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RELATIONSHIP OF ACTUARIES WITH LAWYERS AND ACCOUNTANTS

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1. Independence from the perspective of:
   a. The actuarial profession in the United States and Canada
   b. The accounting profession
   c. The legal profession

2. Professional conduct--is it a function of:
   a. Place of employment
      - in the corporate world
      - in public practice
      - in a multi-professional organization
   b. Reporting relationships
      - to other actuaries
      - to other professionals
      - to laymen

MR. BARRY L. BLAZER: The program is in two parts -- independence and professional conduct. The final report of the Joint Committee on Independence was expected to be the focal point for our discussion of independence. The committee has issued two exposure drafts, the more recent in November, 1975. However, the final report has not been issued. Since it is not known what changes, if any, will be made between the November 1975 exposure draft and the final report, we will focus our discussions on the general question of independence and professionalism.

MR. MICHAEL ROSENFELDER: Actuaries in Canada have been following with great interest the work of the Joint Committee on Independence. Indeed, as far as the Canadian scene is concerned, this discussion is proving to be rather timely. The Canadian Institute of Actuaries has been wrestling with some of the same questions, and for that reason we probably have a little bit of an insight into some of the difficulties that the Joint Committee has been facing. They should certainly be complimented on doing an excellent job, and Canadian actuaries are looking forward with great interest to the final version of their report.

Traditional practices are slightly different in Canada, and it is against this background that the issues discussed by the Joint Committee must be considered.

1. The actuarial work in respect of most life company statements in Canada is performed by an actuary on staff. Compared to the United States, there are relatively few consultants in Canada who spend any substantial

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amount of their time on life company work.

2. For many years, audit practice in Canada has been to express reliance on the actuary regarding reserves and other actuarial items. While practice is not uniform, most of the major companies at the present time do publish the certificate or the opinion of the actuary as part of the annual report to policyholders and shareholders, and in fact, it is expected that this will in due course become mandatory.

3. The auditor normally obtains from the actuary a certificate in respect of the statement reserves, but practice probably varies considerably from company to company with regard to the nature or amount of any discussion between the two professionals or their staffs concerning the reserve bases or calculations. With some cases possibly only minimal contact takes place.

4. There is no parallel in Canada to the U.S. two-level reporting system for stock companies. A single set of reserve assumptions serves the purposes both of the Annual Report to Policyholders (and Shareholders) and of the Statutory Department of Insurance requirements.

5. The work of the actuary establishing statement reserves is subjected to a detailed review every 5 years by the skilled and competent staff of the Federal Department of Insurance.

Currently, therefore, the actuary responsible for the establishment or determination of the reserves of a Canadian life company enjoys a fair degree of freedom of action, although at all times subject to the minimum standards imposed by the Insurance Act and by the Superintendent of Insurance. There are, however, a number of current developments which are causing the profession to re-examine its practices and procedures in this area. These developments include expected changes to the Insurance Act which will probably give the actuary more flexibility in selecting valuation methods and assumptions, and will also require him to state that in his opinion the reserve bases are "appropriate", rather than as hitherto only that the reserves are good and sufficient. The time has also come for the profession to more clearly define its role and responsibilities vis-a-vis the readers of the Life Company Statement and vis-a-vis the external auditor.

One of the issues that has been extensively considered and debated is the so-called "independence" question. The view of the Canadian Institute of Actuaries, Committee on Financial Reporting can probably best be summarized by saying that the actuary's training uniquely qualifies him to select reserve assumptions and develop reserve figures, and indeed that the actuary is the only person competent to do this. In signing his certificate, the "valuation actuary", that is, the actuary establishing or determining the reserves, he is acting as a member of his profession, and not as a company officer, and the mere fact that he happens to be employed by the company does not by itself represent valid grounds for having an outside audit of his work. In discharging his responsibilities, he is bound by the ethics and code of conduct of his profession, and by valuation standards and procedures that the profession may from time to time establish. No one expects the actuary to perform his function without some form of compensation, and the Committee feels that it is not of great relevance whether this takes the form of a salary or fee. The Committee is of course aware of the view expressed in a number of quarters that an actuary in the full-time employ of a

life insurance company cannot perhaps bring to bear the same degree of objectivity that an outside consultant can. Even if this is so, the view of the Committee is that this consideration will be more than outweighed by the intimate knowledge that the company actuary has of the company's products, its method of operation, and the characteristics of the business being valued, something that the outside actuary could not normally hope to match with his necessarily more limited exposure to the company's business. The actuary is expected to perform his work in accordance with the established standards of his profession, and his relationship to the company or form of compensation should be of no concern.

A number of procedural changes, however, do seem to be appropriate at this time.

The status of the actuary signing the certificate is to be formalized by the requirement that a "valuation actuary" be appointed by resolution of the Board. This is similar to a comparable requirement that was, I believe, recently introduced in Britain.

