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EXPOSURE DRAFT

PROPOSED AUDIT AND ACCOUNTING GUIDE

LIFE AND HEALTH INSURANCE ENTITIES

(To supersede AICPA Industry Audit Guide
Audits of Stock Life Insurance Companies)

SEPTEMBER 4, 1998

Prepared by the Life Insurance Audit Guide Task Force of the
Insurance Companies Committee
American Institute of Certified Public Accountants

Comments should be received by December 4, 1998, and addressed to
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AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775
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EXPOSURE DRAFT

PROPOSED AUDIT AND ACCOUNTING GUIDE

LIFE AND HEALTH INSURANCE ENTITIES

SEPTEMBER 4, 1998

Prepared by the Life Insurance Audit Guide Task Force of the
Insurance Companies Committee
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September 4, 1998

Accompanying this letter is the proposed AICPA Audit and Accounting Guide *Life and Health Insurance Entities* that would supersede the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*. This proposed Guide reflects relevant guidance contained in authoritative pronouncements through April 15, 1998. The proposed Guide also incorporates the following authoritative material:

a. SOP, *Auditing Life Reinsurance*, issued November 1984
b. SOP, *Confirmation of Insurance Policies In Force*, issued August 1978
c. Practice Bulletin 8, *Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration and Short-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises*
d. Practice Bulletin 9, *Disclosures of Fronting Arrangements by Fronting Companies*
e. SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises*
f. SOP 94-1, *Inquiries of State Insurance Regulators*
g. SOP 94-5, *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*
h. SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*
i. SOP 95-4, *Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule*
j. SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*
k. Practice Bulletin 15, *Accounting by the Issuer of Surplus Notes*
l. SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*
m. SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*

Summary information about the proposed Guide is provided in the Preface of this document.

The proposed Guide discusses those aspects of accounting and auditing unique to life and health insurance entities and was developed to assist life and health insurance entities in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and to assist independent auditors in auditing and reporting on those financial statements. In addition, the proposed Guide contains significant discussions of statutory accounting practices (SAP) that includes laws, regulations, and administrative rulings adopted by the various states that govern the operations and reporting requirements of life insurance entities. Because this is a category B GAAP document as defined by SAS 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report*, the inclusion of descriptions of SAP does not elevate SAP into GAAP.

This proposed Guide also incorporates accounting and financial reporting requirements issued by the Financial Accounting Standards Board (FASB) and the AICPA Accounting Standards Executive Committee (AcSEC) since the issuance of the AICPA Industry Audit Guide *Audits of Stock Life*

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Insurance Companies through April 15, 1998. Also incorporated in this proposed Guide are new auditing standards issued through April 15, 1998, by the AICPA Auditing Standards Board since the issuance of the pronouncements that this Guide would supersede.

The AICPA Insurance Companies Committee welcomes comments or suggestions on any aspect of the proposed Guide. In order to facilitate the committee's consideration of comments, please include references to specific paragraph numbers, include reasons for any suggestions or comments, and provide alternative wording with supporting reasoning.

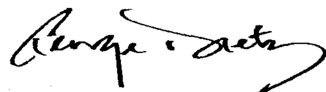
Responses should be addressed to Elaine M. Lehnert, Technical Manager, Accounting Standards, File 3162.LG, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, New York 10036-8775, in time to be received by December 4, 1998. Responses also may be sent by electronic mail over the Internet to ELEHNERT@AICPA.ORG.

Written comments on the proposed Guide will become part of public record of the AICPA and will be available for public inspection at the AICPA library after January 4, 1999, for one year.

Sincerely,

Patrick Shouvlin
Chair
Insurance Companies Committee

William J. Chrnelich
Chair
Life Audit Guide Task Force



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The committee and staff also gratefully acknowledge the contributions made to the development, content, and writing of this audit and accounting guide by Christine Denham, CPA.

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PREFACE

PURPOSE

P-1. This American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide has been prepared to assist life and health insurance entities in preparing financial statements in conformity with generally accepted accounting principles (GAAP) and statutory accounting practices (SAP) and to assist independent auditors in auditing and reporting on those financial statements.

APPLICABILITY

P-2. This Guide is intended to apply to all life and health insurance entities including stock, mutual, fraternal, and assessment entities.[1]

LIMITATIONS

P-3. This Guide does not discuss the application of all GAAP and all generally accepted auditing standards (GAAS) 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.

---

[1]FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises* clarifies that insurance entities, including mutual life insurance enterprises, that issue financial statements described as prepared "in conformity with generally accepted accounting principles (GAAP)" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. The Interpretation concludes that mutual life insurance enterprises that prepare financial statements based on regulatory accounting practices that differ from GAAP, and distribute those financial statements to regulators, should not describe those financial statements as prepared "in conformity with generally accepted accounting principles." When FASB Interpretation No. 40 was issued, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* and FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* exempted mutual life insurance companies, fraternal benefit societies and assessment entities (all of which are hereafter referred to as mutual life insurance entities) from their provisions. Accordingly, there was no authoritative guidance that explicitly addressed how to account for certain insurance activities of mutual life insurance entities. Recognizing the lack of authoritative guidance, the AICPA issued SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises,* which provides accounting guidance for certain participating insurance contracts of mutual life insurance entities. Furthermore, concurrent with the issuance of SOP 95-1, the FASB issued Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts,* that removes the exemption for mutual life insurance entities from FASB Statement No. 60; FASB Statement No. 97, and FASB Statement No. 113 and recognizes that participating life insurance contracts that meet the conditions in paragraph 5 of SOP 95-1 should be accounted for under SOP 95-1, except that stock insurance entities are permitted to apply SOP 95-1.

IMPACT ON OTHER LITERATURE

P-4. GAAP for stock life entities were established by the AICPA Industry Audit Guide *Audits of Stock Life Insurance Entities* (the "original guide"). In June 1982, FASB Statement No. 60 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, was issued. The Life Insurance Audit Guide Task Force of the AICPA Insurance Companies Committee determined that certain useful accounting guidance was not carried forward to FASB Statement No. 60, and should be brought forward in the new Guide so it remains in the authoritative accounting literature. (For example, guidance similar to that in appendix B in the original guide *Accounting for Unamortized Acquisition Costs,* which was not carried forward to FASB Statement No. 60, has been included in this Guide.) The accounting guidance in each chapter reflects the SAP and GAAP developments over the last twenty years.

P-5. Unlike the original guide, this Guide does not establish any new accounting standards or interpret any existing accounting standards, except for paragraph 11.13; however, it does establish expanded or new audit requirements in certain areas, including:

- **Use of an actuary** (see chapter 5, paragraphs 5.37 through 5.43) 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. Such a requirement is the same as the standard established for property and liability insurance companies by SOP 92-4, *Auditing Insurance Entities' Loss Reserves*.

P-6. The Guide also incorporates the following authoritative material:

- SOP, *Auditing Life Reinsurance*, issued November 1984
- SOP, *Confirmation of Insurance Policies In Force*, issued August 1978
- Practice Bulletin 8, *Application of FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration and Short-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, to Insurance Enterprises*
- Practice Bulletin 9, *Disclosures of Fronting Arrangements by Fronting Companies*
- SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises*
- SOP 94-1, *Inquiries of State Insurance Regulators*
- SOP 94-5, *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*
- SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*
- SOP 95-4, *Letters for State Insurance Regulators to Comply with the NAIC Model Audit Rule*
- SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*
- Practice Bulletin 15, *Accounting by the Issuer of Surplus Notes*
- SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*

- SOP 98-6, *Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association*

P-7. The National Association of Insurance Commissioners (NAIC) has undertaken a project to codify SAP because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely not only from state to state, but also for insurance entities within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance entities. This Guide will be updated after the exposure period to reflect the new SAP requirements resulting from the NAIC Codification of Statutory Accounting Principles. (See chapter 3 for a discussion of SAP.)

EFFECTIVE DATE AND TRANSITION

P-8. The provisions of this Guide are effective for financial statements for fiscal years beginning after December 15, 1999. Earlier application is permitted.

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 through 5 provide background information and terminology that is intended to help the reader to better understand the industry. They also include comprehensive discussions of the life insurance business, product characteristics, and general auditing considerations and accounting practices — both statutory accounting practices (SAP) and generally accepted accounting principles (GAAP) — unique to the industry.

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

- Introductory material
- Regulatory matters
- General descriptions of accounting practices, both SAP and GAAP
- Description of the auditor's consideration of internal control, including:
    - Understanding of the control environment
    - Assessment of audit risk
    - 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 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 through 14 concentrate on the major transaction cycles of a life insurance entity. Chapter 15 discusses reports on audited financial statements and contains examples of various reports.

AUDITING

I-5. In selecting particular audit procedures to achieve the audit objectives, the auditor considers the following: (a) the assessment of control risk, (b) the relative risk of error or fraud that would be material to the financial statements, and (c) the expected effectiveness and efficiency of the audit tests. These considerations include the nature or materiality of the transactions being tested, the kinds and competence of available evidential matter, and the nature of the audit objectives to be achieved. 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-6. The nature, timing, and extent of the audit procedures to be applied on a particular engagement are matters of professional judgment to be determined by the auditor based on the

specific circumstances. However, the procedures adopted should be adequate to achieve the audit objectives developed by the auditor, and the evidential matter obtained should be sufficient for the auditor to form conclusions concerning the validity of management's assertions embodied in the financial statements. The combination of the auditor's assessment of control risk and the results of audit procedures should provide a reasonable basis for the auditor's opinion.

I-7. Auditing guidance, including substantial guidance for each area regarding consideration of control environment, assessment of audit risk, and selected control and audit procedures, is provided for each major financial statement component.

Audit Consideration Charts

I-8. The examples of specific audit objectives and control and audit procedures in the auditing sections of chapters 7 through 13 (in addition to the "Consideration of Internal Control" sections), illustrate how the auditor might assess control risk, perform audit procedures, and become familiar with internal control. The charts following each transaction 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 types 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-9. 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-10. *Transactions Not Unique to Life Insurance Entities*. There are many transactions that 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-11. 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:

1. Appendix A - List of Industry Trade Associations, Directories, and Journals
2. Appendix B - Illustrative Financial Statements
3. Appendix C - Life Insurance Entity Specific Disclosures

Chapter 1

OVERVIEW OF THE LIFE AND HEALTH INSURANCE INDUSTRY

INTRODUCTION

1.1 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 companies undertake to relieve the policyholder of all or part of a risk and to spread the total cost of similar risks among large groups of policyholders. The primary purpose 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 due to 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.

1.2 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.

LEGAL FORMS OF ORGANIZATION

1.3 Life insurance entities may be grouped into 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

1.4 Approximately 95% of the life insurance entities in business are owned by stockholders. The remaining 5% are mutual entities, fraternal benefit societies, and assessment entities.

1.5 In addition to the legal forms of organization, life insurance entities can be identified by the types 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 contractholders. *Captive insurance entities* underwrite insurance exclusively for the members or customers of a group. An example of a captive entity is a credit life insurance corporation that writes insurance on customers of its finance company or bank parent.

Stock Insurance Entities

1.6 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 contractholders in the form of participating or contractholder dividends. *Nonparticipating contracts* are those contracts under which contractholders 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

1.7 A mutual insurance entity is an incorporated entity without private ownership interests that operates for the benefit of its contractholders and their beneficiaries. Mutual insurance entities primarily issue participating contracts that pay participating dividends. In a mutual entity, participating contractholders 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 contractholders, and prior contractholders 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 contractholders lose their rights and interests in the mutual insurance entity.

1.8 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 contractholders and the sale of interest-bearing debt.

Fraternal Benefit Societies

1.9 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. Contractholders participate in the earnings of the society, and the contracts stipulate that the society has the power to assess its members should its legal reserves become impaired. Fraternal societies use open contracts, which include 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, that, in turn, elect the officers and directors. Fraternal benefit societies operating under a lodge system are exempt from federal income taxation.

Assessment Entities

1.10 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 company to collect assessments from members if funds are not sufficient to pay claims.

OPERATIONS AND DISTRIBUTION SYSTEMS

Operations

1.11 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, contractholder services, information systems, investment, legal, marketing, product development, and underwriting. These areas can be centralized where 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.

1.12 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:

- *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.

- *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, meets 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.

- *Payment of Benefits and Claims*. The actual 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 (benefit and claim liabilities) 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

1.13 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 system, or some combination thereof; however, they are increasingly relying on other third parties, such as brokers to sell certain life insurance products.

1.14 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.

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

1.16 Distribution systems, which are described in paragraphs 1.17 through 1.19, are distinctive by their relationship with the life insurance entity. However, distributors submit applications for insurance to the insurance entity, which not only accepts or rejects the applications, but generally holds the power to issue binding agreements.

1.17 *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 issuing of contracts. General agents are compensated primarily according to a percentage of the premiums they produce (commissions), 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.

1.18 *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.

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

1.20 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

1.21 Traditional life insurance contracts include whole life, term, and endowment contracts, which 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.

1.22 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 contractholder.

1.23 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 account" is discussed further in paragraph 2.21).

Accident and Health Insurance Contracts

1.24 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 due to total or partial disability resulting from illness or injury.

Annuity Contracts

1.25 Annuity contracts are arrangements whereby a contractholder is guaranteed to receive benefits over a fixed or variable period commencing either immediately or at some future date. Depending on the type of contract, the benefit amount may be fixed or variable.

Investment Contracts

1.26 Investment and similar contracts are those that do not subject the insurer to significant

insurance risks of contractholder mortality or morbidity and are comparable to financial or investment products offered by other types of financial institutions.

Fee for Service Contracts

1.27 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.

1.28 In addition, life insurance entities commonly offer products through noninsurance subsidiaries, such as finance companies, 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

1.29 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*).

1.30 All life insurance entities set limits on the amounts and types 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.

1.31 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 1.32 for assumption reinsurance. The entity issuing the contract remains liable for the payment of the contract benefits.

1.32 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*. In such cases, the original contract is novated and the assuming company legally replaces the ceding company as the primary obligor to the contractholder. 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.

REGULATION

1.33 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 contractholders.

1.34 In a majority of states, life insurance entities may not organize without the authorization of the state insurance department; in states where 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.

1.35 To preserve solvency, statutes generally —

a. Restrict investments of insurance entities to certain amounts and types 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 statues; see paragraph 1.45 for further discussion.)

d. Define those assets not permitted to be reported as admitted assets in *Annual Statements* filed with the state insurance department.

1.36 To promote uniform reporting, all states require that insurance entities operating within their boundaries submit to the insurance commissioner an *Annual Statement* or *Convention Blank* containing annual financial statements and other financial information. *Annual Statements* are required to be filed on a calendar-year basis and are prepared according to accounting principles and practices that are prescribed or permitted by state regulatory authorities (see chapter 3 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 Commissioner (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.

1.37 To promote fair and nondiscriminatory dealings with contractholders, 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 contractholders as required by law. Insurance agents, brokers, and salespersons must qualify for and obtain licenses granted by a state insurance department before they may solicit business in that state.

1.38 In general, premium rates for individual life insurance are unregulated except for credit insurance, for which maximum premium limits are set. 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.

1.39 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.

1.40 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, paragraphs 5.54 through 5.64 for further discussion.)

1.41 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, paragraphs 4.8 through 4.12 for further discussion.)

National Association of Insurance Commissioners (NAIC)

1.42 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 are 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. NAIC meetings are held quarterly to

consider subjects of interest to all insurance regulatory authorities. The association has a number of standing committees that meet throughout the year to consider plans and proposals for presentation at the general meeting. The decisions of the NAIC are not binding on any of the commissioners; however, its recommendations for new rules and procedures or for changes in the old ones are usually adopted voluntarily by the majority of states in the form of appropriate legislation (NAIC model statutes) or regulation.

1.43 *NAIC-Codified Statutory Accounting*. The NAIC has undertaken a project to codify statutory accounting practices because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely, not only from state to state, but for insurance entities within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance entities for their financial reporting to regulatory authorities. (See chapter 3 for a discussion of statutory accounting practices.)

1.44 *Insurance Regulatory Information System*. States monitor the financial condition of insurance entities partially through the Insurance Regulatory Information System (IRIS), which is a series of 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.

1.45 *Risk-Based Capital*. Risk-based capital is a program developed by the NAIC that serves as a benchmark for the regulation of life insurance entities' solvency by state insurance regulators. Risk-based capital 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 risk-based capital. (See chapters 4 and 5.) For life insurance entities, the risk-based capital formula focuses on the following four general types of risk (which are fully discussed in chapter 4):

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

1.46 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 (Act) 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.

1.47 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.

1.48 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. If the life insurance entity or its designated subsidiary is also the principal underwriter of the separate account, its distributors or agents must be qualified and licensed as registered representatives. In addition, the principal underwriter 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.

1.49 In addition, the Federal Trade Commission (FTC) regulates insurance entity mergers, mail-order advertising, and other trade practices affecting competition. The U.S. Department of Labor and the Internal Revenue Service (IRS) administer the Employee Retirement Income Security Act (ERISA) under which private pension plans are regulated. Life insurance entities (except for fraternal benefits 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.

RATING AGENCIES

1.50 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 companies, and are important to consumers who are buying insurance policies where claims may not be filed for years, or even decades. Rating agencies base their ratings on financial reports, interviews with company executives and the rating agency's opinion about the entity's business prospects and quality of management. The major rating agencies are Moody's Investors Service (for financial strength), Duff & Phelps (for claims-paying ability), Standard & Poor's (for claims-paying ability), and A.M. Best (for financial strength).

TAXATION

Federal Taxation

1.51 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 1.52 to 1.57 describe the major tax legislation that has affected the life insurance industry and that are discussed further in chapter 13.

1.52 *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.

1.53 *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 *policyholder surplus account*, subject to future tax if distributed, or if contractholders' 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.

1.54 *The Deficit Reduction Act of 1984.* This act replaced the three-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 contractholder'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/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 contractholder dividends of mutual entities. A portion of contractholder 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.

1.55 *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 must pay if the AMT exceeds the regular tax calculation.

1.56 *The 1988 Tax Act.* This act directly affected contractholders, 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 contractholder for these contracts prior to death. This provision is applicable to contracts issued after June 20, 1988.

1.57 *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 advanced premiums, that will, in effect, defer certain tax deductions or accelerate taxable income or both.

State Taxation

1.58 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

1.59 The primary role of the state guaranty system is to provide protection for contractholders in the event that an insurance entity fails. Generally, a state's guaranty laws provide for the indemnification of losses suffered by contractholders through assessments against other solvent insurers licensed to sell insurance in that state. Under the current premium-based system, each insurance entity pays the same assessment rate based on the volume of business written. There are, however, state-by-state limits on the types of insurance and amounts of losses that the guaranty fund will pay. Losses are generally 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 contractholder currently resides, regardless of the state of domicile of the underwriter. (See chapter 14 for a further discussion.)

1.60 The National Organization of Life and Health Insurance Guaranty Association (NOLHGA) 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

1.61 The life insurance industry has many industry associations to help with the multitude of issues affecting it. A list of some of these organizations appears in appendix A.

INTERNATIONAL CONSIDERATIONS

1.62 The removal of trade barriers among members of the European Community in 1992 and the growing prosperity of the Pacific Rim nations will give U.S. life insurance entities immense opportunities for international expansion. The large number of entities that already operate in the global marketplace will rapidly increase as the ownership of the industry changes and as established insurance entities are purchased by overseas investors.

1.63 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.

Chapter 2

CHARACTERISTICS OF LIFE AND HEALTH INSURANCE PRODUCTS

INTRODUCTION

2.1 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

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

- Life insurance contracts
  - Traditional whole life
  - Term life
  - Endowments
  - Universal life
  - Variable life
  - Adjustable life
  - Living benefit life
  - Supplemental benefits (riders), including waiver of premium and accidental death benefit
  - Supplementary contracts, including settlement options and dividend options

- Accident and health insurance contracts
  - Disability contracts
  - Medical expense insurance, including major medical plans and hospital indemnity plans
  - Medicare supplemental contracts
  - Long-term care contracts

- Annuity contracts
  - Variable annuities
  - Fixed annuities

- Investment contracts
  - Guaranteed investment contracts
  - Other deposit contracts

- Fee-for-service contracts, including administrative services only

Participating or Nonparticipating Classification

2.3 Life, accident and health, or annuity insurance contracts can be sold on a participating or nonparticipating basis. With participating contracts, the contractholder shares in the experience of the insurance entity either through direct reimbursement with participating dividends or through an increase in contract benefits, which is often referred to as a *paid-up addition*. With nonparticipating contracts, contractholders have no right to a share in this experience.

Group or Individual Classification

2.4 All of the types 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, some permanent group life insurance is sold.

2.5 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. Since 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

2.6 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 generally accepted accounting principles (GAAP) as defined in FASB Statements No. 60, 97, 113, 120 and SOP 95-1. (See chapter 7 for a detailed discussion of accounting classification of contract types.)

2.7 Unlike insurance contracts, investment contracts do not subject the life insurance entity to significant mortality and morbidity risks (referred to as *insurance risk*). 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 are generally 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*. Life insurance entities write both short-duration contracts (such as credit life and certain accident and health contracts) and long-duration contracts (such as whole life, guaranteed-renewable accident and health, endowments, universal life, and annuity contracts with significant life contingencies).

TYPES OF CONTRACTS

Life Insurance Contracts

2.8 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 contractholder 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 contractholder 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 type as the original contract, or in extended term insurance for a period of time for the full face amount of the contract.

2.9 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 twenty-payment life), or the age up to which premiums must be paid (for example, sixty-five). 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 contractholders to borrow against the cash value rather than paying premiums in cash. These loans are generally referred to as *policy loans*. The borrower 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 contractholder 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 sixty or sixty-five, and are generally referred to as yearly renewable term (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 the insured the right to requalify for lower premiums after a few years (generally ten years), provided they can satisfy underwriting standards for newly issued life contracts. The resulting premium pattern is generally lower than that of YRT contracts for those who remain healthy. However, the premium pattern is generally higher for those whose health deteriorates since those contracts will be reissued as substandard risks at the reissue date.

2.14 Credit Life. Insurance is another type 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 contractholder. 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 contractholder 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 contractholder (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; however, there may be other forms of surrender charges, such as persistency bonuses or credited interest rate differentials for contracts that persist. 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.

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 contractholder 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 are generally not available to cover liabilities except those of the separate account. 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 contractholder has direct participation in the investment earnings of the separate account or asset pool. Most life insurance entities offer contractholders 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 Exchange Act of 1934 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 contractholders to make changes in their insurance plans without the need for the life insurance entity to issue riders or replace the contract with a more appropriate type as the contractholder's insurance needs or financial situation changes. This type of contract includes features that, within limits, allow changes in the following contract elements:

1. Face amount

2. Premium amount and payment period

3. Duration of coverage

2.25 The flexibility of adjustable life contracts allows the contractholder 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 Contracts*. Living benefit contracts allow contractholders who have whole life contracts and can show proof of a terminal illness to collect portions of the face amount of their life insurance contract while they are still living. The rationale behind this product is that contractholders 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.*

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:

- *Waiver of premium*, which waives required premium payments in the event of disability of the insured.
- *Accidental death benefit*, which 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 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. These options (excluding cash) are usually treated as supplementary contracts.

Accident and Health Insurance Contracts

2.31 *Disability Income Insurance Contracts*. This coverage protects the insured against loss of income due to 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 sixty-five 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 types 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 contractholder through either copayment plans, which specify a formula for sharing of actual medical expenses between the insurer and the contractholder, or deductibles, which specify a dollar amount of medical expense the contractholder 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 (U.S. Code title XVIII) 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.

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 *Long-Term Care Contracts*. These are primarily contracts that provide coverage for nursing home or other continuing care services related to long-term disabilities or the elderly who cannot care for themselves for medical reasons. 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.

Annuity Contracts

2.37 An annuity contract is an arrangement under which the contractholder 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 contractholder 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 *pay-out 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 contractholder 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.

2.38 Benefit payments of annuity contracts can begin immediately or be deferred. *Immediate annuities*, where the first benefit payment begins one interval after purchase, 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.

2.39 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. *Fixed annuities* have benefit payments in fixed dollar amounts that do not change during the payment period, and *variable annuities* have benefit payments defined in annuity units, whose value may fluctuate over the payment period depending on the investment results of the asset pool or separate account. Variable annuities are subject to SEC regulation, similar to variable life products.

Investment Contracts

2.40 Investment contracts are deposit-type contracts that do not subject the insurer to significant insurance risks arising from contractholder 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.

2.41 Life insurance entities often hold assets underlying investment contracts in separate accounts, where preservation of principal is not guaranteed and contractholders 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.

2.42 *Guaranteed Investment Contracts (GICs)*. These contracts provide for a stated rate of interest on all funds deposited with the insurer for a stated period. *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 401K plans, to provide a fixed interest option for plan participants. Bullet GICs are generally designed for annuitants, while window GICs are primarily designed for group plans where the deposit of funds occurs over time. GICs usually provide for a market value adjustment, and may have other surrender charge provisions for premature withdrawal of funds.

2.43 *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 contractholder'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.

2.44 An *immediate participation guaranteed (IPG)* contract is a variation of the DA contract in which the contractholder 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 (IYM).

Fee-for-Service Contracts

2.45 *Administrative Services Only (ASO)*. Many life insurance entities provide ASO contracts 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 (EDP) services, employee benefit plan administration, and mortgage services. 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

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

3.2 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 (GAAP) to comply with SEC regulations, or for other reasons.

STATUTORY ACCOUNTING PRACTICES

3.3 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 National Association of Insurance Commissioners' (NAIC) Annual Statement Instructions, the NAIC *Accounting Practices and Procedures Manuals*, and other sources such as the *Securities Valuation Manual* (published by the NAIC Securities Valuation Office), and accepted practice constitute the body of SAP, which is currently considered a comprehensive basis of accounting other than GAAP. (See Chapter 15, paragraph 15.26)

3.4 SAP are somewhat uniform from state to state, although some differences exist. It is fairly common for a life insurance entity to request from the insurance department of its state of domicile special accounting consideration 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.

3.5 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 contractholders 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 as well as capitalized contract acquisition costs, are assigned no value (referred to as "nonadmitted assets"). With respect to liabilities, SAP generally require formula-driven reserves relating to invested assets and benefit reserve liabilities using statutory tables or other conservative assumptions.

3.6 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 contractholders against adverse fluctuations in an entity's asset base, mortality and morbidity experience, or its expense and investment experience. Surplus also provides the financial strength to permit a life insurer to expand its operation or enter new lines of business (see chapter 4, paragraphs 4.8 through 4.12 for additional discussion of capital adequacy.)

3.7 Life insurance entities currently prepare their statutory financial statements in accordance with accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. The NAIC currently has a project under way to codify SAP through a complete revision of its *Accounting Practices and Procedures Manuals*, which when complete is expected to replace prescribed or permitted SAP as the statutory basis of accounting for insurance entities (referred to hereafter as the "codification"). If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, an accounting practice that departs from that basis of accounting, regardless of whether required by state law or permitted by state regulators, would be considered an exception to the statutory basis of accounting.

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

Permitted Statutory Accounting Practices

3.9 Permitted SAP include practices not prescribed in paragraph 3.8 but allowed by the domiciliary state insurance department. A life insurance entity may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of its statutory financial statements (a) when it wishes to depart from the prescribed SAP, or (b) when prescribed SAP do not address the accounting for the transaction specifically.

Statutory Reporting

3.10 Each state insurance department requires that all life insurance entities writing business in that state file annual financial statements for each individual life insurance entity. These financial statements are prepared on forms prescribed by the domiciliary state on an annual basis (referred to as the *Annual Statement*), and are prepared in accordance with the SAP of that particular state. In addition, some entities may be required to file financial statements on a more frequent basis, such as monthly or quarterly. All states require that the *Annual Statement* be prepared as of December 31, and filed with the various insurance departments by March 1 of the following year in all states in which the entity writes business. The two most recent calendar years must be presented. In addition, specified supplementary financial data must be provided, including an analysis of operations by line of business (gain and loss exhibit), aggregate reserves for life and accident and health policies (Exhibits 8 and 9 of the *Annual Statement*), detailed schedules of investments (Schedules A to DC of the *Annual Statement*), and various other schedules and exhibits. The NAIC's Annual Statement 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. (See chapter 5 for additional discussion of the opinion by a qualified actuary.)

3.11 The NAIC has developed several types of *Annual Statement* forms to be used by particular types of life insurance entities and has assigned each a color cover for easy reference, such as the following:

- Life/health insurers (blue)
- Health/medical insurers (brown)
- Variable/separate account insurers (green)

This is only a partial list. The nature of the insurer's business will dictate which *Annual Statement* form is to be filed.

3.12 Software packages are available from the NAIC that produce *Annual Statement* exhibits, schedules, and financial statements based on input information. The NAIC and many state insurance departments now require filing of the *Annual Statement* on a diskette.

3.13 The NAIC *Annual Statement* and forms have been adopted by each state to promote uniformity in reporting, although variations are required by certain states. The NAIC requires life insurance entities in all states to file audited financial statements and a supplemental schedule of assets and liabilities with their state of domicile insurance department. 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 ninety 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 contractholders.

3.14 In the past, most states, which had adopted laws or regulations requiring independent audits, allowed life insurance entities to file GAAP or consolidated financial statements, or both, provided that the insurance department had granted such approval, and provided that the entity submit specific supplemental SAP/GAAP reconciliations, or separate entity financial statement amounts, or both. More recently, however, the NAIC instructions require the filing of audited statutory-basis financial statements for each individual life insurance entity. These audit rules also require life insurance entities to have their auditors prepare and file a report on significant deficiencies, if any, in the life insurance entity's internal controls, accountant's awareness letter, and an accountant's letter of qualification. (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.

Disclosure Issues

3.15 Financial statements prepared on a SAP basis or any other comprehensive basis of accounting other than GAAP should include all informative disclosures that are appropriate for the basis of accounting used, including a summary of significant accounting policies that discuss the basis of presentation and describe how that basis differs from GAAP. Auditing Interpretation of AU 623, *Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis*, reprinted here as Exhibit 3.1, provides

guidance in evaluating whether informative disclosures are reasonably adequate for financial statements prepared on a statutory basis.

GAAP FINANCIAL STATEMENT DISCLOSURES

3.16 Statement on Auditing Standards (SAS) No. 32, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 431), requires that sufficient disclosure of material matters be made in order for financial statements to be considered in accordance with GAAP. In addition, SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), requires that an audit be planned and performed in such a manner that the auditor will gain a requisite level of understanding of the entity's business on which to base informed conclusions on the adequacy of financial statement content and disclosures.

3.17 Illustrative GAAP-basis financial statements and related note disclosures typical of life and health insurance companies are included in appendix B. 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. Accordingly, this 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. GAAP may require additional disclosures such as information concerning related-party transactions, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, lease commitments, accounting changes, off-balance-sheet risks, 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.

3.18 Sources of guidance that should be consulted with respect to disclosures specific to life insurance activities follow:

a. FASB Statement No. 60
b. FASB Statement No. 97
c. FASB Statement No. 113
d. FASB Statement No. 120
e. Regulation S-X, Article 7 (for public registrants only)
f. SOP 94-5
g. SOP 97-3
h. Practice Bulletin 15

Certain Financial Statements Disclosures

3.19 SOP 94-5, *Disclosure of Certain Matters in the Financial Statements of Insurance Enterprises*, requires insurance entities, where applicable, to make the following disclosures in their financial statements.

3.20 In accordance with SOP 94-5, the disclosures in this paragraph should be made for permitted SAP for the most recent fiscal year presented, regardless of when the permitted SAP was initiated. Life insurance entities should disclose information about permitted SAP that individually or in the

aggregate materially affect statutory surplus or risk-based capital, including GAAP practices when the permitted practices differ from the prescribed SAP. The information to disclose is as follows:

a. A description of the permitted SAP

b. A statement that the permitted SAP differs from prescribed SAP

c. The monetary effect on statutory surplus

Life insurance entities should disclose information about permitted SAP, excluding GAAP practices used, when prescribed SAP do not address the accounting for the transaction. The information to disclose is as follows:

a. A description of the transactions and of the permitted SAP used

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

3.21 The following is an illustration of disclosures that an insurance entity would disclose to meet the requirements of paragraph 3.20 of this guide.

> _Note X. Permitted Statutory Accounting Practices_. The Company, domiciled in ABC State, prepares its statutory financial statements in accordance with accounting practices prescribed or permitted by the ABC State Insurance Department. Prescribed statutory accounting practices as promulgated in a variety of publications of the National Association of Insurance Commissioners (NAIC), as well as in state laws, regulations, and general administrative rules. Permitted statutory accounting practices encompass all accounting practices not so prescribed and for which permission to employ the practice has been received from the State Insurance Department.
>
> The Company has received written approval from the ABC State Insurance Department to discount loss reserves at a rate of X percent for statutory accounting purposes, which differs from prescribed statutory accounting practices. Statutory accounting practices prescribed by ABC State Insurance Department require that loss reserves be discounted at Y percent. As of December 31, 19XX, that permitted practice increased statutory surplus by $XX million over what it would have been had prescribed accounting practice been followed.[1]

3.22 In accordance with SOP 94-5, 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

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

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 the 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 expense attributable to insured events of the current fiscal year and to insured events of prior fiscal years

d. A discussion of the reasons for the change in the provision for incurred claims and claim adjustment expenses attributable to insured events of prior fiscal years and an indication of whether additional premiums or return premiums have been accrued as a result of prior-year effects

Because the scope of SOP 94-5 covers unpaid claims of insurance entities as defined by FASB Statement No. 60, the scope of the unpaid claims disclosure should include accident and health claims, but not life insurance claims.

Risks and Uncertainties

3.23 SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires entities to include in their financial statements information about —

- The nature of their operations.
- The use of estimates in the preparation of financial statements.

In addition, if specified disclosure criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about—

- Certain significant estimates.
- Current vulnerability due to certain concentrations.

Paragraph 18 of SOP 94-6 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—

- Deferred policy acquisition costs of insurance entities.
- Valuation allowances for commercial and real estate loans.

Examples of insurance entity concentrations that may be subject to disclosure if they meet the criteria of paragraph 21 of SOP 94-6 include reinsurance contracts with one reinsurer.

Mutual Life Insurance Entities

3.24 SOP 95-1 requires entities to disclose the following in the financial statements with respect to participating contracts:

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

SECURITIES AND EXCHANGE COMMISSION REPORTING REQUIREMENTS

3.25 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 report on Form 10-K, to distribute an annual report to shareholders pursuant to the SEC's proxy rules, and to file quarterly reports on Form 10-Q. Article 7, Insurance Companies, 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 (e.g., debt) must also comply with certain SEC rules.

TAX-BASIS ACCOUNTING REQUIREMENTS

3.26 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 recordkeeping 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 GAAP. These differences are discussed in chapter 13.

COMPARISON OF GAAP AND SAP

3.27 The primary focus of financial reporting in accordance with GAAP is information about earnings and its components. 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 emphasize the measurement of ability to pay all current and future contractholder 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 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. Table 3.1 presents a summarized comparison of the major difference in accounting treatment between GAAP and SAP for selected financial statement components.

Table 3.1
Summary of Statutory Accounting Practices and Generally Accepted Accounting Principles

The following are highlights of significant differences in accounting treatment between SAP and GAAP for certain financial statement components. As described in paragraph 3.4, statutory accounting may vary by state. SAP in this illustration, although not all-inclusive, represent those practices as described in the NAIC *Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies*.

Area	Statutory Accounting Practices	Generally Accepted Accounting Principles
Bonds	NAIC category 1-5 at amortized cost; NAIC category 6 at stipulated valued	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 exist
Common stock	Fair value	Fair value
Nonredeemable preferred stock	Same as bonds	Fair value
Mortgages	Unpaid balance unless in default	Unpaid balance plus unamortized loan origination fees as prescribed by FASB Statement No. 91 less impairment as per FASB Statement No. 114, as amended by FASB Statement No. 118
Real estate - Investment	Lower of depreciated cost or market	Depreciated cost, after impairment writedown
- Held for sale	Lower of depreciated cost or market	Lower of fair value less cost to sell
Investment in affiliates	Not consolidated—NAIC value	Consolidated, equity basis, or cost as appropriate
Asset Valuation Reserve (AVR)	Formula driven	Not applicable
Interest Maintenance Reserve (IMR)	Interest-rate related net realized gains deferred and amortized to income (net of tax)	Not applicable
Realized gains (losses)	Non-IMR gains reported in income	Recorded in income statement
Unrealized gains (losses) for securities	Recorded directly to surplus	Recorded in income or equity, as appropriate (except for held-to-maturity)

Area	Statutory Accounting Practices	Generally Accepted Accounting Principles
Impairment issues (for marketable debt and equity securities)	Permitted to the extent not provided in the AVR	Write-down for impairment of value that is other than temporary
Nonadmitted assets	Excluded from the balance sheet and charged to surplus	Not applicable
Liability for future policy benefits	Determined using interest, morbidity, and mortality assumptions based on tables and/or formulas prescribed by the state insurance department	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 — require retrospective deposit method of accounting
Due and deferred premiums	Due and deferred premiums recorded as assets	Due premiums reported as assets; deferred premiums offset against liabilities for future policy benefits
Contractholder dividend liability	Provision made for dividends payable on next contract anniversary	Provision made for accumulated earnings expected to be paid to contractholders, including prorata portion of dividends incurred to valuation date; future dividends included in benefit liabilities
Reinsurance	Full credit generally given for authorized reinsurers; net reporting required; reinsurance recognized based on adequate transfer of risk; liability for unauthorized reinsurers	Reinsurance recognized based on adequate transfer of risk; provision for uncollectible reinsurance and gross reporting required under FASB Statement No. 113
Deferred taxes	Not provided	Provision made for temporary differences, NOL, and credit carryforwards under FASB Statement No. 109
Leases	All leases accounted for as operating leases except for leveraged leases by lessors that meet GAAP criteria in FASB Statement No. 13	Classified as capital or operating according to the provisions of FASB Statement No. 13

Area	Statutory Accounting Practices	Generally Accepted Accounting Principles
Liability for postretirement benefits other than pensions	Liability based on vested benefits amortized over a period up to twenty years.	Expected postretirement benefit obligations are recognized over the working life of employees; liability based on vested and nonvested benefits under FASB Statement No. 106
Pension benefits	Usually based on ERISA funding requirements (FASB Statement No. 87 application is optional)	Pension costs calculated based on the projected unit credit method under FASB Statement No. 87
Universal life revenue	Premiums and deposits are recognized as revenue	Premiums and deposits included in contractholder liabilities; revenues consisting of cost of insurance, expense, and surrender charges recognized as revenue
Contract acquisition costs	Charged to expense when incurred	Deferred and amortized (with interest) in relation to the revenue generated (premiums or estimated gross profit, as appropriate) if recoverable from such revenue
Consolidation	Generally not applied	Generally required in accordance with FASB Statement No. 94

Exhibit 3.1
AU Section 9623 - Special Reports

Special Reports: Auditing Interpretation of AU Section 623

Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis.

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 generally accepted accounting principles (GAAP). How should auditors evaluate whether informative disclosures in financial statements prepared on a statutory basis are appropriate?

Interpretation. Financial statements prepared on a statutory basis are financial statements prepared on a comprehensive basis of accounting other than GAAP according to section 623, *Special Reports*, paragraph .04. Section 623.09 states that "When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the auditor should consider whether the financial statements (including the accompanying notes) include all informative disclosures that are appropriate for the accounting basis 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 generally accepted accounting principles. 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 411, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report*, paragraph .04."

Section 623.02 states that generally accepted auditing standards 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. Sections 623.09 and 623.10 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, including a summary of significant accounting policies that discusses the basis of presentation and describes how that basis differs from GAAP. Section 623.10 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 generally accepted accounting principles, similar informative disclosures are appropriate."

In addition, in 1991 the National Association of Insurance Commissioners (NAIC) adopted a new Annual Statement instruction, "Annual Audited Financial Reports" under which insurance enterprises are required to include in their statutory basis financial statements those disclosures that "are appropriate to a CPA audited financial report, based on applicability, materiality and significance, taking into account the subjects covered in the instructions to and illustrations of how to report information in the notes to the financial statements section of [the] Annual Statement instructions and any other

notes required by generally accepted accounting principle...." The laws and regulations of some individual states contain similar requirements.

Therefore, the auditor should also consider the disclosures and illustrations of how to report information in the notes to financial statements section of the Annual Statement instructions.

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.

Interpretation. Disclosures in statutory basis financial statements for items and transactions that are accounted for essentially in the same or in a similar manner under a statutory basis as under GAAP should be the same as, or similar to, the disclosures required by GAAP. Other disclosures considered necessary upon review of the Annual Statement instructions should also be made to the extent that such disclosures are significant to the statutory basis financial statements.

For example, disclosures in statutory basis financial statements concerning financial instruments should include the applicable disclosures required by FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* and FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

Disclosures in statutory basis financial statements for items that are accounted for differently under a statutory basis than under GAAP should be the same as the disclosures required by GAAP that are relevant to the statutory basis of accounting for that item. Such disclosures can be separated into two general categories, which are discussed in the following paragraphs of this Interpretation. The examples presented are for illustrative purposes only and are not intended to be all-inclusive.

Specific disclosures are stated in GAAP literature for the accounting method used in the statutory basis financial statements, even though the item would be accounted for differently under GAAP. In such instances, the applicable GAAP disclosures should be made in addition to those disclosures considered necessary upon review of the Annual Statement instructions.

For example, certain leases entered into by a lessee insurance enterprise that would be accounted for as capital leases under GAAP are accounted for as operating leases by insurance enterprises in their statutory basis financial statements. In such instances, the applicable disclosures for operating leases required by FASB Statement No. 13, *Accounting for Leases*, should be made in the statutory basis financial statements.

Another example is reinsurance transactions. Certain reinsurance contracts are permitted to be accounted for as reinsurance transactions in statutory basis financial statements but would be accounted for as financing transactions under GAAP. In such instances, the applicable disclosures for contracts accounted for as reinsurance transactions that are required by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* should be made in the statutory basis financial statements.

Specific disclosures are not stated in current GAAP literature for accounting methods used in the statutory basis financial statements. If statutory accounting practices (SAP) permit insurance enterprises to use an accounting method that has been superseded under GAAP literature, disclosures that were required under the superseded GAAP literature should be made.

For example, some insurance companies are permitted to account for pensions in their statutory basis financial statements using the same method as required under APB Opinion No. 8, *Accounting for the Cost of Pension Plans*, which was amended by FASB Statement No. 36, *Disclosure of Pension Information*. (APB Opinion No. 8 and FASB Statement No. 36 were superseded by FASB Statement No. 87, *Employers' Accounting for Pensions*, for fiscal years that began after December 15, 1986.) In addition to disclosing the accounting policy for pensions, insurance companies should make the disclosures contained in APB Opinion No. 8 and FASB Statement No. 36 in their statutory basis financial statements. If a company is accounting for pensions using another method of measurement, such as tax, it should make informative disclosures, at a minimum, such as type of benefit formula, funding policy, fair value of plan assets, and amount of pension costs.

A final example is deferred acquisition costs (DAC). Acquisition costs are expensed when paid under SAP and are capitalized and amortized under GAAP. FASB Statement No. 60 requires certain disclosures about DAC
— the nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period. Because DAC are not capitalized under SAP, such disclosures, other than a description of the accounting policy used, are not applicable.

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.

Chapter 4

BUSINESS RISK CONSIDERATIONS

INTRODUCTION

4.1 This chapter is intended to assist the auditor in identifying and assessing the effects of business and economic conditions on inherent risk. In planning the audit of a life insurance entity, the auditor should be aware of the business and economic conditions that affect the industry, and how these conditions affect the entity being audited including the adequacy of the entity's capital.

