account's annual statement generally reflects the investment activity of the separate account and the net flow of funds between the general account (the life insurance entity) and the separate account. Separate account insurance activities, such as premium collection, claims, benefits, and withdrawals are presented on a gross basis in the income statement of the general account.

**14.27** Separate account assets may consist of equity securities, debt securities, mutual funds, shares of UITs, and other vehicles. (See chapter 11,

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<sup>5</sup> This Statement of Position (SOP) was issued in April 2006 by the Auditing Standards Board and was effective on issuance. In addition to amending specific paragraphs contained in the Audit and Accounting Guide *Investment Companies*, the SOP supersedes SOP 01-4, *Reporting Pursuant to the Association for Investment Management and Research Performance Standards*. See also footnote 2 in paragraph 14.19.

"Investments," for a discussion of investment vehicles.) State statutes generally provide that assets allocated to the separate account may be invested and reinvested without regard to the investment limitations or requirements that are generally imposed on the life insurer. Assets of the separate account are generally reported at fair value.

**14.28** The following three approaches are used to invest the underlying assets of variable annuity contracts:

- a. Direct investment by the variable annuity separate account in individual securities (if the separate account is an open-end management investment entity)
- b. Investment in a registered investment entity formed to receive proceeds from such contract holders (if the separate account is a UIT)
- c. Investment in a registered investment entity that generally sells shares to the public (if the separate account is a UIT)

The third approach is available only for tax qualified variable annuities.

**14.29** Separate account liabilities generally consist of reserves for variable contracts, account balances for deposit-type contracts, accrued transfers to the general account, amounts attributable to the investment adviser and administrator (usually the life insurance entity), and amounts due to brokers.

**14.30** Premium and deposit considerations are received and deposited in the life insurance entity's general account. The insurer then transfers the funds to the applicable separate account. In addition to premium and deposit considerations, separate account revenues include investment management, administration and insurance-related fees, investment income, and realized and unrealized capital gains. Charges against income usually take the form of investment advisory fees, service charges, increases in reserves, benefit payments, withdrawals, and realized and unrealized capital losses.

**14.31** When a separate account is initiated, the life insurance entity may make a temporary transfer of surplus funds to the separate account, referred to as *seed money*. Such funds are reported as surplus in the separate account's annual statement, and the transfer of such funds between the general and separate accounts is reported as surplus contributed or withdrawn during the year. The rules and regulations of various states restrict the sale, exchange, or transfer of assets between the general and separate accounts.

**14.32** An asset valuation reserve (AVR) is generally required for separate accounts when the insurer rather than the policyholder bears the risk, and an interest maintenance reserve (IMR) is required for book value separate accounts. SSAP No. 56 paragraph 18 states,

An AVR is required unless:

- a. The asset default or market value risk is borne directly by the policyholders; or
- b. The regulatory authority for such separate accounts already explicitly provides for a reserve for asset default risk, where such reserves are essentially equivalent to the AVR.

An AVR is generally not required for assets supporting traditional variable annuities and life insurance as the policyholder bears the risk of change in



value of the assets. Paragraph 22 of SSAP No. 56, states, "An IMR is required for separate accounts with assets recorded at book value, but is not required for separate accounts with assets recorded at market value."

## U.S. Generally Accepted Accounting Principles—Separate Accounts

**14.33** As discussed previously under SAP, under U.S. GAAP premiums and deposit considerations relating to variable products funded by a separate account are recorded initially by the life insurance entity. Such amounts are often related to FASB ASC 944, *Financial Services—Insurance*, contracts and accordingly should be accounted for as described in chapter 7 of this guide. See chapter 10 for a discussion of deferred acquisition costs amortization method.

**14.34** U.S. GAAP accounting guidance for separate accounts is provided in FASB ASC 944-80. Paragraphs 1–3 of FASB ASC 944-80-25 state that

- a. separate account assets and liabilities should be included in the financial statements of the insurance entity that owns the assets and is contractually obligated to pay the liabilities.
- b. the guidance in the following paragraph applies if the separate account arrangement meets all of the following conditions:
  - i. The separate account is recognized legally; that is, the separate account is established, approved, and regulated under special rules such as state insurance laws, federal securities laws, or similar foreign laws.
  - ii. The separate account assets supporting the contract liabilities are insulated legally from the general account liabilities of the insurance entity; that is, the contract holder is not subject to insurer default risk to the extent of the assets held in the separate account.
  - iii. The insurer must, as a result of contractual, statutory, or regulatory requirements, invest the contract holder's funds within the separate account as directed by the contract holder in designated investment alternatives or in accordance with specific investment objectives or policies.
  - iv. All investment performance, net of contract fees and assessments, must as a result of contractual, statutory, or regulatory requirements be passed through to the individual contract holder. Contracts may specify conditions under which there may be a minimum guarantee, but not a ceiling, as a ceiling would prohibit all investment performance from being passed through to the contract holder.
- c. all of the following guidance applies if a separate account arrangement meets all of the conditions in the preceding paragraph:
  - i. The portion of separate account assets representing contract holder funds should be reported in the insurance entity's financial statements as a summary total, with an equivalent summary total reported for related liabilities.
  - ii. Any liabilities related to minimum guarantees and insurance benefit liabilities under the contracts in excess of the fair value of separate account assets representing contract

holder funds should be recognized as general account liabilities.

- iii. Contract fees and assessments should be reported in accordance with FASB ASC 944-605-25-5.
- iv. For the purpose of evaluating the retention of specialized accounting for investments in consolidation as described in FASB ASC 810-10-25-15, a separate account arrangement should be considered a subsidiary. An insurer is not required to consolidate an investment in which a separate account holds a controlling financial interest if the investment is not or would not be consolidated in the standalone financial statements of the separate account.
- v. Except as described in paragraph 14.34(c)(vi), the insurer should not do either of the following when assessing whether the insurer is required to consolidate an investment held by a separate account:
  - (1) Consider any separate account interests held for the benefit of policy holders to be the insurer's interests.
  - (2) Combine any separate account interests held for the benefit of policy holders with the insurer's general account interest in the same investment.
- vi. Separate account interests held for the benefit of a related party policy holder should be combined with the insurer's general account interest when the "Variable Interest Entities" subsections of FASB ASC 810-10 require the consideration of related parties. For this purpose, a related party includes any party identified in FASB ASC 810-10-25-43 other than
  - (1) an employee of the decision maker or service provider (and its other related parties), except if the employee is used in an effort to circumvent the provisions of FASB ASC 810-10.
  - (2) an employee benefit plan of the decision maker or service provider (and its other related parties), except if the employee benefit plan is used in an effort to circumvent the provisions of FASB ASC 810-10.

As stated in FASB ASC 944-80-25-12, if an insurer concludes that an investment fund should be consolidated and a portion of the fund is owned by the insurer's separate accounts, the insurer should consolidate the investment fund in the following manner:

- a. The portion of the fund assets representing the contract holder's interests should be included as separate account assets and liabilities in accordance with FASB ASC 944-80-25-3.
- b. The remaining portion of the fund assets (including the portion owned by any other investors) should be included in the general account of the insurer on a line-by-line basis. For example, if the consolidated fund held debt and equity securities, those amounts would be included in the debt and securities lines.

Noncontrolling interests should not be included in the separate account liability but rather classified as a liability or equity based on other applicable guidance.

**14.35** Paragraphs 4–5 of FASB ASC 944-80-25 state that all of the following guidance applies if a separate account arrangement does not meet all of the criteria in paragraphs 2–3 of FASB ASC 944-80-25:

- a. Assets representing contract holder funds under the arrangement should be measured and presented the same as other general account assets as prescribed in this topic.
- b. Any related liability should be accounted for as a general account liability.
- c. Revenue and expenses related to such arrangements should be recognized within the respective revenue and expense lines in the statement of operations.

Arrangements in which contract holders' funds are maintained in separate accounts to fund fixed account options of variable contracts, market value adjusted contracts, guaranteed investment contracts, and indexed contracts are examples of separate account arrangements that would not meet the criteria in paragraphs 2–3 of FASB ASC 944-80-25 because all of the investment performance on these investments is not passed through to the contract holder.

**14.36** *Accounting for an insurance enterprise's proportionate interest in a separate account.* As noted in paragraphs 6–7 of FASB ASC 944-80-25, assets underlying an insurance entity's proportionate interest in a separate account (seed money or other investment) do not represent contract holder funds, and thus do not qualify for separate account accounting and reporting. The insurance entity should look through the separate account for purposes of accounting for its interest therein, and account for and classify the assets of the separate account underlying that interest based on their nature as if the assets of the separate account underlying the insurance entity's proportionate interest were held directly by the general account rather than through the separate account structure.

**14.37** As discussed in paragraphs 8–9 of FASB ASC 944-80-25, the guidance in the following paragraph applies if a separate account arrangement meets the criteria in paragraphs 2–3 of FASB ASC 944-80-25 and either of the following conditions exists:

- a. The terms of the contract allow the contract holder to invest in additional units in the separate account.
- b. The insurance entity is marketing contracts that permit funds to be invested in the separate account.

**14.38** If the conditions in the preceding paragraph are met, the assets of the separate account underlying the insurance entity's proportionate interest in the separate account should be accounted for in a manner consistent with the accounting for similar assets held by the general account that the insurance entity may be required to sell. For example:

- a. For a debt or equity security with an unrealized loss, the loss should be accounted for as an other than temporary impairment under the guidance in subtopic 320-10 and recognized immediately in the statement of operations as a realized loss.
- b. The guidance in FASB ASC 360-10 should be followed for both real estate that is held for sale and real estate that is not held for

sale. For real estate that does not meet that Subtopic's held-for-sale criteria, the impairment test should be performed solely using undiscounted cash flows assuming immediate disposition.

**14.39** *Transfers to separate accounts.* As discussed in FASB ASC 944-80-40-1, assets transferred from the general account to a separate account should be recognized at fair value to the extent of the third-party contract holders' proportionate interests in the separate account if the separate account arrangement meets the criteria in FASB ASC 944-80-25-2. Any resulting gain related to the third-party contract holders' proportionate interest should be recognized immediately in earnings of the general account of the insurance entity provided that the risks and rewards of ownership have been transferred to contract holders using the fair value of the asset at the date of the contract holders' assumption of risks and rewards.

**14.40** As discussed in paragraphs 5–8 of FASB ASC 944-80-35, a guarantee of the asset's value or minimum rate of return or a commitment to repurchase the asset would not transfer the risks of ownership, and no gain should be recognized. If the separate account arrangement does not meet the criteria in FASB ASC 944-80-25-2, the transfer should have no financial reporting effect; that is, general account classification and carrying amounts should be retained. The insurance entity should recognize an impairment loss on an asset transferred from the general account to a separate account not meeting the criteria in FASB ASC 944-80-25-2 if the terms of the arrangement with the contract holder are such that the insurance entity will not be able to recover the asset's carrying value. The insurance entity should recognize an impairment loss on its proportionate interest in a separate account arrangement meeting the criteria in FASB ASC 944-80-25-2 in a situation where the current fair value of the insurance entity's proportionate interest in the separate account assets is less than its carrying amount.

**14.41** As discussed in paragraphs 2–3 of FASB ASC 944-80-40, if the transferred asset is subsequently sold by the separate account, any remaining unrecognized gain related to the insurance entity's proportionate interest should be recognized immediately in the earnings of the general account of the insurance entity. If third-party contract holders' proportionate interests in the separate account are subsequently increased, or the insurance entity otherwise reduces its proportionate interest in the separate account arrangement that meets the criteria in FASB ASC 944-80-25-2, the reduction in the insurance entity's proportionate interest may result in additional gain. As discussed in FASB ASC 944-80-35-10, if an insurance entity's proportionate interest subsequently increases as a result of transactions executed at fair value (for example, at net asset value), the increase is considered a purchase from the contract holder and should be recognized at fair value. Paragraphs 1–3 of FASB ASC 944-80-55 provide an example of a general account transfer to a separate account arrangement.

**14.42** FASB ASC 944-320-15-2 states that an insurance entity may report its portion of the separate account value as an investment in equity securities under FASB ASC 320-10 if both of the following conditions are met:

- a. The insurance entity's proportionate interest in the separate account is less than 20 percent of the separate account.
- b. All of the underlying investments of the separate account meet the definition of any of the following:

- i. *Securities* under FASB ASC 320-10
- ii. *Securities* under FASB ASC 944-325
- iii. *Cash and cash equivalents*

Such an investment should be classified as trading in accordance with FASB ASC 944-320-25-1 and accounted for under the guidance in FASB ASC 320-10.

**14.43** FASB ASC 944-80-25-10 notes that the guidance in paragraphs 6–9 of FASB ASC 944-80-25 should be applied also if either of the following conditions exists:

- a. An insurance entity's interest in the separate account represents 20 percent or greater of the separate account interest.
- b. The underlying investments are other than those that meet the definition of any of the following:
  - i. *Securities* under FASB ASC 320-10
  - ii. *Securities* under FASB ASC 944-325-35-1
  - iii. *Cash and cash equivalents*

## SEC Registration—Separate Accounts

**14.44** A separate account is established by resolution of the insurance entity's board of directors in accordance with the insurance laws of the state of domicile. It is subject to policy form approval and other requirements in each state in which the entity offers the annuity. Courts have determined that variable annuities and variable life insurance separate accounts are subject to registration and regulation under the Investment Company Act of 1940 and the Securities Act of 1933, respectively. The registrant is the separate account.

**14.45** Initially, variable annuity issuers registered as management investment entities because they invested their assets in the open market and therefore resembled typical mutual funds in their investment objectives. The Investment Company Act of 1940 has a number of technical requirements for a management investment entity. Among them are requirements for an elected board of directors, proxy statements, and other requirements for publicly held corporations. A separate account of a life insurance entity is not a legal entity. Under state insurance laws, it is owned by and forms a part of the life insurance entity. Therefore, the requirements for a board of directors, proxy statements, and the like, are inconsistent with the status of the separate account as part of the life insurance entity. Further, a separate account cannot exist as an entity apart from the life insurance entity.

**14.46** Accordingly, since 1969, a number of separate accounts have registered under the Investment Company Act of 1940 as UITs to avoid some of the technical requirements for entities registered as management investment entities under that act. Further, the form of a UIT accommodates the need for separate accounting for the performance of specific pools of assets of group annuity contracts, personal annuity contracts, and annuity contracts subject to different tax rules. The UIT form may also accommodate lower expense charges and more flexibility in adding new products.

**14.47** In 1985, the Securities and Exchange Commission (SEC) adopted two registration forms for use by separate accounts offering variable annuity contracts that register under the Investment Company Act of 1940. Form N-3 is the registration form of separate accounts registered as management investment entities. Form N-4 is the registration form for UITs. Though those forms

integrate and codify disclosure requirements for separate accounts and shorten the prospectus, they provide more information to investors. Form N-6 is the registration form for variable life insurance products. The auditor should become familiar with the requirements of each of these forms. Variable life insurance separate accounts register under the Securities Act of 1933.

## Additional Literature—Separate Accounts

**14.48** Chapter 10, "Variable Contracts—Insurance Companies," of the AICPA Audit and Accounting Guide *Investment Companies* provides additional guidance and illustrative financial statements for separate accounts. The AICPA Audit and Accounting Guide *Investment Companies* also provides guidance on reporting financial highlights by separate accounts of insurance enterprises and concludes that separate accounts should provide relevant financial highlights in their financial statements.

## Insurance Related Assessments

**14.49** Insurance entities as well as noninsurance entities are subject to a variety of assessments related to insurance activities, including those by state guaranty funds and workers' compensation second injury funds (see paragraph 14.50). FASB ASC 405-30 provides guidance on accounting by insurance and other entities for assessments related to insurance activities.

### Guaranty Fund Assessments

**14.50** States have enacted legislation establishing guaranty funds. The state guaranty funds assess entities licensed to sell insurance in the state to provide for the payment of covered claims or to meet other insurance obligations, subject to prescribed limits, of insolvent insurance entities. The assessments are generally based upon premium volume for certain covered lines of business. Most state guaranty funds assess entities for costs related to a particular insolvency after the insolvency occurs. At least one state, however, assesses entities prior to insolvencies.

**14.51** FASB ASC 405-30-05-3 discusses that state guaranty funds use a variety of methods for assessing entities. This guide identifies the following four primary methods of guaranty fund assessments:

- a. Retrospective premium based assessments.* Guaranty funds covering benefit payments of insolvent life, annuity, and health insurance entities typically assess entities based on premiums written or received in one or more years *prior* to the year of insolvency. Assessments in any year are generally limited to an established percentage of an entity's average premiums for the three years preceding the insolvency. Assessments for a given insolvency may take place over several years.
- b. Prospective premium based assessments.* Guaranty funds covering claims of insolvent property and casualty insurance entities typically assess entities based on premiums written in one or more years *after* the insolvency. Assessments in any year are generally limited to an established percentage of an entity's premiums written or received for the year preceding the assessment. Assessments for a given insolvency may take place over several years.

- c. *Prefunded premium based assessments.* At least one state uses this kind of assessment to cover claims of insolvent property and casualty insurance entities. This kind of assessment is intended to prefund the costs of future insolvencies. Assessments are imposed prior to any particular insolvency and are based on the current level of written premiums. Rates to be applied to future premiums are adjusted as necessary.
- d. *Administrative type assessments.* These assessments are typically a flat (annual) amount per entity to fund operations of the guaranty association, regardless of the existence of an insolvency.

**14.52** Under SAP, SSAP No. 35R, *Guaranty Fund And Other Assessments*,<sup>†</sup> adopts the majority of U.S. GAAP guidance for recording guaranty fund and other assessments, which is contained in FASB ASC 405-30. Statutory accounting modifications from FASB ASC 405-30 are as follows:

- a. The option to discount accrued liabilities (and reflect the time value of money in anticipated recoverables) is rejected for statutory accounting. Liabilities for guaranty funds or other assessments should not be discounted.
- b. The use of a valuation allowance for premium tax offsets and policy surcharges no longer probable for realization has been rejected for statutory accounting. Evaluation of assets should be made in accordance with SSAP No. 5, and if it is probable that the asset is no longer realizable, the asset should be written off and charged to income in the period the determination is made.
- c. Guidance within FASB ASC 405-30 pertaining to noninsurance entities has been rejected as not applicable for statutory accounting.

Readers should refer to the full text of SSAP No. 35R.

## Other Insurance Related Assessments

**14.53** As noted in FASB ASC 405-30-05-1, entities are subject to a variety of other insurance-related assessments. Many states and some local governmental units have established other funds supported by assessments. The most prevalent uses for such assessments are (a) to fund operating expenses of state

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<sup>†</sup> At the fall 2010 National Association of Insurance Commissioners (NAIC) meeting, SSAP No. 35R, *Guaranty Funds and Other Assessments*, was adopted to incorporate the guidance in FASB *Accounting Standards Codification* (ASC) 405-30 for guaranty fund liability recognition. A change resulting from the adoption of SSAP No. 35R should be accounted for as a change in accounting principle in accordance with SSAP No. 3, *Accounting Changes and Corrections of Errors*. Substantive revisions to paragraphs 4, 6–8, 10–11, and 13–14 are initially effective for the reporting period beginning January 1, 2011. The result of applying SSAP No. 35R should be considered a change in accounting principle in accordance with SSAP No. 3. Pursuant to SSAP No. 3, and the cumulative effect of changes in accounting principles should be reported as an adjustment to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect recognized through surplus from initial application of SSAP No. 35R should reflect the removal of liabilities established under SSAP No. 35, and the reestablishment of liabilities required under SSAP No. 35R. If there is no change in the liabilities recognized (for example, retrospective-premium based assessments), no cumulative effect adjustment should occur. With regards to assets, the entity should complete an assessment of the SSAP No. 35 asset reported as of the transition date. If it is determined that the reported asset exceeds what is allowed under SSAP No. 35R, then the excess asset should be written-off, through unassigned funds, so the ultimate asset reflected corresponds with what is permitted under SSAP No. 35R. Although it is possible that the excess asset will be reinstated once the liability assessment is recognized (prospective-premium based assessments), it is inappropriate to continue to reflect an asset for assessments that are not reflected within the financial statements.

insurance regulatory bodies (for example, the state insurance department or workers' compensation board) and (b) to fund second injury funds.<sup>6</sup>

**14.54** As noted in FASB ASC 405-30-05-6, the primary methods used to assess for these other insurance related assessments are the following:

- a. *Premium based.* The assessing organization imposes the assessment based on the entity's written premiums. The assessing organization may be at the state, county, municipality, or other such level. The base year of premiums is generally either the current year or the year preceding the assessment.
- b. *Loss based.* The assessing organization imposes the assessment based on the entity's incurred losses, or paid losses, in relation to the amount of those losses for all entities subject to that assessment in the particular jurisdiction.

## Reporting Liabilities

**14.55** As discussed in FASB ASC 405-30-25-1, entities subject to assessments should recognize liabilities for insurance related assessments if all of the following conditions are met:

- a. An assessment has been imposed or information available prior to the issuance of the financial statements indicates it is probable that an assessment will be imposed.
- b. The event obligating an entity to pay (underlying cause of) an imposed or probable assessment has occurred on or before the date of the financial statements.
- c. The amount of the assessment can be reasonably estimated.

**14.56** *Probability of assessment.* As discussed in paragraphs 2–3 of FASB ASC 405-30-25, premium based guaranty fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs, and presumed not probable prior to a formal determination of insolvency. A formal determination of insolvency occurs when an entity meets a state's (ordinarily the state of domicile of the insolvent insurer) statutory definition of an insolvent insurer. In most states, the entity must be declared to be financially insolvent by a court of competent jurisdiction. In some states, there must also be a final order of liquidation. Prefunded guaranty fund assessments and premium-based administrative type assessments are presumed probable when the premiums on which the assessments are expected to be based are written. Loss based administrative type and second injury fund assessments are assumed probable when the losses on which the assessments are expected to be based are incurred.

**14.57** *Obligating event.* As discussed in FASB ASC 405-30-25-4, because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may

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<sup>6</sup> Second injury funds provide reimbursement to insurance carriers or employers for workers' compensation claims when the cost of a second injury combined with a prior accident or disability is greater than what the second accident alone would have produced. The employer of an injured or handicapped worker is responsible only for the workers' compensation benefit for the most recent injury; the second injury fund would cover the cost of any additional benefits for aggravation of a prior condition or injury. The intent of the fund is to help insure that employers are not made to suffer a greater monetary loss or increased insurance costs because of hiring previously injured or handicapped employees.



not be the event that obligates an entity. The following defines the event that obligates an entity to pay an assessment for each kind of assessment identified in this guide:

- a. For premium based assessments, the event that obligates the entity is generally writing the premiums or becoming obligated to write or renew (such as multiple year, noncancellable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance entity cannot avoid paying a particular assessment even if that insurance entity reduces its premium writing in the future. In such circumstances, the event that obligates the entity is a formal determination of insolvency or similar triggering event.
- b. For loss based assessments, the event that obligates an entity is the entity's incurring the losses on which the assessments are expected to be based.

**14.58** *Ability to reasonably estimate the liability.* As discussed in FASB ASC 405-30-25-5, one of the conditions in subpoint (b) of FASB ASC 450-20-25-2 for recognition of a liability is that the amount can be reasonably estimated. FASB ASC 450-20-25-5 provides that some amount of loss can be reasonably estimated if available information indicates that the estimated amount of the loss is within a range of amounts. FASB ASC 450-20-30-1 explains that if no amount within the range is a better estimate than any other amount, the minimum amount in the range should be accrued.

**14.59** Entities subject to assessments may be able to obtain information to assist in estimating the total guaranty fund cost or the following years' assessments, as appropriate, for an insolvency from organizations such as the state guaranty fund associations, the National Organization of Life and Health Insurance Guaranty Associations and the National Conference of Insurance Guaranty Funds. An insurance entity need not be able to compute the exact amounts of the assessments or be formally notified of such assessments by a guaranty fund to make a reasonable estimate of its liability. Entities subject to assessments may have to make assumptions about future events, such as when the fund will incur costs and pay claims that will determine the amounts and the timing of assessments. The best available information about market share or premiums by state and premiums by line of business generally should be used to estimate the amount of an insurance entity's future assessments.

**14.60** Estimates of loss based assessments should be consistent with estimates of the underlying incurred losses and should be developed based on enacted laws or regulations and expected assessment rates.

**14.61** Estimates of some insurance related assessment liabilities may be difficult to derive. The development or determination of estimates is particularly difficult for guaranty fund assessments because of uncertainties about the cost of the insolvency to the guaranty fund and the portion that will be recovered through assessment. Examples of uncertainties follow:

- a. Limitations, as provided by statute, on the amount of individual contract liabilities that the guaranty fund will assume, that cause the guaranty fund associations' liability to be less than the amount by which the entity is insolvent.
- b. Contract provisions (for example, credited rates) that may be modified at the time of the insolvency or alternative payout options that

may be offered to contract holders that affect the level and payout of the guaranty fund's liability.

- c. The extent and timing of available reinsurance recoveries, which may be subject to significant uncertainties.
- d. Alternative strategies for the liquidation of assets of the insolvent entity that affect the timing and level of assessments.
- e. Certain liabilities of the insolvent insurer may be particularly difficult to estimate (for example, asbestos or environmental liabilities).

Because of the uncertainties surrounding some insurance related assessments, the range of assessment liability may have to be reevaluated regularly during the assessment process. For some ranges, there may be amounts that appear to be better estimates than any other within the range. If this is the case, the liability recorded should be based on the best estimate within the range. For ranges where there is no such best estimate, the liability that should be recorded should be based on the amount representing the minimum amount in the range.

## Application of Guidance

**14.62** As discussed in FASB ASC 405-30-25-6, application of the recognition criteria in paragraphs 1–5 of FASB ASC 405-30 to the methods used to address guaranty fund assessments and other insurance related assessments is as follows:

- a. *Retrospective premium based guaranty fund assessments.* An assessment is probable of being imposed when a formal determination of insolvency occurs. At that time, the premium that obligates the entity for the assessment liability has already been written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments related to a particular insolvency when a formal determination of insolvency is rendered.
- b. *Prospective premium based guaranty fund assessments.* The event that obligates the entity for the assessment liability generally is the writing, or becoming obligated to write or renew the premiums on which the expected future assessments are to be based (For example, multiple year contracts under which an insurance entity has no discretion to avoid writing future premiums). Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency. Law or regulatory practice affects the event that obligates the entity in either of the following ways:
  - i. In states that, through law or regulatory practice, provide that an entity cannot avoid paying a particular assessment in the future (even if the entity reduces premium writings in the future), the event that obligates the entity is a formal determination of insolvency or similar event. An entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability for the entire amount of future assessments that cannot be avoided related to a particular insolvency when a formal determination of insolvency occurs.
  - ii. In states without such a law or regulatory practice, the event that obligates the entity is the writing, or becoming

obligated to write, the premiums on which the expected future assessments are to be based. An entity that has the ability to reasonably estimate the amount of the assessments should recognize a liability when the related premiums are written or when the entity becomes obligated to write the premiums.

- c. *Prefunded premium based guaranty fund assessments.* A liability for an assessment arises when premiums are written. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability when the related premiums are written.
- d. *Other premium based assessments.* Other premium based assessments, as described in paragraph 14.49, would be accounted for in the same manner as that used for prefunded-premium-based guaranty fund assessments.
- e. *Loss based assessments.* An assessment is probable of being asserted when the loss occurs. The obligating event of the assessment also has occurred when the loss occurs. Accordingly, an entity that has the ability to reasonably estimate the amount of the assessment should recognize a liability when the related loss is incurred.

## Present Value

**14.63** Current practice is to allow, but not require (with limited exceptions, such as pensions and postretirement benefits), the discounting of liabilities to reflect the time value of money when the aggregate amount of the obligation and the amount and timing of the cash payments are fixed or reliably determinable for a particular liability. Similarly, for assessments that meet those criteria, the liability may be recorded at its present value by discounting the estimated future cash flows at an appropriate interest rate.

## Reporting Assets for Premium Tax Offsets and Policy Surcharges

**14.64** As discussed in FASB ASC 405-30-25-8, if it is probable that a paid or accrued assessment will result in an amount that is recoverable from premium tax offsets or policy surcharges, an asset should be recognized for that recovery. As discussed in FASB ASC 405-30-30-11, such asset should be measured based on current laws and projections of future premium collections or policy surcharges from inforce policies. In determining the asset to be recorded, inforce policies do not include expected renewals of short duration contracts but do include assumptions as to persistency rates for long duration contracts.

