



AMERICAN ACADEMY *of* ACTUARIES

DATA TESTING REQUIREMENT IN 2004 P/C ANNUAL STATEMENT INSTRUCTIONS:

GUIDANCE FOR ACTUARIES SIGNING STATEMENTS OF ACTUARIAL OPINIONS ON LOSS AND LOSS EXPENSE RESERVES

**American Academy of Actuaries
Committee on Property and Liability Financial Reporting**

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The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

Data Testing Requirement in 2004 P/C Annual Statement Instructions: Guidance for Actuaries Signing Statements of Actuarial Opinions on Loss and Loss Expense Reserves

The 2004 Annual Statement Instructions issued by the National Association of Insurance Commissioners (NAIC) contain a new paragraph in Section 9, “Scope of Examination and Report of Independent Certified Accountant.” This new statutory guidance is included as Attachment 1 and referred to as “the new data testing requirement” in this document. The Annual Statement Instructions further address the auditor’s review of data used by the Appointed Actuary. For purposes of this letter, the term “loss reserves” is intended to include loss adjustment expense reserves and any other items within the scope of the statutory Statement of Actuarial Opinion.

As it regards testing data used in actuarial analyses, auditors are guided by Statement of Position (SOP) 92-4, *Auditing Insurance Entities’ Loss Reserves*, which requires the auditor to subject the data underlying loss reserve estimates to testing procedures. The data relied upon by the auditor may or may not be the same as the data used by management in developing the loss reserve estimate. Under SOP 92-4, data used by the Appointed Actuary might not have been subject to testing if that data was not also relied upon by the auditor in the course of the statutory financial statement audit. The new data testing requirement ensures that the auditor will become aware of the data and/or data elements that the Appointed Actuary identifies as being significant. However, not all data identified as significant by the Appointed Actuary will necessarily be tested in the statutory financial statement audit; this is a matter of auditor judgment as well as the auditor’s assessment of materiality.

This communication by the American Academy of Actuaries Committee on Property and Liability Financial Reporting (COPLFR) is intended to provide advisory, non-binding guidance to the actuarial community and help describe the respective roles of management, the actuary and the auditor in fulfilling this new requirement. *This communication is not an Actuarial Standard of Practice. It has not been adopted by the Actuarial Standards Board (ASB) and is not binding on any actuary. It should not be deemed to describe or codify generally accepted actuarial practice. From the perspective of the actuarial profession, this is a new requirement and there does not yet exist generally accepted practice for complying with it.*

Although the term “significant” is not defined within the new data testing requirement, COPLFR suggests the following as an example of a definition for use in this instance: A data item or attribute would normally be considered to be “significant” to an analysis of loss reserves if, in the Appointed Actuary’s professional judgment, the correctness of the data item or attribute in the loss reserve analysis is likely to have a material effect on the opinion. Examples of a “material effect” might include a change in the type of opinion rendered (reasonable, qualified, redundant, deficient, or no opinion) or the presence or absence of a risk of material adverse deviation. *[Note: actuaries are not required to use or practice consistent with this definition. It has not been adopted by the ASB and is not binding on any actuary.]* Once the Appointed Actuary has communicated to management and the auditor the data and attributes that he/she believes to be significant, the auditor has responsibility for considering testing such data in the statutory financial statement audit.

To satisfy the new data testing requirement, appointed actuaries identify to management and the auditor the data that is deemed significant in the actuaries’ analysis of loss reserves. Appointed Actuaries are encouraged to contact the company’s management and its auditors before beginning their loss reserve analysis. A sample letter from the Appointed Actuary to management and the audit firm is included as Attachment 2. *While there is no requirement to this effect, written communication among the actuary,*

the company's management and the company's auditor, to be retained for a reasonable time period, may be very beneficial in order to clarify information and create a documentation trail. However, there is no requirement that the actuary make use of the sample letter, and the actuary is encouraged either to adapt the sample letter or use alternative language as appropriate to the actuary's circumstances. The actuary may wish to consult with legal counsel concerning the specific provisions of the NAIC's data testing requirements.

In addition, the American Institute of Certified Public Accountants (AICPA) and COPLFR strongly encourage appointed actuaries to meet with the company's management and its audit firm to discuss the data and the audit in greater depth.

Attachment 3 is a list of questions and answers that may be useful to you as you work through this new process with companies and their auditors. Actuaries may also wish to consult Actuarial Standard of Practice (ASOP) 23 regarding the nature and boundaries of the actuary's responsibilities regarding data quality.

