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## PROFESSIONAL CONDUCT AND INDEPENDENCE OF THE ACTUARY

*Moderator: GEORGE R. WALLACE. Panelists: EDWARD H. FRIEND,  
DALE R. GUSTAFSON, JOHN S. McCOY.*

1. Exposure draft of report by Joint Committee on Independence of the Actuary.
2. Special problems related to self-protection, professional criticism, and follow-on business.
3. The actuary's relation with and/or control of the actuary by other professions and entities.
4. Evolution and current forces - effect on professional conduct and discipline.

MR. GEORGE R. WALLACE: The areas of professional conduct, discipline and independence are closely intertwined. Independence is one facet of professional conduct which we have been actively deliberating for some period of time. I might say these deliberations have been most challenging to our profession, as new ideas and concepts have been brought forward by many and have been subject to rigorous examination by those directly charged with recommending a course of action as well as by a large number of conscientious members of the profession. In the course of these deliberations, it became clear that there is a wide range of well-reasoned views on the subject. As a result, it is obvious that the recommendations of the Joint Committee will not be acceptable to all members of the profession. On the other hand, it is to be hoped that the great majority will find the final report to be such that they can willingly subscribe to it. As it is recognized that the exposure drafts, which you have seen and were prepared by the Joint Committee, have been complex and difficult to completely comprehend, we will today endeavor to have the basic principles of the report set out in a straightforward, informal manner.

Independence is just one facet of professional conduct. As our profession comes more and more under the sharp scrutiny of the public, it will become imperative that high standards of professionalism be quantified for the benefit of the public. Offenses to this code must be dealt with by the profession. To assist in this procedure, the Committee on Discipline has been formed. Today we will also hear something about the organization of this committee, and the problem areas which probably lie ahead.

The panel members are Dale Gustafson, a member of the Joint Committee, John McCoy, an unofficial co-ordinator of the Committee on Professional Conduct and Discipline and Ed Friend, Chairman of the Joint Committee.

MR. DALE R. GUSTAFSON: My remarks will presume a certain amount of background. I will assume that you know that the Joint Committee on Independence was formed about two years ago by the six North American actuarial bodies and I will assume that you have some recollections from trying to read either or both of the exposure drafts of that Committee's work. You will hear quite

a bit about the current status of the Committee report this morning, but I would like to start by stepping back and taking a glimpse at the frame of reference of this work. Then I will comment on a few of the sensitive aspects of our report including a couple that are not of central importance, but which nevertheless brought substantial reactions from you, the members.

We are involved in a very difficult and very dramatic process. That is, the actuarial profession, which is and long has been a profession, is undergoing the transition from being a very successful, private, and inward-looking profession to becoming a publicly recognized and publicly oriented profession. This was, of course, first overtly recognized by the profession with the formation of the American Academy of Actuaries, now something over ten years ago. That, however, was only the first step, and there has been much progress and much activity along the way. The activities and considerations of the Joint Committee on Independence are some of the more important and perhaps most sensitive current aspects of this transition process. To a certain extent, we are groping and trying to find our way along new and unknown paths. A part of the feedback from the membership has been that the Joint Committee on Independence was concerning itself with problems or aspects that did not need to be or should not appropriately be considered by it.

The Joint Committee has looked very carefully at its draft report, and has realized that some of the things that were included in that early draft can appropriately be deleted. It is not that the Joint Committee has in any way changed its attitude or conviction about these matters, but rather that it believes these matters are best dealt with in other ways, by other committees, or in other forums. I will comment on a few examples from the discussions that took place at the last meeting of the Joint Committee at the end of April.

In the cover letter to the draft report that was distributed to the membership last November, there were rather detailed references to reports requested by or obtained for members of the Board of Directors, and some discussion of which public various members of Board of Directors represent. There is now agreement within the Joint Committee that these references in this detail do not belong with the basic report of the Joint Committee, which is intended to deal with underlying principles.

Similarly in conclusion IB2 in the draft report, the Joint Committee included reference to sanctions or actions, in that it suggested that an actuary should not "knowingly remain affiliated with an organization" in which certain activities were carried on. The Joint Committee recognizes that sanctions, punishments, and judgments as to transgressions against professional conduct are properly in the province of other committees, such as the new Committee on Complaints and Discipline, and are not within the province of the development of general principles, which is the basic charge of the Joint Committee on Independence.