**14.65** As discussed in FASB ASC 405-30-30-13, the recognition of such assets related to prospective-premium-based assessments is limited to the amount of premium an entity has written or is obligated to write and to the amounts recoverable over the life of the inforce policies. Accordingly, the expected premium tax offset or policy surcharge asset related to the accrual of prospective premium based assessments should similarly be based on and limited to the amount recoverable as a result of premiums the insurer has written or is obligated to write.

**14.66** A life insurance entity is required to recognize a liability for prospective premium based assessments when the premium is written or obligated to be written by the entity. For retrospective premium based assessments, a life

insurance entity is required to recognize a liability for such assessments at the time the insolvency has occurred.

**14.67** As discussed in FASB ASC 405-30-25-9, to the extent that paid or accrued assessments are likely to result in a recoverable amount in a future period from business currently in force considering appropriate persistency rates, an asset should be recognized at the time the liability is recorded.

**14.68** As discussed in FASB ASC 405-30-35-1, in all cases, the asset should be subject to a valuation allowance to reflect any portion of the asset that is no longer probable of realization. Considering expected future premiums other than on inforce policies in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate.

**14.69** As discussed in FASB ASC 405-30-30-12, the time value of money need not be considered in the determination of the recorded amount of the potential recovery if the liability is not discounted. In instances in which the recovery period for the asset is substantially longer than the payout period for the liability, it may be appropriate to record the asset on a discounted basis regardless of whether the liability is discounted.

**14.70** The policy surcharges referred to in this guide are intended to provide an opportunity for assessed entities to recover some or all of the amounts assessed over a period of time. In a number of instances, there may be policy surcharges that are required as a pass through to the state or other regulatory bodies, and these surcharges should be accounted for in a manner such that amounts collected or receivable are not recorded as revenues and amounts due or paid are not expensed (meaning, similar to accounting for sales tax).

## Pensions

**14.71** Under SAP, SSAP No. 89, *Accounting for Pensions, A Replacement of SSAP No. 8*, Pensions, as amended, adopts sections of FASB ASC 715-20 and 715-30 with the following modifications, according to paragraph 16 of the SSAP:

- a. Calculation of the pension obligation should exclude nonvested employees. Partially vested employees are included only to the extent of their vested amounts;
- b. A liability for ancillary benefits (primarily death and disability benefits) should be accrued prior to the triggering event of these benefits for purposes of Projected Benefit Obligation (PBO) and Service Cost (SC) in accordance with the guidance in FASB ASC 715, *Compensation—Retirement Benefits* (use of a general vesting standard rather than an IRS income tax vesting standard);
- c. A liability for protected, nonvested benefits should be accrued for purposes of PBO and SC in accordance with the guidance in FASB ASC 715 (use of a general vesting standard rather than an IRS income tax vesting standard), when there is no longer a substantial risk of forfeiture;
- d. A liability for nonvested, nonqualified benefits prior to retirement should be accrued for purposes of PBO and SC in accordance with the guidance in FASB ASC 715 (using a general vesting standard rather than an IRS income tax vesting standard);

- e. Entities should perform actuarial analysis consistent with the three month guideline contained within FASB ASC 715;<sup>7</sup>
- f. A reporting entity that utilizes an actuarial valuation as of a date prior to the financial statement date to measure plan assets and obligations, and determines that an additional minimum liability is required to be established in accordance with FASB ASC 715-30-25-3, and if the reporting entity contributes amounts to the plan to fund that additional minimum liability prior to the financial statement date, such amount funded may be used to reduce the additional minimum liability recognized in the reporting entity's financial statements;
- g. It is not acceptable statutory accounting practice to offset pension or postretirement benefits other than pensions liability generated by one plan against the prepaid asset of another plan;<sup>8</sup>
- h. Reporting entities may downsize their operations and in doing so, often offer severance pay and other benefits to displaced workers. Costs associated with downsizing should be recorded as an expense in the financial statements;
- i. The prepaid asset that results from an excess of the fair value of plan assets over the pension obligation should be recorded as a nonadmitted asset;
- j. Any intangible asset offsetting the minimum pension liability (excluding the unamortized incremental liability associated with transition) should be nonadmitted and charged to surplus;
- k. Any additional minimum liability in excess of unrecognized prior service cost that is reported as a component of unassigned funds (surplus), should be classified as an aggregate write-in for gains and losses in surplus;
- l. As of January 1, 2001, the pension obligation or asset not previously recognized related to vested employees may be recorded immediately or may be amortized over future periods;
- m. Paragraphs 1–5 of FASB ASC 715-30-25 are adopted with the modifications described in paragraph 5 of SSAP No. 89;
- n. A net gain (net of excise tax surcharge) resulting from the settlement or curtailment of a pension plan is not recognized until the proceeds are received by the reporting entity;
- o. The reduced disclosure requirements for nonpublic entities described in FASB ASC 715-20-50-5 are rejected. All reporting entities should follow the disclosure requirements included in FASB ASC 715-20-50-1;
- p. For the disclosures relating to the initial date of application in FASB ASC 715-20-50-1, January 1, 2001, should be considered the initial date of application; and
- q. Pension disclosures relating to other comprehensive income in FASB ASC 715-20-50-1 should be made for unassigned funds (surplus) on a statutory basis.

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<sup>7</sup> Items (e) and (f) are incorporated from NAIC Interpretation No. 01-06, *Measurement Date for SSAP No. 8 Actuarial Valuations*.

<sup>8</sup> Incorporated from NAIC Interpretation No. 99-26, *Offsetting Pension Assets and Liabilities*.

SSAP No. 89 exhibit A, *Pension Journal Entry Illustrations*, provides further assistance with implementation.

**14.72** Under GAAP, FASB ASC 715 governs accounting for pensions. Among other matters, FASB ASC 715 requires a calendar year end entity that sponsors a postretirement benefit plan to fully recognize, as an asset or liability, the overfunded or underfunded status of its benefit plan in its year end balance sheet. Additionally, the statement requires recognition, as a component of other comprehensive income (net of tax), gains or losses and prior service costs or credits that arise during the period that are not captured in net periodic benefit cost and also requires (with limited exceptions) balance sheet date measurement of assets and obligations, and additional disclosures.

**14.73** On August 17, 2006, the Pension Protection Act of 2006 was signed into law (Public Law No. 109-280). This pension reform bill requires institutions to fully fund their pensions in 7 years. The legislation allows employers to provide their employees with access to qualified investment advisers, mandates that new employees be enrolled automatically in their entities' 401(k) (or similar) plans unless they opt out, enable workers to continue to save \$15,000 annually and \$5,000 in IRAs, allow existing corporate owned life insurance policies to be grandfathered, and continue to permit Section 1035 employer owned life insurance contract (often referred to as COLI) exchanges.

## Guarantees

**14.74** FASB ASC 460-10 clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing certain guarantees. It also elaborates on the disclosures in FASB ASC 450, which are to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued, even when the likelihood of making any payments under the guarantees is remote.

**14.75** Under SAP, accounting and disclosures with respect to guarantees is addressed in SSAP No. 5R, *Liabilities, Contingencies and Impairment of Assets*, which incorporates, with modification, FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others—an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34*.

**14.76** As discussed in paragraph 33 of SSAP No. 5R, statutory modifications to FASB Interpretation No. 45 include initial liability recognition for guarantees issued as part of intercompany or related party transactions, assessment, and recognition of noncontingent guarantee obligations after recognition and settlement of a contingent obligation and revise the U.S. GAAP guidance to reflect statutory accounting terms and restrictions. Intercompany and related party guarantees (including guarantees between parents and subsidiaries) should have an initial liability recognition unless the guarantee is considered unlimited or is made to or on behalf of a wholly owned subsidiary. (An example of an intercompany unlimited guarantee would be a guarantee issued in response to a rating agency's requirement to provide a commitment to support.) In instances in which an unlimited guarantee exists or a guarantee has been made to or on behalf of a wholly owned subsidiary, this statement requires disclosure, pursuant to the disclosure requirements adopted from FASB Interpretation No. 45. The adoption of FASB Interpretation No. 45 superseded the previously adopted guidance in FASB Interpretation No. 34, *Disclosure*

*of Indirect Guarantees of Indebtedness of Others—an interpretation of FASB Statement No. 5.*

## Equity Contract Holders' Surplus

**14.77** Capital and surplus of a stock life insurance entity consists of capital stock, paid-in or contributed surplus, special surplus funds, and unassigned surplus. Special surplus, also referred to as *appropriated surplus*, refers to amounts of unassigned surplus set aside to provide for contingencies that are not actual liabilities of the entity, such as mortality fluctuation reserves and group contingency reserves.

**14.78** In the case of stock entities, the amount of capital stock required to be issued and maintained is governed by the respective state insurance laws. These laws usually prescribe the minimum value of the shares that may be issued. In addition to the minimum capital stock requirements, there is usually a provision for the payment to stockholders of an additional amount, in the form of surplus, equivalent to a prescribed percentage of the minimum capital stock. Some state laws permit dividends to be paid out of surplus regardless of the source, as long as the minimum statutory surplus amount is maintained.

**14.79** In lieu of capital stock, mutual entities are organized with a prescribed minimum surplus that may vary among states. Such surplus may take the form of guaranty funds, guaranty capital, or other permanently designated funds subject to the payment of interest and subject to repayment under conditions prescribed by the respective state laws.

## Statutory Accounting Practices—Capital and Surplus

**14.80** Under SAP, in addition to the gain or loss from operations and dividends paid, surplus transactions may include the following, which are unique to the insurance industry:

- a. Unrealized capital gains or losses originate as a result of the prescribed method of valuation of investments. The change in the difference between book value and prescribed value occurring between valuation dates, net of deferred taxes thereon, is credited or charged to surplus as unrealized capital gains or losses.
- b. As previously discussed, certain assets are excluded (nonadmitted) from the balance sheet when reporting to the regulatory authorities. The net change between such nonadmitted amounts during the year is charged or credited to surplus.
- c. Any increase or decrease in the amount of the AVR.
- d. Any change in the liability for unauthorized reinsurance is charged or credited directly to surplus.
- e. A life insurance entity may strengthen (or decrease) its contract reserves by changing its actuarial assumptions (for example, a change to the net level reserve basis from the preliminary term reserve basis, or a lowering of the interest assumption); however, decreasing the reserve generally requires prior regulatory approval. The surplus account is charged for the amount necessary to bring reserves accumulated in prior years to the current reserve requirements under the new assumptions.

- f.* Changes in the surplus of the separate accounts, except for changes resulting from the net gain from operations of the separate accounts, should be charged or credited directly to the unassigned funds (surplus) of the general account.
- g.* Changes in deferred tax assets and deferred tax liabilities, including changes attributable to changes in tax rates and changes in tax status, if any, other than the change in deferred tax assets and liabilities on unrealized capital gains or losses, should be recognized as a separate component of gains and loss in unassigned funds (surplus).
- h.* The cumulative gain or loss due to translating foreign operations to U.S. dollars and changes in balance sheet asset and liability values due to foreign currency translation is recorded as a separate component of unassigned funds (surplus).
- i.* The dividends declared are charged directly to unassigned funds (surplus) on the declaration date and are carried as a liability until paid. The amount of the dividend is the cash paid if it is a cash dividend, the fair value of the asset distributed if it is a property dividend, or the par value of the entity's stock if it is a stock dividend. A stock dividend is recorded as a transfer from unassigned funds (surplus) to capital stock. Stock dividends have no effect on total capital and surplus whereas other forms of dividends reduce surplus. Forgiveness by a reporting entity of any debt, surplus note or other obligation of its parent or other stockholders should be accounted for as a dividend.
- j.* The effects of a change in accounting principle or the application of an accounting principle are reported as a charge or credit to unassigned funds (surplus). The effect of these changes should not be included in the determination of net income or loss.
- k.* Corrections of errors in previously issued financial statements are charged or credited directly to unassigned funds (surplus). The effect of corrections of errors should not be included in the determination of net income or loss.
- l.* Expenses relating to the issuance of capital stock, for example underwriting commissions and filing fees, are charged to unassigned funds (surplus).
- m.* Subscriber savings accounts represent a portion of a reciprocal insurance entity's surplus that has been identified as subscribers (policyholders) accounts. When the source of amount credited to the subscriber accounts is from the reciprocal's operations, the amounts are reported as unassigned funds (surplus).
- n.* For reinsurance on inforce blocks of business, gains that occur in the initial calendar year are reported as an increase in surplus on a net of tax basis. As profits emerge from the ceded business, the increase in surplus is amortized into income, as provided for in appendix A-791, "Life and Health Reinsurance Agreements."

## Auditing

**14.81** Generally, the audit objectives, internal control considerations, and auditing procedures for other assets and liabilities, separate accounts, and



shareholders' equity contract holders' surplus are the same as those for any other business entity. For this reason, an audit considerations chart has not been provided for these subjects. However, the following are examples of suggested auditing procedures that may be considered in auditing these kinds of accounts. Note that for an integrated audit performed in accordance with Public Company Oversight Board (PCAOB) standards, for purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained in a financial statement audit. See paragraph .42 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). Also refer to paragraph 54 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for a discussion on the extent of tests of controls (see paragraph .97 of AU section 319).

## Auditing Procedures

**14.82** *Miscellaneous admitted assets and nonadmitted assets.* The auditing procedures for assets in these classifications will be dependent on the nature of the assets. They will be similar to those utilized in the performance of an audit of any other kind of business, including confirmation, calculation, examination, and any other procedure that may be applied to satisfy the auditor.

**14.83** Nonadmitted receivables for annual statement purposes that are included in the GAAP balance sheet may be subjected to the usual auditing procedures necessary to determine their existence and collectability. Furniture and fixtures may be subjected to the usual auditing procedures for additions and disposals and depreciation thereon, similar to those uses in any other kind of business entity.

**14.84** *Other liabilities.* Examples of auditing procedures for these accounts may include the following:

- a. *Amounts withheld.* The auditor may review support for items in this account and verify by confirmation, recalculation, or subsequent payment review.
- b. *Amounts held for agents.* These accounts may be tested in connection with tests of balances due from agents.
- c. *Remittances and other items not allocated.* The auditor may review an aging of these accounts and investigate old, large, or unusual items by references to supporting data.
- d. *Agents' commissions due or accrued.* The auditor may review support for items in this account and verify by confirmation, recalculation, or subsequent payment review. For levelized commission plans, the auditor should test that the appropriate liability is reported for the full amount of the commission due.

**14.85** *Separate account assets.* Because separate account assets consist principally of investments, the auditing procedures to be applied will be similar to those used for other investment accounts, as described in chapter 11. The underlying investment funds (such as mutual funds or UITs) will generally require separate audits for SEC registration purposes under group separate account contract requirements. In addition, the transfers between the general

account and the separate account should be consistent with the description of the related products in the registration statement.

**14.86** *Shareholders' equity contract holders' surplus accounts.* These accounts should be audited to determine the proper classification of such accounts in conformity with applicable accounting principles or practices (GAAP or SAP, as appropriate). Such accounts may also be audited to determine whether they include transactions that should be reflected in net income to conform with the appropriate accounting principles or practices. In general, the audit of capital and surplus is the same as that of other industries; however, there are some additional requirements with respect to statutory minimum capital and surplus requirements applicable to the lines of business written by the life insurance entity. The following are examples of procedures the auditor may consider in auditing capital and surplus amounts in a life insurance entity:

- a. Review recent or in-progress state insurance department examination reports for evidence of compliance with statutory capital and surplus requirements. Review compliance with minimum statutory capital and surplus requirements, including RBC trigger points.
- b. Compare statutory dividend and surplus restrictions with dividends declared and paid and year end surplus levels.
- c. Review accounting treatment of transactions that may have a material effect on statutory surplus (including transactions involving nonadmitted assets), or transactions for which the effect on the statutory financial statements is substantially different from the effect on the GAAP financial statements, especially when entity surplus is at or near statutory minimums or RBC trigger points.
- d. For audits of SAP financial statements, review interest accruals and repayments of surplus notes for compliance with contractual and regulatory requirements and ensure that appropriate financial statement disclosures are made.
- e. For audits of SAP financial statements, reconcile the changes in unassigned surplus, such as change in nonadmitted assets and change in liability for unauthorized reinsurers, to the related assets and liabilities. Review significant reconciling items. The applicable state laws should be reviewed to ascertain compliance with restrictions on surplus, and the validity and propriety of any miscellaneous surplus items should be ascertained.

**14.87** The auditor should be aware of statutory requirements for surplus or capital, or both. The ability to meet statutory requirements and to avoid statutory impairment or insolvency is critical in connection with the fair presentation of the financial statements.

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## Chapter 15

# Reports on Audited Financial Statements

## Reports on Financial Statements

**15.01** The guidance in AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*; AICPA, *PCAOB Standards and Related Rules*, Interim Standards), applies to reports on audited generally accepted accounting principles (GAAP) financial statements of life insurance entities. Such reports may contain an unqualified opinion, an unqualified opinion with explanatory language, a qualified opinion, a disclaimer of opinion, or an adverse opinion. This chapter contains a brief discussion of each of these reports, with an emphasis on illustrating issues that an auditor may encounter in auditing the financial statements of life insurance entities. Additional reporting guidance for public issuers is incorporated from Public Company Accounting Oversight Board (PCAOB) Release No. 2007-005A, *Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements, and Related Independence Rule and Conforming Amendments* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). Practitioners should also refer to PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for additional integrated audit reporting guidance.

**15.02** The illustrative auditors' reports in this chapter are presented to assist auditors in drafting their reports under various 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 reports are illustrative; the facts and circumstances of each particular audit will govern the appropriate form of report.

## Unqualified Opinions on GAAP Financial Statements

**15.03** 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 if the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards or PCAOB standards. The following is an illustration of an auditor's standard report (unqualified opinion) on the GAAP basis financial statements of a life insurance entity.

### Independent Auditor's Report

To the Board of Directors and Shareholders

ABC Life Insurance Company

We have audited the accompanying balance sheets of ABC Life Insurance Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income 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 auditing standards generally accepted in the United States of America.<sup>1</sup> Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. *[Optional for nonissuers: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.]*<sup>2</sup> 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

<sup>1</sup> For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board (AICPA, PCAOB Standards and Related Rules, Auditing Standards)*, replaces this sentence with the following sentence: "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)." On May 14, 2004, the Securities and Exchange Commission (SEC) issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 24, 2004, references in SEC rules and staff guidance and in the federal securities laws to generally accepted auditing standards (GAAS) or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The staff of the PCAOB published a series of questions and answers on PCAOB Auditing Standard No. 1. See the PCAOB website at [www.pcaobus.org](http://www.pcaobus.org) for more information.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .89-.92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also has undertaken a project to determine what amendments, if any, should be made to AU section 508 (AICPA, *Professional Standards*). See the AICPA website at [www.aicpa.org/RESEARCH/STANDARDS/AUDITATTEST/Pages/audit%20and%20attest%20standards.aspx](http://www.aicpa.org/RESEARCH/STANDARDS/AUDITATTEST/Pages/audit%20and%20attest%20standards.aspx) for more information.

<sup>2</sup> This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .85-.88), which was issued by the ASB in June 2004 and provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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 response to the AICPA Governing Council's May 18, 2008, vote to designate the International Accounting Standards Board (IASB) in London as an accounting body for purposes of establishing international financial accounting and reporting principles, the ASB revised Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .56-.59), and issued Interpretation No. 19, "Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .93-.97).

The revision to Interpretation No. 14 removed mention of the International Auditing Practices Committee of the International Federation of Accountants and clarified that the International Auditing and Assurance Standards Board promulgates International Standards on Auditing.

Interpretation No. 19 states that an independent auditor may apply the guidance in AU section 508 (AICPA, *Professional Standards*) when engaged to report on financial statements presented in conformity with International Financial Reporting Standards (IFRSs) as issued by the

(continued)

presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of ABC Life Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Firm Signature]

Certified Public Accountants

[City, State]

[Date]

## Mutual Life Insurance Entities

**15.04** In 1993, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that mutual life insurance entities can no longer issue statutory financial statements that are described as "in conformity with generally accepted accounting principles." As a result of FASB Interpretation No. 40, as amended by FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts—an amendment of FASB Statements 60, 97, and 113 and Interpretation No. 40*, mutual life insurance entities that wish to prepare GAAP financial statements have to apply pertinent authoritative accounting pronouncements, such as FASB statements and interpretations, Accounting Principles Board (APB) Opinions, and AICPA Statements of Position (SOP), that do not explicitly exempt mutual life insurance entities. Statutory financial statements of mutual life insurance entities intended for general distribution must contain an adverse opinion as to GAAP, along with an opinion as to conformity with the statutory basis of accounting.

**15.05** FASB Statement No. 120 did not change the disclosure and other transition provisions of FASB Interpretation No. 40. The disclosure requirements per paragraphs 5–6 of FASB Interpretation No. 40 are as follows:

Mutual life insurance enterprises, like other business enterprises, are required to provide disclosures about significant accounting policies used to prepare financial statements that are intended to be in conformity with generally accepted accounting principles. APB Opinion No. 22, *Disclosure of Accounting Policies*, provides guidance on the content of those disclosures, which should include descriptions of accounting "principles and methods peculiar to the industry in which the reporting entity operates, even if such principles and methods are predominantly followed in that industry."

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(footnote continued)

IASB. Accordingly, when the auditor reports on financial statements prepared in conformity with the IFRSs, in the auditor's report the auditor would refer to the IFRSs rather than U.S. generally accepted accounting principles (GAAP).

## Unqualified Opinions With Explanatory Language

### Emphasis of a Matter

**15.06** In a number of circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. For example, the auditor may wish to emphasize that the life insurance entity is a component of a larger business entity or that it has had significant transactions with related parties, or the auditor may wish to emphasize an unusually important subsequent event or an accounting matter affecting the comparability of the financial statements with those of the preceding period.

Such explanatory information should be presented in a separate paragraph of the auditor's report (either preceding or following the opinion paragraph). Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this kind. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion.

The following is an illustration of an unqualified opinion on the GAAP financial statements of a life insurance entity with an emphasis of a matter regarding the entity's failure to meet minimum risk based capital standards. The circumstances described in the third paragraph of this illustrative report represent assumptions made for purposes of illustration only. A similar paragraph could be adapted for use in an opinion on statutory basis financial statements. They are not intended to provide criteria or other guidelines to be used by auditors in deciding whether an explanatory paragraph should be added to their reports.

#### Independent Auditor's Report

To the Board of Directors and Shareholders

ABC Life Insurance Company

We have audited the accompanying balance sheets of ABC Life Insurance Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income 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 auditing standards generally accepted in the United States of America.<sup>3</sup> 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 life insurance entities, including the Company. At December 31, 20X2, 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].

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<sup>3</sup> See footnotes 1 and 2 in paragraph 15.03.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of ABC Life Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Firm Signature]

Certified Public Accountants

[City, State]

[Date]

## Uncertainties

**15.07** A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive audit evidence 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 and other matters covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

**15.08** Conclusive audit evidence concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related audit evidence 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. An audit includes an assessment of whether the audit evidence 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 audit evidence supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the audit evidence is based on the audit evidence that is or should be available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient audit evidence 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.

**15.09** If the auditor is unable to obtain sufficient audit evidence to support management's assertion 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 qualified opinion or disclaimer of opinion because of a scope limitation is appropriate if sufficient audit evidence 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.

**15.10** Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated attributable to departures from GAAP related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates.

**15.11** Departures from GAAP involving risks or uncertainties generally fall into one of the following categories:

- a. Inadequate disclosure
- b. Inappropriate accounting principles
- c. Unreasonable accounting estimates

**15.12** *Inadequate disclosure.* If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with GAAP or the statutory basis of accounting, the auditor should express a qualified or an adverse opinion.

**15.13** The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements in the context of the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances and necessarily involve both quantitative and qualitative considerations. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of uncertainties both individually and in the aggregate. The auditor performs the evaluation of reasonably possible losses without regard to the auditor's evaluation of the materiality of known and likely misstatements in the financial statements.

**15.14** *Inappropriate accounting principles.* In preparing financial statements, management estimates the outcome of certain kinds of future events. Paragraphs 23 and 25 of FASB Statement No. 5 describe situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, the auditor should express a qualified or an adverse opinion.

**15.15** *Unreasonable accounting estimates.* Usually, the auditor is able to obtain satisfaction regarding the reasonableness of management's estimate of the effects of future events by considering various kinds of audit evidence, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable and that its effect is to cause the financial statements to be materially misstated, the auditor should express a qualified or an adverse opinion.

## Going Concern

**15.16** AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), describes the auditor's responsibility for evaluating whether substantial doubt exists concerning the ability of the entity being audited to continue as a going concern for a reasonable period of time. Chapter 5, "General Auditing Considerations," describes going-concern considerations as they relate to life insurance entities and discusses how a life insurance entity's regulatory capital position should be considered in the auditor's assessment of whether there is substantial doubt about the life insurance entity's ability to continue as a going concern. AU section 341 paragraph .18 states that the auditor should document all of the following:



- a. The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- b. The elements of management's plans that the auditor considered to be particularly significant to overcoming the adverse effects of the conditions or events.
- c. The auditing procedures performed and evidence obtained to evaluate the significant elements of management's plans.
- d. The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated. If substantial doubt remains, the auditor also should document the possible effects of the conditions or events on the financial statements and the adequacy of the related disclosures. If substantial doubt is alleviated, the auditor also should document the conclusion as to the need for disclosure of the principal conditions and events that initially caused him or her to believe there was substantial doubt.
- e. The auditor's conclusion as to whether he or she should include an explanatory paragraph in the audit report. If disclosures with respect to an entity's ability to continue as a going concern are inadequate, the auditor also should document the conclusion as to whether to express a qualified or adverse opinion for the resultant departure from U.S. GAAP.

Additional going concern audit documentation considerations that are specific to life insurance entities are specified in paragraph 5.174 of this guide. The auditor's conclusion about the life insurance entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about the life insurance entity's ability to continue as a going concern," or similar wording that includes the terms *substantial doubt* and *going concern*. The following is an illustration of an auditor's report (unqualified opinion) on the GAAP financial statements of a life insurance entity that includes an explanatory paragraph because of the existence of substantial doubt about the life insurance entity's ability to continue as a going concern for a reasonable period of time. The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. A similar paragraph could be adapted for use in an opinion on statutory basis financial statements. They are not intended to provide criteria or other guidelines to be used by auditors in deciding whether an explanatory paragraph should be added to their reports.

#### Independent Auditor's Report

To the Board of Directors and Shareholders

ABC Life Insurance Company

We have audited the accompanying balance sheets of ABC Life Insurance Company as of December 31, 20X2 and 20X1, and the related statements of income, changes in stockholders' equity, other comprehensive income, 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 auditing standards generally accepted in the United States of America.<sup>4</sup> 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 previously present fairly, in all material respects, the financial position of ABC Life Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that ABC Life Insurance 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 life insurance entities, including the Company. At December 31, 20X2, 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, 20XX. 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 ABC Life Insurance 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 accompanying financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

**15.17** AU section 341 states that inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report (as described in paragraph 15.16) serves adequately to inform users of the financial statements of the auditor's substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Nonetheless, AU section 341 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

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<sup>4</sup> See footnotes 1 and 2 in paragraph 15.03.

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 life insurance entity's ability to continue as a going concern for a reasonable period of time.

### Independent Auditor's Report

To the Board of Directors and Shareholders

ABC Life Insurance Company

We were engaged to audit the accompanying balance sheet of ABC Life Insurance Company as of December 31, 20X2, and the related statements of income, changes in stockholders' equity, other comprehensive income, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management.

The accompanying financial statements have been prepared assuming that ABC Life Insurance 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 life insurance entities, including the Company. At December 31, 20X2, 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, 20XX. 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 ABC Life Insurance 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 previously, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 20X2.

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

## **Evaluating Consistency of Financial Statements**

**15.18** In January 2008, the PCAOB adopted Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (AICPA, PCAOB Standards and Related Rules, Auditing Standards), and related conforming amendments, which became effective November 15, 2008. This standard and its related

amendments, among other significant provisions, update the auditor's responsibilities to evaluate and report on the consistency of an entity's financial statements and align the auditor's responsibilities with FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*. This standard also requires the auditor to recognize, in the auditor's report, an entity's correction of a material misstatement, regardless of whether it involves the application of an accounting principle. This standard also clarifies that the auditor's report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principle or the correction of a misstatement.

