To: Financial Examiners

From: NAIC Examination Unit Staff

Date: January 21, 2015

Re: Sound Practices in Documenting Reliance on Audit Workpapers

Background Information
One of the primary ways for financial examiners to gain efficiencies in conducting exams is to leverage existing work performed by an insurer’s internal and external auditors. However, before placing reliance on audit work, examiners must first ensure that an effective audit function is in place and that the audit work performed meets minimum quality standards. To fulfill this purpose, a general review and assessment of an insurer’s audit function is required through Phase 1 - Part 3 of the exam process. Narrative guidance for use in conducting the review is included in Section 2, Phase 1(C) of the Handbook and a list of specific procedures for use in the review is included in Exhibit E.

With the implementation of critical risk category guidance, exam teams have been granted additional flexibility in relying on the work of auditors to address less significant financial reporting risks. The intent of this change is to allow for even greater efficiencies in utilizing existing audit work to address financial reporting risks that don’t fall within the critical risk categories and aren’t considered to be high financial solvency risks. In these situations, the examiner may choose not to place such risks on a key activity matrix. There is no explicit requirement for the exam team to document which of these risks were adequately addressed by the audit function or to provide rationale for risks that were originally considered, but ultimately not posted to the matrix. The required documentation is a conclusion regarding whether a review of financial reporting risks can be reduced based on the effectiveness of the insurer’s audit function (see Exhibit E step 18c).

For financial reporting risks that are either designed and designated to address a critical risk category or are deemed significant and/or inherently high by the examiner, the method of reliance on audit work has not changed. If the audit work has been deemed effective as a result of the general review performed in Phase 1, the examiner may continue to rely on this work. However, in these situations, the examiner must review, retest (if necessary), annotate and link each relevant workpaper into the examination file in the appropriate phase. This will allow the exam team to document its review and reliance on the work performed in detail, to support the review and assessment of critical risk categories and high risk areas.

As part of the general review and assessment of the audit function, Exhibit E requires the exam team to review audit workpapers to determine whether material financial statement accounts were appropriately reviewed by the external auditor (see step 8a). However, it is up to each individual exam team to determine the level of review to be performed and documentation to be provided in support of this step. In determining the level of review to be performed and documented in this area, the exam team should keep in mind that the purpose of the critical risk category changes are to direct time and resources to the most significant solvency issues facing the company under examination. Therefore, the utilization of audit work should be accomplished in such a way that supports this goal to perform an efficient and effective examination focusing primarily on the most significant solvency threats facing the company.

General Sound Practices
In reviewing the work of various exam teams in this area through the Peer Review Project, some sound practices have been identified. Additional detail is provided in the items listed below:

1. **Perform a High-Level Review of the Audit Function in Phase 1** – As the purpose of leveraging work performed by the audit function of an insurer is to gain exam efficiencies, exam teams should attempt to limit the total amount of time spent in reviewing the existing audit work in Ph. 1. While a meeting with the external auditor and completion of the steps within Exhibit E are required, examiners are encouraged to limit their review of specific workpapers to gaining a general understanding of the scope of the audit and the level of testing performed. In all cases, the exam team should conclude on the competency and adequacy of the audit function. If the function, or portions thereof (i.e. internal or external audit), is not deemed to be effective, the exam team should limit the reliance it places on the function in the remaining phases of the examination.

2. **Conclude on Whether a Review of Financial Reporting Risks Will be Reduced** – As part of the assessment of the insurer’s audit function, the exam team should conclude as to whether its review of financial reporting risk will be reduced based on the effectiveness of the function. If so, the exam team may choose to list the areas of financial reporting risk that will be excluded from review, supported by a brief summary of the audit work performed in those areas. This summary does not need to link in detailed supporting workpapers, but may include a link to an audit program if deemed necessary or appropriate. Examples of sound practices in this area identified through the NAIC’s Peer Review Project are shown below:
   
   a. Support for reliance on audit work to reduce review of financial reporting risks included in one general memo:
      
      CPA Reliance Memo - Type 1A
      CPA Reliance Memo - Type 1B
   
   b. Support for reliance on audit work to reduce review of financial reporting risk separated into separate memos for each area of reliance:
      
      CPA Reliance Memo - Type 2
   
3. **Utilize Relevant Audit Work to Address Identified Risks in Ph. 3 and Ph. 5** – For risks that are identified for review through the risk matrix (or Exhibit V), relevant work performed by the audit function should be leveraged to assist in addressing these risks. In these situations, the audit work should be brought into the examination file, reviewed in detail, retested (if deemed necessary), and annotated to indicate the examiner’s conclusion on and use of the work performed. In situations where significant reliance is placed on audit work to address a high risk of the company, examiners should strongly consider retesting at least one item to gain a full understanding of the nature and scope of testing performed.

