Objectives

• Attendees will be able to understand:
  1. the background of the insurance industry and regulation
  2. common insurance industry concepts and terminology
  3. common statutory accounting variances from US GAAP
Agenda

• Insurance Industry and Regulation
• Model Audit Rule
• Overview of statutory accounting
  – Background
  – Filing requirements
  – Financial statements
  – Statutory auditing considerations
• Key Concepts
Insurance Industry and Regulation
Insurance Industry and Regulation

• Insurance is:
  – a promise of compensation for specific potential future losses in exchange for periodic payment
  – designed to provide financial protection
Insurance Industry and Regulation

• Types of Insurance:
  – Property and Casualty
    • to protect policyholders against the risk of loss for loss or damage to property, or from liabilities they have incurred
  – Life
    • to protect against the financial consequences of an early death or against the financial consequences of outliving one's financial means
  – Health
    • protects against the financial consequences of sickness and illness, and also against the loss of income related to illness or injury
  – Fraternal
    • an organization or association formed to provide mutual aid, benefit, for relief from sundry difficulties
  – Title
    • protects against financial loss from defects in title to real property and from the invalidity or unenforceability of mortgage loans.
Insurance Industry and Regulation

Each company must file a financial report with regulators.
Insurance Industry and Regulation

- National Association of Insurance Commissioners ("NAIC")
  - members consist of the Commissioners of Insurance of all states
  - NAIC is NOT a regulator and has no regulatory authority
  - Decisions of the NAIC usually require state legislative action to become effective and rolled out to the states
Regulatory Requirements

- Annual statement –
  - Uniform report, commonly referred to as "blank"
  - Form and content is updated annually
  - Five different colors, each addresses the needs of regulators:
    - Life
    - Property and Casualty
    - Health
    - Title
    - Fraternal
  - Contains significant amount of financial information
  - Used by regulators to monitor solvency
  - Publically available document
Reporting Requirements – Statutory Annual Statement

Annual Statement Key Contents:

Primary Financial Statements:
- Balance sheet
- Income statement
- Cash flow statement

Disclosures:
- Notes to financial statements
- General interrogatories
- Five year historical data

Reinsurance Information:
- Schedule F for P&C
- Schedule S for Life and Health

Investment Information:
- Schedule A for real estate
- Schedule B for mortgage loans
- Schedule D for bonds and stocks
- Schedule E for cash
NAIC and State Insurance Commissioners

NAIC

State Insurance Commissioners
OCI audit requirements

• Every 3 years, the Office of the Commissioner of Insurance (OCI) will perform an audit of an insurance entity.
• The OCI will review auditor workpapers as part of their review.
• OCI Audit:
  – Significant focus on I/T and controls
  – OCI Audit report may be completed several months later
  – Consideration of OCI findings
    (implications on financial statements and on our audit)
Model Audit Rule (MAR)
Model Audit Rule

- Serves as the cornerstone for monitoring, regulation and governance over the insurance industry.
- Provides guidelines and rules that make it possible for each state's insurance department to properly and thoroughly monitor the health of each insurer's financial condition.
- Officially known as the Annual Financial Reporting Model Regulation
- Developed in cooperation with the American Institute of Certified Public Accountants (AICPA) and the NAIC.
Model Audit Rule - NAIC annual financial reporting model regulation

• Background:
  – 2002: Sarbanes Oxley Act adopted
    • Improve the accuracy and reliability of corporate disclosures
    • Enhance oversight by independent directors and independent auditors
  – 2003 – 2005: NAIC/AICPA Working Group formed and developed proposal
  – Approved by the NAIC – June 11, 2006
  – Effective for financial statement periods after January 1, 2010
  – Implementation guide available from NAIC
Some key components of the Model Audit Rule

- Section 7 – *Auditor Independence*
- Section 14 – *Requirements for Audit Committees*
- Section 16 – *Internal Controls*
Section 7 – Independence

• Prohibits outside auditing firms from performing duties that include:
  – bookkeeping
  – financial information systems design and enactment
  – actuarial tasks
  – internal audit outsourcing services
  – expert services unrelated to the audit
  – and management or human resources services.

• Also requires audit partner rotation requirements
Section 14 – Requirements of Audit Committee

- Each insurer must designate a group of individuals to comprise an audit committee.

