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PROFESSIONAL RELATIONSHIPS WITH CERTIFIED PUBLIC ACCOUNTANTS

A review of the critical relationships with our CPA counterparts on such topics as GAAP, Pension Audit Guide, and the accounting practices for mutual life companies.

CHAIRMAN WILLIAM D. SMITH: Twenty-five years ago, life actuaries were working almost exclusively within life insurance companies. They were even less well known to the public than today as their work rarely reached the public view. Seven percent of Society of Actuaries members were in consulting (public) practice. Although the actuary at that time was rigorously trained, his organization had not all the characteristics required to be truly a profession.

Today, a fourth of the Society membership plus members of other actuarial organizations are in public practice, and the life company actuary's work is no longer so isolated from public view. We find ourselves struggling to attain all the attributes of a true profession, because the public suddenly needs actuarial certification. It has in fact become a legal necessity in certain pension and life insurance areas.

As we have struggled to understand a new relationship with the society we serve, we have suddenly found ourselves working hand-in-hand with someone we barely knew before, the accountant--specifically the C.P.A. who is 25 years or so ahead of us in becoming a profession. In striving to provide meaningful financial information, we both need to understand better the other's position and problems; yet since the two disciplines are different, we do not wish to blend both professions into one different one.

It is the spirit of attempting a better understanding between C.P.A.'s and actuaries that we have assembled today's panel to discuss the relationships between the two professions.

MR. GLEN GAMMILL: I speak as an actuary who has had the opportunity to observe the professional relationships between actuaries and Certified Public Accountants on a daily basis for the last five years as an actuary employed by one of the largest accounting firms in America today. However, my situation has been somewhat unique in that for the last few years I have had the opportunity to view these relationships as both a Fellow of the Society and as a Certified Public Accountant.

For the most part, I feel as though my knowledge gained via each profession's unique discipline has, to a certain extent, operated in synergistic fashion. My accounting expertise and knowledge have aided me in dealing with many "actuarial" problems and, conversely, my actuarial expertise and knowledge have aided me in dealing with many "accounting" problems.

My remarks here today are not dotted with startling formulae or revelations, but, hopefully, they address themselves to the point of discussion, namely Professional Relationships between Actuaries and Certified Public Accountants. All opinions expressed are purely my own and in no way represent the opinions of my firm, Peat, Marwick, Mitchell & Co.

With that background in mind, I would like to first discuss some rather general but pervasive concepts. These concepts revolve around three words: systematic, rational, and consistent. First, let us take a look at the word "consistent".

In essence, I believe that both actuaries and CPA's have respected the goal of consistency since the inception of their respective professions. Consistency, as I am using the word, means that similar methodology should be used to solve similar problems as time passes so that the solutions derived have some comparability as between one another. Quite possibly, the object or the solution of the particular problem has taken on different meanings for actuaries than it has for CPA's when dealing with what was assumed to be the same problem. I maintain that, when our two professions have differed on the topic of consistency, the main problem has been that the appropriate objective was not agreed upon in light of the particular circumstances in which a solution to a problem was sought. The challenge our respective professions have is to ascertain what objectives we want to satisfy in the particular circumstances in which we are dealing, at inception, so that we may restrict the solution to fit the realities of the situation at hand. Consistency is only applicable where circumstances do not change. When circumstances change, consistency is not an overriding concept, but rather, what solutions are realistically fair under the new circumstances.

Next, let us review the concept of "systematic". The concept of a systematic methodology allows us to have "benchmarks" of reasonableness which we need in order to relate to a particular situation as it progresses. In the case of a particular company's financial statements, if the underlying methodology used to generate a component of those financial statements changes, then the footnotes, which are an integral part of the company's financials, may include a reference to such changes and their effect on the current year's financials. This additional disclosure, when utilized with current reported numbers, would allow the user of the financials to compare earnings on a basis consistent with that of the preceding year as a "benchmark" so that the current year's financials will not have to stand alone. Most actuaries and CPA's will, I think, agree with this reporting philosophy.

Finally, a look at the concept of "rational". As professionals, we have a duty to rally behind those approaches and solutions to problem situations that we consider fundamentally fair and that measure the realities of the particular situation we are attempting to resolve. I hope that new problems will not result from the solutions to old problems. So much for general concepts.

In my opinion, the accounting profession has tended toward "actuarial thinking" independently, without the input of the actuarial profession. For example, CPA's have been discussing for many years the theory of discounting deferred taxes. One of the primary reasons this approach has not received general accounting acceptance is the failure to design a practical solution to the problem. CPA's have also given some thought to the area of financial

projection and, in fact, may be required in the not-too-distant future to somehow report on projections as a supplement to the financial statements of their clients. Again, due somewhat to the lack of expertise in the projection area, no practical and sufficiently reliable method of reporting has yet surfaced. In many other areas, such as the recently popular shift to LIFO inventories or the increased use of statistical sampling on audit engagements, mathematically-inclined people, for which actuaries certainly would appear to be in the running, are needed daily to assist in designing practical solutions.

