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Insurance Industry Developments—1994

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

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of insurance companies with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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The staff of the AICPA is grateful to the members of the AICPA Insurance Companies Committee for their contribution to this document.

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Insurance Industry Developments—1994

Industry and Economic Developments

In 1994, economic conditions in the United States have exhibited signs of gradual improvement. However, accompanying this positive news has been a concern that the economy's growth prospects would bring inflationary pressures. The effects of those concerns have been evident in the higher interest rates throughout the year. Such economic conditions have varying effects on insurance companies.

Property and Casualty Insurers

Profits for property and casualty insurers in the first half of 1994 have been weak, largely due to the following.

Record-High Catastrophe Losses. The most devastating catastrophes of 1994 were the Northridge, California, earthquake and the severe storms and low temperatures that swept over the Eastern Seaboard early this year, both of which contributed to the approximately $8.56 billion in catastrophe claims during the first part of 1994. Furthermore, claims costs, especially legal fees, related to noncatastrophic events continue to increase, particularly for environmental-related claims.

Weak Premium Growth. 1994 was, for the seventh straight year, characterized by a soft insurance market. Although the improving economy and large catastrophe claims in 1994 were expected to strengthen market conditions, only certain personal and commercial property lines showed signs of improvement. Offsetting the negative conditions is the improved capacity in the reinsurance market, which is expected to make it more cost-effective for companies to obtain reinsurance.

Declining Investment Yields. Average investment yields declined in the first part of 1994 for property and casualty insurers and are expected to average less than 6 percent for 1994. Realized capital gains, generated in large part by bond portfolios, had a major positive effect on property and casualty insurers' earnings in 1993. However, the bond sales that resulted in those gains are now being reflected in lower investment returns in 1994, because insurers reinvested the proceeds in lower

yielding securities. Furthermore, unrealized capital gains embedded in the industry's bond portfolio, which for the past several years has been a source of strength, were diminished. Moreover, higher interest rates in 1994 have resulted in significant unrealized capital losses, which are not expected to be offset by higher yields on new investments in bond portfolios.

Life and Health Insurers

Profits for the life and health insurance industry continued to improve during the first half of 1994, primarily as a result of general economic factors that have positively affected consumer demand. Much of the recent premium growth has been in individual annuities, group pension sales (particularly separate accounts), and estate planning and investment-oriented life insurance products. Sales of such products do well in a low-interest rate environment, but are negatively affected by higher interest rates. Offsetting those positive conditions are the following.

Competitive Pressures. Banks, mutual funds, and health maintenance organizations are aggressively trying to expand into products traditionally sold by insurance companies. Furthermore, competitive pressures have made expense reduction and consolidations high priorities for many life and health insurers.

Increased Asset/Liability Management Risk. Asset/liability management risk could negatively affect future profitability and cash flows of life and health insurers. The declining investment yields that have affected property and casualty insurers, discussed above, have also had a negative effect on life and health insurers. Although much new money is being invested in higher quality fixed-income investments, many life and health insurers have reacted to the lower interest rates of the past several years by purchasing some riskier nontraditional investments that offer the potential for higher yields. A number of life and health insurers have large holdings of investments, such as collateralized mortgage obligations (CMOs) and mortgage-backed securities (MBSs), which are particularly susceptible to interest-rate volatility. Furthermore, higher interest rates in 1994 have resulted in increases in the sales of interest-sensitive products that include embedded options.

Consumer-Related Market Conduct Challenges. The sales practices of a number of life insurance agents are coming under severe public and regulatory scrutiny. The existence of such practices could result in

policyholder lawsuits against the underwriters and loss of future business. Even though federal health-care reform was not passed by Congress in 1994, a number of states have enacted or are proposing health-care reform measures. The potential impact on insurers remains extremely uncertain. The effect of the health-care debate on the industry is exemplified by the shift from traditional health plans to managed care plans. Furthermore, the risk exists that health-care reform will restrict premium increases and underwriting abilities leading to reduced profit margins.

Impact on Audit Risk

In planning the audit, auditors should consider how changes in insurance companies' businesses in response to industry and economic developments may affect audit risk. Although the economic and industry conditions discussed above affect different companies in different ways, indicators of the higher overall audit risk that may result from these conditions and that auditors should be alert to include the following:

- Pressure on margins and the bottom line
- Loss of business
- Reduced levels of capital
- Loosening of underwriting standards
- Unsound pricing and interest crediting strategies
- Use of surplus enhancement measures
- Restructurings resulting in reductions of staff levels
- Lowering of debt and claims-paying ratings
- Liquidity and duration problems
- Increased exposure to credit risk

Regulatory Developments

The regulatory developments contained in this section include matters that affect audits of statutory financial statements.

Risk-Based Capital

The National Association of Insurance Commissioners (NAIC) has developed a risk-based capital (RBC) program, which is used by state insurance departments to set guidelines for appropriate and timely

regulatory actions relating to insurers that show signs of weak or deteriorating financial condition. The NAIC's RBC instructions contain formulas—which differ for life and health, and property and casualty insurance companies—for determining RBC levels that should be maintained and for linking various levels of RBC to specified regulatory corrective actions.

