## 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

### G. Use of Independent Contractors on Multi-State Examinations

When evaluating staffing needs to schedule examinations of domestic insurers licensed in multiple states, state insurance departments may find it necessary to engage an independent contractor. An independent contractor is defined as anyone employed by the state insurance department that is outside of the department’s staff. Examples of independent contractors, while not inclusive, are as follows:

* Certified Public Accountants
* Contract Examiners
* Specialists

An insurance department’s decision to engage an independent contractor may arise due to, among other things, insufficient examination staff or the need to meet statutory mandates. While the foregoing circumstances may lead an insurance department to contract the services of an independent contractor, the department should consider the long term effects of not maintaining an appropriate level of qualified staff. Maintaining competent examiners on examinations and during interim periods enhances the department’s ability to effectively regulate domestic insurers and foreign insurers with substantial state premium writings. Through the examination process, examiners can enhance their knowledge of state laws and regulations, various types of insurance products, investment practices, loss reserving techniques, reinsurance transactions etc., that are useful in effectively and efficiently assessing a domestic company’s financial condition and results of operations. This internal expertise is particularly important in handling troubled insurance companies.

The use of independent contractors requires the involvement of the state insurance department in directing and monitoring the work performed by the independent contractor. The oversight of independent contractors is primarily the responsibility of the insurance department’s designee.

The role of department designee must be filled by an individual who is certified by the Society of Financial Examiners (SOFE) as a Certified Financial Examiner (CFE) or by an individual who has substantially similar experience, qualifications and background. (Include the details in examination planning memorandum.) This individual must be employed by and conducting work solely on behalf of the State Insurance Department. In general, the department designee should have an accounting, insurance, financial analysis, financial examination, information technology (IT) and/or actuarial background, and insurance backgrounds should primarily be financial in nature. College degrees should generally focus on accounting, insurance, finance, business, risk management or actuarial science. Other professional designations and credentials may also demonstrate expertise in insurance and/or financial examinations.

Depending on the scope of the engagement and extent of the work performed by the independent contractor, the following standards of examination planning, fieldwork, and examination reports are applicable:

1. Standards of Examination Planning and Field Work

a. The procedures shall be planned and developed according to the Handbook under the supervision and with the participation of the insurance department’s designee. This includes review and approval of the examination planning memorandum, which may also warrant a review of workpapers supporting the conclusions reached therein.

b. The insurance department’s designee shall review and approve significant examination workpapers on a timely basis. This includes, but is not limited to the following:

* Applicable risk assessment workpapers, including the examination risk tracker (Exhibit CC), prospective risk assessment (Exhibit V), key activity matrices and consideration of critical risk categories (Exhibit DD).
* Ongoing examination status and explanation of modifications to the approved time budget.

1. The insurance department’s designee shall supervise all significant field work activities, including appropriate review and approval of risks identified and planned procedures prior to beginning Phase 3 and Phase 5.

2. Standards of Examination Conclusions and Reporting

1. The insurance department’s designee shall review and approve key solvency monitoring and completion documents on a timely basis, including the summary review memorandum (Exhibit AA) and evidence of interdepartmental communication of significant issues and concerns.
2. The examination results and findings shall be reviewed for reasonableness and sufficiency, and accompanying workpapers shall be reviewed for adequacy of documentation by the insurance department’s designee.
3. The report shall be prepared by the insurance department in accordance with the Handbook and departmental policy.
4. The report shall be signed by the examiner-in-charge (EIC). If the EIC is an independent contractor, the report shall also be signed by the insurance department’s designee.
5. The insurance department’s designee shall complete the general review section of the Review and Approval Summary (Exhibit Q) to ensure an appropriate depth of review has been performed.

3. Use of a CPA on an Agreed-Upon Procedures Engagement

While not very common, the use of a CPA independent contractor in an examination may be accomplished through an “Agreed-Upon Procedures Engagement.” (Only CPAs can perform an Agreed-Upon Procedures Engagement.) In addition to meeting the standards of examination planning, fieldwork, and examination reports, the following establishes guidelines for engaging a CPA to perform agreed-upon procedures.