As an actuary employed by a rather large accounting firm, I have done a 180° turn in my opinion of what CPA's are, have been and can be. To a large extent, I am just like an independent consulting actuary (with the appropriate restrictions with regard to my firm's ethics and policies) and I experience the same types of frustrations. There are many CPA's who will and can understand, to the degree required by their profession, what an actuarial solution to a particular problem consists of . . . but we must be willing to communicate with them. Obviously, the same comments apply in the other direction.

One specific question, I believe, which continually arises is: What can actuaries who work for an accounting firm do that outside actuaries cannot do and vice versa? The answer is that each can do whatever they wish if the realities of the situation produce fair and equitable results. At this point, I could digress into the no-man's land of "independence" but I think an illustrative example will suffice. If I were to participate in the actuarial assumption process and generate reserve factors in accordance with the AICPA's Audit Guide for Stock Life Insurance Companies for an audit for a client and no one in the client's firm could comprehend the alternatives available in the choice of those assumptions and hence make a management decision regarding their selection, then my firm would not be independent and could not express an opinion with respect to the reserves. There are many other examples, with varying fact situations, which would yield similar but initially-confusing results. Independence by fact and by appearance is also required in many other situations in which actuaries and CPA's face each other.

Practically, as I see the future, there are more challenging insurance and non-insurance problem areas than there are competent actuaries and CPA's to deal with them. I feel confident that, based on our respective professions' understanding of the ultimate objective of each of these numerous problem areas, both professions working together can devise the methodology necessary to solve these problems on a realistic basis.

Many years ago, Mr. Barrow of Barrow, Wade, Guthrie & Co., the first accounting partnership in the United States, which later merged with my firm, was not an accountant at all, but an actuary. Additionally, Mr. Marwick, one of my firm's founders, was a member of the Scots Institute of Accountants and Actuaries. What I am suggesting is that actuaries and accountants did not start off far apart, and that currently, and in the future, we will not be as far apart as some elements in both professions would have us believe.

MR. JARVIS FARLEY:* We have been hearing a lot lately about professionalism. That is a subject of deep interest to accountants and to actuaries alike. Professionalism involves ability, training, experience, judgment, objectivity and integrity. It also involves some means of assuring the people who are affected by the work of the professional that the man who is serving them has those qualities -- some basis for confidence that there exists a sound body of professional principles, that the professional adheres to high standards in the application of those principles, and that the professional who departs from those principles and standards will be called to account.

The basic qualities -- ability, training, experience, judgment, objectivity and integrity -- I will call the substance of professionalism. The demonstrable principles, standards and discipline I will call the forms of professionalism. Professionalism does not exist unless both the substance and the forms are present; and, to avoid misunderstanding, let me emphasize that the forms can never take the place of the substance. A rule can never take the place of judgment. The most intimate knowledge of a book of procedures does not make a professional in the absence of objectivity, judgment, a questioning mind and an independent spirit.

There can be a considerable range in the visibility of the forms of professionalism. Such a range of visibility may result from differences in types of clientele. Accountants and actuaries have been professionals for a long time. During much of that time accountants, in their capacity as auditors, have performed services which affect remote clients, most of whom never see the auditor face-to-face. In order to give such remote clients a basis for confidence in the professional whose work affects them, it is important that the forms of professionalism be visible -- that the remote clients as a class have a basis for knowing that the accountant who serves them is a member of a profession which has high standards and which holds its members to those standards.

For a long time actuaries, both as consultants and as employees of insurance companies, typically had a close and direct personal relationship with their clients. With that kind of close relationship, the client could judge directly the qualities of the actuary -- the substance of his professionalism -- and it was less important that the forms of professionalism be widely visible. In recent years, though, as the work of actuaries has come more and more to affect the interests of remote clients who may never see the actuary, it has become important for actuaries to be more concerned with visibility of the forms of professionalism. Concepts of professional conduct and the power of discipline have existed all along, but it is only in relatively recent years that actuaries have had the sorts of remote clients which make it necessary to give visibility to the forms of professionalism through written guides to professional conduct, opinions of a professional conduct committee, and recommendations of committees on financial reporting principles and on actuarial principles and practices in connection with pension plans.

Recent years have also seen a dramatic increase in the frequency and closeness of the relations between accountants and actuaries, principally in connection with the financial reporting of insurance companies and in connection with pension plans. It has become important, as never before, for actuaries and accountants to have a modus vivendi based on confidence in each

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other as professionals.