**15.19** In the conforming amendments, the PCAOB removed the GAAP hierarchy from its standards because it believes the hierarchy is more appropriately located in the accounting standards. These amendments do not change the principles in AU section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, PCAOB Standards and Related Rules, Interim Standards)*, for evaluating fair presentation of the financial statements in conformity with GAAP.

## Qualified Opinion

**15.20** Paragraph .20 of AU section 508 (AICPA, *Professional Standards*) describes certain circumstances that may require the auditor to qualify the opinion on the financial statements. A qualified opinion states that except for the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with GAAP. Such an opinion is issued under the following circumstances:

- a. There is a lack of sufficient competent audit evidence or there are restrictions on the scope of the audit that have led the auditor to conclude that an unqualified opinion cannot be expressed and the auditor has concluded not to disclaim an opinion.
- b. The auditor believes, on the basis of the audit, that the financial statements contain a departure from GAAP, the effect of which is material, and has concluded not to express an adverse opinion.

## Disclaimer of Opinion

**15.21** Paragraph .61 of AU section 508 (AICPA, *Professional Standards*) describes disclaimers of opinion. A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with GAAP. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer. A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him to form an opinion on the financial statements. A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his audit, that there are material departures from GAAP.

**15.22** Regarding scope limitations, AU section 508 paragraph .62 (AICPA, *Professional Standards*) states the following:

When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles.

## Adverse Opinion

**15.23** Paragraph .58 of AU section 508 (AICPA, *Professional Standards*), describes adverse opinions. An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with GAAP. Such an opinion is expressed if, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with GAAP. When expressing an adverse opinion, the auditor should disclose in a separate explanatory paragraph(s) preceding the opinion paragraph of the report (a) all 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. If the effects are not reasonably determinable, the report should so state. If an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.

## Additional Guidance When Performing Integrated Audits of Financial Statements and Internal Control Over Financial Reporting

**15.24** When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, the auditor may choose to issue a combined report or separate reports on the entity's financial statements and on internal control over financial reporting. Refer to paragraphs 85–98 of Auditing Standard No. 5 for direction about reporting on internal control over financial reporting. In addition, see paragraphs 86–88 of PCAOB Auditing Standard No. 5 that includes an illustrative combined audit report. AU section 508 paragraph .08 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) states that if the auditor issues separate reports on the entity's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the entity's financial statements.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20XX, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, the auditor's report on the entity's financial statements and on internal control over financial reporting should be dated the same date. Refer to paragraph 89 of Auditing Standard No. 5 for direction about the report date in an audit of internal control over financial reporting.

## Reporting on Whether a Previously Reported Material Weakness Continues to Exist

**15.25** The PCAOB issued Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* (AICPA, PCAOB Standards and Related Rules, Auditing Standards). This standard establishes requirements and provides directions that apply when an auditor is engaged to report on whether a previously reported material weakness in internal control over financial reporting continues to exist as of a date specified by management. The engagement described by the standard is voluntary and the standards of the PCAOB do not require an auditor to undertake an engagement to report on whether a previously reported material weakness continues to exist. See the PCAOB website at [www.pcaobus.org](http://www.pcaobus.org) for additional information.

## Auditors' Reports on Statutory Financial Statements of Insurance Entities<sup>5</sup>

**15.26** All states require domiciled insurance entities to submit to the state insurance commissioner an annual statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the annual statements. Statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the insurance regulatory authority of the state of domicile," referred to in this Audit and Accounting Guide as *statutory accounting practices* (SAP). SAP are considered an other comprehensive basis of accounting (OCBOA) as described in AU section 623, *Special Reports* (AICPA, *Professional Standards*).

### NAIC-Codified Statutory Accounting

**15.27** The NAIC codified SAP for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual*. The insurance laws and regulations of most states require insurance enterprises domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed or permitted by state law.

**15.28** Prescribed SAP are practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable

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<sup>5</sup> Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of AU section 623, *Special Reports* (AICPA, *Professional Standards*, AU sec. 9623 par. .60–.77), is included as exhibit 3-1, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of this guide and provides guidance in evaluating whether informative disclosures are reasonably adequate for financial statements prepared on a statutory basis. The second amendment to this interpretation issued by the ASB, effective January 2005, was issued subsequent to the PCAOB adoption of the AICPA standards as interim on April 16, 2003.

to all insurance enterprises domiciled in a particular state. States may adopt the manual in whole or in part as an element of prescribed SAP in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed SAP applicable in each state.

**15.29** Permitted SAP include practices not prescribed by the domiciliary state, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (a) if it wishes to depart from the prescribed statutory accounting practice or (b) if prescribed SAP do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from entity to entity within a state, and may change in the future. In instances where the domiciliary state regulator is considering approval of a request for an accounting practice that departs from the NAIC Manual and state prescribed accounting practices, the domiciliary regulator must provide notice under the requirements as defined in paragraphs 56–57 of the preamble. For additional information, see chapter 3, "Sources of Accounting Principles and Reporting Requirements."

## General Use Reports

**15.30** If an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the regulatory authorities to whose jurisdiction the insurance enterprise is subject, the auditor of those statements should use the general use form of report for financial statements that lack conformity with GAAP (see AU section 623). Paragraph .04 of AU section 544, *Lack of Conformity With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*), states that the auditor should use the standard form of report described in AU section 508 (AICPA, *Professional Standards*), modified as appropriate because of departures from GAAP.

**15.31** Interpretation No. 15, "Auditor Reports on Regulatory Accounting or Presentation When the Regulated Entity Distributes the Financial Statements to Parties Other Than the Regulatory Agency Either Voluntarily or Upon Specific Request," of AU section 623 (AICPA, *Professional Standards*, AU sec. 9623 par. .96–.98), affirms the specifics of AU section 623 paragraph .05(f) and AU section 544. The auditor is precluded from using the form of the report set forth in AU section 623 "in circumstances in which the entity distributes the financial statements to parties other than the regulatory agency either voluntarily or upon specific request." AU section 544 paragraph .04 states that in those circumstances (referring to circumstances in which the financial statements and reports will be used by parties or distributed by the entity to parties other than the regulatory agencies to whose jurisdiction the entity is subject) the auditor should use the standard form of report modified as appropriate because of the departures from U.S. GAAP and then in an additional paragraph express an opinion on whether the financial statements are presented in conformity with the regulatory basis of accounting. See paragraph 15.35 for a report sample.

**15.32** Although it may not be practicable to determine the amount of difference between GAAP and SAP, 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 entities' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and SAP are material and pervasive. Auditors should express an adverse opinion with respect to conformity with GAAP (see AU section 508 paragraph .58 [AICPA, *Professional Standards*]), unless the auditor determines the differences between GAAP and SAP are not material and pervasive.

**15.33** The auditor, when expressing an adverse opinion, is required 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.<sup>6</sup> (See AU section 508 paragraphs .59–.60 [AICPA, *Professional Standards*].) 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 SAP and describe how those practices differ from GAAP.

**15.34** After expressing an 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 SAP. If departures from SAP are found to exist and are considered to be material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under AU section 508 (AICPA, *Professional Standards*) regarding conformity with GAAP.

**15.35** Following is an illustration of an independent auditor's report on the general use financial statements of an insurance enterprise prepared in conformity with SAP, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with SAP. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and SAP 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, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and of 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.

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<sup>6</sup> AU section 431, *Adequacy of Disclosure in the Financial Statements* (AICPA, *Professional Standards*), 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.



We conducted our audits in accordance with auditing standards generally accepted in the United States of America.<sup>7</sup> 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], which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between statutory accounting practices and accounting principles generally accepted in the United States of America, 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 previously do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ABC Insurance Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows<sup>8</sup> for the years then ended.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

[Firm Signature]

Certified Public Accountants

[City, State]

[Date]

The financial statements are not prepared solely for filing with a regulatory agency. (See paragraph .97 of Interpretation No. 15 of AU section 623.) However, if the auditor issues a report in accordance with paragraph .05(f) of AU section 623, nothing precludes the auditor, in connection with establishing the terms of the engagement, from reaching an understanding with the client that the intended use of the report will be restricted, and from obtaining the client's agreement that the client and the specified parties will not distribute the report to parties other than those identified in the report. (See paragraph .98 of Interpretation No. 15 of AU section 623.)

## Limited Use Reports

**15.36** Prescribed-or-permitted SAP for insurance enterprises are considered an OCBOA as described in AU section 623. If an insurance entity's statutory financial statements are intended solely for filing with state regulatory

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<sup>7</sup> See footnotes 1 and 2 in paragraph 15.03.

<sup>8</sup> Reference to cash flows would not be needed if the entity, under GAAP, is not required to present a statement of cash flows.

authorities to whose jurisdiction the insurance entity 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. Such reporting is appropriate even though the auditor's report may be made a matter of public record (see AU section 623 paragraph .05). However, that paragraph further states that limited use 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 entity is subject. The auditor's report should contain a statement that there is a restriction on the use of statutory financial statements to those within the insurance enterprise and for filing with the state regulatory authorities to whose jurisdiction the enterprise is subject. If the financial statements will be provided to any party other than the regulatory authority, a general use report should be used.

**15.37** Although auditing standards do not prohibit an auditor from issuing limited use and general use 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 conformity with GAAP will be able to fulfill all of their reporting obligations with limited use statutory financial statements.

**15.38** Following is an illustration, adapted from paragraph .08 of AU section 623 of an unqualified auditor's report on limited use statutory financial statements prepared in conformity with SAP.

#### 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, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, 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 auditing standards generally accepted in the United States of America.<sup>9</sup> 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*] that is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ

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<sup>9</sup> See footnotes 1 and 2 in paragraph 15.03.

Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows 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 state insurance departments to whose jurisdiction the Company is subject and is not intended to be and should not be used by anyone other than these specified parties.

[Firm Signature]

Certified Public Accountants

[City, State]

[Date]

## General Use and Limited Use Reports

**15.39** The notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discuss SAP and describe how this basis differs from GAAP (see AU section 623 paragraph .10). In general use statutory financial statements, the effects of the differences should be disclosed, if quantified. However, in limited use statutory financial statements, the effects of the differences need not be quantified or disclosed.

**15.40** The auditor should consider the need for an explanatory paragraph (or other explanatory language) under the circumstances described in paragraph .11 of AU section 508 (AICPA. *Professional Standards*), and paragraph .31 of AU section 623, regardless of any of the following:

- a. The type of report—general use or limited use
- b. The opinion expressed—unqualified, qualified, or adverse
- c. Whether the auditor is reporting as to conformity with GAAP or conformity with the SAP

For example, in a general use report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with SAP, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance entity's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

**15.41** The auditor may wish to emphasize a matter in a separate paragraph of the auditor's report (see AU sections 508 paragraph .37 and 623 paragraph .31). When an insurance entity prepares its financial statements using accounting practices prescribed or permitted by the regulatory authority of the state of domicile, and has significant transactions that it reports using permitted accounting practices that materially affect the insurance entity's statutory capital, the auditor is strongly encouraged to include an emphasis of matter paragraph in the report describing the permitted practices and their effects on statutory capital.

**15.42** An example of an emphasis of 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 20XX to write up its home office property to appraised value; under prescribed statutory accounting practices home office

property is carried at depreciated cost. As of December 31, 20X5, that permitted accounting practice increased statutory surplus by \$XX million over what it would have been had the prescribed accounting practices been followed.

**15.43** If subsequent to the initial adoption of the revised manual there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the entity's financial statements, the auditor should refer to the change in an explanatory paragraph of the report (see AU section 508 paragraph .16 [AICPA, *Professional Standards*]). The explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer to the note in the financial statements that discusses the change. The auditor's concurrence with a change is implicit, unless the auditor takes exception to the change in expressing the opinion as to the fair presentation of the financial statements in conformity with GAAP or the SAP.

**15.44** An example of an explanatory paragraph follows:

As discussed in Note X to the financial statements, the Company changed its method of accounting for guaranty funds and other assessments.

### **Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association**

**15.45** In the late 20th century, the life insurance industry experienced allegations of improper market conduct practices such as questionable sales practices and potentially misleading policyholder illustrations. These allegations triggered regulatory scrutiny, class action litigation, significant monetary settlements, and negative publicity related to market conduct issues. As a result, the industry is taking steps to promote a higher standard of ethical behavior that it hopes will reverse the negative perceptions held by many customers. In that regard, the American Council of Life Insurers, the largest life insurance trade organization, established the Insurance Marketplace Standards Association (IMSA) as a nonaffiliated membership organization with its own board of directors composed of chief executives of life insurance entities. IMSA seeks to encourage and assist participating life insurance entities (hereinafter referred to as entities) in the design and implementation of sales and marketing policies and procedures that are intended to benefit and protect the consumer. Entities that desire to join IMSA will be required to adopt the IMSA Principles of Ethical Market Conduct (the principles) and the Code of Ethical Market Conduct (the code) and accompanying comments and respond affirmatively to an assessment questionnaire (the questionnaire). Each prospective member also will be required to conduct a self-assessment to determine that it has policies and procedures in place that will enable it to respond affirmatively to the questionnaire. An entity's self-assessment responses to the questionnaire will need to be validated by an independent examination of the self-assessment. On obtaining an unqualified third party assessment report, entities will be eligible for IMSA membership. Membership in IMSA is valid for a 3 year period. Members are permitted to use IMSA's logo subject to rules set forth by IMSA for advertising and other promotional activities. The assessment process is intended to encourage entities and help them continually review and modify their policies and procedures in order to improve their market conduct practices and those

of the industry and to strengthen consumer confidence in the life insurance business.

**15.46** CPAs in the practice of public accounting, herein referred to as practitioners as defined by AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), may be engaged to examine, provide, or both, various consulting services related to the entity's self-assessment. Paragraphs 15.47–.83 provide guidance to practitioners in conducting and reporting on an independent examination performed pursuant to the AICPA Statements on Standards for Attestation Engagements to assist an entity in meeting the requirements of the IMSA Life Insurance Ethical Market Program (the IMSA program). IMSA requires that such engagements use the criteria it sets forth; consequently, practitioners and life insurance entities should be familiar with the IMSA program and its *Assessment Handbook* and requirements.

## Overview of the IMSA Life Insurance Ethical Market Conduct Program

**15.47** The Principles of Ethical Market Conduct consist of six statements that set certain standards with respect to the sale and service of individually sold life and annuity products. The principles that the entity is required to adopt are as follows:

- a. *Principle 1.* To conduct business according to high standards of honesty and fairness and to render that service to its customers that, in the same circumstances, it would apply to or demand for itself.
- b. *Principle 2.* To provide competent and customer focused sales and service.
- c. *Principle 3.* To engage in active and fair competition.
- d. *Principle 4.* To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.
- e. *Principle 5.* To provide for fair and expeditious handling of customer complaints and disputes.
- f. *Principle 6.* To maintain a system of supervision and review that is reasonably designed to achieve compliance with these principles.

**15.48** IMSA developed the Code of Ethical Market Conduct to expand the Principles of Ethical Market Conduct to the operating level and to identify the attributes of the sales, marketing, and compliance systems that IMSA believes should support each of the principles.

**15.49** To further expand on the principles and code, IMSA developed accompanying comments, which further define the intention of the principles and code and, in some instances, provide examples of implementation.

## IMSA Assessment Questionnaire

**15.50** IMSA developed the questionnaire to provide prospective members with uniform criteria to demonstrate for self-assessment purposes that they have policies and procedures in place that meet the objective of the questions in the questionnaire.

## Insurance Marketplace Standards Association Membership and Certification Process

**15.51** Participation in the IMSA program requires an entity to adopt the principles and code and to undertake a two step assessment process. First, an entity conducts a self-assessment, using the questionnaire and *Assessment Handbook*, with the objective of concluding that it can respond affirmatively to every question in the questionnaire in conformity with the criteria set forth in IMSA's principles, code, and accompanying comments. Second, an independent assessor from a list of IMSA-approved assessors examines the self-assessment materials to determine whether the entity has a reasonable basis for its affirmative responses to the questionnaire.

**15.52** Once the assessment process is complete, the entity submits its IMSA Membership Application (the application) and Self-Assessment Report. The Self-Assessment Report states that the entity has adopted the principles and code, has conducted a self-assessment of its policies and procedures, and has determined that the answer to each of the questions in the questionnaire is *yes* in conformity with the handbook. The entity also submits an unqualified examination report from an IMSA-approved independent assessor.

## IMSA Independent Assessor Application Process and Required Training

**15.53** IMSA will accept independent assessor reports only from those assessors that have been preapproved by IMSA. To become an independent assessor, a candidate is required to submit an IMSA Independent Assessor Application that requires that the candidate meet specific educational and professional requirements established by the IMSA board of directors. IMSA also requires that all independent assessors attend IMSA training as outlined by the board of IMSA. Independent assessors may be of various occupations or professional disciplines, including CPAs.

## IMSA Assessment Handbook

**15.54** IMSA developed an *Assessment Handbook* (the handbook or the IMSA handbook) to assist entities in the implementation of the IMSA program and provide guidance to independent assessors. Entity personnel and independent assessors generally should use the handbook to gain an understanding of the assessment process and as a source of information for performing an assessment. The handbook is intended for entities of all sizes regardless of the means by which they distribute individually sold life and annuity products. IMSA acknowledges that this is a new program that will evolve over time. Therefore, the handbook may be revised as entities and independent assessors provide IMSA with suggestions for improvement. Practitioners should ensure that they are utilizing the most current version of the handbook in planning and performing their work.

## Planning the IMSA Engagement

**15.55** To satisfy IMSA program requirements, practitioners need to perform an examination engagement pursuant to AT section 101 paragraph .44, which states that planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners must have adequate technical training and

proficiency in the attest function and have adequate knowledge in life insurance market conduct and the IMSA program to enable them to sufficiently understand the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

**15.56** The examination should be made in accordance with standards established by the AICPA, including obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the questionnaire are based. To be acceptable to IMSA, the engagement also should be performed in accordance with the criteria set forth in the IMSA handbook.

**15.57** In accordance with AT section 101 paragraphs .48–.50 and the handbook, a practitioner performing the examination should supervise the engagement team, which involves directing the efforts of the engagement team in accomplishing the objectives of the engagement and determining whether the engagement objectives were met. If the practitioner is not an IMSA-approved independent assessor, such an assessor should be a member of the engagement team with responsibility for, among other things, assisting the practitioner in performing these functions.

**15.58** The engagement team should be informed of its responsibilities, including the objectives of the procedures that they are to perform and matters that may affect the nature, extent, and timing of such procedures. The practitioner with final responsibility for the engagement should direct assistants to bring to his or her attention significant questions raised during the attest engagement so that their significance may be assessed. The work performed by each member of the engagement team should be reviewed to determine whether it was adequately performed.

**15.59** IMSA, through its handbook, has adopted a methodology to foster a uniform determination by entities and their independent assessor on whether policies and procedures are in place. The handbook requires that the following three aspects be present: approach, deployment, and monitoring.

## **Establishing an Understanding With the Client**

**15.60** The practitioner should consider the risks associated with accepting an engagement to examine and report on an entity's assertion about its responses to the IMSA questionnaire. The practitioner should establish an understanding with the client regarding the services to be performed. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, and limitations of the engagement. The practitioner should document the understanding in the audit documentation, preferably through a written communication with the client. If the practitioner believes an understanding with the client has not been established, he or she should decline to accept or perform the engagement.

## **Assessments of Attestation Risk**

**15.61** The practitioner should evaluate the attestation risk that policies and procedures may not be in place to support affirmative responses to the questionnaire and should consider this risk in designing the attest procedures to be performed. In examining whether policies and procedures are in place, the practitioner determines whether the policies and procedures have been adopted and are in operation and whether such policies and procedures satisfy the six components required by IMSA for the entity to respond affirmatively

to each question. Whether an entity has policies and procedures in place does not encompass whether those policies and procedures operated effectively as of a particular date, or over any period of time, to ensure compliance with the principles, code, and accompanying comments or about whether the entity or its employees have complied with applicable laws and regulations.

**15.62** Examples of risk considerations that may affect the nature, timing, and extent of testing procedures are listed in paragraphs 15.79–83. Not all the examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, distribution channels, product lines, or sales volume. In determining the examination procedures to be performed, practitioners should assess the impact that those risk considerations, individually and in combination, may have on attestation risk.

**15.63** Before performing attestation procedures, the practitioner must be adequately trained and should obtain an understanding of the entity's overall operations and market conduct practices, as well as its policies and procedures that have been identified in the self-assessment as supporting its affirmative responses to the questionnaire. In addition, the practitioner may obtain an understanding of the operation and history of the entity's distribution systems and products sold and of sales volume by product and distribution system. The practitioner may also obtain an understanding of the entity's past market conduct issues and related corrective measures.

## Obtaining Sufficient Evidence

**15.64** In an attest engagement designed to provide a high level of assurance (referred to as an examination), the practitioner's objective is to accumulate sufficient evidence to restrict attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. In such an engagement, the practitioner may select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can restrict attestation risk to such an appropriately low level. Accordingly, in an examination engagement, it is necessary for a practitioner's procedures to go beyond reading relevant policies and procedures and making inquiries of appropriate members of management to determine whether the policies and procedures supporting affirmative responses to the questionnaire were in place. Examination procedures may also include verification procedures, such as inspecting documents and records, confirming assertions with employees or agents, and observing activities.

**15.65** As outlined in the handbook, the entity should provide the practitioner with adequate information for the practitioner to obtain reasonable assurance that there is a basis for an affirmative response to each of the questions in the questionnaire. The AICPA's concept of reasonable assurance in the context of an attestation engagement is set forth in footnote 11 of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements*, and paragraph .31 of AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*). These concepts are consistent with IMSA's concept of reasonable assurance as defined in the handbook.

**15.66** In an examination of management's assertion about an entity's affirmative responses to the questionnaire, the practitioner's evaluation of sufficiency and competency of evidential matter should include consideration of (a)



the nature of management's assertion and the related indicators used to support such assertions, (b) the nature and frequency of deviations from expected results of applying examination procedures, and (c) qualitative considerations, including the needs and expectations of the report's users.

## Reporting Considerations for IMSA Engagements

**15.67** AT section 101 paragraph .01 defines an *attest engagement* as an engagement in which a practitioner is engaged to issue or does issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party. The accompanying affirmative responses to the questions in the questionnaire are written assertions of the entity. If a practitioner is engaged by an entity to express a written conclusion about management's assertions about its policies and procedures, such an engagement involves a written conclusion about the reliability of an assertion that is the responsibility of the entity. The entity is responsible for the design, implementation, and monitoring of the policies and procedures upon which the responses to the questionnaire are based.

**15.68** Self-assessment is based in part on criteria set forth in the IMSA handbook, which is prepared by an industry organization for the specific use of its members. Such criteria are not suitable for general distribution reporting. Accordingly, the independent accountant's report must contain a statement that it is intended solely for the information and use of the entity's board of directors and management as well as IMSA.

**15.69** IMSA has adopted a uniform assessment report that all independent assessors (regardless of professional discipline) are required to use when reporting on the results of an independent assessment. IMSA has indicated that deviations from its standard report format, except as discussed in the following report, will not be accepted. The following is an illustration of an independent accountant's report on an entity's assertion relating to its affirmative responses to the IMSA questionnaire. The following report deviates from the IMSA format in paragraph 3, where the practitioner specifies that the examination was made in accordance with standards established by the AICPA, and refers to those standards before referring to the criteria set forth in the IMSA handbook. The other deviation is that the report is titled "Independent Accountant's Report" rather than "Independent Assessor Report." Representatives of IMSA have indicated that they will accept only these deviations for reports issued by practitioners.

### Independent Accountant's Report

To [Name of insurer] Board of Directors and the Insurance Marketplace Standards Association:

We have examined management's assertion that the affirmative responses of [Name of insurer] to the questionnaire relating to the Principles of Ethical Market Conduct and the Code of Ethical Market Conduct and Accompanying Comments for individually sold life and annuity products, adopted by the Insurance Marketplace Standards Association (IMSA), are based on policies and procedures in place as of [the IMSA report date]. The Company is responsible for the design, implementation, and monitoring of the policies and procedures in place upon which the responses to the questionnaire are based.

Our examination was made in accordance with attestation standards established by the American Institute of Certified Public Accountants and in

accordance with the criteria set forth in the *IMSA Assessment Handbook*, and included obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the questionnaire are based and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination was not designed to evaluate whether the policies and procedures, upon which the Company's responses to the questionnaire are based, have or will operate effectively, nor have we evaluated whether or not the Company has or will comply with applicable laws or regulations. Accordingly, we do not express an opinion or any other form of assurance thereon.

In our opinion, management's assertion that the affirmative responses to the questionnaire are based on policies and procedures in place as of [*the IMSA report date*] is fairly stated, in all material respects, based upon the criteria set forth in the Principles of Ethical Market Conduct, the Code of Ethical Market Conduct and Accompanying Comments, and the *Assessment Handbook*.

This report is intended solely for the information and use of the board of directors and management of the Company and the Insurance Marketplace Standards Association and is not intended to be and should not be used by anyone other than these specified parties.

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[*IMSA Report Date; see paragraph 15.71*]

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[*Company (Insurer)*]

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[*Name of Independent Assessor; see paragraph 15.70*]

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[*Signature of Independent Accountant or Firm*]

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[*Date of Signature; see paragraph 15.72*]

*Note:* In any instance in which an alternative indicator is used to support an affirmative answer to any question in the questionnaire, such alternative indicator must be fully set forth in an attachment to this Assessor Report (see paragraph 15.73).

**Elements of the Report**

**15.70** *Signatures and identification of the independent assessor.* IMSA prefers that the independent assessor sign his or her name on the report. However, many AICPA member firms require that a manual or printed signature of the firm name be presented on the face of the report and prohibit a member of the firm from signing the report as an individual. Although IMSA will accept this practice, it requires the identification on the face of the independent accountant's report of the IMSA-approved independent assessor who actively participated in and supervised relevant portions of the engagement on behalf of the firm. In addition, in circumstances in which the IMSA-approved independent assessor does not sign the report as an individual, IMSA requires an

affirmation from the independent assessor to be attached to the independent accountant's report. A sample affirmation follows:

Affirmation of Independent Assessor

I, [Print name], affirm that I have reviewed the attached Independent Accountant's Report on management's assertions regarding the IMSA program for [Insurer] as of [IMSA report date] and that I was the Independent Assessor responsible for supervising relevant portions of the assessment identified herein.

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[Signature]

---

[Date of Signature]

**15.71** *IMSA report date.* The IMSA report date referred to in the independent accountant's report is the date of the self-assessment and the date to which the entity and the independent assessor have agreed as the point in time for which the policies and procedures supporting the affirmative responses to the questionnaire are in place. Due care should be taken to ensure that representations made by management on the basis of a self-assessment are current as of the IMSA report date. If a significant amount of time has elapsed between the date of the performance of the practitioner's procedures on certain questions and the IMSA report date, due care should be taken to ensure that policies and procedures were in place as of the IMSA report date.

**15.72** *Date of signature.* The date of signature is the date fieldwork is completed. Changes in the policies and procedures, personnel changes, or other considerations that might significantly affect responses to the questionnaire may occur subsequent to the IMSA report date but before the date of signature or the date when the report is issued. The practitioner should obtain management's representations relating to such matters and perform such other procedures regarding subsequent events considered necessary in the circumstances. The practitioner has no responsibility to perform examination procedures or update his or her report for events subsequent to the date when the report is issued; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's opinion had he or she been aware of them. The practitioner's consideration of such subsequent information is similar to an auditor's consideration of information discovered subsequent to the date of a report on an audit of financial statements described in AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*).

**15.73** *Alternative indicators.* A list of indicators in the handbook corresponds to each of the questions in the questionnaire and lists possible policies and procedures identified by IMSA that an entity can have in place to be able to respond affirmatively to a question. An entity must support each *yes* response to a question by the selection of indicators sufficient to meet the six required components and to meet the objective of each question. IMSA has established limitations on the use of indicators other than those contained in the handbook. Alternative indicators that are used as support for an affirmative response to a question in the questionnaire may require preapproval by IMSA in certain situations, as noted in the handbook. It will be necessary for the practitioner to evaluate whether an alternative indicator used by the entity supports an affirmative response to the question. The alternative indicators should be disclosed by the practitioner to IMSA in the basic independent accountant's report as

an attached appendix, and an explanatory paragraph should be added to the standard independent accountant's report in paragraph 15.69. The following is an example of a paragraph that should be included in the examination report if alternative indicators are used by management. The paragraph should precede the opinion paragraph.