Insurance enterprises are required to disclose the total adjusted capital RBC and the authorized control level capital RBC, which are defined in the NAIC instructions, in their statutory filings for the year ended December 31, 1994. Furthermore, insurance companies may disclose RBC in their financial statements prepared in accordance with generally accepted accounting principles (GAAP). (See the section entitled *Accounting Developments* for a discussion of an AICPA statement of position (SOP) disclosure of certain matters in the financial statements of insurance enterprises and the section entitled *Audit Developments* for discussion of AICPA SOPs on auditors' consideration of RBC.)

Codification of Statutory Accounting Principles

Insurance companies currently prepare statutory financial statements in accordance with the accounting principles and practices prescribed or permitted by the insurance department of their state of domicile. Nevertheless, prescribed statutory accounting practices (SAP) do not address all accounting issues and may differ from state to state. Therefore, 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 companies. The AICPA's Insurance Companies Committee has encouraged the NAIC to complete the codification as soon as possible to achieve the consistency and comparability that is currently lacking in SAP for insurance companies. Because codification will not be effective by the end of the year, auditors may continue to report on statutory financial statements prepared in conformity with accounting practices prescribed or permitted by the insurance department of the state of domicile. (See the section entitled *Audit Issues* for further discussion about permitted SAP.)

Supplemental Schedule of Assets and Liabilities for Life Insurers

The NAIC's 1994 Life, Accident, and Health Annual Statement Instructions (Annual Statement Instructions) require a supplemental schedule of assets and liabilities, which is illustrated in paragraph 9 of

the instructions, to be included with the audited annual statutory financial statements of life and health insurers. The instructions also require auditors to issue a report on the supplemental schedule that states whether the information is fairly presented in relation to the financial statements taken as a whole. The AICPA Insurance Companies Committee has reviewed the information currently required to be included in the supplemental schedule and believes that all the information is either directly related to the financial statements or derived from accounting records that are subject to testing by auditors. Accordingly, in reporting on the supplemental schedule, auditors should follow the guidance in Statement on Auditing Standards (SAS) No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards,* vol. 1, AU sec. 551).

Reinsurance Accounting

The NAIC's property and casualty reinsurance study group has revised the reinsurance section of the NAIC's Accounting Practices and Procedures Manual and is expected to have the revised chapter approved at the December 1994 NAIC meeting. The revisions, which would apply the risk transfer and most of the accounting concepts of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts* (FASB, *Current Text,* vol. 2, In6), to statutory reporting of prospective reinsurance contracts, are expected to be effective in 1995. Auditors should be aware that there may be accounting changes in 1995 as a result of such revisions.

Surplus Notes

Surplus notes, highly subordinated debt instruments issued by mutual insurance companies, have been purchased by many insurance companies in 1994. New NAIC reporting requirements have been proposed for insurer-owned surplus notes, which may be effective for the 1994 statutory financial statements. Auditors of insurance companies that hold such surplus notes as investments should be familiar with how the new requirements may affect the classification and valuation of such investments in the statutory financial statements. Final action on this proposal is expected at the December 1994 NAIC meeting.

Environmental Disclosures

The NAIC Annual Statement Instructions have been revised to require certain additional disclosures regarding reserves for asbestos

and environmental claims, starting in 1995. (See the section entitled *Accounting Developments* for a discussion of an SOP that requires disclosures about liabilities for unpaid claims and claim adjustment expenses.)

Model Investment Law

In August 1994, the NAIC issued for comment a revision of the Model Investment Law. The law would provide guidelines for insurers to follow in purchasing investments. For example, it would allow insurers to participate in derivatives transactions only for purposes of hedging and very limited speculation. It would also require boards of directors to monitor compliance with board-approved investment plans. A final model is expected to be issued in 1995. Auditors should consider whether the enactment of such a law could affect the classification of investments.

Audit Issues

Investments in Derivatives

As interest rates, commodity prices, and numerous other market rates and indices from which derivative financial instruments derive their value have increased in volatility over the past several months, a number of companies have incurred significant losses as a result of their use. Insurance companies are increasingly using such instruments as risk management tools (hedges) or as speculative investment vehicles. The use of derivatives virtually always increases audit risk. Although the financial statement assertions about derivatives are generally similar to assertions about other transactions, an auditor's approach to achieving related audit objectives may differ because certain derivatives—such as futures contracts, forward contracts, swaps, options, and other contracts with similar characteristics—are not generally recognized in the financial statements. Many of the unique audit risk considerations presented by the use of derivatives are discussed in detail in *Audit Risk Alert—1994*.

