RECORD OF SOCIETY OF ACTUARIES
1991 VOL. 17 NO. 1

INDEPENDENT AUDIT – AN ACCOUNTANT'S PERSPECTIVE

Moderator: GLEN M. GAMMILL
Panelists: BRUCE D. BENGTSON
ROD P. FARRELL*
DAVID D. REAL†
Recorder: GLEN M. GAMMILL

A panel of Certified Public Accountants will discuss a full range of issues concerning:

- Objectives of the independent audit
  - Auditor's report
  - Independence issues
- Generally accepted auditing standards (GAAS)
- Role of AICPA and the Insurance Companies Committee (ICC)
- Relationship with other bodies
  - FASB
  - SEC
  - Society of Actuaries
- Current and future agendas for the ICC

MR. GLEN M. GAMMILL: Our industry is influenced by many important constituencies. Among those constituencies is the public accounting profession. Our panelists will provide us with some insights into that profession and into one of their most important services, the independent audit. Our first panelist is David Real. David is a CPA in Texas and Oklahoma and graduated from the University of Oklahoma.

David is the partner in charge of the Audit Department of Grant Thornton in Dallas, and he currently serves on the AICPA's ICC. David is a member of the AICPA, the Texas Society of CPAs, the Oklahoma Society of CPAs, and the Insurance Accounting and Statistical Association (IASA). David will be providing an overview of the public accounting profession and its influence on our industry.

Following David, our next panelist will be Rod Farrell. Rod's a CPA in Texas and New York and graduated from Texas Tech University. Rod's a fellow partner of mine at KPMG Peat Marwick and serves as the insurance coordinator for the Southwest region of our firm. He is a member of the AICPA, the IASA, the National Association of Life Companies (NALC), and the Texas Legal Reserve Officials Association. Rod's focus will be on GAAS and how those standards impact our industry. In a nutshell, he will discuss everything you wanted to know about materiality but were afraid to ask.

* Mr. Rod P. Farrell, not a member of the sponsoring organizations, is a Partner of KPMG Peat Marwick in Dallas, Texas.

† Mr. David D. Real, not a member of the sponsoring organizations, is a Partner of Grant Thornton in Dallas, Texas.

Our final panelist is Bruce Bengtson. Bruce is an FSA. He graduated from Augsburg College with a BA in Math and Physics and joined Deloitte Touche in 1980. Bruce currently serves as a principal in his firm's Actuarial, Benefits and Consulting Department. Bruce will complete the panel's formal remarks by focusing on the role of the actuary in the independent audit activity.

MR. DAVID D. REAL: I'm going to talk about several things, and I hope to keep all of them fairly brief. I will be giving you an organizational overview of the accounting profession, talking briefly about the ICC and its role, and finally discussing the environment in which the insurance industry is operating today.

When Glen first asked me to be a panelist, he told me that one of the things I should consider discussing was the organizational structure of the public accounting profession. As soon as I finished visiting with Glen, I called the AICPA and asked the people there to send me an organizational structure that I could use in this presentation. About a week later, the crate arrived, and I immediately concluded that its contents weren't going to be a lot of value to me. What I'm going to be discussing with you is not something official from the AICPA but my perception of how the accounting profession is organized. There are three types of bureaucracies that the accounting profession deals with on a regular basis, the first are the various state boards of public accounting, the second are the various state societies of public accounting, and the third is the AICPA. The state board of public accounting has something in common with Mike Wallace and Morley Safer of the television show "60 Minutes," and that something is that, when you walk into your office, you never want your secretary to tell you that any of those people are on the telephone because you don't want to hear from them. The state board is a regulatory authority. Its responsibility is for licensing CPAs in a state, and whatever it can give it can also take away. State boards also determine the criteria for being a CPA in a particular state, and that criteria tends to vary from state to state. While each state requires candidates to take the AICPA's uniform examination, which the state board administers, the board can also set other criteria. For example, once you pass the exam, the state of Texas requires two years experience before you can become a CPA in Texas. In Oklahoma, when you pass the examination, you're a CPA. The state boards also deal with such things as reciprocity and the guidelines to transfer your certificate from one state to the other. Such boards also set continuing education requirements. Those requirements have changed vastly over the last five years. Virtually all the states have very aggressively moved into continuing education requirements.