Comprehensive procedures are being formulated by the Institute discussing, in a fair amount of detail, the methodology and procedures that the actuary would in most normal cases be expected to follow in establishing statement reserves. The actuary, if he is asked, would normally be expected to provide the external auditor with reasonable disclosure of the reserve bases and calculations he has used, and generally to co-operate freely and frankly with the external auditor in order to give him the assurance that the reserve computations have indeed been performed in accordance with established actuarial procedures (and if not, his reasons for reaching the conclusions he did). It is likely that the statute will require companies to publish the Opinion of the Actuary with the Annual Report to Policyholders and Shareholders, and a standard form of Certificate or Opinion for this purpose is currently in the process of development.

The rules underlying the preparation of the audit report is, of course, a matter for the accounting profession to determine. The CIA Committee on Financial Reporting, however, is hopeful that some way can be found by the accounting profession to accommodate the somewhat special situation that occurs with life company statements. In arriving at his Opinion, the auditor should be entitled to take into account the explanation given to the auditor by the actuary, the reassurance by the actuary that the reserves indeed comply with established professional standards and procedures, the method of appointment of the "valuation actuary", the regular review by the highly competent staff of the Federal Department of Insurance, and the existence and publication of the Actuary's Opinion as part of the Annual Report. We believe that in discharging his responsibility for the determination of the actuarial reserve, it is irrelevant whether the "valuation actuary" happens to be in the full-time employ of the company or whether he is engaged on a consulting fee basis. Further, we do not believe that an audit of the actuary's work, whether on staff or not, is necessary in normal circumstances. Active discussions of the ramifications of these ideas are currently taking place here in Canada, involving the actuarial and accounting professions, the Superintendent of Insurance, and the industry, and we are hopeful that a solution acceptable to all can indeed be found.

MR. DOUGLAS R. CARMICHAEL:
Introduction. Actuarially determined amounts in audited financial state-

ments are becoming more significant and widespread. Prime examples are: amounts for pension costs in corporate financial statements, amounts for reserves in life insurance corporate statements, and several amounts in financial reports of pension plans. This has had two important and related effects -- increased public reliance on actuaries and increased interaction of actuaries and independent auditors.

Increased public reliance has caused actuaries to be more concerned with the development of professional standards. This concern has many parallels in the professional standards of auditors.

At the heart of professional standards is the question of liability. The expectations of society are 1.) that any professional will follow adequate standards, and 2.) that, should his performance be subject to question, he will be evaluated as to whether he followed the standard of care expected. If a profession has not developed professional standards, that standard of care is going to have to be both implemented and developed after-the-fact; so it behooves all professionals to develop professional standards in advance. It is particularly important, not only because of the liability and the penalties that may be imposed, but also because of the importance of a professional's reputation to his survival. In fact, the effect of litigation on reputation is probably much more significant than any ultimate penalties that might be imposed; so I believe liability is at the heart of professional standards, and with increased public reliance on the work of actuaries, I might address you today as fellow plaintiffs.

Both the increased interaction of our two professions and the increased public reliance on the work of actuaries create a strong, mutual interest in professional standards. The standard of interest today is independence.

The Need for a General Definition of Independence. CPAs have adopted a general definition of independence that applies to all CPAs. Actuaries are considering adopting a concept of independence that recognizes different levels of independence depending on the circumstances.

The public would be better served if the same general definition of independence was adopted. The American Institute of Certified Public Accountants' Code of Ethics recognizes that all CPAs should have the traits of objectivity and integrity. If a CPA, however, is performing an audit of financial statements on which the public will rely, he must meet additional rules that prohibit certain relationships with the preparer of the statements. Generally, these rules prohibit any ownership interest in an audited company and any relationship that would put the CPA in a position of being an employee of the company. I urge actuaries to adopt similar requirements.

The Importance of Independence. A CPA's independence of the management that prepares financial statements is fundamental to the role of auditors in society.

Financial statements present performance measurements of a company. The two key measurements are earning power and solvency. Since the measurements are a reflection of management's performance, management has an incentive to bias them. The auditor's job is to counteract that bias.

Users of financial statements can have more confidence in them if they are audited and reported on by someone outside management. It is really this

idea of being outside management that is fundamental to the auditor's independence, but it should be noted that the auditor is expected to be independent of all those with an interest in financial statements and that includes the users of financial statements as well. He is expected to be independent because he has to act as a moderator of all the interests in financial statements; the preparer and the users of the statements do have an interest that can lead to bias and it is the auditor's task to reduce that bias. This raises some questions of mutual concern.

Offering More than One Service to the Same Client. A CPA will often offer more than one service to the same client; for example, he may be both the auditor and the advisor on income tax matters. Sometime ago, the AICPA considered whether a CPA providing more than one service gave rise to a conflict that could adversely affect the CPA's independence. For example, a CPA providing income tax advice and also expressing an opinion on financial statements that reflected an income tax provision could be deemed by some to be performing incompatible duties.