My remarks focus on their relations in connection with the financial reporting of insurance companies, especially life insurance companies. Most of the liabilities of a life insurance company involve an actuary's appraisal of probable future developments. The financial statements of a life insurance company cannot be prepared on a sound basis without the intimate involvement of an actuary. Shareholders and other interested citizens are remote clients of that actuary. As such, they have an interest in the professional performance of the actuary. In addition, the government of our country has decreed that shareholders and other persons with an interest in any kind of proprietary company should have the benefit of an appraisal by an independent accountant of the quality of the company's financial reporting. In that capacity the accountant has a responsibility to form and express an opinion on the financial statements as a whole, including the actuarial elements of insurance company statements.

The accountant is not trained as an actuary. In order to form a competent opinion, he needs the help of a qualified actuary to provide the evidence to interpret and support the actuarial elements of the financial statements. The accountant must not "rely on" that evidence, in the sense of simply accepting the opinion of the actuary. The accountant must appraise the evidence in order to form his own opinion; and he can appraise the evidence more confidently if he is confident that he is dealing with a qualified professional.

One of the key questions in this relationship between actuaries and accountants is whether the accountant, in forming his opinion about the actuarial elements of financial statements, may use the help of the actuary who was involved in the preparation of the statements, or whether he must use an actuary who is independent of the company in the same sense that the auditing accountant himself is independent of the company. There is today no clear consensus either among actuaries or among accountants as to the answer to that question. At least one accounting firm has taken the position that auditors associated with that firm must use the services of an actuary who is independent of the company; and there are actuaries who share that view.

The more general opinion among actuaries is that the auditor may use actuarial evidence from any qualified actuary in whom he has confidence. The house actuary who participated in the preparation of the statements, or the consulting actuary who was engaged for that purpose, knows more about the company and its operations than an independent actuary can be expected to know. It seems reasonable to believe that the accountant can get the best evidence from the actuary who knows the company best. The accountant must be free to look elsewhere if for any reason he lacks confidence in the evidence furnished by the company's actuary; but the greater his confidence in the professionalism of the company's actuary, the less likely it should be that he would feel the need to look elsewhere. The emphasis, therefore, is on the professionalism of the actuary, not on his independence in the sense that the auditor is independent of the company.

It is important to examine the service which the actuary is actually performing. If any actuary presents for public use a statement which purports to be an appraisal of the quality of the actuarial elements of financial reports that actuary should be independent in the same sense that an auditor is in-

dependent. If, on the other hand, the actuary presents a statement which says, in effect, "I did this work, and in doing it I was guided by good actuarial standards"; and if the independent auditor expresses an opinion on the financial statements as a whole, including actuarial elements of the statements; then the opinion of the auditor would seem to satisfy the requirement of independence and a further requirement that the actuary also be independent is duplicative and expensive.

Paragraph 2(c) of the actuaries' Guides to Professional Conduct says, in part, that the actuary will recognize his ethical responsibilities to the person whose actions may be influenced by his opinions or findings, and when it is not feasible for the actuary to render his opinions directly to such person he will act in such a manner as to leave no doubt that he is the source of the opinions. Opinion A-6 for the Academy, S-6 for the Society, says, in part, that the objective of Guide 2(c) will be more fully satisfied if the published financial statements include a statement of actuarial opinion. The effect of Opinion A-6 and S-6 is to encourage companies to publish a statement of actuarial opinion as a part of their financial statements, along with the opinion of the independent auditor. The question arises naturally whether the company's actuary can sign such a statement. The language of Opinion A-6 and S-6 was carefully chosen to avoid an implication that the actuary signing such a statement must be independent. There is a very fine line between a statement of actuarial opinion which purports to appraise the quality of the actuarial aspects of the financial reports and a statement which says that the actuarial elements meet specified standards. A statement which purports to express a public appraisal of the work should be signed only by an actuary who is independent of the company. A statement which expresses a professional opinion about actuarial material can - under Opinion A-6 or S-6 - be signed by an actuary who is not independent, provided his relationship with the company is clearly described in the statement.

Other problems may arise when an actuary is associated with an accounting firm. If the function of the actuary is solely to review actuarial elements of the financial statements, and to help the auditor with whom he is associated to form his opinion about the statements, there is no problem of ethics or professional conduct. On the other hand, if that actuary, or any other actuary associated with the accounting firm, has done work for the company being audited, then an accountant associated with that firm is not independent as respects that client. If the accountant accepted an auditing assignment in those circumstances he would be reviewing work done by his own firm. In that case, the ethical standards of the accounting profession would prevent the firm from accepting the audit responsibility. If the accounting firm took on the audit, despite that conflict, the ethical guides of the actuarial profession would prevent the actuary from continuing his association with that accounting firm.

