Draft date: 6/6/2023

Virtual Meeting

FINANCIAL EXAMINERS HANDBOOK (E) TECHNICAL GROUP
Tuesday, June 20, 2023
11:00 a.m. – 12:00 p.m. ET / 10:00 – 11:00 a.m. CT / 9:00 – 10:00 a.m. MT / 8:00 – 9:00 a.m. PT

ROLL CALL

Susan Bernard, Chair	California	Lindsay Crawford	Nebraska
John Litweiler, Vice Chair	Wisconsin	Colin Wilkins	New Hampshire
Blase Abreo	Alabama	Nancy Lee Chice	New Jersey
William Arfanis	Connecticut	Tracy Snow	Ohio
N. Kevin Brown	District of Columbia	Eli Snowbarger	Oklahoma
Cindy Andersen	Illinois	TBD	Pennsylvania
Grace Kelly	Minnesota	Tarik Subbagh	Washington
Shannon Schmoeger	Missouri		

NAIC Support Staff: Bailey Henning/Elise Klebba

AGENDA

1. Consider Exposure of Handbook Guidance – *Susan Bernard (CA)*
   a. Exhibit G – Consideration of Fraud and related guidance — Attachment 1
   b. Receivership Law (E) Working Group Referral and Proposed Revisions — Attachment 2

2. Receive Financial Analysis (E) Working Group Referral – *John Litweiler (WI)* — Attachment 3

3. Receive update on Climate and Resiliency (EX) Task Force Referral and Proposed Revisions – *Susan Bernard (CA)*

4. Discuss Any Other Matters Brought Before the Technical Group – *John Litweiler (WI)*

5. Adjournment

SECTION 4 – EXAMINATION EXHIBITS

EXHIBIT G
CONSIDERATION OF FRAUD

COMPANY NAME____

PERIOD OF EXAMINATION ____

EXAMINER-IN-CHARGE ____

In accordance with the Risk-Focused ~~Surveillance~~ examination approach~~Framework~~, the consideration of fraud in financial condition examinations should occur throughout all phases of the examination, primarily through identification and examination of fraud risk factors. Fraud risk factors are conditions that may indicate the occurrence of fraud, such as insufficient review of controls, failure to respond to known accounting irregularities, extraordinary growth or profitability, threat of regulatory action, and missing accounting documentation.

~~The examiner needs to consider fraud risk factors and develop examination procedures in order to adequately obtain reasonable assurance that material misstatements due to fraud are not included in the financial statements.~~ In the planning phase of the examination~~To ensure fraud risk factors identified through the financial analysis process are considered,~~ it is important that the exam team include a discussion of fraud in the planning meeting that takes place with the financial analyst. The analyst's review of unusual fluctuations, performance outside of industry average, etc. can help the examiner understand the tone of the organization as a whole and identify areas that may need to be investigated further during the examination. ~~Moreover, the manner in which the insurer's management identifies, considers and mitigates the risk of fraud should factor heavily into the examiner's understanding of the company and assessment of management.~~

It is also vital that the examiner gain an understanding of the fraud assessment and procedures already completed by the external auditor and the level at which it was completed (i.e., holding company or legal entity level). The external auditors are required by AU Sec. 316—*Consideration of Fraud in a Financial Statement Audit* to perform specific procedures to ensure that the audit has been responsibly planned and performed and to obtain reasonable assurance that the financial statements are free of material misstatement. In accordance with guidance from the American Institute of Certified Public Accountants (AICPA), documentation of the auditor's consideration of fraud should be included in the external audit workpapers, which examiners review within Exhibit E – Audit Review Procedures. ~~The examiner should review the work performed by the auditor and consider the auditor's documentation and findings. The examiner should obtain and review this information in accordance with the review of the external audit workpapers. Although t~~The examiner should utilize the external audit workpaper documentation to the fullest extent deemed reasonable if the auditor's risk assessment is at the appropriate level. However, reliance on the external audit workpapers does not preclude the examiner from identifying and inquiring about fraud risk factors noted during the examination or interviewing company management regarding the possibility of fraud or known fraud occurrences.

~~The consideration of fraud is primarily completed through the identification and examination of fraud risk factors. Fraud risk factors are conditions that may indicate the occurrence of fraud. Some examples include the insufficient review of controls, failure to respond to known accounting irregularities, extraordinary growth or profitability, threat of regulatory action, and missing accounting documentation.~~ Parts 1-3 of this exhibit should be completed regardless of the level of reliance on the external auditor. ~~I~~If the examiner determines that the external audit fraud assessment and/or related procedures are not sufficient, complete, or at the correct level, they should also utilize Part 4: Review Company Operations and Identify Fraud Risk Factors. ~~the following This exhibit includes a detailed checklist of fraud risk factors identified in previously detected fraudulent incidences to assist the examiner in determining applicable fraud risk factors.~~ It may also be beneficial to utilize~~Utilization of~~ the Risk Assessment Matrix (Exhibit K) ~~may be beneficial~~ to identify and assess inherent risks, assess controls, determine residual risks and identify test procedures for applicable fraud risk factors. ~~By properly considering and attesting to fraud risk factors, the examiner is able to obtain reasonable assurance that the financial statements are free from material misstatement due to fraud.~~

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Completion and approval of this document does not indicate that fraud has not been perpetrated on or within the company nor does it provide absolute assurance that committed frauds have been detected. It is possible to complete a properly planned and performed examination and not discover occurrences of perpetrated fraudulent activity. Additional guidance relating to fraud considerations is included in Section 1.

Note: Any examiner may complete the consideration of fraud during the examination, but the examiner-in-charge is required to review and sign-off on the prepared workpapers.

SECTION 4 – EXAMINATION EXHIBITS

PART 1: Consideration of Fraud - Planning

Note: The following section should be completed in accordance with the consideration of fraud while planning the examination. The examiner should provide documentation of the actual review during the planning process as indicated throughout this exhibit.

PLANNING PROCEDURES	COMPLETED BY	DATE
1. Obtain and review the external audit workpapers detailing the fraud consideration documentation. ~~Identify any fraud risk factors or other items noted, in the attached "Fraud Risk Factors" checklist below, that might be indicative of fraudulent activity by either fraudulent financial reporting, the misappropriation of assets or through fraudulent claims.~~ (Note: If the external auditor has performed a fraud risk assessment at the holding company level rather than the insurance company entity level, the external audit workpapers may not provide enough information to warrant a thorough review as outlined in the steps below. In this instance, the examiner may choose not to rely on the external auditor's consideration of fraud and should document the rationale in the workpapers. The examiner may continue the consideration of fraud in ~~Part B –~~ Part 4: Review Company Operations and Identify Fraud Risk Factors.)		
a. Document any fraud risk factors noted and procedures performed by the external auditor to mitigate fraud risk.		
b. Document the results of communications amongst the external auditors, company officials, audit committee or others with respect to the risk of fraud in the entity and known fraudulent activity perpetrated on or within the company. The examiner should consider the level of management informed for all known fraudulent acts.		
c. Review and evaluate the other information, risks or conditions documented by the external auditor with respect to their consideration of fraud and utilize this information, if applicable, to develop and further enhance the planned examination procedures.		
d. Summarize the auditor's consideration of mangement's ability to override controls. Evaluate and document the auditor's determination to perform (or not perform) additional procedures to address the risk of control deviations due to management overrides.		
e. Document other risks or conditions noted by the auditor that resulted in the auditor completing additional auditing procedures or documenting added responses.		
2. Review the company's operations, both financial and non-financial, to identify any additional fraud risk factors. Consider input provided by the financial analyst during the examination planning meeting. ~~Review and adjust the planned examination procedures according to the noted risk factors.~~ Use the external audit workpapers to facilitate this review – if further investigation is warranted, identify any fraud risk factors or other items noted in Part 4: Review Company Operations and Identify Fraud Risk Factors that might be indicative of fraudulent activity by either		

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PLANNING PROCEDURES	COMPLETED BY	DATE
fraudulent financial reporting, the misappropriation of assets or through fraudulent claims. Review and adjust the planned examination procedures according to the noted risk factors.		
a. Document the fraud risk factors identified and the examination procedures designed to mitigate the fraud risk. (Note: These procedures typically entail inquiring of management and others about the risk or occurrence of fraud, performing an evaluation of analytical procedures, considering fraud risk factors, and considering other information deemed pertinent for the determination of fraud.)		
b. For those fraud risk factors identified, document the examination procedures or steps the examiner will perform to mitigate fraud risk. ~~Summarize the auditor's consideration of management's ability to override controls. Evaluate and document the auditor's determination to perform (or not perform) additional procedures to address the risk of control deviations due to management overrides.~~		
~~c. Document other risks or conditions noted by the auditor that resulted in the auditor completing additional auditing procedures or documenting added responses.~~		
~~d. Document any communications the external auditor had regarding fraud, or the risk of fraud, with the company's management, audit committee, or other individuals. The examiner should consider the level of management informed for all known fraudulent acts.~~		
~~e. For those fraud risk factors identified, document the examination procedures or steps the examiner will perform to mitigate fraud risk.~~		
3. Meet with company management to discuss the risk of material misstatement due to fraud in the entity and to inquire whether management is aware of any fraudulent activity that has been conducted on or within the company and if the company is maintaining compliance with federal anti-money laundering requirements. Determine that the company has established antifraud initiatives reasonably calculated to detect, prosecute and prevent fraudulent insurance acts.		
a. Identify the company managers utilized for this discussion and summarize the dialogue results. Include the discussion results in a memorandum for inclusion in the workpapers.		

