

Auditing – Preparing for State Examinations

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Topics for Discussion

- Key Points/General Comments
- State Variations
- Level of Examination Detail
- Examination Checklist
 - Review of Formula Reserves
 - Review of Asset Adequacy Analysis
 - Review of Reinsurance Credits
 - Review of Tax Reserves
- Impact of Sarbanes-Oxley
- Survival Tips

Key Points/General Comments

- Statutory examination
- Hot topics (e.g. XXX, guaranteed benefits, etc.)
- Significant interaction with Company actuaries (interview process)
- Trend towards outsourcing examinations
 - States may retain responsibility for basic procedures
- Multiple subsidiaries may lead to joint state effort
- Three words – Documentation, Documentation, Documentation
 - Company
 - Examiners
 - External Auditors

State Variations

- Based on which state is performing the review, there may be a different focus
- Some states prefer a risk-based approach (i.e. focusing on areas with the most risk), while others may focus on methodologies and calculations
- The length of time between reviews may vary (e.g. New Jersey performs reviews every 5 years), while the typical interval is every 3 years

Level of Examination Detail

- State variations
- Complexity of Company
- Time interval between examinations
- Financial health of Company
- Results of prior examinations
- Annual reserve reviews (e.g. New York)

Examination Checklist

- **Review of Formula Reserves**
 - Review policy forms for the major plan types and become familiar with the various product features
 - Reserves must be established with respect to full or partial (secondary) guarantees stated in policies and contracts
 - Review the reserve methodology used by the company and determine whether such methodology meets Department requirements and minimum statutory requirements
 - Minimum standards take the form of specified valuation interest rates, defined valuation methods and prescribed benefit tables.
 - Quantify the extent, if any, to which such reserves may be less than those required by the Department

Examination Checklist

- Review of Formula Reserves (continued)
 - Identify calculations to be tested
 - Select policies to be tested and independently compute reserves. Such testing will be limited in scope but also designed to appropriately test the major plan reserves
 - Review reserve trends over the last several years, including reserve rollforwards, to identify if any discontinuities exist that might indicate reporting errors or methodology changes

Examination Checklist

- Review of Asset Adequacy Analyses
 - Cash flows from assets allocated to reserves in combination with premium cash flows must be demonstrated to provide adequacy for future liabilities (benefits and expenses). Such demonstration supports and is the basis for verification of the appointed actuary's reserve opinion
 - Reconciliation of assets and liabilities tested as part of the asset adequacy analysis to annual statement amounts as of the date the analysis was performed
 - Review of the nature of the material liabilities, including contract provisions, that have a bearing on future liability flows
 - Review material changes, if any, in the mix and structure of the assets supporting the liabilities since the last examination

Examination Checklist

- Review of Asset Adequacy Analyses (continued)
 - Review of the derivatives employed by the company and how they are modeled for asset analysis purposes
 - Review of the appropriateness of the assumptions used to project asset and liability cash flows under various scenarios. Particular attention will be paid to those assumptions that have a material impact on results and conclusions
 - Review of the reasonableness of the asset and liability cash flow outputs. Additionally, more detailed review might be warranted in the event that the asset or liability cash flows appear not to be as expected based on the nature of the assets or liabilities and the cash flow assumptions

Examination Checklist

- Review of Asset Adequacy Analyses (continued)
 - Challenge & review sensitivity tests performed on the A/L projections. Verify that alternative tests have been performed as needed and that all material sensitivities have been identified and tested
 - Review of the major risk exposures (e.g. mortality risk, interest rate risk, liquidity risk) by major product and assess whether the exposures have been adequately addressed in asset adequacy analysis
 - Review of projected income statements, balance sheets and net cash flows derived from the aggregate projection of assets and liabilities
 - Attention given to asset adequacy analyses does not seem to be consistent among states. More focus will likely be given in the future to the extent that reserve levels are driven off of asset adequacy mechanics

Examination Checklist

- Review of Reinsurance Credits

- Reinsurance reserve credits modify the reported statutory liability of the company. The examination objective is verification of risk transfer and the collectibility of amounts due on risks transferred to the reinsurer
- A review of reinsurance transactions is conducted for which the company incorporates material reserve credits, and the extent to which balance sheet liabilities with respect to such obligations comply with provisions of the state regulations

Examination Checklist

- Review of Statutory and Tax Reserve Relationship and Impact to Taxable Income

- Statutory and tax reserves are developed as part of the calculation to develop statutory tax amounts. Tax reserves must be established on bases that comply with Internal Revenue Code, related regulations and interpretations
- Review reserve methodology used by the company and determine whether such methodology meets requirements
- Review reserve trends over the last several years, identifying any discontinuities that might indicate reporting errors or methodology changes

Examination Checklist

- Review of Statutory and Tax Reserve Relationship and Impact to Taxable Income (continued)
 - Review summary of statutory and tax reserve basis changes and/or refinements by calendar year
 - Review amortization of tax reserve basis changes
 - Review impact of reinsurance reserve activity on taxable income. Determine if gain/loss is properly reflected in taxable income
 - Review tax reserve impact on development of statutory deferred tax asset/liability

Impact of Sarbanes-Oxley

- SOX Section 404 requires management of a public company to report annually on the effectiveness of the company's internal control over financial reporting
- Although the focus is on GAAP, states may give credit in the examinations for the work put in by companies for 404
 - Evaluation, documentation and certification of internal controls and procedures for financial reporting
 - Determining materiality levels and identifying significant accounts
 - Identify processes and transactions that influence significant accounts
 - Determining the type of errors that can occur and their probability of occurring

Survival Tips for Companies

- Assume “survival” = to minimize number of negative exam comments and to get examiners in/out quickly
- Generally, little opportunity to go back and make changes
- Identify individual to be main contact
- Be accessible
- Be Prepared
 - Documentation
 - Organize (i.e. care package)
 - Clean up issues from prior exams
 - Anticipate questions
 - Be open (even with shortcomings)
- Make transfer of information easy

Questions???