Investments in Collateralized Mortgage Obligations

Relatively low interest rates and the use of more sophisticated asset/liability management techniques over the past several years have resulted in increased investments by insurance companies in CMOs and MBSs. As the values of many of such instruments, particularly interest-only and principal-only securities, are extremely sensitive to changes in interest rates, a number of insurance companies have

suffered substantial reductions in the value of their investment portfolios as a result of their use. Auditors should carefully consider the risks inherent in investments in these securities, and, in particular, should—

- Assess management's expertise in monitoring and evaluating the risks associated with, and accounting for, the securities.
- Consider whether the insurance company has set policies and procedures for investing in and accounting for such securities, which are commensurate with their complexity, and risks, and with the company's business and portfolio objectives.
- Consider whether there is appropriate oversight by the board of directors.
- Consider whether unrealized losses or other factors raise any impairment concerns.

CMO derivatives are discussed further in *Audit Risk Alert—1994.*

Liabilities for Unpaid Claims

Rates of increases in liabilities for unpaid claims and claim adjustment expenses have been declining. Though workers' compensation, medical malpractice, and commercial automotive claims costs have shown improved loss experience, general liability losses continue to be high, and residual asbestos claims and other environmental claims and associated legal costs could have a significant negative impact on future earnings. The liability for unpaid claims is inherently a high-risk audit area for several reasons. First, the liability is significant to property and casualty insurers' balance sheets and earnings. Second, estimating the amount to report is highly subjective. Finally, there is an expectation that the estimates will continuously change for the long-tailed business.

A number of factors are particularly indicative of higher risk audit. The following include those that may exist for a number of companies in 1994.

Exposure to Environmental and Asbestos-Related Claims. The ultimate exposure of insurers to environmental and asbestos-related claims is subject to an unusually high degree of uncertainty. During 1994, a number of studies and reports were published, and public statements were made that increase the pressure on companies to improve disclosures in this area and to recognize additional liabilities in their financial statements related to such claims. Auditors of insurance companies that face such claims should carefully evaluate whether the accounting and disclosure requirements of FASB Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59), have

been met. Furthermore, the auditors of publicly held insurance companies should consider whether the disclosures are in accordance with the requirements of the Securities and Exchange Commission (SEC) Staff Accounting Bulletins No. 87, *Views on Contingency Disclosures on Property-Casualty Insurance Reserves for Unpaid Claim Costs*, and No. 92, *Accounting and Disclosures Relating to Loss Contingencies*.

Exposure to Employment-Related Claims. Some reports indicate that the settlements of disability and discrimination claims will turn out to be significantly higher than previously anticipated.

Exposure to Breast-Implant Claims. Some reports indicate that claims related to injuries from defective breast implants could exceed $7 billion.

Changes in Product Mix to More Long-Tail Lines of Business. This factor would usually indicate more uncertainty in determining the ultimate exposure to claims.

Intense Price Competition and Unexplained Premium Growth. Either of these factors could indicate unsound pricing, crediting, or dividend policies. Such policies could lead to the acceptance of unanticipated risks or the inappropriate pricing of those risks, which also could affect the recoverability of deferred acquisition costs and could result in premium deficiencies.

Participation in Involuntary Pools. Insurance enterprises continue to be exposed to large amounts of claims through their participation in involuntary pools and associations. This factor may indicate increased exposure to loss development from previously reported results.

SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance to auditors on obtaining and evaluating sufficient, competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). SOP 92-4, *Auditing Insurance Entities' Loss Reserves*, provides guidance to help auditors understand the loss reserving process and to develop an effective audit approach when auditing loss reserves of insurance entities.

Reinsurance Arrangements

Reinsurance is an important part of many insurance companies' business, and accordingly, it is important for auditors to obtain an

understanding of the reinsurance programs of the insurance companies they audit. The lack of an adequate reinsurance program may expose an insurance company to risks that can jeopardize its financial stability, particularly if its risks are concentrated by type or geographic area. In contrast, excessive reinsurance coverage can significantly reduce the margins available to cover fixed expenses. Significant changes in an insurer's reinsurance programs or retention limits may indicate increased audit risk.

Risk-Transfer Issues. Paragraph 9 of FASB Statement No. 113 provides the following two risk-transfer conditions, both of which must be met for short-duration reinsurance contracts to be accounted for as reinsurance.

a. The reinsurer does not assume significant insurance risk.

b. The contract does not result in the reasonable possibility that the reinsurer may realize a significant loss from the insurance risk.

Generally, contracts that do not meet the conditions for reinsurance accounting should be accounted for as deposits.

For many reinsurance contracts, there is a great deal of judgment involved in determining whether the risk-transfer conditions are met, particularly for multiyear, retrospectively rated reinsurance contracts with adjustable features. Such contracts have become increasingly complex, containing many varieties of terms and features that may impact the assessment of risk-transfer. The SEC staff has expressed concern that preparers of financial statements and their auditors may not be considering appropriately the provisions of paragraph 9(a) of Statement No. 113 in their assessment of whether a reinsurance contract provides indemnification of insurance risk. The paragraph 9(a) criterion must be met independently of the paragraph 9(b) criterion. Timing risk alone does not allow paragraph 9(a) to be met. Furthermore, satisfying paragraph 9(b) is not sufficient justification that paragraph 9(a) has been satisfied. Auditors should analyze carefully the entirety of an insurance company's arrangements with its reinsurer, including all provisions of the reinsurance contracts and any other related agreements, and the impact of any adjustable features on cash flows. The auditor should apply careful judgment in determining whether there is sufficient competent audit evidence supporting risk transfer under both paragraphs 9(a) and 9(b). As the complexity and number of terms increase, so should auditors' professional skepticism.