Auditors were able to put concerns of this type to rest by distinguishing between the responsibility of the client's management and the CPA advisor for representations in financial statements.

A CPA's independence is not impaired when he provides more than one service to his client providing management retains its primary responsibility for the financial statements. The foundation for this conclusion is the proposition that management has the responsibility for the representations in an entity's financial statements including those made on the advice of experts. This has been accepted generally by the public and by securities regulators, notably the Securities and Exchange Commission. Since management has this responsibility, it follows that management must also retain the ultimate authority to determine the form and content of financial statements.

When a CPA offers advice, for example, on income tax matters, management must retain its authority to accept or reject the CPA's recommendation. Management's acceptance and adoption of the recommendation should not be a matter of form. It should be the exercise of an informed judgment to prevent the blurring of the roles of manager and advisor.

The CPA who provides advisory services to his client must also provide sufficient explanation to permit the exercise by management of an informed judgment; this has certain parallels in the work of an actuary. The degree of the explanation that must be provided varies with the circumstances. For example, the nature of the matter and the client's existing knowledge of the subject would influence the amount of explanation needed.

When management exercises an informed judgment and accepts the CPA's suggestions, management accepts the responsibility for the related financial statement presentation. In this way, the roles of the advisor and manager are differentiated and the same CPA may audit the related financial statements with his independence unaffected by his advisory role.

Similarity of Roles of Actuary and CPA. Actuaries often act as technical advisors; in that role, their recommendations are subject to acceptance by the client or its management. In this way, the role of an actuary and a CPA advisor are similar.

In addition, management retains the final decision even when the actuary becomes a fiduciary, because management can change actuaries without restraint. More important, whatever the role of the actuary, an auditor can remain independent even when an auditor and an actuary affiliated with an auditor serve the same client.

Position of a CPA Auditing Financial Statements Containing Actuarial Amounts. An auditor does not audit an actuary's findings when he makes an audit of financial statements. Rather, the auditor makes certain inquiries of the actuary for the purpose of obtaining an understanding of the methods and assumptions used by the actuary as described in the AICPA Statement on Auditing Standards No. 11, Using the Work of a Specialist.

This is the same approach the auditor uses in dealing with other professionals or experts, for example, appraisers, attorneys and engineers whose work may provide support for representations in financial statements.

So long as the actuary retains his professional responsibility for his findings -- and that responsibility can be discharged in spite of a relationship with the entity involved -- it seems irrelevant whether the actuary is associated with a firm of CPAs that is auditing the financial statements.

Questions have also been raised about the objectivity of the criteria established for the selection of specialists in SAS No. 11. Any criteria adopted must be adequate to prevent use of the unsatisfactory work of a specialist who may otherwise appear to be qualified. Criteria of this type are necessary to protect the public's acceptance of a professional's work.

The auditor must retain the right to pass upon the acceptability of an expert using reasonable criteria because the auditor's report is based in part on the use of the specialist's work. To adopt a different view, that is, to require the auditor to audit the work of other specialists before he can use it as a basis for his opinion on the financial statements, would be a regressive step. It would demean the professional standing of specialists in areas other than auditing.

The Importance of an Informed Judgment by the Client. Much discussion has centered around the following AICPA Ethics Ruling #54:

> Question -- If a member's firm renders actuarial services to a client, may the member also express an opinion on the client's financial statements?
>
> Answer -- Even though the member's firm provides actuarial services (the results of which are incorporated in the client's financial statements), 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, the member's independence would not be impaired by such activities. (Emphasis added.)

Some have expressed the view that the only people who could have an "informed judgment" on actuarial matters were individuals who were trained in actuarial science.

The Guide to Professional Conduct and the Opinions as to Professional Conduct, Opinion A-3 "Transmittal of Actuarial Reports" under the subcaption "Actuary Acting For An Insurance Company" reads as follows:

> When an actuary advises an insurance company on premiums, dividends, reserves and related matters, the client is the company, its policymaking executives and in some situations its board of directors and its auditors, whether or not he is an employee of the insurance company. Thus, in such circumstances, the member should satisfy himself that the persons who may be expected to utilize his report are fully cognizant of the significance of his findings. (Emphasis added.)

The words "fully cognizant" as they are used in Opinion A-3 cannot be too different, I believe, than the term "informed judgment" as used in the AICPA Ethics Ruling #54. I would like to close with this question - Is there any difference?

MR. BRUCE E. NICKERSON: I would respond by asking a slightly different question -- Is being fully cognizant of the significance of the actuary's finding comparable to being in a position to make an informed judgment about what the actuary did to arrive at his findings?

MR. CARMICHAEL: I would have to strike the last part of the question because the informed judgment does not apply to what the actuary did. In fact, that is the critical distinction that is often confused. The informed judgment both of the management in accepting final responsibility for the financial statement and of the auditor in what he is expected to do under our professional standards for achieving an understanding does not mean that management or the auditor needs to be fully informed about what the actuary does to arrive at the final amount. You would have to be a trained actuary to do that and so we start off assuming that is impossible.