**Sound Practices Relating to Timing Issues**

In certain situations, the timing of access to internal/external audit workpapers may be restricted such that the examination team will not receive CY workpapers until late in the exam process. In these instances, the exam team may need to adjust its review processes in order to achieve efficiencies in utilizing audit workpapers. While the exam team may choose to conclude that reliance cannot be placed upon the audit function to reduce a review of financial reporting risks due to timing challenges, this conclusion may not always be necessary. An example of an alternate approach that may be taken to achieve efficiencies through an adjustment in the typical review process is described as follows:

1. **Notify Auditors of Upcoming Exam as Early as Possible** – In all instances, the exam team is encouraged to notify the insurer and its independent auditor of an upcoming exam as early in the process
as possible. A number of audit firms have indicated a willingness to accelerate the process to provide access to CY workpapers if they are notified early on in their audit planning process. This is particularly true for any interim or control testwork that may be completed in advance of final audit fieldwork.

2. **Review and Utilize PY Workpapers as Appropriate** – Even if CY audit workpapers are not available for review during exam planning, the exam team may benefit from obtaining and reviewing PY workpapers. These workpapers may be reviewed to get an understanding of the overall audit approach as required by Exhibit E in Phase 1 as well as in Phase 3 control testing of a process that has not changed from the PY.

3. **Discuss any Changes in the CY Audit Approach and Conclude on Planned Reliance** – After reviewing PY workpapers to get an understanding of the overall audit approach and work performed, the exam team may discuss changes in the planned audit approach for the CY with the independent auditor. If the exam team determines that the audit approach will not change significantly in the CY and that PY work was sufficient to reduce a review of financial reporting risks in certain areas, the exam team may choose to plan for reliance on CY audit work to reduce a review of financial reporting risks in those areas. This would allow the exam team to avoid addressing less significant financial reporting risks expected to be reviewed through the CY audit from the exam’s key activity matrixes.

4. **Obtain and Review CY Workpapers Before Finalizing Exam** – Prior to concluding the examination, the exam team should obtain and review CY audit workpapers to verify that the work performed met expectations. If the work meets expectations, such a conclusion should be appropriately documented in the file. If the work performed does not meet expectations, the exam team should supplement the work performed by the independent auditor to address those financial reporting risks originally excluded from the risk matrixes. In this situation, the insurer should be notified of the deficiency identified in the audit workpapers and the resulting impact on the examination budget.
ADDITIONAL SUPPORT FOR RELIANCE ON INDEPENDENT AUDIT FUNCTION

A general review of the audit function of the insurer is documented at Exhibit E (hyperlinked above). In addition to the general review and conclusions, the exam team developed the following documentation to provide additional support for the conclusion to reduce the review of financial reporting risks in certain areas.

Exhibit E - External / Internal Audit Function

Independent Audit Function
Examiners requested, reviewed and assessed selected work papers in accordance with Section 13 of the NAIC Annual Financial Reporting Model Regulation. ABC Audit performed an integrated GAAP audit on the Company and issued statutory-basis financial.

Key areas of review include:
- Investment valuation and impairment
- PC and Life deferred acquisition costs (GAAP)
- Income taxes
- Goodwill (GAAP)
- Pension plans
- Stock-based compensation (GAAP)

Entity-level Control characteristics were found to be effective for:
- Integrity, ethical values and behavior of key executives
- Management’s control consciousness and operating style
- Management’s commitment to competence
- Participation in governance and oversight by the audit committee and those charged with governance
- Organization structure and assignment of authority and responsibility
- Human resource policies and practices
- Formalized risk assessment process
- Monitoring of controls
- Communication process

ABC Audit also concluded the Company’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies for the insurance industry. Management’s selection and application of accounting policies do not give rise to a risk of material misstatement in the financial information reported.

