SEPT 2023

The Evolution of Auditing Insurance Company Loss Reserves

What Insurance Companies Need to Know About Changes to Auditing Estimates

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Johnson Lambert LLP is dedicated to keeping you informed on the impact of upcoming auditing standards. The American Institute of Certified Public Accountants (AICPA) has issued Statements on Auditing Standards (SAS) 143 and 144, which address estimates and the use of specialists for audits of financial statements for periods ending on or after December 15, 2023. Johnson Lambert recently published a white paper, Estimates, Specialists and Risk Assessment, covering these two SAS's and SAS 145, which addresses the auditor's risk assessment process, that are effective for 2023.

This white paper illustrates the impacts to the most significant estimate on an insurance company's balance sheet: the actuarial loss reserve estimate. We will take a closer look at the intersection of the loss reserve estimate and these new auditing standards.

Background

The AICPA released updates applicable to audits of financial statements for periods ending on or after December 15, 2023, including but not limited to:

- **SAS 143** Auditing Accounting Estimates and Related Disclosures; and
- **SAS 144** Amendments to AU-C Sections 501, 540, and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained from External Information Sources

Because of new requirements introduced relating to auditing accounting estimates, SAS 143 is expected to impact the audit process by prescribing a risk assessment process over estimates and testing approaches in response to the assessed risk, including consideration of when the auditor might need to use the work of a specialist. SAS 144 provides further clarification on the use of a specialist, whether it is management's specialist or the auditor's specialist.

Factors Driving Enhanced Auditing Standards:

- Recent changes in Public Company Accounting Oversight Board and international auditing standards,
- Changes in accounting standards,
- Observations from AICPA peer reviews, and
- The need for modernization in the standards.

The Loss Reserve Estimate

Loss reserve estimates, including the related reinsurance recoverable, typically comprise the most complex and subjective amounts on an insurance company's balance sheet. These and other inherent risk factors make the estimate of loss reserves more susceptible to misstatement than, for example, the fair value estimate for an investment portfolio comprised of all level 2 bonds. When the complexity or subjectivity of an estimate is high, such as in the case of loss reserves, the auditor is required to design the extent of audit procedures to adequately address the heightened level of risk.

Given the complexities identified with loss reserves, and the relative dollar value of reserves compared to the balance sheet, the auditor will perform risk assessment procedures over loss reserves and will typically assess loss reserves to be a significant risk of material misstatement, as well as a sensitive estimate. These designations inform the auditor's risk-based audit approach, testing procedures, review of financial statement disclosures and communications with the Board of Directors.

The auditor is required to evaluate the evidence from management and determine whether the loss reserve estimate and related disclosures are reasonable in the context of the applicable financial reporting framework, most commonly Generally Accepted Accounting Principles (GAAP) or Statutory Accounting Principles (SAP), which is a regulatory basis of accounting.

Actuarial Specialists

Actuarial expetise is traditionally necessary to develop the reserve estimate. Management has the ability to hire an actuarial specialist on staff or engage an independent actuarial specialist to assist them with developing the reserve estimate. A common practice for an insurance company is to engage an independent actuarial reserve specialist.

SAS 143 enhances the language around estimates to convey that, even when management uses a specialist, it is **management's responsibility** to:

- Determine the methods, assumptions and data sources needed for the estimate, and when changes are needed to these items,
- Understand the degree of estimation uncertainty, including considering the range of possible outcomes, and
- Address estimation uncertainty, including selecting a point estimate and related financial statement disclosures.

Management should document internal controls that clearly address each of the above responsibilities as they relate to the loss reserve estimate. Management may need to more closely collaborate with its actuarial specialist in order to fulfill these responsibilities and understand the selection of methods and assumptions used to make informed decisions and determine the appropriate point estimate selection. The auditor will have additional inquiries for management and management's actuarial specialist for loss reserves to gain the required understanding of these items.

