

LIFE PRACTICE NOTE 1995-3
December 1995

Reliance upon Third Parties

Introduction

This practice note was prepared by a work group organized by the Committee on Life Insurance Financial Reporting of the American Academy of Actuaries. The work group was charged with developing a description of some of the current practices used by valuation actuaries in the United States. This work group was originally formed in 1992 and issued the first set of Life Practice Notes that year; changes have been made to this set of practice notes on an annual basis to reflect additional information on current practices.

The practice notes represent a description of practices believed by the work group to be commonly employed by actuaries in the United States in 1995. The purpose of the practice notes is to assist actuaries who are faced with the requirement of adequacy testing by supplying examples of some of the common approaches to this work. However, no representation of completeness is made; other approaches may also be in common use. It should be recognized that the information contained in the practice notes provides guidance, but is not a definitive statement as to what constitutes generally accepted practice in this area. Moreover, these practice notes are based upon the model Standard Valuation Law of the National Association of Insurance Commissioners (NAIC). To the extent that the laws of a particular state differ from the NAIC model, practices described in these practice notes may not be appropriate for actuarial practice in that state. This practice note has not been promulgated by the Actuarial Standards Board, nor is it binding on any actuary.

The members of the work group responsible for the original practice notes are as follows:

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Additional review for the 1995 Life Practice Notes was provided by the following members of the American Academy of Actuaries' Committee on Life Insurance Financial Reporting:

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Comments are welcome as to the appropriateness of the practice notes, desirability of annual updating, validity of substantive disagreements, etc. Comments should be sent to Donna R. Claire at her Directory address.

Q. May the appointed actuary rely upon the company's auditor for the substantial accuracy of records and information?

A. Sections 7(B)5 and 8(B)5 of the NAIC model *Actuarial Opinion and Memorandum Regulation* (hereafter the *Model Regulation*) offer, as an alternative, the following sentence as recommended language for the actuarial opinion:

I have relied upon [name of accounting firm] for the substantial accuracy of the inforce inventory and information concerning the liabilities. . . .

However, a Notice to Practitioners, dated February 1991 from the American Institute of Certified Public Accountants (AICPA), states in part the following:

The auditor should not consent to be referred to in an actuarial opinion in which the actuary expresses reliance on the auditor for the accuracy of the underlying data. If the auditor becomes aware that an actuary has expressed such reliance on the auditor, the auditor should advise the actuary that he or she does not consent to such reference, and the auditor should consider other actions that may be appropriate and may also wish to consult with legal counsel.

Q. Upon whom may the appointed actuary rely for substantial accuracy of records and information?

A. The *Model Regulation* allows the appointed actuary to rely on company officers and investment managers. A statement from those relied upon, stating what information and assumptions were provided by that person, must be attached to the actuarial opinion and actuarial

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memorandum. A suggested form for this statement is given in Instruction No. 7 to the annual statement for 1994 (see appendix 1 below).

Appointed actuaries should be aware, however, that both Actuarial Standard of Practice (ASOP) No. 22, *Statutory Statements of Opinion Based on Asset Adequacy Analysis by Appointed Actuaries for Life and Health Insurers* (section 6.3), and ASOP No. 23, *Data Quality* (section 5.3), contain specific requirements governing their obligations to satisfy themselves that data and analyses provided by third parties are reasonable and consistent. The appointed actuary should become familiar with these obligations, and should comply with the standards when relying upon third parties for data or analysis. The proposed revisions to the NAIC model *Actuarial Opinion and Memorandum Regulation* and the proposed revisions to New York Regulation 126 would add the following sentence to the reliance statement: “I have reviewed the information relied upon for reasonableness and consistency.”

Of course, the appointed actuary has the option of personally reviewing the underlying basic records him- or herself. In that case, recommended language is presented in sections 7(B)4 and 8(B)4 of the *Model Regulation*. Some actuaries are reluctant to take this responsibility unless they are also qualified auditors.

