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# Auditing Group Accounts in Examining Life Insurance Company Financial Statements

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**I**N AUDITING the accounts of life insurance companies the principal objective of the independent certified public accountant is to perform the work necessary for him to express an opinion on the financial statements as a whole. His approach usually is to examine the accounts arising from group operations as they relate to the financial statements rather than the accounts related to group operations as a unit; that is, he tests group premium income as a part of the examination of all types of premium income and tests group claims paid as part of the examination of all types of claims paid.

## ESSENTIAL AUDITING PHASES—GENERAL

The essential phases of auditing, in their modern concept, applicable generally to most business organizations are four. Briefly, they are: (1) evaluation of internal control; (2) minimum auditing tests; (3) analytic review; and (4) additional auditing tests.

### Evaluation of Internal Control

Internal control has been defined by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants as:

. . . the plan of organization and all of the coördinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

The basic concept of internal control appears to me to be the segregation of duties and responsibilities so that the activities of one individual or unit serve to check on the activities of another individual or unit. In this way the likelihood of significant errors or irregularities is minimized, and the temptation that may be present if one individual is in complete charge of an entire transaction is removed.

The evaluation of internal control ordinarily comprises (1) the use of charts or the equivalent to show the flow of basic accounting transactions; (2) the physical observation of organizational structure; (3) inquiry of employees concerning their duties; (4) the identification of those

units of the organizational structure functioning as control units; and (5) the determination of whether the indicated internal control is adequate and, if not, in what respects it is inadequate. Where the internal control does not appear adequate the independent accountant is in a position to make suggestions to management for its strengthening.

Internal control is generally considered adequate if it appears that the interrelation of the control units is such as to prevent or detect significant clerical errors or irregularities. Because the basic concept of internal control is that one individual or unit checks upon another, it is not economically practical for internal control to be so extensive as to prevent or detect irregularities that might be perpetrated through the collusion of two or more individuals.

If a company does not have written evidence of its organization and procedures, internal control can be a time-consuming operation requiring the painstaking assembly of information obtained by interviewing employees and observing the flow of transactions through control units.

In many larger organizations the internal auditor will have studied and evaluated internal control in great detail. In these instances the independent accountant may review the internal auditor's survey of internal control and with a minimum of initial investigation can frequently place considerable reliance upon his evaluation. Obviously such a situation tends to eliminate duplication of effort and to enable the independent accountant to make more effective use of his time.

### **Minimum Auditing Tests**

The second phase is the application of minimum auditing tests sufficient to ascertain that the prescribed internal control procedures, as determined in the first phase, are in fact being performed as prescribed. If minimum auditing tests indicate that not all internal control procedures are in fact being performed as prescribed, additional tests may be required.

Where a company sets forth its established procedures in a procedural manual or other written form, such procedures are more likely to be known and followed by its employees.

### **Analytic Review**

An analytic review is the accountants' term for the comparison of items and ratios that should be comparable, the investigation of significant fluctuations, and the consideration of possibilities of errors or irregularities.

The analytic review is applied principally to operating accounts by making comparisons from month to month and from year to year in order to determine fluctuations and trends in the accounts. Unusual fluctuations

are investigated and discussed with appropriate employees. Where such investigations or discussions are not conclusive, it is necessary to apply further audit tests. The investigation of the unusual fluctuations, of course, requires the use of judgment and imagination.

### **Additional Auditing Tests**

The fourth phase supplements the first three phases and requires the application of additional auditing tests in those areas where the prescribed internal control is not adequate, where the minimum auditing tests applied indicate that the internal control is not functioning as prescribed, or where the investigation of significant fluctuations in the analytic review is not conclusive. Additional auditing tests would also be applied where very substantial losses might be sustained as a result of collusion among individuals or ineffectiveness of the system of internal control. For example, it is doubtful that any accountant would forgo the counting of a large amount of currency irrespective of how good the internal control might be.