Another example of a similar nature is the draft report's conclusion IC, which attempts to deal with "follow-on business" where an actuary has made some unfavorable audit criticism. The Joint Committee believes that situations of this nature need to be dealt with, but it now recognizes that this should come as an application of general principles rather than being stated as a part of the original statement of such principles.

The Joint Committee has found that the problems of definition and understanding of principles are complex and illusive, especially when attempting to deal with real relationships in the real world. Of course, as has been apparent from all that has been going on in this area over the past year or so, one of the more sensitive areas is the relationship between the actuarial profession and the accounting profession in dealing with audits. The basic principles appear to be quite simple and straightforward. That is, a professional cannot audit his own work, nor can he audit or be involved in the audit of the work of any other professional with whom he has a family, professional, or financial relationship. These general principles are not in conflict and have long been stated by the accounting profession.

However, in the implementation, in the real workaday world, of these general principles, many situations arise which are reminiscent of the ancient theological arguments that took place in the Middle Ages as to how many angels could dance on the head of a pin.

MR. JOHN S. McCOY: I should like to give you some background information about the Committee on Complaints and Discipline and indicate how it was formed and how it plans to carry out its assignments. The Committee's formation was authorized by the Board of Governors in a resolution approved in October 1975. Prior to the establishment of this Committee, problems regarding complaints and discipline of members of the Society were handled by ad hoc groups appointed by the President as situations arose. It was felt that a standing committee should be established to look into these matters, because there were indications that there would be an increase in activity in this area, and the ad hoc approach not only put an unnecessary burden on the President but also was a rather cumbersome mode of operation. The authorizing resolution called for the appointment of a Committee comprised of at least 12 Fellows and with a Past President of the Society as its Chairman. The committee was authorized in accordance with Article VI of the By-Laws and its activities and proceedings are to be undertaken in accordance with Article VII of the Society's Constitution. Thus the groundwork was laid and it was up to the President to breathe life into the Committee. This he did with the appointment of Ed Lancaster as its Chairman in January 1976. You can see from this that the committee and its operation are still in the very formative stages and most of the points that can be mentioned regarding how it will operate are, at this stage, more theoretical than factual.

The Committee is to consider complaints, brought before it by any member of the Society, which involve professional conduct of or professional relations with others who are students, former members, or non-members, or which involves relations with any other individual or organization where questions of professional conduct may arise. If, in the judgment of the Committee, action is warranted, the Committee may recommend such action to the Board of Governors. As you think about these Committee responsibilities, you can see how broad a scope they encompass, both with respect to matters that may be placed before it, and with respect to the geographical dimensions over which the committee may be asked to exercise judgment. At this stage of the game, we cannot say much about the nature of the matters that will come before the committee--experience will be the answer to that. However, it is clear that complaints may arise from any part of the world in which our members are at work. In anticipation of geographical problems such as this, the chairman, Mr. Edwin Lancaster, suggested that the Committee members be geographically distributed by residence as widely as possible. Of course it was also desirable to diversify with a cross section of Fellows from the consulting and insurance company fields of employment.

Accordingly, a Committee of 19 members was selected, composed of persons who reside in locations throughout the United States and Canada and who represent both insurance company and consulting actuarial fields. Incidentally, we were careful to avoid any overlap in membership with the Academy's Committee on Discipline. Even this broad representation did not seem adequate to do an effective job because of the vast areas to be covered, and therefore it was decided to supplement the Committee members, as needed, with ad hoc representatives who would be selected by Committee members to assist as members of a fact-finding mission at a local level. These appointees would serve for as long as required to complete their assignment and report back their findings to the Committee member who had commissioned them. Another reason for proposing the ad hoc method of dealing with complaints was to expedite Committee action. People make complaints because a matter is troubling them and it is desirable to get the fact-finding action started as promptly as possible. In some situations, delay might prevent one from obtaining the information which might be necessary to properly investigate the case. It is hoped that the ad hoc approach will make it easier to commence fact-finding missions and to obtain results more promptly.

It should be carefully noted that the Committee is not a disciplinary body. It merely serves as an investigating or fact-finding body which makes recommendations of possible action to the Board of Governors after it has completed its review of an assignment. It is probable that the types of cases that will be referred to the Committee will cover a broad range of problems. Some may be simple enough to be completely handled by two or three committee members. Others will likely be so complex as to require the judgment of the entire Committee, and perhaps assistance from outside counsel as well.

