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1995

# Letters for state insurance regulators to comply with the NAIC Model Audit Rule ; Statement of position 95-4;

American Institute of Certified Public Accountants. Insurance Companies Committee

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**STATEMENT OF  
POSITION 95-4**

**AICPA**

**November 3, 1995**

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

Amendment to  
AICPA Audit and Accounting Guide  
*Audits of Property and Liability  
Insurance Companies*  
and AICPA Industry Audit Guide  
*Audits of Stock Life Insurance Companies*

*Prepared by the  
Insurance Companies Committee and  
Approved by the Audit Issues Task Force  
of the Auditing Standards Board*

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## NOTE

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

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Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.*

1 2 3 4 5 6 7 8 9 0 AudS 9 9 8 7 6 5

December 5, 1995

Dear Team AICPA Member:

AICPA recently distributed to you a copy of Statement of Position 95-4, *Letters for State Insurance Regulators to Comply with NAIC Model Audit Rule* (Product Code Number 014892).

An error was found in this printing. The error was contained in paragraph number 13. In this paragraph, the document is referred to as a *proposed* rather than a *final* SOP. This is a final SOP. The corrected sentence reads as follows:

13. This SOP should be applied to audits of statutory financial statements performed for periods ending on or after December 15, 1995. Early application is encouraged.

Please discard the earlier AICPA product and replace it with the newly reprinted version (enclosed).

Sincerely,

  
Blanche Regan,  
Manager, Member Services

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## SUMMARY

This Statement of Position (SOP) provides guidance to auditors on the form and content of communications with state insurance regulators; such communications are required by the National Association of Insurance Commissioners (NAIC) *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).

This SOP amends chapter 9, "Auditor's Reports," of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and chapter 11, "Auditors' Reports," of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*. It is effective for audits of statutory financial statements for periods ending on or after December 15, 1995.

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

## Introduction

1. This Statement of Position (SOP) provides guidance to auditors on the form and content of communications with state insurance regulators. Such communications are required by the National Association of Insurance Commissioners (NAIC) *Annual Statement Instructions Requiring Annual Audited Financial Statements*, which incorporates the January 1991 *Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in July 1995) (hereinafter called the Model Audit Rule). The Model Audit Rule was designed by the NAIC to promote uniformity in state laws and regulations dealing with audits of insurance enterprises' statutory financial statements. Though some states have laws or regulations that differ from the Model Audit Rule, this SOP addresses only the requirements of the Model Audit Rule.

2. To the extent that the Model Audit Rule is changed in the future, the illustrations in this SOP may need to be changed to reflect the revised provisions of the Model Audit Rule. For example, at the time of this SOP, the NAIC is in the process of codifying statutory accounting practices for certain insurance enterprises. The *Annual Statement Instructions Requiring Annual Audited Financial Statements* currently requires that statutory financial statements be prepared using accounting practices prescribed or otherwise permitted by the insurance department of the state of domicile. It is expected that when the NAIC completes the codification of statutory accounting practices, the Model Audit Rule will be amended to require auditors to express opinions on statutory financial statements as to their conformity with the newly codified statutory accounting principles rather than as to their conformity with statutory accounting practices prescribed or permitted by the insurance department of the state of domicile.

## Scope

3. This SOP applies to audits of financial statements of all insurance companies that file audited financial statements with state insurance departments in accordance with the NAIC's Model Audit Rule. It amends the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*.<sup>1</sup>

## Conclusions—Form and Content

### **Awareness**

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

- a. Is aware of the provisions of the insurance code and the rules and regulations of the insurance department of the state of domicile that relate to accounting and financial matters.
- b. Will issue a report on the financial statements in terms of their conformity to the statutory accounting practices prescribed or otherwise permitted by the insurance department of the state of domicile, specifying exceptions as appropriate.

5. The following is an illustration of the awareness letter:

To the Board of Directors of ABC Insurance Company:

We have been engaged by ABC Insurance Company (the Company) to perform annual audits in accordance with generally accepted auditing

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<sup>1</sup> The AICPA has a project under way to prepare an Audit and Accounting Guide, *Audits of Life and Health Insurance Entities*, which covers audits of mutual life insurance companies as well as stock life insurance companies. The new Audit and Accounting Guide would replace the Industry Audit Guide *Audits of Stock Life Insurance Companies* and would incorporate the guidance in this Statement of Position.



standards of the Company's statutory financial statements. In connection therewith, we acknowledge the following:

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

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

### ***Change in Auditor***

6. Section 6 of the Model Audit Rule requires that insurers notify the insurance department of the state of domicile within five business days of the dismissal or resignation of the auditor for the immediately preceding filed audited statutory financial statements. Within ten business days of that notification, the insurer also is required to provide a separate letter stating whether, in the twenty-four months preceding that event, there were any disagreements, subsequently resolved or not, with the former auditor on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of the former auditor, would have caused the auditor to make reference to the subject matter of the disagreement in connection with the auditor's opinion. The Model Audit Rule requires that the insurer provide the insurance department of the state of domicile a letter from the former auditor to the insurer indicating whether the auditor agrees with the statements in the insurer's letter and, if not, stating the reasons for the disagreement.