Reinsurance Recoverables. Recent publicity about defaults by a Lloyds of London syndicate underscores that the credit risk related to ceded reinsurance arrangements continues to concern the insurance industry.

The evaluation of credit risk is important in assessing audit risk related to reinsurance recoverables. The AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* discusses the controls or procedures that ceding companies should implement to evaluate and monitor the financial stability of assuming companies.

Disclosures. Auditors should also consider whether the disclosure of concentrations of credit risk associated with reinsurance receivables and prepaid reinsurance premiums is adequate as required by the provisions of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk* (FASB, *Current Text*, vol. 1, sec. F25). Furthermore, auditors of financial statements of publicly held insurance companies should be aware that the SEC staff has expressed concern about the adequacy of disclosures regarding reinsurance arrangements. The SEC staff expects registrants with material reinsurance recoverables to disclose information about the composition and quality of the asset. Identification of individually material reinsurers and their related balances may be necessary. If the aggregate recoverable consists primarily of numerous small balances, breakdowns of the aggregate according to claims-paying ratings also may be necessary. Significant delinquent balances and allowances for uncollectible amounts should be disclosed, as should significant transactions and balances with related parties. If a reinsurer is a promoter of a registered offering, SEC filings may also have to include financial information about that reinsurer.

Assumption Reinsurance. Early in 1994, Congressional committees held hearings on assumption reinsurance to address concerns about whether policyholders may be adversely affected by assumption reinsurance transactions. Unlike typical reinsurance, assumption reinsurance is intended to extinguish the primary insurer's obligations to the policyholder. Policyholders are given the opportunity to object to the transfer; and if the policyholder does not object within a designated time period, permission to transfer is implied. Assumption reinsurance generally has been reported in a manner similar to the disposition of a line of business rather than as reinsurance. However, the obligation must be extinguished for the assets and liabilities to be removed. Until consent is obtained or implied and a legal extinguishment (novation) has occurred, the insurer transferring the policy is liable under the policy. Auditors should consider whether it is appropriate for insurers to eliminate assets and liabilities related to policies transferred under assumption reinsurance arrangements.

Permitted Statutory Accounting Practices

Insurance companies' statutory financial statements currently are prepared using accounting practices "prescribed or permitted by the insurance department of the state of domicile." The existence of permitted SAP, especially if their use improves the insurance company's statutory financial position or risk-based capital, may contribute to higher audit risk. Attention to such transactions is especially important if an insurer's RBC is at or near statutory minimum levels. Permitted SAP are discussed further in the *Audit Developments* section, where the implications of SOP 94-1, *Inquiries of State Insurance Regulators*, are discussed and in the *Accounting Developments* section, where the implications of the AICPA's expected SOP on *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* are discussed.

Asset Quality and Valuation Issues

Though real estate markets have improved in many areas of the country and the total amount of nonperforming real estate assets and noninvestment grade bonds has declined, some insurance companies still have asset quality problems. Credit quality and other asset quality issues associated with loans, real estate portfolios, troubled debt restructurings, foreclosures and in-substance foreclosures, noninvestment grade bonds, and other assets continue to require careful attention in audits of the financial statements of insurers. The subjectivity of determining asset valuation allowances, combined with continued uncertainty regarding the recoverability of the carrying value of certain assets, reinforces the need for the careful planning and execution of audit procedures in this area.

Restructurings

Competitive pressures have led to a strong focus by insurance companies on reducing costs, and a number of insurance companies have undergone restructurings in 1994. If employees were released, auditors should consider the impact on the internal control structure. Auditors also should be aware that a number of contentious accounting issues are currently under consideration. The FASB's Emerging Issues Task Force (EITF) and SEC staff are addressing a variety of accounting issues related to restructuring charges that increase the audit risk related to amounts reported as restructuring charges. EITF Issue No. 94-3, *Liability Recognition for Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, addresses the following two issues:

1. Whether an entity should recognize a liability and an expense for costs associated with a restructuring
2. Whether additional financial statement disclosures should be made for restructuring charges

(Restructurings are discussed in more detail in *Audit Risk Alert—1994.*)

Related-Party Transactions

Related-party transactions are currently receiving a great deal of public and regulatory scrutiny. Related-party transactions in which insurance companies sometimes participate include—

- Reinsurance arrangements with affiliated entities such as surplus relief reinsurance to entities.
- Loans to insurance companies' officers and directors or their affiliates.
- Fees or commissions paid to officers and directors or their affiliates.
- Tax-sharing arrangements.
- Pooling arrangements.
- Other arrangements, including purchased goods or services from and contracts with officers and directors or their affiliates.