This rather brief outline of the Committee's purpose, its organization, and the method by which it plans to operate, should give you an idea of how it stands today. It is too early to report on how this approach will work in practice. Much, of course, will depend on the nature of the cases that are referred to the Committee, and, of course the test under fire of the procedures which are being established in these developmental stages. It is the Committee's intention to so organize its activities that matters referred to it will receive prompt attention and will be carried to conclusions as quickly as possible. Obviously the work of this Committee will be an important factor in the maintenance of high standards of professional conduct in the actuarial profession. It will probably be a useful cog in the development of standards by which conduct may be judged. Of course, it is the assumption of the Committee on Principles of Professional Conduct establishing those actual guidelines that undoubtedly items which arise from the experience of this Committee will be helpful in clarifying some of these points. Although the Committee's exposure to complaints has been very brief, it is already evident that standards for judgments are rather nebulous and may have to be more carefully delineated. For example, what are the limits of ethical conduct for an actuary or an actuarial firm which is interested in establishing itself in a new professional and/or new geographic area? The answer to this question very probably goes beyond the jurisdiction of the Society alone because of the interacting effect with consumer interests in the availability of competitive services. Without question there will be a need for much greater future attention to the issues involved in the area of professional conduct than has been the case in the past. It is desirable to establish in this Committee the kind of organization that will enable it to cope with its assignments and to help the Society to deal effectively with future problems of this type.

MR. EDWARD H. FRIEND: After over two years of study involving the review of upwards of 1,000 pages of background information, examination of over 50 responses to Exposure Drafts, and approximately 10 formal and informal meetings on the subject, the Joint Committee on Independence of the Actuary is in the process of preparing its final report to the 6 North American actuarial bodies to whom it is responsible for its findings.

The Committee on Independence recognizes two situations in which an actuary is involved where his work, representing his opinions and findings as an actuary, reaches the public. In the first situation the public accepts that work without further confirmation on the basis of the actuary's professionalism and his status as a scientist.

The Committee reaffirmed its position that the profession need not require independence of the actuary when the public does not require public confirmation of his work.

The final Committee report will assert that public acceptance (without audit review) of the publicly reported work of an actuary, whatever his affiliation to the entity for which the work was completed, is to be encouraged through increased emphasis on professionalism and disclosure.

Toward that end, the Committee reaffirmed its requirement for disclosure of an actuary's postural relationship to his employer or client.

In that connection the Committee reasserted the requirement that the actuary disclose any influence on his independent judgment. In particular it asserts that he must disclose circumstances in which he would reach a publicly reported conclusion based on the process of solving for the assumptions which lead to that conclusion.

In general, the Committee reaffirmed its conclusion that the Qualified Actuary should continue to be governed by rigorous standards of professional conduct, and that strong action against offenders and some means of disseminating information about cases of censure, suspension or revocation of membership should be initiated.

In the second situation the public, for one reason or another, requires confirmation of that work. The Joint Committee felt that the profession would be served, because the public would be served, if we required that whenever the work of an actuary is to be reviewed, independence must prevail.

Thus, if the publicly reported work of an actuary is to be publicly confirmed for the purpose of offering comfort or assurance, the confirming professional must be independent of the entity with respect to which the report is rendered and must be independent of the preparer of the original work product. This is true whether the confirming professional actually reviews the original publicly reported work or simply establishes that the preparer of the original publicly reported work product is qualified and competent.

It is up to the Qualified Actuary to avoid a direct or indirect association with a violation of the prohibition against "self-audit."

As an important aside, the waiver of a public confirmation (whether by waiver of a physical review or waiver of the determination that the preparer of the original work product is qualified and competent) is in itself deemed an "audit" for these purposes.

Moreover, it is unimportant whether the publicly confirmed work is part of a larger effort or stands alone, or whether the publicly confirmed work is specifically referenced or simply embraced by the confirmation determination. In all such cases the confirmation (or waiver of such confirmation) is deemed an "audit" for these purposes.

MR. BRUCE E. NICKERSON: What involvement, if any, would the Committee on Discipline have with problems of conduct in connection with the Society's examination program?

MR. McCOY: The Education and Examination would make the first determination and then, if there is an indication that some action should be taken, it would be referred to the Committee on Discipline. They would review the situation and make a recommendation to the Board.