4.2 Although life insurance entities exist to manage the insurance and investment risks of their contractholders, the principle 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, C-1 through C-4. These categories are used in the NAIC RBC formulas, which are discussed in paragraph 4.8, 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).* Also referred to as underwriting risk, this 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 (C-3).* Also referred to as asset/liability matching, this 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 contractholders to withdraw funds prematurely (referred to as *disintermediation*) or result in prepayment of fixed income securities (referred to as *reinvestment risk*).

d. *Business risk (C-4).* This is general business and management risk common to most enterprises. 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

4.3 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 should consider when assessing inherent risk. For the purposes of this 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.

Asset Risk (C-1)

4.4 The indicators of asset risk exposure the auditor should consider include–

- Large investments in noninvestment grade securities.
- Significant investments in affiliates.
- Concentration of investments in a single investee.
- Equity stakes accepted in lieu of principal and interest as well as capitalization of interest.
- Substantial unrealized investment losses.
- Guarantees of publicly issued debt, such as collateralized mortgage obligations (CMOs) or municipal bonds.
- Increasing delinquencies and nonperforming loans as well as little experience in modifications, workout programs, or restructuring.
- Higher delinquency and foreclosure rates than industry averages or prior years experience.
- The refinancing or restructuring of significant amounts of bullet loans.
- Significant exposure to individual real estate investments in concentrated markets or geographic regions.
- Speculative investments.
- Concentrations of mortgages with individual borrowers.
- Significant high-risk loans underwritten (such as high interest rates or second liens).
- Significant mortgages and other loans to affiliates, subsidiaries, joint ventures, limited partnerships, or other related parties.
- The acceptance of additional investment risk to support high crediting rates.
- Significant amounts of investments in derivatives and structured securities.

Insurance Risk (C-2)

4.5 The indicators of insurance risk exposure the auditor should consider include–

- Lack of conservatism in determining benefit liabilities.
- Sensitivity of benefit liabilities to management estimates.
- Extensive use of reinsurance arrangements with poorly rated reinsurers.
- Health insurance products affected by dramatic increases in medical costs.

- Little experience in underwriting and pricing new products such as long-term care contracts.
- Relaxed underwriting standards.
- Trend toward antiselection, particularly in health care products, which may result in deteriorating margins.
- New forms of competition in the traditional life insurance market.
- Significant increases over prior years in the frequency and severity of claims.
- New events, such as the advent of acquired immune deficiency syndrome (AIDS), that may result in deteriorating profits on existing contracts.
- Fixed costs increasing faster than inflation.
- Actual expenses substantially higher than those assumed in pricing.
- Product pricing assumptions based on competitive market pricing without regard to expected costs.
- Underwriting standards inconsistent with the mortality/morbidity assumptions used in product pricing.

Interest Rate Risk (C-3)

4.6 The indicators of interest-rate risk the auditor should consider include–

- Significant increases in surrenders or lapses of contracts.
- Insufficient short-term liquid investments.
- Negative spreads on investment contracts.
- Significant deposit contracts without surrender charges.
- Individually significant balances with single customers for pension or other deposit-type products.
- Inadequate testing of cash-flow or interest-rate scenarios.
- Asset maturities that are not consistent with expected payouts of contractholder liabilities.
- Significant asset/liability mismatches.

Business Risk (C-4)

4.7 Indicators of business risk exposure the auditor should consider include–

- Capital and surplus that are below industry average.
- Poor or deteriorating results under the NAIC RBC model.
- A substantial portion of surplus that is attributable to gains resulting from nonrecurring transactions or other nonrecurring items.
- Transactions and changes in accounting treatment that enhance surplus, such as financial reinsurance or change in benefit and claim liability estimates.
- 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.
- Lack of profitability of new products that are subsidized by a profitable inforce.
- The possibility of large guaranty fund assessments.

- The possibility of federal intervention in the form of nationalized health care that may ultimately change the competitive structure of health insurers.
- Unexpected changes in the individual tax laws, such as those that affected single premium life insurance products and certain types of individual annuities.
  Explosive growth without adequate infrastructure and controls
- Events or transactions that could cause regulators to assume control or supervision of the life insurance entity.
- The possibility of regulatory action to influence or change actions taken by management.
- Downgrading by major rating agencies.

STATUTORY RBC

4.8 The NAIC has developed an RBC program which provides for dynamic surplus formulas (similar to target surplus formulas used by commercial rating agencies). The formulas specify various weighing 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 types of risk described in paragraph 4.2. The amount of risk determined under such formulas is called the authorized control level risk-based capital (ACLC RBC).

4.9 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* (TAC) (equal to statutory capital), plus asset valuation reserve (AVR) and any voluntary investment reserves, plus 50 percent of dividend liability, capital notes, and certain other specified adjustments to the calculated ACLC RBC. The levels of regulatory action, the trigger point, and the corrective actions are summarized in Table 4.1.

Table 4.1
Risk-Based Capital Requirements

LEVEL	TRIGGER	CORRECTIVE ACTION
Company action level RBC (CALC)	TAC is less than or equal to 2.0 x ACLC, or TAC is less than or equal to 2.5 x ACLC with negative trend.	The life insurance entity must submit a comprehensive plan to the insurance commissioner.
Regulatory action level RBC (RALC)	TAC is less than or equal to 1.5 x ACLC, or there is an unsatisfactory RBC Plan.	In addition to the action above, the insurance commissioner is required to perform the examination or analysis deemed necessary, and issue a *corrective order*, specifying the corrective actions required.
Authorized control level RBC (ACLC)	TAC is less than or equal to 1.0 x ACLC.	In addition to the actions described above, the insurance commissioner is permitted but not required to place the life insurance entity under regulatory control.
Mandatory control level RBC (MCLC)	TAC is less than or equal to .7 x ACLC.	The insurance commissioner is required to place the 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 impacting 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 forty-five days of the failure to meet RBC standards. Within sixty 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, 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.

Chapter 5

GENERAL AUDITING CONSIDERATIONS

INTRODUCTION

5.1 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, chapters 1, 2, and 4 of this 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 provides a general discussion of SAP and GAAP relating to the life insurance industry. Appendix A provides sources for additional information on the life insurance industry.

SCOPE OF THE AUDIT ENGAGEMENT

5.2 For each audit engagement, the auditor and the life insurance entity should establish a clear understanding of the scope of the audit services to be provided and the auditor's responsibilities; the auditor may find it useful to obtain this understanding in writing. The nature, timing, and extent of audit procedures to be performed and the type of reports to be issued are based on the scope of the audit services required by the life insurance entity. SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), provides guidance about auditors establishing an understanding with the client regarding services to be performed.

5.3 In defining the scope of audit services, the auditor should consider matters relating to specific reporting responsibilities of the engagement. These matters include—

- The legal structure or organization of the life insurance entity and the number and type of entities that require separate reports on SAP or GAAP financial statements (or both), or that require consolidated statements.

- Regulatory reporting and filing requirements for local, state, and federal regulatory authorities.

- Reporting requirements — of a foreign parent or subsidiaries — such as those for which guidance is provided in SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*, vol. 1, AU sec. 534), 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.

PLANNING THE AUDIT

5.4 The first standard of fieldwork requires that the audit be adequately planned. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), provides broad guidance about audit risk and materiality at both the financial statement level and at the individual account-balance or class-of-transaction level when the auditor plans and performs an audit. The nature, timing, and extent of planning usually varies with the size and complexity of the life insurance entity as well as the auditor's experience with the entity. SAS No. 22 contains guidance on planning and supervising an audit in accordance with generally accepted auditing standards (GAAS).

5.5 SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises,* states that the auditor should consider statutory calculated 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 5.21 through 5.24 for discussion of the auditor's consideration of statutory risk-based capital for life insurance entities.)

5.6 The financial statements of any entity are management's representation of the financial position, results of operations, and cash flows of the entity. The overall audit objective is to obtain an appropriate basis for the expression of an opinion on those financial statements.

5.7 SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), contains guidance on obtaining and evaluating evidential matter regarding management's assertions in the financial statements, in order to express an opinion on those financial statements. Assertions are representations by management that are embodied in the financial statements. In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance or class of transactions. They can be either explicit or implicit, and can be classified according to the following broad categories:

a. Existence or occurrence
b. Completeness
c. Rights and obligations
d. Valuation and allocation
e. Presentation and disclosure

5.8 The audit risk of material misstatement at the account-balance or class-of-transaction level consists of inherent risk, control risk, and detection risk. Inherent risk is the susceptibility of an assertion to material misstatement without regard to the operation of relevant controls. Control risk is the risk that a material misstatement could occur and would not be prevented or detected on a timely basis by the entity's internal control. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

Inherent Risk

5.9 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 be aware of certain aspects of the life insurance entity's operations that are usually subject to a greater level of inherent risk than others. SAS No. 47 provides the auditor with guidance on

considering audit risk and materiality when planning and performing an audit of financial statements in accordance with GAAS.

5.10 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.

5.11 *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 dealing with 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 type of business processed.

5.12 *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 impact 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 effect mortality or morbidity expectations and claims levels.

5.13 *Engagement Characteristics*. The following characteristics pertaining to 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.

d. The life insurance entity has noninsurance subsidiaries such as finance companies, 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

5.14 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: an amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), describes the

objectives and components of an entity's internal control and explains how an auditor should consider internal control in planning and performing an audit. AU sec. 319 requires that to plan the audit, the auditor should obtain an understanding of the entity's internal control sufficient to plan the audit.

5.15 SAS No. 78 defines internal control as "a process–effected by an entity's board of directors, management, and other personnel–designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations."[1] The five components of an entity's internal control are the following:

a. The control environment

b. Risk assessment

c. Control activities

d. Information and communication

e. Monitoring

AU sec. 319 discusses each of these five components.

5.16 The auditor should obtain an understanding of each of the five components of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and whether they have been placed in operation. The auditor's primary consideration, however, is whether a specific control affects financial statement assertions rather than its classification into a particular component.

5.17 The auditor should assess control risk for the assertions embodied in the financial statements. The auditor may assess control risk at a maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control) if the auditor believes controls are unlikely to pertain to an assertion or are unlikely to be effective, or if evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidence from tests of controls about the effectiveness of both the design and operation of a control that would support a lower assessed level of control risk. Tests of controls may be performed concurrently with obtaining the understanding (either as a result of audit planning or not), or they may be performed after obtaining an understanding of the internal control and the assessed level of control risk in determining the nature, timing, and extent of substantive tests to be performed.

5.18 Certain characteristics of internal control, particularly in the control environment, may be unique to life insurance entities. SAS No. 78 states that auditors should obtain a sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment considering both the

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[1] Paragraph 9 of SAS No. 78 provides that "although an entity's internal control addresses objectives in each of the categories referred to in paragraph 6, not all of these and related controls are relevant to an audit of the entity's financial statement."

substance of controls and their collective effect.

5.19 Service organizations. 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. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*, provides guidance on the factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. The relationship of the controls of the service organization to those of the user organizations depends primarily on the nature of the services provided by the service organization. For example, when those services are limited to recording user transactions and processing the related data, and the user organization retains responsibility for authorizing transactions and maintaining the related accountability, there is a high degree of interaction between the controls at the service organization and those at the user organization. In these circumstances, it may be possible for the user organization to implement effective internal controls for those transactions. The degree of interaction, as well as the nature and materiality of the transactions processed by the service organization, are the most important factors in determining the significance of the service organization's controls to the user organization's internal control.

Detection Risk

5.20 The detection risk that the auditor can accept in designing auditing procedures is based on the level needed to restrict audit risk related to the account balance or class of transactions and on the assessment of inherent and control risks. As the auditor's assessment of inherent risk and control risk decreases, the detection risk that the auditor can accept increases correspondingly. It is not appropriate, however, for an auditor to rely completely on the assessment of inherent risk and control risk without performing substantive tests of account balances and classes of transactions because misstatements could exist that might be material when aggregated with misstatements of other account balances or classes of transactions.

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

5.21 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.

5.22 Regulators of life insurance entities have historically focused on capital. The 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 four general types 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 RBC (ACLC).

5.23 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 (TAC) (equal to the sum of statutory capital and surplus and such other items, if any, as the NAIC's RBC instructions[2] may provide) to the calculated ACLC. The levels of regulatory action, the trigger point, and the corrective actions are summarized in paragraph 4.9 and 4.10.

5.24 *Audit Planning*. 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. To accomplish that objective, the auditor assesses the risk that the financial statements contain material misstatements and plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements. Because of the importance of RBC to life insurance entities, RBC should be considered in assessing risk and planning the audit. The auditor should ordinarily obtain and review the client's RBC reports and should understand the RBC requirements for preparing such reports and the actual regulations associated with RBC.

INFORMATION PROCESSING[3]

5.25 Because of the large number of transactions and the need to maintain accountability for individual contracts, most life insurance entities use some form of electronic data processing (EDP) 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, payroll, accounts payable, property and equipment records, and general ledger.

5.26 The sophistication of a life insurance entity's EDP 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 EDP 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.

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

[3]SAS No. 80, *Amendment to Statement on Auditing Standards No. 31,* Evidential Matter, provides guidance to auditors in auditing the financial statements of entities for which significant information is transmitted, processed, maintained, or accessed electronically.

5.27 The use of EDP systems does not affect the objectives of the audit. However, the organizational and control procedures may differ from those used in manual data processing, and audit procedures applied to accounting records maintained on EDP equipment may vary from those applied to records maintained manually.

5.28 The methods an entity uses to process significant accounting applications may influence its control procedures. The auditor's assessment of control risk should encompass the EDP aspects of application systems. Life insurance entities have been leading users of advanced EDP technologies, and the control issues involving EDP should receive considerable attention.

5.29 This Guide does not address the effects of EDP on an audit. Guidance on auditing records for which EDP is a significant factor is contained in the following:

a. SAS No. 70

b. SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.03, 311.09-10)

c. AICPA Audit and Accounting Guide, *Consideration of the Internal Structure in a Financial Statement Audit*

Other non-authoritative guidance on auditing EDP records is contained in the following AICPA Auditing Procedures Studies:

a. *Implementing SAS No. 70, Reports on the Processing of Transactions by Service Organizations*

b. *Audit Implications of Electronic Data Interchange (EDI)*

c. *Auditing With Computers*

ANALYTICAL PROCEDURES

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

5.31 SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards* vol. 1, AU sec. 329), 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 evidential matter 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.

5.32 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, IRIS ratio analysis (see paragraph 1.44), and rating agency reports.

5.33 Examples of analytical procedures the auditor may find useful in planning an audit of a life insurance entity are as follows:

- Comparison of account balances with budget and prior-period amounts

- Analysis of changes between periods for reinsurance activity, underwriting standards, reserve methodologies, and other related factors

- Analysis of related economic factors such as interest rate fluctuations

- Comparison, between periods, of the following:
  - New business premiums and renewal premiums
  - Amounts and types of insurance in force
  - Contract counts
  - Average premium per unit in force
  - Geographical concentration of revenues and assets
  - Source of revenue by agent, broker, or other distribution system
  - Investment income and yield comparison by asset category
  - Composition of asset portfolio
  - Benefits incurred to premiums collected for traditional life products
  - Assets and troubled assets to surplus ratio
  - SAP to GAAP benefit and claim liabilities
  - Taxes to pretax income
  - Capitalized costs to first year premium
  - Relationship between periods of replacement, lapse, reinstatement, and policy loan activity
  - Premiums, related commission amounts, and operating expenses
  - Suspense account activity, ending balances, and aging of individual items

ACCOUNTING ESTIMATES

5.34 In determining the scope of audit procedures to be performed, the auditor should recognize that due to 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 and related amortization, valuation of real estate and mortgage loan portfolios, and income taxes. SAS No. 57, *Auditing Accounting*

Estimates (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates.

USE OF SPECIALISTS

5.35 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 competent evidential matter. Examples of such specialists might include actuaries, appraisers, attorneys, and EDP specialists. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), provides guidance to the auditor who uses the work of a specialist in performing the audit of financial statements.

Auditing Actuarially Determined Accounting Estimates

5.36 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 deferred acquisition costs and related amortization.

5.37 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, deferred acquisition costs, 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 competence and experience should be commensurate with the complexity of the entity's business, which is affected by such factors as the types of contracts underwritten and the environment and risk considerations described in previous chapters in this Guide.

5.38 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 titled *Auditor's Responsibility Concerning Statement of Actuarial Opinion Required by Insurance Regulators*, which provides guidance on this subject.

5.39 Because the process of determining benefit and claim liabilities as well as deferred acquisition costs 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 reportable condition and possibly a material weakness in the entity's internal control. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), describes the auditor's responsibility to communicate reportable conditions to the audit committee.

5.40 _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 SAS No. 57. 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. When 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.

5.41 In accordance with SAS No. 73, 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. 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.

5.42 The auditor should obtain (a) a written report from the outside qualified actuary who calculated or verified the benefit and claim liabilities, and (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.

5.43 The following are descriptions of situations involving the presence or absence of a qualified actuary in management's determination of benefit and claim liabilities, deferred acquisition costs and related amortization, and other material actuarially determined amounts and the recommended response by the auditor to each situation. The guidance in SAS No. 73 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 5.39, this situation may constitute a reportable condition and possibly a material weakness in the internal control. The auditor would be required to use an outside qualified actuary, unless the auditor was a qualified actuary or had one on staff, to develop an independent expectation of the actuarial estimates recorded by the entity.

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

5.44 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 SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322).

OTHER PLANNING CONSIDERATIONS

5.45 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 these procedures:

- Review correspondence files, the previous year's working papers, permanent files, financial statements, the last examination report, rating agency reports, and the auditor's reports.

- Review minutes of the meetings of the governing board and board committees.

- 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.

- Review the status of unsettled claims reports — particularly for health insurance product lines.

- Discuss matters that may affect the audit with the audit firm's personnel responsible for any nonaudit services to the life insurance entity.

- 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.

- Review the current year's interim financial statements and filings with the SEC.

- Review periodic reports to other regulatory bodies.

- Discuss the nature, scope, and timing of the engagement with the entity's management, board of directors, or audit committee.

- Consider the effects of applicable accounting and auditing pronouncements, particularly new ones.

- Coordinate the assistance of life insurance entity personnel in data preparation.

- Determine the extent of involvement, if any, of consultants, specialists, and internal auditors, and identify situations for which accounting estimates are required and relevant factors that may affect these estimates.

- Determine examination status with regulatory authorities. Review correspondences with regulatory authorities. Review examination reports that have been issued.

- Consider the need to conduct audit procedures at third-party administrators such as underwriters, investment managers, and claims administrators.

- Consider the need to conduct audit procedures at reinsurers for material transactions or reinsurance agreements.

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

- Establish the timing of the audit work.

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

- Articles of incorporation
- Bylaws

- Chart of accounts
- Organization chart
- Contracts and agreements, such as leases, contract forms, agent contracts, agreements with third parties such as reinsurers, and agreements with affiliated and related organizations
- Description of the internal control, that is, the control environment, the risk assessment, control activities, information and communication, and monitoring
- Loan agreements, bond indentures, and other debt instruments
- Licensing status and examiner's reports

OTHER AUDIT CONSIDERATIONS

5.47 The decision about the appropriate form of audit report to issue in particular circumstances is often derived by a complex judgment that requires considerable professional experience. The auditor may have to communicate with the regulator to assist with his or her assessment. See chapter 15 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."

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

5.48 The NAIC's *Annual Statement Instructions Requiring Annual Audited Financial Statements*, which incorporates the *January 1991 Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in July 1995) (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. To the extent that the Model Audit Rule is changed in the future, the illustrations in this guide may need to be changed to reflect the revisions.

5.49 *Awareness*. Section 6 of the Model Audit Rule requires that the insurer notify the insurance commissioner of the state of domicile of the name and address of the insurer's independent certified public accountant (hereinafter referred to as *auditor*). In connection with that notification, the insurer is required to obtain an awareness letter from its auditor stating that the auditor—

a. Is aware of the provisions of the insurance code and the rules and regulations of the insurance department of the state of domicile that relate to accounting and financial matters.
b. Will issue a report on the financial statements in 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. Exhibit 5.1 contains an illustration of the awareness letter.

5.50 *Change in Auditor*. Section 6 of the Model Audit Rule requires that insurers notify the insurance department of the state of domicile within five business days of the dismissal or

resignation of the auditor for the immediately preceding filed audited statutory financial statements. Within ten business days of that notification, the insurer also is required to provide a separate letter stating whether, in the twenty-four months preceding 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 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. Exhibit 5.2 contains an illustration of the change in auditor letter.

5.51 Qualifications. Section 12 of the Model Audit Rule requires the auditor to provide a letter to the insurer to be included in the annual financial report stating—

a. The auditor is independent with respect to the insurer and conforms with the standards of his or her profession as contained in the Code of Professional Conduct and pronouncements of the AICPA and the Rules of Professional Conduct of the appropriate state board of public accountancy.

b. The background and experience in general and of the individuals used for an engagement and whether each is a certified public accountant.

c. The auditor understands that the annual audited statutory financial statements and his or her opinion thereon will be filed in compliance with the requirements of the Model Audit Rule and that the domiciliary commissioner will be relying on the information in the monitoring and regulating of the financial position of insurers.

d. The auditor consents to the workpaper requirement contained in the Model Audit Rule and agrees to make the workpapers available for review by the domiciliary commissioner or the commissioner's designee under the auditor's control.[4]

e. The engagement partner is licensed by an appropriate state licensing authority and is a member in good standing of the AICPA.

f. The auditor meets the qualifications and is in compliance with the "Qualifications of Independent Certified Public Accountant" section of the Model Audit Rule.

Exhibit 5.3 contains an illustration of an accountant's letter of qualifications.

5.52 Notification of Adverse Financial Condition. Section 10 of the Model Audit Rule requires that the auditor notify the insurer's board of directors or audit committee in writing within five business days of determination that (a) the insurer has materially misstated its financial condition as reported to the domiciliary commissioner as of the balance-sheet date currently under examination or (b) the insurer does not meet the minimum capital and surplus requirements of the state insurance statute as of the balance-sheet date. The Model Audit Rule also requires the insurer to

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[4]Refer to AICPA, *Professional Standards,* vol. 1, AU sec. 9339, *Working Papers: Auditing Interpretations of Section 339.*

provide (a) to the insurance commissioner of the state of domicile a copy of the notification of adverse financial condition within five days of its receipt and (b) to the auditor evidence that the notification has been provided to the insurance commissioner. If the auditor receives no such evidence, the Model Audit Rule requires the auditor to send the notification to the insurance commissioner directly within the next five business days. Exhibit 5.4 contains an illustration of the notification of adverse financial condition letter.

5.53 _Report on Internal Controls_. Section 11 of the Model Audit Rule requires that insurers provide the insurance commissioner of the state of domicile a written report describing significant deficiencies in the insurer's internal control noted during the audit. Auditors should follow the guidance in SAS No. 60. Additionally, the Model Audit Rule requires insurers to provide a description of remedial actions taken or proposed to correct significant deficiencies, if not covered in the auditor's report. The reports on internal controls should be filed by the insurer within sixty days after filing the annual audited financial statements. Although the Model Audit Rule does not require a report to be issued if the auditor does not identify significant deficiencies, some states may require the auditor to issue a "no material weaknesses letter," as described in SAS No. 60 in such circumstances.

Other Communication Between Auditors and Regulators

5.54 _Auditor's Consideration of State Regulatory Examinations_. SAS No. 57 states that the auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies." SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), notes that "the auditor may encounter specific information that may raise a question concerning possible acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor." Accordingly, it is appropriate that the auditor consider examination reports and related communications between examiners and the insurance entity to obtain competent evidential matter.

5.55 The auditor should review reports of examinations and communications between regulators and the insurance entity and make inquiries of the regulators. In doing so, the auditor should —

- Request that management provides access to all reports of examinations and related correspondence including correspondence pertaining to financial conditions.

- 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.

- Query the 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.

5.56 A refusal by management to allow the auditor to review communications from, or communicate with, the regulator would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion. (See SAS No. 58, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1, AU sec. 508.40-.44].) 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.

5.57 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.

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

5.59 Permitted accounting practices include practices not prescribed in paragraph 5.58 but allowed by the domiciliary state insurance department. Insurance entities may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of their statutory financial statements (a) when the entity wishes to depart from the prescribed SAP, or (b) when prescribed SAP do not address the accounting for the transaction(s). Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

5.60 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. (See paragraphs 3.7 through 3.9 of the Guide.) For each audit, auditors should obtain sufficient competent evidential matter 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.

5.61 Sufficient competent evidential matter consists of any one or combination of the following:

- Written acknowledgment sent directly from the regulator to the auditor. This type of corroboration includes letters similar to attorneys' letters and responses to confirmations.

- Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client.

- Direct oral communications between the regulator and the auditor, supported by written memorandum. (If the auditor, rather than the regulator, prepares the memorandum, the auditor should send such memorandum to the regulator to make sure it accurately reflects the communication.)

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

5.62 If the auditor is unable to obtain sufficient competent evidential matter 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. (See SAS No. 58, AU sec. 508.40-.44.)

5.63 *Availability of Auditor's Working Papers 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 prepared in conducting his or her audit, and any audit-related communications between the auditor and the life insurance entity. Working papers may include audit planning documentation, work programs, analyses, memoranda, letters of confirmation and representation, abstracts 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.[5]

5.64 State regulations require the auditor to retain the audit working papers and communications until the state insurance department has filed a report on the examination covering the period of audit; but no longer than seven years from the date of the auditor's report.

5.65 *Supplemental Schedule of Assets and Liabilities*. The NAIC has revised its *Life, Accident and Health Annual Statement Instructions* to require that insurers filing audited statutory financial statements in accordance with NAIC *Annual Statement Instructions* include a Supplemental Schedule of Assets and Liabilities. The schedule, which is illustrated in the NAIC *Annual Statement Instructions*, requires the auditor to issue a report on the supplemental schedule 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 schedule is either directly related to the basic statutory financial statements or derived from accounting records that are tested by auditors, the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551) should be followed when auditors report on supplemental schedules. SAS 29 provides guidance for both accounting and nonaccounting data.

Communications by Successor Auditors

5.66 SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place or is in process.

Communication of Matters Related to Internal Control

5.67 SAS No. 60 provides guidance on identifying and reporting conditions that relate to an entity's internal control observed during an audit of financial statements. It is contemplated that communication would generally be with the audit committee or individuals 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). Conditions noted by the auditor that are considered reportable under SAS No. 60 should be communicated, preferably in writing. Information that is orally communicated should be documented by the auditor in appropriate memoranda or notations in the

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[5]See Auditing Interpretation No. 1 of SAS No. 41, Working Papers, "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AU sec 9339.01-.15). Refer to that interpretation for more specific guidance.

working papers.

5.68 In addition, 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. (See paragraph 5.54.)

Communication With Audit Committees

5.69 SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards,* vol. 1, AU sec. 380), 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 by SAS No. 61 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 (b) all SEC engagements as defined in SAS No. 61. In addition, communication with the audit committee or its equivalent by the auditor on specific matters as they occur in the conduct of an audit is required by other standards, including SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), SAS No. 54, SAS No. 60, and SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722).

Consideration of Fraud in a Financial Statement Audit

5.70 There are risks inherent in all audit engagements, including the possibility of fraudulent acts that cause a material misstatement of financial statements. SAS No. 82 provides specific 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 cause by fraud. SAS No. 82 requires the auditor to assess the risk of material misstatement due to fraud and consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both (a) misstatements arising from fraudulent financial reporting and (b) misstatements arising from misappropriation of assets in the following categories:

<u>Fraudulent Financial Reporting</u>

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

<u>Misappropriation of Assets</u>

- Susceptibility of assets to misappropriation
- Controls

In addition to requiring the auditor to assess the risk of material misstatement due to fraud, SAS No. 82 provides guidance on how the auditor responds to the results of that assessment, provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud, describes related documentation requirements, and provides guidance regarding the

auditor's communication about fraud to management, the audit committee, and others.

Illegal Acts

5.71 SAS No. 54 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 SAS No. 54, 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 the audit committee or its equivalent (the board of trustees or an owner–manager) in accordance with SAS No. 54.

5.72 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.

5.73 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 and report illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors and irregularities as described in SAS No. 53. 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.

5.74 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.

5.75 Normally, an audit in accordance with GAAS does not include audit procedures specifically designed to detect illegal acts such as those described in paragraph 5.74 above. However, other audit procedures may bring possible illegal acts to the auditor's attention. Such audit procedures might include: (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 domicile state insurance department's laws and regulations and those of any other states in which the entity is licensed to write business; and (c) consideration of the adequacy of client's

procedures for monitoring regulatory compliance.

5.76 Due to 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.

5.77 The auditor also ordinarily obtains written representations from management. The auditor should refer to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), for guidance concerning the absence or 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

5.78 SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), requires 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 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 completion of fieldwork. 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.

5.79 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:

- Recurring operating losses
- Indications of strained liquidity
- Failure to meet minimum capital requirements
- Concerns expressed or actions taken by regulatory authorities regarding alleged unsafe and unsound practices
- Indications of strained relationships between management and regulatory authorities

5.80 SAS No. 59 (paragraph .03) provides the following 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:

a. The auditor considers whether the results of his procedures performed in planning, gathering evidential matter 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 the 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 he should (1) obtain information about management's plans that are intended to mitigate the effect of the conditions or events, and (2) 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 should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) 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.

5.81 SAS No. 59 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:

- Analytical procedures
- Review of subsequent events
- Review of compliance with the terms of debt and loan agreements
- Reading of minutes of meetings of the board of directors and important committees of the board
- Inquiry of an entity's legal counsel about litigation, claims, and assessments
- Confirmation with related and third parties of the details of arrangements to provide or maintain financial support

- Review of the financial strength and liquidity of the parent company, if applicable

- Review of reports of significant examinations and related communications between examiners and the life insurance entity

- Review of asset/liability matching studies and reports

- Review of the life insurance entity's RBC calculations and develop an understanding of any implications on the financial position of the entity

5.82 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.[6] 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 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 —

a. The life insurance entity's existing regulatory capital position.

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

5.83 The auditor should consider the amount of any RBC capital deficiency. In general, the lower the ratio of total adjusted capital to authorized control level RBC, the greater the doubt about the 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 twelve months.

5.84 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.

5.85 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

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[6]Auditors should evaluate a life insurance entity's ability to continue as a going concern even if the entity meets minimum 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 5.21 through 5.24.

obtain evidential matter about the significant elements. For example, the auditor should 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.

5.86 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,[7] 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,[8] the auditor should make inquiries of management officials about their comprehensive financial plan and their plans for filing.

5.87 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.

5.88 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.

5.89 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—

- 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.

- The possible effects of such conditions and events.

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

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

- Management's evaluation of the significance of those conditions and events and any mitigating factors.

- Possible regulatory sanctions, including discontinuance of operations.

- Management's plans, including information about the life insurance entity's capital plan and relevant prospective financial information.

- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities.

5.90 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.[9] The auditor's decision about whether modification of the standard report is appropriate may depend on —

- The life insurance entity's RBC position and the likelihood that this position will improve or deteriorate within the next twelve months.

- 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.

- The extent of recurring operating losses.

- The financial strength and liquidity of the parent company.

- The consequences of defaults under debt and loan agreements.

MANAGEMENT REPRESENTATIONS

5.91 SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 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 for an example of an illustrative management representation letter.) SAS No. 85, paragraph 6, lists matters ordinarily included in a management's representation letter. Auditors of life insurance entities might also obtain representations, if applicable, whether:

- Information returns have been filed on a timely basis with the appropriate regulatory bodies.

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[9]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.

- Pending changes in the organizational structure, financing arrangements, or other matters that have a material effect on the financial statements of the entity are properly disclosed.

- 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 generally accepted accounting principles.

- 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 permitted statutory accounting practices.

- 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.

- Permitted practices used in the preparation of the statutory financial statements.

Exhibit 5.1
Illustration of the Accountant's Awareness Letter

To the Board of Directors of ABC Insurance Company:

We have been engaged by ABC Insurance Company (the Company) to perform annual audits in accordance with generally accepted auditing standards of the Company's statutory financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of *[name of state of domicile]* and the related rules and regulations of the Insurance Department of *[name of state of domicile]* that are applicable to audits of statutory financial statements of insurance enterprises. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of ABC Insurance Company as to their conformity with accounting practices prescribed or permitted by the Insurance Department of *[name of state of domicile]*.

The letter is furnished solely for filing with the Insurance Department of *[name of state of domicile]* and other state insurance departments and should not be used for any other purpose.

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, 19X1 and 19X0.[1] Effective *[date of termination]*, we are no longer auditors of DEF Insurance Company. We have read DEF Insurance Company's statements in its letter dated *[date of insurer's letter]*, which is attached hereto, and we agree with the statements therein. *[However, if the auditor is (a) not in a position to agree or disagree or (b) does not agree with the insurer's statement, the auditor's letter should state that the auditor is not in a position to agree or disagree or that the auditor does not agree with such statements and give the reasons.]*[2]

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[1]If the auditor had not reported on any financial statements, the first sentence should be modified as follows:

> We previously were engaged to audit the statutory financial statements of DEF Insurance Company as of and for the year ending December 31, 19X1.

[2]The insurer's letter may contain a statement, such as—

> In connection with the audits of the statutory financial statements of the Company for the years ended December 31, 19X2 and 19X1, and the subsequent interim period through *[date of termination]*, there were no disagreements with *[CPA Firm]* on any matter of accounting principles, statutory accounting practices prescribed or permitted by the Insurance Department of *[name of state of domicile]*, financial statement disclosure, or auditing scope or procedures, which disagreements if not resolved to their satisfaction would have caused them to make reference to the subject matter of the disagreement in their reports.

Exhibit 5.3
Illustrative Accountant's Letter of Qualifications

To the Board of Directors of GHI Insurance Company:

We have audited, in accordance with generally accepted auditing standards, the statutory financial statements of GHI Insurance Company (the Company) for the years ended December 31, 19X1 and 19X0, and have issued our report thereon dated *[date of report]*. In connection therewith, we advise you as follows:

a. We are independent certified public accountants with respect to the Company and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the *[state]* Board of Public Accountancy.

b. The engagement partner and engagement manager, who are certified public accountants, have [ ] years and [ ] years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most (some) of whom have had experience in auditing insurance enterprises and *[X]* percent of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.

c. We understand that the Company intends to file its audited statutory financial statements and our report thereon with the Insurance Department of *[name of state of domicile]* and other state insurance departments in states in which the Company is licensed and that the insurance commissioners of those states will be relying on that information in monitoring and regulating the statutory financial condition of the Company.

While we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance 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 generally accepted auditing standards is to form an opinion and issue a report on whether the statutory financial statements present fairly in all material respects, the admitted assets, liabilities, and capital and surplus, results of operations and cash flow in conformity with accounting practices prescribed or permitted by the Insurance Department of *[name of state of domicile]*. Consequently, under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to 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, particularly those involving concealment and falsified documents (including forgery), 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 that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditor's report.

d. We will retain the workpapers[3] prepared in the conduct of our audit until the Insurance Department of [*name of state of domicile*] has filed a Report of Examination covering 19X1, but no longer than seven years. After notification to the Company, we will make the workpapers 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 workpapers 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*].[4]

e. The engagement partner has served in that capacity with respect to the Company

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[3]Section 13 of the Model Audit Rule defines workpapers 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.

[4]Refer to AICPA, *Professional Standards,* vol. 1, AU sec. 9339, *Working Papers: Auditing Interpretations of Section 339.*

since [*year that current "term" started*], is licensed by the [*state name*] Board of Public Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.

f. To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC's *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

This letter is furnished solely for filing with the Insurance Department of [*name of state of domicile*] and other state insurance departments and should not be used for any other purpose.

Exhibit 5.4

***Illustration of Notification of Financial Condition Letter When the Audit Is Complete*[5]**

To the Board of Directors:

We have audited, in accordance with generally accepted auditing standards, the statutory financial statement of MNO Insurance Company (the Company) as of December 31, 19X1 and 19X0, and have issued our report thereon dated [*date of report*].

In connection with our audit, we determined that capital and surplus reflected in the statement of admitted assets, liabilities, and capital and surplus of the Company as of December 31, 19X1, as reported on the 19X1 Annual Statement filed with the Insurance Department of [*name of state*] is materially misstated because [*provide explanation*]. Statutory capital and surplus of $___ reported on the 19X1 Annual Statement should be reduced by $___ as a result of the matter in the preceding sentence.[6]

If we do not receive evidence that the Company has forwarded a copy of this letter to the insurance commissioner of [*name of state*] within five business days of receipt, we are required to give the insurance commissioner a copy of this letter within the next five business days.

This letter is furnished solely for filing with the Insurance Department of [*name of state*] and should not be used for any other purpose.

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[5]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 should be modified depending on the relevant facts and circumstances.

[6]The wording of this paragraph is intended for those situations in which audit adjustments would not cause minimum capital and surplus of an insurer to fall below statutory requirements. The paragraph should be reworded if the company did not meet minimum capital and surplus requirements as presented on its Annual Statement as filed with the domiciliary commissioner.

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, and cash flows of [*name of entity*] in conformity with generally accepted accounting principles [other comprehensive basis of accounting], 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. We are responsible for the fair presentation in the [*describe financial statements, for example, GAAP, SAP, or special purpose*] of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles [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].

2. We have made available to your representatives all–

   a. Financial records and related data.
   b. Minutes of the meetings stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

   [may want to include– *"c. All significant contracts and agreements."*]

3. There have been no–

   a. Fraud involving management or employees who have significant roles in internal control.
   b. Fraud involving other employees that could have a material effect on the [*GAAP/SAP*] financial statements.
   c. Communications from regulatory agencies concerning noncompliance with, or deficiencies in financial reporting practices, or other regulatory requirements, that could materially affect the [*GAAP/SAP*] financial statements.

4. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

5. The following have been properly recorded or disclosed in the financial statements:

   a. Related-party transactions and related amounts receivable or payable, including 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, 19X1, as that term is defined in AICPA SOP 94-1, *Inquires of State Insurance Regulators*.

6. There are no–

   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 Financial Accounting Standards Board (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.

7. Provision, when material, has been made for—

   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.

8. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

9. No events have occurred subsequent to balance-sheet date that would require adjustment to, or disclosure in, the financial statements.

10. 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.

11. [*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*].

12. [*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*].

13. 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.

14. All information returns have been filed on a timely basis with the appropriate regulatory bodies.

15. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

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.

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[*Name of Chief Executive Officer and Title*]

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[*Name of Chief Financial Officer and Title*]

Chapter 6

AUDITING INFORCE FILES

INTRODUCTION

6.1 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 *contractholder 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, contractholder benefits, contractholder 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.

6.2 Access to the inforce file is usually limited to authorized individuals involved in contractholder service areas. These individuals may issue contracts, maintain files for change of addresses or beneficiaries, and so on. There should be appropriate segregation of duties among all individuals with authorized access to the inforce files, and appropriate levels of independent reviews.

6.3 In addition, the inforce file is commonly interfaced with many of the life insurance entity's financial systems. Consequently, some 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, some 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 Guide.

6.4 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 following:

Standing Data	Transaction Data
Contract number	Status of contract (such as in force, lapsed, paid up, claim filed, claim paid)
Contractholders' 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
Type of contract	Paid-up additions
Contract issue date	Benefit payments
Period of coverage	Interest credits
Benefits and/or face amount 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	

6.5 The inforce file data are generally updated as a result of processing any one of the following:

- Transactions initially processed through other transaction cycles, as described elsewhere in the Guide, such as premium payments, commission payments, benefit and claim liabilities, reinsurance, and policy loans

- Transactions initiated automatically by the other application systems, such as automatic policy loan for nonpayment of premium and calculation of interest credits for universal life contracts

- Transactions initiated by the contractholder such as surrenders

6.6 Inforce file maintenance includes transactions such as issuing new contracts and 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

6.7 *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 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.

6.8 *Controls Over Inforce Maintenance Transactions*. Access to the inforce file for making changes 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.

6.9 _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 contractholders or manage its business. Therefore adequate controls should be established concerning data security, and procedures should be in place for the recovery of data lost due to 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 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 Since the inventory of insurance contracts inforce is not under general ledger control it is essential to carefully examine the internal control policies and procedures over the inventory. Such a review should highlight the possible types of errors so that the auditor can then direct his or her attention to those areas. The National Association of Insurance Commissioners (NAIC) has revised its *Life, Accident and Health Annual Statement Instructions* to require that insurers filing audited statutory financial statements in accordance with NAIC *Annual Statement Instructions* include a "Supplemental Schedule of Assets and Liabilities." 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. Since 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 SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551) should be followed when auditors report on supplemental schedules. SAS 29 provides guidance for both accounting and nonaccounting data.

6.11 The inventory of contracts inforce must 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 inforce. In larger entities or entities in which detailed listings are unavailable, the auditor must 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 details of insurance contracts inforce to satisfy him or herself that all contracts that should be included in the inventory are included. Such tests are usually performed based on sampling techniques, and generally include tests of data to and from sources independent of the inforce files, such as cash receipts, premium billing records, and contract registers. The auditor should also test 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 inforce should be tested by comparing 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 above and in other chapters) in auditing the accuracy, reliability, and completeness of a life insurance entity's inforce files:

- Review variances between actual and estimated contract counts and inforce amounts of new and existing business by line of business or reserve category.

- 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:

  - Record counts and value of inforce file
  - Additions and deletions to the inforce file
  - Distribution of inforce file by geographic area, issue age, and gender
  - Volume and number of automatic transactions, such as conversion to paid-up status
  - Unusual contractholder data, such as ages outside the normal ranges
  - Individual contracts or groups of contracts that insure the same individual and exceed the entity's retention limits
  - Surrenders, lapses, and death claims (number of contracts and value) relative to the value of insurance in force at the beginning of the period
  - Duplicate contract numbers and missing contractholder data
  - Summary of processing backlogs

- Review periodic reconciliations between inforce transactions and data from other application systems and the general ledger.

- Review details of any system failures, breaches in security, or other unauthorized access related to the inforce files or other interfaced application systems.

- Test cutoff procedures to assure appropriate period-end reporting of inforce data with the general ledger, premium collection system, and other application systems.

- 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 limited circumstances, the auditor may consider verification of the authenticity of contracts included in the inforce inventory by direct confirmation with the contractholders (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, since 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 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 GAAP or statutory accounting practices (SAP) basis. The reinsurance of life insurance contracts may permit the elimination or reduction of the related liability for future contractholder 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).

6.17 Satisfactory results of the comparison of insurance contracts in force with premium collections along with other ordinary audit procedures, discussed above and in the "Auditing" sections of each of the following chapters, generally will provide the auditor with sufficient competent evidential matter as to the validity of those contracts included in the inventory of insurance contracts in force. However, the auditor should consider confirming insurance contracts in force with contractholders when certain circumstances such as the following exist:

1. Proper maintenance of the inventory of insurance in force may be materially deficient due to an absence of segregation of duties or other internal control structure policies and procedures.

2. Trend analyses or ratios that measure insurance in force indicate erratic or unusual results that have not been satisfactorily explained.

3. Additions to insurance in force cannot be related to the collection of premiums.

4. Significant amounts of insurance in force result from related party transactions, and the related party's financial statements are not examined by the auditor.

5. 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.

6. Ceded reinsurance activities can materially increase earnings or investable funds.

6.18 SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), 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.

Chapter 7

INSURANCE REVENUES

INTRODUCTION

7.1 Life and health insurance premiums, annuity considerations, and other contract deposits 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. However, to attract and maintain contractholders, these rates must also be competitive with the premium rates of other entities.

REGULATION OF PREMIUM RATES

7.2 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

7.3 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 type of entity (for example, fraternal benefit societies are exempt), type of contract, and the state of domicile of the life insurance entity. (See chapter 13 for additional discussion.)

ACCOUNTING PRACTICES

7.4 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 generally accepted accounting principles (GAAP). The following discussion of SAP and 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 should be referred to in determining appropriate accounting and reporting treatment in all cases.

7.5 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.

Statutory Accounting Practices

7.6 Premium Revenue Recognition. Under SAP, premiums, annuity considerations, and other contract receipts are recognized as revenue as collected and adjusted for deferred, due and uncollected, and unearned premiums as required by the premium recognition assumptions used in computing contract reserves (see chapter 8). SAP premium amounts also include reinsurance assumed and are reduced by reinsurance ceded (see chapter 12).