Management's assertion supporting an affirmative response to certain questions is supported by the use of alternative indicators, as that term is defined in the IMSA handbook. The attached appendix to this report lists the questions and alternative indicators used by management.

**15.74 *Negative responses.*** IMSA will not grant membership applications to an entity whose application contains a *no* response to any question. In circumstances in which no report will be issued to IMSA, management may request the practitioner to report findings to management or the board of directors. In this situation, the practitioner and management should agree on the means and format of such communication and document this understanding in writing.

**15.75 *Attest documentation (working papers).*** AT section 101 paragraphs .100–.107 states that the practitioner should prepare and maintain attest documentation, the form and content of which should be designed to meet the circumstances of the particular attest engagement. Attest documentation is the principal record of attest procedures applied, information obtained, and conclusions or findings reached by the practitioner in the engagement. The quantity, type, and content of attest documentation are matters of the practitioner's professional judgment and serves mainly to

- a. provide the principal support for the practitioner's report, including the representation regarding the observance of the standards of field work, which is implicit in the reference in the report to attestation standards.
- b. aid the practitioner in the conduct and supervision of the attest engagement.

Attest documentation should be sufficient to (a) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of attest procedures performed, and the information obtained and (b) indicate the engagement team member(s) who performed and reviewed the work. In its required training, IMSA has advised IMSA-approved independent assessors to appreciate the sensitivity of insurers to litigation risks and the production of documents that litigation typically requires. IMSA has reminded assessors and insurers alike that the self-assessment process is designed to demonstrate compliance currently with IMSA assessment criteria and that reports will not be accepted by IMSA unless all questions are answered in the affirmative. Accordingly, IMSA has stated its belief that IMSA-approved assessors will have no need, at least for IMSA's purposes, to maintain documentation of noncompliance with the IMSA assessment criteria currently or in the past.

**15.76** Concern over access to the practitioner's attest documentation might cause some clients to inquire about attest documentation requirements. In situations in which the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents, the practitioner may refer to Interpretation No. 2, "The Effect of an Inability to Obtain Audit Evidence Relating to Income Tax Accruals," of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*,

AU sec. 9326 par. .06–.23), for guidance. See Interpretation No. 4, "Providing Access to or Copies of Attest Documentation to a Regulator," of AT section 101 (AICPA, *Professional Standards*, AT sec. 9101 par. .43–.46), for guidance related to providing access to or copies of attest documentation to a regulator in connection with work performed on an attestation engagement.

**15.77** *Management's representations.* The practitioner should obtain written representation from management

- a. acknowledging management's responsibility for the design, implementation, and monitoring of the policies and procedures in place upon which the responses to the questionnaire are based and that the affirmative responses to the questionnaire are based on such policies and procedures in place as of a specific point in time.
- b. stating that management has adopted the principles and code, and has performed and made available to the practitioners all documentation related to a self-assessment of the policies and procedures in place as of the IMSA report date upon which the affirmative responses to the questionnaire are based.
- c. stating that management has disclosed to the practitioner all matters regarding the design, implementation, and monitoring of policies and procedures that could adversely affect the entity's ability to answer affirmatively the questions in the questionnaire.
- d. describing any related material fraud or other fraud or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which the responses to the questionnaire were made.
- e. stating whether there were, subsequent to the date of management's self-assessment (that is, the IMSA report date), any known changes or deficiencies in the design, implementation, and monitoring of the policies and procedures in place, including any personnel changes or other considerations of reference to the IMSA questionnaire subject matter.
- f. stating that management has disclosed any communication from regulatory agencies, internal auditors, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the IMSA report date (the date of management's assertion) and the date of the practitioner's report (the date of signature).
- g. stating that management has disclosed to the practitioners, orally or in writing, information about past market conduct issues (for example, policyholder complaints or litigation) of relevance to the IMSA questionnaire subject matter and the related corrective measures taken to support affirmative responses in those areas.

**15.78** Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to preclude an unqualified report suitable for submission to IMSA. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

## Assessment of Attestation Risk for IMSA Engagements

**15.79** The following are examples of considerations that may influence the nature, timing, and extent of a practitioner's testing procedures relating to an entity's assertion of its affirmative responses to the questionnaire. The considerations may also affect a practitioner's decision to accept such an engagement. The examples are not intended to be a complete list.

### Management Characteristics and Influence Over the Control Environment

**15.80** The following are the characteristics:

- a. Management's attitude regarding internal control over sales and marketing practices, which may affect its ability to foster a more comprehensive and effective compliance program.
- b. Management's financial support of the internal resources allocated to the development and maintenance of compliance with the IMSA program through adequate funding, resources, time, and so on.
- c. Management's history of ensuring that sales personnel are qualified, trained, licensed, and supervised.
- d. Management's history and systems for tracking complaint and replacement trends.
- e. Management's ability to generate timely, complete, and accurate information on issues of regulatory concern regarding sales and marketing practices.
- f. The entity's relationship with its current independent assessor, regulatory authorities, or both. (The practitioner should gain an understanding of the circumstances surrounding the disengagement of predecessor independent assessors, any issues identified in prior self-assessments or independent assessments, and consider making inquiries of predecessor assessors.)
- g. Consistent application of policies and procedures across product lines and distribution channels. (If the entity did not address each distribution channel, product line, or both because it deemed certain ones to be immaterial in terms of premiums earned or in force, or because of low volume of production, the practitioner will need to use his or her professional judgment to assess whether the omitted product lines or distribution channels should have been considered in the entity's self-assessment and assess the impact on his or her ability to opine on management's assertions by exercising that judgment. The definition of the term *appropriate to its size* in the handbook may also apply.)
- h. Whether the entity's approach to its self-assessment includes validation of the information it collected to support that policies and procedures are in place.

### Industry Conditions

**15.81**

- a. Changes in regulations or laws, such as those governing various products, sales methods and materials, agent compensation, and customer disclosure

- b.* Publicity about sales and marketing practices and increased litigation to seek remedy
- c.* Rapid changes in the industry, such as the introduction of new and complex product offerings or information technology
- d.* The degree of competition or market saturation

## **Distribution, Sales Volume, and Products**

### **15.82**

- a.* The diversity of distribution systems.
- b.* The relative volume of business for different products and distribution systems.
- c.* The length of time that products, distribution systems, or both have been available, used, or both.
- d.* Limitations of an entity's ability to assert control over producers (for example, agents).
- e.* Compliance training provided by management to its producers and employees involved in the sales process.
- f.* The complexity of product offerings.
- g.* The targeted markets for various products.
- h.* Whether the entity is applying for IMSA membership as a fleet of entities or as an individual entity. (If the entity is applying for fleet membership, the independent assessor should plan the engagement to address whether the policies and procedures are in place at each entity within the fleet, including newly acquired subsidiaries or affiliates in the fleet.)

## **Other Considerations**

### **15.83**

- a.* Issues identified in prior self-assessments, independent assessments, and other services provided
  - b.* Findings from recent market conduct examinations conducted by regulatory authorities or internal auditors
  - c.* Policyholder concerns expressed through complaints or litigation
  - d.* Ratings received from rating agencies
-





## Appendix A

### ***List of Industry Trade and Professional Associations, Publications, and Information Resources***

The following is a list of a number of the industry organizations. These sources are useful to the auditor in obtaining an understanding of the insurance industry.

#### **Trade Associations, Professional Associations, and Institutions**

*American Academy of Actuaries (AAA)* was founded in 1965 to represent the profession by four specialty actuarial associations: the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, the Fraternal Actuarial Association, and the Society of Actuaries. It provides standards or criteria of competence as an actuary and promotes education in actuarial science, the exchange of information among actuarial organizations, and the maintenance of standards of conduct and competence. The Casualty Actuarial Society provides actuarial and statistical science in insurance other than life insurance. [www.actuary.org](http://www.actuary.org).

*American Council of Life Insurance (ACLI)* provides a unified association to advance the interests of the life insurance industry; to assure effective government relations for the industry at both federal and state levels; to engage in public affairs activities to support the government relations program; to engage in public outreach activities to foster a positive public image of the industry; and to engage in other activities for the education, information, and assistance of its members. [www.acli.com](http://www.acli.com).

*Insurance Accounting and Systems Association (IASA)* provides education and training with respect to insurance accounting and systems. [www.iasa.org](http://www.iasa.org).

*LIMRA International, Inc.* was founded in 1916 to support and enhance the marketing functions of life insurance entities through original research, as well as products and services based on that research. Today, more than 90 years later, LIMRA is the premier marketing research organization in the financial services industry with more than 850 member life and health insurance entities and financial services entities in more than 70 countries. [www.limra.com](http://www.limra.com).

*Life Office Management Association, Inc. (LOMA)* is an international association of insurance and financial services entities. LOMA helps insurers and the financial services industry improve management and operations through quality employee development, research, information sharing, and related products and services. [www.loma.org](http://www.loma.org).

*The Life Underwriter Training Council (LUTC)* is an independent, nonprofit life insurance educational and training organization. [www.irmi.com/online/insurance-glossary/terms/life-underwriter-training-council-lutc.aspx](http://www.irmi.com/online/insurance-glossary/terms/life-underwriter-training-council-lutc.aspx).

*Medical Information Bureau (MIB)* is organized as a nonstock membership association of life insurance entities of the United States and Canada. The primary mission of MIB is to provide an alert to its member insurance entities against omission and fraud in the underwriting of individual life, health, and disability insurance applications. [www.mib.com](http://www.mib.com).

*Million Dollar Round Table* is an independent, international association of more than 31,500 leading life insurance producers from 464 life insurance entities in more than 80 nations and territories. [www.mdrt.org](http://www.mdrt.org).

*National Alliance of Life Companies (NALC)* is an association of small and medium size life and health insurance companies and a network of corporations and professionals who work to preserve the voice of innovative life insurance companies. [www.nalc.net](http://www.nalc.net).

*National Association of Insurance Commissioners (NAIC)* is an organization of the chief insurance regulatory officials of the 50 states, the District of Columbia, and 54 U.S. territories. It provides a forum for the exchange of ideas and the formulation of uniform policy. The NAIC helps state commissioners fulfill their obligations of protecting the interests of insurance policyholders. [www.naic.org](http://www.naic.org).

*National Organization of Life and Health Insurance Guaranty Associations (NOLHGA)* assists in handling multistate insolvencies, acts as a clearing house for information, and provides a forum for resolution of issues and problems arising from the operation of the state guaranty funds. [www.nolhga.com](http://www.nolhga.com).

*Society of Actuaries* is an international research, education, and membership organization for actuaries in the life and health insurance, employee benefits, and pension fields. [www.soa.org](http://www.soa.org).

*Society of Financial Examiners (SOFE)* is a professional society for examiners of insurance entities, banks, savings and loans, and credit unions where financial examiners come together for training and to share and exchange information on a formal and informal level. [www.sofe.org](http://www.sofe.org).

*Society of Insurance Financial Management (SIFM)* provides a forum for discussion and dissemination of information on accounting, statistical, and management problems in the insurance industry. [www.sifm.org](http://www.sifm.org).

## Trade Publications and Information Resources

The following publications and information resources will assist the auditor in gaining additional knowledge about the insurance industry.

### Directories

Best's *Insurance Reports*, Life-Health Edition. A.M. Best Co. Oldwick, NJ, [www.ambest.com](http://www.ambest.com).

Best's *Directory of Recommended Insurance Attorneys and Adjusters*. A.M. Best Co. Oldwick, NJ, [www.ambest.com](http://www.ambest.com).

*ACLI Life Insurance Fact Book*. American Council of Life Insurance, Washington, DC, [www.acli.com](http://www.acli.com).

### Journals and Other

*Best's Review Life-Health Edition* (monthly), A.M. Best Co., Oldwick, NJ, [www.ambest.com](http://www.ambest.com).

*Best Week* (weekly), A.M. Best Co., Oldwick, NJ, [www.ambest.com](http://www.ambest.com).

*Business Insurance* (weekly), Crain Communications, Inc., Detroit, MI, [www.businessinsurance.com](http://www.businessinsurance.com).

*The National Underwriter, Life-Health Edition* (weekly), National Underwriter Co., Cincinnati, OH, [www.nationalunderwriter.com](http://www.nationalunderwriter.com).

*SNL Financial*, News, financial data, and analysis, [www.snl.com](http://www.snl.com).

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## Appendix B

# Illustrative Financial Statements

In accordance with the notice to constituents to Financial Accounting Standards Board (FASB) *Accounting Standards Codification*<sup>TM</sup> (ASC), the footnote disclosures in the illustrative financial statements included in this guide use "plain English" to reference the requirements of FASB ASC, resulting in broad FASB ASC topic references. An example of "plain English" referencing might read, "as required by the Derivatives and Hedging topic of the FASB *Accounting Standards Codification*." Entities might consider revising their financial statement references to reflect this plain English referencing, rather than the use of specific FASB ASC references.

## Introduction

This appendix contains illustrative financial statements prepared in conformity with generally accepted accounting principles (U.S. GAAP). The financial statements are for illustrative purposes only, are not intended to be comprehensive and are not intended to establish preference among alternative principles acceptable under U.S. GAAP. Decisions about the application of the U.S. GAAP discussed in the accounting and financial reporting sections of this Audit and Accounting Guide should not be made by reference to the illustrative financial statements but by a careful reading of the specified authoritative literature. The illustrative financial statements reflect many of the minimum disclosure requirements for a life and health insurance entity but do not include all of the amounts or transactions discussed in other chapters of the guide or that might be found in practice. For example, the illustrative notes indicate the subject matter generally required to be disclosed, but they should be expanded, reduced, or otherwise modified to suit individual circumstances based on a careful reading of the specified authoritative literature.

The illustrative financial statements do not include other transactions not unique to life and health insurance entities, such as disclosures about segments, employee benefit plans, certain risks and uncertainties, or postemployment benefits other than pensions. Preparers and auditors should consult authoritative pronouncements for guidance on presenting that other information.

The illustrative financial statements do not reflect rules and releases of the Securities and Exchange Commission (SEC) that, for SEC registrants, have an authority similar to other officially established accounting principles. Refer to SEC Regulation S-X, Article 7, *Insurance Companies*.

The illustrative financial statements also do not reflect the impact of laws and regulations of the insurance entity's state of domicile. The impact on the financial statements of such laws and regulations vary by state. States require conformity with the codification of statutory accounting practices in the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual* to the extent it does not conflict with its own state laws and regulations. Refer to the NAIC *Accounting Practices and Procedures*

*Manual*, NAIC Annual Statement Instructions, and specific state laws and regulations to determine the impact of codification and individual state laws and regulations.

These illustrative financial statements are not intended to include items that should be accounted for under the requirements of FASB ASC 815, *Derivatives and Hedging*, and FASB ASC 820, *Fair Value Measurements and Disclosures*, and therefore do not reflect the requirements of these statements, and their amendments. Practitioners should refer to these standards and related amendments for guidance on reporting derivative instruments and hedging activities and fair value measurements. Items in the balance sheet and income statement have been cross referenced to the applicable chapters of this guide, for ease of locating information.

Life and health insurance entities generally present unclassified balance sheets.

Also, preparers and auditors of SEC registrant financial statements are reminded that as discussed in the SEC's *Codification of Staff Accounting Bulletins* Topic 11M (Staff Accounting Bulletin No. 74), and Interpretation No. 3, "The Impact on an Auditor's Report of Accounting Guidance Prior to its Effective Date," of AU section 410, *Adherence to Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, AU sec. 9410 par. .13–.18), filings with the SEC that include financial statements for a period ending after the issuance of an accounting standard but before the required date of adoption of that accounting standard should include disclosure of the impact that the recently issued accounting standard will have on the financial position and results of operations of the registrant when such standard is adopted in a future period. The following disclosures should be considered by registrants:

- A brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier;
- A discussion of the methods of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined;
- A discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless unknown or not reasonably estimable. In that case, a statement to that effect may be made; and
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the new standard (such as technical violations of debt covenant agreements, planned, or intended changes in business practices).

**ABC Life Insurance Company**  
**Balance Sheet\***  
**December 31, 20X2 and 20X1**  
*(Amounts in thousands)*

	<u>20X2</u>	<u>20X1</u>
<i>Assets</i>		
Investments: (chapter 11)		
Debt and equity securities		
Fixed maturities, held to maturity, at amortized cost (estimated fair value: \$47,830 in 20X2 and \$45,255 in 20X1)	\$ 44,864	\$ 46,310
Fixed maturities, available-for-sale, at estimated fair value (amortized cost: \$247,525 in 20X2 and \$219,565 in 20X1)	255,893	214,563
Trading account securities, at estimated fair value (cost: \$4,220 in 20X2 and \$4,419 in 20X1)	3,950	4,190
Mortgage loans	79,258	106,692
Real estate	6,410	6,147
Policy loans	43,549	51,013
Short term investments	<u>7,515</u>	<u>6,321</u>
Total investments	441,439	435,236
Cash and cash equivalents	5,285	3,343
Accrued investment income (chapter 11)	6,660	8,026
Premiums due and other receivables, <sup>1</sup> net of allowance of \$4,500 and \$2,100 for doubtful accounts (chapter 7)	1,647	1,092
Reinsurance receivable on paid and unpaid losses (chapter 12)	596	407
Reinsurance receivable related to contract holder liabilities (chapter 12)	5,714	3,048
Deferred policy acquisition costs (chapter 10)	38,936	36,429

\* Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, establishes a framework for measuring fair value that applies broadly to financial and nonfinancial assets and liabilities and improves the consistency, comparability, and reliability of the measurements.

<sup>1</sup> FASB ASC 310, *Receivables*, and FASB ASC 942, *Financial Services—Depository and Lending*, require, among other things, that the summary of significant accounting policies include the basis for accounting for trade receivables and the classification and method of accounting for other receivables. FASB ASC 310 requires that a description of the accounting policies and methodology the entity used to estimate its allowance for doubtful accounts be included in the notes to the financial statements. Such a description should identify the factors that influenced management's judgment and may also include discussion of risk elements relevant to particular categories of financial instruments. In addition, FASB ASC 310 requires that the summary of significant accounting policies include the policy for charging off uncollectible trade receivables.

FASB ASC 310 contains other presentation and disclosure requirements that may apply to the financial statements of insurance entities. Readers should refer to the full text of FASB ASC 310.

**ABC Life Insurance Company**  
**Balance Sheet—*continued***  
**December 31, 20X2 and 20X1**  
**(*Amounts in thousands*)**

	<u>20X2</u>	<u>20X1</u>
Property and equipment, net of accumulated depreciation	501	420
Other assets (chapter 14)	152	158
Separate account assets (chapter 14)	<u>732</u>	<u>525</u>
Total assets	<u>\$501,662</u>	<u>\$488,684</u>

See accompanying notes to financial statements.



**ABC Life Insurance Company**  
**Balance Sheet**  
**December 31, 20X2 and 20X1**  
*(Amounts in thousands)*

	<u>20X2</u>	<u>20X1</u>
<i>Liabilities</i>		
Future policy benefits (chapter 8)	\$345,887	\$341,207
Guaranteed interest contracts (chapter 8)	21,342	23,555
Policyholders funds on deposit (chapter 8)	49,408	46,202
Unpaid claims	5,418	4,737
Policyholders dividends (chapter 8)	2,335	3,450
Amounts held in escrow and accrued expenses	4,977	4,562
Deferred federal income taxes (chapter 13)	1,412	1,027
Other liabilities (chapter 8 and chapter 14)	253	4,465
Separate account liabilities (chapter 14)	732	525
Total liabilities	<u>\$431,764</u>	<u>\$429,730</u>
Commitments and contingencies (note 14)		
Shareholders' Equity (chapter 14)		
Capital stock: authorized—5,000,000 shares of \$2 par value; 3,341,624 shares issued and outstanding	6,683	6,683
Retained earnings	57,776	55,522
Accumulated other comprehensive income	<u>5,439</u>	<u>(3,251)</u>
Total shareholders' equity	<u>69,898</u>	<u>58,954</u>
Total liabilities and shareholders' equity	<u>\$501,662</u>	<u>\$488,684</u>

See accompanying notes to financial statements.

**ABC Life Insurance Company**  
**Statement of Income**  
**Years Ended December 31, 20X2 and 20X1**  
*(Amounts in thousands)*

	<u>20X2</u>	<u>20X1</u>
<i>Premiums and Other Revenues</i>		
Premiums: (chapter 7)		
Life and annuity premiums	\$ 24,833	\$ 24,783
Accident and health premiums	10,141	9,153
Other premiums	20	43
Contract holder fees (chapter 7)	1,961	1,844
Net investment income (chapter 11)	32,998	35,141
Net realized gains (losses) on investments (chapter 11) and other	4,222	(2,670)
Total premiums and other revenues	<u>74,175</u>	<u>68,294</u>
<i>Benefits and Other Expenses</i>		
Policyholder benefits (chapter 9)	39,158	30,815
Interest credited to policyholder accounts	4,363	4,156
General expenses (chapter 10)	4,288	4,984
Amortization of deferred policy acquisition costs (chapter 10)	1,276	1,305
Underwriting, acquisition, and insurance expenses (chapter 10)	18,029	17,266
Policyholders' dividends (chapter 9)	4,665	6,898
Total benefits and expenses	<u>71,779</u>	<u>65,424</u>
Income before income taxes	2,396	2,870
Income taxes (chapter 13)		
Current	1,547	601
Deferred	(1,405)	540
Total income taxes	<u>142</u>	<u>1,141</u>
Net income	<u>\$2,254</u>	<u>\$1,729</u>
Net income per common share	<u>.67</u>	<u>.52</u>
Dividends per common share	<u>—</u>	<u>.98</u>

See accompanying notes to financial statements.

**ABC Life Insurance Company**  
**Statements of Comprehensive Income (Loss)**  
**Years Ended December 31, 20X2 and 20X1**  
*(Amounts in thousands)*

	<u>20X2</u>	<u>20X1</u>
Net income	\$2,254	\$1,729
Other comprehensive income (loss)	<u>8,690</u>	<u>(1,730)</u>
Total comprehensive income (loss)	<u><u>\$10,944</u></u>	<u><u>\$(1)</u></u>

See note 5 to the financial statements for information about other comprehensive income (loss).

**ABC Life Insurance Company**  
**Statement of Changes in Shareholders' Equity**  
**Years Ended December 31, 20X2 and 20X1**  
*(Amounts in thousands)*

	<i>Capital Stock</i>	<i>Retained Earnings</i>	<i>Accumulated Other Comprehensive Income (Loss)</i>	<i>Total Shareholders' Equity</i>
Balance at January 1, 20X1	\$6,683	\$57,068	\$(1,521)	\$62,230
Net income for 20X1	—	1,729	—	1,729
Shareholders' dividends	—	(3,275)	—	(3,275)
Other comprehensive income (loss)	—	—	(1,730)	(1,730)
Balance at December 31, 20X1	6,683	55,522	(3,251)	58,954
Net income for 20X2	—	2,254	—	2,254
Other comprehensive income	—	—	8,690	8,690
Balance at December 31, 20X2	<u>\$6,683</u>	<u>\$57,776</u>	<u>\$5,439</u>	<u>\$69,898</u>

See accompanying notes to financial statements.

**ABC Life Insurance Company**  
**Statement of Cash Flows**  
**Years Ended December 31, 20X2 and 20X1**  
*(Amounts in thousands)*

	<u>20X2</u>	<u>20X1</u>
Cash flows from operating activities:		
Net income	\$2,254	\$1,729
Adjustments to reconcile net income to net cash provided by operating activities:		
Interest credited to universal life policies	7,927	10,445
Accrual of discount on investments, net	(976)	(1,328)
Net realized (gains) losses on investments	(4,222)	2,670
Depreciation and amortization	3,041	3,534
Amortization of deferred policy acquisition costs	1,276	1,305
Deferred federal income taxes	(2,538)	540
Change in operating assets and liabilities:		
Accrued investment income	1,366	880
Capitalization of deferred policy acquisition costs	(3,783)	(6,645)
Policy liabilities	(3,440)	(16,234)
Other items, net	<u>(644)</u>	<u>3,269</u>
Net cash provided by operating activities	<u>261</u>	<u>165</u>
Cash flows from investing activities:		
Cost of investments purchased:		
Fixed maturities and equity securities	(228,053)	(122,495)
Mortgage loans and real estate	(921)	—
Proceeds from investments sold, redeemed, or matured:		
Fixed maturities and equity securities	206,051	95,177
Mortgage loans and real estate	27,970	18,621
Policy loans, net	2,320	6,468
Short term investments, net	<u>409</u>	<u>15,446</u>
Net cash provided by investing activities	<u>7,776</u>	<u>13,217</u>
Cash flows from financing activities:		
Dividends to shareholders	—	(3,275)
Receipts from universal life policies credited to contract holder account balances	7,918	8,365
Return of contract holder account balances on universal life policies	(4,165)	(3,718)
Withdrawals from interest sensitive contracts	<u>(9,848)</u>	<u>(13,046)</u>
Cash used in financing activities	<u>(6,095)</u>	<u>(11,674)</u>
Net increase in cash and cash equivalents	1,942	1,708
Cash and cash equivalents, beginning of year	<u>3,343</u>	<u>1,635</u>
Cash and cash equivalents, end of year	<u>\$5,285</u>	<u>\$3,343</u>
Supplemental cash flow information:		
Income taxes paid	<u>\$1,205</u>	<u>\$ 785</u>

See accompanying notes to financial statements.

**ABC Life Insurance Company**  
**Notes to Financial Statements**  
**Years Ended December 31, 20X2 and 20X1**

### **1. Organization and Significant Accounting Policies**

*Organization.* ABC Life Insurance Company (ABC or the Company) is a stock life insurance company incorporated in the state of ABC that offers individual life, disability income, long term care, annuity, and investment products. ABC does business in the continental United States, with a concentration in New York, New Jersey, and Connecticut.

*Basis of presentation.* The significant accounting policies followed by ABC that materially affect financial reporting are summarized in the following paragraphs. The accompanying financial statements have been prepared in accordance with GAAP that differ from statutory accounting practices (SAP) used for regulatory authorities. The preparation of the financial statements in conformity with GAAP 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.

*Investments.* Fixed maturity securities available for sale consist of bonds, notes, and redeemable and nonredeemable preferred stock not classified as either trading or held to maturity, and are reported at estimated fair value. Unrealized holding gains and losses, net of tax, on available-for-sale securities are reported as a net amount in other comprehensive income. Deferred policy acquisition cost offsets for universal life type contracts and amounts attributable to certain participating contracts are recorded as a separate component of accumulated other comprehensive income. Fixed maturity securities held to maturity consist of bonds, notes, redeemable and nonredeemable preferred stock which the insurance company has the intent and ability to hold to maturity, and are reported at amortized cost and adjusted for amortization of premium or discount. Declines in fair value of individual held-to-maturity and available-for-sale securities below their cost that are other than temporary have resulted in write-downs of the individual securities to their fair value. The related write-downs have been included in earnings as realized losses. Trading account securities consist of bonds, notes, and redeemable and nonredeemable preferred stock, and common stock held principally for resale in the near term, and are recorded at their estimated fair values. Realized and unrealized gains and losses on trading account securities are included in other income.

Mortgage loans on real estate are carried at unpaid balances and are adjusted for amortization of premium or discount, less allowance for losses. Real estate held for sale is carried at the lower of depreciated cost or fair value less estimated selling costs. Real estate classified as held-for-sale is no longer depreciated. Real estate, including real estate acquired in satisfaction of debt, is carried at depreciated cost. Impaired real estate is written down to fair value with the impairment loss being included in net realized gains (losses) on investments and other. Upon foreclosure (including in-substance foreclosure), the carrying value of the property is recorded at the lower of cost or fair value (less selling costs if to be sold), which becomes its new cost basis. The estimated fair value for real estate is determined based upon independent appraisals and other available information about the property, which may take into consideration a number of factors, including: (i) discounted cash flows (ii) sales of

comparable properties (iii) geographic location of property and related market conditions (iv) disposition costs.

