

FINANCIAL RISKS IN THE AUDIT OF A LIFE INSURER

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ABSTRACT

Recent developments including the EC Insurance Accounts Directive have led to an expansion in the scope of life company audits. Audit teams now include actuaries, computer and tax specialists, and management consultants as well as accountants. This increasingly multidisciplinary approach means that audits can now extend to a review of embedded values, appraisal values and asset shares, which had previously been regarded as solely the preserve of specialist actuarial consultants. This enhanced scope and the greater understanding required by the auditor have increased the importance of financial risks in the audit process. Consequently the audit now also offers more help to life insurers in the management of their financial risks.

INTRODUCTION

1 Section I of this paper introduces the audit and discusses some of the key stages in the audit process and the importance of financial risk assessment therein.

2 Section II then addresses the expanding objectives of the life insurance audit.

3 Section III goes on to discuss the classification of risks, and to consider some of the main financial risks facing life insurers.

4 Section IV considers how the financial risks inherent in a life company are addressed by the auditor in practice.

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A Main requirements of the auditing guideline: Life insurers in the United Kingdom.

1. THE SCOPE OF THE AUDIT

Audit scope

101 Accountants define an audit as “the independent examination of the financial statements of, and expression of an opinion on, the financial statements of an enterprise”.

102 Of course, we normally think of an audit as relating to the balance sheets, profit and loss accounts, other statements and notes produced annually by a company. But the content of “financial statements” and the degree of “independence” required are largely defined in terms of the scope of the audit. So many of the reports produced by accountants, or even actuaries, within and outside an organisation can arguably be described as an audit.

Audit risk

103 Audit risk is defined as the risk that the auditor will issue an inappropriate opinion on the accounts. It may be further subdivided into the following contingent risks:

- (a) Misstatement risk - the risk that misstatements may occur in the financial statements.
- (b) Detection risk - the risk that auditors will fail to detect misstatements that have occurred.

104 Misstatement risk can be further divided into:

- (a) Inherent risk - the risk deriving from characteristics of the enterprise and its environment prior to considering internal controls.
- (b) Control risk - the risk that internal controls will not prevent or detect material errors.

105 Financial risks are clearly an important component of these inherent risks, and the audit approach will be significantly influenced by them. And while the risks to the auditor are not exactly the same as those to his client (strictly the company’s shareholders, or policyholders

for a mutual), they are sufficiently close to make the auditor's work of interest to a client's management.

Audit outputs

106 The main audit output is the audit opinion on which the credibility of an enterprise and its published financial statements depends.

107 However, the work of the auditor should bring many other benefits to his client's management:

- (a) A general review of the main financial risks facing the enterprise and a review of how financial risks might affect the ability of an enterprise to continue to operate as a going concern.
- (b) A review of the ability of internal controls to monitor, control and manage financial risks.
- (c) A detailed review of the potential effect of financial risks by way of substantive testing of assets, liabilities and contingent liabilities, and their presentation in the financial statements.

Financial risks in the audit programme

108 The auditor can use his understanding of financial risks in the audit programme. The audit programme has the following stages:

- (a) Planning.
- (b) Accounting systems.
- (c) Audit evidence.
- (d) Internal controls.
- (e) Review of financial statements.

109 The auditor can use an understanding of financial risks in the following ways.

110 At the planning stage, the auditor will use an analytical review to reassess his knowledge of general financial risks affecting the industry and the financial risks identified in previous audits. He will then seek to focus his investigations in the areas in which financial risks are likely to be most material.

111 The investigation of the accounting systems and internal controls will test whether these systems are capable of identifying, monitoring and controlling the financial risks he has identified.

112 Financial risks are key to the selection of substantive audit evidence, particularly in relation to investments, liabilities and contingent liabilities, where the audit approach is to establish and confirm:

- (a) completeness (eg via reconciliation with other accounting records)
- (b) existence and ownership (eg by confirmation from counterparties and examination of certificates of title)
- (c) valuation (eg by considering restrictions on income or realisation, market information and by investigating unusual features)
- (d) accounting treatment and disclosure (eg by understanding unusual features).