The American Institute of Certified Public Accountants (AICPA) Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (SSAE No. 10), sets forth the standards and provides guidance to the CPA when performing and reporting on engagements to apply agreed-upon procedures. In an agreed-upon procedures engagement, the CPA performs specific procedures on specific elements, accounts or items of a financial statement and issues a report of findings based on those procedures. The insurance department and the CPA agree upon the procedures to be performed by the CPA that the insurance department believes are appropriate. Therefore, the insurance department assumes all responsibility for the sufficiency of the procedures and the risk that those procedures might be insufficient for their purposes. Because the CPA will only report on the findings of the procedures performed, any conclusions regarding the findings, and disposition thereof, must be made by the department. Additionally, the CPA has no responsibility to determine the differences between the agreed-upon procedures to be performed and the procedures that the CPA would have determined necessary had he or she been engaged to perform another form of engagement, such as an audit under generally accepted auditing standards. The department should review SSAE No. 10, and consider the CPA’s professional standards prior to engaging an accounting firm to provide this type of service.

The insurance department must attain certain standards relative to the examination report, planning and field work that are in accordance with the Handbook. These standards relate to the responsibilities of the insurance department and the utility of the examination report in achieving regulatory objectives when engaging a CPA to perform agreed-upon procedures.

4. Conflicts of Interest

Conflicts of interest may occur if an examination of a company is performed by an independent contractor who has a significant relationship with the company, its affiliates, or their management (financial or non-financial) that may impair in fact, or appearance, the independent contractor’s independence. To evaluate any such conflicts of interest, the insurance department should request a disclosure letter from the independent contractor regarding their past, present or planned relationships, both financial and non-financial, with the examined company or its affiliates. The disclosure letter should discuss the nature of the services provided by the independent contractor and the amount of fees paid to the CPA by the company over the preceding five years.

Determining whether a potential conflict of interest exists is a matter of considerable judgment. As independent contractors provide many different types of services (e.g., accounting, auditing, actuarial, management and tax consulting), it will be necessary to evaluate the nature of services provided and the amount of fees involved when determining whether a potential conflict of interest exists.

5. Maintenance of Workpapers

The insurance department should maintain, at a minimum, a complete photocopied set of the CPA’s original workpapers.

6. Independent Contractors’ Immunity Privileges

When hiring independent contractors to perform all or portions of a state insurance examination, the state insurance department should consider the following items related to the independent contractor’s immunity prior to finalizing an agreement.

* Review the NAIC *Model Law on Examinations* (#390), Section 8 to determine if your state has adopted these provisions in its statutes. If your state has not adopted Model #390, confirm if it has adopted similar language which grants immunity to any examiner appointed by a commissioner.
* Determine if there are any relevant court decisions or opinions, which hold that an examiner appointed by the commissioner is granted immunity from liability in the performance of his/her duties.
* Verify if independent contractors in your state are required to carry liability insurance coverage for work performed. Determine if your state provides insurance coverage to these independent contractors in the performance of their duties.

7. Controlling Exam Costs when Utilizing Independent Contractors

It is important to keep in mind that the use of independent contractors can lead to higher examination costs. It is the regulator’s responsibility to appoint and monitor the independent contractor, and it is the insurer’s responsibility to cooperate with the independent contractor and provide appropriate input to facilitate an efficient examination process. The insurer may provide factual input to the regulator based on observations of the independent contractor’s work. High-level company monitoring of the examination process and ongoing two-way communication of problems on the examination (related to the cooperation of the insurer or the performance of the examination) can help ensure the effective use of independent contractors. If state legislation permits and circumstances are warranted, it may benefit the regulator to consider the following procurement procedures in order to control costs when utilizing an independent contractor.

