# KINGFISCHER MUTUAL[1] INSURANCE COMPANY

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## CASE OVERVIEW

Recently, the importance of business and industry knowledge for assessing client business risk has been emphasized in public accounting. The purpose of this case is to develop your understanding of business risk in the insurance industry. The case is based on a composite of actual incidents that occurred in several large insurance companies. A general overview of the insurance industry is given first, followed by background on a hypothetical insurance company (Kingfisher), and a detailed description of its contractual relationship and history with another hypothetical company (Finch).

## INSURANCE INDUSTRY OVERVIEW

In 1995, the insurance industry in the United States managed almost $2.90 trillion of assets and generated revenues of $808.8 billion for the year.[2] Thus, the insurance industry makes a significant contribution to the domestic and global economy, representing over 11% of GDP, and is a common area of specialization within public accounting firms. The insurance industry also serves an important function in the economy. By purchasing insurance for an affordable fixed amount, individuals and businesses are able to transfer exposure to an uncertain and potentially devastating financial loss to an insurance company, allowing them the freedom to pursue their personal and business interests. In this way, through the fostering of economic activity, insurance serves to benefit society as a whole.

### Industry Segments

Within the insurance industry, companies are divided into categories based on the types of products they sell. These categories are broadly 1) life and health, and 2) property and casualty. Life and health companies sell products which address risks associated with death and illness and provide investment opportunities. Property and casualty companies sell products which address risks involving accidental loss or damage to property and liabilities for such damages and/or injuries to persons.

This case is set in the property and casualty segment of the insurance industry. Property and casualty companies usually distinguish their business between personal and commercial markets. Personal markets include products such as automobile and homeowner's insurance which are sold to individuals. Com-

[1]Ownership of mutual companies rests with its policyholders. This is in contrast to stock companies in which ownership rests with its stockholders.

[2]Statistical Abstract of the United States: 1998

mercial markets include products such as workers compensation, general liability, and property insurance which are sold to businesses. Companies may also separately classify certain uncommon products, such as professional liability, fidelity, surety, and excess and surplus lines into a "Special" markets category. These products may be distinguished by the lower volume of policies issued. Generally only "specialist" companies will underwrite them, and operations involve highly technical underwriting and claims issues. Professional liability products would include medical malpractice, a type of coverage that is well known for its volatile nature. Fidelity and surety products include coverage for dishonest acts of employees and financial guarantees. Excess and surplus lines addresses extraordinary insurance requirements (in either size or type) that are not readily available.

### Distribution Systems

Insurers may sell their products through various distribution channels. Under an "agency" system, companies rely upon an independent sales force to sell their policies. Companies will pay a "commission" to the agent when a policy is sold. Companies which utilize their own sales force of employees are described as "direct writers". Some companies may use both types of channels. Recently, new distribution channels have begun to develop such as selling via telephone and the internet.

### The Insurance Transaction Cycle

The insurance transaction cycle begins when customers pay a "premium" to the insurer to purchase insurance coverage for a fixed period of time (the "policy period"). Depending on the distribution system, the insurer will compensate the sales force which produced the sale either through salaries and overhead (direct), or "commissions" (agency). In exchange for the premium, the insurer agrees to pay "claims" to or on behalf of the customer only if certain accidents occur during the policy period which result in financial losses to the customer. If premiums exceed the sum of commissions, operating expenses and claims, the insurer has generated an "underwriting" profit, and if not, an underwriting loss results. However, because the insurer collects premium funds in advance of its claims paying obligation it can derive an additional source of revenue ("investment income") from investing these funds during this interval.

In theory, because the insurer can pool together many similar risks it can establish appropriate premiums that in the aggregate will allow it to pay claims, commissions, and other operating expenses, and with an added boost from some investment income, return a profit to its owners. In practice, however, the profitability of insurers is complicated by other influences such as competition, errors in estimating claims costs, changes in investment rates of return, and developments in the law which affect claims covered by their policies. Such factors can result in insurers being unable to quantify their "cost of goods sold" until many years after a sale has been made.