113 Finally, the auditor needs to ensure that material financial risks are properly reflected and disclosed in the financial statements.

2. OBJECTIVES OF A LIFE COMPANY AUDIT

Audit scope

201 The appointed or statutory actuary is usually responsible for valuing and reporting on or certifying the policy reserves. The appointed actuary concept in many English-speaking countries extends those responsibilities, and the auditors' role has been restricted to:

- (a) the assets
- (b) revenue items
- (c) policy data, and
- (d) systems.

202 The main omission from this list is an overall understanding of the business, which means that in the past the audit of a life company was a mechanical process. As a result, the significance of key features might be missed. But these features may relate to areas such as assets, on which the actuary is to some extent relying on the auditor. So there are potential gaps between the work of the actuary and the auditor.

Recent developments

203 Several developments are acting to fill those gaps:

- (a) Audit teams, at least in the UK, are becoming multi-disciplinary. As well as accountants, there are actuaries, management consultants, investment analysts, lawyers, IT specialists, and tax and compliance

experts. Such experts breathe vitality and understanding into a life audit.

- (b) The UK accountancy bodies issued a new auditing guideline in 1991 which requires auditors to understand the significance of features of the actuarial valuation (the requirements are summarised in Attachment A).
- (c) The EC insurance accounts directive means UK insurers will now have to give a "true and fair" view. This has far-reaching consequences; for example the prudence concept does not justify the creation of secret or hidden reserves has led to a fierce debate in the UK as to whether mathematical reserves can be described as true and fair.
- (d) Development of new methods of recognising life company profits and values, which involve greater volatility in results and require closer involvement by auditors.

204 All these developments do not of course mean that auditors will need to duplicate the work of the actuary. Some of the work of the actuary (usually the abstract of his report for the purpose of statutory insurance returns) will remain outside the scope of the audit. And the rest of his work, like that of any other professional, is important audit evidence, on which the auditor will rely when it is reasonable to do so.

205 The auditor's investigations will therefore focus on the extent to which he can rely on the actuary's work, and how much further review, compliance and substantive testing will be required. Much of this further audit evidence will come from discussions with, and data from, the actuary. However, the likely effect of the developments above is to increase the additional audit investigations that will be required.

Financial risks

206 Financial risks constitute one of the areas that will become more important as a result of the extension of the audit scope and the understanding of life company auditors.

207 The approach to identifying financial risks is multidisciplinary. They may be identified at the planning stage, either from industry considerations, identification in previous audits, or analytical review. Risks may also be identified in the recording of new systems, products or developments, or as a result of discussions with management.

208 Each discipline is then responsible for highlighting financial risks arising from their compliance and substantive testing. The approach will rely for completeness on standard checklists derived for the entire audit practice and for the life industry group.

209 Finally, identification of financial risks is a key consideration in the review performed by the auditor and his reviewing partners.

3. CLASSIFICATION OF RISKS

301 The standard Society of Actuaries classification is restated here:

- C1 Asset depreciation
- C2 Inadequate premium
- C3 Interest rate fluctuations
- C4 General business risks.

302 Of these, C1 and C4 might be regarded more as traditional concerns of the auditor, while C2 and C3 might be regarded more as those of the actuary. But all these risks are important to the auditor, whose opinion implies that the life insurer is a going concern.

303 There are many other ways to classify risks, for example:

- (a) external versus internal
- (b) performance
- (c) controllable versus uncontrollable
- (d) frequent enough for stochastic analysis
- (e) political factors.

304 This paper is concerned with financial risks. It is difficult to draw a clear dividing line between financial and non-financial risks. Arguably, only C1 and C3 risks are financial. Part of the confusion results from the fact that many non-financial risks have substantial financial consequences. However, there are clearly components of C2 and C4 which could readily be described as financial. This paper will therefore include various C2 and C4 risks as financial.

C1 Asset depreciation

305 This is the risk of loss of value of an asset because of default or some impairment of the earnings capacity or value of the property or organisation underlying the asset.