MR. NICKERSON: That I concede went too far. I would still like to ask whether this informed judgment that is required under the relationships with specialists does not extend at least materially beyond the significance of the actuary's findings.

MR. CARMICHAEL: I really cannot speak, of course, about what was meant about being "fully cognizant of the significance of" as it is stated in Opinion A-3 because I was asking for views of others on that, but the informed judgment certainly does relate to the relationship between certain business decisions that a management is expected to make, for example, and financial statements. The attitude of management and the intentions of management, the degree of conservatism, the degree of risk they are willing to run, and their investment policies do have an affect on the financial statements. What the informed judgment means to me is that management should be aware, for example, that there are different assumptions or methods that might be used, and should understand the effect of those different assumptions and methods as far as the effect on the financial statements. The process between the assumptions and the end result is something they do not need to know anything about. That is the area of the expert's work, but they should understand the relationship between the assumptions made and the amounts that finally appear in the financial statements.

MR. BLAZER: Is there anyone from the Professional Conduct Committee present who can shed some light on the background of the term "fully cognizant" as used in Opinion A-3?

Since we apparently do not have anyone from the committee present, I will offer my own interpretation. The first sentence establishes that regardless of whether the actuary is a consultant to or an employee of the insurer, a professional-client relationship exists. The existence of a professional relationship even where the actuary is an employee is often used as an argument against the need for independent review of the actuary's findings, particularly when the actuary has an obligation to be certain that management is fully cognizant of the results of his work. This is strikingly similar to the rationale expressed in AICPA Ruling #54.

MR. E. PAUL BARNHART: Let me first of all emphasize that I am really here just giving a personal interpretation, not attempting to make any kind of comment on the part of the Committee on Independence or anyone else. It would seem to me that two things have to be recognized here. First of all the actuary, whether he is an employee of the company or a consultant, obviously has failed in some respect in his obligation if he has not succeeded in conveying to the management of the company the significance of his findings. Certainly the management of the company has to be in a position to evaluate the actuary's findings in order to make any necessary management decisions or changes that might be implicit in his findings; so it would be a serious mistake to take the view that only the actuary can understand the significance of his own findings. His professional obligation either to his own employer or to his client necessitates that he find the way to communicate clearly and intelligently to that management what the significance of the findings are. I am suggesting that there really is no material difference here; "informed judgment" or "fully cognizant" - I am inclined to feel that in the long run the two really have to be regarded as essentially similar in their import.

MR. CHARLES L. WALLS: I am rather curious to ask Mr. Carmichael what your position is when the management will not pay you for advice; if you render a report and they say "thank you very much, good-bye," what is your obligation to work without compensation thereafter?

MR. CARMICHAEL: That is a very interesting blend of practicality and professional standards. The Securities and Exchange Commission has helped some. They have a rule that an auditor cannot remain independent if he has more than one year's fees outstanding. This is a rule that we felt obliged to adopt also, so I guess the practical import is that you can carry a client for a year, but beyond that you cannot continue to serve as an independent auditor if the fee is outstanding. The other practical problem, taking the simple situation of one engagement and getting paid for that one engagement without concern about a continuing relationship, is governed solely by practical concerns. An auditor, like any businessman, should not end up at the end of the engagement giving his report without having received any money. Progress billing should help. Also, as a practical matter, auditing firms try to do more than merely express an opinion as required by professional standards. They provide the client with other services of value. Certainly it is a matter that has been given a great deal of attention. A bill for a several million dollar audit fee is not just sent through the mail; there is a conference between the client and auditor with the partner on the job softening the blow as much as possible verbally. The

collection of the fee, other than the rule we have about not more than one year's fee outstanding to remain independent, is primarily a matter of good business practice.

MR. BLAZER: I should point out before everyone runs out to study for the CPA exams, that the fee cited by Doug was not a typical example of a fee.

MR. RICHARD S. ROBERTSON: This discussion has brought to the surface of my mind something that has been disturbing me for a long time. It goes back to the first time my company prepared an audited statement for stockholders. Prior to that time, we had simply distributed a statement in the form of the statutory statement and it was not audited. Although this predated the stock company audit guide, it was necessary to make a number of adjustments to the statutory statement to produce a statement which could be considered in accordance with what then were considered Generally Accepted Accounting Principles.

We had nobody on our staff qualified to make the necessary adjustments. Consequently, we had to rely entirely on our auditor and the final statement was probably more their work than ours. The question is, was their audit opinion an independent opinion?

Situations such as our example and the discussion here today lead me to question whether the independence rule of the accounting profession is strong enough. And, if the actuarial profession believes that a stronger standard of independence is appropriate, is it our place to establish such a rule? If we do, how do we resolve conflicts between the actuary's attitude toward independence and the accountant's attitude?