COPLFR generated this guidance document after discussions with the AICPA, the NAIC/AICPA Working Group and the NAIC Casualty Actuarial Task Force. However, it is a working document and is still being reviewed for formal input from the AICPA and NAIC. Further, this document is directed at actuaries; COPLFR understands that there may be forthcoming guidance from the AICPA directed at the audit community. Actuaries are not normally trained to define or specify audit procedures and therefore we look to insurance companies and their auditors as having the ultimate responsibility for determining how to comply with the new data testing requirement. Questions about the new data testing requirement as it relates to specific companies should be directed to the companies' domiciliary regulators.

**New Data Testing Requirement
(from 2004 P&C Annual Statement Instructions Section 9,
“Scope of Examination and Report of Independent Certified Accountant”)**

The insurer shall also require that the independent certified public accountant subject the data used by the Appointed Actuary to testing procedures. The auditor is required to determine what historical data and methods have been used by management in developing the loss reserve estimate and whether the auditor will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of loss data and perform testing as the auditor deems appropriate. Through inquiry of the Appointed Actuary, the auditor should obtain an understanding of the data identified by the Appointed Actuary as significant. It is recognized that there will be instances when data identified by the Appointed Actuary as significant to his or her reserve projections would not otherwise have been tested as part of the audit, and separate testing would be required. Unless otherwise agreed among the Appointed Actuary, management and the auditor, the scope of the work performed by the auditor in testing the claims data in the course of the audit would be sufficient to determine whether the data tested is fairly stated in all material respects in relation to the statutory financial statements taken as a whole. The auditing procedures should be applied to the claim loss and defense and cost containment expense data used by the Appointed Actuary and would be applied to activity that occurred in the current calendar year (e.g., tests of payments on claims paid during the current calendar year).

Sample Letter to Company Management (Copy to Auditor)

[This letter is intended solely as one possible example of the kind of letter an Appointed Actuary might wish to issue to company management (typically with a copy to the auditor) under the NAIC's new data testing requirements. Significant data and attributes will vary depending on the circumstances of a particular assignment and may call for varying approaches to compliance with the NAIC's requirements. There is no requirement that the Appointed Actuary use this letter or any of the specific language or provisions contained herein, or to identify the lines of business or attributes used as examples herein as significant. In fact, the actuary is encouraged either to adapt the language of this sample to the circumstances of a particular company or to develop entirely different language if, in the actuary's professional judgment, it is appropriate or desirable to do so. The actuary may wish to consult with legal counsel concerning the specific provisions of the NAIC's data testing requirements.]

Mr. CFO
XYZ Insurance Company

Dear Mr. CFO:

I understand that ABC CPA has been appointed to audit XYZ Insurance Company's financial statements for the year ended December 31, 200X. I understand that the NAIC Annual Statement Instructions direct insurers to require that the auditor subject the data used by the Appointed Actuary to testing procedures. As the Appointed Actuary of XYZ, I am providing this letter to communicate what data and attributes I believe to be significant to my analysis in support of the XYZ Statement of Actuarial Opinion (SAO).

In this letter, a data item or attribute would normally be considered to be "significant" to my analysis of loss reserves if, in my professional judgment, the correctness of the data item or attribute in the loss reserve analysis is likely to have a material effect on the opinion. Examples of "material effect" might include a change in the type of opinion rendered (reasonable, qualified, redundant, deficient, or no opinion) or the presence or absence of a risk of material adverse deviation.

As of the date of this letter, I expect my analysis of loss and loss adjustment expense reserves to be based on the following data:

1. Direct and Ceded Paid Loss and Defense and Cost Containment Expense (DCC) by statutory line of business and by accident year, at annual evaluations as of XX/XX/200X. For Workers' Compensation, this data is also split to Medical vs. Indemnity. For Commercial Multi-Peril, this data is also split to Property vs. Liability.
2. Direct and Ceded Case Reserves for Loss by statutory line of business and by accident year, at annual evaluations as of XX/XX/200X. For Workers' Compensation, this data is also split to Medical vs. Indemnity. For Commercial Multi-Peril, this data is also split to Property vs. Liability.
3. Direct and Ceded Earned premium by statutory line of business by calendar year as of XX/XX/200X.
4. Reported Claim Counts by statutory line of business and by accident year, at annual evaluations as of XX/XX/200X, for the following lines of business: Workers' Compensation, Personal Auto

Liability and Commercial Auto Liability. For Workers' Compensation, this data is also split to Medical vs. Indemnity. For Commercial Multi-Peril, this data is also split to Property vs. Liability.

5. Direct Paid Adjusting and Other Expense (AOE) by calendar year as of XX/XX/200X.

I believe the Workers' Compensation and Commercial Multi-Peril lines of business to be most significant with respect to the SAO.