306 This area has traditionally been the preserve of the auditor, although it has also been an area of concern to the actuary.

307 The review of C1 risk for a life insurer will include:

- the probability of default of an asset
- materiality and extent of non-diversified risk
- security of an asset
- volatility of an asset the efficacy of financial instruments used to enhance
- returns, protect solvency or eliminate these financial risks
- the effect on solvency and policyholders' reasonable expectations (PRE).

C2 Inadequate premium

308 This is the risk of inadequate pricing of insurance contracts for reasons other than those connected with other risks:

- (a) random adverse fluctuations in experience
- (b) inaccurate estimates of some elements of cost:
 - (i) expenses
 - (ii) claims
- (c) disaster eg an epidemic.

309 This risk has traditionally been the preserve of the actuary.

310 The review of C2 risk for a life insurer will include:

- insurance risk
- tax
- expenses
- lapses

311 These risks are not usually regarded as financial. However, they will have a significant financial effect, particularly on the perceived embedded or appraisal value, which may be presented as an asset in the accounts of a life company's parent (and is thereby linked to C1 risks).

C3 Interest rate fluctuations

312 This is the risk of loss due to variations in the level of interest rates, also known as asset immunisation risk (in the absence of default or impairment of the earnings capacity of the asset). This risk includes the possibility that changes in the level of interest rates will:

- (a) trigger options by customers to withdraw funds
- (b) trigger options by borrowers to repay debt

313 This risk has traditionally been the preserve of the actuary.

314 The review of C3 risk for a life insurer will include:

- sensitivity to financial assumptions in pricing strategy
- options available to asset and liability clients
- investment and disinvestment strategies
- sensitivity and scenario testing
- objective measurement of risk at each checkpoint, translated into capital or reserve requirements
- effect on policyholders' reasonable expectations (PRE)

C4 General business risks

315 This covers the risks common to all business enterprises, which are not covered by the other categories, but which may adversely affect the future of the business as a going concern:

- (a) management incompetence
- (b) regulatory
- (c) social
- (d) technological
- (e) competitive changes
- (f) fear of insolvency.

316 This risk has traditionally been seen as the preserve of the auditor because of his wider business training.

317 The review of C4 risk for a life insurer will include:

- general risk factors such as fraud
- losses due to poor control and systems (especially in unit-linked business)
- distribution issues including non-compliance with regulations
- and many many more.

4. FINANCIAL RISKS IN THE LIFE COMPANY AUDIT IN PRACTICE

401 The major financial risks considered by an auditor today might relate to:

- (a) Recession - falls in investment values
- (b) Recession - falls in interest rates

- (c) Recession - effect on selling and life business
- (d) Non-life losses - pressure to increase profits
- (e) Financial reinsurance
- (f) Complex financial instruments
- (g) Off balance sheet transactions
- (h) Changes in regulations and marketing rules.

402 The audit approach to financial risk in these areas is as follows:

Recession - fall in investment values

403 Recent falls particularly in property-related investment values bring with them significant risks:

- to solvency
- to policyholders' reasonable expectations (PRE)
- to the ongoing viability of an insurer
- in the values disclosed in the financial statements.

404 The audit approach will therefore include the following:

- (a) The impact on solvency of the fall in investment values should be quantified and the solvency position should be considered when reviewing reserve adequacy.
- (b) Ensure properties have been valued recently by qualified valuers and consider the valuation of owner occupied properties.
- (c) Mortgage recoverability and hence provision levels need to be considered taking into account changes in levels of mortgage arrears.
- (d) Consider the value and financing of development properties.
- (e) Consider support for the valuation of unlisted and venture capital investments.
- (f) Consider the impact of joint venture obligations.
- (g) Ensure cash deposits or other investments with institutions with poor credit ratings are appropriately valued.
- (h) Ensure investments continue to perform. Consider valuation of investments with arrears in income.
- (i) Consider also related party investment transfers and the appropriateness of the transfer price.
- (j) Review post balance date investment values and consider how frequently solvency should be monitored.
- (k) Consider the impact of resulting reductions in bonuses and surrender values on policyholders' reasonable expectations (PRE).