Identified Risk of Material Misstatement Due to Fraud:
- Improper recognition of earned premium related to the recognition of top-side financial statement close journal entries to circumvent the routine processes for revenue recognition and related controls for P&C business and manage earnings.
- Manipulation of the estimate of IBNR reserves for P&C business.
Audit Strategies

- Testing strategy was designed based on an ‘effective/support’ evaluation of ITGCs.
- Perform audit of internal control over financial reporting in accordance with PCAOB Auditing Standard No. 5.
- Independent testing of controls over estimation transactions that are generally complex in nature.
- Substantive testing on significant account balances.
- Analyze the investment portfolio for the existence of impaired investments and validate the fair values reported.
  - The process followed to assess investment portfolio holdings for potential other-than-temporary impairment is reasonable and the review for impairment did not identify any needed adjustment.
  - Management properly classified financial instruments measured at fair value.
  - No exceptions were noted in the testing of NAIC designations.
- Substantiate the income tax accounts.
  - No deficiencies were identified in the design or operation of the tax-related controls.
  - All significant deferred income tax items have been properly accounted for in the tax provision.
  - Income tax accounts are free of material misstatement.
- Evaluate data and related assumptions provided to CPA hired actuaries to value the liability for pension and postretirement benefits.
  - The work of CPA hired actuary constitutes relevant and reliable evidential matter to support the reasonableness of the pension and OPEB plan balances.
- Assess the process followed by management to value and record compensation expenses.
- Assess the process followed by management to review goodwill.

Conclusion
Given the general effectiveness of the audit work noted through a review of the areas described above, the exam team will reduce its review of financial reporting risks in those areas.
Exhibit 1B:

MEMO

TO: File
FROM: Examiner
RE: Reliance on work performed by ABC (External Auditors) to reduce testing of financial reporting risks
DATE: June 15, 2014

In addition to the general review of the insurer’s audit function, documented at Exhibit E, this memo documents the exam team’s review of certain audit workpapers for purposes of reducing the number of financial reporting risks selected for review in these areas:

Cash & Investments
Cash handling risks were mapped and control testing was performed (1000). ABC noted cash account controls meet all the control objectives and have been properly implemented, no exceptions were noted. ABC judgmentally selected 25 bank balances to confirm as of 12/31/2013 (1000.2), accounts were reconciled to the GL and a sample of outstanding checks was tested. ABC requested a copy of the last check issued in 2013 and the first check issued in 2014 from significant operating accounts; the checks were in sequential order and dated appropriately for the correct period. No exceptions were noted related to cash account balances.

Investment account risks were mapped and control testing was performed (3000). ABC noted investment account controls meet all the control objectives and have been properly implemented, no exceptions were noted. Independent investment confirmations were obtained and balances were reconciled to the GL. ABC engaged Standard & Poor’s Security Evaluations (SPSE) as a specialist for the purpose of providing fair value estimates of certain classes of fixed income securities. No valuation issues were noted. Sample testing was performed on the purchases and sales of securities. Based on the haphazard sample selection of 11 purchases and 1 sale, investments acquired and disposed of were properly recorded. ABC randomly sample 1 fixed income security per entity and recalculated accrued interest and amortization. No exceptions were noted related to investment account balances.

Work performed by ABC appears to be adequate related to investment and cash account balances as of 12/31/2013 and may be relied upon to reduce financial reporting risks.

Premiums and Receivables
Revenue account risks were mapped and control testing was performed (1500). ABC noted revenue account controls meet all the control objectives and have been properly implemented, no exceptions were noted. ABC obtained a detailed data dump from the system by entity and tied premium totals to the GL. ABC utilized dollar unit sampling for pooled premiums, subsequently, ABC randomly selected a month to test for each selection and obtained the monthly premium detail to determine the monthly written premium. The initial MUS of 35 policies were tested for original application attributes, written premium amount and agreed premium to payment received. Note: In order to agree premium to payment received (step 3), ABC had client pull all invoices for the selected month of the companies noted below. ABC sighted amount from invoice was included in batch deposit listing and also sighted batch total hitting appropriate bank statements. Substantive analytical review was performed over premiums written and unbilled premium receivable. ABC noted the trends appeared to follow expectations and noted no exceptions. ABC haphazardly selected an additional 11 policies to test the accuracy of the earned and unearned premium calculation. No exceptions noted.

