To: Financial Examination Preparers & Reviewers

From: NAIC Financial Examination Staff

Date: April 1, 2011

Re: File Documentation Best Practices for a Risk-Focused Examination

Below are the seven phases of the risk focused examination process and a brief summary of the suggested documentation and things to look for as a reviewer (or self-reviewer) in each phase. The information presented is only a brief outline of information contained in the Handbook and should be used in conjunction with additional guidance provided within the Handbook, and not as a stand alone document. This is not an all-inclusive listing of documentation requirements for accreditation purposes and should not be relied upon as such. The exhibits referenced in the list are tools that the examiner may use to assist them in performing and documenting their risk-focused exam approach. The items in black demonstrate what should be documented and the items in red are considerations that should be made when evaluating the adequacy of the work.

**Phase 1 – Understand the Company**

- **Phase 1 – Part 1 – Understand the Company**
  - Documentation of coordination efforts regarding insurer groups, if applicable (Exhibit Z)
  - Insurer information request (Exhibits A & B)
    - Consideration of IT Risks (Exhibit C)
    - The examiner should be following the 6 step IT Review Process on all examinations, regardless of size. Those 6 steps consist of: (1) Gather necessary IT Planning Information; (2) Review Information Gathered; (3) Request Insurer Control Information and Complete IT Review Planning; (4) Conduct IT Review Fieldwork; (5) Document Results of IT Review; (6) Assist on Financial Examination. This could be done in a brief memo for a small RRG; however, regardless of size, all 6 steps must be completed.
  - Analytical and Operational Reviews (Exhibit F)
    - Documentation of relevant information received from the analyst and/or other insurance department functions
  - Updated Insurer Profile Summary (Exhibit H)

- **Phase 1 – Part 2 – Understanding the Corporate Governance Structure**
  - Documented understanding of organizational structure (e.g. Org. Chart, Flow Chart, etc.) (Exhibit M)
  - Documented understanding of BOD and Mgmt responsibilities and control environment (tone at the top) (Exhibits M & Y)
Exhibit M isn’t a required document but it is good to ensure that the documented understanding touches on each of the topics addressed in Exhibit M.

Exhibit Y isn’t a required document but is a good starting point. The examiner should be customizing the questions based upon each individual company’s needs.

- **Phase 1 – Part 3 – Assessing the Adequacy of the Audit Function**
  - Consideration of Internal and External audit functions (Exhibit E)
    - There must be a conclusion here as to why the examiner believes they can place general reliance on the workpapers. Typically, general reliance can be placed on the auditor’s work based upon a high-level review of the workpapers, prior positive experience with the external audit firm, relevancy of the work performed by the external auditors to examination objectives, etc.

- **Phase 1 – Part 5 – Consideration of Prospective Risks**
  - Assessment of prospective solvency concerns (Exhibit V)
    - It would be a rare occasion for any insurer not to have at least one overarching prospective risk that should be documented and reviewed on Exhibit V. This could be related to personnel turnover, regulatory changes, expanding into new lines of business, etc. (Look at Ex. V for some ideas). Items identified in the interviews, referred from analysts, etc. should be included here.

**Phase 2 – Identify and Assess Inherent Risk in Activities**

- Identification of inherent risk (Exhibit K)
  - Ensure that all critical risk categories have an associated inherent risk on one of the matrices or, if not, ensure that a reasonable explanation as to why the line item isn’t risky enough to merit an inherent risk on the matrices is included in the planning memo.

- An individual assessment for each of the inherent risks:
  - Assessment of the likelihood of occurrence – (Low; Moderate-Low; Moderate-High; or High)
  - Assessment of the magnitude of impact – (Immaterial; Moderate; Severe; or Threatening)
  - Determination of the overall inherent risk – (High; Moderate; or Low)
    - The Overall Inherent Risk Rating Scale should be used when determining the overall inherent risk
    - Look to make sure these ratings are reasonable. Are all of the reserving risks low? Are there any high inherent risks? Etc.

- Completed Examination Memo should include discussion on the following information:

Scope and objectives of examination
Materiality Assessment
Results of analytical review
Results of IT Review
Corporate Governance Assessment
Results of audit function assessment (internal and external)
Scope of prospective risk assessment to be performed
Intended reliance on auditors and other states
Exam staffing and time budgets

Note: Planning (Phases 1-2) should have documented reviews by a supervisor before significant control testing in Phase 3 has begun.

Phase 3 – Identify and Evaluate Risk Mitigation Strategies (Controls)

• Identification and documentation of the examiner’s understanding of mitigating controls related to each identified risk. (Examiners should note that there may be more than one mitigating control for each identified risk; conversely, individual risks may not be addressed by any mitigating controls.)
  o Documentation could include, but is not limited to:
    ▪ Narrative descriptions
    ▪ Flowcharts
    ▪ Sarbanes-Oxley compliance documentation
    ▪ Walkthroughs
  o This can never be ‘n/a’ or blank. Even if the company doesn’t have controls the examiner still must document the issues surrounding the lack of controls (e.g. one person is in charge of all accounting activities, there is no supervisory review, etc.).
  o Read what the examiner has documented. Does the control listed really mitigate the risk identified?