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PART 2: Consideration of Fraud - Testing

Note: The following section should be completed in accordance with the consideration of fraud during testing of the examination. The examiner should provide documentation of the actual review during testing as indicated throughout this exhibit.

TESTING PROCEDURES	COMPLETED BY	DATE
1. Continue to identify fraud risk factors during the examination process. Adapt the planned examination procedures as necessary to mitigate fraud risk.		
a. Review the planned examination approach to determine if modification is necessary, in accordance with the additional identified fraud risk factors.		
b. Evaluate the assessed materiality levels as well as the overall risk assessment, to adequately reflect the discovery of additional fraud risk factors.		
c. Document any changes to the planned examination approach, materiality levels or the overall risk assessments in a memorandum for inclusion in the examination workpapers.		
2. Review the fraud initiatives established by the company to advertise, identify, investigate and report fraudulent acts.		
a. Verify that the established fraud program is advertised and promoted to the company's insureds.		
i. Determine whether claim forms and applications indicate that any person who knowingly presents a false or fraudulent claim for payment of a loss or benefit or knowingly presents false information in an application for insurance is guilty of a crime and may be subject to fines and confinement in prison.		
b. Verify that the company has established a procedure to report fraudulent insurance acts to the insurance commissioner in the manner prescribed by the commissioner.		
3. If applicable, based on the offering of covered products, obtain and verify that the company has established and maintains a written anti-money laundering program that has been approved by senior management and contains the following elements: (i) internal controls based upon the company's risk assessment (that should also cover the brokers and agents used by the company), which are designed to detect and deter money laundering, terrorist financing and other financial crimes associated with its covered products; (ii) the appointment of an anti-money laundering compliance officer including details on the role he/she will play in the day-to-day supervision of the company; (iii) a documented anti-money laundering training program for appropriate personnel and agents; and (iv) documented policies and procedures to perform independent testing on a periodic basis to measure compliance. If the examiner determines that the company has not established, or is not maintaining, such an anti-money		

SECTION 4 – EXAMINATION EXHIBITS

TESTING PROCEDURES	COMPLETED BY	DATE
laundering program, the Financial Crimes Enforcement Network should be notified accordingly. See detail guidance regarding anti-money laundering programs in Section 1.		
a. Obtain copies of the company's risk assessment and independent test plans and review for reasonableness. Review the results of testing performed including any significant issues. If significant issues related to anti-money laundering are identified, the examiner should notify the appropriate federal agency as explained in Section 1, Part IV.		
b. Verify that the company is taking active measures to address all significant deficiencies noted in the independent testing results.		
4. Document the investigation of any potential fraudulent activity noted during the examination process. *(Note: This does not refer to additional fraud risk factors identified.)*		
a. If, after completing the review of fraud risk factors and examination procedures, the examiner identifies a potential fraud situation, the examiner and examiner-in-charge, depending on state guidelines, should either inform the appropriate state insurance department division responsible for investigating potential fraudulent activity, or perform procedures to further investigate the potential fraudulent activity. If the examiner is investigating the potential fraud, the examiner should:		
i. Discuss the nature and effect of the fraudulent activity with the appropriate level of management.		
ii. Attempt to obtain additional evidential matter regarding the fraudulent activity to determine the overall effect on the financial statements and the company operations.		
b. Verify that necessary information regarding the knowledge or reasonable belief that a fraudulent act has been, will be, or is being committed has been communicated to the insurance commissioner as required. (Note: If the state has adopted the NAIC Insurance Fraud Prevention Model Act (#680), information obtained by the commissioner in an investigation of a suspected or known fraudulent act is confidential by law and is not subject to subpoena. In addition, the commissioner, or individual gathering the information on behalf of the commissioner, is not permitted or required to testify in a private civil action regarding the confidential documents.)		

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PART 3: CONSIDERATION OF FRAUD - WRAP-UP

Note: The following section should be completed in accordance with the consideration of fraud during the completion of the examination. The examiner should provide documentation of the actual review during the wrap-up procedures as indicated throughout this exhibit.

WRAP-UP PROCEDURES	COMPLETED BY	DATE
1. Review the fraud risk factors identified throughout the examination and the examination procedures completed to verify that the noted fraud risk factors have been adequately considered throughout the examination process.		
2. Although the focus of the examination is not to detect fraud, verify that the examination has been conducted in a manner to alleviate the risk of fraud through the consideration of fraud risk factors.		
3. Verify that the report of examination properly presents the financial condition of the company with regard to any known instances of fraud perpetrated on or within the company.		

SECTION 4 – EXAMINATION EXHIBITS

PART 4: Review Company Operations and Identify Fraud Risk Factors

Review the company's operations, both financial and non-financial, to identify fraud risk factors. Common fraud risk factors are indicated in the following chart. The fraud risk factors are categorized according to the three conditions typically present when fraud occurs:

- Incentives/pressures to commit fraud.
- Opportunities exist to perpetrate fraud.
- Attitudes/rationalizations that fraud is ethical or acceptable.

For risk factors that are applicable to the insurer under examination provide relevant information regarding that risk in the comments section.

	COMPANY APPLICABILITY			
FRAUD RISK FACTORS	**Y**	**N**	**N/A**	**COMMENTS**
Misstatements from Fraudulent Financial Reporting				
Incentives / Pressures				
1. Are any of the following conditions present that may indicate a personal incentive for management to engage in fraudulent financial reporting?				
a. Are compensatory management bonuses and incentives derived from the company's ability to accomplish aggressive operating or performance results?				
b. Do any other conditions exist that may indicate a motivation for management to engage in fraudulent financial reporting?				
c. Are unduly aggressive financial targets and expectations for operating personnel established by management?				
d. Is management or the board of directors' personal financial situation threatened by the individual's financial interests in the entity?				
2. Is the financial stability or profitability of the company threatened by economic, industry or entity operating conditions?				
a. Is the company subject to new accounting, statutory or regulatory pronouncements that could hinder the company's profitability or financial stability?				
b. Is the company encountering significant competition or market saturation and declining margins?				
c. Is the insurance industry experiencing an increase in the number of insolvencies?				
d. Is the industry experiencing rapid changes in technology?				

FRAUD RISK FACTORS	COMPANY APPLICABILITY			
	Y	N	N/A	COMMENTS
e. Is the holding company's ability to meet its debt service requirements contingent upon increased profits and/or dividends from the insurance subsidiaries?				
f. Has the company experienced unusually rapid growth or profitability when compared with other companies in the same industry?				
3. Does company management have substantial pressure to acquire additional operating capital?				
4. Is management subject to excessive pressure to meet expectations or requirements of third parties?				
a. Is the company highly vulnerable to changes in interest rates?				
b. Does the company need to obtain debt financing or does the company have a marginal ability to meet debt repayment requirements? Are the debt covenants difficult to maintain?				
c. Could the company face adverse consequences on a significant pending transaction (such as a business combination, financing arrangement or contract award) if poor financial results are reported?				
5. Has the company set unrealistically aggressive sales or profitability incentive programs?				
6. Is the company facing the threat of insolvency?				
Opportunities				
1. Do the company's operations provide opportunities to engage in fraudulent activity?				
a. Does the company engage in significant related-party transactions that are not considered to be in the ordinary course of business, or with companies not subject to the examination process or audited by an independent accounting firm?				
b. Are the company's financial statements subject to significant estimates that were determined by subjective judgments or uncertainties, or that can adversely impact the financials if changed?				
c. Does the company have unusual or highly complex transactions (particularly those close to year-end) that are difficult to assess for substance over form?				