The attributes that are significant with respect to the above items are as follows:

- For items 1 through 4, the assignment to line of business and accident year.
- For items 1, 3 and 4, the annual amounts of premiums, payments or reported claims
- For item 2 the amount of reserves at XX/XX/200X.
- For items 1, 2 and 4, the split for Workers' Compensation of Medical vs. Indemnity.
- For items 1, 2 and 4, the split for Commercial Multi-Peril of Property vs. Liability.

The data used in support of the SAO comes to me from Ms. Analyst of XYZ and is generally provided on the 10th workday following the close of the year. Direct AOE and payroll are provided by Mr. Controller of XYZ. I have attached an extract of last year's data files, highlighted to show the data fields that I used for last year's review.

The decision to designate the items listed in this letter as "significant" was based upon my professional judgment and my understanding of XYZ's operations at this time as represented to me by XYZ's management. This listing is intended solely for the use of XYZ and its auditors, and should not be used or relied upon by any other party or for any other purpose. This listing does not indicate in any way that all of these items will, in fact, prove to be significant to the company's reserves or that additional items not specified here will not be identified at some time in the future as having been a significant influence on the company's reserves.

The above list was based on my work for XYZ in prior years, and is subject to change during the course of my review. If I become aware of additional data items that are significant to my review of reserves as of December 31, 2004, I will notify you and, with your concurrence, inform ABC accordingly.

I will rely upon the data identified in this letter when performing my analysis. Any significant discrepancies discovered in the data identified in this letter should be communicated to me by XYZ as soon as possible so that my analysis can be amended accordingly.

I would be happy to meet with you and ABC and answer any questions you may have. Please contact me after you have had a chance to review this letter.

Yours truly,
Ms. Actuary

cc: Mr. Partner, ABC CPA

Answers to Frequently Asked Questions

[These questions and answers, while intended to be of interest and assistance to the actuary, are not authoritative and are not intended to be binding. COPLFR believes these questions and answers reflect factors that many actuaries will take into account when working under the new data testing rules, but other approaches will, no doubt, be used as well.]

Question 1: With respect to the new NAIC Data Testing Requirement, what are the roles of the insurance company, the Appointed Actuary, and the auditor?

Answer:

- The company selects the Appointed Actuary and provides appropriate company data to the Appointed Actuary. The company has the sole contractual relationship with the auditor, including agreement on fees. The company's management is ultimately responsible for the fair presentation of the data. Under the new data testing requirement, the company requires that the auditor subject the data underlying the Appointed Actuary's loss reserve estimates to testing procedures.
- The auditor is responsible for determining the scope of work and designing appropriate testing procedures within the scope of the financial statement audit. Under the new requirement, the auditor should obtain an understanding of the data identified by the Appointed Actuary as "significant."
- Consistent with past practice, the Appointed Actuary requests the data that he/she deems necessary for the loss reserve review. The Appointed Actuary determines whether the data is appropriate for the methods and assumptions he/she uses in the loss reserve analysis. The Appointed Actuary is allowed to rely on the company for the data underlying the SAO, subject to checks for reasonableness and consistency in accordance with ASOP 23. Under the new requirement, the Appointed Actuary will be expected to identify to the auditor the data and/or attributes he/she believes are significant to the SAO.

Question 2: Will all data identified by the Appointed Actuary as significant be tested by the auditor in the financial statement audit? Will all data be tested each year? Is the Appointed Actuary required to include disclosures in the opinion or report as to what data has been tested?

Answer:

- 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.
- The Appointed Actuary is relying on management for the fair presentation of the data. The Appointed Actuary is not required to follow up with the auditor as to what data has been tested, nor to disclose such information in the opinion or report.

Question 3: What work regarding data testing is currently performed in the financial statement audit?

Answer:

- Under SOP 92-4, the auditor is required to subject the data underlying loss reserve estimates to testing procedures. The data relied upon by the auditor may or may not be the same as the data used by management in developing the loss reserve estimate.
- For the audit opinion, the auditor subjects to testing what she/he deems material in the context of the financial statements taken as a whole.
- In connection with the statutory audit as stated in SOP 92-8, *Auditing Property/Casualty Insurance Entities' Statutory Financial Statements – Applying Certain Requirements of the NAIC Annual Statement Instructions*, certain of the information in Schedule P-Part 1 is typically subjected to auditing procedures applied in the audit of the basic statutory financial statements (for example, earned premiums and paid losses).

Question 4: Who determines how the testing gets done? Who determines the sample size and attributes to be tested? Who determines how often the testing needs to be done?