Work performed by ABC appears to be adequate to rely upon related to stated premium and receivables balances as of 12/31/2013 and may be relied upon to reduce financial reporting risks.

Expenses
ABC reviewed all expense account groupings/mappings on operating expense leadsheet (8203). ABC then created a flux analysis automatic document and formatted it to be a ‘variance by group with group subtotals’. At the flux analysis document, ABC identified those accounts/mappings that were tested in other areas. Any expenses tested in other areas are referenced to the respective workpaper(s). For all operating expense accounts/mappings that were not tested elsewhere that met the scope above, ABC obtained the GL and judgmentally selected a sample of 6 entries to test. ABC tested each transaction for evidence of management override, proper classification, and proper period recording. ABC notes all entries hitting the
accounts outside of expectations were manual journal entries. ABC reviewed the transaction to ensure there was a separate preparer and approver. ABC also reviewed support for the entries, noting the support tied to the entry amounts and seemed reasonable. No exceptions noted.

Work performed by ABC appears to be adequate related to expense accounts as of 12/31/2013 and may be relied upon to reduce financial reporting risks.

**Taxes**

ABC performed an overall review of XYZ’s tax provision and footnote disclosures for the year ending 12/31/2013. Supporting documents were reviewed and ABC recalculated the deferred tax asset for each entity. Per ABC’s review, all tax balances were deemed reasonable for the period ending 12/31/2013.

ABC obtained the schedule of premium tax accruals broken out by state. ABC prepared an analytic for the accrual based on the total premiums written in the year multiplied by the weighted average tax rate for the prior year. Per MCAP 450, ABC selected six payments for testing, as the balance of the payments is less than 2x PM, or $8,050,000. For the six payments selected, ABC obtained a copy of the payment and traced it through the bank statement.

Work performed by ABC appears to be adequate related to tax accounts as of 12/31/2013 and may be relied upon to reduce financial reporting risks.

**Conclusion**

Based on the work described above, the exam team concludes that the independent audit work performed at 12/31/13 is sufficient to reduce the exam team’s review of financial reporting risks in the areas of Cash & Investments, Premiums & Receivables, Expenses and Taxes.
Exhibit 2:

Prepared by Examiner

Plan: Planning Memo - Draft
ABC Insurance Company and Affiliates
Review of XYZ Audit Workpapers
Exam as of 12/31/13

Purpose: To document the examination team’s review of work performed by the Company’s external auditor XYZ.

Conclusion: The examination team will place reliance on XYZ audit work to reduce the number of financial reporting risks reviewed during this examination.

Reliance on Audit Work in Federal Income Taxes Function
The examination team assessed the external audit function as competent and we intend to place reliance on XYZ control testing and substantive procedures performed around the Company’s Federal Income Tax functions. The examination team’s review of the XYZ workpapers identified comprehensive internal control testing and substantive procedures addressing the Company’s significant financial reporting risks.

The following summarizes key components of XYZ 2013 audit procedures:

Controls Testing
Financial reporting assertions addressed by the XYZ testing included accuracy, completeness, existence and valuation of tax balances. Key controls tested by XYZ included:

• Quarterly balancing between general ledger and Tax Provision Spreadsheets (GAAP)
• Reconciliation between the tax provisions and the filed tax return (GAAP and STAT)
• Tax provision calculations are reviewed by Tax Management (GAAP and STAT)
• Validation of temporary differences (GAAP and STAT)
• Reasonableness test on permanent differences (GAAP and STAT)
• FIN 48 Reserve items are evaluated and reserve adequacy is analyzed (GAAP & STAT)

Controls were found to be designed and operating effectively as of 12/31/13.

Substantive Procedures Included:

• Testing of Permanent & Temporary Differences
• Testing Recoverability of Deferred Tax Assets
• FIN 48 Testing - Accruals for uncertain income tax positions
• Assessing adequacy of Tax Accruals
• Payments and Refund testing

No findings or other observations were identified as a result of XYZ’s substantive procedures.