### Reinsurance

An insurer may transfer some of its insurance risk to another insurer. This process is known as "reinsurance". In such a transaction the transferor, who will pay a premium and cede claims, is known as the "ceding company" and the transferee, who will collect a premium and assume claims, is known as the "reinsurer" or "assuming company". Reinsurance can be used as a means to manage the insurance risk accumulated by an insurer through the course of its operations. For example, it can be used to increase an insurers' capacity to underwrite new business or to stabilize an insurers' results by controlling large individual losses or accumulations of losses. However, it is important to note that the ceding company does not discharge its claims paying obligation to its insureds through the reinsurance transaction.

### Regulation

Insurance is regulated by individual states. Regulations vary by state, but generally address company solvency, premium rate equity, policyholder relations, and financial reporting.[3] If an insurance company is found in violation of state regulations, it may lose its license to sell insurance in that state.

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[3]AICPA "Audits of Property and Liability Insurance Companies", 1990, p. 18.

## COMPANY BACKGROUND

Kingfischer Mutual Insurance Company is a large mutual property and casualty insurer that has demonstrated steady earnings growth over the past five years. Kingfischer has three main segments: Personal, Commercial, and Specialty. Of these three segments, Specialty is the smallest, accounting for about 10% of revenues and less than 1% of income (see Exhibit 1). Since the Specialty segment had not been performing well for Kingfischer, the management of this segment was under pressure to improve financial results. To generate additional income within the Specialty segment, and enter a new line of business with a minimal capital investment, Kingfischer initiated a relationship beginning in 20X2 with an independent Managing General Underwriter (MGU), Finch Company, which possessed expertise in the excess and surplus lines insurance business. Excess and surplus lines insurance, along with providing coverage for unique risks, also has been said to act as an "escape valve" for the standard markets during periods when there is too much demand and too little supply.

### Contractual Relationship With Finch

In conjunction with this new relationship, Kingfischer placed a considerable amount of fiduciary funds under Finch's management. Kingfischer also delegated a variety of important responsibilities to Finch including: issuing policies, collecting premiums, adjusting and paying claims, arranging for reinsurance, paying reinsurance premiums, collecting reinsurance proceeds, managing fiduciary funds, and premium and loss accounting. Given the breadth and importance of these duties, Finch could be said to "have the pen" of Kingfischer. Although Finch was capable of providing such services to several insurers at the same time, and previously had, Kingfischer was now its only client.

In order to reduce their underwriting risk, Kingfischer instructed Finch to reinsure a large proportion of each policy written (approximately 98%). Therefore, although Kingfischer planned for only a minimal underwriting profit or loss, it also did not in principle bear a great deal of the insurance risk because of the risk transfer that resulted from the extensive reinsurance. As illustrated in Exhibit 2, Kingfischer assessed its own risk in entering the Finch arrangement to be insignificant in contrast to the risk faced by its reinsurers. Kingfischer expected its main source of income from the relationship to be generated by the receipt of "fronting fees" equal to 4% of all premiums underwritten.

In return for performing various duties on behalf of Kingfischer and its reinsurers, Finch would receive a fee based on negotiating expense allowances from Kingfischer and reinsurers as high as possible (income to Finch), and negotiating fronting fees, sales commissions and service fees from various sub-contractors as low as possible (expenses to Finch). Finch was also responsible for paying state premium taxes on the business it produced. Finch's net fee (its gross margin) was limited to a maximum of 12% of the premium volume it generated. An example of Kingfischer's projection of the Finch contract results for the year 20X2 is contained in Exhibit 3.

### Happy Times: Early Growth Of The Business

The principal executive of Finch Company, J. T. Horton, was a widely respected insurance businessman. Mr. Horton had successfully cultivated many strong relationships with a variety of agents, brokers, and reinsurers. As a result of Mr. Horton's extensive business contacts, premium volume underwritten by Finch on behalf of Kingfischer grew from $86 million in 20X2 to $116 million in 20X4 (see Exhibit 4). Finch collected about 32% of this premium income as an expense allowance (68% went to Kingfischer and its reinsurers). After deducting fronting fees and premium taxes (about 6% of premiums), and service fees and commissions (about 20% of premiums), roughly 6% of premium income was left over to pay Finch's operating expenses, with the remainder being Finch's profit.

### Internal Audits

Kingfischer's internal auditors visited Finch every one or two years. These audits generally consisted of procedures designed to evaluate the adequacy of internal control over the fiduciary trust accounts, and to assess whether the calculation of Kingfischer's fronting fees was consistent with the established contractual provisions. The findings of these audits were relatively minor, consisting mainly of recommendations to reconcile certain accounts on a more timely basis, improve follow-up and reporting on outstanding checks, and improve password security. The audits did not include a review of Finch's financial statements, testing of bank accounts, confirmations with policy holders and reinsurers, or an examination of Finch's underwriting or claims handling processes.

