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Risks of material misstatement: Life and health insurance

Note: This practice aid is intended to help auditors identify risks of material misstatement (RMM) in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. This publication is an *other auditing publication* as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, Professional Standards). Other auditing publications have no authoritative status; however, they may help you, as an auditor, understand and apply certain auditing standards.

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Instructions

AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires that the auditor identify and assess the risks of material misstatement (RMM) at the financial statement level and relevant assertion level for classes of transactions, individual account balances, and disclosures to provide a basis for performing further audit procedures. RMM includes both inherent risk and control risk.

To aid auditors in meeting this requirement, this document includes information to help auditors assess RMM in the life and health insurance industry. **These examples do not include all examples of RMM that could apply or be relevant.**

Refer to the AICPA's *Audit and Accounting Guide: Life and Health Insurance Entities* for further information on auditing clients in the insurance industry.

Inherent Risk

The following characteristics may indicate increased inherent risk:

- Management characteristics
    - One person dominates management's operating and financing decision-making process.
    - Management places undue emphasis on meeting earnings projections.
    - Management's reputation in the business community is poor.
    - Management compensation is significantly influenced by earnings.
    - Management lacks experience in addressing the life and health insurance industry, emerging products and issues, noninsurance subsidiaries, or other complex matters.
    - Staff turnover is high, or personnel are inexperienced, or staff levels are insufficient given the volume or kind of business processed.
- Operating and industry characteristics
    - Key financial indicators of the insurance entity significantly differ from industry averages or are inconsistent with the entity's operations.
    - The insurance entity is poorly rated by the rating agencies or has had a recent change in rating.
    - Operating results significantly differ from projected results.

- Market share is changing.
  - Operating results are highly sensitive to economic factors, such as interest rate fluctuations.
  - The asset portfolio has changed significantly or product mix has changed in a way that may affect the appropriate matching of maturities for assets and liabilities.
  - Asset quality is poor, or assets are highly concentrated by type or geographical areas.
  - Significant off-balance-sheet risks exist.
  - New, specialized products have been introduced, or there is rapid growth in previously limited product lines.
  - Decision-making is decentralized and lacks adequate monitoring.
  - Significant changes in regulation or taxation have occurred that may affect the profitability or marketability of a product line or affect general surplus requirements.
  - Lapses and internal replacements are excessive, or the insurance entity has a concentrated book of business in products that allow for immediate and significant surrenders.
  - Significant changes have occurred in the entity's reinsurance programs, retention limits, or availability or cost of reinsurance.
  - There are significant contracts with reinsurers whose financial strength is in doubt.
  - The insurance entity depends on a limited number of agents or brokers to generate new business.
  - Internal or external circumstances raise substantial doubt about the insurance entity's ability to continue as a going concern.
  - Significant issues emerge that may adversely affect mortality or morbidity expectations and claims levels.
- Engagement characteristics
  - Contentious or difficult accounting issues are present.
  - The number and complexity of the types of contracts issued by the insurance entity have increased.
  - The number or amounts of adjustments in prior periods have been significant, including significant deficiencies or material weaknesses.
  - The insurance entity has noninsurance subsidiaries such as finance entities, joint ventures, and mutual funds.
  - The insurance entity is significantly involved in international business that exposes it to many different regulatory authorities and accounting models.

Asset Risk

The indicators of asset risk exposure the auditor may consider include the following:

- Large investments in noninvestment grade securities
- Significant investments in affiliates
- Concentration of investments in a single investee
- Equity stakes accepted in lieu of principal and interest as well as capitalization of interest
- Substantial unrealized investment losses
- Guarantees of publicly issued debt, such as collateralized mortgage obligations or municipal bonds
- Increasing delinquencies and nonperforming loans as well as little experience in modifications, workout programs, or restructuring
- Higher delinquency and foreclosure rates than industry averages or prior years' experience
- Refinancing or restructuring of significant amounts of bullet loans
- Significant exposure to individual real estate investments in concentrated markets or geographic regions
- Concentrations of mortgages with individual borrowers
- Significant high risk loans underwritten (such as high interest rates or second liens)

- Significant mortgages and other loans to affiliates, subsidiaries, joint ventures, limited partnerships, or other related parties
- The acceptance of additional investment risk to support high interest crediting rates
- Significant amounts of investments in derivatives and structured securities
- Downgrading of securities by rating agencies
- Significant changes in interest rates
- Duration of portfolio may not match cash flow needs
- Investment policies and procedures do not exist
- Lack of defined strategy for investments
- Significant amount of other than temporary impairment taken in prior years

Insurance Risk

The auditor may consider indicators of insurance risk exposure, including the following:

- Lack of conservatism in determining benefit liabilities
- Sensitivity of benefit liabilities to management estimates
- Extensive use of reinsurance arrangements with poorly rated reinsurers
- Health insurance products affected by dramatic increases in medical costs
- Little experience in underwriting and pricing new products such as long term care contracts
- Relaxed underwriting standards
- Trends toward *antiselection*, particularly in health care products, which may result in deteriorating margins
- New forms of competition in the traditional life insurance market
- Significant increases over prior years in the frequency and severity of claims
- Events, such as the advent of acquired immune deficiency syndrome, that may result in deteriorating profits on existing contracts
- Fixed costs that are increasing faster than inflation
- Actual expenses that are substantially higher than those assumed in pricing
- Product pricing assumptions that are based on competitive market pricing without regard to expected costs
- Underwriting standards that are inconsistent with the mortality-morbidity assumptions used in product pricing
- The use of credits to offset rate increases
- Lack of approved underwriting guidelines and authorization limits
- Lack of management monitoring concentration of risks
- Lack of control over agents with binding authority
- Policies, endorsements, cancellations may not be processed timely

Interest rate risk and equity markets

The auditor may consider indicators of interest rate risk, including the following:

- Significant increases in surrenders or lapses of contracts
- Insufficient short-term liquid investments
- Negative spreads on investment contracts
- Significant deposit contracts without surrender charges
- Individually significant balances with single customers for pension or other deposit type products
- Inadequate testing of cash flow or interest rate scenarios
- Asset maturities that are not consistent with expected payouts of contract holder liabilities
- Significant asset — liability mismatches

- Significant long-term liabilities (such as structured settlements), supported by assets with significant debtor optionality (such as residential mortgage backed securities)
- Investment program does not provide adequate returns

Business risk

The auditor may consider indicators of business risk exposure, including the following:

- Capital and surplus that are below industry average
- Poor or deteriorating results under the NAIC RBC model
- A substantial portion of surplus that is attributable to gains resulting from nonrecurring transactions or other nonrecurring items
- Transactions and changes in accounting treatment that enhance surplus, such as financial reinsurance or change in benefit and claim liability estimates
- Asset transfers or other activities with affiliates that enhance surplus, such as expense allocations, reinsurance transactions, fronting, and nonadmitted assets transferred to a noninsurance subsidiary
- Lack of profitability of new products that are subsidized by a profitable inforce
- The possibility of large guaranty fund assessments
- The risk of changes in the competitive structure of health insurers due to the Patient Protection and Affordability Act
- Unexpected changes in the individual tax laws, such as those that affected single premium life insurance products and certain types of individual annuities
- Explosive growth without adequate infrastructure and controls
- Events or transactions that could cause regulators to assume control or supervision of the life insurance entity
- The possibility of regulatory action to influence or change actions taken by management
- Downgrading by major rating agencies
- Recent negative publicity that could potentially causes a decline in current customer base and presents additional challenges in obtaining new customers
- Lack of corporate business plan, underwriting strategy, or both
- Lack of an enterprise risk management process
- Merger and acquisition activity

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