MR. JACK MOORHEAD: To what extent has the Society's Committee on Discipline discussed the matter of co-ordination between the Committees on Discipline of different actuarial organizations?

MR. McCOY: The idea is to communicate with these other committees but we want to avoid any antitrust implications which might result from the same opinion coming from several organizations. Certainly every precaution will have to be taken to see that there is no collusion between two independent bodies but decisions would be made known to the other committees.

MR. WILLIAM A. DREHER: The Committee's report would prohibit a "self-audit". This concept seems clear and correct with respect to an actuary who is asked to express an opinion on another actuary's work. However, in the context of audits performed by a CPA on financial statements that include actuarial items based upon the work of an actuary employed by the firm of CPAs, the prohibition is harder to understand and accept. This situation has been confronted by the accounting profession in a recent opinion issued by their Ethics Committee. This opinion related to the independence of an accountant who is auditing a financial statement that includes actuarial information prepared by an actuary employed by the accounting firm. The opinion says that independence will not be impaired "if all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results". Under these circumstances, the actuarial information becomes part of the client's financial statements and the auditor, being independent of the client, is therefore in a position to offer his opinion on those financial statements.

The key issue is the criteria to be used in determining whether the client has "an informed judgment on the results". If the standard of comparison is the quality of knowledge possessed by the actuary, it is most unlikely that any client, unless competent actuaries were employed by the client, could be said to be adequately informed. However, in my judgment, that is not the proper reference point. It is more appropriate to evaluate the level of the client's understanding in relation to his knowledge of other items appearing in his financial statements that are the result of advice coming from other external professional experts. For example, a CPA may give tax advice and this will lead to specific accounting entries relating to tax liabilities; a geologist may evaluate oil reserves and these reserves may be recorded on the books of the company; a lawyer may offer advice on prospective liabilities related to litigation in which the client is involved and these judgments may either lead to a reserve for future judgments related to this litigation or

a conclusion that no reserves are necessary. In each of these instances, the client has substantially less technical competence than the professional expert, but he will have developed a sufficient understanding of the entire set of circumstances and principles involved to appreciate the significance of the advice and to make a reasonable business judgment about the necessary entries in his financial records.

So long as the user of actuarial information has the same relative level of competence to act upon it, I believe it would be fair to conclude that the client has an informed judgment on the results produced by the actuary and that the actuary is, therefore, not responsible for the client's conclusions, even though he has been responsible for the advice which led to those conclusions.

Thus, if the client was deemed to have an informed judgment on the results produced by an actuary employed by an accounting firm, not only would the accountant's independence requirement be satisfied, but another actuary employed by that accounting firm, who had not been involved in the development of actuarial data that were the subject of the accounting audit, could assist the accountant in developing his conclusion that such actuarial items were, for the purposes of the accounting audit, not materially inconsistent with generally accepted actuarial principles and practices.

The critical issue underlying the views presented above is the definition of the term, "informed judgment on the results", and the practical consequence of its application to particular sets of circumstances. The actuarial profession should seek to cooperate with the accounting profession in identifying the factual and subjective criteria to be used in determining whether a client did, in fact, have such an "informed judgment".

MR. FRIEND: The Committee carefully considered the situations which you have outlined and the opinion issued by the Ethics Committee of the accounting profession. The gist of the thinking of our Committee was that it would be a most unusual situation where "all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results". Generally speaking, this opinion is rather subjective and could be subject to many different interpretations. On the other hand, our Committee felt that a stronger position should be taken and that if we were to err, we should err on the side of clarity, knowing that in certain unusual situations we might be prohibiting practices which on their own merits could be considered acceptable.

The Committee also agreed that the actuary preparing the opinion should do so in a personal and professional manner, and therefore it is his opinion which his client may rely upon rather than advice which the client could take unto himself.

A distinction must also be made between actuarial advice or determinations made in the normal course of a client's business which do not directly enter into a financial statement which is subject to audit and those which do. In the former case, no question of self-audit would be raised, but in the Committee's opinion the latter situation would involve self-audit as such.

MR. BARRY BLAZER: What is the next expected action of the Joint Committee with respect to release of materials to the profession?

MR. FRIEND: The Committee is currently working on a draft report which, when finished, will be presented to the Presidents of various bodies with the request that it be submitted to their Board for adoption.