There are two main reasons why the actuarial profession may tend to take a stricter attitude toward what constitutes independence than the accounting profession. First, the actuarial profession includes a strong and capable independent consulting element. In the accounting profession, if one wishes consulting advice, most of the resources and talent are in the same organizations which provide audits. The seeking of consulting advice from an outside organization is feasible when actuarial advice is needed but may be very difficult when accounting advice is needed. Second, the actuary frequently plays a major role in the preparation of an insurance company financial statement. While an outside accountant may occasionally play a major role in the preparation, such a situation is unusual and even there, the role is typically less than that of the actuary.

These considerations have led me to conclude that the standards of the accounting profession for determining when an accountant is sufficiently independent to act in an audit capacity may not necessarily apply to actuaries in similar circumstances.

MR. CARMICHAEL: First - on separation of function -- in large CPA firms the personnel are different. There are different people providing the consulting service and doing the audit, and there has been a long history, particularly since the 1960s when consulting in general, management consulting, and public accounting grew rapidly, about whether providing any kind of management consulting jeopardized the independence of the auditor. Surveys have been done and considerable research shows that for people familiar with what an auditor does, the concern about the possible incompatibility of functions and jeopardizing of independence goes down to insignificant

levels when people know that there are different people providing consulting versus auditing. The personnel are different. There are auditors and there are consultants. There are different divisions within firms frequently working for one client.

Now, on preparing the financial statements, probably the example given was caused by time pressure in the conversion of statutory financial statements to a GAAP basis. I am sure that will not continue in the insurance industry, but for many clients, particularly medium to small-sized clients, the CPA does get heavily involved in the physical preparation of the statements.

CPAs develop certain expertise in writing footnotes for statements filed with the SEC and in certain requirements of the SEC. A large amount of the footnotes may be written by the CPA and an audit, if the client has a poor system, may result in a lot of adjustments to the financial statements. For a small client their closing process may not be too good and there may be hundreds of adjustments to those financial statements. And for particularly small clients the CPA may participate heavily even in preparing the trial balance.

There is an old saying that you cannot audit your own work to which people give a lot of lip service. Personally, I do not think it is true, although the Institute has some very detailed rules on how much accounting work an auditor can do, and most CPA firms divide the steps in the accounting process and try to draw lines. They cannot go beyond a certain step in the detailed accounting work and still do an audit. The SEC also has certain rules. The importance of independence as far as the auditor is concerned is that he is a party outside management who is giving a professional opinion and accepting a professional responsibility for those financial statements. That has a number of benefits for the users and while it is not the most positive thing as far as auditors are concerned, one of the big benefits is that a user can sue someone else besides the company if something is wrong with those financial statements. Users really do not care how deeply involved an auditor gets in physically preparing those financial statements. That by the way has been supported by research and surveys. The CPAs are very conscious of their own rules that have some very specific guidelines on how deeply involved in accounting work you can get. The users do not care. Users are concerned that someone outside management is in there, looking out for them, they hope, and if that is not true they are quite capable and quite ready to sue. The same thing would be true of an actuary's work when there is public reliance.

Now the one remaining issue raised, certainly a related matter, is the standard of independence. I did suggest that independence ought to have one meaning. The question referred to perhaps a higher standard of independence. I think that one standard is important. The public should be able to have one conception of what an independent "blank" means whether an actuary, or auditor. When you call someone, let's say, an independent actuary, the public should have a right to expect that this means certain things, the same things for everybody who is called independent.

MR. GERALD H. GOLDSHOLLE: May I make a couple of brief observations on the question of independence before getting into the subject of the relationship between lawyers and actuaries? First, we are talking when speaking of independence about a situation in which there are degrees of independence.

Perfect independence does not seem to me to be possible. Who is perfectly independent and totally divorced from all other contact with that particular matter? If you want to be retained next year, are you perfectly independent? If you want to be able to bill your fee, are you perfectly independent?

Second, if you could have perfect independence, I am not sure that you would want it. Would you want somebody that comes in this year and has one opinion as to what is appropriate and somebody else comes in next year and has a second opinion? I am not sure that perfect independence if you could have it is something desirable. In terms of the actuarial profession, I am not sure you could have perfect independence today given the number of actuaries and the nature and size of the insurance institutions that exists. Therefore, what is highly desirable is to quantify the degrees of independence that you are willing to take and make disclosure of the conflicts of interest where they do exist. At the bottom line of this, when we are talking about independence as an abstract concept, we have to remember that the independence is being applied against a broad spectrum of what is within the realm of normal, generally accepted principles in actuarial work and in accounting, and to try to achieve perfect independence when the range of acceptable principles is so broad seems to me to be perhaps a mistake. Perhaps an appropriate way of dealing with the problem is to narrow the range of what is acceptable.

I think the key to an actuary's effectiveness, to an accountant's effectiveness, to a lawyer's effectiveness is his ability to exercise independent judgment. Unless you are exercising that independent judgment whether you are outside the company or inside the company you are not providing your client with the kind of service that he deserves, is entitled to and will eventually be required by the courts to obtain.