FASB Statement No. 57, *Related Party Disclosures* (FASB, *Current Text*, vol. 1, R36.102-105), establishes requirements for related-party disclosures. Furthermore, auditors should be aware that the SEC has brought enforcement actions against insurance enterprises for using affiliated transactions to overstate statutory capital and surplus.

SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AICPA, *Professional Standards*, vol. 1, AU sec. 334), provides guidance on procedures that should be considered by auditors in order to identify related-party relationships and transactions and to satisfy themselves concerning the accounting for and disclosure of transactions with related parties.

Wash Sales and Other Year-End Transactions

A source of financial statement misstatement could be improper accounting for significant transactions at or near year-end. For example, the SEC has had a number of enforcement actions involving sales of securities at year-end for which there was an agreement to repurchase the securities after year-end. Auditors should carefully review such transactions to determine the appropriateness of any gain or loss recognized and the effect on statutory capital and surplus of the transaction.

Securities Lending

Insurance companies are increasingly lending securities to other entities as a way to improve their investment yields. Auditors should assess whether an insurance company is at risk for any losses due to lending transactions and whether the accounting for and disclosures about such transactions are adequate.

Audit Developments

Regulatory Risk-Based Capital

In December 1993, the AICPA issued SOP 93-8, *The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises,* which provides guidance on the consideration of RBC in the planning stage of the audit as well as guidance on auditors' reports. The AICPA expects to adopt the guidance in SOP 93-8 for other insurance enterprises, such as property and casualty insurance companies, that are required to calculate regulatory RBC.

Communications with Regulators

In April 1994, the AICPA issued SOP 94-1, which addresses the auditor's consideration of regulatory examinations as a source of evidential matter in conducting an audit of an insurance company's financial statements and the auditor's evaluation of material permitted by SAP applied by insurance companies. The SOP states that auditors should exercise care in concluding that an accounting treatment is *permitted,* and should consider the adequacy of disclosures in the financial statements regarding such matters. For each examination, auditors should obtain sufficient competent evidential matter to corroborate management's assertion that permitted SAP that are material to an insurance company's financial statements, regardless of when the transactions were initiated, are actually accepted by the domiciliary state insurance department.

Since problems may arise in obtaining evidence to corroborate permitted accounting practices, auditors are advised to implement the SOP as soon as possible.

Access to Working Papers

Examiners from state insurance regulatory departments, as well as other regulators, may from time to time request auditors of insurance companies to provide access to working papers. Auditors who have been requested to provide such access should refer to Interpretation

No. 1 of SAS No. 41, *Working Papers* (AICPA, *Professional Standards,* vol. 1, AU sec. 339), entitled "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards,* vol. 1, AU sec. 9339). The Interpretation provides auditors with guidance on—

- Advising management that the regulator has requested access to (and possibly photocopies of) the working papers and that the auditor intends to comply with such request.
- Making appropriate arrangements with the regulator for the review.
- Maintaining control over the original working papers.
- Considering submitting to the regulator a letter clarifying that an audit in accordance with GAAS is not intended to, and does not, satisfy a regulator's oversight responsibilities. (An example of such a letter is illustrated in paragraph 6 of the Interpretation.)

In addition, the Interpretation addresses situations in which an auditor has been requested by a regulator to provide access to working papers before the audit has been completed and the report released. Also, the Interpretation notes that if a regulator engages an independent party, such as another independent public accountant, to perform the working paper review on behalf of the regulatory agency, there are some precautions auditors should observe.

The complete text of this Interpretation was published in the July 1994 issue of the *Journal of Accountancy* ("Official Releases").

Using the Work of a Specialist

In July 1994, the AICPA issued SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1, AU sec. 336), which provides guidance to auditors regarding using the work of specialists, including actuaries. The SAS affirms the requirement that auditors should use an outside loss reserve specialist in auditing insurance companies' liabilities for unpaid claims.

Auditors' Reports on Statutory Financial Statements

In August 1994, the AICPA issued an exposure draft of a proposed SOP, *Auditors' Reports on Statutory Financial Statements of Insurance Enterprises,* which addresses auditors' considerations in reporting on statutory financial statements of insurance companies, and which is expected to be finalized in early 1995. The proposed SOP—

- Would rescind SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies.*

- Discusses matters auditors should include in their reports when issuing limited or general distribution reports on statutory financial statements.
- Discusses matters auditors should evaluate when considering issuing limited distribution reports on statutory financial statements.

Accounting Developments

Financial Statement Disclosures

SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises,* is effective for financial statements issued for fiscal years ending after December 15, 1994. This SOP requires insurance companies, where applicable, to make the following disclosures in their financial statements:

- The accounting methods used in their statutory financial statements that are permitted by state insurance departments
- Detailed information about the development of their liabilities for unpaid property and casualty insurance claims and claim adjustment expenses

The exposure draft of the SOP also had required that insurance enterprises disclose certain information about their adjusted regulatory RBC levels. Though the Accounting Standards Executive Committee (AcSEC) continues to believe that the disclosure of RBC levels is desirable, questions remain about the legality of such disclosures in certain states. Accordingly, AcSEC has decided that it will issue a separate SOP at a later date on RBC disclosures for insurance enterprises.