7.7 In practice, the most commonly used revenue recognition assumption used in computing the contract benefit liabilities for traditional long-duration contracts is the *annual premium method*, which recognizes as premium revenue a full annual premium on the anniversary date of the contract, regardless of the premium payment mode. (See chapter 2, paragraphs 2.9 through 2.10 for a discussion of various premium payment modes.) The *continuous premium method*, which recognizes premium revenue evenly over the contract year regardless of the actual payment mode, is commonly used for accident and health contracts and other short-duration contracts. Other methods may apply to different product lines; however, the annual premium and continuous premium are the most common.

7.8 Regardless of the revenue recognition method employed, life insurance entities generally record premiums as revenue when received, 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*. This is the premium amount charged to the contractholder and recognized as premium revenue when received. Actual premium payments may be made in various modes (referred to as a *modal premium)* in monthly, quarterly, semiannual, or annual installments, or in a single payment.

b. *Net premium or valuation premium*. This is the amount of premium used in the calculation of the statutory reserves. It is based on statutory interest rates and mortality or morbidity assumptions for life and annuity contracts; and interest rates, mortality, and morbidity assumptions for disability contracts. The net premium represents the amount needed to provide for the contract benefits based on statutory interest and mortality (and morbidity for disability contracts) reserve assumptions.

c. *Loading*. This is the difference between the net premium and the gross premium. Theoretically, this amount represents the amount available for expense and profit; however, for some insurance contracts and issue ages, this amount may be negative. (See chapter 8 for a discussion of deficiency reserves.)

d. *Valuation date and contract 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

contract issue date. Generally, the valuation date and the contract anniversary date will be different.

e. *Deferred premium.* These are modal premium payments due after the valuation date, but before the next contract anniversary date. Deferred premiums generally are measured from the next modal premium due date to the next contract anniversary date. Both gross and net deferred premium are calculated. Deferred gross premium is recorded when the mean reserve method (see chapter 8 for discussion) is used and the frequency of the modal premium is other than annual. However, these amounts are accrued in the balance sheet on a net premium basis. This difference in recording the premium revenue and the corresponding asset requires that the loading amount be recorded as an expense.

f. *Due and uncollected premium.* These are gross premium amounts that are due on or before the valuation date but have not been received. Most states allow uncollected gross premium up to sixty days beyond the grace period to be included as an admitted asset in the statutory balance sheet. 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*.

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 life contracts usually require unearned premium adjustments since there is usually not an assumption of a net annual premium payment since these contracts are generally reserved for using a mid-terminal reserve methodology. (See chapter 8 for discussion of reserve methodologies.)

h. *Advance premium.* These are premiums received in advance of the due date. Premium revenues ordinarily do not include more than one year's advance premium. Advance premiums are recorded as premium revenue that is received but are adjusted at the valuation date to reflect the gross premium amount held as a liability since the entity is obligated to return the gross premium amount if the contract is terminated.

i. *Deposit premium or receipts.* Deposits received for group contracts are recorded as a liability due to the entity's obligation to refund the contractholders' balance at the termination of the contract.

7.9 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 GAAP, the specialized industry accounting principles for revenue recognition for life insurance entities are specified in FASB Statement No. 60 and FASB Statement No. 97 (both as amended by FASB Statement No. 120) and SOP 95-1. The reader should refer to the appropriate accounting literature for specific guidance. The following is a brief discussion of the accounting principles relating to premium revenue recognition.

7.13 The definition of the *GAAP gross premium* is the amount charged to the contractholder for an insurance contract. The *GAAP net premium* is defined as the portion of the gross premium needed to provide for all contract benefits and maintenance and settlement expenses as well as to fund the amortization of the deferred acquisition costs (DAC) asset. The underlying assumptions used in calculating the GAAP net premium are generally the same as those used in the GAAP liability and DAC amortization calculations. Accordingly, the statutory concept of loading is not applicable to 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.

7.14 Contract Classification. For accounting purposes, contracts issued by life insurance entities are classified as either *insurance contracts* or *investment contracts* (see exhibit 7.2 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, rather than the contract terms, should be evaluated. (See figure 7.1, Contract Classification Decision Process.)

7.15 Short-Duration Insurance Contracts. 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. These 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.

7.16 _Long-Duration Insurance Contracts_. 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:

- *FASB Statement No. 60 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.

- *Limited-payment contracts*. These 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, and that include such contracts as single-premium whole life contracts, twenty-payment whole life contracts, and single-premium immediate annuity contracts, which include significant life contingencies.

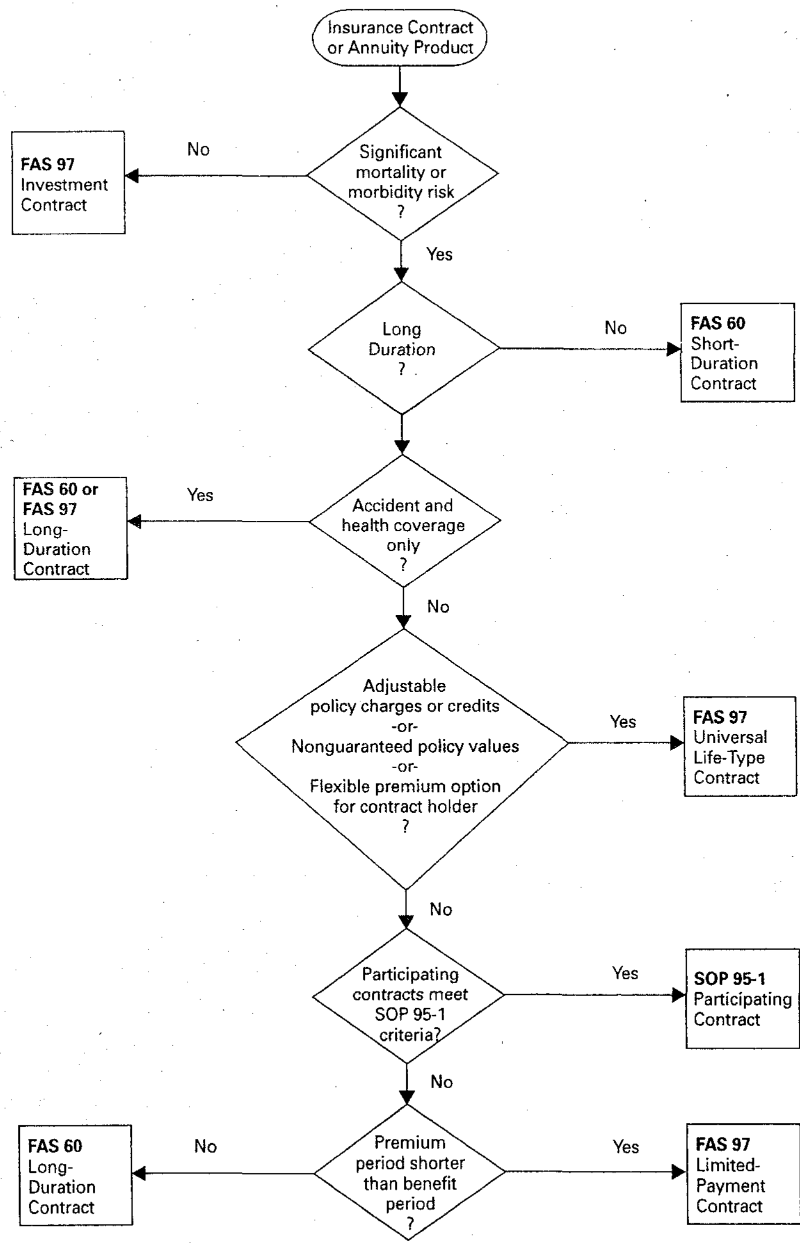
- *Universal life-type contracts*. These are long-duration insurance contracts that do not have fixed or guaranteed terms. Universal life-type contracts differ primarily from other long-duration contracts in the flexibility and discretion that is granted to the insurer or the contractholder or both. Examples of these contracts are variable life insurance, universal life insurance, and other interest-sensitive products.

- *Participating contracts issued by mutual life insurance entities and stock life insurance enterprises*. 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 principle).

7.17 _Investment Contracts_. Investment contracts issued by life insurance entities are contracts that do not incorporate significant mortality or morbidity risk. Such contracts are accounted for in a manner consistent with interest-bearing or other financial instruments issued by other types of financial institutions. Examples of investment contracts include guaranteed investment contracts (GICs) and most deferred annuity contracts during the accumulation phase.

Figure 7.1
Contract Classification Decision Process

The following diagram illustrates a decision process for classifying products for accounting and reporting purposes under FASB Statement Nos. 60 and 97 (as amended by FASB Statement No. 120) and SOP 95-1. The diagram presumes that product characteristics can be determined on a yes-or-no basis. Because of the wide variety of designs, some products undoubtedly will fall into gray areas not illustrated in the diagram. Classification under those circumstances will require an evaluation of the contractual terms of the products.



7.18 *Premium and Deposit Revenue Recognition*. The revenue recognition methodologies applied under GAAP are defined by the accounting classifications of the contracts. (See exhibit 7.3 for revenue recognition methods under GAAP.) These classifications are as follows:

a. *Short-duration insurance contracts*. 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*. Premiums from long-duration contracts, other than universal life-type contracts and limited-payment contracts, are recognized as revenue when due from the contractholder.

7.19 As discussed in paragraph 7.8, deferred premium amounts are a function of the premium payment assumptions used in calculating the benefit liabilities; accordingly, under GAAP, any deferred 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.

7.20 For universal life-type contracts, premium receipts are not recorded as revenues. Gross premium receipts, net of any front-end loads, are recorded as a liability. Front-end loads are deferred over the life of the contract and recorded as a liability in that manner. That liability is increased by credits to the contractholder'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. Amounts charged against the contractholder's account balance for contract services are reported as revenue in the period for which the amounts are assessed unless those amounts compensate the life insurance entity for services to be provided in the future or are consideration for origination of the contract (generally referred to as front-end loads, excess expenses, or initiation fees). These amounts are deferred and amortized to revenue utilizing the same assumptions used to amortize capitalized acquisition costs. The accounting model used for universal life contracts, as defined in FASB Statement No. 97, is referred to as the *retrospective deposit method* (see exhibit 8.1 for an example).

7.21 Limited-payment contracts subject the insurance entity to mortality or morbidity risk over a period that extends beyond the premium collection period. Any excess of the gross premium over the net premium is deferred and is recognized in income in a constant relationship with insurance in force (life insurance contracts) or with the amount of expected future benefits (annuity contracts).

7.22 *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

7.23 In assessing audit risk, the auditor should consider those factors influencing inherent risk 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:

- The premium rates charged are significantly below the industry averages for similar types of products, or the analysis of contract pricing or profitability is inadequate.

- Relationships of cash receipts to recorded premiums are inconsistent with the type or volume of contracts written.

- The life insurance entity's product lines include experience-rated insurance arrangements.

- There are a significant number of internal replacement transactions.

- There are an increasing number of lapses and reinstatements.

- 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.

- Changes in tax legislation affect the life insurance entity's products.

- 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).

- Regulation of capital capacity restricts the life insurance entity's ability to write new business.

- The requirements for the licensing of agents or other intermediaries are not adhered to or require contract changes.

- 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.

- New specialized products are introduced or rapid growth develops in previously limited product lines.

- Dependency on investment and similar contracts in which the fixed rate in the contract exceeds the rate of return on the related investments.

- Market trends indicate a saturated demand for the company's product.

CONSIDERATION OF THE INTERNAL CONTROL FOR AUDITING PREMIUM TRANSACTIONS

7.24 An entity's internal control consists of five components: the control environment, risk assessment, control activities, information and communication, and monitoring. As discussed in chapter 5, the auditor should obtain a sufficient understanding of each of the five components of the entity's internal control to plan the audit of the entity's financial statements. Such an understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

Control Environment

7.25 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:

- 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.
- New products or contracts are being written that require different revenue recognition policies or accounting procedures or that have unique processing requirements.
- The premium accounting system used by the life insurance entity or third-party servicing agent is unsophisticated or inadequate to meet the needs of the entity's financial or regulatory reporting requirements. There is a lack of coordination with key processing systems.
- 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.
- Operations are highly decentralized, and there is a high reliance on third parties or agents for customer correspondence, premium billing, and collection.
- Significant staff turnover, inexperienced personnel, or insufficient staff for the volume of premium transactions processed result in the improper recording of transactions.

Control Activities

7.26 Control activities are those policies and procedures in addition to the other components that management has established to provide reasonable assurance that specific entity objectives are achieved. The auditor should obtain an understanding of those control activities relevant to planning the audit. Examples of typical internal control policies and procedures relating to premium revenue recognition include–

- *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 both the premium rates used in product pricing, changes in rate structures, and reinsurers.

- *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.

- *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.

- *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.

- *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 type, agent, and state) are credited, and that appropriate rate schedules are used for the type of contract and risk assumed.

Information and Communication

7.27 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report an entity's transactions and to maintain accountability for related assets and liabilities.

7.28 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), and valuation.

7.29 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.

7.30 In general, the deposit contract revenue cycle is driven by competitive crediting rates. These 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 with respect to large cases.

7.31 *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.

7.32 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.)

7.33 *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.

7.34 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.

7.35 *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.

7.36 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 thirty to forty-five days) during which the premium can be received without causing the contract to lapse. Generally, life insurance entities delay processing lapses for sixty to ninety 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.)

7.37 When a lapse or termination does occur, the nonforfeiture option selected by the contractholder or an automatic option provided by the contract goes into effect. Commonly, these 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 contractholder 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.

7.38 Specific premium collection methods vary within the life insurance industry, depending on the types 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 when–

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.

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.

7.39 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.

7.40 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 for discussion of nonledger items.)

Audit Consideration Chart

7.41 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

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
Existence or Occurrence and Rights and Obligations		
Revenues recorded relate to the contracts issued or in force during the period. Cash or other consideration is received within the contract terms. Premium deposits, return premium adjustments, and contractholder dividends are properly recorded. Lapse and reinstatement policies are in accordance with the terms of the contract and properly recorded.	Underwriting standards, premium rates, credited interest rates, and contractholder charges are regularly reviewed and monitored by appropriate levels of management. Contract applications are independently reviewed for compliance with the entity's underwriting standards prior to contract issuance. Adequate procedures exist and are routinely monitored to achieve the following: 1. Physically control unissued contract forms. 2. Maintain numerical control over contracts issued. 3. Properly register contract applications and control premium remittances received with applications. 4. Assure correct premium billing of inforce contracts. 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	Obtain and inspect evidence about proper contract issuance for selected new and inforce contracts as follows: 1. Examine contract file for signed application, underwriting approval, and other applicable documents. 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. 3. Compare premiums register to cash receipts records, bank statements, and general ledger. 4. Confirm that contract documents were issued to the contract holder. 5. Test that underwriting procedures were followed for underwriting approval, calculation of premiums and reinsurance, and proper recording of premium payments and reinsured amounts.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
	coverage details are reconciled on a timely basis. Contract endorsements and cancellations or other changes are approved; determinations of additional or return premiums are also reviewed and approved. Contractholder dividends and experience-rated premiums are reviewed and approved. Premium adjustments are compared with contract provisions, and dividends are compared with dividend declaration for compliance. Automatic transactions (for example, interest credits, contracts charges, automatic lapse, automatic policy loans) are reconciled to master file changes and control accounts.	Reconcile monthly summary of premiums written (direct, assumed, and ceded) by line of business with the general ledger. Trace selected noncash premium transactions (meaning, an automatic contract loan) for renewal business to the premium register, and verify the transactions are in accordance with the contract terms. Test proper reporting of new business premiums that are the internal replacement of renewal premiums and related transactions. Test that agents submitting applications are licensed, and inspect agency agreements. 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. Test that contractholder dividends comply with authorization, and reconcile amounts with underlying contract records.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
Completeness		
Contract revenues applicable to future periods are deferred.	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.	Test whether risks in excess of retention amounts are reinsured. Test the computation of reinsurance premiums and commissions; trace to reinsurance records.
	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 established.	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.
	Reconciliations of accounting records and master file information for investment selection for variable products are performed on a timely basis. Processing backlogs are independently monitored for significant fluctuations. Deletions of contract master file records (other than automatic lapses) are approved.	Obtain and review or test reconciliations between the following: 1. The premium register and the general ledger 2. New contract data and the inforce file 3. Contracts issued and contract numerical control records 4. Cash receipts and the premium register 5. The premium and commission registers 6. The premium register and the inforce file
	Contract loan values are reviewed and reconciled to either automatic premium loan amounts or the reduction of contract cash values.	Check calculation of premiums to premium rate tables.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
	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. Adequate procedures exist for monitoring third parties involved in processing or calculating premium or deposit transactions.	For group contracts, perform the following: 1. Reconcile enrollments to premium receipts. 2. Test changes in enrollments to changes in master file records. 3. Consider conducting an independent review of the detailed records of self-administered groups and recalculate any rate adjustments.
	Suspense account balances are analyzed and reviewed for large, old, or unusual items by appropriate personnel.	Reconcile premium receipts to bank deposit slips, to 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.
Valuation or Allocation		
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 reviewed regularly for large, unusual, or old uncleared items, by the 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.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
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 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 that the accumulated totals are correctly reflected in the general ledger accounts.	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.
	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 writeoffs of bad debts and unreconciled items are approved.	For universal life-type contracts and other investment products, compare the cash received to the increase in the account balance. Compare cost of insurance to net amount at risk.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
	Processing controls ensure that current contract master file data is used in calculating premium billings, unearned premium, and due and deferred premium.	
Presentation and Disclosure		
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.
	Comparisons of actual to expected premium revenue by line of business are prepared and significant or unexpected variances are identified and monitored by management.	Test whether disclosures and classifications comply with applicable accounting principles.
		Identify and examine items that may require separate disclosure. Examples are discontinued operations, segment information, gains or losses on foreign currency transactions.
		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 types of service revenue. Investigate the significant items that are noted.

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, as appropriate for the entity.

For example, shown below is an excerpt from Exhibit 1 — Part 1 of *Premiums and Annuity Considerations*. (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 Statement Nos. 60 and 97 (both as amended by FASB Statement No. 120 and SOP 95-1)

Insurance contracts are defined and classified in Financial Accounting Standards Board Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, paragraphs 7 and 8, as:

7. Insurance contracts, for purposes of this Statement, shall 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 enterprise). The factors that shall be considered in determining whether a particular contract can be expected to remain in force for an extended period are:

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

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

8. Examples of short-duration contracts include most property and liability insurance contracts and certain term life insurance contracts, such as credit life insurance. Examples of long-duration contracts include whole-life contracts, guaranteed renewable term life contracts, endowment contracts, annuity contracts, and title insurance contracts. 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 Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, establishes accounting for three classes of long-duration contracts, limited payment-type, universal life-type, and investment contracts. Contract classifications not accounted for under FASB Statement No. 97 are accounted for under FASB Statement No. 60 or SOP 95-1.

Limited-payment contracts are defined by FASB Statement No. 97, paragraph 9, as:

9. 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, are referred to in this Statement as *limited-payment contracts*. The period over which benefits are provided, as used in this

Statement, includes the periods during which the insurance enterprise is subject to risk from policyholder mortality and morbidity and during which the insurance enterprise is responsible for administration of the contract. The benefit period does not include the subsequent period over which the policyholder or beneficiary may elect to have settlement proceeds disbursed.

Universal life-type contracts are defined by FASB Statement No. 97, paragraphs 10—13:

10. Except as provided in paragraph 11, long-duration insurance contracts with terms that are not fixed and guaranteed are referred to in this Statement as *universal life-type contracts*. Universal life-type contracts include contracts that provide either death or annuity benefits and are characterized by any one 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.

11. This Statement does not apply to conventional forms of participating and nonguaranteed-premium contracts. Those contracts are addressed by Statement 60 and Statement 120. A participating or nonguaranteed-premium contract is covered by this Statement, however, 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. Paragraphs 12 and 13 describe some circumstances in which a participating or nonguaranteed-premium contract shall be accounted for as a universal life-type contract. The provisions of paragraphs 12 and 13 are not intended to be either all-inclusive or limiting.

12. A participating contract that includes any of the following features shall 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.

13. A nonguaranteed-premium contract that includes either of the following features shall 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 FASB Statement No. 97, paragraph 7, as:

7. Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as *investment contracts*. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon 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.

FASB Statement No. 97 does not apply to the following types of long-duration insurance contracts:

1. Contracts with terms that are fixed and guaranteed and for which premiums are collected over the same period that benefits are provided

2. Contracts that provide benefits related only to illness, physical injury, or disability

SOP 95-1 applies to life insurance contracts that have both of the following characteristics:

1. They are long-duration participating contracts that are expected to pay dividends to policyholders based on actual experience of the insurance entity

2. 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 Statement Nos. 60 and 97 (both as amended by FASB Statement No. 120 and SOP 95-1)

Premium revenue recognition as defined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*:

Short-Duration Contracts (paragraphs 13 and 14) –

13. Premiums from short-duration contracts ordinarily shall 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 shall 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.

14. 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 shall be recognized as follows:

    a. If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall 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 (paragraph 15 of Statement 60, as amended by FASB Statement No. 97) –

Premiums from long-duration contracts, such as whole-life contracts, guaranteed renewable term life contracts, and title insurance contracts, shall be recognized as revenue when due from policyholders.

Revenue recognition as defined in FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, as follows:

Investment Contracts (paragraph 15) –

15. Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is

contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterprise shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

Limited-Payment Contracts (paragraph 16) —

16. 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. For those contracts, the liability for policy benefits shall be established in accordance with the provisions of Statement 60. The collection of premium does not, however, represent the completion of an earnings process. Any gross premium received in excess of the net premium (FASB Statement No. 60 defines gross premium as " the premium charged to a policyholder for an insurance contract." That Statement defines net premium as "the portion of the gross premium required to provide for all benefits and expenses.") shall be deferred and recognized in income in a constant relationship with insurance in force (when accounting for life insurance contracts) or with the amount of expected future benefit payments (when accounting for annuity contracts).

Universal Life-Type Contracts (paragraphs 17–20)—

17. The liability for policy benefits for universal life-type contracts shall 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 (paragraph 20)

    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 35 through 37 of Statement 60.

18. Amounts that may be assessed against policyholders in future periods, including surrender charges, shall 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 shall represent the element of liability described in paragraph 17(a). Provisions for adverse deviation shall not be made.

19. Premiums collected on universal life-type contracts shall not be reported as revenue in the statement of earnings of the insurance enterprise. Revenue from those contracts shall represent amounts assessed against policyholders and shall 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.

20. 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 shall be reported as unearned revenue and 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, are unearned revenues.

Revenue recognition as defined in paragraph 12, of SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, as follows:

> Premiums from participating insurance contracts should be reported as revenue in the statement of earnings when due from policyholders.

Chapter 8

LIABILITIES FOR FUTURE POLICY BENEFITS (STATUTORY BENEFIT RESERVES) AND OTHER CONTRACT LIABILITIES

INTRODUCTION

8.1 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 generally contain cash accumulation benefits, which cash may be withdrawn at the election of the contractholder. 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 ability to estimate the timing and amount of anticipated future cash flows for large groups of contracts allows life insurance benefit liabilities to be significantly less than the face amounts of the contracts. 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 Guide, the term reserves is used only in discussions of regulation and statutory accounting practices.

8.2 *Liabilities for future policy benefits* are an accrued obligation to policyholders that relates to insured events, such as death or disability. The liability for future policy benefits can be viewed as either an 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.

8.3 Traditional life insurance contracts generally provide guaranteed future cash values and benefits for a fixed premium. Liabilities for traditional life benefits represent the actuarially determined amount that is needed to provide for the future expected benefits to be paid to contractholders.

8.4 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 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 CRVM reserve as specified by the NAIC Universal Life Model Regulation and no less than the cash surrender value.

8.5 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 deferred annuities in their payout phase are equal to the present value of the estimated benefits.

8.6 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 due 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.

REGULATION

8.7 The aggregate benefit 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, most states have adopted the National Association of Insurance Commissioners (NAIC) Model Standard Valuation Law and its interpretations, which defines the minimum level of reserves for most types 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, these model laws have only been adopted by a limited number of states. The required actuarial assumptions and calculation methodologies specified by the NAIC Model Standard Valuation Law generally vary by line of business and by issue date of the contract.

8.8 Recent revisions to the NAIC Model Standard Valuation Law 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. 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

8.9 Each state requires a "Statement of Actuarial Opinion" in each life insurance entity's *Annual Statement*. The NAIC's instructions to the *Annual Statement* require the actuary's reserve opinion to include statements with regard to 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.

8.10 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.

CALCULATION METHODS

8.11 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, due to the historical impracticality of *seriatim* calculations, almost all life insurance entities continue to calculate reserves for traditional life and health products using simplifying 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

8.12 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 statutory accounting practices (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.

8.13 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 twelve 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 contacts 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 one-half of the contract-year premium has been collected, whereas mean reserves assume that the full year's premium is collected. 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

8.14 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.)

8.15 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 which 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 generally accepted accounting principles (GAAP) financial statements for FASB Statement No. 60 contracts.

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 (FPT) and the commissioners' reserve valuation method (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.

ACCOUNTING PRACTICES

8.16 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 GAAP. The following discussion of SAP and 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 types of benefit and claim liabilities within the life insurance industry. The authoritative sources cited in chapter 3 should be referred to in determining appropriate accounting and reporting treatment in all cases.

STATUTORY ACCOUNTING PRACTICES

8.17 Statutory benefit 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 benefit reserves may be determined using either the net level reserve, the modified preliminary term, or full preliminary term methods.

Significant Reserve Assumptions

8.18 *Mortality and Morbidity*. Minimum legal standards for SAP benefit reserves are based on published mortality and morbidity tables prescribed by the various states as recommended by the NAIC.

8.19 *Interest*. State insurance regulations generally prescribe a maximum valuation interest rate that life insurance entities can use in calculating benefit reserves. The NAIC Model Standard Valuation Law contains dynamic maximum valuation interest rates. Maximum valuation interest rates vary by issue date for life insurance contracts and by type of contract for annuity contracts. For life insurance contracts, the maximum valuation interest rates are determined for each calendar year, and those rates apply to all contracts issued in that year for the duration of those contracts. Annuity contracts may use issue year maximum interest rates or change in fund balance rates to calculate the benefit reserve. The life insurance entity may choose to use a rate that is lower than the determined maximum valuation interest rate permitted by the states' valuation laws, thereby increasing reserves.

8.20 *Withdrawals*. Under SAP, estimated future withdrawals (terminations for reasons other than death or maturity) for life insurance contracts are not considered because statutory benefit 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.

8.21 *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 8.78 through 8.87.)

8.22 *Change in Valuation Basis*. When the interest rate, mortality basis, calculation methodology, or other assumptions affecting the valuation basis of inforce business are changed, any increase or decrease in the reserve at the beginning of the year, as a result of a valuation basis change, is charged or credited directly to surplus. Under SAP, no change can be made in the reserves for existing insurance contracts in force that would cause the reserves to be less than the minimum standard in effect when the contracts were issued.

8.23 Regulations for a change in valuation basis vary by state. Any change in valuation basis may

require the advance approval of the state insurance department. Changes in basis of valuation resulting from the increases or decreases in reserves resulting from changes in the basis of

valuation or other changes in mortality tables or interest assumptions are reported in exhibit 8A of the *Annual Statement* and are charged or credited directly to surplus.

Calculation of Reserve Liabilities by Contract Type

8.24 Life Insurance Contracts. In general, for traditional life contracts (including term insurance), state laws allow the life insurance entity to use either the net level reserve method or the modified or full preliminary term method, as described earlier in this chapter, to determine the benefit reserve amounts. The reserve is increased each year initially by net premiums assumed to have been received and then by the interest assumed to have been earned (at the valuation rate) on that opening balance. The reserve balance is reduced each year by mortality (i.e., death benefits assumed to be paid in excess of reserves released). For universal life-type products, a diversity in reserving practices exists; however, state requirements are such that life insurance entities generally hold the surrender or account value (for front-end loaded products), or the account balance less a provision for unamortized expense allowances permitted under state law (for back-end loaded products). The generally accepted minimum statutory reserve for universal life is CRVM reserve as defined by the NAIC Universal Life Model Regulation.

8.25 Aggregate reserves for life contracts are reported in exhibit 8 of the *Annual Statement* and are summarized by line of business, contract type, and reserve table. The net deferred and uncollected premiums are reported in exhibit 13, and the contract claims liabilities are reported in exhibit 11.

8.26 Accident and Health Contracts. Reserves for most accident and health contracts consist of (a) an unearned premium reserve, which generally is the portion of the gross premium that relates to insurance coverage provided beyond the valuation date, (b) for noncancelable or guaranteed renewable contracts and certain other contract types, an active life reserve (similar to reserves for life insurance contracts), and (c) a claim reserve, which is an estimate of the present value of amounts not yet due on claims. Claim reserves are held for both reported and unreported claims.

8.27 Unearned premium reserves are generally computed for most types of accident and health contracts on a pro rata basis over the contract term, using either actual due dates and premium payment modes or a midmonth premium assumption. The calculation of the unearned premium reserve must be consistent with premiums reported as due and unpaid as of the valuation date.

8.28 Benefit reserves, referred to as *active life reserves*, are required on all in force 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. For contractholders 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.

8.29 Claim reserves consist of a reserve for claims incurred but not reported (IBNR) 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 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.

8.30 Claim liabilities are reported in Exhibit 11, Part 1, of the *Annual Statement*. Active life reserves and claim reserves for accident and health contracts are reported in exhibit 9, and are summarized by line of business, contract type, and reserve table.

8.31 *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.

8.32 Individual annuities in the accumulation phase are reserved under the NAIC Model Standard Valuation Law, 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.

8.33 *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 Model Standard Valuation Law. Generally, the minimum liability is equal to the present value of the future payments using the prescribed valuation interest rate as the discount rate. The minimum liability will exceed the amounts deposited accumulated at the guaranteed rate in the contract when the prescribed valuation interest rate is lower than the contract rate.

8.34 *Supplementary Contracts*. Reserves for supplementary contracts without life contingencies are reported as a separate liability in the statutory financial statements in exhibit 10 of the *Annual Statement*. The reserve is similar to those for investment contracts and includes any interest credited or accrued to the valuation date.

8.35 Benefit reserves for supplementary contracts with life contingencies are determined in a manner similar to annuity contracts and are reported as part of the aggregate life reserves.

8.36 *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 statutory valuation net premium. This can occur when the entity's interest or mortality assumptions used to calculate the gross premium are significantly more favorable than the corresponding assumptions permitted in determining statutory reserves.

8.37 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.

8.38 _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, and a reserve for guaranteed insurability options.

8.39 _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 collectibility 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.

8.40 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 for further discussion.)

Participating Dividends

8.41 _Statutory Accounting Practices_. Statutory accounting practices for dividends on individual participating contracts generally require a provision for dividends expected to be paid over the year subsequent to the date of the financial statements. 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.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

8.42 Under GAAP, the overall conceptual approach of the calculation of liabilities for future policy benefits for traditional life and health products is generally the same as SAP; however, the assumptions and methodologies used are usually different.

8.43 The total profit over the life of the contract is identical on any block of business for both SAP and 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 GAAP reporting models (see chapter 3 for further discussion). The SAP model's primary objective is to assure solvency and the ability to pay contractholder benefits. The 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.

8.44 The assumptions used in determining benefit liabilities in 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 contracts described in FASB Statement No. 60, 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.

8.45 The primary differences between the computation of SAP reserves and GAAP benefit liabilities are as follows:

a. GAAP liabilities for FASB Statement No. 60 contracts, include assumptions for withdrawals and nonlevel maintenance expenses; SAP reserves do not (except for a provision for early withdrawals on investment contracts).

b. GAAP mortality, morbidity, and interest assumptions are based on the life insurance entity's future expectations and trends, based on historical experience. The SAP mortality and interest assumptions are those approved by the state insurance department.

c. GAAP liabilities for FASB Statement No. 60 contracts and FASB Statement No. 97 limited-payment contracts contain provisions for adverse deviation, while SAP reserves may have no such specific provision. For those contracts, 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 GAAP liabilities for FASB Statement No. 60 contracts. This causes profits from these contracts to emerge as a level percent of premium plus the effects of differences between the actual result and those assumed. SAP reserves may use other methodologies. (See paragraph 8.15 for discussion.)

Significant Actuarial Assumptions

8.46 The selection of actuarial assumptions affects the incidence of reported profits for traditional life and health insurance products. If the 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 GAAP assumptions are unduly pessimistic, the opposite could occur.

8.47 The selection of actuarial assumptions for 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.

8.48 In determining the reasonableness of the assumptions, either individually or as composite factors, the adequacy of the gross premium must be considered. If the GAAP valuation premium exceeds the gross premium, a loss may be indicated. Such a loss must be recognized in the current period. (See paragraphs 10.38 through 10.48.)

8.49 *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.

8.50 Where 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 (usually fifteen years), 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.

8.51 *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 types 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 antiselection (the tendency for fewer terminations of poor risks) in renewal years.

8.52 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 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.

8.53 *Interest*. The interest assumption for FASB Statement No. 60 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.

8.54 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.

8.55 *Withdrawals*. Withdrawals affect anticipated premiums and death benefits; therefore, the liability computations should include provision for withdrawals, using anticipated withdrawal rates and contractual nonforfeiture benefits. For FASB Statement No. 60 contracts that do not have termination or nonforfeiture benefits, withdrawal assumptions are also generally appropriate because of the effects of terminations on anticipated premiums and claim costs.

8.56 Withdrawal assumptions are based on anticipated termination rates and contractual nonforfeiture benefits. The present value of expected nonforfeiture benefits will usually be less than the aggregate cash values of all contracts outstanding. GAAP liabilities may be less than aggregate cash values, since on a going-concern basis, it is unrealistic to assume that all contracts will be surrendered for cash.

8.57 Withdrawal rates used in determining GAAP liabilities usually vary by plan, issue age, mode of premium, duration, and other factors. If composite rates are used, they should reflect the entities' actual mix of business.

8.58 *Participating Dividends*. See paragraphs 8.78 through 8.87 for discussion.

8.59 *Expense*. 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, GAAP liabilities generally include a provision for maintenance expenses to reflect any significant changes in future maintenance expenses such as increases due to the effects of inflation.

Calculation of Liabilities for Future Policy Benefits by Contract Type

8.60 *Life Insurance Contracts*. For FASB Statement No. 60 long-duration contracts and FASB Statement No. 97 limited-payment contracts, the liability for future policy benefits represents the present value of the future benefits to be paid to contractholders and related expenses less the present value of the related future GAAP net premiums. (See chapter 7 for a discussion of GAAP net premiums and figure 7.1 for Contract Classification Decision Process flowchart.) 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.

8.61 For FASB Statement No. 97 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 FASB Statement No. 97 limited-payment contracts.)

8.62 For FASB Statement No. 60 long-duration contracts and FASB Statement No. 97 limited-payment contracts, GAAP requires that the original assumptions used when the contracts are issued be locked-in and that those assumptions are 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, paragraphs 10.44 through 10.48 for a discussion of loss recognition and paragraphs 10.21 through 10.34 for a discussion of DAC). By locking in the original assumptions, the gains or losses due to actual experience that differ from assumed flow through the income statement in the period in which the differences occur. In the event that future losses are evident, the present value of all such future losses is recognized immediately.

8.63 In accordance with FASB Statement No. 97, 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 (a) the contractholder's

account balance at the valuation date, plus (b) any amounts assessed against the contractholder that are accounted for as unearned revenue at the valuation date, plus (c) any amounts previously assessed against the contractholder that are refundable upon contract termination, plus (d) any probable loss (premium deficiency) as described in paragraphs 35 through 37 of FASB Statement No. 60 (see chapter 10, paragraphs 10.45 through 10.48). Amounts that may be assessed against the contractholder in future periods, such as surrender charges, are not anticipated in the liabilities. In the absence of a contractholder account balance or implicit or explicit contract value, the account balance element (see item (a) above) of the benefit liability is the cash value at the valuation date that could be realized by the contractholder 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.

8.64 For SOP 95-1 participating insurance contracts, a liability for future policy benefits relating to participating contracts should be equal to the sum of (a) the net level premium reserve for death and endowment policy benefits, plus (b) the liability for terminal dividends, plus (c) any probable loss (premium deficiency) as described in paragraphs 35 to 37 of FASB Statement No. 60. 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 is no guaranteed interest rate, the interest rate used in determining guaranteed nonforfeiture values should be used. Finally, if none of the above 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.

8.65 In accordance with SOP 95-1, terminal dividends should be accrued in the liability for future policy benefits if the following conditions are both met.[1]

a. Payment of the dividend is probable
b. The amount can be reasonably estimated

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 deferred acquisition costs.)

8.66 See chapter 14 for a discussion of separate accounts for variable life-type contracts.

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[1]These conditions should be used in the same sense that they are used in FASB Statement No. 5, *Accounting for Contingencies.*

8.67 *Accident and Health Contracts*. For FASB Statement No. 60 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 the same as the statutory claim reserve.

8.68 Aggregate liabilities for FASB Statement No. 60 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. GAAP claim liabilities (before discounting) are generally the same as the statutory claim reserve, although different interest assumptions may be used. Methods and concepts for calculating benefit liabilities are the same as those used in FASB Statement No. 60 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-term contracts, estimates of future premium should, in some cases, consider anticipated premium increases and their effect on lapses and antiselection.

8.69 *Annuity Contracts*. The benefit liability for an annuity contract depends on the type of contract, the premium payment terms, and whether the contract is in the accumulation or pay-out phase. Provision for adverse deviation is included in the assumptions used in calculating benefit liabilities for annuity contracts that are classified as FASB Statement No. 60 contracts or FASB Statement No. 97 limited-payment contracts.

8.70 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; however, if the assumptions result in a gain at issue, such gain should be deferred. 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. Since withdrawals under single premium immediate annuities are usually not permitted, withdrawal assumptions are generally not applicable.

8.71 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 a FASB Statement No. 97 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 risk to the life insurance entity is (a) the failure 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) and (b) that 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.

8.72 The second phase is the pay-out or liquidation phase, during which annuity payments are

made to the annuitant and the mortality risks are introduced. Annuity liabilities during the pay-out phase are similar to liabilities for the immediate annuities discussed above.

8.73 Liabilities for deferred annuity contracts should be based on the accumulation of a maturity value equal to the cash surrender value at the time the annuity enters the pay-out phase.

8.74 Under variable annuity contracts, the contractholder's payments (net of administration and specified sales charges) are used to purchase units of a separate investment account. (See chapter 14 for discussion of separate accounts.)

8.75 *Investment Contracts.* Investment contracts include GICs and other investment contracts as described in chapter 2. For most investment contracts, the benefit liability is equal to the payments or consideration received by the life insurance entity, accumulated at the credited interest rate. These amounts are reported as a liability and accounted for in a manner consistent with the accounting for interest-bearing instruments issued by other financial institutions.

8.76 *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.

8.77 *Reinsurance Accounting.* Under GAAP, according to the provision of FASB Statement No. 113, a ceding life insurance entity generally records anticipated reinsurance recoveries on the contracts in force as a reinsurance receivable asset. 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 treaties that do not provide for adequate transfer of risk as prescribed by FASB Statement No. 113 are treated as deposits.[2]

Participating Dividends

8.78 *Generally Accepted Accounting Principles.* To determine the appropriate accounting in conformity with GAAP for participating business, first determine if the contract meets the criteria in paragraph 5 of SOP 95-1. SOP 95-1 applies to life insurance contracts that are long-duration participating contracts that are expected to pay dividends to policyholders based on 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. If the contract meets the criteria in paragraph 5 of SOP 95-1, 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 paragraph 5 of SOP 95-1 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, or they may be self-imposed as demonstrated by entity policy or practice.

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[2] In June 1997, the AICPA issued a proposed Statement of Position (SOP), *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk.* The proposed SOP would provide guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. Readers should be alert to any final SOP.

8.79 For life insurance entities that do not have earnings restrictions and that use dividend scales unrelated to actual earnings, the specified contract dividends (based on dividends anticipated or intended in determining gross premiums, or as shown by published dividend projections at the issue date of the contracts) should be provided for ratably over the premium paying period. The specified dividend, although payment is not required, is considered a planned contractual benefit in computing GAAP liabilities. However, it may be necessary to identify the amount of this dividend to calculate deferred income taxes in those cases where there is a question as to whether the dividend provision in the liabilities, together with dividends paid or declared, may exceed the amount of dividends otherwise deductible for federal income tax purposes.

8.80 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. The contractholders 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 in a manner similar to the accounting for earnings applicable to minority interests. 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.

8.81 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 (a) a percentage of income on participating business, or (b) an amount per $1,000 of insurance in force of participating business, or (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.

8.82 In establishing provisions for contractholders' share of earnings, consideration must be given to whether earnings applicable to contractholders and stockholders are determined based on earnings or whether they are determined on a basis unrelated to earnings. In instances where earnings applicable to contractholders and stockholders are determined based on earnings before provision for the contractholders' share, adjustments to conform to GAAP creates reconciling items between the inclusion of items in income and expense in GAAP and SAP financial statements. For the purposes of computing a provision for the contractholders' share of earnings, these reconciling items should be considered. For example, a life insurance entity, either by law or by intent, may determine that 90 percent of earnings on participating contracts must inure to the benefit of participating contractholders. If earnings before dividends on its participating business, determined in conformity with GAAP, are $1 million, provision should be made for contractholders' share of earnings by a charge to operations for $900,000 (90 percent of $1 million). Actual dividends should be treated as previously described.

8.83 A second example relates to the legal restriction, which limits the amount that may inure each year to stockholders from certain participating contracts to the greater of (a) 10 percent of the statutory earnings before contractholder dividends or (b) fifty-cents-per-thousand [dollars] of participating life insurance in force.

8.84 For a life insurance entity whose statutory earnings on participating business are subject to the 10 percent limitation, and that is expected to continue to be in that situation, reconciling items and their reversal will affect contractholders' and stockholders' share of participating earnings. For an entity whose statutory earnings on participating business is subject to the

fifty-cents-per-thousand limitation, and that 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 contractholders' 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 fifty-cents-per-thousand.

8.85 Financial statements prepared in accordance with GAAP may reflect predividend income, which would produce an apparent basis of calculation of the contractholders' 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.

8.86 A third example relates to stock life insurance entities that issue participating contracts that follow FASB Statement No. 60 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 contractholders. 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. It should be noted that stock life insurance entities with qualifying contracts are permitted to follow the accounting guidance in SOP 95-1.

8.87 It should be noted that for participating business for which all, or substantially all, of the profits inure to the contractholders or for which amounts that may inure to the stockholder are limited to fifty-cents-per-thousand, adjustments to conform to GAAP will not affect net income or stockholders' equity. However, they will affect individual items within the financial statements. The auditor must determine whether the adjustments to individual items within the financial statements are necessary for fair presentation.

AUDITING

Inherent Risk Factors

8.88 In assessing audit risk, the auditor should consider those factors that influence inherent risk 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:

- Management's selection of actuarial assumptions for pricing and liability calculations are unduly influenced by considerations other than realistic expectations of future performance.

- The entity has a history of introducing new products where actual performance is less favorable than the original assumptions used for pricing and expected gross profit projections.

- Actual investment results are lower or likely to become lower than assumed, causing potential premium deficiency or loss recognition situations.

- Actual lapse or surrender rates are higher than assumed, causing potential premium deficiency and loss recognition — including the potential effects of antiselection.

- Economic conditions exist that increase contractholders' expectations of dividend scales or interest-crediting rates that may affect benefit liability assumptions.

- Volatility in the financial markets or other economic conditions makes assessment of appropriate investment returns or expense levels difficult.

- Unforeseen risks or events significantly affect the adequacy of liabilities for future policy benefits and mortality or morbidity assumptions.