Answer:

- The auditor determines the scope of the audit.
- Within the scope of the statutory financial statement audit, the auditor determines the sample size and attributes, how testing gets done, and how often to test data.
- There may be instances in which the data used by the Appointed Actuary is tested outside the scope of the audit. If these instances occur, the determination of how the testing is done will be handled on a case-by-case basis.
- In general, actuaries are not trained to define or specify data testing procedures. Therefore, if the Appointed Actuary is prescribing or signing off on agreed-upon procedures outside the scope of the audit, he/she is encouraged to obtain appropriate support. The support might encompass such areas as developing appropriate data testing procedures, interpreting the results, and deciding whether or not to use the data in the loss reserve analysis.
- If there are questions about the new data testing requirement in a specific instance, it may be helpful to contact the domiciliary regulators.

Question 5: Is there a difference in procedure if the Appointed Actuary is an employee of the company, the audit firm, or a consulting firm?

Answer:

- No, with respect to the duties identified in this document as being those of the “Appointed Actuary.”
- If the Appointed Actuary serves additional roles, such as being a member of company management or a member of the audit team, he/she may have additional duties. For example, if the Appointed Actuary is also the company CFO, he/she may be responsible for the fair presentation of the data.

Question 6: Most actuaries use multiple methods and various sources of data. Does the actuary need to identify significant data used for all methods, or just those that are ultimately used or heavily weighted in the final range or point estimate?

Answer:

- The Appointed Actuary takes into account his/her level of reliance on the data in determining which data and attributes are deemed “significant”.

- In general, significant data would include just the data that is ultimately used or heavily weighted in the final range or point estimate, whether the data is incorporated into methods or diagnostic tests.

Question 7: What is the process of coordination between management, the Appointed Actuary and the auditor?

Answer:

- The company is responsible for instructing the auditor to subject the data underlying the Appointed Actuary's loss reserve estimates to testing procedures.
- The Appointed Actuary informs the auditor of the data he/she believes is "significant."
- Within the scope of the financial statement audit, the auditor is responsible for determining the scope of work and designing appropriate testing procedures.
- In instances where additional testing is handled outside the scope of the audit, the coordination will be handled on a case-by-case basis.
- It is usually preferable that the Appointed Actuary, company management and the auditor begin having discussions before the loss reserve review is performed.

Question 8: What if the Appointed Actuary materially changes his/her view of what is "significant" based upon work the Appointed Actuary performs subsequent to attaining agreement with the auditor and management?

Answer:

- As soon as practicable, the Appointed Actuary discusses the change with management and the auditor.
- The actuary should not be limited in the use of various methods or data by the original list of "significant" data.

Question 9: What if the auditor's data testing yields significant data discrepancies?

Answer:

- Management advises the Appointed Actuary.
- The actuary revises his/her estimates accordingly to see if there is a material impact on the opinion.
- If so, management is advised and, as the Appointed Actuary deems necessary, a revised opinion is sent to regulators.

Question 10: What data is in scope vs. out of scope of the new data testing requirement?

Answer:

- Though it is not definitively described in the new data testing requirement, we understand from discussions with the NAIC/AICPA Working Group that the following data items are generally within the scope of the new requirement as respects data used by the Appointed Actuary: earned premiums, unearned premiums, loss, and loss adjustment expense. Claim counts can be in-scope but only if they are material to the fair presentation of the financial statements; usually they are out of scope.
- From those discussions, we also understand that non-financial statement data items (e.g. exposures, on-level premium, industry data) are generally not intended to be within the scope. In

addition, data not provided by the company, such as industry loss development factors, proprietary data from a consulting firm, are also not intended to be within the scope.

Question 11: Will the new NAIC Data Testing Requirement have an impact on the work done by an auditor for every statutory audit?

Answer:

- Yes. At a minimum, there will need to be identification of data deemed to be significant by the Appointed Actuary, and discussion among the company, the auditor and the Appointed Actuary.
- The data used by the Appointed Actuary might not otherwise be subject to testing as part of the financial statement audit.
- Beyond this, it is difficult to generalize.

Question 12: Will testing required for the new NAIC Data Testing Requirement already be performed by the auditor under his/her work under Sarbanes-Oxley Section 404?

Answer:

- Not necessarily. Section 404 of the Public Company Accounting Reform and Investor Protection Act (“Sarbanes-Oxley”) has a different focus than the new data testing requirement.
- Further, many insurance companies are not currently required to comply with Sarbanes-Oxley because it applies only to publicly traded companies. The new NAIC Data Testing Requirement applies to all insurance companies filing Annual Statements.