

## PREPARING THE MANAGEMENT DISCUSSION & ANALYSIS REPORT

The Management Discussion and Analysis (MD&A) is a narrative explanation of the insurer's financial position and operations results that supplements the insurer's basic financial statements. To provide guidance for captive insurers preparing their MD&A reports, the Arizona Department of Insurance ("Department") generally follows the National Association of Insurance Commissioners (NAIC) guidelines and Annual Statement Instructions. The Department requires Risk Retention Groups (RRGs) to file an MD&A with their Annual Statement by April 1 each year and also requires Arizona Captive Insurance Companies to file an MD&A with their Annual Report each year.

Please consider the four following issues when preparing your MD&A narrative report:

1. The Department uses "materiality" or "materially" to describe events that require disclosure. It is sometimes difficult to define materiality because not all events have a quantifiable effect on financial statements. Events that have a qualitative effect on the company's operations and financial condition may also be important to a regulator's understanding of the significance of financial results and ratios. You should exercise due care when describing both quantitative and qualitative conditions that will aid our understanding of the significance of financial results. Preparers should always err on the side of full disclosure.
2. We use the phrase "through the eyes of management" to describe the preparer's perspective in reporting the necessary disclosures. Management's commentary in the MD&A should describe the events and conditions that give context to the numerical presentations within the basic financial statements. Often a deficient or overly generalized MD&A simply states the obvious in a boilerplate format, recounting account balances without providing insight or explanation.
3. The MD&A should provide both historical and prospective discussions using year-to-year financial data comparisons. It is always helpful when five-year historical data is available when describing the short and long-term trends and future expectations.
4. There may be specific economic trends that impacted the insurer's historical operations, but are not expected to continue to impact future operations. Alternatively, you may expect emerging economic trends to impact future operations without any historical effect. Preparers may need to discuss both of these situations to provide the regulator with adequate background to understand the insurer's current and prospective operations.

An effective MD&A integrates disclosures regarding historical and prospective aspects of the company's current financial condition, changes in its financial condition and the results of its operations. The discussion should include short and long-term analysis in addition to disclosure relative to the two-year period covered in the numerical presentations. The MD&A should describe the effects of any critical accounting policies, the judgments made in their application, and changes in assumptions or conditions which would have yielded materially different results.

The MD&A narrative is necessary because the numerical presentation and any accompanying notes to the financial statements generally do not provide context for the quality of earnings and the likelihood that past performance is indicative of future performance. The MD&A should specifically discuss material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition.

Captive insurers must get the Department's approval for material plan of operations changes. When captive insurers make material operations changes, the MD&A should include disclosures regarding the Department's approval, any conditions attached to the approval, the effective date of the changes and the impact on financial position and operations results. Please attach a copy of the Department's approval letter as an exhibit to the insurer's MD&A report.

### **Results of Operations**

The MD&A should provide an overview of the previous year of operations, results of the operations, the current financial position of the company and changes in its financial condition. The MD&A should complement the financial statements and provide information relevant to understanding and interpreting the results.

The MD&A should describe any unusual or infrequent events or transactions, significant economic changes that materially impact income and significant components of income or surplus. An effective MD&A identifies the extent to which unusual events impact income or surplus.

The MD&A should disclose any known trends or uncertainties that are likely to have a favorable or unfavorable impact on premiums, income, or surplus. You should disclose any event that affects the relationship between premium and expenses.

If the captive's financial statements report an increase or decrease in premium volume, the narrative should discuss the extent to which the change is attributable to changes in volume of premium written, pricing, or product mix.

### **Prospective Orientation**

The narrative should identify known trends, events or uncertainties that are reasonably likely to impact: (a) liquidity, capital resources, and the mix and cost of such resources; and, (b) premiums, net income and surplus.

### **Material Changes**

The MD&A should adequately identify and quantify the factors contributing to material changes in: (a) individual financial statement line items from year-to-year; or, (b) the typical or expected amount of financial statement line items from year-to-year.

## **Liquidity, Asset/Liability Matching and Capital Resources**

The Department requires Insurers to identify circumstances that could materially affect liquidity if the circumstances are reasonably likely to occur. Liquidity refers to the captive's ability to generate adequate cash to meet its cash needs. The MD&A should contain a detailed discussion of the balance sheet, income statement, or cash flow items that the captive believes may be indicators of its short or long-term liquidity position. A discussion of short-term liquidity should include the cash needs and the capital required to meet the cash needs up to 12 months into the future. A discussion of long-term liquidity should include cash needs and the capital required to meet the cash needs beyond the next 12 months. It is important to discuss matters that have affected the most recent period presented, but are not expected to have short or long-term implications, as well as matters that have not affected the most recent period presented, but are expected to have short or long-term implications.

The MD&A should also discuss the nature and extent of restrictions on the ability of the parent company to meet its premium, loanback or other obligations to the captive and the impact such restrictions may have on the ability of the captive to meet its obligations.

The MD&A should identify any known trends, demands, commitments, events, or uncertainties that are reasonably likely to result in material changes in the captive's liquidity. If you identify any decreases in liquidity, the MD&A should describe the course of action the captive took, or is taking, to remedy the deterioration in liquidity.

The captive should disclose internal and external sources of capital available to improve liquidity, any material unused sources of liquid assets and trends in capital resources, including changes in the mix or relative cost of such resources. This discussion should consider changes between equity, debt and any off-balance sheet financing arrangement and considerations of cash flows from operating, investing and financing.

## **Loss Reserves**

Describe any risks that affect or contribute to the volatility of loss reserves and discuss any changes in reserving practices.

## **Conclusion**

The final product should enable the Department to view the company through the eyes of management. The MD&A should be quantitative and qualitative, complete, reliable, and relevant. Address results of operations, prospective orientation, material changes, liquidity, and volatility of reserves.

See: NAIC 1984-2007 Annual Statement Instructions (pp.23-28); NAIC 1998-2008 Property/Casualty Financial Analysis Handbook 2007Annual/2008Quarterly (pp.121-123 & 227-229).