It seems clear that, in the future, accountants and actuaries will be working in close association with each other on many occasions, and questions about their professional relationship will continue to arise. The American Institute of Certified Public Accountants has established a Committee on Relations with Actuaries, and the American Academy of Actuaries has established a Committee on Relations with Accountants. These two groups meet together several times a year. Acting as liaison committees, they try to understand the needs of each profession and the problems which may arise in the relationships between the professions. The liaison committees don't try

to solve those problems themselves, but they use their familiarity with the structures and the communications within their own professions to see that the problems are properly addressed. As a member of the Academy Committee I would like to express my pleasure at the kind of relationship which has grown between the liaison committees. They have developed a degree of mutual confidence and respect which makes it possible to discuss any sort of problem with objectivity and without reticence. Serious and difficult problems are bound to arise as the two professions work in the same environments. The existence of the liaison committees is a part of the reason why I am confident that those problems will be faced and handled in a way that befits professionals.

MR. BLACKBURN H. HAZLEHURST: Some years ago, it was possible for a corporation which was worrying about the cost of new pension benefits under consideration to expect to be able to vary their pension costs with their resources to some extent. For example, if one-half of the time corporate earnings were expected to be good, and the other half of the time earnings were expected to be poor, the plan sponsor could put in twice the average pension cost in good years and nothing in poor years. As long as the number of poor years didn't outrun the number of good years, the actuary was content, the IRS minimums were met, and contributions would sooner or later become deductible.

Then the accountants, pressed by the SEC, suggested that this was not a reasonable way to record pension costs, since it tended to mislead the stockholder as to the magnitude of good and poor years. The result was Accounting Opinion 8.

Opinion 8 says that almost any actuarial method of expensing pension costs (except postponing them to retirement or adopting pay-as-you-go methods) is acceptable providing it is consistently followed; expenses fall within a prescribed range; and experience gains and losses are recognized and smoothed out. Cash contributions can be on any basis, with any difference between expenses and contributions forming a liability or asset on the plan sponsor's books.

Opinion 8 has sobered some pension-expensing practices. However, it has also curtailed practical funding flexibility, and so has discouraged formation of some pension plans, and liberalization of others.

Actually, a reasonable case can be made that pension and profit-sharing plans have been alike. The continuation of either depends upon the continued good health and willingness of the plan sponsor. Neither has been a contract for ultimate benefits, although both have been plans to move towards benefits.

The real problem seemed to have been that (a) profit-sharing plan participants know where they are, but rarely are told where they are going (and often profit-sharing assets are not efficiently allocated in proportion to reserves needed for some definite benefit goal); and (b) pension plan participants know where they're going (if all holds up), but are rarely told just where they now stand (e.g., in terms of accrued benefits, funded benefits, vested benefits, and benefits if the plan shut down on the last anniversary).

Problems that probably could have been solved best by disclosure, have instead been partially solved by changing the game plan, e.g., pensions have been treated as, and are being made into, promises - and as such, should be expensed consistently.

The development of pension legislation reawakened discussions by auditors as to how to relate to actuaries, this time in regard to the audit of the pension fund as a distinct and separate entity rather than with regard to an ordinarily minor item that is to appear in the plan sponsor's reports.

A committee of the American Institute of Certified Public Accountants (AICPA) issued an exposure draft relative to the audit of pension funds early in 1973. This exposure draft appeared to ask the actuary for a very limited amount of information, based upon the unit credit method of valuation. The accountants would relate the actuary's present value of accrued benefits to the accountant's value of assets, set in a report designed and signed only by the accountants.

Following discussions between actuaries and accountants, the accountants prepared a new draft audit guide late in 1973. The auditors apparently felt they had gone to considerable length in this revision to recognize input of the actuaries. However, the actuaries still had fundamental problems with the approach, as opposed to minor superficial suggestions.

My understanding is that this material has now left the hands of the AICPA and been forwarded to the Financial Accounting Standards Board (FASB), following its establishment, to be used as a starting point for discussions.

The FASB is to establish policy, (for example, that the market value of assets should be disclosed), while the AICPA is to implement policy, (for example, to indicate how the market value should be determined). The SEC overlooks policy established by the FASB.

The FASB has established a ten-man task force to review compliance problems under Employee Retirement Income Security Act (ERISA). This task force includes representatives of various professions and specialities, including at least one actuary, Pres Bassett.

The AICPA has a committee dealing with relations with actuaries that endeavors to meet three times a year with a similar committee of the Academy to handle relations with accountants.

The Academy has sponsored a separate task force to relate to the Labor Department and Internal Revenue, in reviewing ERISA reporting and disclosure requirements, with George Swick as chairman. Possibly this task force will get involved tangentially or directly with auditor/actuary relationships.