Foreclosed properties are actively managed by the company in order to maximize their value. Subsequent to foreclosure, the carrying value of the property is periodically evaluated and a valuation allowance is established, if necessary, to reflect any additional amounts considered unrecoverable upon sale. At the time of the sale, the difference between the sales price and the carrying value is recorded as a realized gain or loss. Policy loans are carried at unpaid balances. Short term investments are stated at amortized cost, which approximates fair value.

Provisions for impairments of securities classified as held to maturity are included in net realized gains (losses) on investments and other. Realized gains and losses are determined by specific identification.

*Cash and cash equivalents.* Cash equivalents are carried at cost, which approximates fair value. Cash equivalents are highly liquid financial instruments with an original maturity of three months or less.

*Deferred policy acquisition costs.* Commissions and other costs of acquiring traditional life insurance, universal life insurance and investment products, and accident and health insurance, that vary with and are primarily related to the production of new and renewal business, have been deferred. Traditional life insurance and accident and health insurance acquisition costs are being amortized over the premium paying period of the related policies using assumptions consistent with those used in computing future policy benefit liabilities. For universal life-type contracts and investment contracts that include significant surrender charges or that yield significant revenues from sources other than the investment of contract holders' funds, the deferred contract acquisition cost amortization is matched to the recognition of gross profit.

Otherwise, deferred policy acquisition costs on investment contracts are amortized using an accounting method that recognizes acquisition costs as expenses at a constant rate applied to net policy liabilities. The effect on the deferred acquisition costs (DAC) asset that would result from realization of unrealized gains (losses) is recognized with an offset to accumulated other comprehensive income in consolidated shareholders' equity as of the balance sheet date.

Effective January 1, 2007, the Company adopted the guidance in FASB ASC 944-30 related to internal replacement modifications.

As a result of the adoption of FASB ASC 944-30 related to internal replacement modification, if an internal replacement modification substantially changes a contract, then the DAC is written off immediately through income and any new deferrable costs associated with the new replacement are deferred. If a contract modification does not substantially change the contract, the DAC amortization on the original contract will continue and any acquisition costs associated with the related modification are immediately expensed.

The adoption of FASB ASC 944-30 related to internal replacement modifications resulted in a reduction to DAC and value of business acquired on January 1, 2007, and an acceleration of the amortization period relating primarily to the Company's group life and health insurance contracts that contain certain rate reset provisions. Prior to the adoption of FASB ASC 944-30 related to internal replacement modifications, DAC on such contracts was amortized over the expected renewable life of the contract. Upon adoption of FASB ASC 944-30 related to internal replacement modifications, DAC on such contracts

is to be amortized over the rate reset period. The impact as of January 1, 2007 was a cumulative effect adjustment of \$XXX, net of income tax of \$XXX, which was recorded as a reduction to retained earnings.

*Deferred sales inducements.* Costs related to sales inducements offered on sales to new customers, principally on investment contracts and primarily in the form of additional credits to the customer's account value or enhancements to interest credited for a specified period, which are beyond amounts currently being credited to existing contracts, are deferred and recorded as other assets. All other sales inducements are expensed as incurred and included in interest credited to contract holders' funds. Deferred sales inducements are amortized to income using the same methodology and assumptions as deferred acquisition costs, and are included in interest credited to contract holders' funds. Deferred sales inducements are periodically reviewed for recoverability and written down when necessary.

*Property and equipment.* Property and equipment are reported at cost, net of accumulated depreciation of \$501,000 and \$420,000 in 20X2 and 20X1, respectively. Property and equipment are depreciated using the straight line method over their estimated useful lives.

*Future policy benefits and expenses.* The liabilities for traditional life insurance and accident and health insurance contract benefits and expenses are computed using a net level premium method including assumptions as to investment yields, mortality, withdrawals, and other assumptions based on ABC's experience modified as necessary to reflect anticipated trends and to include provisions for possible unfavorable deviations. Liability interest assumptions are graded and range from 3 percent to 10 percent. Benefit liabilities for traditional life insurance contracts include certain deferred profits on limited payment policies that are being recognized in income over the contract term. Contract benefit claims are charged to expense in the period that the claims are incurred.

The accrued account balance for nontraditional life insurance and investment contracts are computed as deposits net of withdrawals made by the contract holder, plus amounts credited based on contract specifications, less contract fees and charges assessed, plus any additional interest. Interest crediting rates for universal life and investment products range from 5.50 percent to 9.25 percent.

Included in contract holders' account balances is a provision for contract holder dividends. Benefit liabilities for contract holders' account balances are computed under a retrospective deposit method and represent contract account balances before applicable surrender charges. Contract benefits and claims that are charged to expense include benefit claims incurred in the period in excess of related contract account balances. Interest crediting rates for universal life and investment products range from 5.50 percent to 9.25 percent. Benefits and expenses are charged against the account balance to recognize costs as incurred over the estimated lives of the contracts. Expenses include interest credited to contract account balances and benefits paid in excess of contract account balances.

*Minimum guarantees.* The company issues variable annuity contracts through separate accounts where the company contractually guarantees to the contract holder total deposits made to the contract less any partial withdrawals plus a minimum return. This guarantee includes benefits that are payable in the



event of death, annuitization, or at specified dates during the accumulation period.

*Accounting policy for health liabilities.* Unpaid claims on accident and health policies represent the estimated liability for benefit expenses both reported but not paid and incurred but not reported to ABC through December 31. ABC does not discount its liabilities for unpaid claims. Liabilities for unpaid claims are estimated using individual case basis valuations and statistical analyses. Those estimates are subject to the effects of trends in claim severity and frequency. Although considerable variability is inherent in such estimates, management believes that the liabilities for unpaid claims are adequate. The estimates are continually reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

*Income taxes.* Federal income taxes are charged or credited to operations based upon amounts estimated to be payable or recoverable as a result of taxable operations for the current year. Deferred income taxes have been provided for temporary differences between the tax basis of assets and liabilities calculated using the criteria of FASB ASC 740, *Income Taxes*, and their reported amounts in the financial statements using enacted income tax rates and laws. The Company recognizes interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. The Company did not have any accrued and recognized interest or penalties associated with unrecognized tax benefits for the years ending December 31, 20X2 and 20X1.<sup>2</sup>

*Reinsurance.* In the normal course of business, the Company seeks to limit its exposure to loss on any single insured and to recover a portion of benefits paid by ceding reinsurance to other insurance entities or reinsurers under excess coverage and coinsurance contracts. The Company retains a maximum of \$400,000 of coverage per individual life. Amounts paid or deemed to have been paid for reinsurance contracts are recorded as reinsurance receivable.

*Insurance premium revenues.* Traditional life premiums, which include those products with fixed and guaranteed premiums and benefits and consist principally of whole life insurance contracts, limited payment life insurance contracts, and certain annuities with life contingencies, are generally recognized as revenue when due. Revenues on universal life and investment type contracts consist of contract charges against contract holders' funds for the cost of insurance, administration, surrender charges, actuarial margin, and other fees. Accident and health insurance premiums are recognized as revenue pro rata over the terms of the contracts.

*Separate accounts.* Separate account assets and liabilities generally represent funds maintained in accounts to meet specific investment objectives of contract holders who bear the investment risk. Investment income and investment gains and losses accrue directly to such contract holders. The assets supporting the variable portion of both traditional variable annuities and variable contracts with guarantees are carried at fair value and reported as summary total separate account assets with an equivalent summary total reported for liabilities. Amounts assessed against the contract holders for mortality, administrative, and other services are included in revenue and changes in liabilities for minimum guarantees are included in policyholder benefits in the Statement of

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<sup>2</sup> As these standards are not insurance industry specific, transition and adoption specifics are excluded.

Operations. Separate account net investment income, net investment gains and losses, and the related liability changes are offset within the same line item in the Statement of Operations.

*Business risks and uncertainties.* The development of liabilities for future policy benefits for the Company's products requires management to make estimates and assumptions regarding mortality, morbidity, lapse, expense, and investment experience. Such estimates are primarily based on historical experience and future expectations of mortality, morbidity, expense, persistency, and investment assumptions. Actual results could differ materially from those estimates. Management monitors actual experience and, if circumstances warrant, revises its assumptions and the related future policy benefit estimates.

The Company's investments are primarily comprised of fixed maturity securities, equity securities, real estate, and mortgage loans. Significant changes in prevailing interest rates and geographic conditions may adversely affect the timing and amount of cash flows on such investments and their related values. In addition, the value of these investments is often derived from an appraisal, an estimate or opinion of value. A significant decline in the fair value of these investments could have an adverse effect on the Company's balance sheet.

The Company regularly invests in mortgaged backed securities (MBS) and other securities subject to prepayment and call risk. Significant changes in prevailing interest rates may adversely affect the timing and amount of cash flows on such securities. In addition, the amortization of market premium and accretion of market discount for MBS is based on historical experience and estimates of future payment speeds on the underlying mortgage loans. Actual prepayment speeds will differ from original estimates and may result in material adjustments to amortization or accretion recorded in future periods.

*Guaranty Funds.* Guaranty fund (and other) assessments are accrued at the time the events occur on which assessments are expected to be based.

2. Earnings Per Common Share

Basic and diluted earnings per common share are as follows.

<i>(Thousands, except per common share data)</i>	<i>Income (Numerator)</i>	<i>Shares (Denominator)</i>	<i>Per Common Share Amount</i>
20X2			
Net income	2,254		
Income applicable to common ownership	2,254	3,342	.67
20X1			
Net income	1,729		
Income applicable to common ownership	1,729	3,342	.52

3. Investments

In reporting disclosures about investments in securities, entities should comply primarily with the disclosure requirements in section 50 of FASB ASC 320, *Investments—Debt and Equity Securities*, FASB ASC 323, *Investments—Equity Method and Joint Ventures*, and FASB ASC 325, *Investments—Other*. Other disclosure requirements may also be applicable.

#### 4. 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.

*Short term investments.* For those short term instruments amortized cost is a reasonable estimate of fair value.

*Investment securities and trading account assets.* For securities held for trading purposes and marketable equity securities held for investment purposes, fair values are based on quoted market prices or dealer quotes. For other securities held as investments, fair value equals quoted market price, 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 discounted cash flows. The fair value of policy loans is estimated by discounting the future cash flows using reasonable assumptions for mortality and repayments and 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 ABC's mortgage loans on real estate and policy loans are as follows.

	20X2		20X1	
	(Amounts in thousands)			
	<i>Carrying Amount</i>	<i>Fair Value</i>	<i>Carrying Amount</i>	<i>Fair Value</i>
Mortgage loans on real estate	\$79,258	\$83,506	\$106,692	\$112,027
Policy loans	43,549	60,000	51,013	59,000

#### 5. Accumulated Other Comprehensive Income

Accumulated other comprehensive income (loss) represents cumulative gains and losses on items that are not reflected in earnings. The balances and activity for the years 20X2 and 20X1 are as follows.

	20X2	20X1
	(Amounts in thousands)	
Changes in net unrealized gains (losses) on investment securities:		
Net unrealized gains (losses) arising during the period	\$13,324	\$(1,873)
Reclassification adjustment for gains (losses) included in net earnings	46	(300)
Changes in net unrealized gains (losses) on investment securities	13,370	(2,173)
Adjustments for:		
Policyholder liabilities, deferred acquisition costs and deferred federal income taxes	(4,680)	443
Total other comprehensive income (loss)	\$8,690	\$(1,730)

## 6. Income Taxes

Significant components for income tax expense attributable to continuing operations are as follows.

	<u>20X2</u>	<u>20X1</u>
	<i>(Amounts in thousands)</i>	
Current income tax expense	\$1,547	\$601
Deferred income tax (benefit) expense	<u>(1,405)</u>	<u>540</u>
Total income tax expense	<u>\$142</u>	<u>\$1,141</u>

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the company's deferred tax liabilities and assets are as follows.

	<u>December 31, 20X2</u>	<u>December 31, 20X1</u>
	<i>(Amounts in thousands)</i>	
Deferred tax liabilities:		
Deferred policy acquisition costs	\$ 13,131	\$ 12,297
Future policy benefits	—	512
Accrual of discount on bonds	924	1,982
Other	<u>3,641</u>	<u>1,024</u>
Total deferred tax liabilities	<u>17,696</u>	<u>15,815</u>
Deferred tax assets:		
Policyholder dividends	8,067	8,224
Future policy benefits	851	—
Deferred policy acquisition costs	2,078	1,561
Investment valuation allowance	1,087	1,651
Retirement plan accruals	1,917	497
Tax credits and loss carryforwards	1,820	1,945
Investment income differences	574	556
Other	<u>406</u>	<u>354</u>
Total deferred tax assets	<u>16,800</u>	<u>14,788</u>
Valuation allowance for deferred tax assets	<u>(516)</u>	<u>—</u>
Net deferred tax assets	<u>16,284</u>	<u>14,788</u>
Net deferred tax liabilities	<u>\$1,412</u>	<u>\$1,027</u>

A valuation allowance has been established due to the uncertainty of realized certain tax credits and loss carryforwards, and a portion of other deferred tax assets.

A reconciliation of federal income tax expense as presented in the financial statements and income taxes calculated using the statutory corporate tax rate follows.

	<u>20X2</u>	<u>20X1</u>
	<i>(Amounts in thousands)</i>	
Income from operations	<u>\$2,396</u>	<u>\$2,870</u>
Application of income tax rate	838	1,005
Small company deduction for life insurance companies	(556)	(496)
Policyholders' share of income (loss) in excess of (less than) dividends paid	(264)	752
Dividend received deduction	(3)	(50)
Other	<u>127</u>	<u>(70)</u>
Total tax expense	<u>\$142</u>	<u>\$1,141</u>

### Reconciliation of Unrecognized Tax Benefits

	<u>20X2</u>	<u>20X1</u>
	<i>(Amounts in thousands)</i>	
Beginning Balance	\$XXX	\$XXX
Prior period position increases	XXX	XXX
Prior period position decreases	(XXX)	(XXX)
Current period position increases	XXX	XXX
Current period position decreases	(XXX)	(XXX)
Decreases relating to settlements with taxing authorities	(XXX)	(XXX)
Reductions due to a lapse of applicable statute of limitations	(XXX)	(XXX)
Ending balance	XXX	XXX

None of the aforementioned unrecognized tax benefits, if recognized, would affect the effective tax rate. Additionally, there are no tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of December 31, 20X2. There were no interest or penalties recognized in the statement of operations or the statement of financial position for the years ending December 31, 20X2 and 20X1. Tax years that remain subject to examination by major tax jurisdictions include the years ending December 31, 19X9 through 20X2.

### 7. Financial Instruments With Off Balance Sheet Risk and Concentration of Credit Risk

At December 31, 20X2, ABC held unrated or less-than-investment grade corporate debt securities of \$8,000,000, net of allowance for losses, with an aggregate market value of \$7,500,000. Those holdings amounted to 4 percent of ABC's corporate debt securities investments and less than 2 percent of total assets. The holdings of less-than-investment grade securities are widely diversified and of

satisfactory quality based on ABC's investment policies and credit standards. ABC also invests in mortgage loans principally involving commercial real estate. At December 31, 20X2, 3 percent of such mortgages (\$2,000,000) 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 \$300,000.

8. Liability for Unpaid Claims

The liability for unpaid claims and claim adjustment expenses is based on the estimated amount payable on claims reported prior to the balance sheet date that have not yet been settled, claims reported subsequent to the balance sheet date that have been incurred during the period then ended, and an estimate (based on prior experience) of incurred but unreported claims relating to such period.

Activity in the liability for unpaid claims and claim adjustment expenses for the Company's health and disability coverages is summarized as follows.

	20X2	20X1
	(Amounts in thousands)	
Balance, beginning of year	\$4,737	\$7,669
Less: reinsurance recoverables	296	1,018
Net balance, beginning of year	4,441	6,651
Amount incurred, related to		
Prior years	\$(297)	\$313
Current year	26,197	25,671
Total	25,900	25,984
Amount paid, related to		
Prior years	6,923	8,937
Current year	18,303	19,257
Total	25,226	28,194
Net balance, end of year	5,115	4,441
Plus: reinsurance recoverables	303	296
Balance, end of year	\$5,418	\$4,737

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 \$(7,000) and \$722,000 in 20X2 and 20X1, respectively) decreased by \$297,000 in 20X2 reflecting lower-than-anticipated losses on \_\_\_\_\_, and increased by \$313,000 in 20X1 reflecting higher-than-anticipated losses and related expenses for claims for \_\_\_\_\_.

9. Minimum Guarantees

The following summarizes the liabilities for guarantees on variable contracts reflected in the general account:

	<i>Minimum Guaranteed Death Benefit (MGDB)</i>	<i>Guaranteed Minimum Accumulation Benefit (GMAB)</i>	<i>Guaranteed Minimum Income Benefit (GMIB)</i>	<i>Totals</i>
Balance at January 1 <sup>3</sup>	\$ X,XXX,XXX	\$ X,XXX,XXX	\$ X,XXX,XXX	\$ X,XXX,XXX
Incurred guarantee benefits	X,XXX,XXX	X,XXX,XXX	X,XXX,XXX	\$ X,XXX,XXX
Paid guarantee benefits	<u>X,XXX,XXX</u>	<u>X,XXX,XXX</u>	<u>X,XXX,XXX</u>	<u>\$ X,XXX,XXX</u>
Balance at December 31, 20XX <sup>4</sup>	\$ X,XXX,XXX	\$ X,XXX,XXX	\$ X,XXX,XXX	\$ X,XXX,XXX

The minimum guaranteed death benefit (MGDB) liability is established equal to a benefit ratio multiplied by the cumulative contract charges earned, plus accrued interest less contract benefit payments. The benefit ratio is calculated as the estimated present value of all expected contract benefits divided by the present value of all expected contract charges. The Company regularly evaluates estimates used and adjusts the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised.

The following assumptions and methodology were used to determine the MGDB liability at December 31, 20XX:

- Data used was 1,000 stochastically generated investment performance scenarios.
- Mean investment performance assumption was XX.
- Volatility assumption was XX.
- Mortality was assumed to be 90 percent of the Annuity 2000 table.
- Lapse rates vary by contract type and duration and range from 1 percent to 20 percent, with an average of 3 percent.
- Discount rate was XX percent.

Guaranteed minimum accumulation benefits are considered to be derivatives under FASB ASC 944-815 and are recognized at fair value through earnings.

The guaranteed minimum income benefit (GMIB) liability is established equal to a benefit ratio multiplied by the cumulative contract charges earned, plus accrued interest less contract benefit payments. The benefit ratio is calculated as the estimated present value of all expected contract benefits divided by the present value of all expected contract charges. The Company regularly evaluates estimates used and adjusts the additional liability balance, with a related charge or credit to benefit expense, if actual experience or other evidence suggests that earlier assumptions should be revised. The assumptions

<sup>3</sup> For guaranteed minimum accumulation benefits, incurred guarantee benefits incorporates all changes in fair value other than amounts resulting from paid guarantee benefits.

<sup>4</sup> Included in the total reserve balance are reserves for variable annuity death benefits of \$\_\_\_\_\_, variable annuity income benefits of \$\_\_\_\_\_ and other guarantees of \$\_\_\_\_\_.

used for calculating the GMIB liability at December 31, 20XX, are consistent with those used for calculating the MGDB liability. [Underlying assumptions for the liability related to income benefits include assumed future annuitization elections based on factors such as the extent of benefit to the potential annuitant, eligibility conditions and the annuitant's attained age.] In addition, the calculation of the GMIB liability assumes X percent of the potential annuitizations that would be beneficial to the contract holder will be elected.

10. Reinsurance

The Company utilizes indemnity reinsurance agreements to reduce its exposure to large losses in all aspects of its insurance business. Such reinsurance permits recovery of a portion of losses from reinsurers, although it does not discharge the primary liability of the Company as direct insurer of the risks reinsured. The Company evaluates the financial strength of potential reinsurers and continually monitors the financial condition of reinsurers. The following tables include premium amounts ceded by, assumed to, or from other companies.

	<i>Direct Amount</i>	<i>Ceded to Other Companies</i>	<i>Assumed From Other Companies</i>	<i>Net Amount</i>
	<i>(Amounts in thousands)</i>			
<u>20X2</u>				
Premiums:				
Life insurance	\$2,090	\$560	\$3,330	\$4,860
Accident and health	1,440	1,290	—	150
Annuities	3,130	—	70	3,200
Total earned premiums	<u>\$6,660</u>	<u>\$1,850</u>	<u>\$3,400</u>	<u>\$8,210</u>
<u>20X1</u>				
Premiums:				
Life insurance	\$2,080	\$520	\$3,680	\$5,240
Accident and health	1,510	1,370	—	140
Annuities	1,840	—	30	1,870
Total earned premiums	<u>\$5,430</u>	<u>\$1,890</u>	<u>\$3,710</u>	<u>\$7,250</u>

11. Separate Accounts

At December 31, 20X1 and 20X2, the company had the following variable contracts with guarantees. The Company's variable annuity contracts may offer more than one type of guarantee in each contract; therefore, the sum of amounts listed exceeds the total account balances of variable annuity contracts' separate accounts with guarantees.



**Return of net deposits plus a minimum return:**

**In the event of death**

Account value	\$XXX	\$XXX
Net amount at risk <sup>5</sup>	\$XXX	\$XXX
Average attained age of contract holders	XX	XX
Range of guaranteed minimum return rates	X–X%	X–X%

**At annuitization**

Account value	\$XXX	\$XXX
Net amount at risk <sup>6</sup>	\$XXX	\$XXX
Weighted average period remaining until expected annuitization	XX	XX
Range of guaranteed minimum return rates	X–X%	X–X%

**Accumulation at specified date**

Account value	\$XXX	\$XXX
Net amount at risk <sup>7</sup>	\$XXX	\$XXX
Range of guaranteed minimum return rates	X–X%	X–X%

Account balances of contracts with guarantees were invested in variable separate accounts as follows:

<i>Asset Type</i>	<i>December 31, 20X1</i>	<i>December 31, 20X2</i>
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$	\$
Obligations of states of the United States and political subdivisions of the states		
Corporate debt securities:		
— Investment grade		
— Noninvestment grade		
Foreign debt securities		
Mortgage backed securities		
Equity securities (including mutual funds) <sup>8</sup>		
Real estate		
Mortgage loans		
Derivative financial instruments		
Cash and cash equivalents		
Total	\$ X,XXX,XXX	\$ X,XXX,XXX

<sup>5</sup> Defined as the current guaranteed minimum death benefit in excess of the current account balance at the balance sheet date.

<sup>6</sup> Defined as the present value of the minimum guaranteed annuity payments determined in accordance with the terms of the contract in excess of the current account balance.

<sup>7</sup> Defined as the present value of the guaranteed minimum accumulation balance in excess of the current account balance.

<sup>8</sup> The insurance enterprise may want to consider disclosing mutual funds by investment objective or other meaningful groupings that are useful in understanding the nature of the guarantee risk.

Assets transferred from the general account to the separate accounts are recognized at fair value to the extent of third party contract holders' proportionate interest in separate accounts when the arrangement meets applicable criteria (FASB ASC 944-80-25-2). The gains recognized assets transferred to the separate accounts during 20X2 and 20X1 were XX,XXX and XX,XXX, respectively.

## **12. Guaranty Fund Assessments**

At December 31, 20X2 and 20X1, ABC has recorded \$45,000 and \$67,000, respectively, in liabilities related to guaranty fund (and other) assessments which are included in other liabilities in the balance sheet. At December 31, 20X2 and 20X1, the carried liability was reduced by recoverables for related premium tax offsets and policy surcharges in the amount of \$25,000 and \$35,000, respectively. The period over which the assessments are expected to be paid and the recorded premium tax offsets and policy surcharges are expected to be realized is up to five and four years, respectively.

## **13. Statutory Financial Information**

Under the law of ABC State, the state of incorporation, the maximum dividend that may be paid (without prior approval of the (ABC State) Insurance Department), in any 12 month period is the greater of (a) net investment income for the preceding calendar year or (b) 10 percent of contract holders' surplus at the end of the preceding calendar year. In general, net investment income for dividend purposes is interpreted by the Insurance Department to be the statutory pretax net investment income including net realized capital losses but excluding net realized capital gains. The maximum permissible amount of dividends for 20X3, based on statutory net investment income for 20X2, is \$20,000.

The Company, which is domiciled in ABC State, prepares its statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the ABC state insurance department, which (state of domicile) recognizes for determining solvency under the (state of domicile) Insurance Law. The commissioner of the state of domicile Insurance Department has the right to permit other practices that may deviate from prescribed practices. Prescribed SAP are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in (state of domicile). Permitted SAP encompass all accounting practices that are not prescribed; such practices differ from state to state, may differ from company to company within a state, and may change in the future.

*Note:* Although the following reconciliation to statutory financial information is not required to be disclosed in financial statements prepared in conformity with GAAP, insurance entities sometimes include such disclosures to facilitate use of those financial statements for purposes of filing with state regulatory authorities. The second disclosure on variances from NAIC SAP (as defined in the following paragraphs) and permitted accounting practices is required under FASB ASC 944-505-50.

The following reconciles ABC's statutory net income and statutory surplus and capital stock determined in accordance with accounting practices prescribed or permitted by the Insurance Department of Connecticut with net earnings (loss) and equity on a GAAP basis.

	<u>20X2</u>	<u>20X1</u>
	<i>(Amounts in thousands)</i>	
Statutory net income	\$3,572	\$2,719
Adjustments:		
Future policy benefits and policyholders' account balances	572	894
Deferred policy acquisition costs	60	40
Deferred federal income tax (expense) benefit	(1,405)	540
Valuation of investments	115	270
Postretirement benefits	272	354
Other, net	(932)	(3,088)
GAAP net income	<u>\$2,254</u>	<u>\$1,729</u>
Statutory surplus and capital stock	\$65,388	\$54,505
Adjustments:		
Asset valuation reserves	(1,054)	(1,972)
Statutory surplus, capital stock and asset valuation reserves	(875)	(967)
Fixed income securities	(29,472)	(27,905)
Future policy benefits and policyholders' account balances	115	270
Deferred federal income taxes	(1,412)	(1,027)
Valuation of investments	772	891
Deferred policy acquisition costs	38,936	36,429
Postretirement benefits	(2,272)	(2,354)
Other, net	(228)	1,084
GAAP equity	<u>\$69,898</u>	<u>\$58,954</u>

The Company's statutory financial statements are presented on the basis of accounting practices prescribed or permitted by the [state of domicile] Insurance Department. [State of domicile] has adopted the National Association of Insurance Commissioners' *Accounting Practices and Procedures Manual* as the basis of its statutory accounting practices (NAIC SAP), except that it has retained the prescribed practice of writing off goodwill immediately to statutory surplus in the year of acquisition.

In addition, the commissioner of [state of domicile] Insurance Department has the right to permit other specific practices that may deviate from prescribed practices. The commissioner has permitted the Company to record its home office property at estimated fair value instead of at depreciated cost, as required by NAIC SAP. This accounting practice increased statutory capital and surplus by \$X million and \$X million at December 31, 20X2 and 20X1, respectively, over what it would have been had the permitted practice not been allowed. The Company's statutory capital and surplus, including the effects of the permitted practice, was \$X million and \$X million at December 31, 20X2 and 20X1, respectively.

Had the Company amortized its goodwill over ten years and recorded its home office property at depreciated cost, in accordance with NAIC SAP, the

Company's capital and surplus would have been \$X million and \$X million at December 31, 20X2 and 20X1, respectively.

**14. Commitments and Contingencies**

Future minimum rental payments, principally for administrative offices, under noncancellable operating leases at December 31, 20X2, are: 20X3, \$1,113,000; 20X4, \$1,064,000; 20X5, \$1,011,000; 20X6, \$976,000; 20X7, \$976,000; and \$3,906,000 thereafter. Rental expense was \$1,164,000 in 20X2 and \$1,184,000 in 20X1.

ABC is named as defendant in a number of legal actions arising primarily from claims made under insurance contracts or in connection with previous reinsurance agreements. These actions have been considered in establishing its contract benefit liability. Management and its legal counsel are of the opinion that the settlement of these actions will not have a material effect on ABC's financial position or results of operations.

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## Appendix C

### *Life Insurance Entity Specific Disclosures*

The disclosures in this appendix are life insurance specific disclosures. General disclosure requirements are not included in this appendix.