7. The following is an illustration of the change in auditor letter:

To the Board of Directors of DEF Insurance Company:

We previously were auditors for DEF Insurance Company and, under the date of [*report date*], we reported on the statutory financial statements of DEF Insurance Company as of and for the years ended December 31,

19X1 and 19X0.<sup>2</sup> Effective [date of termination], we are no longer auditors of DEF Insurance Company. We have read DEF Insurance Company's statements in its letter dated [date of insurer's letter], which is attached hereto, and we agree with the statements therein. [However, if the auditor is (a) not in a position to agree or disagree or (b) does not agree with the insurer's statement, the auditor's letter 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.]<sup>3</sup>

### **Qualifications**

8. 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 requirement of the Model Audit Rule and that the domiciliary commissioner will be relying on the information in the monitoring and regulating of the financial position of insurers.
- d. The auditor consents to the workpaper requirements contained in the Model Audit Rule and agrees to make the workpapers available

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<sup>2</sup> 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.

<sup>3</sup> The insurer's letter may contain a statement, such as—

In connection with the audits of the statutory financial statements of the Company for the years ended December 31, 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.

for review by the domiciliary commissioner or the commissioner's designee under the auditor's control.<sup>4</sup>

- e. The engagement partner is licensed by an appropriate state licensing authority and is a member in good standing of the AICPA.
- f. The auditor meets the qualifications and is in compliance with the "Qualifications of Independent Certified Public Accountant" section of the Model Audit Rule.

9. The following is an illustration of the qualification letter:

To the Board of Directors of GHI Insurance Company:

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

- a. We are independent certified public accountants with respect to the Company and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the [*state*] Board of Public Accountancy.
- b. The engagement partner and engagement manager, who are certified public accountants, have [ ] years and [ ] years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most (some) of whom have had experience in auditing insurance enterprises and [X] percent of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.
- c. We understand that the Company intends to file its audited statutory financial statements and our report thereon with the Insurance Department of [*name of state of domicile*] and other state insurance departments in states in which the Company is licensed and that the insurance commissioners of those states will be relying on that information in monitoring and regulating the statutory financial condition of the Company.

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<sup>4</sup> Refer to AICPA, *Professional Standards*, vol. 1, AU sec. 9339, *Working Papers: Auditing Interpretations of Section 339*.

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 insurance commissioners should understand that the objective of an audit of statutory financial statements in accordance with generally accepted auditing standards is to form an opinion and issue a report on whether the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus, results of operations and cash flow in conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile]. Consequently, under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to design our audit to obtain reasonable assurance that errors and irregularities that have a material effect on the statutory financial statements will be detected and to exercise due care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting irregularities. Because of the characteristics of irregularities, particularly those involving forgery and collusion, a properly designed and executed audit may not detect a material irregularity. In addition, an audit does not address the possibility that material errors or irregularities may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of the Company to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control structure that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile].

The Insurance Commissioner should exercise due diligence to obtain whatever other information that may be necessary for the pur-

pose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditor's report.

- d. We will retain the workpapers prepared in the conduct of our audit until the Insurance Department of [name of state of domicile] has filed a Report of Examination covering 19X1, but not longer than seven years, and, on instructions from the Company, will make them available for review by the Insurance Department of [name of state of domicile].<sup>5</sup>
- e. The engagement partner has served in that capacity with respect to the Company since [year that current "term" started], is licensed by the [state name] Board of Public Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.
- f. To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC'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.

### **Notification of Adverse Financial Condition**

10. Section 10 of the Model Audit Rule requires that the auditor notify the insurer's board of directors or audit committee in writing within five business days of a determination that (a) the insurer has materially misstated its financial condition as reported to the domiciliary commissioner as of the balance-sheet date currently under examination or (b) the insurer does not meet the minimum capital and surplus requirements of the state insurance statute as of the balance-sheet date. The Model Audit Rule also requires the insurer to provide (a) to the insurance commissioner of the state of domicile a copy of the notification of adverse financial condition within five days of its receipt and (b) to the auditor evidence that the notification has been provided to the insurance commissioner. If the auditor receives no such evidence, the Model Audit Rule requires the auditor to send the notification to the insurance commissioner directly within the next five business days.

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<sup>5</sup> See note 4.

11. The following is an illustration of the auditor's notification of adverse financial condition letter when the audit is complete:<sup>6</sup>

To the Board of Directors of MNO Insurance Company:

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

In connection with our audit, we determined that capital and surplus reflected in the statement of admitted assets, liabilities, and capital and surplus of the Company as of December 31, 19X1, as reported on the 19X1 Annual Statement filed with the Insurance Department of [name of state] is materially misstated because [provide explanation]. Statutory capital and surplus of \$\_\_\_ reported on the 19X1 Annual Statement should be reduced by \$\_\_\_ as a result of the matter in the preceding sentence.<sup>7</sup>

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

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

### **Report on Internal Controls**

12. 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 structure noted during the audit. Auditors should follow the guidance in Statement on Auditing Standards No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). Additionally, the Model Audit

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<sup>6</sup> A determination that financial statements filed with a state insurance department contain a material misstatement does not necessarily always occur when an audit is complete. The Model Audit Rule requires notification to be provided within five business days of such determination. The language in this illustrative letter should be modified depending on the relevant facts and circumstances.

<sup>7</sup> The wording of this paragraph is intended for those situations in which audit adjustments would not cause minimum capital and surplus of an insurer to fall below statutory requirements. The paragraph 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.

Rule requires insurers to provide a description of remedial actions taken or proposed to correct significant deficiencies, if not covered in the auditor's report. The reports on internal controls should be filed by the insurer within sixty days after filing the annual audited financial statements. No report is required to be issued if the auditor does not identify significant deficiencies.

### **Effective Date**

13. This SOP should be applied to audits of statutory financial statements performed for periods ending on or after December 15, 1995. Early application is encouraged.

**Insurance Companies Committee**  
(1994–1995)

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