Auditing the Loss Reserve Estimate

Once the risk assessment is complete, the auditor designs audit procedures to respond to the risks of material misstatement identified. SAS 143 prescribes the auditor must use one or more of the following methods for testing estimates:

- Obtaining evidence from events occurring up to the date of the auditor's report
- Testing how management made the accounting estimate
- Developing an auditor's point estimate or range

We'll focus first on changes to testing how management developed the loss reserve estimate when management uses a specialist to analyze loss reserves. Referring back to management's responsibility for estimates, the auditor will review and test support provided by management to corroborate the loss reserve estimate. The auditor is required to understand:

The selection and application of methods, significant assumptions, and data used by management in making the loss reserve estimate,

AND

How management selected the point estimate recorded in the financial statements and developed the disclosures about estimation uncertainty.

The methods, assumptions and data used by management or management's specialist and the associated requirements focus on the reasonableness of the estimate and whether judgments made in selecting the estimate give rise to management bias. The standard highlights that estimates are management's responsibility, and management must understand and take responsibility for the methods and assumptions selected by any specialists and the data used by the specialist.

Methods

Consideration is given to the methods used in light of the reporting framework. *A method is a measurement technique used to make an estimate that is applied using a computational tool or process (model).* For property and casualty insurers, neither GAAP nor SAP prescribe a method for insurance companies to estimate loss reserves, and for this reason, understanding the rationale behind the method(s) selected is important.

Common actuarial methods for property and casualty insurers include:

- Loss Development (Paid or Reported)
- Case Reserve Development
- Bornhuetter-Ferguson (Paid or Reported)
- Expected Loss Rate

For life insurers, statutory reserves must follow the method(s) prescribed or permitted by regulatory authorities in the state of domicile, and GAAP reserves must follow the methodology described in FASB ASC 944 for traditional long duration insurance contracts.

Common actuarial methods for life insurers include:

- Net Level Reserve Method
- Principles-Based Reserving (PBR)
- Commissioners Reserve Valuation Method
- Commissioners Annuity Reserve Valuation Method

The auditor needs to understand the judgments made in the method used, including management's basis for any changes in methods, and the weighting of methods in the reserve calculation, including management's basis for changes in the weights. The auditor reviews methods for consistency with other insurance companies in the industry, with those generally accepted by actuaries, and the rationale behind any deviations.

Significant Assumptions

Consideration is given to significant assumptions, which involve judgments based on available information. Assumptions may be selected from a range of appropriate alternatives. Similar to methods, if a significant assumption is used to support management's reported reserve balance, management is responsible for the assumption.

As it relates to loss reserves, the auditor evaluates whether significant assumptions used are appropriate and consistent with other audit evidence obtained, external factors and industry data. For example, if the auditor has knowledge of assumptions used in business plans, or cash flow projections from other areas of the audit or other work performed for a Company, this information may be useful to consider whether significant assumptions used in developing the loss reserve estimate are consistent with assumptions used across the business. The auditor reviews significant assumptions for consistency with other insurance companies in the industry and with those generally accepted by actuaries, and the rationale behind any deviations.

Common actuarial assumptions for property and casualty insurers include:

Initial expected loss ratio	Inflation
Discount rate	Frequency
Severity	Loss development factors
Trend factors	

Common actuarial assumptions for life insurers include:

Interest rate	Inflation
Investment earnings	Mortality
Morbidity	Underwriting classification
Withdrawal rates	

Data

SAS 143 places an emphasis on testing the data which is a necessary step to ensure it is appropriate, relevant and reliable. Management must appropriately understand and interpret the data. The auditor tests the accuracy and completeness of the data used.

As part of the annual audit, management represents in the management representation letter that the loss data provided to the actuary is complete, accurate and reconciled to the underlying accounting records.

Relevant data for the loss reserve estimate may be stated in the significant data letter provided by the actuarial specialist. The data typically includes:

+ Inception-to-date paid claims by line of business
+ Case reserves as of the valuation date by line of business
+ Premiums for the current year
+ Terms and limits of the Company's reinsurance agreements

Changes to Methods, Significant Assumptions and Data

When there are changes to the methods, assumptions and data used to develop the loss reserve estimate, the auditor is required to understand the reason behind the changes by inquiring with management or management's actuarial specialist:

1. Is management's rationale for the change appropriate?
2. Is the change appropriate in the circumstances?
3. Is the change consistent with those used in the business, industry, and environment in which the Company operates?
4. Is the change based on new circumstances or new information?