There is a recent decision in the securities area involving a major accounting firm that was called on the carpet for lack of independence and I am going to read a portion of it as it may be relevant. "An accounting firm cannot be considered independent when the judgment of the auditors is subordinated to the views of the client, or where the auditors consciously acquiesce in the concealment of material information. Similarly, a firm cannot be viewed as independent where it does not take action with respect to serious past deficiencies arising out of intentional misconduct by the client." There are questions as to independence that arise today in the accounting profession even with its relatively rigid definition of independence and I think they are bound to arise. The objective, I think as an outsider looking at the actuary and the accountant, is one of minimizing conflicts, identifying conflicts and letting eventually society make the decision as to how much independence there should be.

MR. CARMICHAEL: I disagree somewhat. It is quite true that you never have perfect independence and that is really at the heart of the problem. The research done indicates quite clearly that users are far more concerned about the fact that the auditor gets paid by the client and that there are flexible accounting principles than they are at all concerned with any consulting services the auditor might provide and what that would mean for independence. No one is going to do work without getting paid, professional work or otherwise. Somebody interested in that work has to pay for it. No one that is not interested in the work is going to pay for it and you are going to have that fundamental problem no matter how you structure things;

so independence can never be perfectly achieved. There are going to be conflicts of interest whether you are an employee or whether you are an outside contractor.

The ruling that Jerry read is reflective of the problem, that is the box or corner, that you get into with rules on independence. Any time one has sub-standard performance, it is normally going to involve doing things that you should not have done or not doing things that you should have done and it can always be turned around and used as evidence that the professional lacked independence. There was that conflict of interest there and the professional sided with the wrong side in that interest. So, to me the wording in that ruling that said the CPA was not independent is almost irrelevant -- certainly beside the point. The important thing was, in that case for example, that they knew about deficiences in financial statements the client had issued and they did not stand up and tell anybody about it. They certainly should have and that was certainly sub-standard performance, but you do not achieve anything more by labeling that lack of independence than when you say that sub-standard performance should not be tolerated, period.

Now, it is because of the impossibility of achieving perfection in independence and the pervasiveness of conflicts of interest no matter where the professional is located that I think a profession needs to adopt a rule on independence that means the same thing in the same circumstances to everybody. It is necessary because an expression of the collective judgment of the profession is necessary so someone cannot come back and say later this fellow was not independent because he gave in to a conflict of interest or this fellow was not independent because he did something that was sub-standard in the circumstances. If the profession collectively states its rules clearly and unequivocally, and says this is what you have to do to be independent, then if you do that, you are independent, and you at least will have the collective support of the profession for what independence means. If you do not have a standard adopted by the collective judgment of the profession, then you are vulnerable to anyone coming in under any circumstances saying you did not have the necessary degree of independence in these particular circumstances because you did the wrong thing.

MR. GOLDSHOLLE: In preparation for coming here today, I did some legal research on the law specifically applicable to actuaries. A search of the literature indicates one article that deals with the legal interface between actuaries and lawyers. A colleague who did a study in the actuarial literature found the same thing - one article. There is not very much on it. It is sort of virgin territory.

We then did a survey of the cases and manually we found virtually nothing. We then enlisted the aid of a computer and we printed out all of the cases in New York and California that used the word "actuary" even once. In New York, there were 39 cases; in California, there were 20 and most of these cases made such profound statements as "the teachers retirement system employed an actuary, accountant, lawyer and janitor." They did not have very much in them. So while there is a very small amount of material on law regarding actuaries, there is a great deal of material on the law regarding boards of directors and their obligations, and on law regarding other professionals and their responsibilities. This law has been and will continue to be applicable to actuaries, and with increasing frequency. Some of it is rather frightening and points out the need for professionalism, for confidence, and for integrity.

Why are lawyers getting into the act? Traditionally, most matters involving actuaries have essentially been the domain of the actuary. All of a sudden, lawyers with increasing frequency are getting involved. Why? Two reasons.

First, boards of directors are becoming increasingly aware of their legal responsibilities. They know what it takes to defend a lawsuit. Many corporations have been sued under the federal securities laws and under state law, and directors are anxiously trying to protect themselves against liability. Second, actuaries themselves are getting concerned about the type of advice that they give and their personal legal responsibility. We have seen the medical malpractice problem arise. There is a lawyers malpractice problem as well. Lawyers are having difficulty obtaining malpractice insurance and the same type of thing is undoubtedly going to spread to other professions.

Let's talk about the board of directors first. The statutes of most states specify that the business of a corporation shall be managed by its board of directors. It is widely recognized that boards of directors do not manage in the conventional sense. What they are expected to do is to provide direction. The cases make it clear that directors should, "Know of and give direction to the general affairs of the institution and its business policy." They also make it clear that the directors are required to use their independent judgment in arriving at these decisions. They must exercise some degree of skill and prudence and diligence. State statutues frequently codify the level of care required by directors. They go something like this:

> Directors and Officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care, and skill which ordinarily prudent men would exercise under similar circumstances in like positions.