SECTION 4 – EXAMINATION EXHIBITS

FRAUD RISK FACTORS	COMPANY APPLICABILITY Y	N	N/A	COMMENTS
d. Does the company have significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification?				
2. Does the company lack appropriate monitoring controls over management?				
a. Is the overall management of the company dominated by a single person or small group without compensating controls (i.e., appropriate oversight by the board of directors or audit committee)?				
b. Does the board of directors lack active involvement in the oversight of the financial reporting process and internal control?				
3. Does the company have a complex or unstable organizational structure?				
a. Is it difficult to determine the organization or individual(s) that control(s) the entity?				
b. Does the company have an overly complex organizational structure involving numerous or unusual legal entities or managerial lines of authority?				
c. Is there a high turnover within senior management, the audit committee, board members or legal counsel?				
4. Does the company have insuffient internal controls or are internal controls operating improperly?				
a. Has the company been observed to employ an ineffective accounting, internal auditing or information technology staff?				
b. Is there a high turnover rate in accounting, internal audit or information technology staff?				
Attitudes				
1. Does company management convey an improper attitude regarding internal controls and the financial reporting process?				
a. Does management neglect to effectively communicate and encourage the company's values or ethics?				
b. Does management have an excessive interest in preserving or increasing the earning's trend through the use of aggressive accounting practices?				

FRAUD RISK FACTORS	COMPANY APPLICABILITY			
	Y	N	N/A	COMMENTS
c. Does management have an interest in engaging inappropriate methods to diminish reported earnings on a tax-motivated basis?				
d. Are there instances of management failing to correct known reportable conditions within an appropriate time frame?				
e. Does management illustrate a substantial disregard for regulatory authorities?				
2. Are management and employees employed in a non-financial department utilized to determine the accounting practices and financial estimates?				
3. Do related or competing businesses consider the management to have a poor reputation?				
4. Have any of the following situations occurred illustrating a strained relationship with either the current or predecessor auditor?				
a. Are there frequent disputes regarding accounting, auditing or reporting matters?				
b. Is the auditor limited to specific individuals or sources of information while conducting the audit?				
c. Are auditor communications with the board of directors or the audit committee restricted?				
d. Does management attempt to influence the auditor and/or the scope of the auditor's work?				
5. Are there any instances of fraud claims against the company or management or any recognized violations of security laws?				
Misstatements from Misappropriation of Assets				
Incentives / Pressures				
1. Are personal financial obligations of management or employees with access to cash and other assets creating pressure to misappropriate assets?				
2. Do adverse relationships exist between the company and employees (i.e., anticipated lay-offs, compensation issues) that may motivate an employee to misappropriate assets?				
Opportunities				
1. Does the company maintain or process large amounts of cash?				

SECTION 4 – EXAMINATION EXHIBITS

FRAUD RISK FACTORS	COMPANY APPLICABILITY			
	Y	N	N/A	COMMENTS
2. Does the company have fixed assets that are easily susceptible to misappropriation (e.g., small size, portability, marketability, lack of ownership identification, etc.)?				
3. Is the company susceptible to fraudulent, unauthorized disbursements (e.g., claim payments or payroll disbursements) being made in amounts that are material to the financial statements?				
4. Do any of the conditions listed below, that may indicate possible deficiencies in the company's internal controls over assets susceptible to misappropriation, exist?				
a. Is there a lack of appropriate management oversight of assets that are susceptible for misappropriation (e.g., inadequate supervision or monitoring of remote locations)?				
b. Is there inadequate record-keeping with respect to assets susceptible to misappropriation?				
c. Is there a lack of appropriate segregation of duties or independent checks not mitigated by other factors?				
d. Does the company lack an appropriate system of authorization and approval of transactions (e.g., benefit or loss payments)?				
e. Are there inadequate physical safeguards over cash, investments, inventory, or fixed assets?				
f. Is there a lack of timely and appropriate documentation for transactions affecting assets susceptible for misappropriation (e.g., rejected claims, benefit payments, etc.)?				
g. Has the company failed to require mandatory vacations for employees in key control functions?				
h. Does management have an inadequate understanding of information technology, which could enable IT employees to misappropriate assets?				
i. Are access controls over automated records, including control over and review of computer systems event logs, inadequate?				
Attitudes / Rationalizations				
1. Does management display a disregard for internal controls by overriding controls or failing to correct control deficiencies?				
2. Is there disregard for the need to monitor and reduce risks relating to the misappropriation of assets?				

FRAUD RISK FACTORS	COMPANY APPLICABILITY			
	Y	N	N/A	COMMENTS
3. Has there been any behavioral or lifestyle changes for management or employees that may indicate that assets have been misappropriated?				
4. Has there been behavior indicating displeasure or dissatisfaction with the company or its treatment of employees?				
Fraudulent Claims				
Note: The following risk factors indicate possible warning signs for fraudulent claims. Although the examiner should not evaluate all submitted claims for fraud, the examiner should verify that the company has established control procedures to mitigate related risk factors. If the company has experienced a significant number of fraudulent claims, the examiner should perform additional procedures to determine the company's actions to prevent and detect fraudulent claims.				
1. Does the company have several claims within the first six months of a coverage period or during the policy's contestable period?				
2. Does the company typically accept photocopied claim forms?				
3. Does the company usually write insurance policies with excessive coverage limits for the type of risk insured?				
4. Does the company fail to adequately review submitted claims and, therefore, inadvertently process claims with the following characteristics?				
a. Write-outs, type-overs, and erasures.				
b. Misspelled medical terms, and terms inconsistent with the diagnosis or treatment.				
c. Suspiciously detailed or extremely vague information concerning the claim;				
d. Stamped or photocopied physician/lawyer approval.				
e. Claimant address is a post office box.				
f. Subjective diagnosis or general statement of diagnosis rather than actual records.				
g. Omitted or different personal information on the claim form.				
h. Claim indicates physicians, attorneys, or employers who are outside the claimant's geographical area, or who have been included on other questionable claims.				

IV. STANDARD EXAMINATION PROCEDURES

Certain general procedures should be considered on all full-scope examinations. The examination program should include a section that explains the nature and extent of these general examination procedures. Automation tools are recommended when conducting examinations to ensure more efficient examinations. This part of the Handbook addresses the following subjects, which are applicable to most examinations:

A. Examiner Request Log
B. Examination Documentation
C. Review of General Ledger and Journal Entries
D. Related Party/Holding Company Considerations
E. Consideration of Fraud
F. Examination Review Responsibilities
G. Letter of Representations
H. Review of Subsequent Events
I. Review of Premium Taxes
J. Summary of Unadjusted Errors

DETAIL ELIMINATED TO CONSERVE SPACE

E. Consideration of Fraud

Examiners should consider the impact and possibility of fraudulent activity while conducting financial condition examinations. In order to effectively complete this task, the examiner should obtain and review the documentation provided by the independent CPA that illustrates their consideration of fraudulent activity. ~~In addition, the examiners should perform a preliminary fraud risk assessment in order to obtain reasonable assurance that the financial statements do not contain misstatements due to fraud.~~ Parts 1-3 of Exhibit G – Consideration of Fraud, included in this Handbook, may be used for documenting ~~conducting and documenting fraud risk factors, as well as~~ the overall consideration of fraud. Additionally, Exhibit G: Part 4 may be utilized to conduct and document fraud risk factors if the CPA workpapers completed in this area are deemed insufficient, incomplete or at the incorrect level (i.e. holding company or legal entity level). ~~.~~

The examiner should consider the risk of fraud for fraudulent company reporting and fraudulent claims incurred by the company. If applicable, based on the offering of covered products, the examiner should also consider the insurer's anti-money laundering program and its ability to detect, monitor, and report suspicious activity, in an effort to prevent the company from being used to facilitate money laundering or the financing of terrorist activities.

a. Fraudulent Company Reporting – Occurs as a misstatement, or omission of amounts or disclosures, in the financial statements (fraudulent financial reporting) or with the theft of assets (misappropriation of assets) that results in the financial statements being improperly stated. Fraudulent company reporting is instigated within a company. It is important for the examiner to understand the controls established within a company to determine whether proper control procedures and supervisory techniques have been implemented to mitigate the risk of this type of fraud. Although proper control procedures may assist in reducing the risk of this fraud, the risk of fraudulent company reporting can never be totally eliminated, due to collusion and other factors.

b. Fraudulent Claims – Occurs when improper or unsupported insurance claims are submitted to the company. These types of claims are more difficult to identify than fraudulent financial reporting, as they typically occur through the collusion of outside individuals (e.g., claimant and doctor). However, the company should have controls and documentation procedures established for claim processing to mitigate these fraud occurrences. The examiner will want to identify the processes in place and verify that they are properly being followed. In addition, the examiner will want to ascertain the company's methods to address identified instances of fraudulent activity and those who perpetrate them.

c. Anti-Money Laundering (AML) Program

Background on Companies Qualifying for AML Review

Although the USA PATRIOT Act of 2001(The Act) requires AML programs for all financial institutions, the Act only applies to those insurance companies offering covered products. These products include: (i) A life insurance policy with any type of cash surrender value; (ii) any annuity contract, other than a group annuity contract; and (iii) any other insurance product with features of cash value or investment. In general, the most significant money laundering and terrorist financing risks in the insurance industry are found in life insurance and annuity products because such products allow a customer to place large amounts of funds into the financial system with the potential of transferring those funds to another person/entity, thus, masking their true origin. Each insurance company issuing or underwriting a covered product must develop and implement an AML program reasonably designed to prevent the insurance company from being used to facilitate money laundering or the financing of terrorist activities. The insurer does not have to implement a company-wide program but, rather, a program that applies only to the insurer’s covered products. Exhibit G provides a detailed checklist of the minimum requirements for the AML program as noted below. The examiner should utilize this checklist when evaluating the company’s AML program.