**External Audits**

Kingfischer's external auditors (Chickadee LLP) considered excess and surplus lines insurance to be an immaterial portion of Kingfischer's overall business. In addition, due to the extensive reinsurance, Chickadee evaluated the risks of Kingfischer's involvement in excess and surplus lines insurance, and its relationship with Finch, as relatively low. Chickadee did examine the financial ratings of several reinsurers and found them to be financially solvent. Chickadee was also impressed with Mr. Horton's reputation for honesty and integrity. Moreover, Kingfischer encouraged Chickadee to rely on the work of their internal auditors whenever possible to enhance audit efficiency. Based on these factors, Chickadee never visited the offices of Finch company.

**Exiting The Specialty Segment**

In 20X6, Kingfischer decided to exit the specialty segment, including excess and surplus lines insurance, because of poor financial performance overall. In fact, other than the income generated by the arrangement with Finch, specialty insurance had been unprofitable for Kingfischer over the past five years (see Exhibit 1). Furthermore, Mr. Horton had left Finch in 20X5, and the new management of Finch was relatively inexperienced and less reliable. In the fall of 20X6, Kingfisher found a buyer, Wise Old Owl Company, for its ongoing specialty operations. However, after a due diligence investigation was performed by their external auditors, Wise Old Owl chose not to "step into the shoes" of Kingfischer in its relationship with Finch. Instead, Wise Old Owl elected only to become involved in the business produced by Finch as a further reinsurer for the remaining 2% of the policies that Kingfischer had not otherwise reinsured. Once this deal was struck with Wise Old Owl, Kingfischer informed Finch that it would terminate its contract with Finch at the earliest date possible within their contract (August 20X7).

**Missing Funds**

In the spring of 20X7, Finch informed Kingfischer that it was encountering cash flow difficulties. Finch reported that it had exhausted the fiduciary funds under its management and would require direct funding by Kingfischer to continue processing claims. The new management of Finch alleged that one cause of the cash flow predicament was that Mr. Horton had previously advanced approximately $6 million in fees from the fiduciary accounts in excess of the amounts contractually allowed by Kingfischer, and that these funds were missing.

Although Kingfischer intends to hold Finch responsible for the missing funds, it may not wait to recover the funds from Finch. Kingfischer is bound contractually by the policies issued to the insureds and must first pay the claims before seeking recovery from its reinsurers. Also, while Kingfischer has every legal reason to hold Finch and Horton accountable, they may not be able to recover the missing funds if the cash has already been consumed. Thus, Kingfischer must now use its own funds to address the critical claims situation. Kingfischer must also forward additional funds to Finch so that Finch will be able to pay their personnel to continue processing claims, or if necessary, subcontract out to another claims processing agency.

**Poor Claims Handling**

In addition, Kingfischer now learned that in 20X6 Finch had slashed the number of staff processing claims by approximately 50% in order to reduce expenses. Unfortunately, this resulted in a serious backlog of claims processed by Finch. Because of the long delays in the payment of claims complaints skyrocketed, and many claimants re-filed claims which resulted in large numbers of duplicate claims clogging the system. Moreover, Kingfischer is concerned that because of the long delays in processing claims, they may be exposed to significant litigation for bad faith claims handling.

Kingfischer now also found itself facing additional difficulty and uncertainty in collecting the anticipated claims payments from its reinsurers. Reinsurers may not provide coverage for extra contractual obligations faced by Kingfischer as a result of its claims handling practices. In addition, reinsurers may dispute other claims submitted for reimbursement and seek audits to verify premium and claims figures reported to them. In this case Kingfischer will either seek to compromise the disputes or be involved in costly and lengthy arbitration or litigation proceedings.