#### **Generally Accepted Accounting Principles Disclosures in Financial Statements**

##### **Investments<sup>\*</sup>**

**C.1** Carrying amounts of investment securities on deposit with regulatory authorities should be disclosed.

**C.2** The disclosure requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 320, *Investments—Debt and Equity Securities*, require that for securities classified as available-for-sale, all reporting enterprises should disclose the aggregate fair value, the total gains for securities with net gains in accumulated comprehensive income, and the total losses for securities with net losses in accumulated other comprehensive income, and information about the contractual maturities of those securities as of the most recent statement of financial position presented by major security type as of each date for which a statement of financial position is presented. For securities classified as held-to-maturity, all reporting enterprises should disclose the aggregate fair value, gross unrecognized holding gains, gross unrecognized holding losses, the net carrying amount, the gross gains and losses in accumulated other comprehensive income for any derivatives that hedged the forecasted acquisition of the held-to-maturity securities, and information about the contractual maturities of those securities as of the most recent statement of financial position presented by major security type as of each date for which a statement of financial position is presented.

**C.3** The following major security types should be included in this disclosure, though additional types also may be included as appropriate:

- a. Equity securities
- b. Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies

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<sup>\*</sup> In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. According to FASB, the objective of this ASU is to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards by changing the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and disclosing information about fair value measurements. The amendments include those that clarify FASB's intent about the application of existing fair value measurement and disclosure requirements and those that change a particular principle or requirement for measuring fair value or disclosing information about fair value measurements. This ASU, which is to be applied prospectively, is effective during interim and annual periods beginning after December 15, 2011. Early application, which is not permitted for public entities, is permitted for nonpublic entities, but no earlier than for interim periods beginning after December 15, 2011.

- c. Debt securities issued by states of the United States and political subdivisions of the states
- d. Debt securities issued by foreign governments
- e. Corporate debt securities
- f. Mortgage backed securities
- g. Other debt securities

**C.4** The disclosure requirements of FASB ASC 320-10-50 require that for all investments in an unrealized loss<sup>1</sup> position, including those that fall within the scope of FASB ASC 325, *Investments—Other*, for which other-than-temporary impairments have not been recognized, an investor should disclose the following in its annual financial statements:

- a. As noted in FASB ASC 320-10-50-6, as of each date for which a statement of financial position is presented, quantitative information, aggregated by category of investment—each category of investment that the investor discloses in accordance with FASB ASC 320 and cost method investments—in tabular form:
  - i. The aggregate related fair value of investments with unrealized losses.
  - ii. The aggregate amount of unrealized losses (that is, the amount by which cost exceeds fair value).
- b. As of the date of the most recent statement of financial position, additional information (in narrative form) that provides sufficient information to allow financial statement users to understand the quantitative disclosures and the information that the investor considered (both positive and negative) in reaching the conclusion that the impairment(s) are not other than temporary. (The application of step 2 in FASB ASC 320-10-35-30 should provide insight into the investor's rationale for concluding that unrealized losses are not other-than-temporary impairments. The disclosures required may be aggregated by investment categories, but individually significant unrealized losses generally should not be aggregated.) This disclosure could include all of the following:
  - i. The nature of the investment(s);
  - ii. The cause(s) of the impairment(s);
  - iii. The number of investment positions that are in an unrealized loss position;
  - iv. The severity and duration of the impairment(s); and
  - v. Other evidence considered by the investor in reaching its conclusion that the investment is not other-than-temporarily impaired, including, for example, industry analyst reports, sector credit ratings, volatility of the security's fair value, or any other information that the investor considers relevant.

As discussed in FASB ASC 320-10-50-7, the disclosures in 1(a)–2(a) in FASB ASC 320-10-50-6, should be segregated by those investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer.

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<sup>1</sup> An unrealized loss is the amount by which the cost of an investment exceeds its fair value.

As discussed in FASB ASC 320-10-50-8, the reference point for determining how long an investment has been in a continuous unrealized loss position is the balance sheet date of the reporting period in which the impairment is identified. For entities that do not prepare interim financial information, the reference point is the annual balance sheet date of the period during which the impairment was identified. The continuous unrealized loss position ceases upon either of the following:

- a. The recognition of an other-than-temporary impairment
- b. The investor becoming aware of a recovery of fair value up to (or beyond) the cost of the investment during the period

**C.5** As noted in FASB ASC 325-20-50-1, for cost method investments, an investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

- a. The aggregate carrying amount of all cost method investments
- b. The aggregate carrying amount of cost method investments that the investor did not evaluate for impairment
- c. The fact that the fair value of a cost-method investment is not estimated if no identified events or changes in circumstances may have a significant adverse effect on the fair value of the investment, and either of the following:
  - i. That the investor determined, in accordance with paragraphs 16–19 of FASB ASC 825-10-50, that it is not practicable to estimate the fair value of the investment
  - ii. That the investor is exempt from estimating fair value under FASB ASC 825-10

## Separate Accounts

**C.6** FASB ASC 944-80-50-1, requires insurance entities to disclose the following related to separate accounts:

- a. The general nature of the contracts reported in separate accounts, including the extent and terms of minimum guarantees
- b. The basis of presentation for both of the following:
  - i. Separate account assets and liabilities
  - ii. Related separate account activity
- c. A description of the liability valuation methods and assumptions used in estimating the liabilities for additional insurance benefits and minimum guarantees
- d. All of the following amounts related to minimum guarantees:
  - i. The separate account liability balances subject to various types of benefits, for example:
    - (1) Guaranteed minimum death benefit
    - (2) Guaranteed minimum income benefit
    - (3) Guaranteed minimum accumulation benefit
  - ii. Disclosures within the categories of benefits identified in (d)(i) for the types of guarantees provided may also be appropriate, for example, all of the following:

## Life and Health Insurance Entities

- (1) Return of net deposit
  - (2) Return of net deposits accrued at a stated rate
  - (3) Return of highest anniversary value
- iii. The amount of liability reported for additional insurance benefits, annuitization benefits and other minimum guarantees, by type of benefit, for the most recent balance sheet date
- iv. The incurred and paid amounts related to (d)(iii) for all periods presented
- v. For contracts for which an additional liability is disclosed in (d)(iii), the net amount at risk and weighted average attained age of contract holders
- e. The aggregate fair value of assets, by major investment asset category, supporting separate accounts with additional insurance benefits and minimum investment return guarantees as of each date for which a statement of financial position is presented
- f. The amount of gains and losses recognized on assets transferred to separate accounts for the periods presented

## Financial Instruments, Derivative Instruments, and Hedging Activities

**C.7** The disclosure requirements of FASB ASC 825, *Financial Instruments*, should be considered.

## Deferred Acquisition Costs

**C.8** As discussed in FASB ASC 944-30-50-1, insurance entities should disclose all of the following in their financial statements:

- a. The nature of acquisition costs capitalized
- b. The method of amortizing capitalized acquisition costs
- c. The amount of acquisition costs amortized for the period

**C.9** As noted in FASB ASC 944-30-50-4, the notes to financial statements should describe the accounting policy applied to internal replacements, including whether or not the entity has availed itself of the alternative application guidance outlined in paragraphs 44–45 of FASB ASC 944-30-35 and, if so, for which types of internal replacement transactions.

## Sales Inducements to Contract Holders

**C.10** As discussed in FASB ASC 944-30-50-3, an insurance entity should disclose all of the following:

- a. The entity's accounting policy for sales inducements, including both of the following:
  - i. The nature of the costs deferred
  - ii. The method of amortizing those deferred costs
- b. The amount of costs deferred and amortized for each of the periods presented
- c. The unamortized balance of deferred costs as of each balance sheet date



## **Liabilities for Unpaid Claims and Claim Adjustment Expenses for Accident and Health Insurance**

**C.11** As discussed in FASB ASC 944-40-50-1, insurance entities should disclose in their financial statements the basis for estimating the liabilities for unpaid claims and claim adjustment expenses.

**C.12** As noted in FASB ASC 944-40-50-3, for each fiscal year for which an income statement is presented, all of the following information about the liability for unpaid claims and claim adjustment expenses should be disclosed:

- 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
- d. The reasons for the change in incurred claims and claim adjustment expenses recognized in the income statement 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

**C.13** As noted in FASB ASC 944-40-50-4, insurance entities 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 any of the following:

- a. Claims for toxic waste cleanup
- b. Asbestos-related illnesses
- c. Other environmental remediation exposures

**C.14** Also, as noted in FASB ASC 944-40-50-5, insurance entities should disclose both of the following in their financial statements:

- a. The carrying amount of liabilities for unpaid claims and claim adjustment expenses relating to short-duration contracts that are presented at present value in the financial statements
- b. The range of interest rates used to discount the liabilities disclosed in (a)

## **Liabilities for Future Policy Benefits**

**C.15** As discussed in FASB ASC 944-40-50-6, insurance entities should disclose in their financial statements the methods and assumptions used in estimating the liability for future policy benefits, and as noted in FASB ASC 944-40-50-7, also are encouraged to disclose the average rate of assumed investment yields in effect for the current year.

**C.16** FASB ASC 944-80-50-1, requires insurance entities to disclose the following:

- a.* A description of the liability valuation methods and assumptions used in estimating the liabilities for additional insurance benefits and minimum guarantees
- b.* All of the following amounts related to minimum guarantees:
  - i.* Disclosures within the categories of benefits identified in (d)(i) for the types of guarantees provided may also be appropriate, for example, all of the following:
    - (1) Return of net deposit
    - (2) Return of net deposits accrued at a stated rate
    - (3) Return of highest anniversary value
  - ii.* The amount of liability reported for additional insurance benefits, annuitization benefits and other minimum guarantees, by type of benefit, for the most recent balance sheet date
  - iii.* The incurred and paid amounts related to (iii) for all periods presented
  - iv.* For contracts for which an additional liability is disclosed in (iii), the net amount at risk and weighted average attained age of contract holders

## Income Taxes

**C.17** Insurance entities should disclose the portions of retained earnings in excess of statutory unassigned surplus, upon which no income tax provisions have been made, and the reasons therefore.

## Surplus Notes

**C.18** In accordance with FASB ASC 944-470-25-1, insurance entities should account for surplus notes as debt in the financial statements of the issuer and comply with existing disclosure requirements for debt instruments.

**C.19** In accordance with FASB ASC 944-470-50-1, insurance entities should disclose the domiciliary state insurance commissioner's role and ability to approve or disapprove any interest or principal payments.

## Stockholders' Equity

**C.20** According to FASB ASC 944-505-50-1, insurance entities should disclose the following information in their financial statements relating to stockholders' equity, statutory capital and surplus, and the effects of SAP on the entity's ability to pay dividends to stockholders:

- a.* The amount of statutory capital and surplus
- b.* The amount of statutory capital and surplus necessary to satisfy regulatory requirements (based on the entity's current operations), if significant in relation to the entity's statutory capital and surplus
- c.* The nature of statutory restrictions on payment of dividends and the amount of retained earnings that is not available for the payment of dividends to stockholders

**C.21** As discussed in FASB ASC 944-505-50-2, the disclosure requirements beginning in the following paragraph apply to annual and complete sets of interim financial statements prepared in conformity with generally accepted

accounting principles. The disclosures in the following paragraph should be made if both of the following conditions are met:

- a. The use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had National Association of Insurance Commissioners' (NAIC's) statutory accounting practices been followed
- b. Either of the following conditions is met:
  - i. State-prescribed statutory accounting practices differ from the NAIC's statutory accounting practices
  - ii. Permitted state statutory accounting practices differ from either state-prescribed statutory accounting practices or the NAIC's statutory accounting practices

**C.22** As noted in FASB ASC 944-505-50-3, if the criteria in FASB ASC 944-505-50-2 are met, insurance entities should disclose both of the following at the date each financial statement is presented:

- a. A description of the prescribed or permitted statutory accounting practice
- b. The related monetary effect on statutory surplus of using an accounting practice that differs from either state-prescribed statutory accounting practices or the NAIC's statutory accounting practices

Refer to chapter 3, "Sources of Accounting Principles and Reporting Requirements," for examples of illustrative disclosures from FASB ASC 944, *Financial Services—Insurance*.

## Participating Policies

**C.23** As discussed in FASB ASC 944-30-50-2, the following should be disclosed in the financial statements with respect to long-duration participating life insurance contracts that meet the criteria in FASB ASC 944-20-15-3:

- a. The average rate of assumed investment yields used in estimating expected gross margins
- b. The nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period

**C.24** Also as discussed in FASB ASC 944-40-50-8, an insurance entity should disclose in the financial statements, with respect to long-duration participating life-insurance contracts that meet the criteria in FASB ASC 944-20-15-3, the methods and assumptions used in estimating the liability for future policy benefits.

**C.25** As noted in FASB ASC 944-50-50-1, insurance entities should disclose all of the following in their financial statements:

- a. The relative percentage of participating insurance
- b. The method of accounting for policyholder dividends
- c. The amount of dividends
- d. The amount of any additional income allocated to participating policyholders

## Reinsurance

**C.26** As discussed in paragraphs 3–4 of FASB ASC 944-20-50, all insurance entities should disclose the nature, purpose, and effect of ceded reinsurance transactions on the insurance entity's operations. Ceding entities also should disclose the fact that the insurer is not relieved of its primary obligation to the policyholder in a reinsurance transaction.

**C.27** According to FASB ASC 944-310-45-6, although amounts recoverable on unasserted claims should be reported as reinsurance receivables, separate presentation or disclosure of various types of receivables is not precluded.

**C.28** As discussed in FASB ASC 944-605-50-1, all insurance entities should disclose all of the following in their financial statements:

- a. For all reinsurance contracts, both of the following:
  - i. Methods used for income recognition on reinsurance contracts
  - ii. If not reported under FASB ASC 944-605-45-1 in the statement of earnings, as separate line items or parenthetically, the amounts of earned premiums ceded and recoveries recognized under reinsurance contracts
- b. For short-duration contracts, all of the following:
  - i. Premiums from direct business
  - ii. Reinsurance assumed
  - iii. Reinsurance ceded, on both a written and an earned basis
- c. For long-duration contracts, all of the following:
  - i. Premiums and amounts assessed against policyholders from direct business
  - ii. Reinsurance assumed and ceded
  - iii. Premiums and amounts earned
- d. For foreign reinsurance accounted for by the open year method, all of the following should be disclosed for each period for which an income statement is presented:
  - i. The amounts of premiums, claims, and expenses recognized as income on closing underwriting balances
  - ii. The additions to underwriting balances for the year for reported premiums, claims, and expenses
- e. The amounts of premiums, claims, and expenses in the underwriting account for each balance sheet presented

**C.29** As discussed in FASB ASC 944-605-50-2, appropriate disclosure of both of the following items is encouraged:

- a. The extent to which reinsurance contracts indemnify the ceding entity against loss or liability relating to insurance risk
- b. Indemnification policies as part of the required disclosure in the preceding paragraph about the nature and effect of reinsurance transactions

**C.30** Disclosure in the financial statements of an insurance entity's accounting policies under FASB ASC 250, *Accounting Changes and Error Corrections*, should include a description of the methods used to account for foreign reinsurance.

**C.31** As noted in FASB ASC 944-825-55-1, under the provisions of FASB ASC 825-10-50, a ceding entity should disclose concentrations of credit risk associated with both of the following:

- a. Reinsurance receivables
- b. Prepaid reinsurance premiums

**C.32** As discussed in paragraphs 2–3 of FASB ASC 944-825-55-2, even if a ceding entity does not have a significant concentration of credit risk with a single reinsurer, concentration of credit risk disclosures may be required under the provisions of FASB ASC 825-10-50. If a ceding entity is aware that reinsured risks have been retroceded to a diverse group of retrocessionaires, disclosures about concentrations of credit risk still should be made under FASB ASC 825-10-50 because the assuming entity's rights under the retrocessions generally are not available to the ceding entity to mitigate its credit risk. That is, the ceding entity's concentration of credit risk from the assuming entity is unchanged.

## **Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk**

**C.33** In accordance with paragraphs 1–2 of FASB ASC 340-30-50, the following should be disclosed about all insurance and reinsurance contracts that do not transfer insurance risk, except for long duration life and health insurance contracts:

- a. Entities should disclose a description of the contracts accounted for as deposits and the separate amounts of total deposit assets and total deposit liabilities reported in the statement of financial position.
- b. Insurance entities should disclose the following information regarding the changes in the recorded amount of the deposit arising from an insurance or reinsurance contract that transfers only significant underwriting risk:
  - i. The present values of initial expected recoveries that will be reimbursed under the insurance or reinsurance contracts that have been recorded as an adjustment to incurred losses.
  - ii. Any adjustment of amounts initially recognized for expected recoveries. The individual components of the adjustment (meaning, interest accrual, the present value of additional expected recoveries, and the present value of reductions in expected recoveries) should be disclosed separately.
  - iii. The amortization expense attributable to the expiration of coverage provided under the contract.

## Guaranty Fund and Other Insurance Related Assessments

**C.34** As discussed in FASB ASC 405-30-50-1, FASB ASC 275-10-50 and FASB ASC 450-20-55 address disclosures related to loss contingencies. That guidance is applicable to assessments covered by FASB ASC 405, *Liabilities*. Additionally, if amounts have been discounted, the entity should disclose in the financial statements the undiscounted amounts of the liability and any related asset for premium tax offsets or policy surcharges as well as the discount rate used. If amounts have not been discounted, the entity should disclose in the financial statements the amounts of the liability, any related asset for premium tax offsets or policy surcharges, the periods over which the assessments are expected to be paid, and the period over which the recorded premium tax offsets or policy surcharges are expected to be realized.

## SAP Disclosures in Financial Statements

**C.35** Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of AU section 623, *Special Reports* (AICPA, *Professional Standards*, AU sec. 9623 par. .60-.77), as revised for the NAIC codification, provides guidance on what kinds of informative disclosures are necessary for financial statements prepared on a statutory basis.<sup>2</sup>

**C.36** Refer to the NAIC *Accounting Practices and Procedures Manual* for statutory footnote disclosures that are required in audited statutory financial statements by the NAIC.

**Note:** Public life insurance entities should refer to Regulation S-X, Article 7, *Insurance Companies*, for disclosure requirements.

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<sup>2</sup> The second amendment to this interpretation occurred in January 2005, subsequent to the Public Company Accounting Oversight Board adoption of the AICPA standards as interim on April 16, 2003.

## Appendix D

# *International Financial Reporting Standards*

**Note:** The following content may include certain changes made since the original print version of the guide.

## Introduction

The following information provides a brief overview of the ongoing globalization of accounting standards, International Financial Reporting Standards (IFRSs) as a body of accounting literature, the status of convergence with IFRSs in the United States, and the related issues that accounting professionals need to consider today.

## Globalization of Accounting Standards

As the business world becomes more globally connected, regulators, investors, audit firms, and public and private companies of all sizes are expressing an increased interest in having common accounting standards among participants in capital markets and trading partners around the world. Proponents of convergence with, or adoption of, IFRSs for financial reporting in the United States believe that one set of financial reporting standards would improve the quality and comparability of investor information and promote fair, orderly, and efficient markets.

Many critics, however, believe that U.S. generally accepted accounting principles (GAAP) are the superior standards and question whether the use of IFRSs will result in more useful financial statements in the long term and whether the cost of implementing IFRSs will outweigh the benefits. Implementing IFRSs will require a staggering effort by management, auditors, and financial statement users, not to mention educators.

The increasing acceptance of IFRSs, both in the United States and around the world, means that now is the time to become knowledgeable about these changes. The discussion that follows explains the underpinnings of the international support for a common set of high quality global standards and many of the challenges and potential opportunities associated with such a fundamental shift in financial accounting and reporting.

The international standard setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations. However, as cross-border transactions and globalization increased, other nations began to take interest, and the global reach of IFRSs expanded. More than 100 nations and reporting jurisdictions permit or require IFRSs for domestic listed companies (and most have fully conformed to IFRSs as promulgated by the International Accounting Standards Board [IASB] and include a statement acknowledging such conformity in audit reports). Several countries are expected to transition to IFRSs by, or beginning

in, 2011, and many other countries have plans to converge (or eliminate significant differences between) their national standards and IFRSs.

For many years, the United States has been a strong leader in international efforts to develop globally accepted standards. Among other actions in support of IFRSs, the U.S. Securities and Exchange Commission (SEC) removed the requirement for foreign private issuers registered in the United States to reconcile their financial reports with U.S. GAAP if their accounts complied with IFRSs as issued by the IASB. In addition, the SEC continues to analyze and evaluate appropriate steps toward, and challenges related to, converging U.S. GAAP with IFRSs, as subsequently described.

In addition to the support received from certain U.S. based entities, financial and economic leaders from various organizations have announced their support for global accounting standards. Most notably, in 2009, the Group of Twenty Finance Ministers and Central Bank Governors (G20), a group from 20 of the world's systematically important industrialized and developing economies (with the 20th member being the European Union, collectively), called for standard setters to redouble their efforts to complete convergence in global accounting standards.

Acceptance of a single set of high quality accounting standards may present many significant opportunities, including the improvement in financial reporting to global investors, the facilitation of cross-border investments, and the integration of capital markets. Further, U.S. entities with international operations could realize significant cost savings from the use of a single set of financial reporting standards. For example, U.S. issuers raising capital outside the United States are required to comply with the domestic reporting standards of the foreign country and U.S. GAAP. As a result, additional costs arise from the duplication and translation of financial reporting information.

Many multinational companies support the use of common accounting standards to increase comparability of financial results among reporting entities from different countries. They believe common standards will help investors better understand the entities' business activities and financial position. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors. In addition, some believe that in a truly global economy, financial professionals, including CPAs, will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world.

Although certain cost reductions are expected, the initial cost of convergence with IFRSs is expected to be one of the largest obstacles for many entities, including accounting firms and educational institutions. Substantial internal costs for U.S. corporations in the areas of employee training, IT conversions, and general ledger software have been predicted. In addition, the time and effort required from various external functions, including the education of auditors, investors, lenders, and other financial statement users, will be significant factors for consideration.

Although the likelihood of acceptance of IFRSs may lack clarity for the time being, U.S. companies should consider preparing for the costly transition to new or converged standards, which likely will include higher costs in the areas of training and software compliance.



## Who is the IASB?

The IASB is the independent standard setting body of the IFRS Foundation, formerly, the International Accounting Standards Committee Foundation. As a private sector organization, the IFRS Foundation has no authority to impose funding regimes on countries. However, a levy system and national contributions through regulatory and standard-setting authorities or stock exchanges have been introduced in a number of countries to fund the organization. Although the AICPA was a founding member of the International Accounting Standards Committee (IASC), the IASB's predecessor organization, it is not affiliated with the IASB.

The IASB, founded on April 1, 2001, in London, England, is responsible for developing IFRSs and promoting the use and application of these standards. In pursuit of this objective, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

The structure includes the following primary groups: (a) the IFRS Foundation, an independent organization having two main bodies: the IFRS Foundation trustees and the IASB; (b) the IFRS Advisory Council; and (c) the IFRS Interpretations Committee, formerly the International Financial Reporting Interpretations Committee (IFRIC). The trustees appoint the IASB members, exercise oversight, and raise the funds needed, but the IASB itself has responsibility for establishing IFRSs.

The IASB board members are selected chiefly upon their professional competence and practical experience. The trustees are required to select members so that the IASB will comprise the best available combination of technical expertise and international business and market experience and to ensure that the IASB is not dominated by any particular geographical interest or constituency. The IASB has members from several different countries, including the United States. The members are responsible for the development and publication of IFRSs, including *International Financial Reporting Standard for Small- and Medium-sized Entities (IFRS for SMEs)*, and for approving the interpretations of IFRSs as developed by the IFRS Interpretations Committee.

The IFRS Interpretations Committee, founded in March 2002, is the successor of the previous interpretations committee, the Standing Interpretations Committee (SIC), and is the interpretative body of the IASB. The role of the IFRS Interpretations Committee is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRSs or issues in which interpretations are not sufficient.

IFRSs are developed through a formal system of due process and broad international consultation, similar to the development of U.S. GAAP.

Readers are encouraged to become involved in the standard-setting process by responding to open calls from the standard setting organizations.

## What Are IFRSs?

The term *IFRSs* has both a narrow and broad meaning. Narrowly, IFRSs refers to the numbered series of pronouncements issued by the IASB, collectively called *standards*. More broadly, however, IFRSs refer to the entire body of authoritative IASB literature, including the following:

- Standards, whether labeled IFRSs or International Accounting Standards (IASs)<sup>1</sup>
- Interpretations, whether labeled IFRIC (the former name of the interpretive body) or SIC (the predecessor to IFRIC)<sup>2</sup>

The preface to the IFRS 2010 *Bound Volume* states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities, including commercial, industrial, and financial entities, regardless of legal form or organization. IFRSs are not designed to apply to not-for-profit entities or those in the public sector,<sup>3</sup> but these entities may find IFRSs appropriate in accounting for their activities.

The IASB's *Framework for the Preparation and Presentation of Financial Statements* (IASB Framework) establishes the concepts that underlie the preparation and presentation of financial statements for external users. The IFRS Foundation is guided by the IASB Framework in the development of future standards and in its review of existing standards. The IASB Framework is not an IFRS, and when there is a conflict between the IASB Framework and any IFRS, the standard will prevail. The IASB Framework is an overall statement of guidance for those interpreting financial statements, whereas IFRSs are issue and subject specific.

When an IFRS specifically applies to a transaction, other event, or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS and considering any relevant implementation guidance issued by the IASB for the IFRS.

Further, if an IFRS does not address a specific transaction, event, or condition explicitly, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, states that management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. With respect to the reliability of financial statements, IAS 8 states that the financial statements (a) represent faithfully the financial position, financial performance, and cash flows of the entity; (b) reflect the economic substance of transactions, other events, and conditions; (c) are neutral; (d) are prudent; and (e) are complete in all material respects. When making this type of judgment, management should refer to, and consider the applicability of, the following in descending order:

- The requirements and guidance in IFRSs dealing with similar and related issues
- The definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the IASB Framework
- The most recent pronouncements of other standard setting bodies (for example, U.S. GAAP, other accounting literature, and accepted industry practices) to the extent that these do not conflict with IFRSs

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<sup>1</sup> See [www.iasb.org](http://www.iasb.org) for a current listing of International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

<sup>2</sup> See [www.iasb.org](http://www.iasb.org) for a current listing of International Financial Reporting Interpretations Committee and Standing Interpretations Committee interpretations.

<sup>3</sup> Generally speaking, *public* means government-owned entities, and *private* means nongovernment-owned entities.

## **IFRS for SMEs**

*IFRS for SMEs* is a modification and simplification of full IFRSs aimed at meeting the needs of private company financial reporting users and easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained, global accounting and financial reporting standard applicable to the general purpose financial statements of entities that, in many countries, are known as small- and medium-sized entities (SMEs). Full IFRSs and *IFRS for SMEs* are promulgated by the IASB.

*SMEs* are entities that publish general purpose financial statements for external users and do not have public accountability. An entity has public accountability under the IASB's definition if it files its financial statements with a securities commission or other regulatory organization or it holds assets in a fiduciary capacity (for example, banks, insurance companies, brokers and dealers in securities, pension funds, and mutual funds). It is not the IASB's intention to exclude entities that hold assets in a fiduciary capacity for reasons incidental to their primary business (for example, travel agents, schools, and utilities) from utilizing *IFRS for SMEs*.

The needs of users of SME financial statements often are different from the needs of users of public company financial statements and other entities that likely would use full IFRSs. Whereas full IFRSs were designed specifically to meet the needs of equity investors in the public capital markets, *IFRS for SMEs* was developed with the needs of a wide range of users in mind. Users of the financial statements of SMEs may be more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage, and solvency issues. Full IFRSs may impose a burden on SME preparers in that full IFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as IFRSs have become more detailed. As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective.

Practically speaking, *IFRS for SMEs* is viewed as an accounting framework for entities that do not have the capacity or resources to use full IFRSs. In the United States, the term SME would encompass many private companies.

In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles and amended appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01). This amendment gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. Accordingly, IFRSs are not considered to be an other comprehensive basis of accounting. Rather, they are a source of GAAP.

As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs*, has been removed. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs* and a private company's expenditure of money, time, and effort to convert to *IFRS for SMEs*.<sup>4</sup>

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<sup>4</sup> CPAs are encouraged to consult their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *International Financial Reporting Standard for Small- and Medium-sized Entities* within their individual state.

