August 26, 2011

Ms. Kim Kushmerick
Accounting Standards
AICPA
1211 Avenue of the Americas
New York, NY 10036

Re: June 23, 2011 Working Draft of AICPA Audit and Accounting Guide Property and Liability Insurance Entities

Dear Ms. Kushmerick:

On behalf of the Committee on Property and Liability Financial Reporting of the American Academy of Actuaries,[1] I welcome the opportunity to offer our thoughts and comments on the above document dated June 23, 2011. I am writing in response to your request for input from various constituencies in the financial reporting community. Actuaries are both users and preparers of financial statements, and we are pleased to provide the following observations for your consideration.

Chapter 3—Premiums

Section 3.02—"Assumed reinsurance premiums" is defined as "Premium income less return premiums arising from contracts entered into to reinsure other insurance companies that provide the related primary coverage." The problem with this definition is that it does not cover retrocessional assumed premium, due to the phrase "related primary coverage." This could be resolved by deleting the word "primary" or using another word in place of primary ("reinsured" would be one possibility). We also note that the definition of "ceded reinsurance premiums" refers to reinsurance purchased from other insurance companies. Given that such coverage is provided by entities other than traditional insurance companies (such as syndicates, captive insurance companies, reinsurance companies, and pools), we suggest changing the reference from "insurance companies" to "insurance entities."

Section 3.07—We suggest tightening up the first sentence regarding the standard most commonly used in rate regulation. Our understanding is that most jurisdictions use the following language: "Premium rates shall not be inadequate, excessive, or unfairly discriminatory."

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[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Section 3.31—The wording in Section 3.31 is ambiguous because “short-duration” is never defined and the term “short-duration” also is used in Section 3.31a to circularly define which contracts should be considered “short-duration.” Also, Section 4.04 refers to Chapter 3 in discussing short-duration contracts. A definition of “short-duration” in or before 3.31 would clarify this section.

In addition, in Section 3.31 b (ii), the definition of “long-duration contracts” seems to imply that such contracts must *require* the performance of services other than insurance. The performance of services may apply in some cases, but not in all cases.

Section 3.32—The wording in Section 3.32 creates further ambiguity with the statement, “A short-duration contract is not necessarily synonymous with a term of one year or less.” It is helpful that examples are provided, but an additional explanation as to why the given examples are considered short-duration (even though the policy term is greater than one year) would make this more clear.

Section 3.41—Discussion in this section relates to the unearned premium reserves (UPR) “for most property and casualty insurance contracts” using a pro-rata method. No mention is made of how auditors should view unearned premium reserves for “other” contracts, such as warranty, collateral protection, or those involving free tail coverage related to death, disability, and retirement (DD&R) exposure. Given that special procedures are required to quantify the UPR, the guide should cover how to address these other contracts.

Sections 3.64 and 3.65—References are made to the GAAP and SAP guidance on how contracts should be grouped for the purpose of determining whether a premium deficiency reserve (PDR) exists. This guidance should be clarified—as written, it can be interpreted in several different ways. Examples of how companies typically group their contracts would be helpful for calculating the PDR. There are other areas in which similar direction is provided (such as the approach for calculating anticipated investment income and on the interest rate to be used), so it would seem that such detail also could be included here on the topic of grouping.

Sections 3.65 to 3.75—Two examples of how to calculate anticipated investment income (the investment income approach and the discounting approach) are provided. Besides being arithmetically different, there is a fundamental difference between these two approaches in that the investment income approach includes investment income (whether earned or unearned) on all funds available from in-force policies, and the discounting approach includes only investment income on the unearned portion of the in-force policies. The inclusion of the already earned portion of in-force policies for the calculation of investment income seems to contradict the intent of PDR (which, as stated in Section 3.62, is based on the related unearned premium) as well as the principle of conservatism that underlies statutory accounting. The inclusion of the investment income approach in the explanation and examples legitimizes this flawed interpretation. The document more truly would reflect the accounting guidance if references were not made to the investment income approach and only the discounting approach were cited.

Chapter 4—The Loss Reserving and Claims Cycle

The entire section on Auditing Loss Reserves in the current edition of the AICPA Audit and Accounting Guide has been removed from this draft. That section contained extensive guidance on auditing the data used for loss reserving as well as testing the reasonability of the loss reserve estimates. Guidance is included on the auditor's use of specialists, the development of reserve ranges, and loss reserve disclosures. It is unclear why this large section was removed. We viewed the information in that section to be valuable, and we would like to see that guidance provided in this document or elsewhere.

Section 4.08—We suggest changing the clause in the second-to-last sentence of the paragraph from "per risk and aggregate coverage" to "per occurrence and aggregate coverage." We similarly suggest changing the reference in the last sentence from "per-risk" to "per-occurrence."

Section 4.22—We also suggest that the guide consider mentioning that some companies establish case reserves on individual claim files on a statistical basis reflecting average claim severities paid out in the recent past for similar claims.

Section 4.36—The wording indicates that actuaries generally use the same projection methods to estimate both gross and net loss reserves. Casualty actuaries, however, use a variety of methods to develop gross and net loss reserve estimates. The approach, sometimes, is to separately estimate gross from net. At other times, the actuary will estimate gross and ceded reserves separately; the difference between the two equals the net loss reserves. In addition, sometimes the actuary will estimate net and ceded reserves separately; the sum of the two equals the gross loss reserves. There is no one preferred method for addressing gross versus net reserves.

Section 4.38—We suggest adding insured amounts and/or policy limits to the listing here.

Section 4.74—Our comments on this section relate not to management's need for selecting a best estimate but to the manner in which management may rely on specialists such as actuaries to develop that best estimate. Actuaries typically will provide loss reserve estimates stated either as a reasonable range (from low to high), as a point estimate, or both. But actuarial professional standards (specifically Actuarial Standard of Practice No. 43, *Property/Casualty Unpaid Claim Estimates*), promulgated by the Actuarial Standards Board, state categorically that "the terms 'best estimate' and 'actuarial estimate' are not sufficient identification of the intended measure ..." When an actuary chooses to develop a point estimate of indicated reserves rather than a range, that point estimate is commonly referred to as an "actuarial central estimate" rather than a "best estimate." We therefore recommend that the reference to "best estimate" in Section 4.74 clearly indicate that it is management's best estimate—not the best estimate from the specialist—that is pertinent to the auditor.

Chapter 5—Investments and Fair Value Considerations

Section 5.03—This section appears to address investment strategy as opposed to the investments themselves. For that reason, we suggest using the phrase "evaluation of investment strategy" rather than "evaluation of investments" in the first sentence of this section.

Section 5.17—The last sentence of this section refers to "initial recognition." There is no definition of this term, which could cause confusion as to its precise meaning.

Section 5.101—The word "holding" in the phrase "unrealized holding gains" can be deleted without any loss of meaning.

Chapter 6—Reinsurance

Section 6.82—This section on Control Activities appears in the Reinsurance section, but similar wording easily could be inserted into previous chapters on Premiums, Loss Reserves, and Investments. It is unclear why Control Activities are addressed here and not elsewhere.

Chapters 7 through 9

We have no substantive comments on Chapter 7 (Income Taxes), Chapter 8 (Insurance-Related Expenses, Taxes, and Assessments), or Chapter 9 (Captive Insurance Entities).

We appreciate your consideration of these comments and hope that you will find them useful. Thank you for this opportunity to comment on the working draft of the AICPA Audit and Accounting Guide for Property and Liability Insurance Entities.

Sincerely,

Joseph A. Herbers
Chair, Committee on Property Liability Financial Reporting
American Academy of Actuaries