Q. What other tests of data reliability must the appointed actuary perform?

A. Beginning with the 1994 annual statement, the appointed actuary will be required to state that certain in-force claim and asset information from the valuation model reconciles to certain annual statement totals. The Annual Statement Instruction No. 6 (see appendix 1) gives suggested language for the actuarial opinion reflecting this reconciliation.

The external auditors will also be required to extend their audit procedures to the same annual statement figures (see appendix 2). In the event that an auditor should find a material error in those annual statement figures, the auditor must inform the appointed actuary of the problem and the appointed actuary must decide whether there is a material effect on reserves. In this way, the regulators can be assured that the appointed actuary has relied on data that an outside auditor has reviewed. The AICPA is considering requiring as part of the audited statement a Supplemental Schedule of Assets and Liabilities that would contain all the totals to which the appointed actuary must reconcile.

This Supplemental Schedule (see appendix 3) contains a complete list of annual statement items that must be reconciled. Only the information actually used by the appointed actuary in the valuation needs to be reconciled to the statement. If, for instance, an appointed actuary does not perform cash flow testing in the valuation, reconciliation of asset figures generally would not be necessary.

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Q. Under what circumstances are claim figures used in asset adequacy testing reconciled to Schedule O?

A. Schedule O is completed for those lines of business for which claim runout data are used to establish claim reserves. This is always the case for group and individual health insurance. Certain large companies may use this process for other lines of business as well (e.g., individual life and group life). In that case, a separate table for those lines of business is included for Schedule O.

The intent of the statement instruction appears to be that Schedule O should be completed even if the data are used only for a part of the reserve (e.g., the reserve for claims submitted more than 15 days after the closing date of the statement).

Q. Is this reconciliation all that an appointed actuary does to satisfy the requirements of ASOP No. 22?

A. The reconciliation required by the annual statement instructions is at a broad level. While this reconciliation provides general satisfaction that the data are reasonable, the division of data among important subsets can have a material effect on reserves. Accordingly, many appointed actuaries make more detailed tests than are required by the annual statement instructions.

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Appendix 1

Annual Statement Instructions—Actuarial Opinion

Note: The following text is from the 1994 NAIC Life and Accident and Health Annual Statement Instructions.

6. The scope paragraph should include a paragraph such as the following regarding data used by the appointed actuary in forming the opinion:

In forming my opinion on [specify types of reserves] I relied upon data prepared by [name and title of company officer(s) certifying in-force records and/or other data] as certified in the attached statements. I evaluated that data for reasonableness and consistency. I also reconciled that data to [Exhibits and Schedules to be listed as applicable] of the company's current annual statement. In other respects, my examination included such review of the actuarial assumptions and actuarial methods used and such tests of the calculations as I considered necessary.

7. There shall be attached to the actuarial opinion a statement(s) by the company officer(s) who prepared the underlying data similar to the following:

I, [name of officer], [title], of [name of company], hereby affirm that the listings and summaries of policies and contracts in force as of December 31, 199X, and other liabilities prepared for and submitted to [name of appointed actuary] were prepared under my direction and, to the best of my knowledge and belief, are substantially accurate and complete and are the same as, or derived from, the in-force records and other data which form the basis for the annual statement(s).

I, [name of officer], [title], of [name of company], hereby affirm the listings, summaries, and analysis relating to data prepared for and submitted to [name of appointed actuary] in support of the asset-oriented aspects of the opinion were prepared under my direction and, to the best of my knowledge and belief, are substantially accurate and complete and the same as, or derived from, the records and other data which form the basis for the annual statement(s).

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Appendix 2

Annual Statement Instructions—Annual Audited Financial Reports

The following text is from paragraph 9, Scope of Examination and Report of Independent Certified Public Accountant:

The insurer shall require the independent certified public accountant to subject the information included in the Supplemental Schedule of Assets and Liabilities (illustrated below) to the auditing procedures applied in the audit of the current statutory financial statements to determine whether such information is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole and agrees to the insurer's annual statement filed with the state insurance departments and the NAIC.

The Supplemental Schedule should be included with the audited annual statutory financial statements. The auditor should issue a report on the supplemental information as to whether the information is fairly stated in relation to the financial statement taken as a whole.