• Testing of risk mitigation strategies/controls, if controls appear to be designed appropriately to mitigate risks.
  o Control testing should be in place unless the examiner is able to provide adequate rationale to support how the controls are not designed appropriately or as to how it truly would be more efficient to skip control testing and move on to Phase 4. (NOTE: If controls are not tested the resulting control assessment MUST be ‘weak’).
  o Reliance may be placed on controls (rating of Strong or Moderate Risk Management) only if the controls have been tested and documented.
    ▪ Testing procedures may include, but are not limited to:
      • Inquiry
      • Observation
      • Walkthroughs
      • Re-performance
      • Examination of documents
- Read what they’ve documented as test procedures. Does this testing really relate to the control that is listed?

- Determination and documentation of the overall risk mitigation strategy/control rating – (Strong; Moderate; or Weak).
  - Note: If more than one control exists for an identified risk, the examiner will consider all controls related to one identified risk into one combined assessment of Strong, Moderate, or Weak.
  - Is the rating appropriate? Inquiry alone ≠ Strong. Walkthrough alone ≠ Strong.
  - Did they use the appropriate sample size for cyclical controls?

<table>
<thead>
<tr>
<th>Control Frequency</th>
<th>Control Occurrences</th>
<th>Sample Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Quarterly</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Monthly</td>
<td>12</td>
<td>3-5</td>
</tr>
<tr>
<td>Weekly</td>
<td>52</td>
<td>5-12</td>
</tr>
<tr>
<td>Daily</td>
<td>250</td>
<td>25-40</td>
</tr>
</tbody>
</table>

**Phase 4 – Determine Residual Risk**
- Determination of calculated residual risk by combining the overall inherent risk assessment with the overall control assessment through the use of the residual risk grid – (High; Moderate; or Low)
  - Ensure this calculation is correct based upon the table below.

<table>
<thead>
<tr>
<th>Inherent Risk</th>
<th>Strong Risk Controls</th>
<th>Moderate Risk Controls</th>
<th>Weak Risk Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Moderate or High</td>
<td>Moderate or High</td>
<td>High</td>
</tr>
<tr>
<td>Moderate</td>
<td>Low or Moderate</td>
<td>Moderate</td>
<td>Moderate*</td>
</tr>
<tr>
<td>Low</td>
<td>Low</td>
<td>Low</td>
<td>Low*</td>
</tr>
</tbody>
</table>

- Judgmental residual risk considerations, if the examiner determines that the calculated residual risk is not appropriate.
  - If judgmental residual risk is utilized there should be documentation as to the rationale for each instance.
- Conclusion of overall residual risk rating for each identified risk - (High, Moderate; or Low)
  - Should be equal to JRR, or if JRR wasn’t utilized it should be equal to calculated residual risk.
Note: Should have documented reviews by a supervisor before significant substantive testing in Phase 5 has begun.

**Phase 5 – Establish/Conduct Examination Procedures**
- Documentation of selection/design of substantive test procedures.
  - The type and quantity of substantive test procedures should be based upon the overall residual risk assessment for each individual residual risk.
  - The exam procedures should be directly related to an identified risk and the controls reviewed in Phase 3 by which the residual risk was obtained.
    - High Residual Risk = Required substantive testing
    - Moderate Residual Risk = Reduced substantive tests along with more reliance placed on detailed analytical procedures
    - Low Residual Risk = Minimal substantive tests, if any, with more reliance on high level analytical procedures
- Documentation of substantive work performed and results noted
- Look at the work performed. Does the testing really relate back to the inherent risk?

**Phase 6 – Update Prioritization and Supervisory Plan**
- Based upon the information obtained in the previous five phases
  - updated priority score for the insurer, and
  - established supervisory plan for ongoing analysis
- Documents shared with the analyst summarizing the results of the onsite examination
- This column SHOULD NOT be left blank on the matrix. If there is no change to the prioritization or supervisory plan then that should be documented.

**Phase 7 – Draft Examination Report and Management Letter**
- Signed Management Representation Letter (Exhibit T)
- Completed examination report
- Completed management letter
- This column SHOULD NOT be left blank on the matrix. If there are no MLCs or Report comments, that should be documented.

**Other Considerations**
- Documented consideration of Fraud (Exhibit G)
- Review of events subsequent to the examination period(Exhibit P)
- Review of reinsurance contracts
- Documentation of sample selection and sampling techniques
- Evidence of communication (bi-weekly memos, status updates, etc.) with department senior management
  - This should include more than just budget numbers. It should talk the reviewer through what issues and progress the examiner has made.

Note: All workpapers should have documented reviews by a supervisor, including dated sign-offs.