- (l) Review short-term capital plans.

Recession - falls in interest rates

405 Lower interest rates may affect solvency if policy liabilities are unmatched or if valuation interest rates have to be reduced.

406 The audit approach will therefore consider the following:

- (a) The effect of lower dividends and rents on the maximum permitted valuation interest rate.
- (b) The effect of lower interest rates on bonus levels and policyholders' reasonable expectations.
- (c) The extent of matching of assets and liabilities identified as part of the actuary's resilience test.
- (d) Effect on embedded and appraisal values of a lower investment return assumption.

Recession - effect on selling and life business

407 Recession will have several effects on the life business:

- Lower sales and consequent expense overruns
- Forced selling and policyholder circumstances may lead to high lapse rates
- Clawback of commission and recovery of loans to salesforces may be difficult
- Risk of fraud and money-laundering increases.

408 The audit approach will therefore be:

- (a) Review sales and lapse assumptions used for items in the financial statements such as embedded values.
- (b) Review distribution and maintenance expenses.
- (c) Consider adequacy of expense overrun and closure reserves.
- (d) Ensure that sales force finance and commission finance have been comprehensively reviewed.
- (e) Review adequacy of provision for doubtful debts.
- (f) Ensure the client's procedures are properly documented and appear adequate.
- (g) Enquire as to the extent of insurance cover in the event of fraud.
- (h) Review extent and cover for indemnity commission.

- (i) Review correspondence with policyholders.
- (j) Ensure that marketing rules are complied with by agents.

Poor non-life results

409 Poor non-life results may increase the pressure to boost shareholder profits. The major risks relate to:

- segregation of linked and non-linked assets
- segregation of with-profit and non-profit assets
- expense allocations.

410 The audit approach to these risks is as follows:

- (a) Ensure consistency of treatment between different subsidiaries or funds
- (b) Review expense allocation
- (c) Review unit-pricing procedures
- (d) Consider policyholders' reasonable expectations (PRE).

Financial reinsurance

411 New and more sophisticated financial reinsurance products continue to emerge. The main risks are that:

- such contracts may not be identified and so inadequate disclosure or inappropriate accounting treatments may result
- recent non-life catastrophes may lead to failures of reinsurers, particularly off-shore
- similarly, poor results may lead to disputes.

412 The audit approach is therefore as follows:

- (a) Enquire of clients whether such contracts have been entered into.
- (b) Review individual contracts which release significant amounts of surplus.
- (c) Scrutinise list of reinsurers.
- (d) Discuss client's security procedures.
- (e) Investigate long outstanding balances.
- (f) Obtain up to date security lists.
- (g) Ensure adequate provisions are made.
- (h) Take care with reinsurers in poorly regulated countries or states.

Financial instruments

413 Complex financial instruments offered are increasingly being offered by financiers to hedge exposures, alleviate solvency strain and increase returns. The major risks result from lack of familiarity with such instruments:

- These instruments may be inappropriate or excessively priced
- There may be difficulties with regulatory or tax treatment
- Accounting treatment and disclosure may be inappropriate
- Counter-party risks

414 The audit approach to these instruments will be as follows:

- (a) Make enquiries of the client as to the existence of such instruments.
- (b) Understand their purpose and their effect including taxation.
- (c) Ensure that accounting and valuation policies are appropriate.
- (d) Review counter-party risks.
- (e) Discuss the extent of stock lending and procedures to control the amounts involved.
- (f) Identify beneficial ownership of collateral and the assets borrowed.

Off balance sheet transactions

415 Off balance sheet transactions eg mortgage securitisation may result from solvency constraints. Such transactions should not be improperly excluded from the balance sheet.

416 The audit approach to the financial risks is as follows:

- (a) Enquire as to the existence of such vehicles
- (b) Ensure they are properly accounted for
- (c) Consider whether balance sheet offsets are properly justified.

Changes in regulations and marketing rules

417 Changes in regulations or failure to comply with marketing rules can have a disastrous effect on a life company, potentially requiring reimbursement of policyholders.