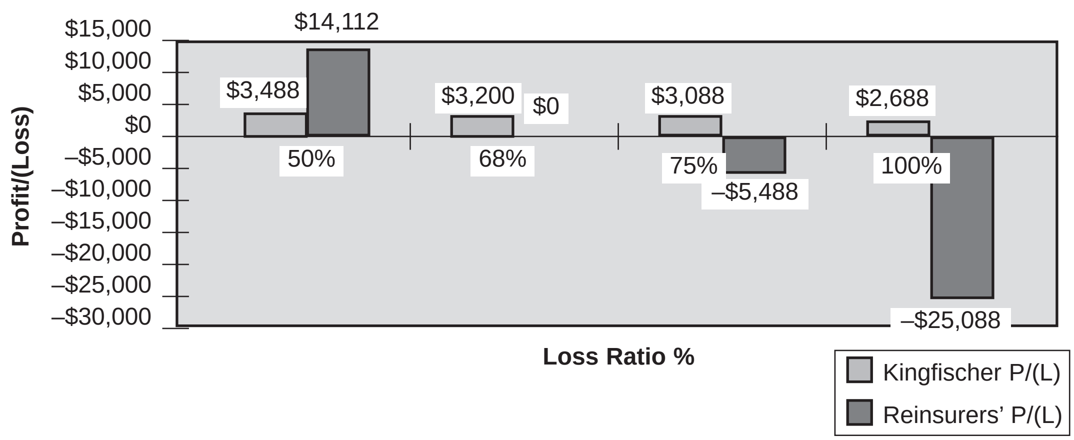
## DISCUSSION QUESTIONS

1. What important risks did the contractual arrangement with Finch pose for Kingfisher?
2. Were any of these risks overlooked by Kingfischer's management, their internal auditors, or their external auditors? What role does business and industry knowledge play in risk evaluation?
3. What additional procedures could have been performed by Kingfischer's internal or external auditors?
4. What damages are likely to be incurred by Kingfischer as a result of its contractual relationship to Finch?

**Exhibit 1**
**Kingfischer Mutual Insurance Company Net Income by Segment**
**($ Millions)**

| Segment | 20X7 | 20X6 | 20X5 | 20X4 | 20X3 |
|---|---|---|---|---|---|
| PERSONAL | | | | | |
| Homeowners | 230 | 100 | 90 | 50 | 150 |
| Automobile | 20 | 5 | 5 | 10 | 35 |
| Total | 250 | 105 | 95 | 60 | 185 |
| COMMERCIAL | | | | | |
| Workers Comp. | 200 | 190 | 170 | 125 | 130 |
| SPECIALTY | | | | | |
| Professional Liability | 0 | (1) | (6) | (23) | (3) |
| Excess & surplus | 2 | 4 | 3 | 5 | 4 |
| Total | 2 | 3 | (3) | (18) | 1 |
| GRAND TOTAL | 452 | 298 | 262 | 167 | 316 |

**Exhibit 2**
**Kingfischer Risk Assessment**
**($ Thousands)**




*Note:* the loss ratio is equal to claims divided by premiums.

**Exhibit 3**
**Kingfischer projection of Finch contract for 20x2**
**($ Thousands)**

| | Gross | Reinsurance | Net |
|---|---|---|---|
| Premiums | 80,000 | (78,400) | 1,600 |
| Fronting Fees | 3,200 | | 3,200 |
| Ceding Commissions | (25,600) | 25,088 | (512) |
| Claims* | (54,400) | 53,312 | (1,088) |
| Profit/(Loss) | 3,200 | 0 | 3,200 |

*Claims estimated at 68% of premiums

**Exhibit 4**
**Finch Company Gross Premiums and Net Fees**
**($ Thousands)**

| | 20X7 | 20X6 | 20X5 | 20X4 | 20X3 | 20X2 |
|---|---|---|---|---|---|---|
| Gross Premiums | 61,800 | 91,800 | 86,100 | 117,000 | 95,800 | 86,100 |
| REVENUES | 19,000 | 29,000 | 26,400 | 39,600 | 33,400 | 27,800 |
| EXPENSES | | | | | | |
| Insurer fees | 2,400 | 3,600 | 3,400 | 3,500 | 2,800 | 2,600 |
| State premium taxes | 1,200 | 1,800 | 1,600 | 2,200 | 1,800 | 1,600 |
| Agents commission | 12,600* | 18,400* | 15,600 | 24,800 | 21,600 | 16,100 |
| Reinsurance fees | 300* | 500* | 500 | 600 | 600 | 200 |
| Net fees | 2,500 | 4,700 | 5,300 | 8,500 | 6,600 | 7,300 |

*Figures are estimated.

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