- Increased competition or changes in tax legislation affect the lapse and surrender assumptions used in benefit liability calculations.

- Changes in reinsurance availability or agreements affect actuarial assumptions.

- Changes in regulations or application of accounting principles (SAP or GAAP) alter benefit liability requirements, assumptions, or calculation methodologies. Changes in tax regulations require benefit liabilities to be calculated on a different basis.

- Changes in the entity's underwriting standards or marketing strategy result in the acceptance of substandard risks or a change in business practices.

- The entity's surplus position is weak in comparison to the industry standard or close to minimum statutory levels.

- The life insurance entity has international operations, and benefit liabilities for operations outside the U.S. must conform to accounting principles and regulations in the country of domicile.

CONSIDERATION OF THE INTERNAL CONTROL FOR AUDITING LIABILITIES FOR FUTURE POLICY BENEFITS AND OTHER CONTRACT LIABILITIES

8.89 A key element in an effective audit is an understanding of the industry, operating environment, and internal control over financial reporting. An entity's internal control over financial reporting consists of five elements: the control environment, risk assessment, the control activities, information and communication, and monitoring. 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 plan the audit of the entity's financial statements. Such an understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

Control Environment

8.90 The control environment as related to benefit liability 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 benefit liabilities transactions include the following:

- 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.

- Operations are highly decentralized or there is significant reliance on third parties to provide necessary data to calculate significant benefit liabilities.

- 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.

- There is heavy reliance on manual processes or on one individual for benefit liability calculations.

- Staff is inexperienced or insufficient in relation to the complexity and volume of transactions involved in the calculation of benefit liabilities.

Control Activities

8.91 Control activities are those policies and procedures in addition to the other components that management has established to provide reasonable assurance that specific objectives will be achieved. The auditor should obtain an understanding of those control activities relevant to planning the audit. The following are examples of typical internal control procedures and policies relating to benefit liability transactions:

- *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 actuarial assumptions used in calculations of liabilities for future policy benefits.)

- *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.

- *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.

- *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.

- *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 to evaluate those calculations and the resulting liability amounts by appropriate personnel.

Information and Communication

8.92 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report an entity's transactions and to maintain accountability for related assets and liabilities.

8.93 The flow of accounting records for benefit and claim liability transactions usually encompasses all functions relating to selection of valuation assumptions, calculation of liability factors and aggregate liability amounts, evaluation of the adequacy of benefit liabilities, and 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, which can be mainframe or PC based. In general, most benefit liability systems generate amounts that are analyzed as of the valuation date and recorded in the financial records by manual journal entries.

8.94 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 which consists of valuation cells representing groups of contracts with similar characteristics. Contracts that are grouped into a valuation cell typically share one 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 (i.e., contracts with relatively few policies in force) there may be a "mapping" to a major plan. An example of this would be a life paid up to 95 contract with relatively few policies in force which may be modeled as a whole life contract. Valuation cell issue ages may be quinquenniel, with a male issue age of 35 cell representing policies sold to males ages 33 through 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 some 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.

8.95 A general summary of the process of calculating benefit reserve factors for traditional life and annuity contracts (for both SAP and GAAP) is as follows:

1. The selected mortality assumptions (and withdrawal assumptions for 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.

2. 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.

3. The net premium is then calculated using the entity's selected method (for 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 GAAP liabilities, also referred to as the *valuation premium*, are based on assumptions for mortality, interest, dividends, withdrawal, and expenses.

4. 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.

5. 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

8.96 In auditing aggregate benefit liabilities of life insurance entities, the auditor may consider the following matters regarding 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.

8.97 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

8.98 As described earlier in this chapter, the NAIC has established minimum levels of reserves for most types 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. 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.

8.99 In performing an audit of statutory financial statements, the auditor should —

- Discuss the cash flow testing with management to obtain an understanding of the company's cash flow testing procedures and analyses.

- Based on the auditor's evaluation of risk, review and test the reasonableness of assumptions and calculations where necessary.

- Determine that any additional statutory reserves required as a result of the cash flow testing have been recorded by the company.

Auditing GAAP Benefit Liabilities

8.100 In reviewing the reasonableness and appropriateness of the assumptions used in the calculations of the GAAP benefit liabilities, the auditor may find the following guidelines helpful.

8.101 *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 GAAP benefit liabilities uses its own actuarial factors based on assumptions developed using the entity's own historical, present, and projected experience.

8.102 *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 where appropriate.

8.103 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.

8.104 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.

8.105 *Interest*. In estimating yields for current contract issues, the entity considers its current and historical portfolio yields, trends in such yields, types 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, while others use scaled down or graded interest assumptions since 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 FASB Statement No. 60 contracts must include a provision for adverse deviation.

8.106 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.

8.107 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 in force business, the auditor may use the average new money rate or the average portfolio yield rate for a reasonable period. For entities 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.

8.108 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 that the ultimate interest-crediting rates, including amounts such as those credited as persistency bonuses, are accumulated.

8.109 Although it is not possible to establish a precise guideline that will apply in all circumstances, the auditor should be satisfied that the interest rates used are 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. The auditor should consider the facts and circumstances and make a professional judgment as to the reasonableness and conservatism of the rate used.

8.110 *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 should 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.

8.111 Established entities should use accepted withdrawal tables, such as those published by organizations such as Linton, only if the results produced by using such tables are comparable with the entity's actual withdrawal experience.

8.112 Different types 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 GAAP benefit liabilities should 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 FASB Statement No. 60 contracts.

8.113 For all contracts, the entity's actual cash value scale should be used in the GAAP benefit liability calculation.

8.114 *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 types of contracts should be considered in evaluating the reasonableness of expense assumptions. (See chapter 10 for discussions of expenses.)

8.115 *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 GAAP contract benefit liabilities and the related recoverability of acquisition expenses. In some 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 when 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, the audit report should consider modification.

8.116 New life insurance entities should use conservative provisions for adverse deviations for FASB Statement No. 60 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 should 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.

8.117 For a new entity to depart from regulatory practices or to use a valuation premium that is less than the gross premium, the auditor should consider each assumption as described below. In considering these assumptions, the assistance of an outside qualified actuary is required. (See chapter 5 for a discussion of use of specialists.)

8.118 *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.

8.119 *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.

8.120 *Withdrawals*. For an entity with little experience, the auditor should 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.

8.121 *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 types of contracts are considered in estimating expense assumptions. (See chapter 10 for discussions of expenses.)

Audit Consideration Chart

8.122 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.

Audit Consideration Chart
Benefit and Other Contract Liabilities

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
Existence or Occurrence and Rights and Obligations		
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: 1. Benefit liability valuation file and inforce file. 2. Unearned premiums (including reinsurance credits), to inforce file, reinsurance records, and general ledger records. 3. Prior- and current-year statutory accounting practices (SAP) and generally accepted accounting principles (GAAP) liability and in force amounts. 4. SAP reserves and GAAP benefit liabilities.	For participating contracts, perform the following: 1. Review contractholder dividend liability calculation to determine that it was calculated in accordance with authorized entity practice, contract terms, and statutory requirements. 2. Review computation of restrictions on earnings from participating business.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
	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. Compare beginning and ending balance and obtain explanations of any unexpected differences. 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.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	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.	For in force models, review client-prepared test results and evaluate how adequately the models reproduce the actual in force and actual results such as gross premium, expenses, and statutory reserves.
	Adequate procedures exist for monitoring third parties involved in processing or calculating benefit and claim liability data.	Review model tests under varying conditions to determine whether they are properly responsive to changes in experience.
	Adequate procedures exist with respect to experience-rated contracts to ensure that– 1. Data used in refund calculations are reconciled to actual premium and claim records. 2. Proper cutoff of activity is established.	Review calculation of liabilities for GAAP deferred premium amounts for propriety of calculation and proper recording (deduction of GAAP-deferred benefit premiums from GAAP benefit liabilities).
	Adequate procedures exist with respect to investment contracts to ensure that Proper cutoff of activity is established.	Review SAP reserves to determine that all special reserves, such as deficiency reserves on guaranteed-interest products, have been properly recorded.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Valuation or Allocation		
Benefit and claim liabilities and other contract liabilities recorded on the balance sheet are adequate and reasonable estimates of contract obligations incurred, and are correctly computed using methodologies and assumptions that are appropriate for the underlying contracts.	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).
	Actuarial assumptions and methodologies are formally documented and approved by the appropriate level of management, including any subsequent revisions.	Analyze and obtain explanations for changes between periods for the following: 1. Actuarial assumptions and methodologies. 2. Benefit liabilities by line of business. 3. Mortality, investment, or persistency gains/losses by reserve basis. 4. Claim liabilities by coverage type. 5. Ratio of claim liabilities and unearned premium. 6. Loss ratios by line of business for short-duration contracts.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Any manual calculations or adjustments, in addition to automated calculations of benefit and claim liabilities, are reviewed by appropriate personnel.	Evaluate the claim methodology and determine that it is appropriate for the underlying contracts, consistently applied and periodically reviewed by management.
	Procedures are in place to assure that actuarial assumptions and methodologies are in accordance with regulatory guidelines.	For 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. For changes in assumptions and valuation practices, evaluate the appropriateness of the changes in light of the entity's experience studies, type of contracts, and other relevant factors.

<u>Audit Objectives</u>	*Examples of Selected Control <u>Procedures and Techniques</u>*	*Examples of Auditing <u>Procedures</u>*
	A formal review process exists to assess that– 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. 2. The benefit and claim calculation methodologies are appropriate. 3. The factors resulting from the application of the methodology or formulas to the assumptions, and the resulting liability amounts are accurate. 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.	Review results of interest, mortality, morbidity, withdrawal, and expense studies relating to liability assumptions and compare to current assumptions being used for benefit liabilities. Review correlation of investment policy and related interest liability assumptions to the type of products being sold, the design of the products being sold, and how and to whom the products are being marketed. For SAP reserves, perform the following: 1. Test that the appropriate reserve and premium factors are applied to in force amounts (for example, reserve and premium factors agree with pub-lished tables, client-developed reserve factors, or for universal life contracts — amounts of contract funds). 2. Consider whether contract benefit and premium patterns coincide with actual contract specifications. 3. Consider the need to perform tests of the computation of client reserve and premium factors.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		4. Perform tests to determine whether deferred premiums are properly computed and included in the reserve calculations. 5. Perform tests to determine whether the benefit and claim reserve summaries are clerically accurate and complete.
	Detailed records of reinsurance assumed or ceded are compared to the reinsurance liability records, including any adjustments, and are reviewed by appropriate personnel.	Test in force contracts to determine whether– 1. All in force 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. 2. To ensure that unusual or unexpected additions or deletions are identified, compare valuation cells at the beginning and end of the reporting period.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
		Test universal life-type contracts, annuity contracts and investment contracts in force to determine whether– 1. Premium payments, cost of insurance, and other contract charges and interest credits are properly applied to individual account balances or investment contracts. 2. Contract account balance summary is clerically accurate and complete. 3. Proper cutoff is established to ensure that the liability calculations consider all premium or contract deposit amounts received.
Presentation and Disclosure		
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.	Actuarial reviews of reserving assumptions, methodologies, and liability amounts are adequate, and monitored by management.	Review methodology of premium and liability calculations and summarizations for consistency and reasonableness.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
	Management reports are prepared and reviewed which may include the following: 1. Benefit and claim liabilities by line of business. 2. Changes in actuarial assumptions or calculation methodologies.	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.
	3. Analysis of gains and losses by source of earnings such as mortality, investment, expense and persistency by reserve basis.	Review recent state insurance department examination reports for evidence of compliance with statutory benefit and claim reserve levels.
	4. Reserve deficiency if any (SAP and GAAP), if applicable. 5. Yearly comparative ratios of benefit liabilities to insurance in force, by line of business, type or grouping of contracts.	Review minutes, agreements, contracts, invoices, and other documents for evidence of other liabilities that should be accrued. Test whether disclosures comply with 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 contractholder 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 contractholder survives to the end of the endowment period, he or she will receive the face amount of the contract; if a contractholder 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 contractholders 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 contractholders 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 contractholders, and investment earnings rate are as follows:

Assumptions

Contract Year	Mortality Rate	Persisting Lives—End of Year	Investment Earnings Rate
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 contractholder benefits, assumptions as to expenses are required; however, for purposes of these examples, expenses have been ignored. In addition, for FASB Statement No. 60 products, provisions for adverse deviation are required. 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 Statement No. 60 is a prospective reserve method. Contractholder 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.[1] For products with annual premium payments, such as the example endowment contract, where premiums are collected annually from surviving contractholders, 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[2] needed to be collected from the surviving contractholders 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 ÷ 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 to be paid in year 1—$40,000—are discounted for one year, since they are assumed to be paid at the end of the year. Similarly, the benefits to be paid in year 2 are discounted for two years, and so on.[3] Note that in year 5, the death benefits are assumed to be incurred prior to payment of the endowment benefit.

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[1]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 contractholder 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 and/or in force.

[2]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.

[3]Discount factors are calculated as: $1 \div 1.05$ for year one; $1 \div 1.05^2$ for year 2; $1 \div 1.05^3$ for year 3; etc.

Policy Benefits

Year	Death Benefits	Endowment Benefits	Total Benefits	Present Value of Contract Benefits at End of Year: 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 to be collected in year 1—$1,800,000—are not discounted, because they are assumed to be collected at contract inception. The gross premiums for year 2—$1,792,800—are discounted for one year, since they are assumed to be collected on the first anniversary, one 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

Year	Total	Present Value of Gross Premiums at End of Year: Issue Date	Year 1	Year 2	Year 3	Year 4	Year 5
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 ÷ 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 * 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:

Year	Present Value of Net Premiums at End of Year					
	Issue Date	Year 1	Year 2	Year 3	Year 4	Year 5
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

	End of Year					
	Issue Date	Year 1	Year 2	Year 3	Year 4	Year 5
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	—
Contractholders' 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 contractholder benefit liabilities under FASB Statement No. 60 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 8.19, 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

	Year 1	Year 2	Year 3	Year 4	Year 5
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	$1,791,701	$3,655,862	$5,594,446	$7,609,574	$ —

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.[4]

Reserve Factors

	Year 1	Year 2	Year 3	Year 4	Year 5
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 should refer to chapter 10 for guidance.

[4]See footnote 1. Reserve factors usually represent, at a given point in time, the amount of reserve required for each $1,000 of insurance in force.

Chapter 9

BENEFIT AND CLAIM PAYMENTS

INTRODUCTION

9.1 Life and health insurance and annuity contracts provide benefits promised under the contract terms in return for premiums or other consideration received from the contractholders.

Types of Benefit and Claim Payments

9.2 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

9.3 *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. 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.

9.4 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 contractholder. 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 for further discussion.)

9.5 *Matured Endowments*. Matured endowments are amounts payable to the contractholder 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.

9.6 *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. Annuity benefit payments can be fixed amounts or linked to the investment performance of

specified assets or separate accounts. Annuity benefit payments can be for life or may be made over some other stipulated period of time.

9.7 The main types of annuities are the following:

- *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.

- *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.

- *Refund annuities* are similar to annuities certain. There are two common types 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.

- *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.

- *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. (See chapter 14 for a discussion of separate accounts.)

9.8 Surrender Benefits. Surrenders occur when the contractholder 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.

9.9 Accident and Health Benefits. Accident and health contracts generally provide benefits such as reimbursement for hospital and medical costs, disability payments (see paragraph 9.10), 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 coordination of benefits with other insurers.

9.10 Disability Benefits. Disability contracts generally provide specified benefits, for a stated period or for life, in the event the insured is unable to work due to total or partial disability because of 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.

9.11 *Participating Dividends*. Both mutual and stock life insurance entities may write contracts that have participating dividend features. When 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 contractholder 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 the life insurance entity's board of directors or trustees and paid or credited according to the payment option selected by the contractholder. Some contracts also provide for payment of a *terminal dividend* when a contract terminates due to 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 contractholder 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.

9.12 *Experience-Rated 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

9.13 Most states have provisions to regulate the payment of benefits. These regulations are generally designed to protect contractholders, and usually apply to requirements for notice of claims, proof of loss, and payment of claims.

9.14 Payment of contractholder 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 for further discussion of participating dividends.)

ACCOUNTING PRACTICES

9.15 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 generally accepted accounting principles (GAAP). The following discussion of SAP and 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 types of benefit and claim payments within the life insurance industry. The authoritative sources cited in

chapter 3 should be referred to in determining appropriate accounting and reporting treatment in all cases.

Statutory Accounting Practices — Benefit and Claim Payments

9.16 Contract benefits and claims are reported in the *Annual Statement* on an incurred basis. They include benefits and claims paid, adjusted for (a) benefit and claim payments due but unpaid, (b) reported claims in the course of settlement, (c) claims contested, and (d) an estimate of claims incurred but not reported as of the valuation date. 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, and investment contracts.

9.17 Benefits reported in the summary of operations are those related to direct business, plus reinsurance assumed, reduced by reinsurance ceded.

9.18 *Participating Contracts*. Participating dividends are recorded as an estimate of dividends to be paid in the following year, as each contract reaches its anniversary date. Annual dividends are generally payable on contract anniversary dates. The board resolution authorizing the payment of dividends is usually made annually for contracts reaching anniversaries within the following calendar year.

9.19 Annual participating dividends on individual contracts are generally determined from formulas based on actuarial methods. These methods are designed to provide a basis whereby an entity's divisible surplus may be prorated to the various classifications of contracts. The dividend formula, commonly referred to as *dividend scales*, must be approved by the board of directors or trustees, and the dividend must be formally declared before any legal obligation exists. When declared, the liability for the following year's dividend is recorded for the amount so declared in the current year's accounts.

9.20 For life insurance entities that have a history of paying dividends on participating contracts and for which there is reasonable expectation that the dividend will be declared for premiums earned in that period, some states require a liability to be recorded for the estimated amount.

Generally Accepted Accounting Principles — Benefit and Claim Payments

9.21 In general, the principal differences between 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. FASB Statement No. 97, paragraph 21, states the following, "Payments to policyholders that represent a return of policyholder balances are not expenses of the insurance entity and shall not be reported as such in the statement of earnings. Amounts reported as expenses shall include benefit claims in excess of the related policyholder balances, expenses of contract administration, interest accrued to policyholders, and amortization of capitalized acquisition costs."

b. Participating dividends. The accounting for participating dividends is described in chapter 8.

AUDITING

Inherent Risk Factors

9.22 In assessing audit risk, the auditor should consider those factors influencing inherent risk 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:

- 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.
- Unforeseen risks or events require benefit payments where the risk was not considered covered or where the risk significantly affects mortality or morbidity assumptions.
- The life insurance entity's claims adjudication process is relatively unsophisticated.
- 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.
- The life insurance entity employs aggressive claims settlement practices with respect to denying or contesting benefits due under related contracts.
- Changes in tax regulations affect the volume of claims or surrenders for certain types of contracts.

CONSIDERATION OF THE INTERNAL CONTROL FOR AUDITING CONTRACT BENEFIT AND CLAIM TRANSACTIONS

9.23 A key element in an effective audit is an understanding of the industry, operating environment, and internal control over financial reporting. An entity's internal control consists of five elements: the control environment, risk assessment, control activities, information and communication, and monitoring systems. 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 plan the audit of the entity's financial statements. Such an understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

Control Environment

9.24 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 mitigating the effectiveness of specific control policies or procedures of the entity. Such factors that relate to benefit and claim transactions include the following:

- Benefit operations are highly decentralized or there is significant reliance on third parties to provide necessary data to process benefit amounts due.

- 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.

- 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.

- There is heavy reliance on manual processes for benefit processing.

- Staff is inexperienced or insufficient in relation to the complexity and volume of transactions involved in the benefit processing area.

Control Activities

9.25 Control activities are those policies and procedures in addition to the other components that management has established to provide reasonable assurance that specific objectives will be achieved. The auditor should obtain an understanding of those control activities relevant to planning the audit. The following are examples of typical internal control procedures and policies relating to benefit and claim payments and other related contract liability transactions:

- *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.

- *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.

- *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.

- *Adequate safeguards of access to and use of assets and accounting records.* Data files and production programs have adequate safeguards against unauthorized access.

- *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 contractholders; and reviews are performed to determine that continuous benefit payments, such as annuity or disability payments, are valid and supported by the appropriate documentation.

Information and Communication

9.26 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to record, process,

summarize, and report an entity's transactions and to maintain accountability for related assets and liabilities.

9.27 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.

9.28 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 if 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 for discussion).

9.29 Once the benefit amount has been determined, the appropriate benefit recipient is identified. The recipient could be the contractholder 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.

9.30 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.

9.31 *Life Insurance Contracts*. When 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.

9.32 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.

9.33 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 discussion).

9.34 *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 physician's reports; however, other proof may be required with varying levels of supporting evidence depending on the type of illness or disability related to the claim.

9.35 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.

9.36 *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 contractholder is notified of the pending maturity and generally has several options for payout of the proceeds.

9.37 *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. Board resolutions authorizing the payment of dividends are usually made annually for contracts reaching anniversaries within the following calendar year. The amount apportioned for distribution to contractholders 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. Life insurance entities 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 when contracts terminate by maturity, surrender, or death.

9.38 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.

9.39 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

9.40 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.

Audit Consideration Chart
Benefit and Claim Payments

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
Existence or Occurrence and Rights and Obligations		
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 contractholders 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 are the following: 1. Verify that the contract was in force at transaction date. 2. Determine that the transaction was recorded and processed on the benefits processing and insurance in force systems. 3. Determine the authenticity of the claim. 4. Recalculate the benefit. 5. Determine that reinsurance recovery has been identified and accurately calculated and subsequently received. 6. Trace to the claims register.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
		Procedures for death benefits, disability and accident, and health are the following: 1. Determine that the claim is acceptable under the terms of the contract coverage. 2. Determine that independent investigative reports were obtained in appropriate circumstances. For matured endowments, determine that the benefit is in accordance with the contract terms. For annuity benefits, determine the following: 1. The contract has fulfilled its fixed accumulation period, or an annuitization request was submitted by contractholder. 2. The contract has been properly set up for repetitive payments, if appropriate.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		For surrender benefits, perform the following: 1. Determine that the transaction was allowable. 2. Recalculate the surrender value and/or agree surrender values to established cash surrender value tables. 3. Test that policy loans, interest, terminal dividends, and any other contract charges or credits have been properly reflected. 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 and/or expense deductions. For contractholder dividends and profit- sharing participations, perform the following: 1. Determine that participating benefit is due in accordance with contract terms. 2. Agree dividend and profit sharing participation rates to rate files.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
Completeness		
All benefits or claims incurred or paid in the current period are appropriately included in the financial statements.	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.	Test the clerical accuracy of the books of original entry (for example, claims register), historical claim databases, and key statistical data summary reports.
	Inquiry and observation to determine that management has established adequate procedures for monitoring third parties involved in processing or calculating benefit or claim payments.	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.
	Inquiry and observation to determine that management has established adequate procedures with respect to experience-rated contracts to ensure that— 1. The data used in refund calculations are reconciled to actual premiums and claims records. 2. Proper cutoff of activity is established.	Review experience-rated refund calculations to determine that— 1. The data used in the calculations are reconciled to actual premium and claim records. 2. Actual activity through end of the reporting period is considered. 3. Experience-rated refunds are calculated in accordance with the contract provisions and are recorded correctly as to account, amount, and period.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Inquiry and observation to determine that management has established adequate procedures with respect to benefit and claim payment transactions to ensure that— • Proper cutoff of activity is established.	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.
	• Significant variances between expected and actual payments are analyzed and monitored by appropriate personnel. Processing backlogs are monitored and large or unusual fluctuations are investigated by appropriate personnel.	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.
	Suspense account balances are analyzed and reviewed by appropriate personnel for large, old, or unusual items.	
Valuation of Allocation		
All benefits or claims incurred or paid in the current period are included in the financial statements in the proper amount.	Adequate procedures exist to identify and pursue reinsurance recoveries for benefit and claim payments.	Compare ratios for prior periods and obtain explanations for any unexpected or significant changes as to the following: 1. Average death claims to average contract size. 2. Benefits or claims incurred to premium income.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
	Benefit/claim payments are calculated using the appropriate contract data.	3. Cash surrender benefits paid to reserve amount at the last valuation date.
	Loss development techniques are used to establish IBNR for accident and health claims.	4. Contractholder dividends to participating premium income and to income before contractholder dividends.
		For participating contracts, perform the following: 1. Review contractholder dividend liability calculation and the change for the year to determine that it was calculated in accordance with authorized practices, contract terms, and statutory requirements. 2. Review computation of restrictions on earnings from participating business.
		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.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
Presentation and Disclosure		
Benefit/claims paid or incurred are properly classified, described, and disclosed in the financial statements, including notes, in conformity with applicable accounting principles.	Management reports are prepared and reviewed, which may include the following: 1. Ratio of claims incurred to claims liabilities by coverage type. 2. Life insurance claims incurred to insurance in force. 3. Contractholders' dividends to participating premium income and to income before contractholder dividends. 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.	Review minutes, agreements, contracts, contested claims files, and other documents for evidence of other liabilities that should be accrued. 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. Test whether disclosures comply with GAAP or SAP, as applicable.

Chapter 10

COMMISSIONS, GENERAL EXPENSES, AND DEFERRED ACQUISITION COSTS

INTRODUCTION

10.1 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 types of selling or distribution expenses are typically the principal operating expenses of life insurance entities.

10.2 For statutory reporting purposes, the operating expenses of life insurance entities are classified as (a) commissions, (b) general expenses, and (c) taxes, licenses, and fees. Statutory accounting practices require that all costs be charged to expense as incurred. In many instances, due to 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.

10.3 Under generally accepted accounting principles (GAAP), 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.

10.4 The primary reason for the difference in reporting methods is that the statutory accounting practices (SAP) and GAAP reporting models have different principal objectives. The SAP model's principal objectives emphasize the ability to meet contractholder obligations and liquidity; the income statement effect is a secondary concern. The primary focus of GAAP financial reporting is information about earnings and its components.

REGULATION

10.5 In general, commission rates are not regulated except in certain states where 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 overrides and represent additional compensation to the agent. These allowances are restricted in certain states 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

10.6 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 GAAP. The following discussion of SAP and GAAP accounting for commissions, general expenses, and deferred acquisition costs 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 deferred acquisition costs within the life insurance industry. The authoritative sources cited in chapter 3 should be referred to in determining appropriate accounting and reporting treatment in all cases.

Statutory Accounting Practices

10.7 Under SAP, commissions and allowances (representing agent or broker compensation) are included in the Annual Statement on exhibit 1, Part 2, "Premiums and Annuity Considerations." All amounts paid or accrued as due are included, and no deferral is allowed. Commission amounts are reported as first year, single, renewal, and reinsurance ceded and/or assumed, and are classified by line of business.

10.8 General expenses are reported in the Annual Statement on exhibit 5, "General Expenses," and are allocated to two broad categories: insurance and investments. The insurance category is further allocated to (a) life insurance (including annuities), (b) accident and health insurance, and (c) all other lines of business. General expenses allocated to the lines of business 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. These amounts also include imputed rent for owner-occupied real estate and the related tenant costs associated with occupancy, such as electricity.

10.9 General expenses allocated to the investment category include the costs associated with all investment activities. Examples of investment-related expenses generally include 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 above), except depreciation (which is reported separately on exhibit 2, "Net Investment Income") and real estate taxes (which is reported separately on exhibit 6, "Taxes, Licenses, and Fees"). Investment expenses are deducted from gross investment income to report net investment income in the revenue section of the Statement of Operations.

10.10 Taxes, licenses, and fees are reported in exhibit 6 in the period incurred. These costs are allocated to lines of business in the same manner as general expenses and include costs such as real estate taxes, premium taxes, payroll taxes, insurance licenses, and examination fees. Federal income taxes are not included in exhibit 6 but are reported separately in the Statement of Operations.

10.11 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 and cost of collection in excess of loading on deferred and uncollected premiums* (see chapter 7), which is reported separately as an expense in the Statement of Operations.

Generally Accepted Accounting Principles

10.12 Under GAAP, commissions, allowances, and other costs that *vary with and are primarily related to* the acquisition of new and renewal business are generally deferred and amortized. These deferred amounts, referred to as *deferred acquisition costs (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, as appropriate. (See exhibit 10.1.)

10.13 Some portions of a life insurance entity's costs, such as investment expenses, product development expenses, market research expenses, contract maintenance expenses, and general overhead, are not associated directly with acquiring business and are not appropriate for deferral. As is the case with other business entities, such expenses are charged to operations as incurred.

10.14 Determination of Deferrable Costs. Acquisition costs are defined in FASB Statement No. 60, paragraph 28. FASB Statement No. 97, paragraph 24, identifies certain acquisition costs related to universal life-type insurance contracts and investment contracts that are not deferrable.

- *For all contracts*, FASB Statement No. 60, paragraph 28, states, "Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs."

- *For universal life-type contracts*, FASB Statement No. 97, paragraph 24, states, "Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period shall be charged to expense in the period incurred."

10.15 The identification of acquisition costs requires considerable judgment; in making these judgments, due consideration should be given to the concepts of reasonable conservatism[1], 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 types 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 In some 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.

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[1]See FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information,* for a discussion of the term conservatism as it is used in this Guide.

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 operate on the mail-order plan, and to acquire business, these entities incur costs for brochure design and printing, postage, advertising, and other direct solicitation expenses. Regardless of the method used by a particular entity to sell insurance, an acquisition expense should be deferred only if the expense both varies with and is primarily related to the production of business.

10.18 Issue expenses, as opposed to selling expenses, are generally incurred in the home office of a life insurance entity. In some 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, 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 FASB Statement No. 97 contracts level renewal expenses in the premium-paying period do not require that a reserve be provided 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 FASB Statement No. 60 contracts, capitalized acquisition costs are amortized in proportion to premium revenue recognized cost 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. FASB Statement No. 60, paragraph 29, requires that, "To associate acquisition costs with related premium revenue, acquisition costs shall be allocated by groupings of insurance contracts consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts."

Amortization of DAC

10.21 The principal purpose of amortization is to systematically match costs with related revenues or gross profits, as appropriate. Amortization differs by type of contract.

10.22 *FASB Statement No. 60 Contracts and FASB Statement No. 97 Limited-Payment Contracts*. Amortization methods for FASB Statement No. 60 long-duration contracts and short-duration contracts, as well as for FASB Statement No. 97 limited-payment contracts, are described by FASB Statement No. 60, paragraphs 29 through 31; such costs are amortized in proportion to earned premium. (Refer paragraphs 7.14 through 7.17 for contract classifications.)

> Acquisition costs shall be capitalized and charged to expense in proportion to premium revenue recognized. To associate acquisition costs with related premium revenue, acquisition costs shall be allocated by groupings of insurance contracts consistent with the enterprise's manner of acquiring, servicing, and

measuring the profitability of its insurance contracts. Unamortized acquisition costs shall be classified as assets.

> 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, shall be applied to applicable unearned premiums throughout the period of the contracts.

> Actual acquisition costs for long-duration contracts shall be used in determining acquisition costs to be capitalized as long as gross premiums are sufficient to cover actual costs. However, estimated acquisition costs may be used if the difference is not significant. Capitalized acquisition costs shall be charged to expense using methods that include the same assumptions used in estimating the liability for future policy benefits.

10.23 *Universal Life-Type Contracts*. DAC balances for universal life-type contracts are amortized in proportion to gross profits as defined in FASB Statement No. 97, paragraphs 22 and 23:

> Capitalized acquisition costs shall 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 shall be computed using the rate of interest that accrues to policyholder balances (sometimes referred to as 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 shall be substituted as the base for computing amortization.

> Estimated gross profit, as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall 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. Amounts expected to be assessed for mortality (sometimes referred to as the 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 as described in paragraph 24)

c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances

d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as surrender charges)

e. Other expected assessments and credits, however characterized

10.24 In general, for universal life-type contracts accounted for under FASB Statement No. 97, 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 types of assumptions used in FASB Statement No. 60 contracts, for example, persistency and mortality; however, the gross profit estimate does not include any provision for adverse deviation.

10.25 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.

10.26 In estimating expected gross profits, FASB Statement No. 97, paragraph 23(b), requires that gross profit estimates include acquisition costs not capitalized; however, this generally refers to recurring acquisition-related costs, such as ultimate level commissions that do not meet FASB Statement No. 97 criteria for deferral. Generally, noncontract-related expenses, such as certain overhead costs, and contract-related expenses that are not eligible for deferral under FASB Statement No. 60 are not included in estimated gross profits.

10.27 *SOP 95-1 Participating Insurance Contracts*. DAC amortization for SOP 95-1 participating insurance contracts is similar, but not identical, to FASB Statement No. 97 contracts. SOP 95-1 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.

10.28 In computing amortization, SOP 95-1, paragraph 21, requires interest to be accrued to the unamortized balance of capitalized acquisition costs at a 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.

10.29 Estimated gross margin, as the term is used in SOP 95-1, paragraphs 22 and 23, shall include estimates of the following:

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 paragraph 15a), 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

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.

10.30 *Alternative Basis for DAC Amortization*. When significant negative gross profits are expected in any period, FASB Statement No. 97 requires an alternative base of amortizing the DAC balance. The possible alternative bases are the present value of estimated gross revenues, gross expenses, or the amount of insurance in force.

10.31 A change in the basis for amortizing DAC that is required due to 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 estimates, as provided by Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes.* Following the change, the new basis of amortization should be consistently applied in future periods.

10.32 *Interest Charges on DAC*. FASB Statement No. 97 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 provided by APB Opinion No. 20.

10.33 *Investment Contracts*. For investment contracts accounted for under FASB Statement No. 97, 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 Statement No. 91, *Accounting for Nonrefundable Fees and Costs*

Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases. For investment contracts that include significant surrender charges or that yield significant revenue from sources

other than the investment of contractholder funds, the amortization methods described for universal life-type contracts are generally used.

Calculation Methodologies

10.34 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, as appropriate, in that period (see exhibit 10.1 for examples of calculation methodologies).

10.35 *Work Sheet Method*. There are two types 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 in force adjusted for actual terminations, while using the same expense factors as the static work sheet methodology. The dynamic work sheet method is required for FASB Statement No. 97 contracts, and generally preferred for FASB Statement No. 60 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 where actual persistency materially differs from expected. Careful consideration should be given to persistency assumptions when using either method.

10.36 *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 in force. The expense reserve factors can be either standard cost factors or adjusted factors for costs 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.

10.37 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

10.38 *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 in force 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 recalculation of amortization schedules.

10.39 Recoverability testing of FASB Statement No. 60 contracts consists of determining if all

the expected gross premiums collected over the life of a certain group of insurance contracts are sufficient to recover all deferred acquisition costs 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.

10.40 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 deferred acquisition costs, 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.

10.41 FASB Statement No. 97 requires that the loss recognition requirements of FASB Statement No. 60 should also be applied to 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.

10.42 *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 where 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.

10.43 Annual tests of premium deficiencies are generally appropriate for short-duration contracts.

10.44 *Loss Recognition (Premium Deficiency)*. The provisions in FASB Statement No. 60 dealing with loss recognition (premium deficiency) apply to FASB Statement No. 60 contracts, FASB Statement No. 97 limited-payment and universal life-type contracts, and SOP 95-1 participating contracts. For these contracts, it is anticipated that the original assumptions 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.

10.45 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 following form:

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)

10.46 This deficiency represents a loss that, in conformity with GAAP, should be recognized immediately by a charge to earnings and (a) a reduction of unamortized acquisition costs or (b) 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 shall be estimated periodically for comparison with the liability for future policy benefits (reduced by unamortized acquisition costs) at the valuation date, and particularly when the entity has experienced or anticipates adverse deviations from original assumptions that could materially affect the liabilities.

10.47 While 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 some 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.

10.48 *Loss Recognition Tests for Investment Contracts*. FASB Statement No. 97, paragraph 27, as it relates to the application of loss recognition (premium deficiency) provisions of FASB Statement No. 60, 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

10.49 *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, where a loss is indicated, the company 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, when 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 contractholder persistency. However, when profits on participating contracts issued by stock entities are restricted (see chapter 8), the stockholders' share of any loss is recognized.

10.50 *Internal Replacements*. An *internal replacement* is the replacement of one contract form with another within the life insurance entity. FASB Statement No. 97 addresses internal replacements of traditional life contracts by universal life-type contracts only. For these transactions, life insurance entities are required to charge to expense the unamortized DAC balance associated with the replaced contracts and any difference between the cash surrender value and the previously recorded liability at the time of replacement.

10.51 *Other Than Universal Life-Type Contracts*. For internal replacements other than those described in paragraph 10.50, the accounting practices are varied and are based on the circumstances of the transaction. Some entities view internal replacement transactions as a continuation of a contractual relationship and continue to defer the related unamortized DAC of the old contract over the life of the new contract. Other entities charge to expense the unamortized balance of the deferred acquisition costs of the replaced contracts.

10.52 If the accounting practice for internal replacements, other than replacement by a universal life-type contract, is changed, and if the effect is material, life insurance entities should reflect the accounting change as well as disclose the change in their reports to shareholders/contractholders as a change in accounting principle, as described in paragraphs 18 through 26 of APB Opinion No. 20.

AUDITING

10.53 *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).

10.54 *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. Due to the significance of these actuarially determined estimates, the use of an outside qualified actuary is required. (See chapter 5, paragraphs 5.37 through 5.43, for guidance on the use of actuaries.)

Inherent Risk Factors

10.55 In assessing audit risk, the auditor should consider those factors influencing inherent risk related to commissions, general expenses, and deferred acquisition costs, including factors relating to management, commission processing, cost allocation, and expense management. Such factors might encompass the following:

- Management's philosophy toward deferral and amortization of contract acquisition costs, evaluation of the type of costs that are deferred, including product development costs, and tests for premium deficiencies are considered aggressive in comparison to the industry.

- Management tends to change its philosophy toward the deferral and amortization of contract acquisition costs from year to year.

- The life insurance entity has commission structures with varied tiers and complex formulas. Commission patterns are not predictable.

- Products have features combining high commission payments and early cash value accumulations.

- Commission rates are significantly above industry averages for similar products and distribution systems.

- Regulatory restrictions on agent compensation and allowances and other acquisition costs may exist.

- The entity has changed distribution methods or compensation and incentive arrangements with agents and brokers.

- Agent and broker turnover is high or there are flexible policies with regard to advances to agents.

- Requirements for licensing agents or other intermediaries are not adhered to or require changes in compensation contracts.

- Experienced lapse or surrender rates are higher than assumed, causing potential premium deficiency and possible loss recognition situations.

- 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.

- The entity's DAC amortization methodology is not sensitive to changes in persistency.

- Qualified actuaries are not used in the calculation of DAC balance, recoverability testing, loss recognition evaluation, or gross profit tests.

- The entity markets universal life-type products with tiered interest-rate structures, making gross profit calculations complex for amortization of DAC for those products.

- 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.

CONSIDERATION OF INTERNAL CONTROL FOR AUDITING COMMISSIONS, GENERAL EXPENSES, AND DEFERRED ACQUISITION COSTS

10.56 A key element to an effective audit is an understanding of the industry, operating environment, and internal control over financial reporting. An entity's internal control consists of five elements: the control environment, risk assessment, control activities, information and communication, and monitoring. 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 plan the audit of the entity's financial statements. Such an understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

10.57 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

10.58 The control environment, as related to commissions and deferred acquisition costs 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 deferred acquisition costs transactions include the following:

- There is a heavy reliance on third parties or agents for premium collection. Premiums are submitted net of commissions are incomplete, or require additional analysis to be applied to individual agents, contracts, and proper accounts.

- A substantial increase in volume or level of backlog for premium and/or related commission transactions exists. The processing error rate is significant or increasing.

- 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.

- New products have been introduced that require changes to the commission processing systems, or the degree of complexity of commission processing is increasing.

- 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.

- 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.

- 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 Statement No. 97.

- There is excessive reliance on one individual for DAC calculations.

Control Activities

10.59 Control activities are those policies and procedures in addition to the other components that management has established to provide reasonable assurance that specific objectives will be achieved. The auditor should obtain an understanding of these control activities relevant to planning the audit. The following are examples of typical internal control procedures and policies relating to commissions and deferred acquisition costs transactions:

- *Proper authorization of transactions and activities.* Written commission guidelines are in place assigning appropriate individuals the responsibility for approval of compensation rates and the authority to approve compensation rates used in product pricing and changes in the current rate structures. Procedures are in place for approval of special compensation arrangements with agents or brokers, including monitoring for regulatory compliance.

- *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. Independent reviews of the work performed should be conducted. Functions of issuing, authorizing, and signing checks should be separate from those involved in processing vendor invoices and maintaining accounts payable or commission payable records.

- *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.

- *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.

- *Independent checks on performance and proper valuation of recorded amounts.* There

are procedures in place to ensure that commission registers and accounts payable/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 type 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.

Information and Communication

10.60 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report an entity's transactions and to maintain accountability for related assets and liabilities.

Commissions and Allowances

10.61 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.

10.62 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.

10.63 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 through 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.

10.64 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 — net of commissions due — to the insurance entity and the premiums and related commissions are recorded in the financial records.

10.65 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.

10.66 Agents' credit balances that include commissions and allowances incurred, but not yet paid, are recorded as liabilities on the balance sheet.

General Expenses

10.67 The flow of accounting records for most general expenses and tax transactions is typically the same as those found in other types of industries. However, the reporting process that requires allocation of expenses to Annual Statement categories for statutory purposes, and to acquisition and maintenance expenses for GAAP purposes, is unique to insurance entities (described earlier in this chapter).

Deferred Acquisition Costs

10.68 The methods used to identify, record, and amortize deferred acquisition costs 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, 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—

- 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.

- Acquisition costs, as described above, 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 for recoverability testing. In addition, GAAP amortization methodologies may differ by contract classification.

- The two steps described above 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.

10.69 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

10.70 The auditor may consider the following specific audit objectives and examples of selected control and auditing procedures in auditing commission, general expense, and deferred acquisition cost 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.

10.71 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

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Existence or Occurrence and Rights and Obligations		
Commissions	Commissions	Commissions
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 — 1. Agent compensation contracts. 2. Special compensation arrangements. 3. Changes in commission rate structures. 4. Contingent commission arrangements. 5. Bonuses and awards. 6. Expense reimbursement agreements 7. Compliance with regulatory restrictions, which is monitoring by appropriate levels of management.	Review agent compensation contracts, expense reimbursement agreements, and any other special compensation arrangements. 1. Test that commission payments are made in accordance with the related contract. 2. Test that expense reimbursements are in accordance with agreements and applicable state insurance law. 3. Review selected expense reports and supporting details submitted by agents.
	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.	

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		Taxes 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.
All general expenses recorded in the income statement are properly supported as charges against the entity and relate to the period under review.	DAC and Other Expenses Formal procedures or accounting systems exist to— 1. Identify expenses that meet the entity's criteria for deferral. 2. Appropriately allocate acquisition costs to contract groupings or lines of business.	DAC and Other Expenses Review the current criteria and nature of contract acquisition costs deferred. Compare to prior periods for consistency. Evaluate reasonableness and consistency of cost allocations to lines of business or contract types. Obtain explanations for unusual items.
Recorded deferred acquisition costs (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.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Completeness		
All commission data and related payments are appropriately recorded and accumulated in the proper accounts and master file records.	Commissions	Commissions
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 generally accepted accounting principles (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 uncleared items by the appropriate personnel.	Test that commission data is correctly recorded in the appropriate individual agents' account.
All contract acquisition costs available for deferral are appropriately deferred, in accordance with the entity's accounting policies.	Reconciliations are carried out between— 1. Commission register and premium register. 2. Commission register and the general ledger. 3. Commission register and commission payment listing, which are reviewed and approved by appropriate personnel.	Test proper cutoff of commission register. Test clerical accuracy of commission payment amounts. Review commission suspense accounts for overall changes from period to period and for old or unusual items. Obtain explanations for significant items.
	Proper cutoff is established to ensure commissions, allowances, and premium taxes are accrued for premiums collected at period end.	Confirm of selected amounts of commissions paid and balances unpaid as of a specific date, as appropriate.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	DAC and Other Expenses	DAC and Other Expenses
	Systems exist to identify acquisition costs properly and are monitored by appropriate personnel.	Compare changes between periods for— 1. General expenses levels to premium income. 2. Exhibit 5 categories as a percentage of total expense. 3. General expenses accrued to total expense levels. 4. Functional or departmental budgets or estimated expenses to actual expense.
	Reconciliations of expenses used in DAC calculations to total entity expenses are regularly prepared and reviewed by appropriate personnel.	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.
	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.	Test the clerical accuracy of the accumulation of DAC and related amortization calculations. Test adjustment of acquisition expenses for deferred premiums.
	Reinsurance expense allowances are reviewed and appropriately included in acquisition cost. Any adjustments are approved by appropriate personnel.	