418 The audit approach to these financial risks is as follows:

- (a) Review definitions of subsidiaries and associates
- (b) Review the effect of life tax reform
- (c) Review correspondence with regulatory authorities
- (d) Review training and marketing standards.

5. CONCLUSION

501 General considerations arising in the assessment of financial risk as part of any audit can easily be extended to the assessment of financial risk in a life company.

502 When actuaries and auditors team up, the result is a powerful addition to that process.

503 Finally, while thanking Nigel Masters and Philip Moore for their comments on this paper, I should point out that the ideas expressed here do not necessarily reflect the views of my employers. Instead they represent my own personal views, as augmented by material produced by the UK accountancy profession and the LOMA research paper:

“Capital management in the life insurance industry” by
SW Forbes, MA Berkowitz, C Carroll, DE Neve, L Roth, AT Spencer.

Attachment A

Main requirements of the auditing guideline: Life insurers in the United Kingdom

1 The Auditor must understand the relevant background, particularly as it affects the valuation of long-term business and the emergence of surplus, bonus policy and solvency:

- classes of business
- distribution channels
- regulatory environment
- new business product mix
- new products
- composition and suitability of investments
- valuation basis
- provisions and reserves
- bonus philosophy
- investment conditions
- taxation
- new factors such as AIDS

2 The Auditor should make an analytical review of the financial statements:

- single and regular premium new business to budget and prior
- years
- lapse ratio to prior years

- initial commission ratio
- claims to prior years
- free asset ratio
- investment yield

3 In relation to the valuation of long-term liabilities, the Auditor must consider any relevant reports made to the Directors by the Actuary and discuss with him matters relevant to the valuation of long-term liabilities, to satisfy himself (or obtain reasonable assurance) that:

- the assets of the long-term fund are not less than the related liabilities
- systems and controls are operating satisfactorily to establish the reliability of valuation data
- accounting records are consistent with valuation data
- assets used for the valuation are consistent with accounting records
- procedures and controls are operating satisfactorily for the purpose of the valuation, reports and certificates provided by the actuary
- he understands the implications of any formal reports and correspondence involving the Actuary, the insurer or the regulatory authorities
- he understands the implications of any matters relating to record-keeping, systems or controls
- the Actuary is prepared to give the certificate for the purposes of insurance companies legislation and would give similar comfort, if required, with regard to the financial statements
- the extent of disclosure is consistent with a true and fair view
- he knows the quantum of free reserves

4 In respect of unit-linked business, the Auditor must obtain a proper understanding of

- the separate identification of assets matching linked liabilities
- units in force and movements in the value of each internal linked fund
- the calculation of the unit price
- the value of units created and cancelled
- the amounts deducted for management charges
- the provision for deferred tax in the pricing and financial statements

5 In relation to the distribution of surplus, the Auditor should establish from the reports to the Directors by the Actuary, augmented by consultation with the Actuary as appropriate, that:

- the amount of surplus or proportion distributed to shareholders has not been materially affected by a change in the valuation approach or assumptions or by exceptional circumstances requiring disclosure
- any distribution of surplus is valid and complies with the ICA and articles of association
- participating policyholders have received not less than their minimum entitlement under the insurer's statutes.

6 The Auditor must be satisfied with the accurate recording and recognition (including pricing and cut-off procedures) of

- premium income
- commission
- claims paid
- outstanding claims
- reinsurance payments
- investment income, taxation and charges (for unit-linked funds)
- unit-linked and non-linked liabilities.

7 The Auditor may be required to make a report to the regulatory authorities (through the insurer unless he doubts the management's integrity or competence or management is unwilling to cooperate) in the circumstances of an adverse occurrence that may lead to a material loss if disclosure might be in the interests of existing and prospective policyholders:

- the insurer may not have the required minimum margin of solvency
- evidence of imminent collapse
- evidence of an occurrence likely to lead to material diminution of the insurer's net assets
- significant failure or weakness in accounting and other records or internal control systems
- the insurer's failure to comply insurance company legislation
- financial information reported to the DTI is misleading in a material particular.