The AICPA has developed a resource that compares *IFRS for SMEs* with corresponding requirements of U.S. GAAP. This resource is available in a Wiki format, which allows AICPA members and others to contribute to its development. To learn more about the resource, view available sections, and contribute to its content, visit the Wiki at <http://wiki.ifrs.com/>.

## The Financial Accounting Standards Board and IASB Convergence Efforts<sup>5</sup>

To address significant differences between IFRSs and U.S. GAAP, the Financial Accounting Standards Board (FASB) and the IASB agreed to a "Memorandum of Understanding" (MoU), which was originally issued in 2006 and subsequently updated. Readers are encouraged to monitor the FASB and IASB websites for additional developments regarding the convergence efforts, such as discussion papers, exposure drafts, and requests for comments.

## Comparison of U.S. GAAP and IFRSs

One of the major differences between U.S. GAAP and IFRSs lies in the conceptual approach: U.S. GAAP is based on principles, with heavy use of rules to illustrate the principles; however, IFRSs are principles based, without heavy use of rules.

In general, a principles-based set of accounting standards, such as IFRSs, is broad in scope. The standards are concise, written in plain language, and provide for limited exceptions and bright lines. Principles-based standards typically require a higher level of professional judgment, which may facilitate an enhanced focus on the economic purpose of a company's transactions and how the transactions are reflected in its financial reporting.

A noticeable result of these differences is that IFRSs provide much less overall detail. In developing an IFRS, the IASB expects preparers to rely on core principles and limited application guidance with fewer prescriptive rules. In contrast, FASB often leans more toward providing extensive prescriptive guidance and detailed rules. The guidance provided in IFRSs regarding revenue recognition, for example, is significantly less extensive than U.S. GAAP. IFRSs also contain relatively little industry-specific guidance.

An inherent issue in a principles-based system is the potential for different interpretations of similar transactions across jurisdictions and entities, which may affect the relative comparability of financial reporting.

Because of long-standing convergence projects between the IASB and FASB, the extent of the specific differences between IFRSs and U.S. GAAP is decreasing. Yet, significant differences remain, which could result in significantly different reported results, depending on a company's industry and individual facts and circumstances. For example, some differences include the following:

- IFRSs do not permit last in, first out (LIFO) inventory accounting.
- IFRSs allow for the revaluation of assets in certain circumstances.

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<sup>5</sup> Because the convergence projects discussed are active and subject to change, updates will be posted periodically to [www.journalofaccountancy.com](http://www.journalofaccountancy.com). Readers also are encouraged to monitor the progress of these projects at the respective boards' websites: [www.iasb.org](http://www.iasb.org) and [www.fasb.org](http://www.fasb.org).

- IFRSs use a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRSs have a different probability threshold and measurement objective for contingencies.
- IFRSs generally do not allow net presentation for derivatives.

U.S. GAAP also addresses some specific transactions not currently addressed in IFRSs, such as accounting for reorganizations, including quasi reorganizations; troubled debt restructuring; spin-offs; and reverse spin-offs. In addition, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The difference in the amount of industry-specific guidance also illustrates the different approaches. Currently, IFRSs include only several standards (for example, IAS 41, *Agriculture*)<sup>6</sup> that might be regarded as primarily industry-specific guidance. However, the scope of these standards includes all entities to which the scope of IFRSs applies. In contrast, U.S. GAAP has considerable guidance for entities within specific industries. For example, on liability recognition and measurement alone, U.S. GAAP contains specific guidance for entities in the following industries, which is not found in IFRSs:

- Health care
- Contractors and construction
- Contractors and the federal government
- Entertainment, with separate guidance for casinos, films, and music
- Financial services, with separate guidance for brokers and dealers and depository and lending, insurance, and investment companies

For nonmonetary transactions, U.S. GAAP provides specific guidance for the airline, software, and entertainment industries.

## SEC Work Plan

The SEC continues to affirm its support for a single set of high-quality, globally accepted accounting standards and for the convergence of U.S. GAAP and IFRSs. In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to Release No. 33-8982, *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*. The February 2010 release provides a confirmation of the SEC's continued support for convergence, highlights positive aspects of narrowing the differences between the two sets of standards, and outlines additional considerations required before adoption of a single standard is achieved.

The release also states that a more comprehensive work plan is necessary to lay out the work required to support a decision on the appropriate course to

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<sup>6</sup> In addition to IAS 41, *Agriculture*, the other IFRSs that address issues specific to certain industries are IFRS 4, *Insurance Contracts*, and IFRS 6, *Exploration for and Evaluation of Mineral Resources*.

incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, timeframe, and methodology for any such transition. The SEC has indicated that it will carefully consider and deliberate whether a potential transition is in the best interest of U.S. investors and markets.

During 2011, assuming completion of the convergence projects and the SEC staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. The work plan is included as an appendix at the end of the SEC's release, which is located on the SEC's website at [www.sec.gov](http://www.sec.gov).

AICPA

On February 24, 2010, president and CEO of the AICPA Barry Melancon issued a statement on the SEC's plan to work toward the incorporation of IFRSs in the U.S. financial reporting system. The statement noted that the AICPA supports the thoughtful and concrete steps the SEC is taking, as outlined in its plan, to prepare for the transition. The AICPA understands that it will need to fulfill a number of responsibilities to make the use of IFRSs in the United States a success. Ongoing efforts include the following:

- Continuing to educate AICPA members about IFRSs
- Working with accounting educators, textbook authors, and educational institutions to prepare future professionals to use IFRSs
- Making certain the voice of U.S. CPAs is heard internationally
- Incorporating questions about IFRSs into the Uniform CPA Exam

The AICPA believes that it is critical for the SEC to set a specific date for the use of IFRSs in the United States and encourages the SEC, as it completes this work plan in 2011, to ensure investor confidence is maintained and key milestones lead successfully to global standards in 2015. In moving forward, it is essential that all stakeholders—regulators, investors, auditors, educators, financial statement users, and preparers—have the knowledge and tools they need to successfully navigate any change in U.S. accounting rules. The AICPA is doing its part now to prepare these stakeholders for this fundamental shift in financial reporting.

Additional Resources

Website	URL
AICPA	<a href="http://www.aicpa.org">www.aicpa.org</a>
AICPA International Financial Reporting Standards Resources	<a href="http://www.ifrs.com">www.ifrs.com</a>
International Accounting Standards Board	<a href="http://www.iasb.org">www.iasb.org</a>
Comparison Wiki of <i>International Financial Reporting Standard for Small- and Medium-sized Entities</i> and U.S. generally accepted accounting principles	<a href="http://wiki.ifrs.com">http://wiki.ifrs.com</a>
Financial Accounting Standards Board	<a href="http://www.fasb.org">www.fasb.org</a>

## Appendix E

### ***Schedule of Changes Made to the Text From the Previous Edition***

**As of May 1, 2011**

This schedule of changes identifies areas in the text and footnotes of this guide that have changed since the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

<u>Reference</u>	<u>Change</u>
Preface	Updated.
Paragraphs 1.05, 1.08, and 1.41	Updated.
Footnote * in chapters 1, 7–10, 12, and 14	Updated for current status of the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) Insurance Contracts Project.
Paragraph 2.02	Revised for clarification.
Paragraph 2.39	Updated.
Paragraph 3.20	Revised for National Association of Insurance Commissioners (NAIC) Revised Model Audit Rule.
Former footnote 5 in paragraph 3.20	Deleted, no longer applicable.
Paragraphs 3.31–.67	Revised to incorporate FASB <i>Accounting Standards Codification</i> (ASC) 820, <i>Fair Value Measurement</i> , and FASB ASC 825, <i>Financial Instruments</i> .
Table 3-1	Revised to reflect the exposure of proposed Statement of Statutory Accounting Principles (SSAP) No. 101, <i>Income Taxes, A Replacement of SSAP No. 10R and SSAP No. 10</i> ; status of joint FASB and IASB lease project; and revisions to SSAP No. 43R, <i>Loan-backed and Structured Securities</i> , and SSAP No. 91R, <i>Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities</i> .
Paragraph 4.02	Revised for clarification.
Paragraph 4.07	Revised for clarification.

(continued)

<u>Reference</u>	<u>Change</u>
Former footnote 11 in paragraph 5.84 and former footnote    in paragraph 5.112	Deleted, no longer applicable.
Footnote 28 in heading before paragraph 5.137	Added to reflect Section 14(F) of the NAIC Revised Model Audit Rule.
Paragraphs 8.32 and 8.60	Revised for clarification.
Paragraph 8.117	Revised for current environment.
Footnote † in heading before paragraph 10.12 and in paragraph 10.17	Revised to address FASB Accounting Standards Update (ASU) No. 2010-26, <i>Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)</i> .
Footnote * in heading before paragraph 11.08	Revised to update the status of the FASB and IASB Insurance Contracts Project.
Paragraphs 11.14–.15	Revised for SSAP No. 26, <i>Bonds, excluding Loan-backed and Structured Securities</i> .
Footnote    in paragraph 11.19 and paragraphs 11.20–.21	Revised for revisions to SSAP No. 43R.
Footnote ** in paragraph 11.28 and paragraph 11.28	Revised for revisions to SSAP No. 91R.
Footnote †† in paragraph 11.35	Added to reflect proposed FASB ASU <i>Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements</i> .
Former footnote    in paragraph 11.56	Deleted, no longer applicable.
Footnote      in heading before paragraph 11.100	Added to reflect issuance of FASB ASU No. 2011-02, <i>Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring</i> .
Footnote * in paragraph 13.25	Revised for the issuance of proposed SSAP No. 101.
Former footnote 2 in paragraph 13.29	Deleted, no longer applicable.
Paragraphs 14.07–.08 and footnote †	Revised for FASB ASU No. 2010-20, <i>Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses</i> .



<u>Reference</u>	<u>Change</u>
Paragraph 14.34	Revised to reflect the issuance of FASB ASU No. 2010-15, <i>Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force</i> .
Paragraph 14.52	Revised to reflect the issuance of SSAP No. 35R, <i>Guaranty Fund and Other Assets</i> .
Paragraphs 14.75–.77	Added to reflect FASB ASC 460, <i>Guarantees</i> , and SSAP No. 5R, <i>Liabilities, Contingencies and Impairments of Assets</i> .
Paragraph 15.19	Revised for clarification.
Former footnote 6 in heading before paragraph 15.26	Deleted, no longer applicable.
Appendix A	Revised for clarification.
Appendix B	Revised for clarification.
Appendix D	Updated.
Index	Updated.



## Glossary

The following terms can be found in the Financial Accounting Standards Board *Accounting Standards Codification* glossary:

**accumulation phase.** The period during an annuity contract before annuitization. An insurance entity may call an annuity having an accumulation phase a deferred annuity.

**acquisition cost.** Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts.

**annual policyholder dividends.** Amount of dividends to policyholders calculated and paid each year, representing the policyholders' share of divisible surplus.

**annuity contract.** A contract in which an insurance entity unconditionally undertakes a legal obligation to provide specified pension benefits to specific individuals in return for a fixed consideration or premium. An annuity contract is irrevocable and involves the transfer of significant risk from the employer to the insurance entity.

**assuming entity.** The party that receives a reinsurance premium in a reinsurance transaction. The assuming entity (or reinsurer) accepts an obligation to reimburse a ceding entity under the terms of the reinsurance contract.

**assumption.** The substitution of one debtor for another, whereby the second debtor agrees to assume the debt obligation of the original debtor.

**base contract.** The type of contract specified in the policy form before the addition or election of riders or other contract features. For example, for an annuity with a guaranteed minimum income benefit rider, the annuity would be considered the base contract.

**captive insurance entity.** An insurance entity that does business primarily with related entities (further industry-specific information provided in the following list of terms).

**cash surrender value.** The amount of cash that may be realized by the owner of a life insurance contract or annuity contract upon discontinuance and surrender of the contract before its maturity. The cash surrender value may be different from the policy account balance due to outstanding loans (including accrued interest) and surrender charges.

**ceding entity.** The party that pays a reinsurance premium in a reinsurance transaction. The ceding entity receives the right to reimbursement from the assuming entity under the terms of the reinsurance contract.

**claim.** A demand for payment of a policy benefit because of the occurrence of an insured event.

**claim adjustment expenses.** Expenses incurred in the course of investigating and settling claims.

**contract exchange.** The legal extinguishment of one contract and the issuance of another.

**contract period.** The period over which insured events that occur are covered by the reinsured contract. Commonly referred to as the coverage period or the period that contracts are in force.

**cost recovery method.** A revenue recognition method under which premiums are recognized as revenue in an amount equal to estimated claim costs as insured events occur until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

**credit life insurance.** Life insurance, generally in the form of decreasing term insurance, that is issued on the lives of borrowers to cover the payment of outstanding loan balances in case of death.

**defined benefit plan.** A defined benefit plan provides participants with a determinable benefit based on a formula provided for in the plan.

**defined contribution plan.** A plan that provides an individual account for each participant and provides benefits that are based on all of the following:

- a. Amounts contributed to the participant's account by the employer or employee
- b. Investment experience
- c. Any forfeitures allocated to the account, less any administrative expenses charged to the plan

**deposit method.** A revenue recognition method under which premiums are not recognized as revenue and claim costs are not charged to expense until the ultimate premium is reasonably estimable, and recognition of income is postponed until that time.

**dividends to policyholders.** Nonguaranteed amounts distributable to policyholders of participating life insurance contracts and based on actual performance of the insurance entity as determined by the insurer. Under the various state insurance laws, dividends must be apportioned to contract holders on an equitable basis. The dividend allotted to any contract often is based on the amount that the contract, as one of a class of similar contracts, has contributed to the earnings available for distribution as dividends. Dividends include annual policyholder dividends and termination dividends.

**endowment contract.** An insurance contract that provides insurance from inception of the contract to the maturity date (endowment period). The contract specifies that a stated amount, adjusted for items such as policy loans and dividends, if any, will be paid to the beneficiary if the insured dies before the maturity date. If the insured is still living at the maturity date, the policyholder will receive the maturity amount under the contract after adjustments, if any. Endowment contracts generally mature at a specified age of the insured or at the end of a specified period.

**fraternal benefit societies.** An entity that provides life or health insurance to its members and their beneficiaries. Policyholders normally participate in the earnings of the society, and insurance contracts stipulate that the society has the power to assess its members if the funds available for future policy benefits are not sufficient to provide for benefits and expenses.

**fronting arrangements.** Reinsurance arrangements in which the ceding entity issues a policy and reinsures all or substantially all of the insurance risk with the assuming entity.

**general account.** An undivided fund maintained by an insurance entity that commingles plan assets with other assets of the insurance entity for investment purposes. That is, funds held by an insurance entity that are not maintained in a separate account are in its general account.

**gross premium.** The premium charged to a policyholder for an insurance contract. Also, refer to net premium.

**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.

**guaranteed investment option.** Component of a variable contract that guarantees a specific rate of performance.

**guaranteed minimum accumulation benefit.** A minimum accumulation benefit or a guaranteed account value floor that is available to a deferred annuity contract holder in cash.

**guaranteed minimum income benefit.** A guarantee, that regardless of the separate account performance, the contract holder will be able to annuitize after a specified date and receive a defined periodic minimum benefit. These benefits are available only if the contract holder elects to annuitize.

**guaranteed minimum withdrawal benefit.** A benefit that provides a contract holder a guarantee that a minimum amount (usually stated as a percentage of premiums) will be available for withdrawal over a specific period. Regardless of the contract value, the contract holder is guaranteed the right to periodic withdrawals from the contract until the amount of premiums deposited into the contract is withdrawn.

**incurred but not reported 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.

**insurance risk.** The risk arising from uncertainties about both underwriting risk and timing risk. Actual or imputed investment returns are not an element of insurance risk. Insurance risk is fortuitous; the possibility of adverse events occurring is outside the control of the insured.

**integrated contract feature.** A contract feature in which the benefits provided by the feature can be determined only in conjunction with the base contract.

**internal replacement.** A modification in product benefits, features, rights, or coverages that occurs by a contract exchange; by amendment; endorsement; or rider to a contract; or by the election of a benefit, feature, right, or coverage within the contract.

**lapse rate.** The rate at which insurance contracts terminate through the failure of the insureds to continue required premium payments. The lapse rate may also be considered a rate of *nonpersistence*. It is usually expressed as a ratio of the number of contracts on which the insureds failed to make

premium payments during a given period to the total number of contracts at the beginning of the period from which those lapses occurred.

**liability for claim adjustment expenses.** The amount needed to provide for the estimated ultimate cost required to investigate and settle claims 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 future policy benefits.** An accrued obligation to policyholders that relates to insured events, such as death or disability.

**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).

**life insurance entity.** An entity that can issue annuity, endowment, and accident and health insurance contracts as well as life insurance contracts. Life insurance entities may be either stock or mutual organizations.

**limited-pay contract.** Long duration insurance contract with terms that are fixed and guaranteed, and for which premiums are paid over a period shorter than the period over which benefits are provided. Limited-pay contracts subject the insurer to risks arising from policyholders mortality and morbidity over a period that extends beyond the period or periods in which premiums are collected.

**long term care benefit.** A feature of a deferred annuity in which, if during the accumulation phase, the contract holder has an insurable event (for example, disability, loss of activities of daily living) that meets the criteria specified in the contract, additional benefits in excess of the account balance will be paid.

**maintenance costs.** Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

**market value annuity.** A contract that provides for a return of principal plus a fixed rate of return if held to maturity, or alternatively, a market-adjusted value if the surrender option is exercised by the contract holder before maturity. The market-adjusted value is typically based on current interest crediting rates being offered for new market value annuity purchases.

**minimum guaranteed death benefit.** A feature in an annuity, life insurance, or similar contracts that provides that in the event of an insured's death, the beneficiary (or insurer in the case of a reinsurance contract) will receive the higher of the current account balance of the contract or another amount defined in the contract.

**morbidity.** The relative incidence of disability resulting from disease or physical impairment.

**mortality.** The relative incidence of death in a given time or place.

**net amount at risk.** The guaranteed benefit in excess of the current account balance. For guarantees in the event of death, the net amount at risk is the minimum guaranteed amount available to the contract holder upon death in excess of the contract holder's account balance at the balance sheet date. For guarantees of amounts at annuitization, the net amount at

risk is defined as the present value of the minimum guaranteed annuity payments available to the contract holder determined in accordance with the terms of the contract in excess of the current account balance.

**net level premium reserve.** The excess, if any, of the present value of future guaranteed death and endowment benefits over the present value of future net premiums.

**nonintegrated contract feature.** A contract feature in which the benefits provided are not related or dependent on the provisions of the base contract.

**nonparticipating insurance.** Insurance contracts that are not entitled to dividends. Usually issued by a stock life insurance entity at premium rates that are usually lower than those charged where dividends are payable. Mutual entities may issue nonparticipating contracts.

**original contract.** The contract that was initially entered into by the contract holder prior to any potential internal replacement activity.

**participating insurance.** Insurance in which the contract holder is entitled to participate in the earnings or surplus of the insurance entity. The participation occurs through the distribution of dividends to policyholders.

**persistency.** The compliment of the termination rate, persistency is the renewal quality of insurance contracts, that is, the number of insureds that keep their insurance in force during a period. Persistency varies by plan of insurance, age at issue, year of issue, frequency of premium payment and other factors.

**prospective reinsurance.** Reinsurance in which an assuming entity agrees to reimburse a ceding entity for losses that may be incurred as a result of future insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

**ratchet death benefit.** A death benefit equal to the highest account balance among prior specified anniversary dates adjusted for deposits less partial withdrawals since the specified anniversary date.

**reinsurance.** A transaction in which a reinsurer (assuming entity), for a consideration (premium), assumes all or part of a risk undertaken originally by another insurer (ceding entity). For indemnity reinsurance, the legal rights of the insured are not affected by the reinsurance transaction and the insurance entity issuing the insurance contract remains liable to the insured for payment of policy benefits. Assumption or novation reinsurance contracts that are legal replacements of one insurer by another extinguish the ceding entity's liability to the policyholder.

**reinsurance receivables.** All amounts recoverable from reinsurers for paid and unpaid claims and claim settlement expenses, including estimated amounts receivable for unsettled claims, claims incurred but not reported, or policy benefits. (For the purpose of this guide, reinsurance receivables and recoverable are used interchangeably and include reinsurance receivables on paid losses and reinsurance recoverables on unpaid losses.)

**retroactive reinsurance.** Reinsurance in which an assuming entity agrees to reimburse a ceding entity for liabilities incurred as a result of past

insurable events covered under contracts subject to the reinsurance. A reinsurance contract may include both prospective and retroactive reinsurance provisions.

**retrocession.** The circumstance in which a reinsurer, in turn, enters into reinsurance contracts with other reinsurers.

**retrospective deposit method.** Accounting methods that measure the liability for policy benefits based on policyholder balances.

**return of premium death benefits.** A death benefit equal to the total deposits made by the contract holder less any withdrawals.

**risk of adverse deviation.** A concept used by life insurance entities in estimating the liability for future contract 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 casualty insurance entities.

**roll up death benefit.** A death benefit equal to the total of deposits made to the contract less an adjustment for partial withdrawals, accumulated at a specified interest rate.

**sales inducements.** Contractually obligated inducements that are identified explicitly in a contract and are in excess of current market conditions. A sales inducement to a contract holder enhances the investment yield to a contract holder. The three main types of sales inducements are immediate bonus; a persistency bonus, and an enhanced yield bonus.

**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.

**seed money.** An investment of noncontract holder funds by an insurer in a separate account when it is established, to support the initial or on-going operations of the separate account.

**separate account.** A separate investment account established and maintained by an insurance entity under relevant state insurance law to which funds have been allocated for certain contracts of the insurance enterprise or similar accounts used for foreign originated products. The term separate account includes separate accounts and subaccounts or investment divisions of separate accounts.

**separate account arrangement.** An arrangement under which all or a portion of a contract holder's funds is allocated to a specific separate account maintained by the insurance enterprise.

**statutory accounting practices (SAP).** Accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance entity is required to follow when submitting its financial statements to state insurance departments.

**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 that have been paid by the insurer.



**surrender charge.** Amounts expected to be assessed against policyholder balances at contract redemption, whole or partial, regardless of how the charges are labeled, such as contingent deferred sales charges.

**term life insurance.** Insurance that provides a benefit only if the insured dies within the period of time specified in the contract. The insurance is for level or declining amounts for stated periods such as 1, 5, or 10 years or to a stated age. Term life insurance generally has no loan or cash value.

**termination.** In general, the failure to renew an insurance contract. Involuntary terminations include death, expirations, and maturities of contracts. Voluntary terminations of life insurance contracts include lapses with or without cash surrender value and contract modifications that reduce paid-up whole life benefits or term life benefits.

**traditional variable annuity.** An insurance product in which all the contract holder's payments are used to purchase units of a separate account.

**variable annuity contract.** An annuity in which the amounts of payments to be made in units, rather than in dollars. When payment is due, the amount is determined based on the value of the investments in the annuity fund.

**whole life contract.** Insurance that may be kept in force for a person's entire life by paying one or more premiums. It is paid for in one of three different ways: (a) ordinary life insurance (premiums are payable as long as the insured lives), (b) limited payment life insurance (premiums are payable over a specified number of years), and (c) single premium life insurance (a lump-sum amount paid at the inception of the insurance contract). The insurance contract pays a benefit (contractual amount adjusted for items such as policy loans and dividends, if any) at the death of the insured. Whole life insurance contracts also build up nonforfeiture benefits.

The following is a list of additional terms that have been used in this guide:

**accidental death benefit.** The benefit in addition to the death benefit that is paid on a life insurance contract if the death resulted from an accident. It is often referred to as double indemnity (pays twice the face value of the contract). Time and age limits usually apply; for example, the insured must die within 90 days of the accident and be under age 60.

**accumulation period.** The time frame during which an annuitant makes premium payments or deposits to the life insurance entity.

**actuary.** An expert who is professionally trained in the evaluation of risk and the science of mathematical probabilities. For life and health insurance entities, membership in the American Academy of Actuaries and compliance with the qualifications of the Actuarial Standards Board is evidence of professional qualification.

**adjustable life insurance.** A life insurance contract that allows the contract holder to change the plan of insurance, raise or lower the premium or face amount of the contract, and change the schedule of the premium payments or protection period.

**advance premiums.** The premiums collected in advance of the premium due dates.

**adverse selection.** See **antiselection**.

**age at issue.** See **issue age**.

**agent (insurance).** A representative of an insurance entity who writes and services new and renewal business. Agents may be employees or independent contractors.

**agents' balances.** The net of advances from the entity to agents, and commissions credited to the agent's account. Generally, these accounts represent amounts owed to the entity by agents.

**annual statement (convention statement, blank, or form).** A statement on a prescribed form furnishing information regarding an insurance entity's financial condition as of December 31 and its operations for the year. The statement is filed by March 1 of the following year with insurance departments of the various states in which an entity is authorized to transact business.

**annuity, deferred.** An annuity that will begin on a future date, either at the expiration of a fixed number of periods or at the attainment of a stated age.

**annuity, immediate.** An annuity, purchased with a single payment, which begins making payments soon after the premium is paid.

**annuity, variable.** See **variable annuity contract**.

**antiselection.** The tendency of persons who possess a greater likelihood of loss to apply for or continue insurance to a greater extent than others.

**assessment entities.** Entities selling to groups of similar interests, such as church denominations or professional groups. Some assessment entities also sell directly to individual members of the general public. Such entities may or may not collect premiums. If funds are not sufficient to pay claims, assessments may be made against members.

**asset share.** A realistic estimate of the amount accumulated by an insurance entity for each dollar of insurance in force. An asset share study involves a projection of cash flow based on the best estimates of mortality, interest, withdrawals, dividends, and expenses, and their times of occurrence. Asset shares depict hypothetical financial results on a unit of business. Generally, an asset share calculation is made for a unit contract on a particular plan and at a particular issue age representative of a particular class of contract. The calculation of asset shares may be made prospectively or retrospectively. They are often made for projecting financial results into the future on the basis of assumed rates of mortality, interest, expense, and withdrawals, and for testing the effect of hypothetical changes in such rates. An entity's entire business or a block of its business may be approximately represented by a grid of representative unit contracts weighted according to the distribution of business. Asset shares for such a grid may be aggregated to show approximate financial results for the business so represented.

**assets, admitted.** Assets stated at permitted values in the annual statement filed with the various insurance departments.

**assets, ledger.** Assets that were traditionally recorded on an entity's general ledger, usually representing cash accounting transactions.

**assets, nonadmitted.** Assets or portions thereof that are not permitted to be reported as admitted assets in the annual and quarterly statements

that are filed with the various insurance departments. Such assets include agents' balances, furniture, fixtures, supplies, equipment other than certain data processing equipment, certain amounts of deferred tax assets, and intangible assets other than goodwill.

**assets, nonledger.** Assets that traditionally were not recorded on an entity's general ledger such as accrued interest, other accrued income on investments, and due and deferred premiums, usually representing noncash accounting transactions.

**association value.** The value for annual statement purposes of certain invested assets. These values are set by the National Association of Insurance Commissioners and may differ from market value or amortized cost.

**assumption.** In life insurance, a set of rates (for example, mortality or interest rates) on which calculations to determine premiums, reserves, and so on, are based.

**automatic policy loan.** A loan made under a provision in a life insurance contract that a premium not paid by the end of the grace period will be automatically paid from the proceeds of a policy loan made by the entity if there is sufficient cash value.

**back end load.** Charge subtracted from benefit payments, usually to offset entity expenses and to encourage persistency.

**beneficiary.** The person named in the contract to receive all or part of the insurance proceeds at the death of the insured.

**benefit.** Any payment made under the terms of an insurance contract.

**block of business.** In the broad sense, a group of contracts as distinguished from a line of business. The term can be used in a narrow sense to refer to a particular group of contracts issued under the same plan in a particular year.

**book of business.** The total amount of insurance in force on an insurance entity's books at a particular date.

**broker.** An independent contractor who represents a number of life insurance entities and who negotiates and services insurance contracts. Legally, the broker represents the insured in securing the most favorable contract terms.