Management may make changes to its estimation process from time to time. Management should carefully document the reason the change is needed. The evolution of analytics and other business tools allow for more precise and accurate data to be available more timely which can impact methods, assumptions and data used in the estimation process.

Management's Selection of a Point Estimate

It is managements' responsibility to select a point estimate for the loss reserves based on the range of reasonable outcomes. The point estimate represents the amount that management records in the financial statements for loss reserves. Generally, accounting standards specify that management must select its best estimate of the ultimate cost of settling the claims.

Many insurance companies select the actuarial central estimate, or ACE as the point estimate, and can point to the actuarial specialist's report for the methods and assumptions used. Some insurance companies select a point estimate that is greater than or less than the ACE. The auditor is required to understand management's selection of a point estimate which involves understanding if management took appropriate steps to evaluate estimation uncertainty in developing its loss reserve estimate and related disclosures. The GAAP and SAP disclosure requirements addressing loss reserve estimates and estimation uncertainty have not changed, however, management should consider its enhanced understanding of loss reserves in its disclosures in the notes to the financial statements.

Other Options to Audit the Loss Reserve Estimate

Obtain Evidence from Subsequent Events

The auditor may obtain evidence from subsequent events occurring up to the date of the auditor's report; however, this testing method should generally not be used on its own. Loss reserves often develop over a number of years, with the exception of certain short-tailed lines such as property, auto physical damage and health claims. As such, reviewing evidence through the audit report date, which typically covers less than 5 months after year end, may not provide sufficient, appropriate audit evidence on its own.

Regardless of the auditor's testing approach, the audit team is required to comply with AU-C Section 560, Subsequent Events and Subsequently Discovered Facts which requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all subsequent events that require adjustment of or disclosure in the financial statements have been identified and appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.

Develop an Auditor's Point Estimate or Range

Under SAS 143, the auditor continues to be permitted to rely on the work of management's actuarial specialist for loss reserves; however, there may be facts and circumstances that prompt the auditor to use its own specialist to develop a point estimate or range. Risk factors that are present could include:

+ The auditor's retrospective review of the prior year reserve estimate indicates that management's current process is not expected to be effective,
+ Management's internal controls over the reserve estimation process are not properly designed or implemented,
+ There are appropriate alternative assumptions or sources of data that can be used to develop an auditor's point estimate or range, or
+ Management has not taken appropriate steps to understand or address estimation uncertainty of loss reserves.

When these risk factors are not present, the auditor will have more flexibility to test how management made the estimate.

Actuarial Report Restrictions

Certain restrictions included in an actuarial report may affect the auditor's ability to rely on the work of the actuarial specialist. These may include, but are not limited to, distribution restrictions, disclaimers or limitations in the report regarding the auditor's use of the report. Management should scan the report to ensure it is free from such restrictions on the auditor's use, or additional audit procedures may be necessary.

Conclusion

The changes to auditing accounting estimates such as loss reserves will have limited visibility in the audit report for insurance companies, beyond the potential for enhanced disclosures in the notes to the financial statements over the estimate and estimation uncertainty. The changes, however, demand management and the auditor understand the methods, assumptions and data used to develop the estimate as well as internal controls surrounding the estimation process. The intangible result will be greater audit quality as auditing standards are modernized with changes in the economic and accounting standard-setting environment.

Management and its actuarial specialist should be prepared for new auditor inquiries related to management's loss reserve point estimate and the underlying methods and assumptions used.

Are You and Your Organization Ready?
☐ Understand the underlying data, methodology, and assumptions used in developing the loss reserve estimate, including when it is developed by a specialist
☐ Understand and document controls in place at your organization over loss reserve accounts, journal entries, and related IT applications
☐ Understand and document controls in place at your organization over the work of management's specialist
☐ Document basis for conclusion for management's recorded loss reserve point estimate
☐ Communicate with your loss reserve specialist regarding new requirements and the need for enhanced collaboration with the auditor

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