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		Compare changes between periods in total and by component for— 1. Composition of acquisition costs by expense category. 2. Allocation methodologies of acquisition costs and other expenses. 3. Ratio of DAC to premium revenue. 4. DAC per contract and per unit of insurance in force. 5. Grouping of lines of business. 6. Actual acquisition costs to budgeted amounts. 7. Actual to assumed experience for mortality, morbidity, persistency, expense levels, investment yields or gross profit. 8. Acquisition costs to general insurance expenses. 9. Ratio of amortized DAC to DAC asset balance. 10. Loss ratios (historical and prospective) and results of operations for accident and health and credit contracts.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
		11. Amounts of unamortized DAC by contract grouping or cell used in amortization calculation.
Valuation or Allocation		
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.	Commissions Commission rates and special compensation arrangements with agents or brokers are approved by appropriate levels of management.	Commissions Test agent or broker expense reimbursements to determine that 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 amounts due to or from agents. Obtain explanations of any unusual, old, or disputed amounts.
Recorded DAC are appropriately deferred and recoverable from related contract revenues or expected gross profits, as appropriate.	DAC and Other Expenses Allocations of contract-related expenses and acquisition costs, by line of business or contract type, are reviewed by appropriate personnel.	DAC and Other Expenses Review the recoverability of DAC by comparing 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.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
	Periodic reconciliations are performed between actual cost 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.	For identified loss recognition situations, determine that DAC balances are appropriately reduced or that premium deficiency liabilities are accrued.
		For life insurance entities using a factor approach, perform the following: 1. Review entity's analysis of persistency, investment yields, mortality, morbidity, and expenses to test reasonableness of DAC assumptions. 2. Test that 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. 3. Test factor calculations and determine that contracts are included in the proper DAC valuation cells to which the factors are applied.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
		4. For contracts or lines of business that have lapse experience, which is substantially different from expected, test that the results of the entity's experience (or industry experience when industry studies are used) is used to develop DAC factors. 5. Review reconciliations of actual acquisition cost incurred and estimates used in expense assumptions. For life insurance entities using a work sheet approach, review the entity's lapse experience by contract type or other grouping and determine that any material deviation from assumed persistency is considered in evaluating recovery of DAC balances. For universal life-type contracts and investment contracts, perform the following: 1.Review the present value (PV) of expected future gross profit calculations in relation to PV of DAC balances to determine recoverability.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		2. Compare assumptions or original projections used to develop gross profit calculations with actual experience.
		3. Test that interest rate assumptions are consistently applied.
Presentation and Disclosure		
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.		
	General	General
	Formal management review policies and guidelines exist with respect to— 1. Agent compensation contracts. 2. Contingent or nonstandard compensation arrangements. 3. Compliance with regulatory environment 4. Expense reimbursement agreements.	Test whether disclosures comply with GAAP or SAP as applicable. For statutory financial statements, test whether classifications and disclosures comply with applicable state regulations.
	Procedures for the calculation and amortization of DAC, including allowable types of cost and allocation methodologies, are reviewed and approved by appropriate levels of management.	Review finance committee minutes, agent compensation contracts, rate books, and contract forms to ascertain that deferral policies are appropriate and adequately disclosed and described.

Exhibit 10.1
Accounting for Deferred Acquisition Costs

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 below.

FASB Statement No. 60 and Limited Payment-Type Contracts

For FASB Statement No. 60 contracts and 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, 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 three 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 follows:

Year	Contracts In Force at the Beginning of the Year (1)	Terminations (2)	Contracts In Force at the End of the Year (3)	Annual Amortiz. for Contracts In Force (Col 3 x $20)	Writeoff of Unamortized Balances on Termination (5)	Total Amortization (6)	Expected Premium Income (7)	Amort. as a Percentage of Premium (7/6)
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 since the original assumptions at issue anticipate that terminations will begin almost immediately with respect to any year's block of business.

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 tables below illustrate amortization under this method. For simplicity, the first table illustrates amortization without regard to interest accruals on the unamortized 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

Year	Premium Revenue (1)	Ratio of Annual to Total (2)	Prescheduled Amortization (3) $(\Sigma(3)*(2))$	Ratio of Amortization to Premiums (4) $((3)/(1))$
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%
	$300,000	100.0%	$60,000	20%

DAC Amortization
With Interest Accruals on Unamortized Balances

PREMIUM **DAC**

Year	Expected Premium Revenue (1)	Ratio of Annual to Total (2)	Interest Rate Assumption (3)	Present Value Factor (4)	Present Value of Premiums (5)	Beginning Balance (6)	Gross Amortization Ratio (7)	Prescheduled Ratio of Gross Amortization (8)	Annual to Total (9)	Interest (10)	Cost Recovered (11)	Pre-scheduled Ending Balance (12)
1	$100,000	33.3%	6.0%	1.000	$100,000	$60,000	0.2148	$21,476	33.3%	$2,181	$19,296	$40,704
2	80,000	26.7%	6.0%	0.943	75,440	40,704	0.2148	17,181	26.7%	1,502	15,679	25,025
3	60,000	20.0%	5.0%	0.898	53,880	25,025	0.2148	12,886	20.0%	639	12,247	12,778
4	40,000	13.3%	5.0%	0.848	33,920	12,778	0.2148	8,590	13.3%	220	8,370	4,408
5	20,000	6.7%	5.0%	0.807	16,140	4,408	0.2148	4,408	6.7%	0	4,408	0
	$300,000	100.0%			$279,380			$64,541	100.0%	$4,541	$60,000	

Legend:

Column Formula

(2) (1)/Σ(1)
(5) (1) * (4)
(7) Beginning DAC/Σ(5)
(8) (1) * (7)
(9) (8)/Σ(8)
(10) ((3) * (6)) - ((3) * (8))/(1 + (3))
(11) (8) - (10)
(12) (6) - (11)

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 follows:

Year	Planned Amortization	Planned Unamortized Cost End of Year	Expected Insurance In Force End of Period (,000)	Planned Unamortized Cost per M of Insurance In Force
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	-	-	-
	$60,000			

Assume that actual experience emerges as follows:

Year	Actual Premium Revenue	In Force End of Period (000)	Planned Amortization Cost per M Insurance In Force	Unamortized Cost End of Period	Amortization Amount	Amortization Ratio of Premiums Collected
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%
	$310,000				$60,000	

Under this method, if persistency is higher or lower than assumed, the unamortized cost factors (or "expense reserve factor") 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:

Year	Policies Expected to Be In Force at Beginning of Each Year
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 $60,000/3,000 = $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:

Year (1)	Expected In Force Beginning of Year (2)	Interest Rates (3)	Present Value Factor (4)	Present Value of 1 (Due at the Beginning of Each Year) at the Beginning of Year 1 (5) (2 x 4)
1	1.0	.06	1.000	1.000
2	.8	.06	.943	.754
3	.6	.05	.890	.534
4	.4	.05	.848	.339
5	.2	.05	.807	.161
				2.788

The annuity present value factor for the premium paying period is 2.788. By dividing this factor into the initial acquisition cost of $60 per policy, an interest adjusted expense premium of $21.51 is computed. In other words, the total of $21.51 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:

Year	Expected In Force Beginning of Year	Interest Rate	Unamortized Cost Beginning of Year	Expense Premium Payment $21.51*(1)	Interest [(3)-(4)] *(2)	Cost (4)-(5)	Unamortized Cost End of Period (3)-(6)	Per In Force at End of Year
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	1.0	6%	$60.00	$21.51	$2.31	$19.20	$40.80	$51.00
2	.8	6%	40.80	17.21	1.41	15.80	25.00	41.67
3	.6	5%	25.00	12.91	.60	12.31	12.69	31.72
4	.4	5%	12.69	8.60	.21	8.39	4.30	21.50
5	.2	5%	4.30	4.30	--	4.30	--	--
						$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. When 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 Contract

Schedules One, Two, and Three from FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, 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 twenty-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 (refer to FASB Statement No. 97, paragraphs 22 through 25). During year 1, actual experience is assumed to be the same as management's estimate. During year two, 20 percent of policyholders surrender their contracts. Management's original estimate was that 12 percent of policyholders would surrender their contracts in year two. Interest is credited to policyholder balances at 9 percent.[2]

Illustration of Computation of Gross Margins for Long-Duration Participating Contracts

Schedules 1, 2, and 3 from SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, 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 fifty-five-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 (refer to FASB Statement No. 97, paragraphs 22 through 25). 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.[3]

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[2]Source: FASB Statement No. 97, paragraph 79.

[3]See footnote 2.

[FASB Statement No. 97, paragraph 80]

Schedule One — Computation of Estimated Gross Profit

Year	Surrender Charges (a)	Mortality Assessments (b)	Mortality Cost Incurred (c)	Expense Assessments (d)	Recurring Expenses Incurred (e)	Investment Income Related to Policy Balances (f)	Interest Credited to Policy Balances (g)	Estimated Gross Profit	Revised Gross Profit at Year 2
1	$ 13,298	$ 17,300	$ (3,685)	$ 11,700	$ (12,176)	$ 6,405	$ (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	(88,833)	32,577	(33,712)	2,618,726	(2,244,622)	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

Explanation of columns:
(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 contractholder account balances at the expected crediting rate of 9 percent.

[FASB Statement No. 97, paragraph 81]

Schedule Two — Computation of Amortization Rate

		Original Estimate	Revised Estimate
Present value of estimated gross profit, years 1 to 50 (from Schedule One)	(x)	$180,944	$176,087
Present value of capitalized acquisition costs	(y)	$ 90,986	$ 90,986
Amortization rate = (y)/(x)	(z)	50.284%	51.671%

Schedule Three — Illustration of Amortization

	Original Estimate	Revised Estimate
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 One) at 51.671% (revised rate from Schedule Two)	(17,897)	(17,897)
	$75,211	$74,798
Balance based on Original Estimate	$75,211	
Balance based on Revised Estimate	74,798	
Adjustment required	$ (413)	
Net amortization recognized		
In year one	$ 6,754	
In year two	$10,622	

[SOP 95-1, Appendix A, 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)	(Increase) Decrease in NLPR (g)	Dividends Incurred (h)	Post-dividend Gross Margins (i)	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%:									$371,261	$ 362,945

Explanation of columns:
(a) Gross premiums.
(b) Interest, at 8.5% 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% 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) through (h) inclusive.

[SOP 95—1, Appendix A, Illustration of Computation of Gross Margin]
Schedule 2 — Computation of Amortization Rate

		Original Estimate	Revised Estimate
Present value of estimated gross profit, years 1–55, evaluated at issue (from Schedule 1)	(a)	$371,261	$362,945
Present value of capitalized acquisition costs, years 1-55, evaluated at issue	(b)	$263,309	$263,309
Amortization rate = (b)/(a)	(c)	70.923%	72.548%

[SOP 95—1, Appendix A, Illustration of Computation of Gross Margin]
Schedule 3 — Illustration of Amortization

		Original Estimate	Revised Estimate
Capitalized costs, year 1		$241,500	$241,500
Interest accrual at 8.5%	(a)	20,528	20,528
Amortization, year 1 Gross margin 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 (a+e)		$ 17,344	
In year 2 (g + n based on revised estimates + Difference between (f) at original estimate and at Revised estimate)		$ 17,772	

Chapter 11

INVESTMENTS

INTRODUCTION

11.1 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 contractholders, 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.

11.2 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*.

11.3 Currently, the majority of assets in a typical life insurance entity's portfolio consist of debt securities, equity securities, mortgage and other loans, real estate investments, and policy loans. Most life insurance entities have separate investment departments responsible for investable funds; however, they may also use outside advisors 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

11.4 Because life insurance entities have a fiduciary responsibility to meet their obligations to contractholders, 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 types of investments life insurance entities are

permitted to make, limit the amount of investments in each type of investment and in any one issuer, and establish requirements for valuing admitted assets in the statutory financial statements.

11.5 Limitations on assets can be both quantitative and qualitative. Quantitative limitations are those that pertain to the total holdings of any type 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.

11.6 Investments not qualifying as admitted assets due 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.

11.7 The NAIC issued a Model Investment Law which provides guidelines for insurers to follow in purchasing investments. Several states have adopted the NAIC Model Investment Law. Others have not. 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

11.8 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 generally accepted accounting principles (GAAP). The following discussion of SAP and 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 should be referred to in determining appropriate accounting and reporting treatment in all cases.

SECURITY INVESTMENTS

Debt Securities

11.9 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 (commercial paper), and negotiable certificates of deposit (CDs). Some other investments that may be classified as debt securities include redeemable preferred stock, GICs, and asset-backed securities, such as collateralized mortgage obligations (CMOs), mortgage participation certificates (MPCs), credit-tenant mortgages (CTMs), interest-only and principal-only certificates (IOs and POs), 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 GAAP. Under GAAP, investments in debt securities (including redeemable preferred stocks) are classified at acquisition into one of three categories, as prescribed by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and accounted for as follows:

a. Debt securities classified as *held-to-maturity* are those debt securities that the life insurance entity has the positive intent and ability to hold to maturity. These securities are measured at amortized cost unless there is a decline in their fair value that is considered other than temporary.[1]

b. Debt securities classified as *trading securities* are those that are bought and held principally for the purpose of selling in the near term. These securities are reported at fair value, with unrealized gains and losses included in earnings.

c. Debt securities not classified as either *trading securities* or *held-to-maturity* shall be classified as *available-for-sale* securities and reported at fair value. Changes in the fair value of the debt securities classified as *available-for-sale* are reported as unrealized holding gains or losses, which are reported net of applicable deferred income taxes; amounts attributed to policyholders and DAC (as referred to in paragraph 11.13) as a separate component of stockholders' equity until realized unless there is a decline in their fair value that is other than temporary. (See paragraphs 11.48 and 11.49 for additional discussion.)

11.11 Amortization of premium or discount is calculated using the interest method, which results in a constant effective yield, typically using the contractual maturity date in accordance with FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. The prepayment method, as described in paragraph 19 of FASB Statement No. 91 may also be used particularly for asset backed securities such as CMOs, IOs, and POs. Amortization calculations may require the use of estimates, such as prepayment assumptions on CMOs or interest and return of investment allocations on IOs and POs. The current year's amortization or accretion is recorded as a charge or credit to interest income. FASB Statement No. 115 provides guidance on accounting and reporting for all investments in debt securities. FASB Statement No. 91 provides guidance on the application of the interest method and other amortization matters. EITF Issue No. 89-4, *Accounting for a Purchase Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*, as amended by EITF 93-18, *Recognition of Impairment for an Investment*

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[1]Paragraph 7 of FASB Statement No. 115, as amended by FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, 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. Footnote 4 of FASB Statement No. 125 states that as a result of the amendment to paragraph 7 of FASB Statement No. 115, "securities that were previously classified as held-to-maturity may need to be reclassified" and that "reclassifications of interest-only strips or other securities from held-to-maturity to available-to-sale required to initially apply [FASB Statement No. 125] would not call into question an entity's intent to hold other debt securities to maturity in the future."

in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate, provides guidance on accounting for CMO and interest-only certificate transactions.

11.12 Interest and dividend income, including amortization of premium and discount, are included in earnings, for all three categories of investments under FASB Statement No. 115.

11.13 As a result of inquiries and comments by SEC registrants and their auditors, at the July 12, 1994 EITF meeting, the SEC staff made an announcement regarding the effects of adopting FASB Statement No. 115 on certain assets and liabilities. The SEC staff would expect registrants to comply with the guidance in this announcement when registrants adopt FASB Statement No. 115 and FASB Interpretation No. 40. The FASB staff believes that both public and non-public entities should comply with the guidance in this announcement. The text of this announcement is as follows:

> Registrants currently are evaluating the effect on their financial statements of adopting FASB Statement No. 115. The SEC staff has been asked whether certain assets and liabilities, such as minority interests, certain life insurance policyholder liabilities, deferred acquisition costs, and the present value of future profits, should be adjusted with a corresponding adjustment to shareholders' equity at the same time unrealized holding gains and losses from securities classified as available-for-sale are recognized in shareholders' equity. 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?
>
> This issue is not addressed specifically in the literature. However, paragraph 36(b) of FASB Statement No. 109 addresses specifically the classification of the deferred tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity. Paragraph 36(b) of FASB Statement No. 109 requires that the tax effects of those gains and losses be reported as charges or credits directly to the related component of shareholders' equity. That is, the recognition of unrealized holding gains and losses in shareholders' equity may create temporary differences for which deferred taxes would be recognized, the effect of which would be reported in a separate component of shareholders' equity along with the related unrealized holding gains and losses. Therefore, FASB Statement No. 109 requires that deferred tax assets and liabilities 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 a separate component of shareholders' equity rather than charges or credits to income in the statement of income.
>
> By analogy to the requirements of FASB Statement No. 109, the SEC staff believes that, in addition to 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 minority interest, policyholder liabilities, deferred acquisition costs that are amortized using the gross-profits method, or amounts representing the present value of future profits 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 shareholders' equity. 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, registrants should adjust minority interest for a portion of the unrealized holding gains and losses from securities classified as available-for-sale if those gains and losses relate to securities that are owned by a less-than-wholly-owned subsidiary whose financial statements are consolidated. Certain policyholder liabilities also 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, certain asset amounts that are amortized using the gross-profits method, such as deferred acquisition costs accounted for under FASB Statement No. 97, and the present value of future profits recognized as a result of acquisitions of life insurance entities accounted for as purchase 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 FASB Statement No. 60 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 _SAP_. Under SAP, debt securities are carried at amortized cost, subject to the valuation standards of the NAIC, as described in the NAIC's *Valuations of Securities* manual. As with GAAP, amortization or accretion under SAP is calculated by the interest method. Debt securities that do not qualify for amortization under the *Valuations of Securities* manual are carried at the value listed in the manual, referred to as *association value* (made up of two parts: an actual or estimated market price and an NAIC designation, which is a rating for quality), or at book value, whichever is lower. Generally, nonqualifying debt securities are those that are in default or otherwise impaired with regard to principal or interest payments or some other valuation factor. Usually, the life insurance entity does not accrue interest income for debt securities in default or with interest or principal payment ninety days in arrears. Effective for year-end 1998, debt securities not listed in the manual, or obligations listed with no value, require the determination of an acceptable value that can be substantiated to the appropriate NAIC subcommittee or regulatory

agency. In the event that a debt security is not listed in the *Valuations of Securities* manual or is listed with no value, the life insurance entity is required to submit sufficient information on these securities to the NAIC Securities Valuation Office for a determination of market value. The security can be held for one year as a non-rated security. After one year, if a rating has not been received by the NAIC Securities Valuation Office, the security must be given a rating of 6*.

11.15 Guidance for accounting for loan-backed and structured securities, including CMOs, is provided in the NAIC's *Accounting Practices and Procedures Manual*. At purchase, loan-backed and structured securities are recorded at purchase cost. 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. Loan-backed and structured securities are subject to the valuation standards of the NAIC as described in the *Accounting Practices and Procedures Manual* and *Valuations of Securities* manual.

11.16 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.

11.17 Realized and unrealized gains and unrealized losses for assets classified as debt securities are included in the interest maintenance reserve (IMR) and asset valuation reserve (AVR) calculation.

Securities Lending Transactions

11.18 Life insurance entities may also lend debt securities (referred to as "securities lending")[2] or enter into other agreements such as repurchased agreements, reverse repurchase agreements or dollar repurchase and dollar reverse repurchase agreements. These types of transactions are generally short-term in nature, ranging from one to thirty 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 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.

11.19 GAAP. Securities lending transactions are transfers of financial assets, some of which meet the criteria in paragraph 9 of FASB Statement No. 125 requiring (a) the transferor to account for the transfer as a sale of the loaned securities for proceeds consisting of the collateral and a forward repurchase commitment and (b) the transferee to account for the transfer as a purchase of the borrowed securities in exchange for the collateral and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the transferred securities

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[2]Life insurance entities may also lend equity securities, although it is not as common as lending debt securities.

and the transferee has obtained control over those securities, having the ability to sell or repledge them. In that case, creditors of the transferor have a claim only to the collateral and the forward repurchase commitment.

11.20 However, many securities lending transactions are accompanied by an agreement that both entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets. Paragraphs 27 through 29 of FASB Statement No. 125 define the conditions that must be present for an agreement to both entitle and obligate the transferor to repurchase. Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, the securities loaned are considered pledged as collateral against the cash borrowed, and any rebate paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral as set forth in paragraph 15 of FASB Statement No. 125.

11.21 The transferor of securities being loaned accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) 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 (or securities).

Repurchase Agreements and Wash Sales

11.22 Repurchase agreements (repos) and reverse repurchase agreements, including dollar repurchase and dollar reverse repurchase agreements, are contracts to sell and repurchase or to purchase and sell back the same or similar (same issuer). In addition, these transactions often involve mortgage-backed securities (also referred to as *pass-through certificates* or *mortgage-participation certificates*).

11.23 GAAP. If the criteria in paragraph 9 of FASB Statement No. 125 are met, 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. Paragraph 29 of FASB Statement No. 125 states "to be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transfer must at all times during the contract term have obtained cash or collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others."

11.24 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 Statement No. 125. 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.

Equity Securities

11.25 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.

11.26 GAAP. Under GAAP, equity securities that have readily determinable fair values as defined by FASB Statement No. 115 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 Statement No. 115 or do not have readily determinable fair values should be consolidated or accounted for under APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, using the *cost* or *equity* method.

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

11.28 Equity securities not listed in the *Valuations of Securities* manual or listed with no value, require the determination of an acceptable 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 Securities Valuation Office for a determination of market value.

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

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

b. Net worth of a noninsurance subsidiary, adjusted to use only those assets of the subsidiary that would constitute admitted assets if owned directly by an insurance entity

c. Net worth of a noninsurance subsidiary with its value adjusted for restrictions on downstream insurance subsidiary and goodwill assets

d. Cost adjusted to reflect subsequent operating results of the subsidiary with its value adjusted for restrictions on downstream insurance subsidiary and goodwill assets. (Operating results of the noninsurance subsidiary should be in accordance with GAAP, and operating results for an insurance subsidiary should be in accordance with SAP.)

e. Market value for a partially owned subsidiary that is listed and publicly traded on a national securities exchange

f. Any other value that can be substantiated to the satisfaction of the NAIC Subcommittee on Valuation

11.30 In addition to the alternatives listed in paragraph 11.29, when the valuation of noninsurance subsidiaries uses financial information prepared in accordance with GAAP, section 4 of the *Valuations of Securities* manual requires that the subsidiary's financial statements for the most recent fiscal year must be audited by an independent certified public accountant in accordance with generally accepted auditing standards.

11.31 Realized and unrealized gains and losses for assets classified as equity securities are included in the AVR calculation (see paragraphs 11.40 through 11.45) in the equity component except for certain preferred stock assets that may be included in the default component.

Futures, Options, and Similar Financial Instruments

11.32 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. As interest rates, commodity prices, and other market rates and indices from which certain financial 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, 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*.

11.33 Options and futures contracts can also be entered into for speculative purposes, but most insurance regulators prohibit life insurance entities from these types of speculative transactions. Although the criteria to qualify for hedging 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, or currency exchange risk, and the financial instrument used as a hedge must reduce the specific risk exposure.

11.34 GAAP. Under GAAP, to the extent derivatives are financial instruments as defined in FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit* Risk; the disclosure requirements set forth in FASB Statements No. 105, No. 107, *Disclosures about Fair Value of Financial Instruments*; and No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, must be met. Other accounting and reporting requirements for derivative financial instruments are included in FASB Statements No. 52, *Foreign Currency Translation*, and No. 80, *Accounting for Futures Contracts*, as well as a variety of FASB EITF Consensuses including but not limited to No. 84-7, *Termination of Interest-Rate Swaps*; No. 84-14, *Deferred Interest Rate Setting*; No. 84-36, *Interest Rate Swap Transactions*; No. 86-34, *Futures Contracts Used as Hedges of Anticipated Reverse Repurchase Transactions*; No. 87-26, *Hedging Foreign Currency Exposure with a Tandem Currency*; No. 90-17, *Hedging Foreign Currency Risks with Purchased*

Options; No. 91-1, *Hedging Intercompany Foreign Currency Risks*; No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions*; No. 96-13, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled In, a Company's Own Stock*.[3]

11.35 The AICPA publication *Derivatives–Current Accounting and Auditing Literature* summarizes current authoritative accounting and auditing guidance and provides background information on basic derivative contracts, risks, and other general considerations.

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

11.37 Generally, for assets carried at amortized cost, any gain or loss on options and futures contracts qualifying as a hedge is deferred until the ultimate disposition of the hedged transaction and is used to adjust the basis of the hedged item. If the hedge was not effective and the contract expires or is terminated through a closing transaction, the gain or loss is recognized currently as a realized gain or loss. Financial instruments that are off-balance-sheet items, such as interest-rate swaps, are disclosed in the notes to the financial statements.

11.38 Any unrealized gains or losses on options that hedge assets carried at market value, such as separate accounts or contracts not intended as hedges, are recorded as unrealized gains or losses.

11.39 Realized gains or losses on interest-related hedged instruments are included with the gains and losses on the hedging investments and deferred and amortized according to the requirements of the IMR calculation.

Interest Maintenance Reserve and Asset Valuation Reserve

11.40 Interest Maintenance Reserves (IMR) and Asset Valuation Reserves (AVR) are required for statutory financial statements only. Under SAP, beginning with 1992 statutory financial statements, the NAIC replaced the mandatory securities valuation reserve (MSVR) with two reserves, the IMR and AVR. The NAIC's objectives in replacing the MSVR were to develop an asset valuation reserve 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 is 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. To this end, the NAIC has adopted the AVR

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[3]The disclosure requirements of FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, superseded the disclosure requirements of the consensus in EITF Issue No. 91-4, *Hedging Foreign Currency Risks with Complex Options and Similar Transactions*. FASB has issued FASB Statement No. 133, *Accounting for Derivatives Instruments and Hedging Activities* which significantly affects accounting for derivative instruments and hedging activities and also gives guidance about which products that may currently be considered insurance products would be classified as derivatives. This Guide will be updated during the exposure period to reflect the relevant guidance of FASB Statement No. 133.

and the IMR, which, taken together, are deemed by regulators to be more appropriate for a life insurance entity's balance sheet than the previous MSVR.

11.41 The IMR, for all types 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.

11.42 The AVR calculation generally expands the previous MSVR to include all invested asset classifications. The change in the AVR is charged directly to surplus in a manner similar to the prior MSVR reporting. The AVR contains two components (each of which has two subcomponents), each intended to address specific areas of asset risk:

- The *default component* contains provisions for future credit-related losses on most types of securities. Its two subcomponents are—
  - 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 mortgaged-backed securities.
  - The mortgage subcomponent, which contains default provisions for farm, commercial, and residential mortgages.
- The *equity component* contains provisions for credit-related losses for all types of equity investments. Its two subcomponents are—
  - The common stock subcomponent, which includes affiliated, unaffiliated, and all other investments in the nature of common stock.
  - 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.

11.43 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).

11.44 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.

11.45 The NAIC Annual Statement Instructions, the NAIC *Accounting Practices and Procedures Manuals*, and the NAIC *Securities Valuations* manual 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

11.46 _GAAP_. Under GAAP, as stated in FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, paragraph 28, as amended by FASB Statement No. 115, realized gains and losses are accounted for as follows:

> Realized gains and losses on all investments (except investments that are classified as *trading securities* and those that are accounted for as hedges as described in FASB Statement No. 52, *Foreign Currency Translation*, and FASB Statement No. 80, *Accounting for Futures Contracts*) shall be reported in the statement of earnings as a component of other income, on a pretax basis. Realized gains and losses shall be presented as a separate item in the statement of earnings or disclosed in the notes to the financial statements. Realized gains and losses shall not be deferred to future periods either directly or indirectly.

11.47 _Unrealized Holding Gains and Losses_. 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 are excluded from earnings and reported as a net amount in a separate component of stockholders' equity-contractholders' surplus until realized. FASB Statement No. 109, *Accounting for Income Taxes*, provides guidance in paragraph 36 about reporting the tax effects of unrealized holding gains and losses reported as a separate component of contractholders' equity. (Also, see EITF announcement in paragraph 11.13.)

11.48 _Fair Value Declines That Are 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.* For example, if it is probable that the life insurance entity will be unable to collect all amounts due according to the contractual terms of a debt security not impaired when acquired, an other than temporary impairment is considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as a new cost basis and the amount of the writedown should be included in earnings as a realized loss. The new cost basis should not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of securities in the available-for-sale category and subsequent decreases in fair value that are not other than temporary are included in the separate component of stockholders' equity-contractholders' surplus used to report unrealized holding gains and losses for this category. Auditing interpretation of SAS No. 1, *Long-Term Investments* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), Interpretation AU section 9332.04 through 9332.14, discusses factors that auditors should consider in evaluating fair value declines of marketable securities below carrying value.[4]

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[4]SAS No. 81, *Auditing Investments*, which supersedes SAS No. 1, section 332, *Long-Term Investments*, and deletes Interpretation No. 1 of SAS No. 1, section 332, "Evidential Matter for the Carrying Amount of Marketable Securities," provides guidance to auditors in auditing investments in debt securities and equity securities as defined in FASB Statement No. 115 and investments accounted for under APB Opinion No. 18. SAS No. 81 is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application is permissible.

11.49 Additionally, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, paragraph 51, addresses accounting for unrealized gains and losses that are considered other than temporary for equity securities that are not addressed by FASB Statement No. 115, paragraph 3, as follows:

> If a decline in the fair value of an equity security that is not addressed by Statement No. 115 because it does not meet the criteria in paragraph 3 of that Statement is considered to be other than temporary, the investment shall be reduced to its net realizable value, which becomes its new cost basis.

The amount of the reduction shall be reported as a realized loss. A recovery from the new cost basis shall be recognized as a realized gain only at sale, maturity, or other disposal of the investment.

11.50 Abstract Topic D-44, EITF 89-4, and EITF 93-18 provides additional guidance on what is meant by an other than temporary decline in fair value. 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 due to a decline in market value below cost, many factors need to be considered, including—

- The length of time and extent to which the market value has been less than book value.

- The financial condition and near-term prospects of the issuer, including any specific events that may influence its operation.

- 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.

11.51 _Transfers Between FASB Statement No. 115 Categories_. Changes in circumstánces 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 Statement No. 115, paragraph 15, the transfer of a security between categories is accounted for at fair value at the date of the transfer. 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 as prescribed by FASB Statement No. 91. Transfers from the held-to-maturity category should be rare, except for transfers due to changes in circumstances identified in subparagraphs 8(a) through 8(f) of FASB Statement No. 115. Given the nature of a trading security, transfers into or from the trading category also should be rare. As of the date of transfer 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 securities category, the unrealized holding gain or loss at the date of transfer 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 recognized as a separate component of shareholders' equity-contractholders' surplus.

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 shall continue to be reported as a separate component of shareholders' equity-contractholders' surplus, 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.

11.52 _SAP_. 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. Losses relating to impairment, and all realized and unrealized gains and losses on common stocks, are classified as credit-related. Realized gains and losses that are interest-related are included in the calculation of the IMR and are deferred and amortized into investment income over the remaining life of the assets sold.

INVESTMENTS OTHER THAN SECURITIES

Mortgage Loans

11.53 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.

11.54 _GAAP_. Under 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 paragraph 19 of FASB Statement No. 91) 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. 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. Paragraphs 12 through 16 of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan — Income Recognition and Disclosures* address methods for measuring and reporting impairment. Paragraph 6 of FASB Statement No. 114 provides four situations which 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 Statement No. 65[5], *Accounting for Certain Mortgage Banking Activities*, to those operations. Therefore, mortgage loans held for sale should be reported at the lower of cost or market value in conformity with FASB Statement No. 65. Mortgage-backed securities held for sale in conjunction with mortgage banking activities shall be classified as trading securities and reported at fair value in conformity with FASB Statement No. 65, as amended by FASB Statement No. 125.

11.55 *Interest Income*. Interest income on all loans should be accrued and credited to interest income as it is earned, using the interest method. FASB Statement No. 118 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. Refer to Practice Bulletin No. 6, *Amortization of Discounts on Certain Acquired Loans*, for certain acquired loans.[6]

11.56 *Loan Fees, Costs, Discounts, and Premiums*. FASB Statement No. 91 establishes the accounting for loan origination fees and costs. [7] 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.

11.57 Fees received for a commitment to originate or purchase a loan or group of loans 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.

11.58 For purchased loans, the initial investment includes the amount paid to the seller, net of fees paid or received. 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). Premiums and discounts on purchased loans are recognized as an adjustment of yield over the contractual

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[5]The FASB currently has a project on its agenda which will amend FASB Statement No. 65. Readers should be alert to any final pronouncement.

[6]The AICPA currently has a project on its agenda which will amend Practice Bulletin No. 6. Readers should be alert to any final pronouncement.

[7]The staff of the FASB 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*.

life of the loan unless prepayments are probable and can be reasonably estimated (See paragraph 11.56).

11.59 FASB Statement No. 91 addresses fees and costs in refinancings or restructurings other than a troubled debt restructuring and requires that 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 Statement No. 91 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.

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

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

11.62 For mortgages that are in default or being foreclosed, the carrying value is adjusted for unpaid interest and additional expenses, such as legal fees, to the extent they are expected to be recovered from the ultimate disposition of the property. Nonrecoverable costs should be expensed in the period incurred. In the event that the value of the collateral for a mortgage loan in default is less than the carrying value, a valuation reserve should be considered for the estimated uncollectible amount. Mortgage loans that are in default or under foreclosure proceedings should continue to be classified as mortgage loans until the life insurance entity has clear title to the underlying collateral, and then the asset should be reclassified as real estate.

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

11.64 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.

Troubled Debt Restructurings

11.65 FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended by FASB Statement No. 114, establishes the accounting for troubled debt restructurings (TDRs). A restructuring of a debt constitutes a troubled debt restructuring 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. FASB Statement No. 121 also provides guidance for accounting for TDRs.

11.66 *Modifications of Terms*. Modifications of terms for TDRs include one or a combination of the following:

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 Statements No. 15 and 114.

11.67 *Receipts of Assets*. If assets, including equity interests, are acquired in full or partial satisfaction of a loan, the creditor should report the receipt of such assets at their fair value less cost to sell 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 paragraph 28 of FASB Statement No. 15) should be recognized as a loan loss. 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.

11.68 *In-Substance Foreclosures*. Paragraph 34 of FASB Statement No. 15, as amended by FASB Statement No. 114, requires that the accounting for receipts of assets be applied when a troubled debt restructuring 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.

11.69 FASB Statement No. 114 requires a creditor to measure impairment based on the fair value of the collateral when a creditor determines that foreclosure is probable. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce cash flows available to repay or otherwise satisfy the loan.

11.70 *SAP*. Under SAP, life insurance entities record the cost of real estate acquired through foreclosure at the lower of the fair market value at date of foreclosure or the outstanding principal balance, which includes uncollected interest, plus other costs incurred 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.

11.71 Additionally, statutes and regulations of the domicile state may contain provisions that require the disposal of foreclosed properties within a certain period of time.

Real Estate Investments

11.72 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, while others may incur an operating loss and may result in a gain or loss at disposal.

11.73 GAAP. Under GAAP, real estate investments (except those held for sale) are recorded at cost less accumulated depreciation and less an allowance for any impaired value. Depreciation and other related charges or credits are recorded as investment expense or operating expense, depending on the balance-sheet classification of the underlying assets.

11.74 Authoritative accounting guidance is provided by SOP 78-9, *Accounting for Investments in Real Estate Ventures*[8]; FASB Statement No. 66, *Accounting for Sales of Real Estate*; FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*; FASB Statement No. 98, *Accounting for Leases*; FASB Statement No. 105; FASB Statement No. 34, *Capitalization of Interest Cost*; and the Audit and Accounting Guide, *Guide for the Use of Real Estate Appraisal Information*. AICPA Practice Bulletin 1, *Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance*, provides guidance on accounting for real estate acquisition, development, or construction (ADC) arrangements. In addition, consensuses of the FASB's EITF provide guidance on various matters relating to real estate investments. Furthermore, FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides guidance on accounting for real estate held for disposal.

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

11.76 Real estate used in the entity's operation is carried at amortized cost, and the life insurance entity is required to charge itself imputed rent, which is recorded as investment income in exhibit 3 and as an operating expense in exhibit 5.

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[8]The AICPA currently has a project on its agenda to amend SOP 78-9. Readers should be alert to any final pronouncement.

Joint Ventures and Partnerships

11.77 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 (LBO) 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.

11.78 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 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.

11.79 *GAAP*. Under 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 SOP 78-9; APB Opinion 18; FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*; and FASB Statement No. 94. 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. In addition, consensuses of the FASB's EITF provide guidance on various matters affecting investments in joint ventures and partnerships.

11.80 *SAP*. Under SAP, these types of investments are generally reported as other invested assets accounted for under the equity method. In addition, it may also be necessary to account for capital gains, return of capital, and dividends.

11.81 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. The NAIC's *Purposes and Procedures of the Securities Valuation Office* should be referred to for specific guidance on the AVR.

Policy Loans

11.82 Policy loans are loans made to contractholders using their life insurance contract's cash value as collateral. There are no statutory restrictions applied to this type of investment other than that the loan taken by contractholders may not exceed the cash surrender value of the policy. In addition, the loan interest rate is regulated in most states. If the contractholder stops paying premiums after a policy loan equals the surrender value, the contract is terminated.

11.83 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.

11.84 Policy loans are unique to life insurance entities and are carried on the balance sheet at the unpaid principal balance plus accrued interest under SAP. This practice is commonly used for GAAP.

INVESTMENT INCOME DUE AND ACCRUED

11.85 *Investment income due* represents certain amounts of income which are legally owed to the company as of the statement date but have not yet been received. Investment income should not be accrued if collectibility is doubtful. For statutory purposes, these uncollectible amounts should be treated as nonadmitted.

11.86 *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 ex-dividend on or prior to the statement date and payable after that date.

AUDITING

Debt and Equity Securities

11.87 SAS No. 81, *Auditing Investments*, which supersedes SAS No. 1, section 332, *Long-Term Investments*, and deletes Interpretation No. 1 of SAS No. 1, section 332, "Evidential Matter for the Carrying Amount of Marketable Securities," provides guidance to auditors in auditing investments in debt securities and equity securities as defined in FASB Statement No. 115 and investments accounted for under APB Opinion No. 18. SAS No. 81 is effective for audits of financial statements for periods ending on or after December 15, 1997. Early application is permissible.

Inherent Risk

11.88 In assessing audit risk, the auditor should consider those factors influencing inherent risk related to investments, including factors relating to management, investment operations, and portfolio characteristics. Such factors might encompass the following.

Investments in General

- The entity's general investment policy is very aggressive and encourages the use of new and innovative types of securities or other investment vehicles that are susceptible to investment valuation adjustments.

- The types of investments, length to maturity, rates of return, and other investment

strategies are not well matched to the type of products sold or the cash flow needs of the entity.

- 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.

- Investments are concentrated either by certain types (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.

- There is a high concentration of investments in securities subject to prepayment risk, such as CMOs and Government National Mortgage Association (GNMA) securities.

- Foreign investments are threatened by actions of foreign governments (for example, foreign exchange controls).

- The amount of higher risk or unusual investment vehicles has increased (for example, joint ventures, interest-rate swaps, or securities lending).

- The competitive environment requires the use of investment strategies that seek high rates of return.

- 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.

- The cash flow expectations of the parent company or the subsidiaries' needs for surplus are high.

- Compensation of investment personnel is closely linked to investment returns.

- The entity uses subsidiaries, limited partnerships, or other legal organization forms as vehicles for higher risk investments.

Debt and Equity Securities

- The life insurance entity places substantial reliance on outside investment managers, brokers, and traders, who have significant discretionary authority over investment decisions.

- The life insurance entity uses sophisticated cash management techniques, or cash flow projections presume utilization of float.

- Various economic factors cause rapid fluctuations in market interest rates and securities prices.

- There is a high concentration of investments classified as held-to-maturity under FASB Statement No. 115.

Futures, Options, and Other Derivatives

- 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.

- There is uncertainty regarding the financial stability of a counterparty.

- High volatility in interest rates, currencies or other factors are affecting the value of derivatives and possibly their continued accounting for as a hedge.

Mortgage Loans and Real Estate

- Existing liens, imperfect deeds, or title positions exist that prevent the life insurance entity from having clear title to real property or collateral.

- 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).

- 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.

- There are master leases on mortgaged or owned real estate properties.

- Government regulations are becoming more prohibitive in relation to rent controls, mandated upgrading to comply with new or existing building codes, or foreclosure ability.

- There is a significant decline in the market values of real properties or collateral.

- 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.

- Troubled mortgage loans are restructured without due consideration given to the value of the underlying collateral.

- Significant doubt exists regarding the financial solvency or stability of private mortgage insurers, loan servicers or title insurers utilized by the entity.

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.

Policy Loans

- Policy loan activity is increasing.

CONSIDERATION OF INTERNAL CONTROL FOR AUDITING INVESTMENT TRANSACTIONS

11.89 A key element to an effective audit is an understanding of the industry, operating environment, and internal control over financial reporting. An entity's internal control consists of five elements: the control environment, risk assessment, control activities, information and communication, and monitoring. 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 plan the audit of the entity's financial statements. Such an understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

Control Environment

11.90 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.

Investments in General

- Formal investment policies do not exist or are limited in scope.
- Periodic reviews of investments for other than temporary impairments are not performed or are inadequate.
- There are frequent or unusual intercompany or related-party transactions.
- Forecasts and analysis of investment operations results are limited.
- An independent valuation specialist is not used to value certain investments.
- 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.
- Investment department personnel are unsophisticated or given limited training in relation to the investment portfolio managed.

Debt and Equity Securities

- Holding of securities exists in-house rather than at an independent third-party custodian.
- The entity does not take physical control of the underlying collateral for reverse repurchase agreements or other forms of borrowed securities.

- Formal policies do not exist that would provide for a review of all reverse repurchase and dollar reverse repurchase contracts to determine whether they have been appropriately reported as financing or sales transactions.

- The entity does not periodically assess the appropriateness of debt and equity classifications as held-to-maturity, trading, or available-for-sale.

- The entity does not properly monitor transfers between the three debt and equity security categories.

Futures, Options, and Other Derivatives

- Dependence on one individual for all organizational expertise on derivatives activities.

- There is inadequate information to effectively monitor derivatives transactions, including inadequate or untimely information about derivatives values.

- There is significant use of derivatives without relevant expertise within the entity.

Mortgage Loans and Real Estate

- There are no formal policies established and monitored regarding interest rates, mortgage terms, property appraisal preparation and review, foreclosure proceedings, or credit-worthiness of borrowers or major tenants.

- There are no periodic appraisals of wholly owned real estate or real estate supporting mortgage loans.

- Troubled mortgage loans are restructured without due consideration given to the value of the underlying collateral.

Joint Ventures and Other Investments

- 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.

- Significant audit adjustments are reported by joint venture management.

- 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).

- Investment department personnel provide poor documentation for evaluation of substance over form analysis for accounting treatment of joint venture transactions.

