Through the lens of an auditor’s actuary

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17 September 2014

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Background
Risk-based approach

- The auditing standards[1] require auditors to identify and assess the risk of material misstatement in the financial statements.
  - Identification and assessment of this risk is based on the auditor's understanding of the entity and its environment, including its internal controls.
  - Material misstatement in the financial statements can occur as a result of inherent risk, error or fraud.

[1] Source: AICPA Audit and Accounting Guides

Background
The audit opinion

- Identifies the company subject to the audit, the financial statement date(s) and the accounting standards under which the audit was performed
- Explains management's responsibility
  - Prepare and fairly present the financial statements in accordance with the specified accounting principles
- Explains the auditor's responsibility
  - Express an opinion on the financial statements based on the audit performed
- Briefly describes the general requirements under those standards, for example:
  - Planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement
  - Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements
  - Assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation

Background
The audit opinion

- Provides an opinion on the financial statements
  - For example, “present fairly, in all material respects, the consolidated financial position of {company name} as of {the financial statement filing date} in accordance with the specified accounting principles”
  - Can also say “… does not present fairly …”
- Includes the audited financial statements

Background
Planning

- Develop materiality standard
  - Auditor sets materiality at an appropriate level based on determination of whether an error or omission would influence the decisions of financial statement users
  - Those accounts exceeding identified materiality levels are the focus of the audit, with supplemental procedures performed on accounts falling below the identified levels
- Identify key estimates
  - Those estimates that require additional focus by the auditor
  - Examples of accounts affected by key estimates for a property/casualty insurer include:
    - Loss and loss adjustment expense reserves
    - Premium deficiency reserves
    - Reinsurance recoverables

Background
Loss and LAE reserves

- Loss and LAE reserves generally give rise to significant risks due to:
  - The significance they typically have on the financial statements of a property/casualty insurance company
  - The inherent judgments necessary to estimate reserves
- Examples of conditions/events that may indicate the existence of risks of material misstatement:
  - Management's selection of assumptions are unduly influenced by considerations other than realistic expectations of future performance
  - Management's concerns with earnings and selection of its best estimate without proper support
  - Changes in underwriting standards or marketing strategy result in acceptance of higher risks or a change in business practices
  - Weak surplus in comparison to industry standards or close to minimum requirements
  - Unqualified specialists are involved in the calculation and review of loss reserves

Source: AICPA Audit and Accounting Guides, Property and Liability Insurance Entities, Chapter 4, *Auditing Loss Reserves*

Background
Auditing loss reserves

Audit procedures usually include a combination of the following:

1. Test the process used by management to develop the estimate
   - Appropriateness of method(s)
   - Reasonableness of assumptions
   - Reliability of data
2. Test the operating effectiveness of controls over how management made the estimate, together with substantive procedures
3. Develop an independent point of estimate or range to corroborate the reasonableness of management's best estimate
   - If the auditor's assumptions or methods differ from management's, auditor should obtain an understanding of management's assumptions or methods
   - If using a range, auditor should narrow the range until all outcomes in the range are considered reasonable
4. Review subsequent events or transactions occurring prior to the date of the auditor's report

Source: AICPA Audit and Accounting Guides, Property and Liability Insurance Entities, Chapter 4, *Auditing Loss Reserves*

Background
Use of loss reserve specialists

- The auditing standards permit the auditor to use the work of a specialist during an audit and that specialist could be:
  - An auditor’s external or internal loss reserve specialist
  - Management’s external loss reserve specialist who is not an employee of the entity
- If information to be used as audit evidence has been prepared using the work of management’s specialists, the auditor should:
  - Evaluate the competence, capabilities and objectivity of that specialist
  - Obtain an understanding of the work of that specialist
  - Evaluate the appropriateness of that specialist’s work as audit evidence for the relevant assertion

Source: AICPA Audit and Accounting Guides, Property and Liability Insurance Entities, Chapter 4, *Auditing Loss Reserves*

Background
Noteworthy items

- Auditing procedures focus on the recorded reserve and how management determines this estimate.
  - Unless management books to the appointed actuary's indication, then the actuarial opinion and supporting actuarial report only provide corroborative evidence of the reasonableness of the recorded reserve.
    - The auditors will want to understand differences in results but may not get into all of the details regarding the appointed actuary's methods and assumptions.
    - Auditors still need to subject data used by the appointed actuary to testing in accordance with NAIC data testing requirements.
- The actuarial opinion may not be available prior to the auditor's sign-off on the reserves.
  - The auditor will most likely want to meet with the appointed actuary to discuss the type of opinion that will be issued and whether there are significant risks that could result in material adverse deviation.
- The scope of the work performed by the appointed actuary and auditor can and will differ.