Derivative Financial Instruments

In October 1994, the FASB issued FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments* (FASB, *Current Text,* vol. 1, sec. F25). The Statement requires disclosures about derivative financial instruments—futures, forward, swap, or option contracts, or other financial instruments with similar characteristics. The Statement requires that disclosures be made about the amounts, nature, and terms of derivative financial instruments. Furthermore, a distinction must be made between financial instruments held or issued for trading purposes (including dealing and other trading activities measured at fair value with gains and losses recognized in earnings) and financial instruments held or issued for purposes other than trading. A variety of other disclosures

are required and encouraged by the Statement. Insurance companies that register with the SEC should be aware that the SEC intends to issue guidance to require many of the disclosures that are encouraged in FASB Statement No. 119. FASB Statement No. 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, with a one-year delay for entities with less than $150 million in total assets. Furthermore, the FASB expects to publish illustrations applying the disclosure requirements of FASB Statement No. 119 before year-end. Auditors should consider whether the disclosures made by their clients in their financial statements are adequate and appropriate in view of the new requirements. Derivatives are discussed in detail in *Audit Risk Alert—1994*.

Offsetting

Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7 (FASB, *Current Text*, vol. 1, sec. I27), says that "it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts* (FASB, *Current Text*, vol. 1, sec. B10), becomes effective for financial statements issued for periods beginning after December 15, 1993. The Interpretation defines *right of setoff* and specifies what conditions must be met to have that right. Auditors should consider whether insurance companies have properly implemented Interpretation No. 39.

Impairment of Loans

In May 1993, the FASB issued FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan* (FASB, *Current Text*, vol. 1, sec. I08), which addresses the accounting by creditors for impairment of certain loans and applies to financial statements for fiscal years beginning December 15, 1994. The Statement is applicable to all creditors and to all loans, uncollateralized as well as collateralized, except large groups of smaller-balance homogeneous loans that are collectively valued for impairment, loans that are measured at fair value or at the lower of cost or fair value, leases, and debt securities as defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FASB, *Current Text*, vol. 1, sec. I80). It applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

FASB Statement No. 114 requires that impaired loans that are within its scope be measured based on the present value of expected future cash

flows discounted at the loan's effective interest rate or as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral-dependent.

The Statement amends FASB Statement No. 5 to clarify that a creditor should evaluate the collectibility of both contractual interest and contractual principal of all receivables when assessing the need for a loss accrual. The Statement also amends FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FASB, *Current Text*, vol. 1, sec. D22), to require a creditor to measure all loans that are restructured in a troubled debt restructuring involving a modification of terms in accordance with its provisions.

Auditors should carefully consider the implications of applying the new provisions of the Statement on audit risk. Aspects of applying the new Statement that warrant particular consideration include—

- Proper identification of all loans to which the Statement should be applied.
- The reasonableness of estimates of future cash flows and interest rates used in discounting.
- The appropriateness of amounts used to measure impairment if alternatives to present-value amounts, such as fair values of collateral or observable market prices, are used.
- The relationship between the identification of impaired loans under the Statement and the classification of loans under regulatory classification systems.
- The presentation of accrued interest receivable and its relationship to valuation allowances.
- The relevance of concepts of performing and nonperforming assets.

Investments in Certain Debt and Equity Securities

In May 1993, the FASB issued FASB Statement No. 115, which became effective for fiscal years beginning after December 15, 1993. The Statement addresses the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities. It establishes three categories of reporting debt and marketable equity securities: held-to-maturity (reported at amortized cost), trading (reported at fair value with unrealized gains and losses included in earnings), and available-for-sale (reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholder's equity). The Statement also specifies the accounting treatment for transfers between categories.

FASB Statement No. 115 also requires insurance companies to determine whether declines in the fair value of individual securities classified as either held-to-maturity or available-for-sale below their amortized cost bases are other than temporary. For example, if it is probable that an investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment is considered to have occurred. If such a decline is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as the new cost basis, with the amount of the write-down included in earnings (that is, accounted for as a realized loss). Any reserves for other than temporary declines in the value of securities should be reversed.

Because the classification of debt and equity securities under FASB Statement No. 115 may be very subjective, auditors should apply careful judgment in assessing whether insurance companies have properly classified their investments. The impact of sales of securities designated as held-to-maturity should be closely scrutinized in assessing management's assertions regarding securities remaining in the held-to-maturity portfolio.

The SEC has brought a number of enforcement actions against insurance enterprises that failed to write down securities for other than temporary declines. Accordingly, the evaluation of whether impairments of investments are other than temporary is an area requiring particularly careful auditor judgment.

In-Substance Foreclosures

The AICPA has withdrawn two practice bulletins about the substantive repossession of collateral because the underlying issues have been addressed in FASB Statement No. 114. AcSEC determined that Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,* and Practice Bulletin 10, *Amendment to Practice Bulletin 7, Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,* shall be superseded as of the effective date of implementation of FASB Statement No. 114.