Another Academy task force headed by Ed Boynton is working with the Cost Accounting Standards Board (CASB), which is still another force. The CASB promulgates pension cost accounting for government contractors. Since this affects pension cost accounting for a number of substantial corporations, these results could have a wide effect. The CASB has issued preliminary material in some detail, and evidently plans to release a formal exposure draft shortly.

Still another task force set up by the Academy under the leadership of Walter Grace has been established to monitor general developments in the area of pension fund financial statements.

If all these groups take their work seriously, problems of auditing pension funds should be well aired.

Suggestions

It appears that the fundamental issues still remain in terms of what assets to use, and in terms of the extent to which the actuary is to be relied upon by the accountant.

For example, auditors must generally form their own opinion when the matter may require special expertise. Thus, the auditors evidently cannot simply accept the report of a specialist assessing the amount of gas reserves in the ground, but must independently decide whether this assessment is reasonable, retaining separate specialists, if necessary.

Further, even if the auditors were to accept someone else's statement, they don't want the auditors' statement encumbered by what may be a long and perhaps not entirely pertinent report prepared by someone else.

In this connection, it is my view that:

1. It is probably not reasonable to expect accountants or any other profession to accept limitations by actuaries on areas these other professions may wish to become involved in. More importantly, it is unlikely they will acquiesce to such a request.
2. It is reasonable for actuaries to observe their own Guides and Opinions in releasing any actuarial information. This must be especially true in matters of public interest, such as the portrayal of the actuarial status of a pension plan for public consumption.

If this is reasonable, and in the public interest, and if the actuaries all observe their own Guides, then accountants and others should accept our view, keeping in mind that this process still allows us to furnish helpful information, providing we design our part of the total portrayal and sign our part.

3. The actuaries' Guide and Opinions appear to follow public interest by indicating that actuaries should not provide information out of the context designed by the actuary, to be used in a context designed by someone else, for the purpose of informing a third party.

The appropriate approach would seem to be to have actuaries discipline themselves to prepare a brief summary report designed and signed by actuaries, to be used only in its entirety by accountants.

The accountants, while including the actuarial summary report in its entirety, do not need to rely upon the actuary's statement. In fact, they must be free to comment in any way on the report and/or to use the information in the actuarial statement in an alternative manner elsewhere in the audit report.

Just as the accountant need not rely upon the actuary, so the actuary must not allow his report to be abridged in a manner not designed and signed by the actuary. Further, the actuary needs to include his own statement of assets, and assumptions that the actuary used in determining assets, in his brief report.

The point is that the actuary is making a judgement as to the actuarial position of the pension fund, a judgement which involves an appraisal of the present value of income (including the worth of existing assets), and the present value of future benefit payments.

For the actuary, such judgement involves recognizing events, each of which often has a very low probability of happening at a given time. Presumably, the actuary, in selecting his best aggregate assumption, as required by law, will recognize his best understanding not only as to future investment performance, and future decrements due to turnover, disability, death and retirement; but also the future economic effect on salaries, investment return and social security; the future effect of investment policy, and personnel policy; and the future effect of changes likely to take place with regard to the plan sponsor that may impact upon the size, character, and pension benefits of the group of plan participants.

All of these assumptions, and others, tend to relate to each other. Many, if not most, of the assumptions involve at least some subjective judgement on the part of the actuary. He would be wise not to content himself with counting up the liabilities in some supposedly definitive way as if they were potatoes in a basket; or allow himself to be considered as simply doing just that.

Special Considerations

It is an interesting aspect of the relationship between actuaries and accountants, that accountants do not have to peer into the future as much as actuaries, nor perhaps do they have to make as many subjective judgements as actuaries.

Thus, on the one hand, like accountants, actuaries are now given direct responsibility by the government. Just as the accountants, while generally retained by the company, must basically serve the interests of the shareholders, the enrolled actuary, while similarly retained generally by the plan sponsor, evidently must now serve the interests of the plan participants.

On the other hand, there is a significant difference in my mind. The auditors presumably do not need to disclose any knowledge they may have that in the future the business is likely to suffer because of events that have not yet occurred, and that have less than an even chance of occurring in the future.

However, the actuary primarily peers into the future. The actuary is fundamentally concerned with what is likely to happen far into the future, summing up the value of events, each one of which usually has only a small chance of occurring at any given time.

Given this fundamental need for the actuary to disclose his view of the future, how should the actuary treat a similar understanding that the plan is likely to be buffeted by upcoming events that may be disclosed to him on a highly confidential basis, and/or may not be certain?

For example, suppose the auditor designs and controls the statement of condition of the pension plan. Suppose it is a steel pattern plan where there is a well-defined additional liability if certain plants are closed. Suppose the plan sponsor asks the actuary to estimate the additional cost of such a plant closing, i.e., suppose the actuary has reason to believe such closing is quite possible, although not certain. Suppose that this information is highly confidential and that its untimely publication could damage the company for various reasons.