EXHIBIT A
EXAMINATION PLANNING PROCEDURES CHECKLIST

COMPANY NAME____

PERIOD OF EXAMINATION ____

The following checklist details the components of Phase 1 and Phase 2, as well as other information that should be considered during the planning process. Narrative guidance is provided within Section 2 of this Handbook to aid examiners in understanding the risk-focused surveillance process.

	Examiner	Date
<u>Pre-planning Procedures</u>		
1. At least six months prior to the as-of date, notify the company and its external auditors, with company personnel's assistance, that an examination will take place and that the auditor workpapers will be requested when the exam begins.		
2. If the examination is to be performed on a company that is part of a holding company group, send an informal notification at least six months prior to the as-of date to other states that have domestics in the group.		
3. Call the examination in the Financial Exam Electronic Tracking System (FEETS) at least 90 days prior to the exam start date.		
a. If the examination is to be performed on a company that is part of a holding company group, document your attempts to coordinate the exam with the Lead State and other domestic state(s) within your group. Utilize Exhibit Z – Examination Coordination to assist with this process.		
4. Send preliminary information requests to the company with sufficient lead-time to allow information to be provided prior to the start of examination fieldwork. Exhibit B – Examination Planning Questionnaire and Exhibit C, Part One – Information Technology Planning Questionnaire can be utilized to assist in developing pre-planning requests. **Note**: The examiner is encouraged, with input from the financial analyst when possible, to customize Exhibit B to the insurer being examined prior to submitting the information request.		
<u>Phase 1 – Understand the Company and Identify Key Functional Activities to be Reviewed</u>		
Part 1: Understanding the Company		
Step 1. Gather Necessary Planning Information		
Meet with the Financial Analyst		
1. Meet (in person or via conference call) with the assigned financial analyst (and/or analyst supervisor) to gain an understanding of company information available to the department. In addition, discuss risks and concerns highlighted in the Insurer Profile Summary as well as the company's financial condition and operating results since the last		

examination. Ascertain the reasons for unusual trends, abnormal ratios and transactions that are not easily discernible. Document a summary of significant risks identified by the analyst for further review on the examination. **Note**: An email exchange, in and of itself, is not deemed sufficient to achieve the expectation of a planning meeting with the assigned analyst.

   a. If deemed necessary, obtain supporting documentation from the most recent annual financial statement analysis to aid in the identification of significant risks and facilitate ongoing discussion with the analyst.

Obtain Existing Documentation

2. Obtain copies of relevant information available to the insurance department as deemed necessary to aid in the identification of significant risks. (**Note:** Review of these documents may have already been performed by the analysis unit, while other documents may readily be available on I-Site+ in accordance with NAIC general filing deadlines and requirements.) Such information may include but is not limited to:

   a. Annual financial statements.

   b. Previous examination report and supporting workpapers.

   c. Market conduct report (if deemed applicable).

   d. CPA financial statement audit report.

   e. Actuarial opinion.

   f. Independent loss reserve analysis report, if done.

   g. Management’s discussion and analysis letter.

   h. Risk-based capital (RBC) report.

   i. Holding company registration statements.

   j. SEC registration statements, most recent 10-K and 10-Q.

   k. CPA’s audit of internal control over financial reporting (SOX) report.

   l. Examination Jumpstart reports.

   m. IRIS reports.

   n. Department’s correspondence file.

   o. Inter-divisional memorandum.

   p. NAIC database reports (RIRS, CDS).

q. Credit rating agency reports.

r. Articles of incorporation, bylaws and amendments.

s. Recently approved agreements or contracts (e.g., expense-sharing agreements, assumption reinsurance contracts, custodial agreements, etc.).

t. Form F – Enterprise Risk Report.

u. Own Risk and Solvency Assessment (ORSA) summary report.

Obtain Additional Information

3. Use the understanding of company information already available to the department to determine what additional information is necessary to assist in examination planning. Develop customized information requests to obtain additional information from the company to assist in exam planning, as necessary.

Assess the Effects of External Environmental Conditions

4. Assess the effects of external environmental conditions and factors. Focus on conditions which affect the company's operations, primary lines of business and investments. Examples include recent regulatory developments, industry climate, competition in the marketplace, recent market entrants, etc. As part of this assessment, examiners should consider the NAIC Solvency Monitoring Risk Alert and/or the AICPA Audit Risk Alert.

Identify Significant Accounting and Reporting Issues

5. Identify significant accounting and reporting issues affecting the examination. Consider the impact of changes in the NAIC *Accounting Practices and Procedures Manual, Annual Statement Instructions,* statutes and department rulings. Also consider company departures from statutory accounting principles, permitted practices, significant accounting transactions (e.g., loss portfolio transfers, financial reinsurance, assumption reinsurance, loss reserve discounting) and new types of investments (e.g., derivatives, private placements, etc.).

Meet with Other Department Personnel

6. Meet with the in-house actuary to discuss the company's historical reserving issues and extent of data validation required.

7. Meet with the chief examiner or designee to discuss:

   a. Planning materiality and the preliminary examination approach.

   b. The possible use of a specialist (e.g., actuary, information systems, investment, appraiser, IT examiner, reinsurance expert). If applicable, prepare "request for bid" letters, or similar documents, for the use of a specialist.

c. Significant events (e.g., pending merger/acquisition) and department concerns.

d. Impact of conditions present in the industry and economy relative to the examination plan.

e. Staff experience requirements.

f. Relationship with the internal and external auditors.

Contact Other Regulators

8. When conducting an exam of an insurer that is part of a holding company group that includes a company (or companies) that are at least in part regulated by regulators outside of the state insurance regulatory structure, contact the appropriate state, federal and international regulators to determine areas of concern for the group that should be addressed during the exam.

Meet with Company Representatives

9. Meet with company personnel to discuss relevant examination issues such as the following:

   a. Significant changes in the company's operations, major lines of business and corporate governance.

   b. Personnel or systems changes that would significantly affect the areas of accounting controls, procedures, systems or approval authorities. The same inquiries should be made of the electronic data processing (EDP) department and the internal audit department's procedures and scope.

   c. Scheduling a meeting with the external auditor to review the financial statement audit workpapers and any Sarbanes-Oxley workpapers.

   d. Plans for scheduling interviews with key members of management.

   e. Whether the company outsources critical business functions to third parties. **Note:** If the examiner determines that the insurer outsources critical functions to third parties, additional consideration and test procedures may need to be performed during the IT review and during control and substantive testing phases of the examination.

10. Follow-up on requests for additional required reports and records (if necessary).

11. Obtain relevant internal audit reports for review and consideration.

12. Request trial balance and other accounting records used to prepare annual financial statements.

13. If required based on anticipated risk-assessment, request pertinent information to confirm investment and bank accounts.

14. Discuss relationship with the internal and external auditors.

Meet with the Company's Appointed Actuary

15. Arrange a meeting with the appointed actuary to review the objectives and scope of the actuary's work and to obtain an understanding of the methods and assumptions used in establishing the actuarially determined asset or liability. Consider:

    a. The materiality and risks (e.g., nature and type of business, loss development, reinsurance, etc.) associated with the accounts.

    b. The actuaries' professional qualifications, reputation and relationship with the insurer.

    c. Any changes in methodology or assumptions from the prior examination.

    d. The actuaries' interaction with the internal and external auditors.

    e. Any changes to the reserving platform (i.e. computer program) since the prior examination.

Consideration of Fraud

16. Complete planning procedures for the consideration of fraud utilizing Exhibit G – Consideration of Fraud: Part 1 (or similar document).