- Insurers with prior year direct written and assumed revenues between:

<table>
<thead>
<tr>
<th>Premiums written and assumed</th>
<th># of Independent members</th>
</tr>
</thead>
<tbody>
<tr>
<td>$300m - $500m</td>
<td>50%</td>
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<tr>
<td>&gt; $500m</td>
<td>75%</td>
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</tbody>
</table>
Section 16 – Management’s report of internal control over financial reporting

• Required for companies with $500 million or more in direct written premiums (reviewed annually)

• No auditor attestation required
  – However, auditors are required to “consider the most recently available Management’s Report of Internal Control over Financial Reporting in planning and performing the audit of the statutory financial statements.”
Statutory Accounting
What is Statements of Statutory Accounting (SAP)?

The principles required by the NAIC and by state law which must be followed by insurance companies in submitting their financial statements to the NAIC and state insurance departments. Such principles differ from generally accepted accounting principles (GAAP) in some important respects.
Significant filing requirements:

• Annual statement – to be filed by March 1
  – Including but not limited to: Actuarial opinion, MD&A, Risked-Based Capital Report, investment supplements and investment risk interrogatories.

• Audited statutory financial statements and various other letters due – April 30 or June 1 (dependent on deadline from CMS)

• Additional filing requirements from audit firm based on results. Required annually are (1) Letter of qualifications, (2) Communication on Internal Control Matters noted in Audit and (3) Covered Expense Opinion. Other filings are situational based.

• Quarterly statements within 45 days after the close of the first three calendar quarters of the year
Statutory financial statements

- Statement of assets, liabilities and capital and surplus
- Statement of revenues and expenses
- Statement of changes in capital and surplus
- Statement of cash flows
- Supplementary schedules
  - Summary investment schedule
  - Investment risks interrogatories
Statutory Accounting Guidance

• NAIC Accounting Practices and Procedures Manual
  – Statements of Statutory Accounting Principles
  – Appendices
  – Issue Papers
  – Interpretations of Emerging Accounting Issues Working Group
• Annual Statement Instructions
  – Changes affecting the Annual Statement usually adopted by no later than the Summer National Meeting of the year of change
• Purposes and Procedures Manual of the NAIC Investment Analysis Office
  – Provides guidance related to accounting and valuation of invested assets
Background –
NAIC codified statutory accounting

• Statutory financial statements are prepared using accounting principles and practices prescribed or permitted by the insurance department of the state of domicile, referred to as statutory accounting practices.
• The insurance laws and regulations of the states generally require insurance companies domiciled in those states to comply with the guidance provided in the NAIC Accounting Practices and Procedures Manual, except as otherwise prescribed or permitted by state law.
• Preparers of financial statements and auditors of an insurance entity should continually monitor the status of the new guidance adopted as part of the revised Manual and the effects on the prescribed practices of the domiciliary state.
Background –
Prescribed statutory accounting practices

• Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations and general administrative rules applicable to all insurance enterprises domiciled in a particular state.
  – Wisconsin prescribed practices (see Wisconsin Administrative Code, Ins. 9.10)
    1. Limitations on investments that are outside the scope of the Manual
    2. Nonadmits certain receivables carried by HMOs
    3. Minimum reserving standards for health policies are different than the Manual.
    4. Requires the change in contingency reserves to be recorded through underwriting income.
Background – Permitted statutory accounting practices

• Permitted SAP includes practices not prescribed, but allowed by the domiciliary state regulatory authority upon request. An insurance entity may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of its statutory financial statements if either of the following occurs:
  a. The entity wishes to depart from the prescribed SAP;
  b. The prescribed SAP do not address the accounting for the transaction specifically;
  c. The entity obtains correspondence from the Department of Insurance permitting the practice.

• Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.
Key Concepts and Terminology
Key Concepts and Terminology

- Unearned Premiums
- Claim or Loss Reserves
- Investment Asset Valuation
- Non-admitted Assets
- Risk-Based Capital
- Administrative Services Contract
- Reinsurance
- Premium Deficiency Reserve
- Short or Long Duration Contracts
Unearned Premium Reserves

- Represent the portion of premiums that the company has received on a policy that relates to protection to be provided in the future
- Unearned premiums present deferred income that will be recognized in future accounting periods
- Commonly used for short duration type life, health and P&C insurance products
Unearned Premium Reserves

• Benefit Driven Reserves
  – are used for traditional long duration contracts
  – utilize assumptions about future mortality, persistency, and interest rates with respect to the insured business to develop estimates of the present value of the future benefits
  – reserves are a function of future benefits to be paid, thus are "driven" by the benefit.
Claim or Loss Reserves

– Claims shall be recognized as a expense when a covered or insured event occurs.