Now suppose the accountant asks the actuary to state the plan liabilities - without permitting the actuary to design the context in which such liabilities will be disclosed or to qualify his statement in any way? What does the accountant expect the actuary to do with his special potential plant closing information? What does the actuary feel he should do, if he is the plan's enrolled actuary, and is asked to furnish information that, if given out of the actuary's carefully designed context, may be misleading or damaging, or both?

It would seem that the actuary must guard carefully against his report being abridged in a manner which may separate his present value of benefits from his present value of assets, or which may fail to disclose information in the context, and subject to the supporting statements and qualifications, that the actuary deems appropriate to his work, especially if he is the enrolled actuary for the plan, and the information coming from him will be used to advise the plan participants and their representatives.

Opinion

Below is a draft of an actuarial Opinion (or Recommendation of an appropriate committee) that could be issued to clarify this. I don't think the Opinion breaks new ground. It just applies previous thinking to a specific situation, and indicates that the past and current Opinions really are to be observed.

DRAFT OF
OPINION

PREPARATION OF ACTUARIAL INFORMATION FOR AUDITS
OF PENSION FUNDS AND FOR
CERTIFICATION REQUIRED BY LEGISLATION AND REGULATION

Introduction

This Opinion is intended to interpret and amplify Sections 2 c), 4 a), and 5 a) of the Guides to Professional Conduct, and to clarify the intent of Opinions S-3 and S-4 as specifically applied to the problem of preparing actuarial information in connection with an independent audit of a pension fund initiated by a Certified Public Accountant. Similar considerations are applicable to portrayals of the actuarial status of pension plans prepared in connection with legislation.

Applicable Guides and Opinions

The following material from the Guides to Professional Conduct is pertinent:

- "2 c). The member will recognize his ethical responsibilities to the person or organization whose actions may be influenced by his actuarial opinions or findings. When it is not feasible for the member to render his opinions or findings directly to such person or organization, he will act in such a manner as to leave no doubt that he is the source of the opinions or findings and to indicate clearly his personal availability to provide supplemental advice and explanation.

If such opinions or findings are submitted to another actuary for review, either he or the actuary will be available for supplemental advice and explanation.

- "4 a). The member will customarily include in any report or certificate quoting actuarial cost, reserves, or liabilities a statement or reference describing or clearly identifying the data and the actuarial methods and assumptions employed.
- "5 a). The member will neither engage in nor condone any advertising or other activity which can reasonably be regarded as being likely to attract professional work unfairly, or where the tone, form, and content are not strictly professional."

The following material from Opinion S-3 bears on the matter being discussed:

"Definitions: An actuarial report is essentially a statement of actuarial findings, conclusions or recommendations resulting from the actuary's experience and judgment, applied within the framework of a

particular set of facts and assumptions. In this Opinion, the term is intended to include any communication, certificate or report based, in whole or in part, on knowledge which is peculiar to an actuary or where the reader of any such communication, certificate or report may be influenced by the fact that the writer is an actuary.

The term client is intended to include any person or organization for whom an actuarial report is prepared, and whose actions or decisions may reasonably be expected to be influenced by such a report."

"Objective: Any manner of transmittal of an actuarial report which involves the risk that the underlying facts and assumptions, and the limitations resulting from their use, are not fully communicated to the client involves a corresponding risk that the conclusions or recommendations may be misinterpreted or misapplied. It is important, therefore, that this risk be minimized or eliminated."

"Thus, if the report is delivered by a non-actuarial associate of the member, or through a bank or trust company, the Committee believes that the member should recognize the risk of misinterpretation or misuse, and he should guard against it by application of the procedures indicated by Guide 2(c). This can be done where the actuary does not sign or deliver the report, by the concurrent use of a supplemental statement, signed by the actuary, covering the actuarial portions of the material included.

As a special case of the foregoing, it is the opinion of the Committee that a member should not become a party to any arrangement whereby a bank, investment advisor, insurance broker or other separate person or organization will use reports prepared by the member, unless the member is identified and it is clearly understood and agreed that the member's responsibility is to the employer whose plan or proposed plan is the subject of the report and that the provisions of Guide 2(c) will be strictly observed."

The following material from Opinion S-4 is also pertinent:

Paragraph 3 a) indicates that each actuarial report should include "the name of the person or firm retaining the actuary for the report, and the purpose which the report is intended to serve."

Paragraph 3 d) further indicates that each report should include an indication of "the book and market values of assets and the asset value used in the valuation."