Consideration of Related Parties

17. Obtain relevant information to assist in identifying related party relationships and transactions (e.g., identify parent, affiliates, subsidiaries and ultimate controlling person, principal owners, large shareholders, board of directors, officers, etc.). **Note:** Review of this information may have already been performed by the department analyst.

Step 2. Review of Gathered Information

18. Utilizing the gathered information, obtain an understanding of the company's business and corresponding risk exposures. Exhibit CC – Issue/Risk Tracking Template (or similar document) should be used to accumulate significant risks or issues identified through the review of information gathered.

19. Prepare a time budget and allocate work assignments for the examination and obtain the chief examiner or designee's approval.

Step 3. Analytical and Operational Reviews

20. Perform high-level analytical and operational reviews directed toward overall financial condition and profitability of the company. The examiner should leverage the NAIC Financial Profile Report and rely on work previously performed by the analyst when possible.

Set Planning Materiality Levels

21. Based on the preliminary analytical review and understanding of the company's business, determine planning materiality and tolerable error.

Step 4. Consideration of Information Technology Risks

22. Utilize Exhibit C, Part Two – Evaluation of Controls in Information Technology (IT) Work Program (or a similar document) to assist in conducting the review and assessment of IT General Controls.

23. Review the IT examiner's assessment of the effectiveness of the company's IT general control (ITGC) environment and the impact of IT findings (if any). Consider whether IT risks have been sufficiently mitigated to allow for testing of application controls in Phase 3. If the ITGC environment is not effective, the examiner would be required to perform additional testing in later phases of the exam before relying on system generated reports or controls in place at the insurer.

Step 5. Update the Insurer Profile Summary

24. Provide updates to the analyst regarding any significant initial findings for incorporation into the Insurer Profile Summary. Updates to the Insurer Profile Summary can be suggested throughout the examination process.

Part 2: Understand the Corporate Governance Structure

1. Conduct interviews with key members of management, members of the board of directors and/or audit committee of the insurer, as well as any other employees deemed necessary.

2. Document an understanding and assessment of the insurer's corporate governance framework by considering the information included in Exhibit M – Understanding the Corporate Governance Structure to address each of the following significant categories:

    a. Board of directors

    b. Organizational structure

    c. Assignment of authority and responsibility

    d. Management

    e. Risk-management function (for ORSA companies, complete the

ORSA Documentation Template found in Section 1, Part XI).

Part 3: Assessing the Adequacy of the Audit Function

Meet with Internal and External Auditors

1. Conduct a meeting with the external auditors to review both the financial statement audit workpapers and any Sarbanes-Oxley workpapers to discuss the scope of the audits (e.g., materiality, risk assessment and significant accounts/processes).

   a. Review relevant prior year audit workpapers if current year audit is in progress.

   b. Review pertinent management letters.

2. Utilize Exhibit E – Audit Review Procedures, to assess the adequacy of internal and external audit functions.

Part 4: Identifying Key Functional Activities

1. Determine key functional activities (e.g., premiums, claims investments) by considering information gathered to this point. The insurance organization may be examined on the same basis as it manages risk and controls itself, so key functional activities should typically correspond organizationally to the insurer. Consider discussing proposed key functional activities with the company before making final determinations. Complete applicable documentation for those activities determined to be significant.

Part 5: Consideration of Prospective Risk Indications of Solvency Concerns

1. Based on the preliminary analytical review, input from the analyst and the knowledge and understanding of the company, identify prospective risks that may indicate potential future solvency concerns for the company.

2. Determine where the prospective risks identified will be addressed. For broad prospective risks that impact more than one key functional activity, post the risks to Exhibit V – Overarching Prospective Risk Assessment for review. For risks that are directly associated with a particular key activity, post the risk to that activity's risk matrix for review.

<u>Phase 2 – Identify and Assess Inherent Risk in Activities</u>

1. Identify and assess inherent risks for key activities using a risk assessment matrix or similar tool. Consider both financial reporting risks and other than financial reporting risks in this process.

2. Ensure that each inherent risk identified should be associated with at least one of the nine branded risk classifications identified in Exhibit L – Branded Risk Classification.

3. Complete Exhibit CC – Issue/Risk Tracking Template by verifying that each item has been linked to a risk statement on a key activity matrix or Exhibit V – Overarching Prospective Risk Assessment or by documenting that additional work is not deemed necessary.

4. Complete Exhibit DD – Critical Risk Categories to determine whether all relevant critical risk categories have been included/considered on a risk matrix. In situations where a particular critical risk category is not addressed by at least one risk statement, the exam team should explain, in the planning memorandum, the rationale for why a critical risk category is not considered applicable to the company under exam.

5. Complete the planning process, including Exhibit I – Examination Planning Memorandum.

6. Obtain the chief examiner's or designee's approval of planning documentation, including Exhibit I – Examination Planning Memorandum, before control and detail testwork is performed.

EXHIBIT E
AUDIT REVIEW PROCEDURES

COMPANY NAME____
PERIOD OF EXAMINATION ____________________________________
EXAMINATION FIELD DATE ___________________________________
PREPARED BY____
DATE____

GUIDANCE

NAIC: Annual Financial Reporting Model Regulation (#205)
AICPA: Statement of Position (SOP) 95-4 – Letters for State Insurance Regulators to Comply with the NAIC Model Audit Rule
AICPA: Practice Alert 94-1 – Dealing with Audit Differences
AICPA: Statement on Auditing Standards (SAS) 89 – Audit Adjustments Federal Law: Sarbanes-Oxley Act of 2002 (SOX)
AICPA: AU Sec. 316 – Consideration of Fraud in a Financial Statement Audit
AICPA: Audit Risk Alert – Obtain current year alert
AICPA: SAS 104–111 – Risk Assessment Standards
AICPA: SAS 114 – The Auditor's Communication with those Charged with Governance
AICPA: Ethics Interpretation No. 501-8 – Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Provisions in Connection with Audit and Other Attest Services

OVERVIEW

The intent of the risk assessment process in a risk-focused examination is to identify areas of higher risk in order to enable more efficient use of examiner resources. A key to determining whether potential for material misstatement exists within the financial statements is to evaluate the insurer's audit function, which is made up of both internal and external audits.

The NAIC *Annual Financial Reporting Model Regulation* (#205) (commonly referred to as the Model Audit Rule (MAR)) was implemented in order to improve state insurance department surveillance of financial insurers by requiring an annual statutory audit of financial statements, which report the financial position and results of operations of insurers by independent certified public accountants. The primary objective of a statutory audit is to enable the external auditors to express an opinion as to whether the insurer's statutory financial statements are presented fairly in all material respects in conformity with the accounting practices prescribed or permitted by the applicable state of domicile. Effective in 2010, the MAR has additional requirements, including a mandatory Attestation of Internal Control by management for insurers with premiums greater than $500 million. Portions of the MAR are referenced throughout this document.

External auditors conduct audits in accordance with Generally Accepted Auditing Standards (GAAS) for non-public companies, and the rules and auditing standards of the Public Company Accounting Oversight Board (PCAOB) for publicly traded companies. GAAS require that the audit be conducted with independence, due professional care, ethical standards, objectivity and adequate planning/supervision. The PCAOB is responsible for the development of auditing and attestation standards related to quality control, ethics and independence for publicly traded companies. When these standards are adhered to, the external auditor's opinion lends credibility to such financial statements and thereby assists in promoting confidence that the insurer's financial condition is fairly presented.

Insurance companies often establish an internal audit function to assist in fulfilling such responsibilities as safeguarding assets, ensuring reliability of financial records, verifying compliance with internal procedures and assessing the efficiency of internal controls. Depending on the nature and extent of the internal auditor's work, the examiner may utilize their work to gain an understanding of the internal control structure or to assess control risk for specific identified risks.

As the insurance industry becomes more complex in responding to technological, global and market changes, the roles of the insurance regulator and external auditor become more demanding. In many aspects, insurance regulators and auditors face similar challenges, and increasingly their roles are perceived as complementary. Insurance regulators may utilize external auditors' work to assist them with their oversight responsibilities. Likewise, the auditors, in carrying out their duties, may also look to the insurance regulators for information that may increase audit effectiveness.

The control documentation required by the audit standards provides state insurance regulators with an enhanced ability to perform a risk assessment and thus should be used to the extent feasible in performing a risk-focused examination. By leveraging off the work performed by the company's internal and external auditors, insurance regulators may be able to avoid duplication of audit and examination procedures, thereby increasing the efficiency and effectiveness of the examination. If the internal or external auditor's work is utilized, the examiner should assess and draw conclusions about the quality, adequacy and results of the auditor's work, including verification of procedures as necessary. The examiner's professional judgment should be used in determining the extent of the auditor's work to be reperformed, if any. This judgment should be based on a number of factors, including the risk associated with the testing area and the errors noted by the auditor.