The cases have long held that directors of insurance companies and banks will be held to a much higher standard of care than the ordinary director of a manufacturing corporation. As a matter of fact, the New York insurance law has a provision that says in the event of a fraudulent insolvency of an insurer, a director is guilty of a misdemeanor unless he exercised the appropriate degree of care required of directors of insurance companies.

What is negligence? What is the appropriate degree of care? The cases say, "It is impossible to give the measure of culpable negligence for all cases as the degree of care required depends on the subjects to which it is to be applied." What would be slight neglect in the care of a quantity of iron might be gross neglect in the care of a jewel. It is clear that directors of insurance companies, for example, cannot rely exclusively on the supervision of their business by the state insurance department. A 1930's case involved a suit against various directors of an insolvent insurance company. The directors claimed, "Well look, we knew the Superintendent (of Insurance) had examined the company and we relied on his examination to point out any deficiencies." The court rejected that as a defense. A director cannot rest entirely upon the vigilence of a Superintendent of Insurance. Such reliance constitutes no answer to a charge of nonfeasance. It is the specific responsibility of a director of an insurance company to do many things in the investment area and particularly in the dividend area. It is that area that I think the actuaries are most concerned about.

The board of directors, by law, is charged with the determination and payment of dividends to policyholders of mutual insurance companies and to participating stock companies.

> Every domestic mutual life insurance corporation shall be organized, maintained and operated for the benefit of its members. In declaring and paying such dividends as the Board may declare, they shall be fair and equitable to the policyholders.

There is a very practical matter in passing upon dividends. All the board can be expected to do is to direct the company's dividend policy, but to do this the actuaries traditionally prepared memoranda, dividend formula and the like. The board members are not actuaries but have a background in business. All they can reasonably be expected to do is to apply their general business sense to what the actuaries have recommended. They know what interest rates are possibly better than most actuaries. They can determine whether or not these methods that are being used make sense and they can also monitor the officers' actions to make sure that what is being done is fair and equitable from their point of view. They require information in advance. They require information in understandable form.

The lawyer's role in much of this is to make sure that the information that is going to the board of directors is in such form that a reasonable director can understand it, can act on it, can raise the necessary questions, and can make the informed judgments that the law requires him to make.

The general standard of care under state laws is not the only standard of care directors must comply with. The federal securities law apply what is generally regarded as a higher standard of care. A director, to avoid personal liability for the full amount of any securities issued under a registration statement by his company, must have and be able to prove that he has conducted reasonable investigation, and has reasonable ground to believe, and did believe that the material statements in the registration statement were true and complete. The standard of care is a higher standard than under New York law, the standard of the prudent man managing his own property. Under ERISA, to the extent that a board of directors is a fiduciary or the individuals are, they too will be held to meet higher standards of care on behalf of plan participants.

There are a couple of things that are on the horizon in terms of director responsibility. You know about class actions. You know about derivative actions. Generally the level of care required by directors has been rising dramatically in recent years.

The cases and concepts in the federal securities area with its statutory higher standard of care have been filtering down to the state law area. The courts are becoming harsher and harsher on defendant. The courts are granting broader relief when they find something wrong. They are no longer limited to just damages. They are giving injunctive relief and restructuring boards of directors entirely.

Another significant element is the fact that politicalization has set in. Groups of people are trying to use the corporation to achieve political ends. They are turning the legal system into a method to achieve those political ends.

And, finally, it is not yet here, but I predict it is going to come, there is liability for inadequate results. Litigation has only been instituted when something went wrong in the past. With the increasing duties of care, directors are going to be held liable for not doing things good enough. It will not be sufficient, I predict, for directors merely to say nothing bad happened. They will have to be able to account for their actions as to why something good did not happen, why they did not seize the corporate opportunities that presented themselves.

In short, directors are becoming increasingly aware of their own personal liability and responsibility, and the courts are no longer letting them get away with something. To quote from a decision of the highest court of the State of New York last year, "We regarded it sufficient to reiterate the long standing rule that the director does not exempt himself from liability by failing to do more than passably rubber stamp the decisions of the active managers."

MR. BLAZER: Jerry, do you see a direct relationship between the responsibilities that the boards are being held to and the responsibility that actuaries in the future will be held to? I think we have been fortunate as a profession not to have really had our day in court.

MR. GOLDSHOLLE: Yes, I think there is in fact a parallel. The parallel arises in the case particularly with accountants. Accountants have already been subject to suit in many different circumstances. Mr. Leslie Shapiro, at Concurrent Session A on ERISA*, pointed out a case in which a CPA of a major accounting firm was criminally convicted as a result of a misleading footnote contained in a financial statement which was found by the jury to have been known to him to have been misleading.