OPINION

1. In the Opinion of the Committee it would be a violation of Guide 2 c) for a Member of the Academy of Actuaries to contribute actuarial information to an intermediary such as an auditor, for use in connection with preparation of a statement that is likely to influence a third party, such as plan participants and other interested persons, unless:

DISCUSSION—CONCURRENT SESSIONS

- (a) The actuary designs the portrayal of actuarial information.
 - (b) The intermediary agrees to use this information portrayal unaltered, and
 - (c) The actuary signs the actuarial portrayal.
2. The Guides to Professional Conduct and Opinions need to be observed by each Member lest they put nonconforming members in a position of unfair advantage in accepting professional work.

Accordingly, in the Opinion of the Committee, failure to follow the procedures set forth above will also be considered a violation of Guide 5 a).

3. In the Opinion of the Committee, an actuarial portrayal of the condition of the pension plan should include the actuary's statement of assets used as well as liabilities determined, and an indication of the assumptions the actuary used in determining assets as well as the assumptions used in determining liabilities.

MR. RANDOLPH H. WATERFIELD, JR.:* In reading the History of the Actuarial Profession which was published in connection with your Twenty-fifth Anniversary, I noted that the motto of the Society is, "The work of science is to substitute facts for appearances and demonstrations for impressions." I hope that even in the case of relationships with accountants, there's some room for that kind of objective philosophy.

As was mentioned by others on the panel, there are two basic areas in which we have had relationships -- the area of pension plans and the area of life insurance companies. As was mentioned earlier with respect to pension plans, there have not been significant problems because of the fact that our concern has been limited to the effects of the pension plan on the company's financial statements, generally the annual charge to income which, in many instances, is not material to the financial statements taken as a whole. Our concern has principally been with consistency of application which, of course, is what APB 8 was all about.

In the case of life insurance companies, however, the situation is considerably different because of the significance of reserves and their effect on net income. The reserves and probably the investments are the two largest items in the financial statements and they're almost always material so that we've had to have more concern about the fair presentation of reserves and their effect on net income.

In the case of pension plans under Employee Retirement Income Security Act (ERISA), there is still some question as to what the relationship between actuaries and auditors may be depending upon how the rules read with respect to what the financial statements will include. If the financial statements are to include the liability under the plan, then I think we will have a situation similar to that which exists in the life insurance area because of the significance of those liabilities. If the regulations as ultimately published do not include the liability in any financial statements of the

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plan and permit the trust financial statements to be presented separately as they are generally today, I think the problem is alleviated because the auditors can report on the trust and the actuaries can report separately on the liability. How this will come out at this point in time, I really don't know.

In looking at our relationship, I think it is important to focus upon the differences in our roles. While it has been alluded to, I would like to clarify the fact that we as CPAs, as opposed to accountants in general, are principally auditing or verifying the work that has been performed by others. There may be other CPAs who work for the company, such as the Chief Financial Officer, or it may be an actuary in the case of insurance reserves. Actuaries, on the other hand, except for consulting actuaries who are in some cases acting in an audit capacity, are making initial actuarial determinations -- performing the work which we are engaged to audit. You are similar to the company's accountant and, in many cases, are the company's accountant.

It was mentioned earlier as to how the accounting profession and the actuarial profession might fit together. To the best of my knowledge, there's no intention on anyone's part in the American Institute of CPAs or in the public accounting profession that there should be any merger between the actuarial profession and the accounting profession, and I want to dismiss that idea rather quickly. I think even those of us who have actuaries as a part of our firm, in many instances, really consider them to be similar to other types of consultants that we employ, whether they be industrial engineers, attorneys, or whatever the case may be. Our principal concern is that of fulfilling our audit responsibility and particularly how we audit actuarial matters.

There has been some discussion and I think Jarvis Farley spoke very clearly about our responsibility which is to give an opinion on the financial statements taken as a whole, both with respect to financial position and with respect to results of operations. In the case of life insurance companies, the reserves are such a significant portion of the financial statements that for us to merely accept the opinion of someone else and not form any opinion on our own would not permit us to give an opinion on the overall financial statements. The magnitude of the problem is such and the rules of our profession are such that we would not merely be limited to taking an exception to the reserves, but would probably disclaim an opinion on the financial statements taken as a whole. In the past, when we had to deal with this problem in the Audit Guide for Life Insurance Companies, we looked into existing practice. We learned that CPAs were, in some cases, expressing reliance on consulting actuaries, on State Insurance Departments, company actuaries or, in other cases, were not expressing any reliance at all. Since practice varied, it was our responsibility to make sure that practice became uniform.

In those cases where we were relying on company actuaries, we came to the conclusion that that would be no different than if we were to rely on the company's CPA for some other portion of the financial statements, and that we had no basis for reliance in that instance because of the lack of independence. It would be the same as accepting management's representation as to any item in the financial statements without any further investigation.

