

December 9, 2003

Mr. Thomas W. Kwieciak
Administrator, Insurance Programs
Building Industry Association of Washington
Post Office Box 1909
111 21st Avenue NW
Olympia, WA 98501

Dear Mr. Kwieciak:

You have asked that we provide a response to the two reviews of our November 5, 2003 letter regarding the L&I rate increase and other related issues. These reviews were conducted for L&I by Milliman USA (Milliman) and Bickerstaff, Whatley, Ryan & Burkhalter (Bickerstaff).

The Milliman review appears to be a response to a number of carefully worded questions that do not address the key areas of concern noted in our letter. Both responses are misleading due to the use of actuarial standards being used to address financial reporting concerns. For example, neither review disputed the fact that L&I books an explicit margin as a liability in their financial statements. Booking a margin as a liability is not allowed under generally accepted accounting principles (GAAP). Accordingly, we recommended an investigation of this matter in the context of reported financial statements. Both Milliman and Bickerstaff responded by noting that actuarial standards allow for explicit margins. Their responses are not relevant, as actuarial principles also state that appropriate reserve estimates depend on the financial reporting context in which the reserve will be presented. It is our understanding that RCW 43.88.037 requires the State to maintain an accounting and reporting system in conformance with GAAP.

As clearly stated in our review, and repeated by both Milliman and Bickerstaff, PwC did not perform independent actuarial calculations. However, PwC did perform a hindsight test of the accuracy of L&I reserve estimates in each of the past nine years, which revealed a conservative bias. While Milliman questioned the appropriateness of this retrospective test, and Bickerstaff characterized it as “disingenuous,” such an approach is commonly used to help assess the accuracy of accounting estimates. Statement of Auditing Standard 99, *Consideration of Fraud in a Financial Statement Audit*, provides the following guidance:

“The auditor also should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management. The significant accounting estimates selected for testing

should include those that are based on highly sensitive assumptions or are otherwise significantly affected by judgments made by management. With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates.”

In summary, it is important to remain focused on the following points:

- 1. L&I’s own actuarial estimates indicate that reported reserves in their financial statements have been overstated 9 out of the past 9 years.** This fact has not been disputed. Audit guidance requires an auditor to consider such information when evaluating whether a potential bias represents a risk of material misstatement.
- 2. L&I books an explicit margin as a liability in its financial statements.** This fact has not been disputed. Accounting guidance requires such a margin to be booked as part of equity (contingency reserve).
- 3. There is a significant undisclosed difference between reserves discounted using a 4% interest rate and L&I’s own projected investment yield.** This fact has not been disputed. Understanding how much margin may be embedded in the reserve account is useful in assessing the financial health of L&I.
- 4. Financial reporting standards apply to the preparation of financial statements, not actuarial standards.** Actuarial standards may be used to confuse the issue, but ultimately auditors are required to use accounting standards when auditing in conformance with GAAP.
- 5. A lack of transparency exists at L&I regarding how reserve levels are determined and rates are established.** Based on information provided to PwC during our review, we believe that neither L&I nor Milliman produce actuarial reserve or ratemaking reports that contain sufficient clarity that another actuary could make an objective appraisal of the work.

These issues raise concerns regarding the adequacy of controls currently established to ensure fair representation of L&I’s financial statements.

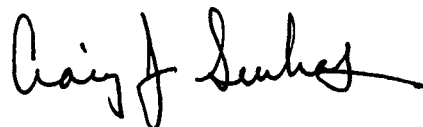
* * * * *

Please contact us at (206) 398-3518 with any questions.

Sincerely,



Kevin L. Wick, FCAS, MAAA
Principal Consultant



Craig J. Scukas, FCAS, MAAA
Principal Consultant