Last year, we had a case in which a managing partner of a major accounting firm, in the case of National Student Marketing, prepared a financial statement that contained another misleading footnote and in an unaudited part of the statement contained an item that should not have been taken as income as found by the jury. The court did not find that he was intentionally evilly motivated; it merely found that he was reckless. He did not do enough. These are facts that are to be determined by a jury as to whether or not the actuary has done enough, or the accountant has done enough.

These are not securities cases alone. These are cases which arose under criminal statutes making it a crime to provide misleading information to the government and under mail fraud statutes because the mails were used. The actuary will similarly be liable because under ERISA the actuarial reports with respect to pension plans are sent through the mails and filed with a government agency.

MR. GEORGE R. WALLACE: I am on the Joint Committee on Independence, and am pleased to see that this one, very controversial area has been raised. I do not know whether the legal profession has solved it for us, because in Mr. Goldsholle's remarks he indicated that the directors had to have an informed judgment. Maybe that solves our problem. The Joint Committee has not come up with a final report and obviously this is one of the areas of great difficulty for us. I was very glad to see that Mr. Carmichael and, of course, Mike Rosenfelder are saying basically the same thing, that the chief issue is that of professionalism. Now, in cases where independence is required, it certainly is the objective of the Joint Committee to define independence in

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such a way that it is probably consistent with the accountants' definition of independence, leaving aside this particular thorny issue of the self audit situation, which is admittedly thorny and which I would not like to get into because it has yet to be resolved.

MR. PETER E. FRIEDES: My question is directed to Mr. Carmichael. You said that an audit firm can serve a client in two services -- (for example, Audit and Tax Advice) because the Independent Audit is done for the stockholders and the public, and the Tax Advice is done for the management and management has the ultimate responsibility. Therefore, there is no inherent conflict, and I would agree with that.

Your analogy is that an audit firm can serve as the actuary and the auditor because the actuary is serving management, like the tax advisor. But under ERISA, the actuary must now serve the plan participants, whose interests might be in conflict with the stockholders. Is this unique characteristic -- that the actuary must serve plan participants--being considered by the AICPA?

MR. CARMICHAEL: The distinction is recognized and is being considered. I do not think it would lead me to a different conclusion about the necessary responsibility of management for the representations in the financial statements. The actuary, it is true, would have to be satisfied with the appropriateness of what management ultimately decided on and would in certain circumstances be compelled to resign if management was going ahead with something the actuary thought was inappropriate. So the standards of behavior require that the actuary may require severance of the relationship, but it does not change the ultimate authority or responsibility of management for those representations.

MR. FRIEDES: So you believe the Accounting Principles Board will certainly allow the situation where the auditor is both the actuary and the auditor?

MR. CARMICHAEL: Yes. It would be an ethics ruling of our organization.

MR. BARNHART: This is a related question to the one just asked. It is directed to you, Doug, and it relates back to part of your response to Dick Robertson's question earlier where you indicated that it was not felt there was a conflict of interest if different personnel with a CPA firm work, say, on preparing a financial statement as compared to auditing that statement. Now here is the point where I have trouble with this.

Suppose that a consulting actuarial firm has developed the reserves, the methods and basis of the reserves, and has participated in the direct preparation of a financial statement. Then a CPA firm audits that statement. I believe that you indicated in this situation that the responsibility of the auditor would be at least to satisfy himself about the qualifications and the general methodology employed by those actuaries. Is that a fairly correct summary of what you were commenting on there?

MR. CARMICHAEL: It is close. He would have to satisfy himself about the professional qualifications of the actuary and most people have some rules and guidelines for this. He would not have to satisfy himself on the methods. He has to understand what methods are being used. He has to understand what those methods result in as far as financial statement amounts, but he does not need to satisfy himself that those are the right methods.

MR. BARNHART: We agree at least then on the qualifications. Here is a point that bothers me. If the actuarial division of the CPA firm has done this work, in other words, someone within the same firm, and then that firm's auditors audit that work, I still feel that there is a measure of conflict of interest here. In this case it certainly is going to be presumed that the CPA firm would not have put those actuaries on that initial work of preparing the financial statement unless they felt in the first place that they were qualified to do it. It seems to me that you are in a position of a distinct conflict of interest at this point because now in your auditing capacity you are saying, "we are going to at least question or satisfy ourselves about the qualifications of the actuaries," when in fact this is really already presumed. I do not see how you escape a rather definite conflict of interest at this point.

MR. BLAZER: Paul, in the time remaining I will respond to your observation. When the actuarial division of a CPA firm does consulting work for an audit client, it is because the client has retained the actuaries as consultants. Such a relationship does not come about by the assignment of personnel by the auditor. Further, the key to the relationship is professionalism. The actuary has a professional responsibility to his client that is not reduced or eliminated because he is consulting with an audit client. When I am retained by a client, I am no less professional because I am affiliated with a public accounting firm.