**captive insurance entity.** Entity formed to insure the risks of an affiliated corporation, typically its parent. Reasons for forming a captive insurance entity include the following:

- a. Instances when insurance cannot be purchased from commercial insurance entities for business risk; in many instances, entities within an industry form a joint captive insurance entity for that reason.
- b. Premiums paid to a captive insurance entity are deductible as a business expense for tax purposes in certain circumstances. However, sums set aside in a self insurance program are not deductible as a business expense.
- c. Insurance can be obtained through the international reinsurance market at a more favorable premium, with higher limits of coverage.

- d. Investment returns can be obtained directly on its invested capital. However, competent personnel to manage and staff the entity could be excessively expensive; and further a catastrophic occurrence or series of occurrences could bankrupt the entity.

**CARVM (commissioners' annuity reserve valuation method).** A modified preliminary term reserve method permitted to be used for computing certain annuity reserves in SAP financial statements.

**cession.** Insurance passed on to the reinsurer by the direct issuer or ceding entity. Frequently, under certain kinds of reinsurance agreements, each transaction is given a number called a cession number.

**coinsurance.** The sharing of an insurance risk. In life insurance, this arises most frequently in connection with reinsurance where the direct issuer passes some of its risk to another entity, the reinsurer, to avoid a disproportionately large risk on one insured. The reinsurer receives a proportionate part of the premiums less commissions and is liable for a corresponding part of all payments (dividends, cash values, death claims) made by the direct issuing entity. Less frequently, *coinsurance* refers to an arrangement whereby the insured underwrites part of a loss.

**commissioners' annuity reserve valuation method.** See **CARVM**.

**commissioners' reserve valuation method.** See **CRVM**.

**commissioners standard ordinary table.** Mortality table established by law in most states as the basis for legal minimum standards for calculating nonforfeiture values and contract reserves.

**contract.** The printed document issued to the insured by the entity stating the terms of the agreed upon insurance arrangement.

**contract (existing).** The contract that is currently held by the contract holder and excludes nonintegrated contract features.

**contract (replaced).** The contract that currently is held by the contract holder and is exchanged or modified in an internal replacement transaction.

**contract (replacement).** The new or modified contract in an internal replacement transaction.

**contract anniversary date.** The yearly recurrence of the *contract date*. The contract date is a date specified in the contract from which premium payment dates are calculated and from which *contract years* for nonforfeiture option purposes are measured. The *date of issue* is the date of execution and the date from which incontestable and suicide clause time limits are measured. The contract date may differ from the date of issue; for example, when the contract is dated back.

**contract holder.** A person who has an insurance contract in his or her possession or under his or her control. The term is frequently applied to describe the insured, regardless of the ownership of the contract.

**contract or membership fee.** Under the monthly premium plans for some accident and health insurance, the initial consideration is larger than the subsequent monthly premiums. The extra initial consideration is ordinarily termed a *contract fee* but is sometimes designated a *membership fee*. It is common practice to permit the agent to retain the entire amount of this

fee as compensation for securing the business. This term is also used sometimes in connection with life insurance to designate a portion of the gross premium which is the same whether the contract is for a large amount or a small amount, so that the total premium per thousand is less in large policies than in small policies.

**contract premium.** The premium specified by the insurance contract; also referred to as the **gross premium**.

**contract reserve.** The contract reserve may be regarded as the excess of the present value of the future benefits provided in the contract over the present value of the future net premiums payable under the contract. The contract reserve may also be regarded as the excess of the accumulated value of the net premiums already collected over the accumulated value of the benefits already paid.

**contract reserve strengthening.** A voluntary transfer of amounts from surplus to contract reserves to provide for future contract benefits based on more pessimistic assumptions. Such a transfer may result from the use of a lower interest assumption or of a different experience table with the assumption of the same or a lower rate of interest in the valuation of the contracts than was used in the respective valuation at the previous year-end (statutory term).

**contribution method.** A method of computing dividends whereby contributions made by any class of contracts to the entity's earnings is determined by comparing actual experience with assumptions made for mortality, interest, withdrawals, and expense in setting premium rates. Mutual life insurance entities are required to distribute divisible surplus to contract holders equitably. This is understood to mean the distribution of divisible surplus to the various classes of contracts in accordance with the contributions of such contracts to such divisible surplus. In its classic form, the contribution method determines dividends according to the three main sources of surplus earnings reflecting actual experience with respect to mortality, interest, and expenses.

**convention statement, blank, or form.** See **annual statement**.

**coverage.** An insurance enterprise's exposure to loss. The concept of coverage would typically include policy limits, deductible, insured, and covered property or insured event.

**coverage period.** See **contract period**.

**crediting rate.** The interest rate credited on a life insurance policy or annuity contract. This credit interest rate may be a guaranteed fixed rate, a variable rate, or some combination of both.

**CRVM (commissioners' reserve valuation method).** A modified preliminary term reserve method permitted to be used for computing certain life insurance benefit reserves in SAP financial statements. See description of method in paragraph 8.16(b).

**curtate.** Reserve methodology assuming all premiums are received at the beginning of the year and all benefits are paid at the end of the year.

**decreasing term insurance.** A kind of term insurance that has a face value that decreases over a period of years.

**deferred premium.** The semiannual, quarterly, or monthly net premium needed to complete premium payments for the current contract year, but not yet due. In computing statutory contract reserves for individual life insurance, deferred premiums are assumed to be paid in full.

**disability.** Incapacity because of accident or illness.

**disability benefit feature.** A feature included in some life insurance contracts or annuity contracts providing for waiver of premiums or payment of a monthly income in the event the insured has become totally or permanently disabled, or both.

**dividend class or classification.** A group of contracts that the entity decides to consider as comprising a homogeneous unit for dividend purposes because of similarities in essential characteristics (premium rate, reserve, nonforfeiture bases, and so on). Sometimes, this term is more narrowly taken to mean a group of contracts for which dividends per \$1,000 of insurance are identical because all essential characteristics (contract series, plan, age, year of issue, and so on) are identical.

**dividend deposit.** The accumulated amount, including interest, of all dividends that have been left by a contract holder as interest bearing deposits.

**dividend fund.** The amount specified by management at contract inception to which interest is credited and from which mortality and expense charges are assessed in the dividend determination mechanism.

**dividend fund interest rate.** The interest rate determined at policy issuance used to determine the amount of the dividend fund. It is the rate used to credit interest to the dividend fund, and against which experience is measured to determine the amount of the interest portion of dividends paid to individual policyholders.

**dividend fund method.** A method used by some mutual life insurance entities in the development of the entity's premium-dividend-contract value structure.

**dividend interest rate.** The total interest rate the entity pays on its dividend fund.

**dividend option.** The privilege allowed a contract holder of choosing among certain methods of using participating dividends. The dividends may be, for example: (a) paid in cash, (b) applied toward the payment of premiums, (c) left on deposit at interest, (d) used to purchase paid-up additional insurance, or (e) used to purchase one year term insurance.

**dividend scales.** The actuarial formulas used by life insurance entities to determine amounts payable as dividends on participating policies based on experience factors relating, among other things, to investment results, mortality, lapse rates, expenses, premium taxes, and policy loan interest.

**duration.** Length of time benefits will be paid. Some policies will pay benefits for 1 or 2 years, whereupon the insured must agree to be retrained for other work. Other policies pay benefits as long as the insured is unable to do the job for which he or she is suited by training, education, and experience (often up to age 65, when retirement programs take over). Some policies pay lifetime benefits.

**earned premium.** The pro rata portion of the premium applicable to the expired period of the contract. Generally used in connection with short term accident and health coverage.

**endorsements or riders.** Agreements not contained in the standard printed contract form, but printed, stamped, written on, or attached to it. When they are made a part of the contract, they alter, amend, extend, or restrict the provisions of the standard contract form.

**excess interest credits.** The excess of interest credited by an insurance entity over the amount guaranteed.

**experience premium method.** A method for determining participating dividends to contract holders. Under this method, the dividend is determined as the excess of the premium charged over a premium reflecting current levels of claim experience, interest, and expenses with appropriate provision for contingencies. This method is most commonly used for dividends earned under supplementary benefits such as accidental death or waiver of premium disability benefits. A variation of the method has sometimes been used for dividends on life insurance contracts. In this modified form, a conservative<sup>1</sup> interest assumption is used in determining the experience premium, and an excess interest factor is added to the dividend as otherwise determined from the excess of the premium charged on the modified experience premium.

**expiry.** Termination of insurance when the end of the period of term of the insurance contract is reached.

**extended term insurance.** Life insurance acquired under a nonforfeiture option in a contract providing for the use of cash surrender value to acquire term insurance for the face amount of the contract, the length of the term depending on the age at lapse and the cash surrender value.

**face amount.** The amount stated on the face of the contract that will be paid in the event of death or at contract maturity date.

**Fellow of the Society of Actuaries.** A full member of the Society of Actuaries. The Society of Actuaries is a professional actuarial society covering North America that maintains rigorous examination requirements for admission to membership.

**first year commission.** Any commission payable on the first year premiums.

**first year premiums.** Any premiums due during the first year the contract is in effect.

**foreign entity.** An insurance entity incorporated under the laws of another state or territory of the United States. For example, an entity domiciled in New York and writing business in Utah is a foreign entity in Utah.

**fortuitous.** Occurring by accident or chance, not by anyone's intention.

**full preliminary term reserve method.** A modified reserve method under which no reserve is established at the end of the first contract year.

**fund method.** A method of computing participating dividends based on asset share calculations.

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<sup>1</sup> See paragraph 8.113.

**funds held.** The holding by a ceding entity of funds representing the unearned premium reserve, the outstanding loss reserve, or both, applied to the business it cedes to a reinsurer.

**gains or losses from interest.** The difference between net investment income and interest required to maintain reserves. A change in the interest basis on which reserves are determined automatically results in a change in the indicated gain or loss from interest.

**gains or losses from lapse or surrender.** Differences between reserves held on surrendered or lapsed contracts and cash values paid or reserves required on other forms of insurance taken by the insured in lieu of payment of cash value.

**gains or losses from loadings.** Differences between expense loading contained in the premiums of the period and expenses for the period.

**gains or losses from mortality for annuities and supplementary contracts involving life contingencies.** Differences between expected and actual reserves released by death during the period.

**gains or losses from mortality for ordinary life policies.** Differences between expected death benefits on the entity's reserve basis and death benefits incurred for the period, net of reserves released by death.

**generally accepted accounting principles (GAAP).** The conventions, rules, guidelines, and procedures that define accepted accounting practice.

**grace period.** The period, usually 1 month (31 days), following the due date of a premium during which the premium may be paid without penalty or other additional requirements. The contract remains in force during this time. The grace period is required by law.

**gross premium reserve.** A reserve determined by subtracting the present value of future gross premiums from the present value of future expenses and benefits.

**guaranteed renewable contract.** An insurance contract whereby the insured has the right to continue in force by the timely payment of premiums for a period that coincides approximately with the average working lifetime (for federal income tax purposes at least until age 60), with the right reserved by the insurer to make changes in premium rates by classes. See also **noncancelable contract**.

**high deductible policy.** An insurance policy whereby the policyholder is responsible for the payment of claims under a specified deductible amount. Typically, the insurer pays all losses under the contract and seeks reimbursement from the policyholder for claims paid subject to the deductible amount.

**home service life insurance.** Life insurance on which a premium is collected on a weekly, biweekly, or monthly basis, usually at the home of a policyholder. The face value of the policy is usually \$1,000 or less.

**income disability benefit.** The income disability benefit of a life insurance contract commonly requires that the insured be totally and permanently disabled, but the requirement of permanence is not ordinarily made for an income disability benefit contained in a health insurance contract. Some



health insurance contracts provide reduced benefits during partial disability.

**incontestable clause.** A provision in a life or noncancelable accident and health insurance contract whereby the insurance entity cannot contest the contract, except for nonpayment of premiums, after the contract has been in force for a stated period (usually one or two years) from date of issue.

**incurred claim.** A situation in which the insured has experienced some event (death, accident, sickness, and so on) so that payment under the terms of an insurance contract is due from the entity.

**industrial insurance.** Insurance written in relatively small amounts covering life, total and permanent disability, and accidental death benefits, whereby the premiums are usually collected on a weekly or monthly basis by an agent of the entity. Also referred to as **home service life insurance**.

**inforce (in-force, in force).** Generally, policies and contracts written and recorded on the books of an insurance carrier that are unexpired as of a given date.

**initial contract reserve.** The reserve on a contract at the beginning of the contract year. It is equal to the amount of the reserve at the close of the preceding contract year (the terminal reserve) plus the net premium for the current contract year.

**installment premium.** A premium paid in installments throughout a contract year, rather than annually. Semiannual, quarterly, monthly, and sometimes weekly premiums are considered installment premiums. (The basic premium in life insurance is an annual premium.)

**insurable risk.** Condition in which an applicant has met an insurance entity's standards. Requirements include a loss that is (a) definable, (b) **fortuitous**, (c) one of a large number of homogeneous exposures, and (d) carries a premium reasonable in relation to a potential loss. In life insurance, the conditions are generally dependent on the health of the insured.

**insurance examiner.** The representative of a state insurance department assigned to participate in the official audit and examination of the affairs of an insurance entity.

**insured.** The party covered by an insurance policy.

**interest credited rate.** The interest rate at which interest income is credited to an **interest-sensitive** insurance policy.

**interest sensitive product.** A life insurance policy or annuity contract that provides an explicit guaranteed interest rate subject to being reset by the insurer after a specified period of time.

**investment expenses.** Expenses that are properly chargeable against investment income.

**investment year method.** Under this procedure, investment income is paired with each life insurance policy according to the time frame in which the premiums for that particular policy are received.

**investment yield.** The interest rate the entity expects to earn on the assets supporting the policies, net of investment expense.

- issue age.** The age of the contract holder on the effective date of the contract. This is frequently the "age nearest birthday" on the effective date.
- Keogh (HR10) account.** Any defined benefit or defined contribution plan that covers one or more self-employed individuals.
- lapse.** The termination of a contract by failure to pay a premium due. If the contract has no cash value, the contract becomes forfeited, is terminated, and is out of force. If the contract has a cash value, the protection may be continued in modified form through the purchase of paid-up additions or term insurance.
- legal reserve life insurance.** Life insurance provided by an insurance entity operating under insurance laws specifying the minimum basis for the reserves the entity must maintain for its insurance contracts.
- level premium insurance.** Insurance for which the premium is distributed evenly over the coverage period.
- levelized commission.** Compensation in which an insurance agent's fee for the sale of a policy is the same year after year. Most life insurance entities pay a high first year commission and lower commissions in later years; such a commission structure is controversial because critics believe that it is heavily weighted towards selling a product at the expense of subsequent service.
- liabilities, ledger.** Liabilities traditionally recorded on the entities general ledger. These generally result from cash accounting transactions.
- liabilities, nonledger.** Liabilities traditionally not recorded on the entity's general ledger. These generally result from noncash accounting transactions.
- life expectancy.** The average number of years of life remaining for persons of a particular age according to a particular mortality table.
- life insurance in force.** The sum of the face amounts, plus dividend additions, of life insurance contracts outstanding at a given time. Additional amounts payable under accidental death and other special provisions are not included.
- line of business; kind of insurance.** The level of aggregation at which some cash flow testing must be performed. Line of business criteria are a common method of acquisition, method of servicing, and measurement of profit.
- loading.** An amount obtained by subtracting the net premium from the gross premium.
- master contract.** Refers to a group insurance contract issued to an employer or trustee establishing a group insurance plan for members of an eligible group. Group members receive certificates as evidence of insurance, summarizing benefits provided under the master contract.
- maturity.** The time when payment under a life insurance or endowment contract becomes due. A life insurance contract matures upon the death of the insured. An endowment contract matures upon the death of the insured or at the end of a specified period of time, whichever occurs first.
- mean reserve.** A contract reserve computed as of the middle of a contract year on the assumption that the full net annual premium for that year has

been paid. The mean reserve for any contract year is equal to the mean (or average) of the initial reserve at the beginning of that year and the terminal reserve at the end of that year.

**modal premium.** The premium or amount of premium due at regular intervals. See **mode**.

**mode.** The frequency of premium payment. The mode may be weekly, monthly, quarterly, semiannually, or annually.

**modified preliminary term reserve method.** A method of computing a contract reserve under which a lesser portion of the first year's premium paid by the insured is added to the reserve than of premiums of subsequent years. There are various methods for arriving at the difference. The Illinois standard method and the commissioners' reserve valuation method are both modified preliminary term reserve methods.

**modified reserve method.** Any of various reserve methods whereby an entity establishes smaller reserves in the first contract year than under the net level reserve method.

**morbidity table.** A statistical table showing the incidence, by age, of eligibility for a given sickness or accident benefit, based on the assumed morbidity that is being defined by the table. It is an instrument for measuring the probabilities associated with the given benefit and is one factor in computing premiums and reserves for contracts providing such benefit.

**mortality cost.** The assumed mortality cost (cost of insurance) for any year is the contribution necessary from each contract to meet the net death benefits anticipated during that year. It may be calculated by multiplying the net amount at risk at the beginning of the contract year by the death rate (shown in the mortality table used in the computations) at the age attained by the insured at the beginning of the contract year.

**mortality ratio.** The ratio of actual death benefits of the period to expected death benefits.

**mortality table.** A statistical table showing the proportion of persons expected to die at each age, based on the assumed mortality that is being defined by the table, usually stated as so many deaths per thousand. It is the instrument for measuring probabilities of life and death. It is used as one factor in determining the amount of premium required at each age at issue of a contract.

**mortgage servicing agent.** An agent servicing mortgage loans for the mortgagee at a prescribed rate under a contractual agreement.

**mutual life insurance entities.** Entities that operate for the benefit of their contract holders and their beneficiaries and have no stockholders. Earnings are distributed to holders of participating contracts; however, some mutual life insurance entities issue nonparticipating contracts.

**net level reserve.** A contract reserve computed by a method under which the increase in reserve for the first contract year is not reduced to accommodate acquisition expenses. For comparison, see **preliminary term reserve**.

**net premium (valuation premium).** As used under SAP, that portion of the premium utilized in determining the valuation reserve and computed on the basis of prescribed mortality and interest rates. As used under GAAP,

the portion of the gross premium required to provide for all benefits and expenses. See **gross premium**.

**noncancelable contract.** An insurance contract whereby the insured has the right to continue in force by the timely payment of premiums for a period that coincides approximately with the average working lifetime (for federal income tax purposes at least until age 60), during which period the insurer has no right to make unilateral changes in any provision of the contract while the contract is in force. See also **guaranteed renewable contract**.

**nonforfeiture value.** The value, if any, either in cash or in another form of insurance, available upon failure to continue the required premium payments. The other forms of insurance available are **extended term insurance** and **reduced paid-up insurance**.

**nonledger assets.** See **assets, nonledger**.

**nonledger liabilities.** See **liabilities, nonledger**.

**open contracts.** Coverage normally used on an indefinite basis under Ocean Marine Insurance and Inland Marine Insurance (Transportation Insurance). Business risks for the damage or destruction of a shipper's goods in transit. While the policy is in force, the shipper is required each month to submit to the insurance entity reports on goods being shipped to be covered by the policy; premiums are also submitted at that time.

**ordinary life insurance.** Life insurance usually issued in face amounts of \$1,000 or more with premiums payable on an annual, semiannual, quarterly, or monthly basis. The term is also used to mean a plan of insurance for life with premiums payable for life.

**overriding commission.** Payment to a broker or agent on any particular line of insurance written by other agents within a particular geographical area.

**paid-up additions.** Option under a participating life insurance policy by which the policy owner can elect to have the dividends purchase paid-up increments of permanent insurance.

**paid-up insurance.** Insurance, including nonforfeiture paid-up insurance and paid-up additions purchased by dividends, on which all premiums have been paid and that is payable at the death of the insured or at the maturity date. It may be participating (sharing in dividend distribution).

**participating dividends.** See **dividends (to contract holders)**.

**policy loan.** A loan made by a life insurance entity to a contract holder on the security of the cash surrender value of the underlying contract.

**preferred risk.** An insured on whom the entity expects to experience a better-than-average mortality.

**preliminary term reserve.** A contract reserve in which a lesser portion of the first year's premium paid by the insured is added to the reserve than of premiums of subsequent years. There are various methods for arriving at the difference.

**premium tax.** A tax assessed, where applicable, as a percentage of premiums paid to the entity by contract holders residing in the state.

**premiums in course of collection.** Premiums due to the entity but unpaid.

- rated contract.** An insurance contract issued at higher than the standard premium rate to cover the extra risk of an insured with impaired health or hazardous occupation.
- reciprocal or interinsurance exchange.** 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).
- reduced paid-up insurance.** A form of insurance available as a nonforfeiture option. It provides for continuation of the original insurance plan, but for a reduced face amount with no further payment of premiums.
- reentry term life insurance.** Yearly renewable term life insurance under which an insured can usually re-apply for term insurance every fifth year at a lower premium than the guaranteed renewal rate. If the insured's health is good (as documented by evidence of insurability), the guaranteed renewable term premium can be reduced. If not, the guaranteed rate must be continued to be paid on renewal.
- reinstatement.** A restoration of a lapsed contract to an active status. All contracts contain a provision stating the conditions under which reinstatement will be allowed.
- renewable term insurance.** Term insurance providing the right to renew at the end of the term for another term or terms without providing evidence of insurability. The premium rates may increase at each renewal period.
- renewal premium.** Any premium payable for an insurance contract after the first contract year.
- reserve basis.** The particular set of assumptions as to interest and mortality or morbidity on which reserves are calculated.
- retention.** The amount of insurance risk that an entity retains for its own account. Any insurance issued in excess of the retention is reinsured. In group insurance, this term is also used to define the percentage of premium collected that the entity will retain for expenses and contingencies.
- retention limit.** The maximum amount of insurance on one life that an entity will retain at its own risk.
- retrospective reserve.** A contract reserve computed as the accumulated value of net premiums paid to date reduced by the accumulated value of benefits paid to date.
- return premium.** A provision permitting an insured or an insurance entity to cancel a property and casualty or a health insurance policy at any time before its expiration date. The insured must send written notice to the insurance entity, which then refunds the excess of the premium paid above the customary short rates for the expired term. If the insurance entity cancels, it sends written notice to the insured of cancellation and refunds the unearned portion of the premium.
- reunderwriting.** The reexamination of the insurance risk of the entire contract for purposes of acceptance or rejection or for rating the risk for pricing purposes.
- rider.** Endorsement to an insurance contract that modifies clauses and provisions of the contract, either adding, excluding, or limiting coverage.

**risk based capital requirements.** Regulatory and rating agency targeted surplus based on the relationship of statutory surplus, with certain adjustments, to the sum of stated percentages of each element of a specified list of entity risk exposures.

**service fee.** The fee paid to servicing agents, or the nonvested renewal commissions paid to the servicing life insurance agent after the expiration of normal renewal commissions on a contract.

**settlement option.** A choice of an alternative method of payment of the proceeds of an insurance or annuity contract, by the insured or his beneficiary, in lieu of the basic method of payment provided in the contract. Usually, a settlement option envisages annuity or installment payments even if the basic method of payment provides for a lump sum settlement.

**settlement period.** The estimated period over which a ceding entity expects to recover substantially all amounts due from the reinsurer under the terms of the reinsurance contract.

**single premium.** A lump sum consideration received by an insurance entity in accordance with an insurance or annuity contract.

**statutory.** Relating to the laws or regulations of the state government.

**statutory reserve.** A contract reserve equal to or greater than the minimum reserve computed under the method prescribed by state regulation, which method specifies the mortality or morbidity table to be used, the rate of interest to be assumed, and the formula to be applied.

**statutory surplus.** Admitted assets less liabilities, determined in accordance with statutory accounting practices.

**stock life insurance entities.** Entities that operate for the purpose of obtaining profit for their stockholders. In general, stock life insurance entities issue nonparticipating contracts, but some also issue participating contracts.

**structured settlement.** Periodic payments to an injured person or survivor for a determinable number of years or for life, typically in settlement of a claim under a liability policy. Terms may include immediate reimbursement for medical and legal expenses and rehabilitation, and long term payments for loss of income or as compensation for other injuries. A structured settlement can be expected to be less costly to the insurance carrier than a lump sum settlement, especially if it enables costly litigation to be avoided.

**substandard insurance.** Insurance issued on lives involving extra hazards due to physical condition, occupation, habits, or family history. An extra premium is charged for the extra risk, thus making the total premium higher than that on standard insurance. These are also referred to as **rated contracts**.

**suicide clause.** A provision in a life insurance contract that the risk of death by suicide (sane or insane) is excluded during the first one or two years after the date of issue. In event of suicide within this period, there is only a refund of premiums paid.

**supplementary contract.** A contract issued by the entity to a beneficiary in exchange for the matured contract when a life insurance contract is settled under one of the settlement options.

**supplementary contract without life contingencies.** A supplementary contract providing for leaving a specified sum with the entity at interest at a specified rate, subject to withdrawal under stated conditions of all or any part of the interest or of the original sum with interest or for payment by the entity of a specified number of installments of a specified amount. Interest is taken into consideration in computing the amount of each installment. No life contingencies are involved.

**supplementary contract with life contingencies.** A supplementary contract issued in the form of a life annuity contract on one or more lives or a combination of an annuity certain for a specified period and a deferred life annuity of any kind.

**surrender.** To accept some form of nonforfeiture option. Usually the contract is physically surrendered to the insurance entity either for cash or in exchange for an extended or paid-up contract.

**tabular cost.** As used in the annual statement, the aggregate expected mortality and disability cost for certain life insurance contracts.

**tabular interest.** As used in the annual statement, generally known as the interest required to maintain the reserve. The amount of interest that it had been assumed would be earned during the year on the reserves and on the valuation premiums on all contracts that were in force at any time during the year.

**tabular net premium.** As used in the annual statement, this term refers to the premium that is used in determining the contract reserve. It is frequently referred to as the net premium or the valuation (or actuarial) premium.

**terminal contract reserve.** The contract reserve at the end of the contract year. It is equal to the amount of the reserve at the beginning of the contract year (the initial reserve) plus interest on the reserve for one year and less the cost of insurance for the respective contract year.

**termination dividend.** A special or extra dividend payable at termination of a contract by maturity, death, or surrender. Usually, a minimum number of premium payments are required for a terminal dividend to be paid.

**termination rate.** The rate at which insurance contracts fail to renew. Termination rates usually are expressed as a ratio of the number of contracts on which insureds failed to pay premiums during a given period to the total number of contracts in force at the beginning of the period from which those terminations occurred. The complement of the termination rate is *persistence*, which is the renewal quality of insurance contracts, that is, the number of insureds that keep their insurance in force during a period. Persistence varies by plan of insurance, age at issue, year of issue, frequency of premium payment, and other factors.

**total and permanent disability.** Total disability that is presumed to be permanent in character. Frequently, total disability is presumed to be permanent (for the purpose of beginning benefits) if it has persisted, and has been total, for some specified period of time, such as three or six months.

**uncollected premiums.** Premiums due but not yet paid on contracts still carried on the entity's books as being in force.

**underwriter.** An individual or entity that insures risks, an agent who solicits insurance, or an employee who determines whether applicants are suitable risks for insurance.

**underwriting.** The process of examining and accepting or rejecting insurance risks, and classifying those selected as standard or substandard, so as to charge the proper premium.

**unearned premium reserve.** A liability for the unearned portion of the premiums of each contract in force. Generally associated with accident and health insurance.

**universal life insurance.** Life insurance under which (a) premiums are generally flexible, (b) the level of death benefits may be adjusted, and (c) mortality, expense, and other charges may vary. This insurance is sometimes referred to as unbundled life insurance because its three basic elements (investment earnings, cost of protection, and expense charges) are separately identified both in the policy and in the annual report to the policyholder.

**unreported claim.** A situation in which the insured has died or become disabled so that payment under the terms of an insurance contract will be demanded from the entity but the entity has not yet received notice of the claim. Insurance entities set up estimated reserves for unreported claims. See also **incurred but not reported claims**.

**valuation premium.** See **net premium**.

**variable life insurance.** Life insurance under which the benefits payable upon death or surrender vary to reflect the investment experience of a **separate account** supporting such policies.

**viatical settlement.** The payment(s) made before death on living benefit contracts for those who can show proof of a terminal illness or deterioration in health.

**waiver of premium.** A waiver of premium benefit is also typically included in noncancelable or guaranteed renewable disability income contracts. In such contracts, it is not required that disability be permanent.

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