FASB Statement No. 114 clarified that paragraph 34 of FASB Statement No. 15 was intended to apply to a troubled debt restructuring or other circumstance in which a debtor surrendered property to the creditor, and the creditor was in possession of the asset with or without having to go through formal foreclosure procedures. FASB Statement No. 114 is effective for fiscal years beginning after December 15, 1994.

Similarly, the SEC amended its interpretive guidance to inform registrants that have adopted FASB Statement No. 114 that they should not

apply the portion of the SEC's Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities,* that addresses the accounting for substantive repossessions of collateral (*Federal Register,* May 19, 1994).

Mutual Life Insurance Enterprises

In April 1993, the FASB issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises* (FASB, *Current Text,* vol. 2, sec. In6). The Interpretation clarifies that companies, including mutual life companies, that issue financial statements described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. The Interpretation concludes that mutual life insurance companies that prepare financial statements based on regulatory accounting practices that differ from GAAP, and distribute those financial statements to regulators, should not describe these financial statements as prepared "in conformity with generally accepted accounting principles."

The Interpretation would have been effective for financial statements issued for fiscal years beginning after December 15, 1994, except for the disclosure provisions, which are effective for fiscal years beginning after December 15, 1992. However, on September 30, 1994, the FASB issued an exposure draft, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises—Deferral of the Effective Date of FASB Interpretation No. 40,* which would defer the effective date to fiscal years beginning after December 15, 1995. Nevertheless, the disclosure requirements remain effective for fiscal years beginning after December 15, 1992, and include—

- The accounting principles and methods used to account for investments in debt and equity securities and insurance activities in accordance with APB Opinion 22, *Disclosure of Accounting Policies* (FASB, *Current Text,* vol. 1, sec. A10).
- A brief description of Interpretation No. 40, including its effective date and transition provisions, and that financial statements prepared on the basis of SAP will no longer be described as prepared in conformity with GAAP after the effective date of this Interpretation.

Furthermore, the FASB expects to issue a final Statement, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts,* that would remove the exemption of mutual life insurance enterprises from FASB

Statements No. 60, *Accounting and Reporting by Insurance Enterprises* (FASB, *Current Text*, vol. 2, sec. In6), No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FASB, *Current Text*, vol. 2, sec. In6), and No. 113, and permit stock life insurance companies to apply the accounting provisions of the AICPA's SOP, which is discussed in the next paragraph, for contracts that meet the criteria in the SOP. The Statement would also be effective for financial statements issued for fiscal years beginning after December 15, 1995.

On March 24, 1994, the AICPA issued an exposure draft of an SOP, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*. The SOP will be effective for financial statements issued for fiscal years beginning after December 15, 1995. A final SOP is expected to be issued by the end of 1994. The SOP, which was issued jointly with the FASB exposure draft discussed in the preceding paragraph, provides accounting guidance for long-duration contracts with the following characteristics.

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

Income Recognition on Impaired Loans

In October 1994, the FASB issued FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (FASB, *Current Text*, vol. 1, sec. I08). FASB Statement No. 118 amends FASB Statement No. 114 to allow creditors to use existing methods for recognizing interest income on impaired loans. To accomplish that, it eliminates the provisions in FASB Statement No. 114 that describe how creditors should report income on impaired loans. FASB Statement No. 118 does not change the provisions in FASB Statement No. 114 that require creditors to measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, or as a practical expedient, at the observable market price of the loan or the fair value of the collateral if the loan is collateral-dependent. FASB Statement No. 118 also amends the disclosure requirements in FASB Statement No. 114 to require certain disclosures about the recorded investment in impaired loans, of the related amounts of

investment income reported and received, and the creditors' policy for recognizing interest income related to those loans. FASB Statement No. 118 is effective concurrent with the effective date of FASB Statement No. 114, that is, for financial statements for fiscal years beginning after December 15, 1994, with earlier application encouraged.

SEC Industry Guide 6

Insurance companies that register with the SEC should be aware that the continued presentation of the Guide 6 tables on a net basis is acceptable, even though loss reserve tables on a gross basis became preferable after the adoption of FASB Statement No. 113. However, for periods in which the income recognition provisions of Statement No. 113 have been applied, the SEC staff believes that at a minimum, additional data should be provided that (1) reconcile the net end-of-period liability (the original reserve estimate in the ten-year table) with the related gross liability on the balance sheet and (2) present the gross reestimated liability as of the end of the latest reestimation period, with separate disclosure of the related reestimated reinsurance recoverable. Furthermore, the SEC staff expects that there should be a thorough discussion of the effects of a company's reinsurance program in Management's Discussion and Analysis.

Segment Reporting

Auditors should be aware that all types of entities, including insurance companies, are subject to the provisions of FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, *Current Text*, vol. 1, sec. S20). FASB Statement No. 14 requires that the financial statements of a business enterprise include information about the enterprise's operations in different industries, its foreign operations and exports sales, and its major customers. FASB Statement No. 14 also requires that an enterprise operating predominantly or exclusively in a single industry identify that industry.