Policy Loans

- New products or processes have been introduced that do not adequately support policy loan activity and reporting requirements.

Control Activities

11.91 Control activities are those policies and procedures in addition to the other components that management has established to provide reasonable assurance that specific objectives will be achieved. The auditor should obtain an understanding of those control activities relevant to planning the audit. The following are examples of internal control procedures and policies relating to investment operations:

- *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 board of directors and designated levels of management. Potential investment transactions and investment policy changes are reviewed and approved by the board of directors or the finance committee and recorded in the minutes. System security violations and failures are adequately monitored.

- *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.

- *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.

- *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.

- *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 promptly on a timely basis; appropriate personnel review and approve reconciliations. Adjustments to investment accounts are reviewed and approved by authorized personnel.

Information and Communication

11.92 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to identify, assemble, analyze, classify, record, process, summarize, and report an entity's transactions and to maintain accountability for related assets and liabilities.

11.93 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 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.

11.94 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.

11.95 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.

11.96 Historically, life insurance entities have maintained their financial records on a cash basis (referred to as *ledger accounts*), with end-of-period adjustments (referred to as *nonledger accounts*), 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.

11.97 Investment income and realized gains and losses generally comprise interest and dividend payments, amortization or accretion of premiums and discounts, real estate income, and gains and losses on sales 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).

11.98 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 a company 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.

11.99 Accounting transactions may also arise from changes in fair values or regulatory valuations of the investment portfolio. These adjustments are made at the valuation date and are often referred to as nonledger transactions. In numerous jurisdictions investment valuation adjustments made for regulatory reporting purposes may differ in many respects from those made in accordance with GAAP.

11.100 _Special Considerations_. The investment community regularly develops new types of securities or other investment vehicles (for example, asset-backed products or other derivative products). The auditor should obtain an understanding of the types 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

11.101 The auditor may consider the following specific audit objectives, 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.

Audit Consideration Chart
Investments

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Existence or Occurrence and Rights and Obligations		
	General	General
Investments included in the balance sheet physically exist. Recorded investment acquisitions and disposals have occurred during the period under examination.	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.
The company 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 company records. Discrepancies are promptly resolved.	Confirm significant or unusual transactions for interest, dividend, or other investment income transactions.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	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.
	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>	<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.	Obtain confirmations that securities purchased under repurchase agreements, but not delivered, are being held by the sellers or the sellers' custodian on the company's behalf. Confirm with brokers the status of securities in transit.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Daily transaction reports are independently analyzed.	Examine securities to determine whether they are registered or payable to the entity, an authorized nominee, or the bearer.
	Mortgages and Other Loans and Real Estate Investments	Mortgages and Other Loans and Real Estate Investments
	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.	Examine evidence of insurance and property tax payments for mortgage collateral and real estate investments. Review adequacy of insurance coverage.
	Perfection of the deed, title positions, and 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.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
		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.
Completeness		
	General	General
Investment asset accounts include all investments of the company. Investment income accounts include all transactions during the period.	Written policy statements detailing investment guidelines, hedging techniques, asset/liability matching procedures, and limitations are prepared and monitored by designated levels of management.	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.
Investment rêcords are properly compiled, and totals are properly included in the investment accounts.	Potential investment transactions are reviewed by an investment advisory committee and approved by a finance committee.	Compare investment yields during the period with expected yields based on previous results and current market trends; investigate significant discrepancies.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Investment systems permit forecasting of expected investment income and the forecasts are compared with actual amounts and reviewed by designated levels of management.	Examine input and output data and balances in individual investment accounts to test whether transactions are properly recorded and authorized.
	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.	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.
	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.	Review suspense account trial balances for large, unusual, and old uncleared items.
		Test accruals of investment income for appropriate cutoff date, and proper exclusion of overdue amounts.
	Suspense accounts (including clearing accounts) are reconciled and reviewed by the appropriate personnel for large, unusual, or old uncleared items.	Test clerical accuracy of subsidiary ledgers for policy loans. Agree balances to general ledger accounts.
	Securities	Securities
	Buy-and-sell orders to brokers are compared to brokers' advice.	Inspect and count securities held by the client. Obtain confirmation from the custodian of securities held for the account of the client.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	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.
	Mortgages and Other Loans	Mortgages and Other Loans
	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.	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.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Real Estate Investments	Real Estate Investments
	Written policies detailing restructuring, refinancing, and foreclosure guidelines and underwriting standards are current and monitored by appropriate levels of management.	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.	
	Master leases are periodically reviewed by appropriate personnel.	
Valuation or Allocation		
	General	General
Invested assets are included in the financial statements in the appropriate amounts. Investment income and expense, and gains and losses are recorded 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/premium, rental income, and depreciation.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Valuations for statutory reporting purposes are reviewed for conformity with National Association of Insurance Commissioners (NAIC) published values.	Examine summaries of interest, dividend, and principal payments for indications of impairment. Test computations and the statutory classifications of realized gains and losses.
	Unrealized gains and losses are reconciled with prior values, and are properly segregated as to accounting category of the securities.	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.
	Allowances for the valuation of investments are substantiated by evidential matter.	Review debt securities and mortgage loans in default for proper exclusion of uncollectible amounts.
	Adjustments of investment accounts and master file information are reviewed and approved by authorized personnel.	Review consistency of accounting methodologies between parent and any subsidiary or joint venture. Determine appropriate adjustments, if any.
	Interest and dividends are reviewed for accuracy by reference to independent sources.	Obtain financial reports of joint ventures or limited partnerships, and compare reported amounts of dividends, net rentals, and so on, to the records.
	Investment income amounts due but not received are reconciled to estimated income lists and compared to subsequent income received.	

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Calculation methodologies for premium/discount amortization, depreciation, and investment income accruals are reviewed and approved by the appropriate personnel.	Test calculation of the AVR and IMR.
	Proper records are maintained regarding calculation of the AVR and IMR.	
	Securities	Securities
	Determine that formal policies and procedures are in place to categorize securities at acquisition as to the appropriate accounting classifications as prescribed in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Periodic reviews of categorizations are performed and appropriate documentation is prepared for any category transfers.	Compare recorded costs of investments to published market quotations at the trade date. Consider reasonableness of commission rates, taxes, and other fees.
	Securities for which there is no active market are monitored for valuation at cost and are written down to far value when required. Periodic reviews of fair values are performed for other than temporary impairments.	

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
	Securities valuations are obtained from outside brokers.	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 Statement No. 115 categories.
	Market prices for purchases and sales are compared with independent sources.	Review the documentation for FASB Statement No. 115 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/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.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		Analyze yield by the type of mortgage-derivative or asset-backed security (such as CMOs) for indications of unusually high or low yields or yields that differ significantly from expectations. Analyze amortization schedules using appropriate prepayment and default assumptions.
	Mortgages and Other Loans	Mortgages and Other Loans
	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.
	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, or construction (ADC) 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.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Restructured mortgage loans are reviewed for compliance with in-substance foreclosure criteria.	Test mortgage loan prepayment assumptions and amortization methodologies for proper valuation.
	Real Estate Investments	Real Estate Investments
	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.
		Review depreciation methodologies and test calculations.
		Review sale–leaseback transactions for appropriate accounting treatment.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
Presentation and Disclosure		
Investments are properly classified, described, and disclosed.	General	General
	Management reviews and monitors investment transactions and related results for compliance with authorized limits, yield and maturity requirements, and regulatory requirements.	Test whether disclosures comply with GAAP. For statutory financial statements, test whether classifications and disclosures comply with applicable regulations.
	Management reviews and monitors invested assets with off-balance-sheet risks and concentrations of credit risks for appropriate disclosure.	Inquire about pledging, assignment, or other restrictions. Review finance committee minutes. Examine loan agreements. 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. Compare changes in each category of the investment portfolio between periods. Review asset reclassifications for appropriateness.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Futures, Options and Derivatives	Futures, Options and Derivatives
	FASB Statement No. 119 has extensive disclosure requirements for derivative instruments.	Determine whether appropriate disclosures are made for derivative instruments.

Chapter 12

REINSURANCE

INTRODUCTION

12.1 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*.

12.2 Life insurance entities enter reinsurance agreements primarily to—

- Spread the risk of its insurance contracts.
- Reduce exposure on particular risks or classes of risks.
- Provide the financial capacity to accept risks and contracts with larger face amounts than those that could otherwise be accepted.
- Help stabilize operating costs, which may be sensitive to fluctuations in claims experience, or stabilize mortality costs.
- 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.
- Protect against accumulations of losses arising out of catastrophes such as unanticipated death claims in geographic areas that have suffered natural disasters.
- Limit liabilities of captive insurance entities to a level considered acceptable by the parent company.
- Assist in financial and tax planning strategies.
- Obtain underwriting assistance with respect to risk classification, or broaden the ability to market products with which the life insurance entity has little experience.
- To exit a line of business.

12.3 Most life insurance entities set limits on the amounts and types 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 contractholders, 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, or avoid part of the statutory surplus strain that results from writing new business.

12.4 For reasons similar to those described in paragraph 12.2, 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.

Types of Reinsurance Transactions

12.5 Reinsurance transactions occur between insurance entities, not contractholders or insureds. In *indemnity reinsurance transactions*, the ceding entity remains primarily liable to the contractholder 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 contractholder is generally unaware of any indemnity reinsurance transactions that may occur and continues to hold the original contract.

12.6 In *assumption reinsurance transactions* (also referred to as *novations*), the assuming entity legally replaces the ceding company 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 types of transactions, the contractholder 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 contractholders 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 contractholder.

12.7 *Fronting* is an arrangement between two or more insurers whereby the fronting entity will issue contracts and then cede all or substantially all of the risk through a reinsurance agreement to the other insurer(s) for a ceding commission. Such arrangements may be illegal if the intent is to circumvent regulatory requirements. (See chapter 5 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 contractholders.

12.8 Reinsurance Commissions. Reinsurance agreements generally provide for a basic ceding commission, which is intended to reimburse the ceding entity for the costs incurred for 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.

12.9 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, 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 statutory accounting practices (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. Some states have rules or regulations that can prohibit the accounting treatment described above for surplus relief transactions that do not transfer adequate risk.

Types of Reinsurance Entities

12.10 There are three common types 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 Types of 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 types of agreements:

- *Yearly renewable term*. When reinsurance is ceded on a YRT basis, the ceding entity purchases from the reinsurer one-year renewable term 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* (ART) or *risk premium reinsurance* (RPR), and are usually designed to protect the ceding entity from large unanticipated mortality losses.

- *Coinsurance*. 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 contractholder 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 company 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 is insufficient to pay the high first year commissions and other costs associated with issuance and to establish the initial benefit liability.

- *Modified coinsurance (Mod Co)*. This type of reinsurance differs from coinsurance in that the statutory mean reserves and the supporting assets are retained by the ceding entity. (See chapter 8 for a discussion of mean reserves.) In addition to the transactions associated with coinsurance, a mean reserve adjustment payment between the assuming and ceding entities is made at a specified date, generally the end of each year. The mean reserve adjustment may be positive (payable to the ceding entity) or negative (payable to the reinsurer).

  The mean reserve adjustment is calculated as the increase in mean 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. As with coinsurance, the assuming entity ordinarily participates in the mortality, persistency, and other risks.

- *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 some 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 assets in a trust account or a letter of credit.

12.16 Most states have specific requirements for the level or type 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. 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 generally accepted accounting principles (GAAP). The following discussion of SAP and 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 types of reinsurance transactions within the life insurance industry. The authoritative sources cited in chapter 3 should 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 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). The assuming entity's accounting for reinsurance normally parallels the original accounting for direct business. The NAIC has adopted the *Life and Health Reinsurance Agreements Model Regulation*, which has been required for accreditation since December 1994. In general, this regulation applies to all domestic life and health insurers and to all other licensed life and health insurers that are not subject to a substantially similar regulation in their domiciliary state. This regulation does not apply to assumption reinsurance, YRT reinsurance, or certain nonproportional reinsurance such as stop loss or catastrophe reinsurance. Chapter 24 of the NAIC *Accounting Practices and Procedure Manual for Life, Accident Insurance Companies* provides guidance on accounting for reinsurance transactions on a SAP basis.

12.21 The specific type of reinsurance agreement, such as YRT, coinsurance, or modified coinsurance, will determine the specific accounting; however, transfer of risk is an essential element in determining allowable accounting treatment. Some states prohibit the recognition of increased surplus resulting from arrangements that do not transfer risk. To determine whether the reinsurance agreement is constructed so as to shift sufficient economic risk requires significant judgment. Indications of nontransfer of economic risk may include the following:

- 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*

- Refund of the amount of surplus relief plus interest by the ceding entity in the event of cancellation of the reinsurance agreement

- Noncancellation of the contract by the ceding entity until the assuming entity has received funds advanced plus an insurance charge

- Large provisional commissions with payback through subsequent adjustments of the commissions based on experience

- Experience-rated refunds, recapture clauses, or automatic buy-back provisions

12.22 _Unauthorized Reinsurers_. Credit for reinsurance with unauthorized reinsurers may be permitted if the ceding entity holds cash, securities, a letter of credit, or other forms of collateral of the assuming entity, at least equal to the amount of reserve credit taken. If the security requirements are not met, the ceding entity must establish a liability to offset credits taken in various balance sheet accounts for reinsurance ceded to 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-Rated 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.

Generally Accepted Accounting Principles

12.24 As with SAP, the 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 Statement No. 113, and EITF Topic No. D-34, *"Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113,"* describe the accounting and reporting for ceded reinsurance. EITF No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, and EITF Topic No. D-35, *"FASB Staff Views on Issue 93-6,"* provide accounting guidance for multiple-year retrospectively rated contracts.

12.25 _Conditions for Qualifying for Reinsurance Accounting_. In general, FASB Statement No. 113 requires a determination process of whether or not the reinsurance agreement, despite its form, is reinsurance. FASB Statement No. 113, paragraphs 8 through 13, which are reprinted in exhibit 12.1, 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. FASB Statement No. 113, paragraph 18, incorporates the accounting from FASB Statement No. 60 for those contracts that do not meet the conditions for reinsurance accounting (see paragraph 12.36).

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. Determining whether an agreement that reinsures a long-duration insurance contract is long-duration or short-duration is a matter of judgment, which 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 12.6) extinguish the ceding entity's liability to the contractholder 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 contractholders would not result in the removal of the related assets and liabilities from the ceding entities records. For these agreements, the ceding entity should report estimated reinsurance receivables, and should report any prepaid reinsurance premiums 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 offset exists, as defined in FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

12.29 Reinsurance receivables and prepaid reinsurance premiums should be recognized in a manner consistent with the related liabilities (estimates for claims incurred but not reported and future 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 collectibility 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.

Reporting Reinsurance Revenues and Costs

12.31 Short-Duration Prospective Reinsurance. 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. Prospective reinsurance agreements are the most common for short-duration contracts in the life insurance industry.

12.32 Short-Duration Retroactive Reinsurance. 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. (See paragraph 22 of FASB Statement No. 113 for accounting for gain amortization.) The deferred gain should be amortized over the estimated remaining settlement period. If the opposite occurs (amounts paid exceed the recorded liabilities), the ceding entity should increase the related liabilities or reduce the reinsurance receivable, or both, at the time the reinsurance agreement is entered into, and the excess is charged to earnings.

12.33 For short-duration retroactive reinsurers, paragraph 24 of FASB Statement No. 113 (quoted below) should be followed:

> 24. Changes in the estimated amount of the liabilities relating to the underlying reinsured contracts shall be recognized in earnings in the period of the change. Reinsurance receivables shall reflect the related change in the amount recoverable from the reinsurer, and a gain to be deferred and amortized, as described in paragraph 22 [of FASB Statement No. 113], shall be adjusted or established as a result. 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 shall 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.

12.34 For short-duration prospective and retroactive reinsurance, paragraph 25 of FASB Statement No. 113 (quoted below) should be followed:

> 25. When practicable, prospective and retroactive provisions included within a single contract shall be accounted for separately. If separate accounting for prospective and retroactive provisions included within a single contract is impracticable, the contract shall be accounted for as a retroactive contract provided the conditions for reinsurance accounting are met.

12.35 *Long-Duration Reinsurance*. The estimated costs of long-duration reinsurance agreements should be amortized over the remaining life of the underlying reinsured contracts. The estimated costs should be amortized over the contract period of the reinsurance if the reinsurance contract is short duration. The difference, if any, between the amounts paid for a reinsurance contract and the amount of the liability for contract benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortized.

12.36 In general, the amounts recorded for those reinsurance agreements that qualify for reinsurance accounting under FASB Statement No. 113 are as follows:

- Liabilities and reinsurance recoveries related to future contractholder 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.

- Acquisition costs are capitalized regardless of whether the business is reinsured. Under certain types of reinsurance agreements (coinsurance and modified coinsurance), 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.

- 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.

12.37 *Reinsurance Agreements Not Qualifying for Reinsurance Accounting Under FASB Statement No. 113*. FASB Statement No. 113, paragraph 18, does not specifically address accounting for reinsurance agreements that do not meet the conditions for reinsurance accounting, other than to incorporate the provisions from FASB Statement No. 60, paragraphs 39 and 40, which continue in effect as follows[1]:

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

b. Proceeds from reinsurance transactions that represent recovery of acquisition costs shall reduce applicable unamortized acquisition costs in such a manner that net acquisition costs are capitalized and charged to expense in proportion to net revenue recognized [see paragraph 29 of FASB Statement No. 60]. If the ceding enterprise has agreed to service all of the related insurance contracts without reasonable compensation, a liability shall be accrued for estimated excess future servicing costs under the reinsurance contract. The net cost to the assuming enterprise shall be accounted for as an acquisition cost.

12.38 *Unauthorized Reinsurers*. For GAAP financial statements, transactions with unauthorized reinsurers and transactions with authorized reinsurers are treated the same way.

12.39 *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 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.

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[1]In June 1997, the AICPA issued a proposed Statement of Position (SOP), *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk.* The proposed SOP would provide guidance on how to account for insurance and reinsurance contracts that do not transfer insurance risk. Readers should be alert to any final SOP.

AUDITING

Inherent Risk Factors

12.40 In assessing audit risk, the auditor should consider those factors influencing inherent risk related to reinsurance assumed and ceded, including factors relating to management, product characteristics, underwriting approach, marketing strategies, financial objectives, and the economic and regulatory environment. Such factors might encompass the following:

- The life insurance entity is involved in a significant amount of international reinsurance, or reinsurers are in jurisdictions with foreign exchange controls.
- The ceding entity's reinsurers are in financial difficulty.
- Reinsurance has become unavailable at the life insurance entity's desired retention levels and costs.
- There are significant or unexpected changes in the entity's reinsurance programs.
- Risk assumed under treaty arrangements is excessive.
- Financial information is inadequate or is not received on a timely basis.
- Regulations may not permit the treatment of certain reinsurance agreements as reinsurance.
- Significant reinsurance agreements involve wholly owned subsidiaries or other related parties.

CONSIDERATION OF INTERNAL CONTROL FOR AUDITING REINSURANCE TRANSACTIONS

12.41 A key element to an effective audit is an understanding of the industry, operating environment, and internal control over financial reporting. An entity's internal control consists of five elements: the control environment, risk assessment, control activities, information and communication, and monitoring. 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 plan the audit of the entity's financial statements. Such an understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

Control Environment

12.42 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:

- 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.

- The absence of executed contractual agreements between the ceding entity and the reinsurer.

- Reinsurance coverage that is inadequate, does not meet the business needs of the entity, or does not reflect management's intended reinsurance program.

- Reinsurance agreements that do not transfer adequate economic risk even though doing so was the intent of the parties.

Control Activities

12.43 Control activities are those policies and procedures in addition to the other components that management has established to provide reasonable assurance that specific objectives will be achieved. The auditor should obtain an understanding of those control activities relevant to planning the audit. The following are examples of typical internal control procedures and policies relating to reinsurance transactions:

- *Proper authorization of transactions and activities.* Written guidelines for reinsurance transactions are in place assigning the responsibility for approval to appropriate individuals.

- *Segregation of duties.* Reinsurance transactions, claims processing, benefit payments, premium collection, key information systems functions, master file maintenance, and general accounting activities should be appropriately segregated, and independent reviews should be conducted of the work performed.

- *Design of adequate control over documents and records.* There are procedures to ensure that fictitious or duplicate reinsurance transactions are not included in the records and to prevent or detect the omission of valid transactions.

- *Adequate safeguards of access to and use of assets and accounting records.* Data files and production programs have adequate safeguards against unauthorized access; and adequate safeguards exist over access to any collateral from the assuming entity that may be held by the ceding entity.

- *Independent checks on performance and proper valuation of recorded amounts.* Recorded 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.

Information and Communications

12.44 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report an entity's transactions and to maintain accountability for related assets and liabilities.

12.45 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.

12.46 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.

12.47 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 contractholder.

12.48 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

12.49 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.

12.50 The ceding entity's control procedures for evaluating the financial responsibility and stability of assuming entities may vary, depending on the type of agreements (such as YRT and coinsurance) and other factors, and may include—

- 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 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.

- 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 IRIS results filed with regulatory authorities.

- Inquiring about the assuming entities' retrocessional practices and experience.

- Inquiring about the general business reputation of the assuming entities and the background of its owners and management.

- 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.

- Considering the need for and evaluating the adequacy of collateral from the assuming entities on certain reinsurance agreements.

12.51 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 the Guide.

12.52 The absence of adequate procedures, or the failure to apply adequately designed procedures, may constitute a reportable condition in the ceding entity's internal control. Reportable conditions are discussed further in chapter 5.

Planning Substantive Tests of Reinsurance Ceded

12.53 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 with the sale and servicing of the reinsured contracts. The auditor should perform procedures to evaluate the collectibility 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 contractholders if ceded reinsurance activities can materially increase current earnings or investable funds. (See paragraphs 6.15 through 6.18 for a discussion of confirmation of insurance contracts in force.)

12.54 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:

- 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 GAAP, as appropriate.

- Trace entries arising from selected reinsurance agreements to the appropriate records.

- Trace selected transactions to supporting documents and test the related receivables and payables.

- Test or recalculate balances and transactions in accordance with the agreement terms.

- Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may also be appropriate.

Reinsurance Assumed

12.55 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.

12.56 The assuming entities control procedures may vary depending on the type of contracts (such as YRT and coinsurance) and other factors, and may include—

- 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.

- Monitoring the actual results reported by the ceding entity and investigating the reasons for and the effects of significant deviations from anticipated results.

- Visiting the ceding entity and reviewing and evaluating its sales, underwriting, benefits processing, and actuarial policies and procedures.

- Obtaining from the ceding entity a service auditor's report on policies and procedures placed in operation and, if he or she intends to seek evidential matter to support an assessment of control risk below the maximum, a report on policies and procedures placed in operation and tests of operating effectiveness. (See SAS No. 70.) 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.

12.57 Additional control procedures of the assuming entity may include:

- 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.

- 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.

- Inquiring about the general business reputation of ceding entities and the background of its owners and management.

12.58 The absence of adequate procedures, or the failure to apply adequately designed procedures, may constitute a reportable condition in the assuming entity's internal control. Reportable conditions are discussed further in chapter 5.

Planning Substantive Tests of Reinsurance Assumed

12.59 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:

- Performing procedures such as certain of the procedures specified in paragraphs 12.55 and 12.56

- Meeting with and reviewing the workpapers of the ceding entity's auditor (see SAS No. 1, *Part of Audit Performed by Other Independent Auditors* [(AICPA, *Professional Standards*, vol. 1, AU sec. 543])

- Performing auditing procedures at the ceding entity or requesting the auditor of the ceding entity to perform agreed-upon procedures

- Obtaining 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 SAS No. 70)

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:

- 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 GAAP, as appropriate.

- Trace entries arising from selected reinsurance agreements to the appropriate records.

- Trace selected transactions to supporting documents and test the related receivables and payables.

- Test or recalculate balances and transactions in accordance with the agreement terms.

- Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may also be appropriate.

Audit Consideration Chart: Reinsurance Transactions in General

12.60 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

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
Existence or Occurrence and Rights and Obligations		
All amounts due to/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.
	Cumulative reports of reinsurance activity are reviewed to evaluate risk exposure and compliance with the terms of the agreement.	Test the propriety of reinsurance balances payable by reference to reinsurance agreements and contract records.
	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.	Confirm significant reinsurance balance and contract terms with assuming and ceding entities, as appropriate.
	Adequate procedures are in place to ensure that— — Reinsurance transactions are recorded in accordance with the contract terms and supported by insurance contracts in force. — Special provisions of reinsurance contracts are properly computed and recorded.	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: — Major reinsurers — Balances per major reinsurer — Percentage of past due receivables — Unusual or unexpected balances

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Criteria and procedures for ceding and assuming reinsurance are established.	Compare recorded reinsurance reserve amounts to assumed and ceded detail records and evaluate whether reinsurance amounts are properly calculated and recorded.
Completeness		
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 results with expected 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 company.	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.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
	Periodic reviews are made of internal control and accounting records of ceding entities and/or other third parties to ensure the reliability and accuracy of reported transactions. Ceded reinsurance information is reconciled to reinsurance premium and commission detailed records and general ledger accounts. Periodic reviews are made of detailed reports received from ceding entities.	For entities *ceding* reinsurance risks, perform the following: 1. Obtain and analyze financial information of assuming entities such as financial statements, the independent auditor's report, Securities and Exchange Commission (SEC) reports, and reports filed with regulatory authorities. 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. 3. Evaluate the need for an on-site review of the assuming entities controls and accounting records.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
		For entities *assuming* reinsurance risks, perform the following: 1. Analyze the ceding entities' financial stability. 2. Evaluate the need for an on-site review of the ceding entities' controls, accounting records, and compliance with underwriting standards. 3. Trace recorded transactions to reports from ceding entities.
Valuation or Allocation		
Amounts due to or from reinsurers are properly computed in accordance with the provisions of the re-insurance 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: 1. Obtain an understanding of the business objective of the contract. 2. Determine the proper accounting treatment. 3. Review documentation of required management review and approval.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Auditing Procedures
Amounts due or 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/ceded are compared to the reinsurance reserve records, including any adjustments and are reviewed by appropriate personnel. Writeoffs of amounts due from reinsurers are approved by appropriate personnel.	For reinsurance *ceded,* perform the following. 1. Test the calculations of premiums, claims, and expense allowances by reference to the terms of the contracts and the entity's accounting records. 2. Test computation of contingent reinsurance commissions and experience rating refunds. Evaluate the collectibility of amounts recorded as recoverable from assuming entities, including— 1. Adequacy of collateral. 2. Financial condition of the assuming entity. 3. Adequate fulfillment of the ceding entity's obligations under the contract (for example, underwriting standards). For reinsurance *assumed,* perform the following: 1. Determine compliance of ceding entity with underwriting guidelines.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Auditing Procedures*
		2. Test calculations of expense allowances, experience refunds, and contingency reserves and compare with contract terms.

Exhibit 12.1
FASB Statement No. 113 —
Criteria for Qualifying for Accounting as Reinsurance

Paragraphs 8 through 13 from FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, are reprinted below in their entirety.

Indemnification Against Loss or Liability Relating to Insurance Risk

8. Determining 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 enterprise and related reinsurers. A complete understanding includes an evaluation of all contractual features that (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) or (b) delay of timely reimbursement of claims by the reinsurer (such as through payment schedules or accumulating retentions from multiple years).

Reinsurance of Short-Duration Contracts

9. Indemnification of the ceding enterprise against loss or liability relating to insurance risk in reinsurance of short-duration contracts requires both of the following, unless the condition in paragraph 11 is met:

   a. The reinsurer assumes significant insurance risk under the reinsured portions of the underlying insurance contracts.

   b. It is reasonably possible that the reinsurer may realize a significant loss from the transaction.

   A reinsurer shall not be considered to have assumed significant insurance risk under the reinsured 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 enterprise would prevent this condition from being met.

10. 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 enterprise 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.

11. Significance of loss shall be evaluated by comparing the present value of all cash flows, determined as described in paragraph 10, with the present value of the amounts paid or deemed to have been paid[2] to the reinsurer. If, based on this comparison, the reinsurer is not exposed to the reasonable possibility of significant loss, the ceding enterprise 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[3].

Reinsurance of Long-Duration Contracts

12. Indemnification of the ceding enterprise 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 as that concept is contemplated in Statement 60 and FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. Statement 97 defines long-duration contracts that do not subject the insurer to mortality or morbidity risks as investment contracts. Consistent with that definition, a contract that does not subject the reinsurer to the reasonable possibility of a significant loss from the events insured by the underlying insurance contracts does not indemnify the ceding enterprise against insurance risk.

13. The evaluation of mortality or morbidity risk in contracts that reinsure policies subject to Statement 97 shall be consistent with the criteria in paragraphs 7 and 8 of that Statement. 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 illnesses, physical injury, or disability) also shall be consistent with those criteria.

Additional guidance for FASB Statement No. 113 criteria for qualifying for accounting as reinsurance can be found in EITF Topic D-34, Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113.

[2]Payments and receipts under a reinsurance contract may be settled net. The ceding enterprise may withhold funds as collateral or may be entitled to compensation other than recovery of claims. Determining the amounts paid or deemed to have been paid (hereafter referred to as "amounts paid") for reinsurance requires an understanding of all contract provisions.

[3]This condition is met only if insignificant insurance risk is retained by the ceding enterprise on the reinsured portions of the underlying insurance contracts. The term *insignificant* is defined in paragraph 8 of FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, to mean "having little or no importance; trivial and is used in the same sense in this Statement.

Exhibit 12.2

FASB 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

<u>November 14, 1996</u>

On November 14, 1996, an 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 collectibility 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, an FASB representative made the following announcement at the EITF meeting:

An FASB representative announced that the FASB staff has received questions about whether *EITF Abstracts*, Topic No. D-54, *"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,"* applies to the purchaser's 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[4]. 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

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[4]This announcement will be combined with Topic D-54 in *EITF Abstracts.*

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 above 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 continent on the purchase business combination and because the seller has not participate 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 he guarantee arrangement is in the form of a reinsurance arrangement) because that guarantee arrangement wold not be contemporaneous with the purchase business combination.

Observation Related to Seller's 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.

Chapter 13

TAXATION OF LIFE INSURANCE ENTITIES

INTRODUCTION

Federal Income Taxes

13.1 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 or "the Code") and related Treasury regulations that apply specifically to life insurance entities. Sections 801-818 and 842-848 of the IRC applies to all business entities that meet the definition of a *life insurance company* as described in paragraph 13.3. This chapter is intended to familiarize the reader with significant and unique features of life insurance taxation.

13.2 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 1984 act, life insurance companies are taxed on all sources of income at ordinary corporate tax rates. The 1984 act 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 13.18, remains from the prior law for many stock life companies.

13.3 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 Internal Revenue Code definition it must meet the following requirements on an annual basis:

1. 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; and

2. 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% 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 above. In addition, other terms referred to in this chapter may have unique meaning under the IRC.

ELECTION TO FILE A CONSOLIDATED RETURN

13.4 For taxable years beginning after December 31, 1980, the common parent of an affiliated group that has one 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% stock ownership test of the IRC is satisfied.

Five-Year Affiliation Requirement

13.5 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 (see Section 1504 (c)(2)(A) of the Internal Revenue Regulations). 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.

13.6 Consolidation rules for life and nonlife consolidated tax returns are complex, and the auditor should consider retaining the services of life insurance tax specialist for advice in these matters.

ELEMENTS OF LIFE INSURANCE COMPANY TAXABLE INCOME

13.7 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 rather than generally accepted accounting principles.

Life Insurance Gross Income

13.8 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):

   1. Premiums and annuity considerations.

   2. Annuity and other fund deposits.

   3. Consideration received for supplementary contracts involving life contingencies and those not involving life contingencies.

   4. Commissions and expense allowances on reinsurance ceded.

b. Tax adjustments to gross premium income should be made as follows:

1. *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.

2. *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 does 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.

3. *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.

   a. *Decrease in tax basis reserves.* Generally, tax basis reserve decreases are classified as part of "Gross Income." See paragraph 13.9*b* for discussion of tax basis reserves.

   b. *Gross investment income.* Generally, the gross investment income of a life insurance company is treated for tax purposes in a manner similar to other business entities. However, there are some areas of unique treatment as discussed below. The items of gross investment income include—

      1. Interest income, which include—

         (a.) 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 life insurance company taxable income through the "proration mechanism" discussed in paragraph 13.9c.
         (b.) Amortization of bond premium and accrual of market discount.
         (c.) Original issue discount (OID).

      2. Dividend income.

      3. 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.

      4. Royalty income.

5. 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).

6. Capital gains and losses.

7. 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 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

13.9 The Annual Statement deductions are generally allowed for tax purposes, subject to tax modifications (for example, 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 contractholders 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 the tax basis benefit reserves at the beginning of the year, the increase is included as a deduction for increase in the statutory basis benefit reserves. If the statutory basis benefit reserves at the beginning of the year are larger than the statutory basis benefit reserves at the end of the year, the excess is included in income as a decrease in the statutory basis benefit reserves. The following items are included in computing the change in a life insurance company's tax basis benefit reserves: (1) life insurance tax basis reserves; (2) unearned premiums and unpaid losses; (3) the discounted amounts necessary to satisfy obligations under insurance or annuity contracts not involving life, health, or accident contingencies; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance

and liabilities for premium deposit funds; (6) 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.

1. *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 (CRVM), and annuity contracts should be valued by the statutory commissioners' annuity reserve valuation method (CARVM). Both methods are prescribed by the NAIC. A two-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 twenty-six states. The Code also provides that the *prevailing commissioners' standard tables for mortality and morbidity*, which is the table permitted by at least twenty-six states, should be used in calculating tax basis statutory reserves for life insurance benefits. The tax basis statutory reserves for life insurance benefits are the greater of the reserves computed as described above or the net surrender value. However, the tax basis statutory reserve for life insurance benefits may not exceed the statutory reserve amounts. This calculation shall be done on a contract-by-contract basis.

2. *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 dividend received deduction 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 contractholders in their capacity as such, regardless of whether the contract is participating or not. Policyholder dividends may include: (a) 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, (b) premium adjustments, (c) excess interest, and (d) 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 Code, as described above, and may include amounts that are not treated as policyholder dividends under statutory accounting rules, and may apply to nonparticipating contracts. For mutual insurance companies, the amount of policyholder dividends deduction is reduced by the differential earnings amount (see paragraph 13.14 for discussion).

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 and 6 of the Annual Statement, are deductible as other deductions. The following limitations and adjustments should apply to certain deductions:

1. 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.

2. Charitable contributions are limited to of 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, and all other allowable deductions.

3. In addition, a loss from a noninsurance business is limited by the Code 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, in an effort to increase the tax burden on the life insurance industry, Congress enacted a tax law change requiring life insurance companies to capitalize contract acquisition costs. Due to 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 tax Code 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 sixty-month amortization period.

13.11 In applying the proxy method, the following percentages of net premiums of the specified insurance contracts, written directly or through reinsurance, are capitalized:

Types of Contracts	
Annuities	1.75%
Group life	2.05%
Other life (including noncancellable or guaranteed renewable accident and health)	7.70%

The capitalized amount is limited to the company's total *general deduction* for that year. General deductions includes 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 operations loss deduction.

13.12 *Operations Loss Deduction (OLD)*. 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 three-year carryback and a fifteen-year carryforward limitation, except for those companies that qualify as new life insurance companies, which are permitted an additional three years.

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 *Differential Earnings Amount for Mutual Life Insurance Companies*. The equity interest of a stock life insurance company is held by the stockholders. By contrast, the equity interest of a mutual insurance company is held by its contractholders. A perceived inequity was identified since the return on investment to stock life companies (that is, stock dividends) is not deductible to the company, yet the return on equity to mutual company "equity owners" is deductible as a contractholder dividend.

13.15 In recognition of the presumption that part of contractholder dividends paid by mutual companies could be construed as distributions of the companies' earnings to the contractholders as owners, a mechanism was introduced into the law attempting to equalize the taxation of mutual life insurance companies and stock life insurance companies.

13.16 The mechanism chosen to apply this theoretical approach of identifying ownership distributions by a mutual company is called the *differential earnings amount* (DEA). The DEA is computed by multiplying the company's average equity base for the taxable year by the *differential earnings rate* (DER). The DER is computed by the IRS based on earnings reported by all mutual life insurance companies and the fifty largest stock life insurance companies. The DEA reduces otherwise deductible policyholder dividends since it approximates the earnings distributed by the mutual insurance company. The excess of the DEA over policyholder dividends for the taxable year should reduce the ending statutory reserves of the mutual insurance company.

13.17 The DER computed by the IRS is generally not available prior to the completion of the audited financial statements. However, various industry groups may provide estimates of the current year DER. The IRS has indicated that the DER cannot be negative.

13.18 *Phase III Income*. Under pre-1984 law, a portion of stock life insurance company taxable income 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 net operating losses.

13.19 *Dividends-Received Deduction*. As with nonlife insurance companies, life insurance companies are generally entitled to a dividends-received deduction; however, special rules apply to life insurance companies. This deduction is determined in part on the life insurance company's ownership of the dividend paying company.

Computation of Federal Income Tax Liability

13.20 The computation of federal income taxes is generally the same as in other industries. The Internal Revenue Code provides two systems of income taxation for all taxpayers including life insurance companies, the regular tax (taxable income is determined as described above 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 alternative minimum tax.

13.21 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 Code to arrive at alternative minimum taxable income (AMTI). The alternative minimum tax is generally 20 percent of the AMTI. The AMT is the excess of AMTI over the regular tax liability.

13.22 *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 three preceding years) may continue to compute first quarter estimated tax payments based on the preceding year's tax liability.

State Taxes

13.23 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.

13.24 *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. 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.

13.25 Most states require premium tax payments in February of the year following the year that the premiums were written; however, some states require quarterly premium tax payments. Thus, insurers generally have substantial premium tax liabilities as of December 31 of each year. Rather than computing the liability on a state-by-state basis, most 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.

13.26 *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.

13.27 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

13.28 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 generally accepted accounting principles (GAAP). The following discussion of SAP and 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 should be referred to in determining appropriate accounting and reporting treatment in all cases.

Statutory Accounting Practices

13.29 A life insurance company's federal income tax liability is the greater of its regular tax liability or its AMT liability. Statutory accounting does not require a provision for deferred taxes, therefore, the provision for federal income taxes of a life insurance company is current income taxes. As discussed previously, the provision for federal income taxes for a life insurance company is based on the estimated current year's tax liability, and should provide for the expected liability for the current year's taxable transactions.

13.30 *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 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. However, in extraordinary instances it may be appropriate to charge such adjustments directly to the surplus account.

13.31 *Tax Return Accounting*. In general, tax return accounting follows statutory accounting with several exceptions that have been discussed above. These exceptions are summarized in table 13.1.

Table 13.1
Comparison of Tax Return Accounting Rules and Statutory Accounting Practices

	SAP	Tax Return Accounting
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.
a. Deferred Uncollected Premiums	Included in premiums and reported as assets on balance sheet.	Excluded from gross premium income.
b. Advance Premiums and Premium Deposit Funds	Excluded from premiums and reported as liabilities on balance sheet.	Included in gross premium income.
c. Experience Rated Refunds	Often netted against premium and annuity considerations.	Deductible as policyholder dividends.
Investment Income • Interest Income — Tax Exempt Interest Income — Proration	• Included in gain from operations income. • N/A	• Policyholder's share included in LICTI via decrease of ending tax basis reserves. • Increases the percentage of tax exempt interest income and dividends received which are subject to tax.
— Market Premium and Discount on Bond Obligations	Amortized and accrued currently.	• Option 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 above.	Must accrue original issue discount currently.
• Dividend Income	Included in gain from operations	Generally included in taxable income, except some amounts may be reclassified as return of capital or capital gain depending on the paying entity's circumstances.
• Rental Income	Included in operations income. May include an amount for occupying company owned real estate (imputed rent).	Imputed rent is eliminated.

	SAP	Tax Return Accounting
• 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.	• Tax return accounting rules may require an item be reported in a different period than SAP. • Only specific charge-off method allowed on worthless mortgages.
• Capital Gains and Losses	Included in gain from operations, to the extent not included in the IMR.	Taxed when realized.
General Deductions	Charged to gain from operations as incurred.	• Subject to tax accounting rules generally applicable to other nonlife entities.
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.	• Determined using interest rates, morbidity and mortality tables, and calculation methods as provided in the Internal Revenue Code. • Liabilities not qualifying as life insurance statutory benefit reserves are discounted using IRS rates.
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.
IBNR	Included in statutory benefit reserves.	Estimate deductible as benefits.
Policyholder Dividends	Change in liability for policyholder dividends charged to operations income.	Amounts paid or accrued during the taxable year are deductible.
Other Adjustments • Contract Acquisition Costs	Charged to gain from operations when incurred.	• Capitalization of a fixed percentage of net premiums on certain insurance contracts. • Amortized over 120 months.
• Operations Loss Deduction	N/A	• May be carried back three years and forward fifteen years to offset past or future taxable income, if any. • New life insurance companies may qualify for eighteen-year carryforward.

	SAP	Tax Return Accounting
• Small Life Insurance Company Deduction (available to life insurance companies having end-of-year total assets of $500 million or less)	N/A	• Deduction is equal to 60 percent of the LICTI under $3 million. • Phased out for LICTI over $3 million and eliminated for LICTI in excess of $15 million.
• Differential Earnings Tax (increases LICTI of mutual life insurance companies only)	N/A	• Equal to the average equity base of the mutual life insurance company multiplied by a differential earnings rate published by the IRS.
• Phase III tax	N/A	• The 12/31/83 balance of policyholder surplus account may become taxable. • *Independent of operations gain or loss* of the company.
• Dividends Received Deduction	N/A	• 70 percent of dividends received from less than 20 percent owned corporations. • 80 percent of dividends received from 20 percent or more but less than 80 percent owned corporations. • 100 percent of dividends received from 80 percent or more owned corporations.

Generally Accepted Accounting Principles

13.32 Under GAAP, the accounting principles for income taxes for life insurance entities as well as other business entities are specified in FASB Statement No. 109. The sections of FASB Statement No. 109 that have a significant effect on life insurance entities are paragraphs 35 through 38 relating to intraperiod tax allocation, paragraph 31(d), and paragraph 44(d).

13.33 Under FASB Statement No. 109, 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.

13.34 *Determining Current Tax Liability or Asset*. 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 13.1 through 13.27.

13.35 *Determining 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 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:

- Deferred acquisition costs
- Life insurance statutory benefit reserves
- Statutory unearned premium reserves (generally for accident and health contracts)
- Certain discounted accident and health liabilities

Basic differences that will never have a tax consequence are not considered temporary differences.

13.36 *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.

13.37 *Determine Deferred Tax Asset Valuation Allowance*. 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, (1) prudent and feasible, (2) 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 (3) an action that would result in the realization of deferred tax assets.

However, if after all four sources as described above 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.

AUDITING

Inherent Risk Factors

13.39 In assessing audit risk, the auditor should consider those factors influencing inherent risk related to federal and state taxes, including factors relating to management, product characteristics, and economic and regulatory environment. Such factors might encompass the following:

- The life insurance entity has historically underprovided for its federal income tax liability.

- Management places undue emphasis on meeting projected tax liabilities on earnings projections.

- Significant changes in regulation or taxation have occurred.

- The entity is a member of a tax consolidated group, and its tax provisions are dependent on amounts from affiliates.

CONSIDERATION OF THE INTERNAL CONTROL FOR AUDITING INCOME TAX TRANSACTIONS

13.40 A key element to an effective audit is an understanding of the industry, operating environment, and internal control over financial reporting. An entity's internal control consists of

five elements: the control environment, risk assessment, control activities, information and communication, and monitoring. 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 plan the audit of the entity's financial statements. Such an understanding allows the auditor to assess audit risks and facilitate the design of effective and efficient audit tests.

Control Environment

13.41 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 taxes transactions include the following:

- A single person dominates the decision-making process with regard to tax issues and tax planning strategies.