1. The regulator should have minimum qualification standards that the independent contractor should meet in order to be considered in the procurement process. The independent contractor should have the following:

* Practical experience with the type of work that is out for bid;
* Qualified personnel; and
* Demonstrable success on prior contract examinations.

1. The regulator should consider having a meeting with all qualified vendors (independent contractors) and the insurer to further explain, clarify, or identify areas of concern. This meeting should address the following:

* A detailed description/specification of the work to be performed in terms of required outcomes. Specifications should be written to encourage, not discourage, competition consistent with seeking overall economy for the purpose intended. The goal is to invite maximum reasonable competition;
* Concerns of the insurer, independent contractor and the department of insurance; and
* Time frame of the bidding process.

c. The potential independent contractor should describe their organizational and staff experience as well as past experience, which should be described in sufficient detail to demonstrate their ability to perform the functions outlined by the department. For long-term projects, the independent contractor should document their experience, capability, and commitment to perform project management functions.

d. The independent contractor should provide a minimum of three references who may be contacted where services similar in scope to the requirements outlined by the department have been provided. The state department should consider the independent contractor’s experience with other state insurance departments.

e. Prior to selecting the independent contractor, the regulator should consider at least three competitive bids.

f. The most responsive and responsible independent contractor whose bid reflects the lowest price should be considered. “Responsible” means that the vendor has the capability, integrity, and reliability to provide the services needed. Being “responsive” means that the bid conforms in all material respects to the requirements outlined by the department.

Various types of contracts exist and each type of contract should be considered by the regulator when utilizing independent contractors. Fixed fee contacts and cost-reimbursement type contracts are two common types of contracts. Fixed fee contracts are contracts for a set amount, regardless of the expenses or hours incurred by the independent contractor. Under this scenario, the independent contractor is fully responsible for performance costs and enjoys (or suffers) resulting profits (or losses) based on the efficiency and effectiveness of their examination progress. Fixed fee contracts are typically appropriate when the work to be performed by the independent contractor can be described clearly and the regulator can write clear and detailed specifications for how the work is to be done. If a fixed fee contract is not chosen, the regulator may use a cost-reimbursement type contract. In this type of contract, the department agrees to compensate the independent contractor at a fixed hourly rate plus compensation for reimbursable expenses. If this type of contract is used, the regulator should strongly consider making it a three-party contract between the state department, the independent contractor and the insurer.

If a fixed fee contract is used, independent contractor travel expenses are irrelevant to the regulator. If a contract that allows for cost reimbursement is utilized, the regulator should consider the extent of the independent contractor’s travel expenses. It is recommended that the regulator monitor the independent contractor’s travel expenses. The regulator should consider the recommended per diem rates for lodging, meals and incidentals set forth within Section 1, Part II, D of this Handbook (this is also available on the NAIC Web site).

The above mentioned guidance, as it relates to procurement, contracts and travel expenses, combined with continued monitoring of the independent contractor’s work may result in significant cost decreases. It is encouraged that the time budget be communicated to the insurer, however, final approval of the budget should reside with the insurance department and the work of the independent contractor should be directed by the state regulator. Consider holding frequent status meetings with the independent contractor to ensure that the adequacy and timeliness of the work being performed is meeting the department’s expectations. The development of a detailed time budget for the independent contractor will allow the insurance department and the insurer to compare the actual work performed with expectations. The time budget should estimate the time to complete examination sections, which typically are annual statement line items, system processes, related controls or the company background. The independent contractor should submit time budgets to the state insurance department on at least a monthly basis, or as often as a detailed time and expense billing report is required to be submitted. The detailed time budget should also include an estimated date of completion for all fieldwork. If any action, or lack of action, by the insurer causes the independent contractor’s hours to significantly increase (i.e., a greater than 10% increase in the budgeted time for a specific examination area), the independent contractor should immediately communicate this to the state department, who would then contact the insurer. This same communication process should take place if the independent contractor becomes aware of any material transactions that took place subsequent to the balance sheet date.