The purpose of this form is to provide guidance for the review and assessment of audit workpapers in conjunction with the state insurance department's financial examination of an insurer. This form should assist the examiner in understanding the risks identified by the external and internal auditors, how those risks were addressed, and the overall audit conclusions reached. This information may enable the examiner to conduct the risk assessment in a more effective manner. In order to fully understand the risk methodology and work performed by the external and internal auditors, the examiner should meet with the auditors prior to reviewing the workpapers to discuss the methodology regarding specific key areas, including any consideration and attestation of internal controls in accordance with SOX for publicly held companies and the Risk Assessment Standards for non-public companies. This meeting should include key engagement team members, such as the engagement partner or manager, to ensure that information is sourced from those with the most knowledge and understanding of the insurer and its financial statements.

REVIEW GUIDELINES AND INSTRUCTIONS

This form provides the examiner with a guide to facilitate the planning, performance and assessment of the internal and external auditor workpaper review, along with the review of SOX reports. This form should be completed during Phase 1, Part 3 of the risk-focused examination process.

It should be noted that not all insurers will have an internal audit department and, for those that do, the examiner should use professional judgement and consideration of the internal audit department's independence from management in the reporting structure in placing reliance on the work performed by the internal audit department. For companies where there is no segregation between management and the internal audit function, additional procedures may be required in reviewing the work performed by the internal audit department.

SARBANES-OXLEY ACT OF 2002 CONSIDERATIONS

Section 302, *Corporate Responsibility for Financial Reports,* requires principal officers to certify annual and quarterly reports. These certifications should provide information regarding the internal control structure, changes to internal controls and possible concerns on material weaknesses or significant deficiencies.

Section 404, *Management Assessment of Internal Controls,* requires annual reports to include an internal control report identifying management's responsibility for establishing and maintaining an adequate internal control structure, a management assessment on the effectiveness of the internal control structure, and an independent auditor attestation and opinion report on the assessment made by management.

If available, these documents could significantly assist the examiner in documenting and assessing the insurer's internal controls over financial reporting. Discussions with the insurer can be useful in the review of these documents in determining what information is pertinent to the examination planning objectives and what information would be most useful to the examiner.

COOPERATION OF EXTERNAL AUDITOR

If the examiner does not receive the full cooperation of the external auditor, the examiner needs to report this occurrence to the company under examination. Examiners may be forced to duplicate audit work already performed if the external auditor does not provide the audit workpapers to the insurance regulators in a timely fashion. Insurance regulators need to be provided with applicable audit workpapers prior to on-site fieldwork, as reliance on audit work will affect the examination scope and extent of additional detail tests.

The American Institute of Certified Public Accountants (AICPA) has developed a four-step process that may be followed by regulators who are experiencing difficulty in obtaining access to external auditor workpapers, who have questions with respect to the external auditor's individual engagement to perform a statutory audit, or who have concerns about the work performed by the external auditor. The AICPA proposes that the regulator should initially follow the current process of working through the company to obtain access. To increase the chances of success in obtaining the external audit work, examiners are encouraged to notify the external auditor, with the assistance of company personnel, at least six months before the as-of date of an upcoming examination so the auditor can adjust its schedule to make the work available to the examiner earlier. Should the regulator deem that additional response is required, after informing appropriate management, the financial examiner would contact the following individuals in this suggested order, as needed:

1. The engagement partner.

2. The designated national firm representative (see the NAIC website for a listing of Big Four firm contacts).

3. Chair of the insurer's Audit Committee.

4. State Board of Accountancy, Ethics (or Qualitative Review) Committee, or other regulatory bodies deemed appropriate.

This process, excluding Step 4, is informal, non-authoritative and non-binding. This process is in addition to the remedies available to regulators. The benefits of the additive process would be to help enhance communication between regulators and independent certified public accountants, improve the effectiveness of obtaining access to audit working papers on a timely basis, and assist in strengthening the quality of statutory audits. The AICPA has communicated to practitioners the statutory requirement to provide access to audit working papers and audit-related correspondence as defined by statute.

AUDIT REVIEW PROCEDURES

GENERAL INFORMATION: External

Accounting Firm ______________________________

Years on Engagement ______________________________

Date of Reports ______________________________

Independent Accounting Firm Contacts:

NAME	TITLE

GENERAL INFORMATION: Internal

Accounting Personnel ______________________________

Years of Experience ______________________________

Scope of Audits ______________________________

Date of Reports ______________________________

Internal Audit Contacts:

NAME	TITLE

Examiner	Date

External Auditor Workpaper and Report Review

1. Obtain the external auditor's engagement letter to ensure that there are no indemnification clauses or other unusual items included in the engagement letter.

***Guidance Point*: An indemnification clause between an insurer and an external auditor automatically breaches the independence of that auditor. If an indemnification clause exists, whether directly or indirectly, the examiner must evaluate whether it is reasonable to place reliance on the work of the external auditor. Additionally, the inclusion of an indemnification clause in a statutory auditing engagement letter is a breach of independence as outlined in the AICPA Ethics Interpretation 501-8.**

2. If not already performed by the financial analyst, obtain the following correspondence as required by the NAIC *Annual Financial Reporting Model Regulation.* Evaluate the content of the correspondence for consideration in the planning phases of the examination.

   a. If there was a change in auditor since the last examination, obtain the following documents:

      i. An "Awareness Letter" noting the external auditor's understanding of the insurance codes and regulations applicable to the insurer and affirming that the opinion expressed on the financial statements is in terms of their conformity to the statutory accounting principles.

         1. For additional information on frequency expectations for Awareness Letter filings by state, please review the NAIC's Guide to Compliance with State Audit Requirements.

      ii. A "Notification Letter" from the insurer to the commissioner stating whether, in the 24 months preceding the change in auditor, there were any disagreements with the former auditor.

      iii. A "Confirmation Letter" from the former auditor stating whether they agree with the statements contained in the insurer's "Notification Letter" and, if not, stating the reasons for which he or she does not agree.

   b. A "Qualification Letter" from the external auditor which includes the following representations:

      i. The auditor is independent.

      ii. The audit staff assigned to the engagement have sufficient background, designations and experience, in general, and the experience in audits of insurers.

      iii. The auditor's opinion will be filed in compliance with regulation.

      iv. The auditor consents to make available for review all workpapers and communications obtained as part of the audit to the examiner.

	Examiner	Date
v. The auditor is properly licensed by an appropriate state licensing authority and is a member in good standing with the AICPA.		
vi. The auditor meets the qualifications of an Independent Certified Public Accountant as defined in Section 7 of the NAIC *Annual Financial Reporting Model Regulation.*		
c. "Notification of Adverse Financial Condition," if applicable, outlining the reasons for the classification of Adverse Financial Condition.		
d. "Communication of Internal Control Related Matters Noted in an Audit," which outlines any unremediated material weaknesses noted during the audit.		
3. If not already performed by the financial analyst, obtain a copy of all recorded and unrecorded audit adjustments for the most recent year of the examination period (or multiple years of the examination period, if deemed necessary), along with supporting documentation regarding the adjustments or explanations from the external auditor. Evaluate the adjustments for consideration in the planning phases of the examination. ***Guidance Point*: The examiner should use information regarding audit adjustments identified by the external auditor in identifying risks or internal control weaknesses. This consideration should be documented within the examiner's workpapers.**		
4. If not already performed by the financial analyst, obtain a copy of the signed management representation letter for the most recent year of the examination period (or multiple years of the examination period, if deemed necessary), which acknowledges that management is responsible for the presentation of the financial statements and has considered all uncorrected misstatements and concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate. (Practice Alert 94-1: Dealing with Audit Differences; SAS 89: Audit Adjustments)		
a. Review the entire management representation letter to determine if there are any non-standard representations or representations that would have an impact on the examination.		
5. If not already performed by the financial analyst, obtain a copy of the internal control-related matters presentation materials for the most recent year of the examination period (or multiple years of the examination period, if deemed necessary), including the Management Letter, prepared by the external auditor for the audit committee's review. Verify that the presentation took place through review of audit committee meeting minutes. ***Guidance Point*: The external auditor is required to provide written communication to the audit committee of all significant deficiencies or material weaknesses known by the external auditor. These comments from the external auditors should be a good guide as to what areas will need additional test work.**		
6. If not already performed by the financial analyst, obtain from the external auditor a copy of the independent statutory audit report and opinion for the most recent year of the examination period (or multiple years of the examination period, if deemed necessary).		