- The entity does not use a life insurance tax specialist in determining its federal income tax provision.

Control Activities

13.42 Control activities are those policies and procedures in addition to the other components that management has established to provide reasonable assurance that specific entity objectives will be achieved. The auditor should obtain an understanding of those control activities relevant to planning 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:

- Proper authorization of transactions and activities
- Segregation of duties
- Design of adequate controls over documents and records (there is adequate control over records of temporary differences)
- Adequate safeguards of access to and use of assets and accounting records
- Independent checks on performance and proper valuation of recorded amounts

Information and Communication

13.43 The information system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to record, process, summarize, and report an entity's transactions and to maintain accountability for related assets and liabilities.

13.44 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

13.45 The auditor may consider the following specific audit objectives and, 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

Taxes— Current Provision

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Substantive Auditing Procedures
Existence or Occurrence and Rights and Obligations		
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.
	Movement 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/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.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Substantive Auditing Procedures
	Management reports regarding accrued tax liabilities for life insurance benefits are prepared and reviewed. These reports may include the following: — Changes in insurance statutory benefit reserves from prior year — Comparison of insurance statutory benefit reserves on a policy by policy basis versus the aggregate on a statutory basis —Impact of new policy issues on statutory reserves — Review changes in statutory assumptions to determine if an accounting change has taken place	
Completeness		
All current taxes payable and current expenses that should be accrued at the balance-sheet date have been recorded.	Management review of financial statements, with comparison of prior-year financial statements, and prior-year tax returns to ascertain the reasonableness of the following: — Book/tax differences — Effective tax rate Income tax filings and assessments are addressed promptly and are reviewed, approved, and related to the financial records by a representative a management.	Compare the various tax account balances with those of prior periods and investigate expected changes (or the absence of expected changes). Compare the relationships of current income tax expense to pretax income with such relationships for prior years.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Substantive Auditing Procedures
Valuation or Allocation		
Current income taxes payable/receivable, deferred tax asset, and current expense are recorded at appropriate amounts.	Review of 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.
	Review movements in policyholder surplus account for calculation of Phase III tax. If applicable, consider 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.
	Review 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 investee has a significant interest. Examine the opinion and related disclosure to ensure that items that affect the audit are properly considered in the entity's tax accounting.
	Review recent legislative developments for their impact on tax calculation.	
	Management investigation of differences in return to provisions to mitigate similar differences in current year.	

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Substantive Auditing Procedures
Presentation and Disclosure		
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: — Analysis of all differences between financial and taxable income — Analysis of all differences between statutory and taxable income — Analysis of federal, foreign, and state and local taxes — Analysis of federal ordinary and capital gains tax — Effective tax rate analysis — The ratio of income tax expense to pretax income, operating earnings, budget, etc. Determine whether footnotes are in conjunction with company policy.	Review whether disclosures comply with generally accepted accounting principles (GAAP). For audits of statutory financial statements, test whether classifications and disclosures comply with applicable regulations. Read finance committee minutes. 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.

Taxes— Deferred Taxes

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Substantive Auditing Procedures*
Existence or Occurrence and Rights and Obligations		
All deferred liabilities for income taxes payable on the balance sheet represent amounts owed to government 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 made and consistently applied and the settlements have been appropriately recorded.
	Movement in deferred tax balances are reviewed for reasonableness by management.	
	Reconciliation between current tax calculation of temporary differences and the tax basis of the balance sheet at the beginning and ending year is performed and reviewed for reasonableness.	Review to ensure that return to provision reconciliation is reflected in the end of the period tax basis balance sheet.
Completeness		
All deferred taxes payable and deferred tax expense that should be accrued at the balance sheet date have been recorded.	Management review of financial statements, with comparison of prior-year financial statements, and prior-year tax returns to ascertain the reasonableness of temporary differences as compared to movements in the tax basis balance sheet.	Compare the various tax account balances with those of prior periods and investigate expected changes (or the absence of expected changes).
	Management reports are prepared and reviewed detailing the difference between the beginning year book and tax bases of assets and liabilities to the year-end difference between book and tax bases of assets and liabilities.	Reconcile the amounts of the changes in the deferred income tax balances between the current period and the prior period with the provision for deferred income taxes.

Audit Objectives	Examples of Selected Control Procedures and Techniques	Examples of Substantive Auditing Procedures
	Income tax filings and assessments are addressed promptly and are reviewed, approved, and related to the financial records by a representative a management.	Compare the relationships of deferred income tax expense to pretax income with such relationships for prior years.
		Reconcile the current year book/tax timing differences to the change in balance-sheet account balances.
Valuation or Allocation		
Deferred income taxes payable and current expense are recorded at appropriate amounts.	Review reasonableness and necessity for valuation allowances.	Schedule a reversal of temporary differences in conjunction with projected return results.
	Management reports are prepared and reviewed detailing positive and negative evidence with respect to realizability of deferred tax assets.	Review positive and negative evidence for determining the realizability of the deferred tax asset.

Audit Objectives	*Examples of Selected Control Procedures and Techniques*	*Examples of Substantive Auditing Procedures*
Presentation and Disclosure		
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: — The details of the differences the between statutory rate of tax on pretax income and the effective rate of tax on pretax income — Components of the net deferred tax provision — Components of the year-end deferred tax liability (asset) and reconciliation to year-end balance sheet — Calculation of deferred tax asset valuation	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, SURPLUS NOTES, SEPARATE ACCOUNTS, INSURANCE-RELATED ASSESSMENTS AND SHAREHOLDERS' EQUITY-CONTRACTHOLDERS' SURPLUS

INTRODUCTION

14.1 This chapter provides a brief description of statutory accounting practices (SAP) and generally accepted accounting principles (GAAP) and examples of suggested audit procedures for other assets and liabilities unique to life insurance entities, separate accounts, insurance-related assessments and shareholders' equity or contractholders' surplus. For those areas where auditing procedures may be unique to life insurance entities, examples of selected auditing procedures are included in the Auditing section (see paragraphs 14.58 through 14.64). 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 "Consideration of the Internal Control" and the "Audit Consideration Chart" have been omitted.

OTHER ASSETS

14.2 *Other assets* may include some or all of the following:

- Life insurance premiums and annuity considerations deferred and uncollected (see chapter 7 for a discussion)
- Accident and health premiums due and unpaid (see chapter 7 for a discussion)
- Amounts recoverable from reinsurers (see chapter 12 for a discussion)
- Nonadmitted assets (see paragraph 14.3 for a discussion)

Nonadmitted Assets (statutory financial statements only)

14.3 *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 are the following:

- Agents' debit balances
- Furniture and equipment (except electronic data processing equipment)
- Due and unpaid accident and health premiums (more than one modal premium past due for individual contracts, or ninety days past due for group contracts)
- Cash advances to officers and employees

- Accrued income on investments in default
- Excess of amounts loaned over stipulated percentages of related collateral
- Prepaid and deferred expenses
- Goodwill and similar intangible assets
- In a few states, amounts recoverable from unauthorized reinsurers, unless covered by amounts due to such reinsurers (in other states, a separate liability is required to be established for such amounts)
- Excess of book value over admitted asset value of securities and other investments (see chapter 11 for further discussion)

14.4 SAP specifically designates certain assets as nonadmitted, while state laws may designate additional assets as nonadmitted. Most of the preceding nonadmitted assets are self-explanatory. In general, receivables (other than those due from contractholders) should be classified as nonadmitted assets unless they are collateralized. Life insurance entities maintaining accounts for furniture and other equipment and charging operations with depreciation are generally required to treat undepreciated balances as nonadmitted assets; however, some states permit furniture and equipment to be treated as admitted assets in amounts up to stipulated percentages of the aggregate of all other assets. Unauthorized investments and investments in excess of amounts authorized by statute are nonadmitted (see chapter 11 for discussion). In many states, insurance entities are not permitted to own their own stock, and loans collateralized by such stock are also classified as nonadmitted assets.

14.5 Changes in nonadmitted assets between valuation dates are charged or credited directly to surplus, except for the change in nonadmitted investment income due or accrued, which is included as part of investment income.

14.6 Under GAAP, the concept of nonadmitted assets does not exist. These assets should be included in the balance sheet, where appropriate. Any receivables must be subject to the usual review as to collectibility, and appropriate valuation reserves 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

14.7 Other liabilities generally consist of accrued expenses, taxes, licenses, and fees (see chapter 10 for a discussion). Additional other liabilities unique to life insurance entities may include–

- Amounts withheld or retained by the life insurance entity as an agent or trustee, such as payroll withholdings and amounts held in escrow for payment of taxes and insurance under mortgage loans.

- Amounts held for agents, which generally represent credit balances in agents' accounts.
- Remittances and items not allocated, which represent cash clearing accounts and other suspense accounts (see chapter 7, paragraph 37, for a discussion of suspense accounts).
- Liabilities for employee benefits not provided in other accounts, such as a liability for accrued or unused vacations, nonqualified pension plans, and postemployment benefits.
- Commissions to agents due or accrued, including levelized commission agreements.
- Reinsurance in unauthorized entities (see chapter 12 for a discussion).
- 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.

SURPLUS NOTES

14.8 Practice Bulletin 15, *Accounting by the Issuer of Surplus Notes,* provides GAAP guidance on accounting for surplus notes. Surplus notes[1] are financial instruments issued by insurance enterprises that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations.

14.9 The following are some general characteristics of surplus notes:

- Approval of the issuance by the domiciliary state insurance commissioner (commissioner)
- Stated maturity date in most but not all cases
- Scheduled interest payments
- Approval of the payment of principal and interest by the commissioner
- Nonvoting
- Subordinate to all claims except those of shareholders for stock companies
- Subordinate to all claims except policyholder residuals for mutual companies (after policyholder liabilities are settled)
- No or limited acceleration rights other than for rehabilitation, liquidation, or reorganization of the insurer by a governmental agency

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[1]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.

- Proceeds from issuance in the form of cash, cash equivalent, or some other asset with a readily determinable fair value satisfactory to the commissioner

14.10 Mutual insurance enterprises are owned by their policyholders and cannot raise capital by issuing shares of common or preferred stock; thus, many mutual insurance enterprises have issued surplus notes. Early issuances of surplus notes were generally by financially troubled mutual insurance enterprises 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 enterprises 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 enterprises have issued surplus notes.

14.11 *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.

14.12 Consistent with paragraph 16 of FASB Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, a debtor shall derecognize a surplus note if and only if it has been extinguished. According to paragraph 16 of FASB Statement No. 125, 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 delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled 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. [Footnote omitted]

14.13 *Accrual of Interest*. 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.

14.14 *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.

SEPARATE ACCOUNTS

14.15 A separate account is a legally restricted fund that is segregated from all other assets of the life insurance entity. Separate accounts are established in conformity with state insurance laws and are generally not chargeable with liabilities that arise from other business of the 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 are generally not available to cover liabilities except those of the separate account. Separate accounts are most commonly used to fund the assets for fixed-benefit annuity contracts

and variable life insurance and annuity contracts. Variable life insurance and annuity contracts are designed to give the contractholder the ability to choose the contract's underlying investment vehicle from the investment options offered by the life insurance entity, and to bear the risk of investment performance. These contracts have features whereby benefits, cash surrender values, or premium amounts, or all three, may vary with the investment performance of a specific separate pool of assets, usually a separate account. Separate accounts are also used to fund group pension contracts.

14.16 With variable life and annuity contracts, the contractholder has direct participation in the investment earnings of the separate account or asset pool. Most life insurance entities offer contractholders 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 funds may be sponsored by the life insurance entity and are generally invested in various instruments such as equity securities or high-grade bonds. Cash values of variable contracts are not guaranteed, and actual investment experience may cause fluctuations in the cash values and benefit amounts; however, more recent contracts have introduced terms whereby the benefit amount often may not fall below a contractually determined guaranteed minimum amount.

14.17 Variable life insurance and annuity contracts are subject to the Securities and Exchange Act of 1934 and the Investment Company Act of 1940. Most variable products must be sold only by appropriately licensed representatives under the Securities Act of 1933. (For additional discussion on variable annuity separate accounts see chapter 7 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*)

Statutory Accounting Practices — Separate Accounts

14.18 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 through the income statement.

14.19 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. The insurance activities, such as premium collection, claims, and benefits, are accounted for as transactions of the general account.

14.20 Separate account assets may consist of equity securities, debt securities, mutual funds, shares of unit investment trusts, and other vehicles. (See chapter 11 for 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.

14.21 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 company)

b. Investment in a registered investment company formed to receive proceeds from such contract holders (if the separate account is a unit investment trust)

c. Investment in a registered investment company that generally sell shares to the public (if the separate account is a unit trust)

The third approach is available only for tax-qualified variable annuities.

14.22 Separate account liabilities generally consist of reserves for variable contracts, amounts due to the investment advisor and administrator (usually the life insurance entity), and amounts due brokers.

14.23 Transfers for premium or deposit considerations received by the separate account usually are net of charges levied on gross considerations received by the life insurance entity. The amounts retained by the life insurance entity are usually to pay commissions, premium taxes, and underwriting costs. In addition to premium and deposit considerations, separate account revenues include 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, and realized and unrealized capital losses.

14.24 When a separate account is initiated, the life insurance entity may make a temporary transfer of surplus funds, referred to as *seed money*, to the separate account. 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.

Generally Accepted Accounting Principles — Separate Accounts

14.25 As discussed previously under SAP, under 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 Statement No. 97 contracts and accordingly should be accounted for as described in chapter 7 of this Guide. For life insurance entities that have variable business acquisition costs incurred by the life insurance entity, the DAC amortization should be based on the insurance entity's revenue source that is typically the sum of insurance charges, investment advisory fees, administrative fees, and other charges.

14.26 GAAP accounting guidance for separate accounts is provided in FASB Statement No. 60, paragraph 54 as follows:

> Investments in separate accounts shall be reported at market except for separate account contracts with guaranteed investment returns. For those separate accounts, the related assets shall be reported in accordance with paragraphs 45–51. Separate account assets and liabilities ordinarily shall be reported as summary totals in the financial statements of the insurance entity.

(Paragraphs 45 through 51 of FASB Statement No. 60, amended by FASB Statement Nos. 91, 97, 114 and 115, provide accounting guidance with respect to investments and are summarized in chapter 11.)

SEC Registration — Separate Accounts

14.27 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 1940 and 1933 Acts, respectively. The registrant is the separate account.

14.28 Initially, variable annuity issuers registered as management investment companies because they invested their assets in the open market and therefore resembled typical mutual funds in their investment objectives. The 1940 Act has a number of technical requirements for a management investment company. 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.

14.29 Accordingly, since 1969, a number of separate accounts have registered under the 1940 Act as unit investment trusts to avoid some of the technical requirements for companies registered as management investment companies under that Act. Further, the form of a unit investment trust accommodates the need for separate accounting for the performance of specific pools of assets of group annuity contracts, personal contracts, and annuity contracts subject to different tax rules. The unit investment trust form may also accommodate lower expense charges and more flexibility in adding new products.

14.30 In 1985, the SEC adopted two registration forms for use by separate accounts offering variable annuity contracts that register under the Investment Company Act. Form N-3 is the registration form of separate accounts registered as management investment companies. Form N-4 is the registration form for unit investment trusts. Though those forms integrate and codify disclosure requirements for separate accounts and shorten the prospectus, they provide more information to investors. The auditor should become familiar with their requirements. Variable life insurance separate accounts register under the Securities Act of 1933.

INSURANCE-RELATED ASSESSMENTS

14.31 Insurance enterprises 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. The AICPA issued SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*, which provides guidance on accounting by insurance and other enterprises for assessments related to insurance activities.

Guaranty-Fund Assessments

14.32 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 enterprises. 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.

14.33 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 enterprises 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 enterprises 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 a 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 enterprises. 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.

14.34 State laws often allow for recoveries of guaranty-fund assessments by entities subject to assessments through such mechanisms as premium tax offsets, policy surcharges, and future premium rate structures.

Other Insurance-Related Assessments

14.35 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 insurance

regulatory bodies (for example, the state insurance department or workers' compensation board) and (b) to fund second-injury funds.[2]

14.36 The primary methods used to assess for these other insurance-related assessments are the following.

a. *Premium-based*. The assessing organization[3] imposes the assessment based on the entity's written premiums. 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 that amount for all entities subject to that assessment in the particular jurisdiction.

Reporting Liabilities

14.37 Entities subject to assessments should recognize liabilities for insurance-related assessments when 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.

14.38 Probability of Assessment. Premium-based guaranty-fund assessments, except those that are prefunded, are presumed probable when a formal determination of insolvency occurs,[4] and presumed not probable prior to a formal determination of insolvency. 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.

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[2]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.

[3]The assessing organization may be at the state, county, municipality, or other such level.

[4]For purposes of this SOP, 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.

14.39 *Obligating Event*. Because of the fundamental differences in how assessment mechanisms operate, the event that makes an assessment probable (for example, an insolvency) may 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.

14.40 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, noncancelable policies) the premiums on which the assessments are expected to be based. Some states, through law or regulatory practice, provide that an insurance enterprise cannot avoid paying a particular assessment even if that insurance enterprise 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.

14.41 For loss-based assessments, the event that obligates an entity is an entity's incurring the losses on which the assessments are expected to be based.

14.42 *Ability to Reasonably Estimate the Liability*. One of the conditions in FASB Statement No. 5, *Accounting for Contingencies,* for recognition of a liability is that the amount can be reasonably estimated. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provides that some amount of loss can be reasonably estimated when available information indicates that the estimated amount of the loss is within a range of amounts. When no amount within the range is a better estimate than any other amount, the minimum amount in the range shall be accrued.

14.43 Entities subject to assessments may be able 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 (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF). An insurance enterprise 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 enterprise's future assessments.

14.44 If a non-insurance entity's assessments are based on premiums, it may consider the amount of premium the self-insurer would have paid if it had insured its liability with an insurer as well as past assessments that have been incurred when determining the liability. If a non-insurance entity's assessments are based on losses, it should consider the losses that have been incurred by the company when determining the liability. Most often assessments that impact non-insurance entities that self-insure workers' compensation obligations are for second-injury funds. Second-injury funds generally assess insurance entities and self-insurers based on paid losses. A non-insurance entity may develop an accrual for its second-injury liability based the following 1) the ratio of the entity's prior period paid workers' compensation claims to aggregate workers' compensation claims in the state that was used as a basis for previous assessments, 2) total fund assessments in prior periods, or 3) known changes in the current period to either the number of employees self-insured by the entity or the number of workers subject to recoveries from the second-injury fund that might alter total fund assessments and the entity's proportion of the total fund assessments.

14.45 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.

14.46 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:

- 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

- 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 contractholders that affect the level and payout of the guaranty fund's liability

- The extent and timing of available reinsurance recoveries may be subject to significant uncertainties

- Alternative strategies for the liquidation of assets of the insolvent company that affect the timing and level of assessments

- 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. When 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

14.47 A discussion on applying the conclusions in paragraphs 14.37 through 14.46 to the methods used to address guaranty-fund assessments and other insurance-related assessments 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,[5] the premiums on which the expected future assessments are to be based. Therefore, the event that obligates the entity generally will not have occurred at the time of the insolvency.

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.

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 as the related premiums are written.

d. *Other premium-based assessments.* Other premium-based assessments, as described in paragraph XX, would be accounted for in the same manner as 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 as the related loss is incurred.

Present Value

14.48 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.

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[5] For example, multiple-year contracts under which an insurance enterprise has no discretion to avoid writing future premiums.

Reporting Assets for Premium Tax Offsets and Policy Surcharges

14.49 When 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 in an amount that is determined based on current laws and projections of future premium collections or policy surcharges from in-force policies. In determining the asset to be recorded, in-force policies do not include expected renewals of short-duration contracts but do include assumptions as to persistency rates for long-duration contracts. 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 in-force policies. A life insurance entity is required to recognize a liability for prospective-premium-based assessments as the premium is written or obligated to be written by the entity. 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.

14.50 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. Accordingly, 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 consistency rates, an asset should be recognized at the time the liability is recorded.

14.51 In all cases, the asset shall 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 in-force policies in evaluating the recoverability of premium tax offsets or policy surcharges is not appropriate.

14.52 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 where 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.

14.53 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 some 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 where amounts collected or receivable are not recorded as revenues and amounts due are paid and not expensed (i.e., similar to accounting for sales tax).

SHAREHOLDERS' EQUITY–CONTRACTHOLDERS' SURPLUS

14.54 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.

14.55 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 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.

14.56 In lieu of capital stock, mutual entities are organized with 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

14.57 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:

- 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 is credited or charged to surplus as unrealized capital gains or losses.

- 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.

- Any increase or decrease in the amount of the asset valuation reserve (AVR) and interest maintenance reserve (IMR) between valuation dates is charged or credited to surplus, except for the amortization of IMR amounts, which is included in the summary of operations.

- Any change in the liability for unauthorized reinsurance is charged or credited directly to surplus.

- 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, such changes generally require 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.

AUDITING

14.58 Generally, the audit objectives, internal control considerations, and auditing procedures for other assets and liabilities, separate accounts, and shareholders' equity-contractholders' 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 should be considered in auditing these types of accounts.

Auditing Procedures

14.59 *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 type of business – including confirmation, calculation, examination, and any other procedure that should be applied to satisfy the auditor.

14.60 Nonadmitted receivables for *Annual Statement* purposes that are included in the GAAP balance sheet should be subjected to the usual auditing procedures necessary to determine their existence and collectibility. Furniture and fixtures should be subjected to the usual auditing procedures for additions and disposals and depreciation thereon, similar to those uses in any other type of business entity.

14.61 *Other Liabilities*. Examples of auditing procedures for these accounts may include–

- *Amounts withheld*. The auditor should review support for items in this account and verify by confirmation, recalculation, or subsequent payment review.

- *Amounts held for agents*. These accounts should be tested in connection with tests of balances due from agents.

- *Remittances and other items not allocated*. The auditor should review an aging of these accounts and investigate old, large, or unusual items by references to supporting data.

- *Agents' commissions due or accrued*. The auditor should 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.

14.62 *Separate Account Assets*. Since 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 unit investment trusts) will generally require separate audits for SEC registration purposes under group separate account contracts 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.

14.63 *Shareholders' Equity–Contractholders' Surplus Accounts*. These accounts must 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 should 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:

- 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 risk-based capital (RBC) trigger points.

- Compare statutory dividend and surplus restrictions with dividends declared and paid and year-end surplus levels.

- 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.

- 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.

- 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.

14.64 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.

Chapter 15

REPORTS ON AUDITED FINANCIAL STATEMENTS

REPORTS ON FINANCIAL STATEMENTS

15.1 The guidance in SAS No. 58, as amended by SAS No. 79, *Amendment to Statement on Auditing Standards No. 58,* Reports on Audited Financial Statements, 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. Guidance on reporting on statutory financial statements is incorporated from SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises,* which was issued in December 1995.

15.2 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

15.3 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with GAAP. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). 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, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material

misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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

[Signature]
[Date]

MUTUAL LIFE INSURANCE ENTITIES

15.4 In April 1993, the FASB issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that mutual life insurance enterprises can no longer issue statutory financial statements that are described as "in conformity with generally accepted accounting principles." 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*, is effective for financial statements for fiscal years beginning after December 15, 1995. Accordingly, mutual life insurance entities that wish to prepare GAAP financial statements in 1996 and beyond have to apply pertinent authoritative accounting pronouncements, such as FASB Statements and Interpretations, Accounting Principles Board Opinions (APB), and AICPA Statements of Position, that do not explicitly exempt mutual life insurance entities. For statutory financial statements of mutual life insurance entities issued before that effective date, auditors may report on the statutory financial statements as being in conformity with GAAP. After the effective date, statutory financial statements of mutual life insurance entities intended for general distribution will contain an adverse opinion as to GAAP, along with an opinion as to conformity with the statutory basis of accounting.

15.5 FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40. The disclosure requirements per paragraphs 5 and 6 of 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."

UNQUALIFIED OPINIONS WITH EXPLANATORY LANGUAGE

Emphasis of a Matter

15.6 In some 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 enterprise 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. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type. 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 RBC 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, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation

required by (*state of domicile's insurance regulatory body*).

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

[Signature]
[Date]

Uncertainties

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

15.8 Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

15.9 If the auditor is unable to obtain sufficient evidential matter 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 evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

15.10 Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due 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 his perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances. 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 his 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 types 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, he should express a qualified or an adverse opinion.

15.15 *Unreasonable Accounting Estimates*. Usually, the auditor is able to satisfy himself regarding the reasonableness of management's estimate of the effects of future events by considering various types of evidential matter, 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, he should express a qualified or an adverse opinion.

Going Concern

15.16 SAS No. 59 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 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. If the auditor concludes that there is substantial doubt about a life insurance entity's ability to continue as a going concern for a reasonable period of time, the report should include an explanatory paragraph (following the opinion paragraph) to express that conclusion or disclaim an opinion (see paragraph 15.17). 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, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

The accompanying financial statements have been prepared assuming that ABC 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, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by (*state of domicile's insurance regulatory body*). The Company has filed a comprehensive financial plan with the commissioner outlining the Company's plans for attaining the required levels of regulatory capital by December 31, 19XX. To date, the Company has 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.

[Signature]
[Date]

15.17 SAS No. 59 states that inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report (as described above in paragraph 15.8) 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, SAS No. 59 does not preclude the auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the auditor's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an auditor's report containing a disclaimer of opinion as the result of uncertainties relating to an auditor's substantial doubt about a 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 have audited the accompanying balance sheets of ABC Life Insurance Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to report on these financial statements based on our audits.

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

The accompanying financial statements have been prepared assuming that 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, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by (*state of domicile's insurance regulatory body*). The Company has filed a comprehensive financial plan with the commissioner outlining its plans for attaining the required levels of regulatory capital by December 31, 19XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of 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 above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 19X2.

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

[Signature]
[Date]

QUALIFIED OPINIONS

15.18 Paragraphs 20 through 57 of SAS No. 58, as amended by SAS No. 79, describe 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 when —

- There is a lack of sufficient competent evidential matter 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.

- 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

15.19 Paragraphs 61 through 63 of SAS No. 58, as amended by SAS No. 79, describe 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. 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. The opinion should state that the scope of the audit was not sufficient to warrant the expression of an opinion. In addition, the report should disclose any other reservations the auditor has regarding fair presentation in conformity with GAAP. The auditor should not identify the procedures that were performed or 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.

Adverse Opinion

15.20 Paragraphs 58 through 60 of SAS No. 58, as amended by SAS No. 79, describe 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 when, 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. When 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.

AUDITORS' REPORTS ON STATUTORY FINANCIAL STATEMENTS OF INSURANCE ENTITIES

15.21 All states require domiciled insurance entities to submit to the state insurance commissioner an *Annual Statement* on forms developed by the NAIC. The states also require that audited statutory financial statements be provided as a supplement to the *Annual Statements*. Currently, statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the insurance department of the state of domicile," referred to in this Guide as *prescribed-or-permitted statutory accounting*.

15.22 The NAIC is in the process of codifying statutory accounting practices for certain insurance entities. When the NAIC completes the codification of statutory accounting practices (the codification), it is expected that the states will require that statutory financial statements be prepared using accounting practices "prescribed in the NAIC's *Accounting Practices and Procedures Manual*," referred to in this Guide as *NAIC-codified statutory accounting*.

15.23 This section of the Guide is intended to apply to audits of statutory financial statements pre- and postcodification. The term *statutory basis of accounting* is used in this Guide to refer to whatever is accepted as the statutory basis of accounting; currently, that is prescribed-or-permitted statutory accounting. When codification is complete, it is expected that the statutory basis of accounting for insurance entities will be NAIC-codified statutory accounting.

Prescribed-or-Permitted Statutory Accounting

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

15.25 Permitted statutory accounting practices include practices not prescribed in the sources described in paragraph 15.24, but allowed by the domiciliary state insurance department. Insurance entities may request permission from the domiciliary state insurance department to use a specific accounting practice in the preparation of the entity's statutory financial statements (a) when it wishes to depart from the prescribed statutory accounting practices, or (b) when prescribed statutory accounting practices do not address the accounting for the transaction(s).

NAIC-Codified Statutory Accounting

15.26 The NAIC undertook the project to codify statutory accounting practices because the current prescribed-or-permitted statutory accounting model results in practices that may vary widely — not only from state to state, but also for insurance entities within a state. The codification is expected to result in a hierarchy of statutory accounting practices that will provide a comprehensive basis of accounting that can be applied consistently to all insurance entities. Current statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA)[1] under SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623). When codification is complete, it is anticipated that a statutory basis for accounting for insurance entities other than NAIC-codified statutory accounting will be considered neither GAAP nor OCBOA.[1] Paragraphs 27 through 30 of SAS No. 62 provide guidance on reporting on financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA. That guidance is for financial statements prepared in accordance with an agreement (for example, a loan agreement) and that form of report should not be used for statutory financial statements of insurance entities.

GENERAL DISTRIBUTION REPORTS

15.27 Under SAS No. 62, if an insurance entity's statutory financial statements are intended for distribution other than for filing with the insurance departments to whose jurisdiction the insurance entity is subject, the auditor of those statements should use the general distribution form of report for financial statements that lack conformity with GAAP. Paragraph .04 of AU section 544, *Lack*

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[1]When the codification is complete, certain amendments to SAS No. 62 will be required.

of Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), requires the auditor to use the standard form of report described in SAS No. 58 (refer to AU section 508.08) modified as appropriate because of departures from GAAP.

15.28 Although it may not be practicable to determine the amounts of differences between GAAP and the statutory basis of accounting, the nature of the differences is generally 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 the statutory basis of accounting are material and pervasive. Therefore, auditors should express an adverse opinion with respect to conformity with GAAP (refer to AU section 508.67), unless the auditor determines the differences between GAAP and the statutory basis of accounting are not material and pervasive.

15.29 SAS No. 58 requires an auditor, when expressing an adverse opinion, to disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (a) all of the substantive reasons for the adverse opinion, and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[2] If the effects are not reasonably determinable, the report should so state and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss the statutory basis of accounting and describe how that basis differs from GAAP.

15.30 After expressing an adverse or qualified opinion on the statutory financial statements as to conformity with GAAP, auditors may express an opinion on whether the statutory financial statements are presented in conformity with the statutory basis of accounting under AU sec. 544. If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, an accounting practice that departs from that basis of accounting, regardless of whether required by state law or permitted by state regulators, would be considered an exception to the statutory basis of accounting. Accordingly, if such departures are material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under SAS No. 58 regarding conformity with GAAP.[3]

15.31 Following is an illustration of an independent auditor's report on the general distribution statutory financial statements of an insurance entity prepared in conformity with prescribed-or-permitted accounting practices, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with the statutory basis of accounting. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and the statutory basis of accounting are not reasonably determinable.

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[2]SAS No. 32, *Adequacy of Disclosure in the Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 431), 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.

[3]See footnote 1.

Independent Auditor's Report

To the Board of Directors
ABC Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 19X2 and 19X1, and the related statutory statements of income and changes in surplus, and of cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As described more fully in Note X to the financial statements, the Company prepares these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of (*state of domicile*[4]), which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between the statutory basis of accounting and generally accepted accounting principles, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with generally accepted accounting principles, the financial position of ABC Insurance Company as of December 31, 19X2 and 19X1, or the results of its operations or its cash flows for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Insurance Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note X.

[Signature]
[Date]

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[4]If, as anticipated, NAIC-codified statutory accounting becomes the statutory basis of accounting, this paragraph should be modified to state that the company prepared the financial statements using accounting practices "prescribed by the NAIC's *Accounting Practices and Procedures Manual*," or other appropriate language.

LIMITED DISTRIBUTION REPORTS

15.32 Prescribed-or-permitted statutory accounting for insurance entities currently is considered an OCBOA as described in SAS No. 62. If an insurance entity's statutory financial statements are intended solely for filing with state insurance departments 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. Paragraph .05f of SAS No. 62 recognizes that such reporting is appropriate even though the auditor's report may be made a matter of public record. However, that paragraph further states that limited distribution reports may be used only if the financial statements and report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance entity is subject. The auditor's report should contain a statement that there is a restriction on distribution of the statutory financial statements to those within the insurance entity and for filing with the state insurance departments to whose jurisdiction the insurance entity is subject.

15.33 Although auditing standards do not prohibit an auditor from issuing limited distribution and general distribution reports on the same statutory financial statements of an insurance entity, it is preferable to issue only one of those types of reports. Few, if any, insurance entities that do not prepare financial statements in accordance with GAAP will be able to fulfill all of their reporting obligations with limited distribution statutory financial statements.

15.34 Following is an illustration, adapted from paragraph 8 of SAS No. 62, of an unqualified auditor's report on limited distribution statutory financial statements prepared in conformity with prescribed-or-permitted accounting practices.

Independent Auditor's Report

To the Board of Directors
XYZ Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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*[5]) which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and the management of XYZ Insurance Company and for filing with state insurance departments to whose jurisdiction the Company is subject and should not be used for any other purpose.

[Signature]
[Date]

15.35 In accordance with paragraph 10 of SAS No. 62, the notes accompanying an insurance entity's statutory financial statements should contain a summary of significant accounting policies that discusses the statutory basis of accounting and describes how the basis differs from GAAP. However, the effects of the differences need not be quantified.

GENERAL AND LIMITED DISTRIBUTION REPORTS

15.36 The auditor should consider the need for an explanatory paragraph under the circumstances described in paragraph 11 of SAS No. 58 and paragraph 31 of SAS No. 62 regardless of any of the following:

a. The type of report — general or limited distribution

b. The opinion expressed — unqualified, qualified, or adverse

c. Whether the auditor is reporting as to conformity with GAAP or conformity with the statutory basis of accounting

For example, in a general distribution report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with the statutory basis of accounting, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance entity's ability to continue as a going concern; such paragraph should follow both opinion paragraphs.

15.37 As discussed in paragraph 37 of SAS No. 58 and paragraph 31 of SAS No. 62, in a separate paragraph of the auditor's report, the auditor may wish to emphasize a matter. When an insurance entity prepares its financial statements using accounting practices prescribed or

[5]See footnote 4.

permitted by the insurance department of the state of domicile and it has significant transactions that it reports using permitted accounting practices that materially affect the insurance entity's statutory capital,[6] 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.

15.38 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 19XX to write up its property to appraised value; under prescribed statutory accounting practices property is carried at depreciated cost. As of December 31, 19X5, that permitted accounting practice increased statutory surplus by $XX million over what it would have been had the prescribed accounting practices been followed.

REPORTING ON MANAGEMENT'S ASSESSMENT PURSUANT TO THE LIFE INSURANCE ETHICAL MARKET CONDUCT PROGRAM OF THE INSURANCE MARKETPLACE STANDARDS ASSOCIATION

15.39 Within the past several years, the life insurance industry has experienced allegations of improper market conduct practices such as questionable sales practices and potentially misleading policyholder illustrations. These allegations have 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 (ACLI), the largest life insurance trade organization, has 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 companies. 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 three-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.

15.40 Certified public accountants in the practice of public accounting (herein referred to as practitioners as defined by Statement on Standards for Attestation Engagements [SSAE] No. 1, *Attestation Standards* [AICPA, *Professional Standards*, vol.1, AT sec. 100, "Attestation

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[6] If, as anticipated, NAIC-codified statutory accounting replaces the prescribed-or-permitted statutory basis of accounting, such permitted practices would be considered exceptions.

Engagements"]), may be engaged to examine and/or provide various consulting services related to the entity's self-assessment. Paragraphs 15.41 through 15.73 provide guidance to practitioners in conducting and reporting on an independent examination performed pursuant to the AICPA SSAEs 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

15.41 The Principles 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:

> Principle 1
> To conduct business according to high standards of honesty and fairness and to render that service to its customers which, in the same circumstances, it would apply to or demand for itself.
>
> Principle 2
> To provide competent and customer-focused sales and service.
>
> Principle 3
> To engage in active and fair competition.
>
> Principle 4
> To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.
>
> Principle 5
> To provide for fair and expeditious handling of customer complaints and disputes.
>
> Principle 6
> To maintain a system of supervision and review that is reasonably designed to achieve compliance with these Principles of Ethical Market Conduct.

15.42 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.

15.43 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

15.44 As noted paragraph 15.39, 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

15.45 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.

15.46 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

15.47 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 certified public accountants.

IMSA Assessment Handbook

15.48 IMSA developed an *Assessment Handbook* (the Handbook or the IMSA Handbook) to assist companies in the implementation of the IMSA program and provide guidance to independent assessors. Entity personnel and independent assessors 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 companies 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 companies 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

15.49 To satisfy IMSA program requirements, practitioners need to perform an examination engagement pursuant to SSAE No. 1 (AT sec. 100), 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 should 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.

15.50 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. This SOP is intended to provide neither all the required criteria set forth in the IMSA Handbook nor all the applicable standards established by the AICPA.

15.51 In accordance with SSAE No. 1 (AT sec. 100.33–.35) 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.

15.52 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 work performed by each member of the engagement team should be reviewed to determine if it was adequately performed.

15.53 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 the following three aspects be present: approach, deployment, and monitoring.

Establishing an Understanding With the Client

15.54 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, limitations of the engagement, provision for changes in the scope of the engagement, and the expected form of the report. The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter.

Assessments of Attestation Risk

15.55 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, as discussed in appendix B. 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.

15.56 Examples of risk considerations that may affect the nature, timing, and extent of testing procedures are listed in paragraph 15.73. 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.

15.57 Before performing attestation procedures, the practitioner should 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 should 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 should also obtain an understanding of the entity's past market conduct issues and related corrective measures.

Evidential Matter

15.58 In an examination engagement performed under the attestation standards, the practitioner's objective is to accumulate sufficient evidence to limit 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 should select from all available procedures any combination that can limit 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 should also include verification procedures, such as inspecting documents and records, confirming assertions with employees or agents, and observing activities.

15.59 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 SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400.13) and SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500.30). These concepts are consistent with IMSA's concept of reasonable assurance as defined in the Handbook.[7]

15.60. 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

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[7]*Reasonable (assurance)* is defined in the Handbook as follows: "In the context of the IMSA program documents, the term *reasonable* is used to modify assurance, as an acknowledgment that it is virtually impossible to provide absolute and certain assurance that an event will happen (e.g., that a policy will address every possible circumstance, or that procedures will be applied without exception). *Reasonable*, as a qualifier, suggests that there exists a standard in both design and performance, and that such a standard, while conforming to the judgment or discernment of a knowledgeable person, is neither excessive nor extreme."

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

15.61 SSAE No. 1 (AT sec. 100) defines an attest engagement as one in which a practitioner is engaged to issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. The accompanying affirmative responses to the questions in the Questionnaire are written assertions of the entity. When 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.

15.62 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 should 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.

15.63 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 below, will not be accepted. The following is an illustration of an independent accountant's report on a company'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 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 should not be used for any other purpose.

____

[*IMSA Report Date; see paragraph 15.65*]

____

[*Company (Insurer)*]

____

[*Name of Independent Assessor; see paragraph 15.64*]

____

[*Signature of Independent Accountant or Firm*]

____

[*Date of Signature; see paragraph 15.66*]

Note: In any instance where 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 15.67).

Elements of the Report

15.64 *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 where 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,______________, affirm that I have reviewed the attached Independent
> [*print name*]
> Accountant's Report on management's assertions regarding the IMSA program for
> ______________ as of _________________and that I was the Independent Assessor
> [*insurer*] [*IMSA report date*]
> responsible for supervising relevant portions of the assessment identified herein.
>
> [*Signature*] [*Date of Signature*]

15.65 *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.

15.66 *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 SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report").

15.67 *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. A company 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 15.63. The following is an example of a paragraph that should be included in the examination report when alternative indicators are used by management. The paragraph should precede the opinion paragraph.

> Management's assertion supporting an affirmative response to certain questions are 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.

15.68 *Negative Responses.* IMSA will not grant membership applications to an entity whose application contains a "no" response to any question. In circumstances where 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.

15.69 *Working Papers.* The practitioner should prepare and maintain working papers in connection with an engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner's needs on the engagement to which they apply. Although it is not possible to specify the form or content of the working papers that a practitioner should prepare in connection with an assessment because circumstances vary in individual engagements, the practitioner's working papers ordinarily should indicate that—

a. The work was adequately planned and supervised.

b. Evidential matter (SSAE No. 1, AT sec. 100.36–.39) was obtained to provide a reasonable basis for the conclusion that the policies and procedures underlying the affirmative responses contained in the Questionnaire are in place.

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.

15.70 Concern over access to the practitioner's working papers might cause some clients to inquire about working paper requirements. In situations where 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 the auditing Interpretation "Evidential Matter: Auditing Interpretation of Section 326" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.06–.17) for guidance. See the attest Interpretation "Attestation Standards: Attestation Engagements Interpretations of Section 100" (AICPA, *Professional Standards*, vol. 1, AT sec. 9100.58) for guidance related to providing access to or photocopies of working papers to a regulator in connection with work performed on an attestation engagement.

15.71 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.

15.72 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

15.73 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

- 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

- 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, etc.

- Management's history of ensuring that sales personnel are qualified, trained, licensed, and supervised

- Management's history and systems for tracking complaint and replacement trends

- Management's ability to generate timely, complete, and accurate information on issues of regulatory concern regarding sales and marketing practices

- 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 inquires of predecessor assessors.)

- 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.)

- 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

- Changes in regulations or laws, such as those governing various products, sales methods and materials, agent compensation, and customer disclosure

- Publicity about sales and marketing practices and increased litigation to seek remedy

- Rapid changes in the industry, such as the introduction of new and complex product offerings or information technology

- The degree of competition or market saturation

Distribution, Sales Volume, and Products

- The diversity of distribution systems

- The relative volume of business for different products and distribution systems

- The length of time that products, distribution systems, or both have been available, used, or both

- Limitations of an entity's ability to assert control over producers

- Compliance training provided by management to its producers and employees involved in the sales process

- The complexity of product offerings

- The targeted markets for various products.

- 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 company within the fleet, including newly acquired subsidiaries or affiliates in the fleet.)

Other Considerations

- Issues identified in prior self-assessments, independent assessments, and other services provided

- Findings from recent market conduct examinations conducted by regulatory authorities or internal auditors

- Policyholder concerns expressed through complaints or litigation

- Ratings received from rating agencies

Appendix A

LIST OF INDUSTRY TRADE ASSOCIATIONS, DIRECTORIES, AND JOURNALS

The following is a list of some of the industry organizations. These sources are useful to the auditor in obtaining an understanding of the insurance industry.

Trade 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, Conference of Actuaries in Public Practice, Fraternal Actuarial Association, and Society of Actuaries. It provides standards or criteria of competence as an actuary and promotes education in actuarial science, exchange of information among actuarial organizations, and maintenance of standards of conduct and competence. The Casualty Actuarial Society provides actuarial and statistical science in insurance other than life insurance.

American Insurance Association (AIA) acts as a high-level policy organization for large stock companies. It deals with broad questions of position on proposed legislation and regulation, establishment of good public relations, and methods of conducting the business.

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.

Independent Insurance Agents of America (ILKA) promotes agent education and supports legislation of interest to the public as well as the insurance industry and opposes legislation detrimental to members' interests.

Insurance Accounting and Systems Association develops improved theory and practice with respect to insurance accounting and systems.

Life Communicators Association (LCA) is an international organization which provides professional development to its members in the life insurance and related financial services communications.

LIMRA International, Inc. was founded in 1916 to support and enhance the marketing functions of life insurance companies through original research, as well as products and services based on that research. Today, over 80 years latter, LIMRA is the premier marketing research organization in the financial services industry with more than 700 members — life/health insurance companies and financial services companies in nearly 60 countries.

Life Office Management Association, Inc. (LOMA) is an international association of insurance and financial services companies. LOMA helps insurers and the financial services industry improve management and operations through quality employee development, research, information sharing and related products and services.

Life Insurance Conference (LIC) is an association of life insurance companies which serve the basic

life and health insurance needs of the general public through various distribution methods. The LIC serves its members through the interchange of experience and ideas, maintaining high standards of business conduct which are in the best interests of policyholders, and representing its members in connection with legislative, regulatory and consumer issues.