Consensus Decisions of the FASB's Emerging Issues Task Force

The EITF frequently discusses accounting issues involving financial instruments, real estate, or insurance contracts that are important to insurance companies. A description of recent issues is provided below; however, readers should consult detailed minutes for additional information.

EITF Issue No. 93-14, *Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises*, extends

the conclusions in EITF Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises, Cover Arrangements,* to direct insurance contracts between insurers and policyholders, such as funded self-insurance arrangements.

EITF Issue No. 93-18, *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate,* addresses the effect of FASB Statement No. 115 on certain aspects of EITF Issue No. 89-4, *Accounting for a Purchased Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate.* Discussion included whether FASB Statement No. 115 changes (1) the measure of an impairment loss for those instruments addressed in EITF Issue No. 89-4, and (2) the consensus on EITF Issue No. 89-4 about the timing for recognition of an impairment loss for those instruments. Discussion also included whether previously recognized impairment losses for those instruments should be remeasured at fair value for purposes of determining the cumulative catch-up adjustment upon initial adoption of FASB Statement No. 115.

EITF Issue No. 94-3 addresses whether an entity should recognize a liability and an expense for costs associated with a restructuring and, secondarily, whether additional financial statement disclosures should be made for restructuring charges.

EITF Issue No. 94-4, *Classification of an Investment in a Mortgage-Backed Interest-Only Certificate as Held-to-Maturity,* involves discussion of the application of the classification criteria of FASB Statement No. 115.

EITF Issue No. 94-5, *Determination of What Constitutes All Risks and Rewards and No Significant Unresolved Contingencies in a Sale of Mortgage Loan Servicing Rights under Issue 89-5,* involves accounting for transfers of mortgage servicing rights.

EITF Issue No. 94-7, *Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock,* addresses financial instruments that may be settled with a specified number of shares of an entity's stock or with a cash amount calculated based on the value of a specified number of shares of an entity's stock, including the following:

1. Whether the instrument should be classified as an asset or an equity instrument
2. How gains and losses are reported
3. Whether the instrument should be accounted for separately if it is embedded in another financial instrument
4. How to treat the instrument for earnings per share computations

EITF Issue No. 94-8, *Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring,* involves a discussion of how to account

for the difference between the recorded investment in a loan being restructured and the fair value of debt securities received at the time of conversion.

Appendix D-39 to the EITF Abstracts contains FASB staff responses to certain technical inquiries about implementation of FASB Statement No. 115. Included is a discussion concerning a mortgage derivative product held by a regulated institution. The product becomes subject to examiners' divestiture authority. The Statement considers whether such an instrument may be classified at acquisition as a held-to-maturity security under FASB Statement No. 115. Though the FASB response does not explicitly apply to insurance companies, insurance enterprises may have analogous situations.

Appendix D-40 contains a FASB staff announcement, *Sale of Securities Following a Business Combination Expected to Be Accounted for as a Pooling of Interests.*

Appendix D-41 contains an SEC staff announcement, *Adjustments in Assets and Liabilities for Holding Gains and Losses as Related to the Implementation of FASB Statement No. 115.*

Other Insurance Companies Committee Projects

Guaranty Fund and Other Assessments. The committee is considering a preliminary draft of an SOP, which addresses how insurance enterprises should apply FASB Statement No. 5 in determining when to accrue liabilities for assessments. Also being considered is recognition of assets for premium tax offsets and surcharges related to the assessments. An exposure draft is expected to be issued in early 1995.

Deposit Accounting for Certain Reinsurance and Insurance Contracts. A task force is drafting an SOP on deposit accounting for reinsurance contracts and direct insurance business. The committee is expected to consider preliminary conclusions in early 1995, and an exposure draft is expected to be issued later in 1995.

Audit and Accounting Guide for Life and Health Insurers. The AICPA plans to issue an exposure draft of a Proposed Audit and Accounting Guide *Life and Health Insurance Enterprises* by the end of 1994. The guide, when completed, would supersede the existing industry audit guide *Audits of Stock Life Insurance Companies.* The proposed guide discusses accounting and auditing for life and health insurance companies and was developed to assist accounting practitioners and auditors in preparing and auditing the financial statements of life and health insurers. The exposure draft incorporates new accounting and financial reporting requirements issued by the FASB and the AcSEC and

new auditing standards issued by the AICPA since issuance of the guide that would be superseded. A final guide is expected to be issued in late 1995.

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This Audit Risk Alert supersedes *Insurance Industry Developments—1993.*

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Practitioners should also be aware of the economic, regulatory, and professional developments in *Audit Risk Alert—1994,* which may be obtained by calling the AICPA Order Department at the number below and asking for product number 022141.

Copies of AICPA publications referred to in this document can be obtained by calling the AICPA Order Department at (800) TO-AICPA. Copies of FASB and GASB publications referred to in this document can be obtained directly from the FASB or GASB by calling the FASB/GASB Order Department at (203) 847-0700, ext. 10.

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