	Examiner	Date
a. Verify that the audit report has an unmodified audit opinion, except with regard to the use of prescribed or permitted practices related to statutory accounting in the insurer's state of domicile. If an unmodified opinion was not issued, document the rationale for the modified opinion (e.g. qualified, adverse) and how this was considered during the examiner's risk assessment process.		
b. Identify any issues (material findings, contingencies, subsequent events, etc.) that should be considered during the examination. Document any issues noted and how they were considered during the examiner's risk assessment process.		
c. Ensure that the audited financial statements reconcile to the annual statement. If not, the examiner should ask the external auditor to provide an explanation for any differences.		
7. Discuss the audit with key members of the external audit engagement team. Inquire if there were any concerns with regard to the company under examination. The examiner should document any issues identified by the external auditor and consider those issues, if any, to assist in the planning phases of the examination. ***<u>Guidance Point:</u>*** **This discussion should include, but not be limited to, audit scope and planning, audit methodology and audit findings. The examiner should obtain a copy of the external auditor's risk assessment if one was not provided in the workpapers. Upon request of the state insurance department conducting the regulatory examination, the audit partner in charge of the engagement should be available for potential questions regarding the audit.**		
8. Obtain from the external auditor a complete copy of all relevant workpapers, including work performed at the parent or holding company level, in accordance with Section 13 of the NAIC *Annual Financial Reporting Model Regulation.* ***<u>Guidance Point:</u>*** **The high-level general review of the workpapers is to assess the competency and approach of the external auditor and determine what work is available and conducted in a manner that will allow reliance by the examiner. The examiner will perform a detailed review on any workpapers related to specific control or substantive test work that may be relied upon to address specific risks identified for matrix review during Phase 3 and Phase 5.**		
a. Review at a high-level the workpaper index and workpapers to identify any material financial statement accounts to determine if they were appropriately reviewed by the external auditor. Consider the impact the auditor's work will have on the identification of risks necessary for assessment by the examiner. ***<u>Guidance Point</u>*:** **Accounts that were not reviewed by the external auditor may correspond to the auditor's completed risk assessment and methodology. The examiner should not default to the same risk assessment as the auditor without evaluating the adequacy of the auditor's rationale.**		
b. Determine whether any workpapers will be excluded from the examiner's review and document the rationale for the exclusion.		
c. If the external auditor utilized work previously completed by the internal audit department or used the internal audit staff in completing any of their planned audit procedures, obtain supporting documentation of the external auditor's use of the		

Examiner	Date

internal audit department. (See the "Internal Auditor Workpaper and Report Review" section for additional procedures relating to the internal audit function.)

d. Review the workpapers at a high level to identify the internal controls reviewed or tested by the external auditor. Consider whether the external auditor had reviewed different control procedures in prior year audits and obtain the relevant workpapers from prior years as appropriate.

Guidance Point: **Note that external auditors often test internal controls on a rotational basis. Therefore, it may be necessary for the examiner-in-charge to request prior year workpapers from the external auditor in addition to the current year workpapers. The examiner may place reliance on testing from prior years if they are able to determine that the controls have not significantly changed.**

e. Document and evaluate any discrepancies or findings noted during the high-level review of the workpapers.

9. Obtain a copy of the external auditor's documentation in relation to AU Sec. 316—*Consideration of Fraud in a Financial Statement Audit*. The AU 316 documentation should assist the examiner in completing Exhibit G – Consideration of Fraud, Parts 1-3. If the assessment and related fraud procedures completed by the auditor are deemed insufficient, incomplete, or at the incorrect level (i.e., holding company or legal entity level), the examiner should also complete the fraud risk factor checklist within Exhibit G - Consideration of Fraud, Part 4.

Guidance Point: **The fraud risk factors identified by the external auditor in relation to AU 316 and by the examiner in Exhibit G should impact the examiner's consideration of risks inherent within the entity and impact the overall risk assessment and examination procedures completed by the examiner.**

10. Obtain copies of all legal letters obtained by the external auditor.

a. Review the legal letters to identify common themes or pending issues pertaining to insurer operations or class-action lawsuits that may impact the assessment of identified or potential risks.

b. Review the legal letters to determine the scope of further communication with legal counsel regarding litigation, claims, assessments and unasserted claims.

Guidance Point: **Risks identified within legal letters would most likely be classified as legal, reputation or operational risks.**

11. If the external auditor relied on a report of internal controls (SOC 1) provided by the insurer's service provider (data processing, claims processing, etc.), consider the adequacy of the external auditor's use and reliance of the report within their audit workpapers to facilitate the examination process.

a. Consider the documentation within the external or internal auditor's workpapers describing the consideration of any SOC reports and any assessment of risks resulting from the SOC report findings in completing the overall risk assessment.

	Examiner	Date
12. Obtain and review copies of the workpapers relating to the review and assessment of the company's Information Technology (IT). If necessary, include department IT staff in the review. ***<u>Guidance Point</u>*: The review of IT should be done in conjunction with the completion of Exhibit C – Evaluation of Controls in Information Technology.**		
13. If the insurer is required to comply with SOX, obtain the following reports and determine what impact, if any, the content may have on the scope and extent of the examination:		
a. Section 302, *Corporate Responsibility for Financial Reports*, which includes certification from principal officers of the annual and quarterly reports.		
b. Section 404, *Management Assessment of Internal Controls*, which includes a management assessment on the effectiveness of the internal control structure and an independent auditor attestation and opinion report on the assessment made by management.		
<u>Internal Auditor Workpaper and Report Review</u>		
14. Obtain and document an understanding of the internal audit department's role in the internal control structure, including recent changes in the internal audit department, such as personnel, approach and reporting relationship changes.		
a. Determine that the board of directors and senior management are restricted from delegating their responsibilities for establishing, maintaining and operating effective audit activities (e.g., establishment of an annual audit plan that is reviewed by the audit committee).		
b. Determine that audit activities are performed by an independent and qualified staff that is objective in evaluating the insurer's financial reporting risks and internal controls, including management information systems. In order to be independent, internal audit members should not have other operational, risk management, or accounting responsibilities (unless exempt in accordance with NAIC Model #205).		
15. If the internal audit department is deemed independent and qualified, obtain documentation of all the internal audits conducted by the internal audit department since the previous examination. Perform a high-level review of selected internal audit reports to determine whether:		
a. Audit activities help maintain or improve the effectiveness of insurer risk management processes, controls and corporate governance.		
b. Audit activities provide reasonable assurance about the accuracy and timeliness of recorded transactions and the accuracy and completeness of financial reports.		
c. Audit activities provide assistance, guidance and/or suggestions where needed.		
16. After review of internal audit reports, if the examiner has determined that the internal audit department is competent, the internal audit department may be used for preparing examination workpapers.		

	Examiner	Date
<u>Conclude on the Review of Internal and External Audit Functions</u>		
17. Follow up on any unresolved questions and issues identified during the review of the auditors' workpapers. Document any issues and responses provided.		
18. Prepare a memorandum documenting:		
a. The overall review of the internal and external auditors' workpapers.		
b. The examiners assessment and conclusion on the competency and adequacy of external and internal audit documentation as part of the corporate risk management process.		
c. The examiners conclusion regarding whether a review of financial reporting risks can be reduced based on the effectiveness of the insurer's audit function.		

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Susan Bernard, Chair of the Financial Examiners Handbook (E) Technical Group (FEHTG)

FROM: Kevin Baldwin and Laura Slaymaker, Co-Chairs of the Receivership Law (E) Working Group (RLWG)

DATE: November 15, 2022

RE: Pre-Liquidation Coordination and Information Sharing Memorandum of Understanding

The Receivership Law (E) Working Group of the Receivership & Insolvency (E) Task Force adopted a template for a Memorandum of Understanding ("MOU") that can be utilized to facilitate transitional planning and preparation, communication and information sharing with guaranty funds, starting when a troubled property and casualty insurer faces a material risk of being liquidated as insolvent. The insurance financial regulators, insurance receivers and the guaranty funds need advance planning for the transition from a troubled insurance company to liquidation. The MOU template is flexible and can be tailored to the individual state insurance department and the specific troubled property and casualty insurer situation. The attached MOU is also posted to the Receivership and Insolvency (E) Task Force webpage as a resource for state insurance departments.

The MOU was subsequently adopted by the Financial Condition (E) Committee on Nov. 15, 2022. The RLWG encourages the FEHTG to consider including reference to this MOU template when updating existing *Financial Condition Examiners Handbook* guidance regarding considerations to promote early communication in property and casualty insurer pre-liquidation situations.