– Claims payments and related expense payments are made subsequent to the occurrence of a covered or insured event, therefore it is necessary to establish a liability to recognize expense in the correct period.

– Liabilities shall be established for any unpaid claims and unpaid losses, unpaid loss/claim adjustment expenses and incurred costs.
Claim or Loss reserves

- Claims reserves consist of:
  - Reported losses: are expected payments for losses related to insured events that have occurred and have been reported but not paid.
  - Incurred but not reported (IBNR): is the expected payments for losses related to insured events that have occurred but have not been reported to the insurer as of the statement date.
  - Loss adjustment expenses: are the expected payments for costs to be incurred in connection with the settlement of claims.
Claim or Loss reserves

- Claims liabilities are based upon the estimated ultimate cost of settling the claims using past experience adjusted for current trends, and any other factors that would modify past experience.

- Liabilities are generally not discounted

- Changes in estimates of the liabilities resulting from the continuous review process, including the consideration of differences between estimated and actual payments, shall be considered a change in estimate and expensed to the income statement once known.
# Investment Asset Valuation

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<thead>
<tr>
<th></th>
<th>Statutory</th>
<th>GAAP</th>
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<tbody>
<tr>
<td>Bonds &amp; Preferred Stocks</td>
<td><strong>Amortized Cost</strong></td>
<td><strong>Fair Value</strong></td>
</tr>
<tr>
<td>Common Stocks</td>
<td></td>
<td><strong>Fair Value</strong></td>
</tr>
<tr>
<td>Mortgage Loans</td>
<td></td>
<td><strong>Loan Balance</strong></td>
</tr>
<tr>
<td>Real Estate</td>
<td></td>
<td><strong>Depreciated Cost</strong></td>
</tr>
<tr>
<td>Misc. Assets</td>
<td></td>
<td><strong>Equity Basis or Fair Value</strong></td>
</tr>
</tbody>
</table>
Non-admitted Assets

- Non-admitted Assets
  - SSAP #4 – Assets and Non-admitted Assets
  - Assets that cannot be claimed in statutory balance sheet
  - Non-admitted assets identified in SSAPs and state laws
  - Reflect regulator skepticism as to availability for paying policyholder claims
Common Non-admitted Assets

- Premiums Receivable (or from affiliates) more than 90 days past due
- Premium notes past due
- Furniture, equipment, and supplies
- Leasehold improvements
- Loans on personal security
- Unsecured loans and deposits
- Application software

- Prepaid expenses
- A portion of EDP equipment and operating software (3%)
- A portion of goodwill (10%)
- A portion of net deferred income tax assets
Risk-based capital (RBC)

- RBC is a program developed by the NAIC that serves as a benchmark for the regulation of life insurance entities’ solvency by state insurance regulators.
- RBC requirements set forth dynamic surplus requirements (300%) based on formulas similar to target surplus formulas used by commercial rating agencies based on type (life, health, P&C).
- Formula computes the amount of capital insurer needs in light of risks associated with its operations
- Compares this amount to the capital insurance company has
- Regulatory action prescribed if company has less capital than required.
Risk-based capital (continued)

Two key numbers produced by Risk-based capital formula:

- Total Adjusted Capital ("TAC")
- Amount of Capital Insurer $Has$
- Company Action Level RBC ("CAL-RBC")
- Amount of Capital Insurer $Needs$

\[
\frac{\text{Company Has}}{\text{Company Needs}} = \frac{\text{Total Adjusted Capital}}{\text{Company Action Level - RBC}}
\]
Risk-based capital (continued)

- RBC Ratio > 100%: No Action
- 100% to 75%: Company Action Level
- 75% to 50%: Regulatory Action Level
- 50% to 35%: Authorized Control Level
- < 35%: Mandatory Control Level
Risk-based capital (continued)

• The risk-based capital of health maintenance organization insurers shall be determined in accordance with the formula set forth in the risk-based capital instructions. The formula shall take into account, and may adjust for the covariance between each of the following:
  a) Asset risk
  b) Credit risk
  c) Underwriting risk
  d) All other business risks and such other relevant risks as are set forth in the risk-based capital instructions
     – Consider implications related to going concern
Fee-for-service contracts – Administrative services