In the above paragraph, the “supplemental information” represents a schedule listing the items to which the auditor has extended his or her procedures.

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Appendix 3

Annual Statement Instructions — Annual Audited Financial Reports

Note: The following material is a summary example of certain financial data included in other exhibits and schedules subjected to audit procedures by independent auditors and utilized by actuaries in the determination of reserves.

Example Insurance Company
Supplemental Schedule of Assets and Liabilities—December 31, 199X
Schedule 1—Selected Financial Data

Investment Income Earned

Government bonds	XXXXXXX
Other bonds (unaffiliated)	XXXXXXX
Bonds of affiliates	XXXXXXX
Preferred stocks (unaffiliated)	XXXXXXX
Preferred stocks of affiliates	XXXXXXX
Common stocks (unaffiliated)	XXXXXXX
Common stocks of affiliates	XXXXXXX
Mortgage loans	XXXXXXX
Real estate	XXXXXXX
Premium notes, policy loans, and liens	XXXXXXX
Collateral loans	XXXXXXX
Cash on hand and on deposit	XXXXXXX
Short-term investments	XXXXXXX
Other invested assets	XXXXXXX
Derivative instruments (financial options and futures)	XXXXXXX
Aggregate write-ins for investment income	<u>XXXXXXX</u>
Gross investment income	<u><u>XXXXXXX</u></u>

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Assets

Real Estate Owned—Book Value Less Encumbrances (Schedule A—Part 1)	<u>XXXXXX</u>
Mortgage Loans by Type—Book Value (Schedule B—Part 1)	
Farm mortgages	XXXXXX
Residential mortgages	XXXXXX
Commercial mortgages	<u>XXXXXX</u>
Total mortgage loans by type	<u>XXXXXX</u>
Mortgage Loans by Standing—Book Value (Schedule B—Part 2)	
Good standing	XXXXXX
Good standing with restructured loans	XXXXXX
Interest overdue more than three months	XXXXXX
Foreclosure in process	<u>XXXXXX</u>
Total mortgage loans by standing	<u>XXXXXX</u>
Other Long-Term Assets—Statement Value (Schedule BA)	<u>XXXXXX</u>
Collateral Loans (Schedule C—Part 1)	<u>XXXXXX</u>
Bonds & Stocks of Parents, Subsidiaries & Affiliates—Book Value (Sched. D)	
Bonds	XXXXXX
Preferred Stocks	XXXXXX
Common Stocks	<u>XXXXXX</u>
Total	<u>XXXXXX</u>
Bonds and Short-Term Investments by Class and Maturity	
Bonds by Maturity—Statement Value (Schedule D—Part 1A)	
Due within 1 year or less	XXXXXX
Over 1 year through 5 years	XXXXXX
Over 5 years through 10 years	XXXXXX
Over 10 years through 20 years	XXXXXX
Over 20 years	<u>XXXXXX</u>
Total by maturity	<u>XXXXXX</u>

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Assets (cont'd.)

Bonds by Class—Statement Value (Schedule D—Part 1A)	
Class 1	<u>XXXXXX</u>
Class 2	<u>XXXXXX</u>
Class 3	<u>XXXXXX</u>
Class 4	<u>XXXXXX</u>
Class 5	<u>XXXXXX</u>
Class 6	<u>XXXXXX</u>
Total by class	<u>XXXXXX</u>
Total Bonds Publicly Traded (Schedule D—Part 1A)	<u>XXXXXX</u>
Total Bonds Privately Placed (Schedule D—Part 1A)	<u>XXXXXX</u>
Preferred Stocks—Statement Value (Schedule D—Part 2)	<u>XXXXXX</u>
Common Stocks—Market Value (Schedule D—Part 2)	<u>XXXXXX</u>
Short-Term Investments—Book Value (Schedule DA—Part 1)	<u>XXXXXX</u>
Financial Options Owned—Statement Value (Schedule DB—Part A)	<u>XXXXXX</u>
Financial Options Written & In Force—Stmnt. Value (Sched. DB—Pt. B)	<u>XXXXXX</u>
Financial Futures Contracts Open—Current Price (Sched. DB—Pt. C)	<u>XXXXXX</u>
Cash on Deposit (Schedule E)	<u>XXXXXX</u>

Inforce

Life Insurance In Force	
Industrial	<u>XXXXXX</u>
Ordinary	<u>XXXXXX</u>
Credit Life	<u>XXXXXX</u>
Group Life	<u>XXXXXX</u>
Accidental Death Insurance In Force	<u>XXXXXX</u>

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Inforce (cont'd.)