### **RELIANCE UPON INTERNAL AUDITOR**

Previously I have mentioned the reliance the independent accountant may, under certain conditions, place upon the evaluation of internal control by the internal auditor. The independent accountant considers the work of the internal auditor an essential component of internal control, and in this connection the independent accountant is interested in learning the scope and extent of the internal auditor's work. To form an opinion of the internal auditor's work, the independent accountant will frequently read the internal auditor's reports and programs and perhaps in some instances refer to his working papers. As a result of the internal auditor's work, the independent accountant may well be able to limit the extent of his detail audit tests. The internal auditor's detail audit tests do not substitute, however, for detail audit tests by the independent accountant because the latter must make some tests in order to determine that the prescribed internal control procedures are in fact being performed as prescribed and to satisfy himself that the internal auditor's tests were properly performed.

One part of the internal auditor's work that the independent accountant considers particularly important in internal control is the examination of the policyholders' own records relating to group contracts. It is only by examining the group policyholders' records that substantially conclusive assurance can be obtained of the proper receipt of premiums, of the correctness of individual coverages, and of the eligibility of claimants under the contracts. The internal auditor's examination of the policyholders' records is the principal means of establishing the degree of reliance that

may be placed upon the data submitted to the insurer by the group policyholder.

### **ESSENTIAL AUDITING PHASES—GROUP OPERATIONS**

The evaluation of internal control (the first phase) entails a comprehensive review of the aspects of group operations affecting accounting. Such a review would include the handling of premium billings and premium collections for both self-accounting groups and home-office accounting groups, the processing of claims by both the home office and field offices, the computation and payment of commissions, and the determination and payment of dividends. The review would also include the procedures for determining the premiums due and the claims unpaid at the year end. Because of the complexities in group operations, particularly in large life insurance companies, the evaluation of internal control for the group lines of business could well be a substantial undertaking.

Minimum auditing tests (the second phase) would of course be applied to each type of group transactions and to year-end assets and liabilities in which the internal control had been evaluated as satisfactory.

Traditionally, auditors have determined the items to be examined by the selecting from a segment of the transactions or accounts, all of the larger amounts together with a representative number of smaller amounts. For example, the selection might consist of all group death claims of \$10,000 or over and every fiftieth group death of less than \$10,000. This method of selection emphasizes the more important items.

In recent years many auditors have adopted statistical sampling techniques to select items to be examined. These techniques are based on the application of concepts of mathematical probability. The development of a statistical sampling plan for use in auditing may be expected to require extensive study and the assistance of mathematicians. The examination and evaluation of a sample selected by the application of statistical techniques enables the auditor to express an opinion on the reliability of the population from which the sample was selected. For example, a sample of group health claims examined might be evaluated as providing at least 95 per cent reliability that the total health claims for a period were not overstated by more than \$25,000.

The analytic review (the third phase) requires the preparation of analyses of detail operating accounts relating to group business. Group premiums might be spread by line of business for each month of the year and compared with the premiums for one or more of the preceding years and with statistics as to insurance-in-force and possibly commissions paid. Similarly, claims paid might be spread by type of benefit for each month

of the year and compared with the claims paid by months in prior years. Unusual fluctuations observed would be discussed with appropriate employees and if necessary investigated by further audit tests or perhaps detailed analysis.

Additional audit tests (the fourth phase) would be applied in any instance where the internal control was not satisfactory, as in a claim office where one individual handles all aspects of a particular type of claim. Additional audit tests would also be applied in instances where the minimum audit tests indicated an undue number of errors or errors of particular significance. For example, a health claim clerk might have been found to have been approving claims exceeding the maximum benefit allowable; in this case it would be necessary to extend the test of claims processed by this individual and to examine sufficient additional claims to determine whether other health-claim clerks were making the same error. I have previously indicated that the results of the analytic review might require additional audit tests. For example, group life insurance premiums for a particular month might show a sharp increase due to the erroneous classification of a number of group annuity considerations as group insurance premiums; assuming that this fluctuation could not be accounted for by supplementary statistical data or explained by responsible employees, additional tests of premiums would be made to determine its cause.

In addition to the auditing techniques I have discussed, the independent accountant would make the usual tests of footings and postings of books of original entry and year-end inventories of premiums due, unpaid claims, etc., pertaining to group operations just as he would with similar records pertaining to all the other operations of the company.

The specific detailed procedures followed by independent accountants in examining the various types of vouchers and other documents relating to group operations are similar to those made by the internal auditors and with these you are of course familiar.