- Many insurance entities provide Administrative Services Only (ASO) contracts or Administrative Services Contracts (ASCs) for groups or other insurance entities.
- The insurance entity is not at risk, but only handles the administration of the insurance coverage or other services for a service fee. Stop-loss policies are often sold along with administrative service contracts.
- Under an ASO plan, claims are paid from a bank account owned and funded directly by the uninsured plan sponsor; or, claims are paid from a bank account owned by the insurance entity, but only after the insurance entity has received funds from the uninsured plan sponsor that are adequate to fully cover the claim payments.
- Under an ASC plan, the insurance entity pays claims from its own bank accounts, and subsequently receives reimbursement from the uninsured plan sponsor.
Reinsurance

- Used by insurance companies to manage risks assumed from their policyholders.
- Frequently, insurance entities respond to market conditions or capital limitations by writing contracts on risks for amounts that exceed either their financial capacity or willingness to be at risk of loss.
- Such risks are spread among other insurance entities through reinsurance, which is the indemnification by one insurer (referred to as the reinsurer or the assuming entity) of all or part of a risk originally underwritten by another insurer (referred to as the ceding entity or the direct writer).
- Consideration of financial strength of the reinsurance entity is important when entities cede risk. AM Best Company performs ratings of insurance entities using a uniform scale.
Premium deficiency reserve

• Per SSAP 58: “When the anticipated losses, loss adjustment expenses, commissions, other acquisition costs, and maintenance costs exceed the recorded unearned premium reserve, and the estimated future renewal premium on existing policies, a premium deficiency reserve shall be recognized by recording an additional liability for the deficiency with a corresponding charge to operations.

• *Expected* loss on in-force policies that has yet to be recorded

• To be recorded if premiums and returns on investments, after taking into account all expenses, is not sufficient to meet claims
Short or Long Term Duration Contracts

Insurance Products

- P&C/Health
  - Some Life
- Short Duration
- 6-12 Months
- Renew at Company Option

- Life
- Long Duration
- 5-50+ Years
- Renew at Policyholder Option
Useful SSAPs
Useful SSAPs

Fundamental statutory statements:
• SSAP #4 – Assets and Non-Admitted Assets
• SSAP #5 – Liabilities, Contingencies and Impairments of Assets

Cash and investments:
• SSAP #2 – Cash, Drafts and Short-term Investments
• SSAP #30 – Investments in Common Stock
• SSAP #43R – Asset Backed Securities
• SSAP #100 – Fair Value Measurements
Useful SSAPs (continued)

Assets and non-admitted assets:
• SSAP #6 – Uncollected Premium Balances, Bills Receivable for Premiums, and Amounts Due From Agents and Brokers
• SSAP #16R – Electronic Data Processing (EDP) Equipment and Accounting for Software
• SSAP #19 – Furniture, Fixtures and Equipment; Leasehold Improvements Paid by the Reporting Entity as Lessee; Depreciation of Property and Amortization of Leasehold Improvements
• SSAP #22 – Leases
• SSAP #29 – Prepaid Expenses

Invested assets:
• SSAP #26 – Bonds, Excluding Loan-Backed and Structured Securities
• SSAP #40 – Real Estate Investments
• SSAP #68 – Business Combinations and Goodwill
Useful SSAPs (continued)

Revenue and receivables:
• SSAP #54 – *Individual and Group Accident and Health Contracts*
• SSAP #84 – *Certain Health Care Receivables and Receivables Under Government Insured Plans* (Pharmaceutical Rebate Receivables)

Revenue recognition:
• SSAP #62 – *Risk Transfer*
• SSAP #52 – *Deposit-Type Contracts*
• SSAP #66 – *Retrospectively Rated Contracts*
Useful SSAPs (continued)

Claims and reserves:
- SSAP #55 – *Unpaid Claims, Losses and Loss Adjustment Expenses*
- SSAP #61 – *Life, Deposit-Type and Accident and Health Reinsurance*

Liabilities and contingencies:
- SSAP #89 – *Accounting for Pensions*
- SSAP #14 – *Postretirement Benefits Other than Pensions*

Income Taxes:
- SSAP #101R – *Income Taxes*
Useful SSAPs (continued)

Related parties:
• SSAP #25 – Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties
• SSAP #97 – Investments in Subsidiary, Controlled and Affiliated Entities
Resources

- Wisconsin Administrative Code -
  [https://docs.legis.wisconsin.gov/code/admin_code/ins/](https://docs.legis.wisconsin.gov/code/admin_code/ins/)

- NAIC - [www.naic.org](http://www.naic.org)

- Wisconsin Office of the Commissioner of Insurance –
  - [www oci wi gov](http://www.oci.wi.gov)
Questions???

Thank you!