Life Insurance Policies with Disability Provisions In Force	
Industrial	<u>XXXXXXX</u>
Ordinary	<u>XXXXXXX</u>
Credit Life	<u>XXXXXXX</u>
Group Life	<u>XXXXXXX</u>
Supplementary Contracts In Force	
Ordinary—Not Involving Life Contingencies	
Amount on Deposit	<u>XXXXXXX</u>
Amount of Annual Income Payable	<u>XXXXXXX</u>
Ordinary—Involving Life Contingencies	
Amount of Annual Income Payable	<u>XXXXXXX</u>
Group—Not Involving Life Contingencies	
Amount on Deposit	<u>XXXXXXX</u>
Amount of Annual Income Payable	<u>XXXXXXX</u>
Group—Involving Life Contingencies	
Amount of Annual Income Payable	<u>XXXXXXX</u>
Annuities—Ordinary	
Immediate—Amount of Annual Income Payable	<u>XXXXXXX</u>
Deferred—Fully Paid Account Balance	<u>XXXXXXX</u>
Deferred—Not Fully Paid—Account Balance	<u>XXXXXXX</u>
Annuities—Group	
Immediate—Amount of Annual Income Payable	<u>XXXXXXX</u>
Deferred—Fully Paid Account Balance	<u>XXXXXXX</u>
Deferred—Not Fully Paid—Account Balance	<u>XXXXXXX</u>
Accident and Health Insurance—Premiums In Force	
Ordinary	<u>XXXXXXX</u>
Group	<u>XXXXXXX</u>
Credit	<u>XXXXXXX</u>

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Inforce (cont'd.)

Deposit Funds and Dividend Accumulations

Deposit Funds—Account Balance	<u>XXXXXXX</u>
Dividend Accumulations—Account Balance	<u>XXXXXXX</u>

Claims Payments—Net Amount Paid Policyholders 199X
(Schedule O—Part 1)

Group Accident and Health

		<u>Year Loss Reported</u>			
<u>Year Loss Incurred</u>	199X—4	199X—3	199X—2	199X—1	199X
199X—4					----
199X—3	----				----
199X—2	----	----			
199X—1	----	----	----		
199X	----	----	----	----	

Other Accident and Health

		<u>Year Loss Reported</u>			
<u>Year Loss Incurred</u>	199X—4	199X—3	199X—2	199X—1	199X
199X—4					----
199X—3	----				----
199X—2	----	----			
199X—1	----	----	----		
199X	----	----	----	----	

Other Coverages That Use Developmental Methods to Calculate Claims Reserves

		<u>Year Loss Reported</u>			
<u>Year Loss Incurred</u>	199X—4	199X—3	199X—2	199X—1	199X
199X—4					----
199X—3	----				----
199X—2	----	----			
199X—1	----	----	----		
199X	----	----	----	----	

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Appendix 4

**Annual Statement Instructions
Schedule O—Part 3
Reserve and Liability Methodology—Exhibit 9B**

<u>Line of Business</u>	<u>Methodology*</u>	<u>Amount**</u>
Industrial Life		XXXXXX
Ordinary Life		XXXXXX
Individual Annuity		XXXXXX
Supplementary Contracts		XXXXXX
Credit Life		XXXXXX
Group Life		XXXXXX
Group Accident & Health		XXXXXX
Credit Accident & Health		XXXXXX
Other Accident & Health		XXXXXX
Total		<u>XXXXXX</u>

*Indicate for which coverages actual claim runout data are used in setting reserves. For those coverages, Parts 1 and 2 of Schedule O must be completed. For other coverages, Parts 1 and 2 are not needed.

**Exhibit 9B net of reinsurance.