In the case of relying on consulting actuaries or on state insurance departments, we had a combination of problems. While they may have been independent, and in some cases the consulting actuaries were, there was also a problem as to whether or not there were any generally accepted auditing standards in the actuarial profession. While you have your code of conduct, there are no such generally accepted auditing standards. You may have seen in many instances auditors reports where they have expressed reliance on other CPAs for a portion of the financial statements, principally a subsidiary or something of that nature. The basis for that reliance in the past has been the fact that we are both members of the same profession, subject to the same basic rules and the same basic generally accepted auditing standards. Therefore, that expression is not a qualification, but merely an indication of division of responsibility between two people in the same profession who are presumably following the same rules and regulations. Even in that instance, however, materiality enters into the determination of whether or not you can continue to express reliance on another public accountant. If, for example, the amount of work that is performed by another public accounting firm becomes material in relation to the total, the principal auditor has to address himself to whether he can continue to be the principal auditor -- whether he can, in fact, express reliance when someone else is doing an unreasonably large proportion of the work. Some firms follow a guideline such as, when somewhere in excess of 25% of the assets and revenues would be audited by someone else, then the other public accounting firm would no longer assume responsibility for the engagement. You could carry that to an extreme where one auditor signs a consolidated account and 5 other firms are doing all of the substantial auditing. In those situations, that auditor should not assume responsibility for those accounts. It is in that context that we concluded in the Life Insurance Audit Guide that we could not express reliance on other public accounting firms or on actuarial firms, as the case may be, because of the materiality of reserves in most instances.

I should point out what now happens in practice. As you well know, some of the public accounting firms have their own actuarial divisions. Others, such as our firm, have hired actuaries, few in number, to act as liaison between our audit personnel and consulting or company actuaries during the course of the audit. Some other firms have established formal or informal relationships with consulting actuarial firms to provide the same sort of liaison. Others have used individual consulting actuarial firms, and some have elected to audit reserves themselves, in many instances not relying on any other firm, but working directly with the company actuaries. I think that the firm that takes the latter position may do so if the people that are doing that work are highly qualified -- more than just having done one or two audits in the life insurance industry.

The means of using or working with actuaries are important. Our philosophy is essentially to work with, to understand, and to form an opinion as to the reasonableness of the actuarial matters on which the actuary has either given us an opinion or in which the actuary has been involved. I think most people in the past believed that, in the case of statutory reserves, there was never a significant problem because, once you have been satisfied by the actuary that the tables were proper and the company had considered all reserves that were required under the policies, the actual audit function of calculating the reserve was a routine thing that any clerical person could do, let alone a CPA.

The area of generally accepted accounting principles became somewhat more complex, however, because of the fact that we did not have published tables. It was necessary to develop factors from assumptions and it was necessary to test those factors. I think experience has shown us now that we can do some of these things because there are computer programs available on which we can generate factors for comparison with the company's factors. Where we need actuarial assistance in that respect generally is to explain why those factors never agree -- because of the different assumptions that may be used such as when deaths occur. In many cases, it requires an actuary to help us explain why they are different, or whether or not such explanations are reasonable.

The only other thing I would like to say is that we are continuing to work with the actuarial profession. As Mr. Farley mentioned, we do have a joint committee of the AICPA and the American Academy of Actuaries. In addition, the AICPA has a Task Force on Non-accounting Experts which is working with the subject of how we, as auditors, should use non-accounting experts -- how we should deal with actuaries, geologists, attorneys, and other people in that category. We also have an AICPA Task Force on Insurance Auditing which is the successor to the Insurance Accounting and Auditing Committee that wrote the Audit Guide and is presently working on a Fire and Casualty Audit Guide and informally working with the American Academy of Actuaries Committee on Financial Reporting to review recommendations and interpretations from an accounting standpoint. Our work is to update that Audit Guide which was written in 1966. We found that there were some things that weren't covered in the existing Fire and Casualty Audit Guide that came up in connection with the Life Audit Guide. Also, as a result of applying the Fire and Casualty Audit Guide, we have found other areas that just were not covered. The discounting of liabilities, for example, is one of the practices that may or may not be followed in the property and casualty industry. This Task Force plans to work with the Casualty Actuarial Society.

There is also an AICPA Task Force on Accounting for Mutual Life Insurance Companies which is really just getting organized and does plan on working with the American Academy of Actuaries Committee on Financial Reporting and other interested parties before coming to any conclusions on that subject.

There is also an AICPA Task Force on Purchase Accounting, which is working with a group in the actuarial profession on the subject of accounting for purchases of life insurance companies under Accounting Principles Board Opinion Nos. 16 and 17.

As you can see, we are working closely with the actuarial profession in many areas and have hopes for a continuing improved relationship.