What do auditors generally look for?
Actuarial opinion

- The appointed actuary's qualifications
- The type of opinion being issued (e.g., reasonable, inadequate, excessive, qualified, no opinion)
- Whether there are significant risks that could result in material adverse deviation and what those risks are
- Issues with respect to the reconciliation of data to Schedule P
  - As we shall see, the auditors are required to subject Schedule P to certain testing procedures
- Relevant comments that might influence the auditor's identification or assessment of the risk of misstatement

What do auditors generally look for?
Actuarial report – the results

- Position of the recorded reserve relative to the actuarial range and consistency therein
  - Inconsistency may be a sign of earnings management
- Changes in the actuarial estimate of ultimate loss in the aggregate and by line and by year relative to the prior estimate of unpaids
  - If changes in prior-year ultimates are significant relative to the prior-year unpaids, then the auditors will want to understand the cause and the changes that the actuary has made to the actuarial methods, assumptions and/or selections in consideration of this development
- Reasonableness of the ultimate loss estimate for the current accident year (policy/underwriting year)
  - Auditors often perform analytics as part of their assessment of the reasonableness of the actuarial estimate, such as loss ratios, loss cost, severity, frequency, etc., relative to changes in the pricing, inflationary trends, limits/layers/retentions, claims handling, etc.
  - Implications with respect to need for premium deficiency reserve

What do auditors generally look for?

Actuarial report – the methods

- Appropriateness of the methods for the line(s) of business being evaluated
- Whether the entity’s data is sufficient to have adequate statistical credibility
  - For example, if the company only has a handful of open claims, then use of traditional methods, such as loss development, may not be appropriate.
- Whether current methods are consistent with those used in the past and past methods have resulted in appropriate estimates
  - This will come through in the change in ultimate analysis
  - Actual versus expected (AvE) should also be performed

What do auditors generally look for?
Actuarial report – the assumptions

- Reasonableness of the assumptions used in consideration of the entity's book of business, policy limits, reinsurance retention, geographic and industry considerations, claims handling practices, and other factors
- Whether the assumptions are consistent with each other, the supporting data, relevant historical data and industry data
- Whether changes in the business or industry may cause other factors to become significant to the assumptions
- That the assumptions have a basis and are anchored to a source, whether it be company data, industry data or some other reasonable source
  - As noted in the CASTF Regulatory Guidance on Property and Casualty Statements of Actuarial Opinion, use of the phrase "actuarial judgment" in a report "is not considered to be proper explanation. A descriptive rationale is needed."[1]

[1]Source: Appendix 2a of 2013 COPLFR Practice Note

Actuarial report
Case study #1

- You are the loss reserve specialist ABC LLP
- Spend 5 to 10 minutes reading the situation outlined in the hand out
- Be prepared to discuss

What do auditors generally look for?
Actuarial report – the data

- The company requires that the auditor subject the data underlying the appointed actuary's loss reserve estimates to testing procedures.
  - Under the requirement, the auditor should obtain an understanding of the data identified by the appointed actuary as "significant."
    - While not defined, significant is intended to mean a data item that if incorrect would likely have a material impact on the opinion (i.e., could result in a change in the actuarial opinion).
  - The auditor is responsible for determining the scope of work and designing appropriate testing procedures within the scope of the financial statement audit.
    - Not all data identified by the appointed actuary as significant will be tested by the auditor, and not all data will be tested each year; this is a matter of auditor judgment and depends on the auditor's assessment of materiality and other considerations.
  - Although not required, best practice would be for the appointed actuary to write a letter to company management and its auditors identifying the significant

What do auditors generally look for?

Actuarial report – the data

- The company also requires that the auditor subject the current Schedule P – Part 1 to the auditing procedures applied in the audit of the current statutory financial statements.
  - Purpose is to determine whether Schedule P – Part 1 is fairly stated in all material respects in relation to the statutory financial statements taken as a whole
  - Auditing procedures apply to activity that occurred in current calendar year
    - e.g., tests of payments on claims for all accident years paid in current calendar year

Actuarial report
Case study #2

- You are the loss reserve specialist ABC LLP
- Spend 5 to 10 minutes reading the situation outlined in the hand out
- Be prepared to discuss

Questions

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