If there are any questions regarding this referral, please contact NAIC staff (Jane Koenigsman) to discuss.

III. GENERAL EXAMINATION CONSIDERATIONS

This section covers procedures and considerations that are important when conducting financial condition examinations. The discussion here is divided as follows:

A. General Information Technology Review
B. Materiality
C. Examination Sampling
D. Business Continuity
E. Using the Work of a Specialist
F. Outsourcing of Critical Functions
G. Use of Independent Contractors on Multi-State Examinations
H. Considerations for Insurers in Run-Off
I. Considerations for Potentially Troubled Insurance Companies
J. Comments and Grievance Procedures Regarding Compliance with Examination Standards

DETAIL ELIMINATED TO CONSERVE SPACE

I. Considerations for Potentially Troubled Insurance Companies

A troubled insurance company is broadly defined as an insurance company that is either in or is moving towards a financial position that subjects its policyholders, claimants and other creditors to greater-than-normal financial risk, including the possibility that the company may not maintain compliance with the applicable statutory capital and/or surplus requirements (*Troubled Insurance Company Handbook*). The "Prioritization Framework" as discussed in the NAIC's *Financial Analysis Handbook* identifies troubled companies as Priority 1.

In situations in which an examination is being planned for a troubled insurance company (i.e., Priority 1 company), the NAIC's *Accreditation Program Manual* (Part B3: Department Procedures and Oversight) indicates that "the department should generally follow and observe procedures set forth in the NAIC *Troubled Insurance Company Handbook.*" However, regulators may also consider leveraging the insights in the *Troubled Insurance Company Handbook* for Priority 2 companies, which are defined in the *Financial Analysis Handbook* as "high-priority insurers that are not yet considered troubled but may become so if recent trends or unfavorable metrics are not addressed."

The following guidance provides an overview of key elements to consider during an examination. Additional insights to assist in enhancing a state's monitoring and surveillance of troubled insurance companies, including regulatory actions available to Departments of Insurance (DOIs), can be found in the *Troubled Insurance Company Handbook*.

<u>Communication Expectations</u>

If an examination is planned or ongoing for a troubled or potentially troubled company, or through the course of the examination that the domestic regulator elevates the priority level of the company to troubled or potentially troubled, it is critical that the domestic regulator communicates proactively and timely with other impacted state insurance regulators. It is also important that the non-domiciliary state communicates with the domestic regulator prior to taking any action against the insurer. This can be particularly important if the corrective action plan implemented by the domestic regulator depends on continued operations of the insurer in other states. Depending on the circumstances, it may also be appropriate to communicate certain information with other parties, such as other regulatory bodies, company management, and state guaranty funds. Establishing a coordinated communication system among the relevant parties will help facilitate the domestic regulator's surveillance of the troubled company.

The timeliness of communication with other regulators should be commensurate with the severity of the event, and it should include information about the troubled company's situation and the proposed corrective action. It may also include a request for other jurisdictions to assist in the implementation of the plan. When determining which states to notify, the department may consider those in which the company: 1) has a significant amount of written, assumed or ceded insurance business; 2) has significant market share; 3) is licensed; 4) has affiliates; 5) utilizes fronting entities; 6) has pooled companies; and 7) is seeking to write business or obtain a license. If it is reasonably anticipated that corrective plans will not prevent a finding of insolvency or insolvency is reasonably possible, advance communication to the guaranty funds is critically necessary for a successful transition to liquidation. If the guaranty funds are notified in a timely manner, they may be able to provide additional guidance and assistance in preparing the company for liquidation. The Memorandum of Understanding (MOU), which is maintained on the Receivership and Insolvency (E) Task Force web page, is an optional tool available to regulators that can help to facilitate this communication and information sharing as well as transitional planning and preparation.

Pre-Receivership Considerations

Depending on the circumstances of the troubled company's situation, the department may determine that the appropriate course of action is to place the company in receivership. There are several steps that the department can take to ensure a smooth transition to receivership, should that be necessary. Having a thorough understanding of the company's rights and ownership of its assets, as well as its liabilities and obligations can help the department manage the possible transactions that could occur if the company is placed in receivership. It may also help the regulator understand if inappropriate transactions occur in anticipation of receivership, such as preferential payments to related entities and payment of management bonuses or expense reimbursements. As part of the corrective plan, the department may consider requesting the implementation of controls surrounding the troubled company's operations. For instance, it may be necessary for management to establish controls around acceptance of new business or new commitments by the company, as well as recordkeeping requirements if the insurer is involved with reinsurance.

If an examination is planned or ongoing for a troubled or potentially troubled company, the examination should increase its review of risks and controls surrounding financial reporting processes in the areas discussed above. For example, the exam may have a greater focus on the following areas:

- Gaining an understanding of the location (i.e., bank accounts, deposits, custodial accounts, letters of credit, etc.) and ownership (i.e., funds held with reinsurers, intermediaries, MGAs/TPAs, etc.) of company assets.
- Gaining an understanding of possible encumbrances on company assets that may be triggered if the financial position of the company continues to deteriorate.
- Gaining an understanding of the provisions within various agreements that the company has entered into (i.e., reinsurance agreements, agreements with service providers, investment advisors, etc.) that could be impacted by being placed into receivership.
- Reviewing transactions involving the movement of company assets.
- Identifying primary responsibility for obligations and liabilities, such as tax payments, pension plan contributions, pledges of assets, etc.
- Additional testing to ensure the completeness of policy and claims data.

If receivership or liquidation is triggered, and assets are transferred to the receiver or guaranty fund to settle obligations, it is important that the company's data be maintained in such a format to ensure that policies can continue to be maintained and claims can continue to be paid. For example, the company should have the ability to export its claims data through a defined format (Uniform Data Standards [UDS]) that would allow the data to be received and utilized by a third-party guaranty fund. Therefore, the examination may include additional procedures as part of the IT review to identify and locate data storage and processes, understand the format of the data, and ensure that proper functionality exists for timely and efficient export of policy and claims data in the event of a receivership.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

MEMORANDUM

TO: Susan Bernard, Chair, Financial Examiners Handbook (E) Technical Group

FROM: Judy Weaver, Chair, Financial Analysis (E) Working Group

DATE: April 27, 2023

RE: Enhanced Regulatory Guidance

As you may be aware, the Financial Analysis (E) Working Group (FAWG) meets annually in Kansas City to discuss among other things, potentially troubled insurers and insurance groups. During this meeting, FAWG also discusses issues and industry trends, including identifying any that are potentially adverse or might warrant communication and coordination with other NAIC groups. As a result of the issues and trends discussed, FAWG would like to refer the following item to the attention of your group.

1. **Strategic/Operational Risks of Health Insurers** – Due to their nature, health insurers are exposed to a number of strategic and operational risks that differ from those faced by other insurers, which have the potential to significantly impact their current and prospective solvency position. In addition, a health insurer's processes to identify and mitigate exposures to these risks can be difficult to assess and evaluate during the initial licensure and ongoing, off-site financial analysis processes. As such, it is recommended that additional guidance on strategic/operational risks faced by health insurers be considered for incorporation in the NAIC's *Financial Condition Examiners Handbook* to encourage review of these risks during an onsite examination. Examples of unique strategic/operational risks with the potential to impact the solvency of health insurers include, but are not limited to:

    a. **Failure to Maintain Adequate CMS Star Rating** – For health insurers writing Medicare business, a low or lowering of the Star rating may result in a loss of bonus payments, concerns regarding the insurer's reputation leading to loss of membership, decrease in underwriting results, and changes in future strategic plans.
    b. **Failure to Properly Identify/Code Member Health Status** – For ACA plans that are subject to risk adjustment programs, a failure to properly identify and code member health status for risk scoring could significantly impact the risk adjustments due to the health insurer through the program. For example, an insurer with ineffective coding processes could owe a material risk adjustment payment even though it experiences higher than average medical loss ratios.
    c. **Failure to Plan for Variation in Membership Levels** – Many health insurers are exposed to significant swings in enrollment (increases or decreases), which can impact solvency if the company is not adequately capitalized and prepared to adjust operational support up or down to accommodate changes in membership. This operational risk is often interrelated with underpricing concerns, which could lead to rapid growth.
    d. **Challenges in Provider Contracting –** Given the importance of provider contracting in maintaining an adequate network and controlling the cost of healthcare services, a failure to implement effective practices in this area could quickly lead to solvency concerns.

If there are any questions regarding the proposed recommendation, please contact me or NAIC staff (Bruce Jenson at *bjenson@naic.org*) for clarification.