The Life Underwriter Training Council (LUTO) is an independent, nonprofit life insurance educational and training organization.

Medical Information Bureau (MIB) is organized as a non-stock membership association of life insurance companies of the U.S. and Canada. The primary mission of MIB is to provide an alert to its member insurance companies against omission and fraud in the underwriting of individual life/health/disability insurance applications.

Million Dollar Round Table is an independent, international association of nearly 19,000 leading life insurance producers at 450 life insurance companies.

National Association of Insurance Commissioners (NAIC) is an organization of the chief insurance regulatory officials of the fifty states, the District of Columbia, and four U.S. Territories. It provides a forum for the exchange of ideas and the formulation of uniform policy. The NAIC helps commissioners fulfill their obligations of protecting the interests of insurance policyholders.

National Insurance Claims Association is a national trade organization offering a central contract point for professionals in the business of insurance claims to network effectively by exchanging current news of the marketplace and sharing marketing contacts and methods.

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.

Society of Actuaries is an international research, education, and membership organization for actuaries in the life and health insurance, employee benefits, and pension fields.

Society of Insurance Accountants (SIA) provides a forum for discussion and dissemination of information on accounting, statistical, and management problems in the insurance industry.

Trade Publications and Directories

The following publications 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, N.J. 08858
Best's Recommended Insurance Attorneys and Adjusters, A.M. Best Co. Oldwick, N.J. 08858
Insurance Information Sources, Gale Research Company, Detroit, MI 48226-2599
Life Insurance Fact Book, American Council of Life Insurance, Washington, D.C. 20004
Statistics of Fraternal Beneficiary Societies, Egbert, Fidlar & Chambers, Davenport, IA

Journals

Best's Review—Life-Health Edition (monthly). A.M. Best Co. Oldwick, N.J. 08858
Best's Weekly—Life-Health Edition (weekly). A.M. Best Co. Oldwick, N.J. 08858
Business Insurance (weekly), Crain Communications, Inc. Detroit, Mich. 48207
The National Underwriter, Life-Health Edition (weekly). National Underwriter Co. Cincinnati, Ohio 45202

Appendix B

ILLUSTRATIVE FINANCIAL STATEMENTS

INTRODUCTION

This appendix contains illustrative financial statements prepared in conformity with generally accepted accounting principles (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 GAAP. Decisions about the application of the GAAP discussed in the accounting and financial reporting sections of this 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 such 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. SEC Regulation S-X, Article 7, *Insurance Companies*, should be referred to.

The illustrative financial statements are in conformity with accounting standards issued up to and including Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 127, *Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125*. Preparers and auditors of financial statements should refer to subsequent FASB Statements and other GAAP for additional requirements.

Life and health insurance entities generally present unclassified balance sheets.

ABC Life Insurance Company
Balance Sheet
December 31, 19X2 and 19X1

	19X2	*19X1*
Assets		
Investments:		
Debt and equity securities		
Fixed maturities, held to maturity, at amortized cost (estimated fair value: $47,830,000 in 19X2 and $45,255,000 in 19X1)	$ 44,864,000	$ 46,310,000
Fixed maturities, available for sale, at estimated fair value (amortized cost: $247,525,000 in 19X2 and $219,565,000 in 19X1)	255,893,000	214,563,000
Trading account securities, at estimated fair value (cost: $4,220,000 in 19X2 and $4,419,000 in 19X1)	3,950,000	4,190,000
Mortgage loans	79,258,000	106,692,000
Real estate	6,410,000	6,147,000
Policy loans	43,549,000	51,013,000
Short-term investments	7,515,000	6,321,000
Total investments	441,439,000	435,236,000
Cash and cash equivalents	5,285,000	3,343,000
Accrued investment income	6,660,000	8,026,000
Premiums due and other receivables, net of allowance of $4,500,000 and $2,100,000 for doubtful accounts	1,647,000	1,092,000
Reinsurance receivable on paid and unpaid losses	596,000	407,000
Reinsurance receivable related to contractholder liabilities	5,714,000	3,048,000
Deferred policy acquisition costs	38,936,000	36,429,000
Property and equipment, net of accumulated depreciation	501,000	420,000
Other assets	152,000	158,000
Separate account assets	732,000	525,000
Total assets	$501,662,000	$488,684,000

See accompanying notes to financial statements.

ABC Life Insurance Company
Balance Sheet
December 31, 19X2 and 19X1

	19X2	*19X1*
Liabilities		
Future policy benefits	$345,887,000	$341,207,000
Guaranteed interest contracts	21,342,000	23,555,000
Policyholders' funds on deposit	49,408,000	46,202,000
Unpaid claims	5,418,000	4,737,000
Policyholders' dividends	2,335,000	3,450,000
Amounts held in escrow and accrued expenses	4,977,000	4,562,000
Deferred Federal income taxes	1,412,000	1,027,000
Other liabilities	253,000	4,465,000
Separate account liabilities	732,000	525,000
Total liabilities	431,764,000	429,730,000
Commitments and contingencies (Note 12)		
Shareholders' Equity		
Capital stock: authorized - 5,000,000 shares of $2 par value; 3,341,624 shares issued and outstanding	6,683,000	6,683,000
Retained earnings	57,776,000	55,522,000
Net unrealized appreciation (depreciation) of available for sale securities, net of taxes	5,439,000	(3,251,000)
Total shareholders' equity	69,898,000	58,954,000
Total liabilities and shareholders' equity	$501,662,000	$488,684,000

See accompanying notes to financial statements.

ABC Life Insurance Company
Statement of Income
Years Ended December 31, 19X2 and 19X1

Premiums and Other Revenues		
Premiums:	*19X2*	*19X1*
Life and annuity premiums	$ 24,833,000	$ 24,783,000
Accident and health premiums	10,141,000	9,153,000
Other premiums	20,000	43,000
Contractholder fees	1,961,000	1,844,000
Net investment income	32,998,000	35,141,000
Net realized gains (losses) on investments	4,222,000	(2,670,000)
Total premiums and other revenues	74,175,000	68,294,000
Benefits and Other Expenses		
Policyholder benefits	39,158,000	30,815,000
Interest credited to policyholder accounts	4,363,000	4,156,000
General expenses	4,288,000	4,984,000
Amortization of deferred policy acquisition costs	1,276,000	1,305,000
Underwriting, acquisition, and insurance expenses	18,029,000	17,266,000
Policyholders' dividends	4,665,000	6,898,000
Total benefits and expenses	71,779,000	65,424,000
Income before income taxes	2,396,000	2,870,000
Income taxes		
Current	1,547,000	601,000
(Prepaid) Deferred	(1,405,000)	540,000
Total income taxes	142,000	1,141,000
Net income	2,254,000	1,729,000
Net income per common share	.67	.52
Dividends per common share	--	.98

See accompanying notes to financial statements.

ABC Life Insurance Company
Statement of Shareholders' Equity
Years Ended December 31, 19X2 and 19X1
(amounts in thousands)

	Capital Stock	Retained Earnings	Net Unrealized Appreciation (Depreciation), net of taxes	Total Shareholders' Equity
Balance at January 1, 19X1	$6,683	$57,068	$ (1,521)	$62,230
Net income for 19X1	--	1,729		1,729
Shareholders' dividends	--	(3,275)		(3,275)
Net change in unrealized gains and losses of available for sale securities	--	--	(1,730)	(1,730)
Balance at December 31, 19X1	6,683	55,522	(3,251)	58,954
Net income for 19X2		2,254		2,254
Net change in unrealized gains and losses of available for sale securities	--	--	8,690	8,690
Balance at December 31, 19X2	$6,683	$57,776	$5,439	$69,898

See accompanying notes to financial statements.

ABC Life Insurance Company
Statements of Cash Flows
Years Ended December 31, 19X2 and 19X1

	19X2	*19X1*
Cash flows from operating activities:		
Net income	$2,254,000	$1,729,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Interest credited to universal life policies	7,927,000	10,445,000
Accrual of discount on investments, net	(976,000)	(1,328,000)
Net realized (gains) losses on investments	(4,222,000)	2,670,000
Depreciation	194,000	181,000
Amortization of deferred policy acquisition costs	2,847,000	3,353,000
Deferred Federal income taxes	(2,538,000)	540,000
Change in operating assets and liabilities:		
Accrued investment income	1,366,000	880,000
Deferred policy acquisition costs	(7,354,000)	(5,340,000)
Policy liabilities	1,407,000	(16,234,000)
Other items, net	(644,000)	3,269,000
Net cash provided by operating activities	261,000	165,000
Cash flows from investing activities:		
Cost of investments purchased:		
Fixed maturities and equity securities	(228,053,000)	(122,495,000)
Mortgage loans and real estate	(921,000)	--
Proceeds from investments sold, redeemed, or matured:		
Fixed maturities and equity securities	206,051,000	95,227,000
Mortgage loans and real estate	27,970,000	18,621,000
Policy loans, net	2,320,000	6,468,000
Short-term investments, net	409,000	15,446,000
Net cash provided by investing activities	7,776,000	13,217,000

(continued)

ABC Life Insurance Company
Statements of Cash Flows
(continued)
Years Ended December 31, 19X2 and 19X1

	19X2	*19X1*
Cash flows from financing activities:		
Dividends to shareholders	--	(3,275,000)
Receipts from universal life policies credited to contractholder account balances	7,918,000	8,365,000
Return of contractholder account balances on universal life policies	(4,165,000)	(3,718,000)
Withdrawals from interest-sensitive contracts	(9,848,000)	(13,046,000)
Cash used in financing activities	(6,095,000)	(11,674,000)
Net increase in cash and cash equivalents	1,942,000	1,708,000
Cash and cash equivalents, beginning of year	3,343,000	1,635,000
Cash and cash equivalents, end of year	$5,285,000	$3,343,000
Supplemental Cash Flow Information:		
Income taxes paid	$1,205,000	$ 785,000

See accompanying notes to financial statements.

ABC Life Insurance Company
Notes to Financial Statements
Years Ended December 31, 19X2 and 19X1

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 State 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 below. The accompanying financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) which differ from statutory accounting practices 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, redeemable and nonredeemable preferred stock not classified as either trading or held to maturity and are reported at estimated fair value, with unrealized gains and losses adjusted for other than temporary declines in fair value shown net of applicable taxes, deferred policy acquisition cost offsets for universal life type contracts and amounts attributable to certain participating contracts as a separate component of shareholder's equity. 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 are adjusted for amortization of premiums or discounts and other than temporary declines in fair value. Trading account securities consist of bonds, notes, 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 net realized gains (losses) on investments.

Mortgage loans on real estate are carried at unpaid balances, and 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 and losses which are considered other than temporary. 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. 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; and (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 are included in net realized gains and losses. 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 contractholders' funds, the deferred contract acquisition cost amortization is matched to the recognition of gross profit.

Otherwise, deferred contract acquisition costs on investment contracts are amortized using an accounting method that recognizes acquisition as expenses at a constant rate applied to net policy liabilities.

Property and equipment: Property and equipment are reported at cost, net of accumulated depreciation of $1,915,000 and $1,721,000 in 19X2 and 19X1, respectively, using the straight-line method of depreciation 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. Reserve interest assumptions are graded and range from 3% to 10%. 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.

Included in contractholders' account balances is a provision for contractholder dividends. Benefit liabilities for contractholders' 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% to 9.25%. 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.

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 and their reported amounts in the financial statements using enacted income tax rates and laws.

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 enterprises 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 contractholders' 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 contractholders who bear the investment risk. Investment income and investment gains and losses accrue directly to such contractholders. The assets of each account are legally segregated and are not subject to claims that arise out of any other business of the company. The assets and liabilities are carried at market value. Deposits, net investment income, and realized and unrealized capital gains and losses on separate account assets are not reflected in the Statements of Income of ABC and are reflected directly in separate account liabilities.

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 where 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, as well as 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 market value of these investments could have an adverse effect on the Company's balance sheet.

The Company regularly invests in mortgaged backed securities 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 mortgage backed securities 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.

2. Investments

The aggregate fair value, gross unrealized holding gains, gross unrealized holding losses and amortized cost for available for sale and held to maturity securities by major security type are as follows:

	December 31, 19X2 (amounts in thousands)			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held to maturity				
Total corporate debt securities	$44,864	$3,134	$ (168)	$ 47,830
Available for sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 2,340	$ 73	$ --	$2,413
Obligations of states of the U.S. and political subdivisions of the states	1,434	162	--	1,596
Corporate debt securities	142,075	7,109	(1,294)	147,890
Mortgaged-backed securities	101,676	2,673	(355)	103,994
Total	$ 247,525	$ 10,017	$ (1,649)	$255,893

ABC Life Insurance Company
Notes to Financial Statements - (continued)

Fixed maturities held in the "held to maturity" category are stated at amortized cost on the balance sheet.

Fixed maturities held in the "available for sale" category are stated at estimated fair value on the balance sheet.

The carrying amounts and estimated fair values of the company's fixed maturity investments at December 31, 19X1 are as follows:

	December 31, 19X1 (amounts in thousands)			
Held to maturity	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Total corporate debt securities	$46,310	$1,970	$(3,025)	$45,255
Available for sale				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$ 3,569	$ 63	$(29)	$3,603
Obligations of states of the U.S. and political subdivisions of the states	3,347	98	(1)	3,444
Corporate debt securities	138,831	1,818	(8,597)	132,052
Mortgaged-backed securities	73,818	1,989	(343)	75,464
Total	$ 219,565	$ 3,968	$ (8,970)	$214,563

ABC Life Insurance Company
Notes to Financial Statements - (continued)

The amortized cost and estimated fair value of debt securities for each investment category, by contractual maturity, are as follows (expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties):

	December 31, 19X2 (amounts in thousands)	
	Amortized Cost	Estimated Fair Value
Held to maturity		
Due in one year or less	$ 1,612	$ 1,700
Due after one year through five years	9,544	10,323
Due after five years through ten years	4,282	4,452
Due after ten years	--	--
	15,438	16,475
Other securities with multiple repayment dates	29,426	31,355
Total	$ 44,864	$ 47,830
Available for sale		
Due in one year or less	$ 1,088	$ 1,090
Due after one year through five years	21,753	22,626
Due after five years through ten years	83,057	86,244
Due after ten years	26,826	28,478
	132,724	138,438
Mortgaged-backed securities	101,676	103,994
Other securities with multiple repayment dates	13,125	13,461
Total	$ 247,525	$ 255,893

The Company owned $22,318,000 and $20,304,000 of fixed maturities considered below investment grade at December 31, 19X2 and 19X1, respectively. Investment grade is defined as "Baa" and higher on Moody's ratings and "BBB" and higher on Standard & Poor's bond ratings.

At December 31, 19X2 and 19X1, investments in bonds totaling $1,247,000 and $1,250,000, respectively, were on deposit with state insurance departments to satisfy regulatory requirements.

ABC Life Insurance Company
Notes to Financial Statements - (continued)

Proceeds, gross realized gains, and gross realized losses from the sales of available for sale securities follows:

	December 31,	
	19X2	19X1
	(amounts in thousands)	
Proceeds	$ 181,137	$ 50,561
Gross realized gains	5,132	769
Gross realized losses	(1,169)	(1,409)

The Company's equity investments in redeemable preferred stocks at December 31, 19X1, are carried at their estimated fair value of $4,190,000. At December 31, 19X1 gross unrealized depreciation pertaining to equity securities was $229,000.

Changes in the difference between market value and cost of investments were as follows (brackets denote excess of cost over estimated fair value):
The carrying amounts and fair values of the Company's investments in mortgages were as follows:

	December 31, 19X2		December 31, 19X1	
	(amounts in thousands)			
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Commercial	$81,849	$82,910	$103,686	$106,179
Residential	596	596	5,960	5,848
	82,445	83,506	109,646	112,027
Less allowance for mortgages losses	(3,187)	---	(2,954)	---
	$79,258	$83,506	$106,692	$112,027

Mortgages are stated at their aggregate unpaid balances, less an allowance for loan losses of $3,187,000 (19X2) and $2,954,000 (19X1). Activity in the allowance for mortgage loss is summarized as follows:

	19X2	*19X1*
	(amounts in thousands)	
Balances at the beginning of the year	$ 2,954	$ 3,200
Provisions for potential mortgage loan losses	668	3,145
Losses charged against the mortgage loan loss reserve	(435)	(3,391)
Balance at the end of the year	$ 3,187	$ 2,954

The Company's mortgage portfolio is monitored closely through the review of loan and property information such as debt service coverage, annual operating statements, and property inspection reports. This information is evaluated in light of current economic conditions and other factors such as geographic and property-type loan concentrations. This evaluation is part of the regular review to determine whether adjustments to the allowance for potential loan losses are warranted. Management believes the mortgage loss reserve is sufficient to provide for potential loan losses. However, management cannot predict with assurance impact of future economic circumstances or how the mortgage and real estate portfolios would be affected by various economic circumstances.

Impairment of loans having carrying values of $4,524,000 in 19X2 and $3,962,000 in 19X1 has been recognized in conformity with FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. The total allowance for credit losses related to those loans was $900,000 and $850,000 in 19X2 and 19X1, respectively. For impairment recognized in conformity with FASB Statement No. 114, the entire change in present value of expected cash flows is reported as bad debt expense in the same manner in which impairment initially was recognized or as a reduction in the amount of bad debt expense that otherwise would be reported.

The Company's mortgage loan portfolio is highly concentrated in the northeast section of the country. Approximately 58% of the Company's mortgages are in the Middle Atlantic region, predominantly New York City and State, with the remainder of the portfolio being fairly evenly dispersed among other geographic regions. The Company invests in a diversity of mortgages consisting of office, apartment, retail, industrial, and residential loans. Greater than 52% of these mortgages are invested in apartment and retail type investments. It is the Company's policy to generally obtain a first mortgage on properties for which the loan to value of collateral ratio is less than 75%.

At December 31, 19X2, the Company had six commercial real estate loans, with an aggregate principal balance of $14,765,000 and accrued interest of $1,950,000 which were 60 days or more delinquent. All of these loans were in process of foreclosure. Included in the commercial real estate loans are loans with an aggregate principal balance of $8,092,000 that were non-income producing for the twelve-month period ending December 31, 19X2. At December 31, 19X2, the Company had established a mortgage loss reserve of $3,187,000 as an allowance for potential mortgage losses.

Real estate acquired through foreclosure or "in-substance foreclosure" during the year at December 31, 19X2 and 19X1 amounted to $410,000 and $147,000.

3. Net Investment Income

Revenues in the accompanying statement of income for the years ended December 31, 19X2 and 19X1 include net investment income from the following sources:

	19X2	*19X1*
	(amounts in thousands)	
Fixed maturities	$22,049	$20,581
Preferred stock	--	736
Mortgage loans	9,035	11,763
Real estate	817	105
Policy loans	3,159	3,461
Short-term investments	411	456
Other	41	17
	35,512	37,119
Investment expenses	2,514	1,978
Net investment income	$32,998	$35,141

Net realized investment gains (losses) by class of investment are summarized as follows:

	19X2	*19X1*
	(amounts in thousands)	
Fixed maturities	$5,192	$340
Preferred stock	(324)	101
Mortgage loans	(632)	(3,132)
Real estate	16	--
Short-term investments	(2)	--
Other	(28)	21
Net realized gains or (losses)	$4,222	$(2,670)

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 contractholders 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:

	19X2		19X1	
	(amounts in thousands)			
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Mortgage loans on real estate	$79,258	$83,506	$106,692	$112,027
Policy loans	43,549	60,000	51,013	59,000

5. Income Taxes

Significant components of the provision for income taxes attributable to continuing operations are as follows:

	19X2	19X1
	(amounts in thousands)	
Current income tax expense	$1,547	$601
(Prepaid) deferred income tax (benefit) expense	(1,405)	540
Total income tax expense	$ 142	$ 1,141

ABC Life Insurance Company
Notes to Financial Statements - (continued)

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 (in thousands):

	December 31, 19X2	December 31, 19X1
	(amounts in thousands)	
Deferred tax liabilities:		
Deferred policy acquisition costs	$ 13,131	$ 12,297
Future policy benefits	--	512
Accrual of discount on bonds	924	1,982
Other	3,641	1,024
Total deferred tax liabilities	17,696	15,815
Deferred tax assets:		
Policyholder dividends	9,887	10,169
Future policy benefits	851	--
Deferred policy acquisition costs	2,078	1,561
Investment valuation reserves	1,087	1,651
Retirement plan accruals	1,917	497
Investment income differences	574	556
Other	406	354
Total deferred tax assets	16,800	14,788
Valuation allowance for deferred tax assets	(516)	--
Net deferred tax assets	16,284	14,788
Net deferred tax liabilities	$ 1,412	$ 1,027

ABC Life Insurance Company
Notes to Financial Statements - (continued)

A reconciliation of the provision for federal income taxes as presented in the financial statements and income taxes calculated using the statutory corporate tax rate follows:

	(amounts in thousands)	
	19X2	*19X1*
Income from operations	$2,396	$2,870
Application of income tax rate	838	1,005
Small company deduction for life insurance companies	(694)	(496)
Policyholders' share of income (loss) in excess of (less than) dividends paid	(364)	752
Dividend received deduction	(3)	(50)
Change in valuation allowance	338	--
Other	27	(70)
Total tax expense	$ 142	$ 1,141

6. **Financial Instruments with Off-Balance-Sheet Risk and Concentrations of Credit Risk**

ABC enters into interest rate swap programs for the purpose of minimizing exposures to fluctuations in interest rates for certain assets and liabilities held. The notional amount of interest rate swaps outstanding at December 31, 19X2 and 19X1 was $500,000 million and $800,000, respectively. The amount at risk, on a present value basis, of terminating or replacing at current market rates outstanding interest rate swaps in a loss position at December 31, 19X2 was $10,000. For 19X2 and 19X1, net gains (losses) of $200,000 and $(13,592), respectively, were recorded in connection with interest rate swap activity.

At December 31, 19X2, ABC held unrated or less-than-investment grade corporate debt securities of $8,000, net of reserves for losses, with an aggregate market value of $7,500. Those holdings amounted to 3% of ABC's corporate debt securities investments and less than 1% 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, 19X2, 3% of such mortgages ($10,000) 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 $5,000.

7. Derivative Financial Instruments Held or Issued for Purposes Other Than Trading

The Company's principal objective in holding or issuing derivatives for purposes other than trading is asset-liability management. The operations of the Company are subject to a risk of interest-rate fluctuations to the extent that there is a difference between the amount of the Company's interest-earning assets and the amount of interest-bearing liabilities that mature or reprice in specified periods. The principal objective of the Company's asset-liability management activities is to provide maximum levels of net interest income while maintaining acceptable levels of interest-rate and liquidity risk and facilitating the funding needs of the Company. To achieve that objective, the Company uses a combination of derivative financial instruments, including interest-rate forwards, futures, forward rate agreements, swaps, options, caps, floors , and other conditional exchange contracts.

Interest-rate forward and futures contracts are commitments to either purchase or sell a financial instrument at a specific future date for a specified price and may be settled in cash or through delivery of the financial instrument. Forward rate agreements are forward-like contracts that settle in cash at a specified future date based on the differential between a specified market interest rate and a fixed interest rate applied to a notional principal amount.

An interest-rate swap is an agreement in which two parties agree to exchange, at specified intervals, interest payment streams calculated on an agreed-upon notional principal amount with at least one stream based on a specified floating-rate index. Interest-rate options are contracts that grant the purchaser, for a premium payment, the right to either purchase or sell a financial instrument at a specified price within a specified period of time or on a specified date from or to the writer of the option. Interest-rate caps and floors are option-like contracts that require the seller to pay the purchaser at specified future dates the amount, if any, by which a specified market interest rate exceeds the fixed cap rate or falls below the fixed floor rate, applied to a notional principal amount.

Interest-rate forward and swap agreements are used to modify the repricing characteristics of interest-earning assets, while options, caps, floors and other conditional exchange agreements are used to limit the interest expense associated with the Company's liabilities.

Income or expense on derivative financial instruments used to manage interest-rate exposure is recorded on an accrual basis as an adjustment to the yield of the related interest-earning assets or interest-bearing liabilities of the periods covered by the contracts. If a derivative financial instruments that is used to manage interest-rate risk is terminated early or results in a single payment based on the change in value of an underlying item, any resulting gain or loss is deferred and amortized as an adjustment to the yield of the designated assets or liabilities over the remaining periods originally covered by the derivative financial instrument.

Deferred gains totaling $675,000 at December 13, 19X2, resulting from terminated and expired option contracts are included in other liabilities and will be amortized as a reduction of interest expense from the Company's short-term liabilities over the next two years.

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 which have not yet been settled, claims reported subsequent to the balance sheet date which 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 adjustment expenses for the Company's health and disability coverages is summarized as follows:

	19X2	*19X1*
	(amounts in thousands)	
Balance at January 1	$ 81,638	$104,222
Less: reinsurance recoverables	4,021	13,831
Net balance at January 1	77,617	90,391
Amount incurred	334,699	370,409
Amount paid, related to		
Prior years	94,083	121,470
Current year	248,721	261,713
Total	342,804	383,183
Net balance at December 31	69,512	77,617
Plus: reinsurance recoverables	4,115	4,021
Balance at December 31	$ 73,627	$ 81,638

9. 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 includes premium amounts ceded/assumed to/from other companies.

ABC Life Insurance Company
Notes to Financial Statements - (continued)

	Direct Amount	Ceded to Other Companies	Assumed from Other Companies	Net Amount
	(amounts in thousands)			
19X2				
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	$6,660	$1,850	$3,400	$8,210
19X1				
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	$5,430	$1,890	$3,710	$7,250

10. 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 (State) Insurance Department), in any 12-month period is the greater of (i) net investment income for the preceding calendar year or (ii) 10% of contractholders' 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 19X3, based on statutory net investment income for 19X2, 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. Prescribed statutory accounting practices include state laws, regulations, and general administrative rules, as well as a variety of publications of the National Association of Insurance Commissioners (NAIC). Permitted statutory accounting practices 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. Furthermore, the NAIC has a project to codify statutory accounting practices, the result of which is expected to constitute the only source of "prescribed" statutory accounting practices. Accordingly, that project, which is expected to be completed in 19X3, will likely change the definitions of what comprises prescribed versus permitted statutory accounting practices, and may result in changes to the accounting policies that insurance enterprises use to prepare their statutory financial statements.

ABC Life Insurance Company
Notes to Financial Statements - (continued)

[Note: Although the following statutory financial information is not required to be disclosed in financial statements prepared in conformity with generally accepted accounting principles, insurance entities sometimes include such disclosures to facilitate use of those financial statements for purposes of filing with state regulatory authorities.]

The accounting practices of insurance companies are prescribed by certain regulatory authorities. Certain of these practices differ from the generally accepted principles used in preparing the financial statements of ABC.

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.

	19X2	*19X1*
	(amounts in thousands)	
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	$2,254	$1,729
Statutory surplus and capital stock	$65,388	$54,505
Asset valuation reserves	(1,054)	(1,972)
Statutory surplus, capital stock and asset valuation reserves	(875)	(967)
Adjustments:		
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	39,818	39,445
Postretirement benefits	(2,272)	(2,354)
Other, net	(1,110)	(1,932)
GAAP equity	$69,898	$58,954

11. Commitments and Contingencies

Future minimum rental payments, principally for administrative offices, under noncancellable operating leases at December 31, 19X2, are: 19X3, $1,113,000; 19X4, $1,064,000; 19X5, $1,011,000; 19X6, $976,000; 19X7, $976,000; and $3,906,000 thereafter. Rental expense was $1,164,000 in 19X2, and $1,184,000 in 19X1.

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.

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.

GAAP DISCLOSURES IN FINANCIAL STATEMENTS

Investments

1. Carrying amounts of investment securities on deposit with regulatory authorities should be disclosed.

2. The disclosure requirements of FASB Statement No. 115 require that for securities classified as available-for-sale, and separately for securities classified as held to maturity, entities disclose the aggregate fair value, gross unrealized holding gains, gross unrealized holding losses, and amortized cost basis by major security type as of each date for which statement of financial position is presented. 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
    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

3. Adjustments to deferred acquisition costs and other assets and liabilities as a result of including unrealized gains or losses as part of shareholders' equity should be disclosed.

Financial Instruments

4. The disclosure requirements of FASB Statement No. 105 and 107 as amended by FASB Statement No. 119 should be considered.

5. According to FASB Statement No. 119, entities should disclose financial instruments with off-balance sheet risk, financial instruments with concentrations of credit risk, and derivative financial instruments.

Assets and Liabilities Related to Reinsurance Transactions

6. Separate assets should be established for the following items related to reinsurance ceded:

    a. Estimated reinsurance receivables (relating to paid and unpaid claims and claims

incurred but not reported) arising from ceding transactions

b. Amounts paid to the reinsurer related to the unexpired portion of reinsured contracts (prepaid reinsurance premiums)

Deferred Acquisition Costs

7. According to FASB Statement No. 60, insurance entities should disclose in their financial statements the nature of acquisition costs capitalized, the method of amortizing those costs, and the amount of those costs amortized for the period.

8. According to EITF Issue No. 92-9, the SEC Observer of the meeting stated that if a public company acquires a life insurance entity accounted for as a purchase and the acquirer recognizes an asset for the present value of future profits (PVP) the following should be disclosed:

   a. A description of the company's accounting policy

   b. An analysis of the present value of future profits asset account for each year for which an income statement is presented, including the PVP balance at the beginning of the year, the amount of PVP additions during the year arising from acquisitions of insurance entities, the amount of interest accrued on the unamortized PVP balance during the year, the interest accrual rate, the amount of amortization during the year, the amount of any writeoffs during the year due to impairment and how those writeoffs were determined, and the PVP balance at the end of the year

   c. The estimated amount or percentage of the end-of-the-year PVP balance to be amortized during each of the next five years

Liabilities for Unpaid Claims and Claim Adjustment Expense for Accident and Health Insurance

9. According to FASB Statement No. 60, insurance entities should disclose the following in their financial statements:

   a. The basis for estimating the liabilities for unpaid claims and claim adjustment expenses

   b. 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 and the range of interest rates used to discount those liabilities

   c. Whether the insurance entity considers anticipated investment income in determining if a premium deficiency relating to short-duration contracts exists

10. SOP 94-5 states that for each period in which an income statement is presented the following should be disclosed:

   a. The balance in the liability for unpaid claims and claim adjustment expenses at the

beginning and end of the period presented, with, if net balances are presented, separate disclosure of the related amount of reinsurance recoverable

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

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 period and to insured events of the prior period

11. SOP 95-4 also requires entities to disclose the reasons for the change in the provision for incurred claims and claim adjustment expenses attributable to insured events of prior periods and whether additional premiums or return premiums have been accrued as a result of the prior-period effects.

12. EITF 93-5 states that, if liabilities are discounted, insurance entities should disclose the undiscounted amounts of the liability and any related recovery, and the discount rate used.

Liabilities for Future Policy Benefits

13. According to FASB Statement No. 60, requires insurance entities to disclose the methods and assumptions used in estimating the liability for future policy benefits and encourages disclosure of the average rate of assumed investment yields in effect for the current year.

Income Taxes

14. Insurance entities must 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.

Stockholder's Equity

15. According to FASB Statement No. 60, insurance entities should disclose the following in their financial statements the following information relating to stockholders' equity, statutory capital and surplus, and the effects of statutory accounting practices 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

16. For permitted statutory accounting practices that differ from prescribed practices, SOP 94-5 requires the disclosure of the following:

a. A description of the permitted statutory accounting practice

b. A statement that the permitted practice differs from prescribed practices or that prescribed practices do not address the transaction
c. The monetary effect on statutory surplus

17. When prescribed statutory accounting practices do not address the accounting for the specific transaction, SOP 94-5 requires disclosure of the following about the permitted accounting practice, excluding GAAP practices:

a. A description of the transaction and of the permitted statutory accounting practice used
b. A statement that prescribed statutory accounting practices do not address the accounting for the transaction

Participating Policies

18. According to FASB Statement No. 60, insurance entities should disclose the relative percentage of participating insurance, the method of accounting for policyholder dividends, and the amount of any additional income allocated in participating policyholders in their financial statements.

19. For life insurance contracts accounted for under SOP 95-1 entities are required to disclose the following:

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

Reinsurance

20. In compliance with FASB Statement No. 113, all insurance entities should disclose the following in their financial statements:

a. The nature, purpose, and effect of ceded reinsurance transactions on the insurance entities's transactions on the insurance entities's operations (ceding entities also should disclose the fact that the insurer is not relieved if its primary obligation to the policyholder is a reinsurance transaction)

b. For short-duration contracts, premiums from direct business, reinsurance assumed, and reinsurance ceded, on both a written and an earned basis; for long-duration contracts, premiums and amounts assessed against policyholders from direct business, reinsurance assumed and ceded, and premiums and amounts earned

c. Methods used for income recognition on reinsurance contract

d. The amount of earned premiums and recoveries recognized under reinsurance contracts in the statement of earnings, as separate line items or parenthetically, or disclose in the footnotes

21. A ceding entities should disclose concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premium under the provisions of FASB Statement No.105.

Mutual Life Insurance Entities

22. FASB Interpretation No. 40, as amended by FASB Statement No. 120, states that the following is to be disclosed:

    a. Significant accounting policies that are unique to mutual life insurance entities
    b. Other accounting matters not unique to mutual life insurance entities along with monetary amounts, if material that would be required under GAAP

SAP DISCLOSURES IN FINANCIAL STATEMENTS

23. AU 9623.60 -.79 states that when the statutory financial statements contain items that are the same as or similar to those in GAAP-basis financial statements, the disclosures necessary for GAAP-basis financial statements are appropriate.

24. Refer to the NAIC Annual Statement Instructions or the NAIC Model Rule (Regulation) Requiring Annual Audited Financial Reports for statutory footnote disclosures that are required in audited statutory financial statements by the NAIC.

Note: Public life insurance entities should refer to SEC Rule 7 of Regulation S-X for disclosure requirements.

Glossary

accidental death benefit. The benefit in addition to the death benefit that is paid on a life insurance contract if the death occurred due to 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 ninety days of the accident and be less than age sixty.

accumulation period. The time frame during which an annuitant makes premium payments or deposits to the life insurance entity.

acquisition cost. The expense of soliciting and placing new or renewal business on the life insurance entity's books. These costs vary with and are primarily related to the acquisition of insurance contracts, and generally include agent's commissions, underwriting expenses, medical report fees and other sales and marketing support services.

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 type of life insurance contract that allows the contractholder 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 (antiselection). The tendency for less desirable risks to seek or continue insurance, or to select options of settlement that are more favorable to them.

age at issue. See *issue age*.

agent. A representative of an insurance entity who writes and services new and renewal business. Agents may be employees or independent contractors.

agent's 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 policyholder dividends. Amount of dividends to policyholders calculated and paid each year, representing the policyholders' share of divisible surplus.

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 contract. A contract that provides fixed or variable periodic payments made from a stated or contingent date and continuing for a specified period, such as for a number of years or for life.

Also refer to *variable annuity contract*.

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. An annuity that includes a provision for benefit payments to vary in amount, according to the investment experience of the separate account in which the deposits or premium amounts paid to provide for this annuity are allocated.

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. Asset shares calculation 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 Statement that is filed with the various insurance departments. Such assets include agents' balances, furniture, fixtures, supplies, and equipment other than certain data-processing equipment.

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.

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. 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.

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 prior to its maturity.

ceding entity. The original or direct insurer who reinsures with another entity called the reinsurer or assuming entity.

cession. Insurance passed on to the reinsurer by the direct issuer or ceding entity. Frequently, under certain types of reinsurance agreements, each transaction is given a number called a cession number.

claim. A demand for payment of a contract benefit because of the occurrence of an insured event such as the death or disability of the insured or the maturity of an endowment or the incurrence of hospital or medical bills.

claim adjustment expenses. Expenses incurred in the course of investigating and settling claims. Claim adjustment expenses include any legal and adjusters' fees, and the costs of paying claims and all related expenses.

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' standard ordinary (CSO) 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 insurance contract.

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.

contractholder. 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 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.

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 be due to 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 where 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 contractholders equitably. This is understood to mean 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*.

cost recovery method. Under the cost recovery method, 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.

coverage period. See *contract period*.

credit life insurance. Insurance issued on the lives of borrowers to cover payment of outstanding loan balances in case of death.

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 type of term insurance that has a face value which decreases over a period of years.

deferred first year commission. A commission payable on monthly, quarterly, or semiannual premiums for the first contract year except the initial premium.

deferred premiums. The semiannual, quarterly, or monthly net valuation 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.

defined benefit plan. A benefit plan stating the amount of benefit to be received by the employee after retirement or the method of determining such benefits. The employer's contributions under such a plan are actuarially determined.

defined contribution plan. A benefit plan under which contributions are fixed in advance by formula, and benefits to retiring employees may vary.

deposit method. Under the deposit method 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.

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 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 contractholder 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 company pays on its dividend fund.

dividend option. The privilege allowed a contractholder 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.

dividends (to contractholders). Amounts distributed or credited to contract owners of participating contracts. Under the various state insurance laws, dividends must be apportioned to contractholders on an equitable basis. The dividend allotted to any contract should be 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 terminal dividends.

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.

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.

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 contractholders. 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 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 (FSA). 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.

fraternal benefit societies. An organization 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.

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.

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 one month (thirty-one 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. The premium specified by the insurance contract to be paid by the contractholder; also referred to as the *contract premium.* Also, refer to *net premium.*

gross premium reserve. A reserve determined by subtracting the present value of future gross premiums from the present value of future expenses and benefits.

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 renewable contract. An insurance contract where the insured has the right to continue in force by the timely payment of premiums that coincides approximately with the average working lifetime (for federal income tax purposes at least until age sixty), with the right reserved to the insurer to make changes in premium rates by classes. See also *noncancelable contract.*

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

that 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 but not reported (IBNR) claims. Claims relating to insured events that have occurred, but have not yet been reported to the insurer or reinsurer as of the date of the financial statements.

incurred 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, where 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.*

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 as installment premiums. (The basic premium in life insurance is an annual premium.)

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.

insurance risk. The risk arising from uncertainties about both (a) the ultimate amount of net cash flows from premiums, commissions, claims, and claim settlement expenses paid under a contract (often referred to as *underwriting risk*) and (b) the timing of the receipt and payment of those cash flows (often referred to as *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.

insured. The person on whose life an insurance contract is issued.

investment expenses. Expenses that are properly chargeable against investment income.

investment yield. The interest rate the company expects to earn on the assets supporting the policies, net of investment expense.

issue age. The age of the contractholder 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.

lapse rate. The rate at which insurance contracts terminate through failure of the insureds to continue making premium payments. The lapse rate may also be considered a rate of *non-persistence*. 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.

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.

liabilities, ledger. Liabilities traditionally recorded on the entity's general ledger. These generally consist of cash accounting transactions.

liabilities, nonledger. Liabilities traditionally not recorded on the entity's general ledger. These generally consist of noncash accounting transactions.

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. The liability for future policy benefits can be viewed as either (a) 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 (b) the accumulated amount of net premiums already collected less the accumulated amount of benefits and expenses already paid to or on behalf of policyholders.

liability for unpaid claims. The amount needed to provide for the estimated ultimate cost of settling claims relating to insured events that have occurred on or before a particular date (ordinarily, the balance sheet date). The estimated liability includes the amount of money that will be required for future payments of both (a) claims that have been reported to the insurer and (b) claims relating to insured events that have occurred but have not been reported to the insurer as of the date the liability is estimated.

life expectancy. The average number of years of life remaining for persons of a particular age according to a particular mortality table.

life insurance enterprise. An enterprise that can issue annuity, endowment, and accident and health insurance contracts as well as life insurance contracts. Life insurance enterprises may be either stock or mutual organizations.

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.

loading. An amount obtained by subtracting the net premium from the gross premium.

maintenance costs. Costs associated with maintaining records relating to insurance contracts and with the processing of premium collections and commissions.

master contract. Refers to 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.

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. The relative incidence of disability due to disease or physical impairment.

morbidity table. A statistical table showing the incidence, by age, of eligibility for a given sickness or accident benefit, based on the assumed morbidity which 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. The relative incidence of death in a given time or place.

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 which 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 contractholders 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 amount at risk. The face amount of the contract less the terminal reserve for the contract year.

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.

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. Refer to *gross premium*.

noncancelable contract. An insurance contract where 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 sixty) 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*.

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.

option. A contract allowing, but not requiring, its holder to buy (call) or sell (put) a specific or standard commodity or equity security or other financial instrument at a specified price during a specified time period or on a specified date.

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.

paid-up insurance. Insurance, including nonforfeiture paid-up insurance and paid-up additions purchased by dividends, on which all premiums have been paid and which 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 contractholders)*.

participating insurance. Insurance in which the contractholder is entitled to share in the entity's earnings through dividends that reflect the difference between the premium charged and the actual experience.

policy loan. A loan made by a life insurance entity to a contractholder 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. The tax, where applicable, is assessed as a percentage of premiums paid to the entity by contractholders residing in the state.

premiums in course of collection. Premiums due to the entity but unpaid.

prospective reinsurance. Reinsurance in which an assuming enterprise agrees to reimburse a ceding enterprise 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.

rated contract. An insurance contract issued at higher than 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.

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.

reinsurance. A process by which the reinsurer (assuming entity) agrees to indemnify the reinsured

(ceding entity) against risk insured by the reinsured for a reinsurance premium or other consideration. The reinsured may be referred to as the original direct insurer or the ceding entity.

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.

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 that an entity will retain at its own risk, on one life.

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. A reinsurance of reinsurance. For example, entity A cedes reinsurance to entity B who, in turn, reinsures with entity C all or part of the reinsurance assumed from entity A. The reinsurance ceded to entity C by entity B is called a retrocession.

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.

rider. Endorsement to an insurance contract that modifies clauses and provisions of the contract, either adding, excluding, or limiting coverage.

risk of adverse deviation. A concept used by life insurance enterprises in estimating the liability for future contract benefits relating to FASB Statement No. 60 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.

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.

separate accounts. Separate accounts constitute a separate operation from the general fund. The assets of the separate account are only available to fund the liabilities of variable annuity contractholders, pension funds, and others with contracts requiring premiums or other deposits

to the separate account.

<u>service fee.</u> 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.

<u>settlement option.</u> 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.

<u>settlement period.</u> The estimated period over which a ceding enterprise expects to recover substantially all amounts due from the reinsurer under the terms of the reinsurance contract.

<u>single premium.</u> A lump-sum consideration received by an insurance entity in accordance with an insurance or annuity contract.

<u>statutory.</u> Relating to the laws or regulations of the state government.

<u>statutory accounting practices (SAP).</u> Accounting principles required by statute, regulation, or rule, or permitted by specific approval, that an insurance enterprise is required to follow when submitting its financial statements to state insurance departments.

<u>statutory reserve.</u> 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.

<u>stock life insurance entities.</u> 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.

<u>subrogation.</u> 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.

<u>substandard insurance.</u> 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.

<u>suicide clause.</u> 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.

<u>supplementary contract.</u> 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.

<u>supplementary contract without life contingencies.</u> 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 type.

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 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.

term insurance. Insurance providing for a death benefit only if the insured dies within the period of time specified in the contract. Coverage can be level or reducing amounts for stated periods such as one, five, or ten years or to a stated age. It provides life insurance protection for a temporary period of time and, therefore, is the least expensive. There are generally no loan or cash values. A term contract may be convertible, that is, it may grant the privilege of exchange without medical examination, for permanent insurance on the whole life or endowment plan. It may also be renewable at the option of the insured without furnishing evidence of insurability (guaranteed renewable).

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. 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.

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 persistency, which

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.

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 who 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.

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 (IBNR) claims*.

valuation premium. See *net premium*.

variable annuity contract. An annuity that includes a provision for benefit payments to vary according to the investment experience of the separate account in which the amounts paid to provide for this annuity are allocated.

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.

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.