The various state societies of CPAs function under several local and regional chapters. Such societies have numerous member services. Generally, local firms get a greater benefit from these societies because they offer business evaluations of your practice, and they provide advice on how to better run the practice and how to prepare for peer reviews. For example, if your firm practices before the Securities and Exchange Commission (SEC), there's a requirement that it have a peer review. That review means that another accounting firm reviews certain of your projects and audits during the year. The state society can also arrange for these peer reviews. Such societies can also arrange for malpractice insurance.

The AICPA is the granddaddy of all the professional accounting bodies. The AICPA has the greatest day-to-day influence on the accounting profession. The AICPA was

founded in 1887 and currently has over 300,000 members. It maintains a staff of about 800 people, and its national headquarters is in New York City. The AICPA also has an office in Washington, D.C. The AICPA has several objectives: to promote uniform certification and requirements for maintaining professional competence; to promote public confidence and professional integrity; and to serve as a national representative of the accounting profession before regulatory bodies. One of the AICPA's most important objectives is to provide technical advice to both the government and private sectors.

There are three major accounting driven bodies that have a dramatic impact on the profession: first, the Accounting Standards Board (ASB); second, the Accounting Standards Executive Committee (ACSEC); and third, the FASB. The ASB was formed in 1978 and is responsible for the promulgation of auditing standards -- not accounting theory, but the actual process of doing the audit. The ASB currently comprises 18 members drawn from every sector of accounting from government to public to private. Publications are basically issued through statements on auditing standards called SASs. Most of you are probably familiar with one of their publications, SAS No. 11, concerning using the work of a specialist. SAS No. 11 applies when accountants work with actuaries during the course of an audit. The ICC, which I'm going to talk about in a moment, reports through ACSEC. However, anything that we issue dealing with auditing is issued through the ASB. ASB is also responsible for the various industry audit guides such as the stock life guide and the property and casualty guide.

In 1959, the AICPA formed the Accounting Principles Board (APB). Subsequently, most of the promulgation that came out dealing with accounting theory was from the APB. But in 1972, the APB was replaced by ACSEC and shortly thereafter FASB was formed. FASB is the final authority on promulgating accounting theory. One of the Statements of Financial Accounting Standards (SFAS) that you're probably familiar with is SFAS No. 60 dealing with the insurance industry. Obviously, there's a little competition between all of these different bureaucracies within the profession.

There are many committees within the AICPA ranging all the way from the Relations with Actuaries Committee to the ICC of which I'm a member. The ICC cannot promulgate new auditing material nor can it promulgate new accounting theory. The ICC can only interpret and give guidance to the application of current theory and current auditing practices. A problem occurs when the ICC steps outside of what already exists as promulgated by the ASB or the FASB. In such cases, we get our hands slapped. This is my third year on the committee, and we've had many projects on the table. Quite frankly, my first two years of service were very frustrating because we'd send a paper to ACSEC, ACSEC would look at it and send it to ASB, ASB would say to send it to FASB, and it was almost impossible to get anything issued.

Things change and our productivity seems to have improved. Let's review a few of the ICC's completed projects. The ICC completed the Property Liability Insurance Company audit guide. This guide was in the works for more than five years. Practice Bulletin 8, which focuses on the application of SFAS No. 97 to the insurance enterprise, was finally issued. This bulletin was issued at a point when, in my opinion, it was no longer meaningful. The ICC has also issued some notes to

practitioners relating to auditor responsibility concerning the Statements of Actuarial Opinion required by insurance regulators. At this time, there is a project in process to rewrite the audit guide for stock life insurance companies. This project is a hot item, and the AICPA wants it done in two years. There's also a proposed standard of practice (SOP) for guidance in assessing transfer of risk in property and liability insurance companies. This SOP is basically a reinsurance paper and has been reviewed by ACSEC. ACSEC has said it has its own agenda for reinsurance, which means that the FASB is going to be addressing reinsurance. I can tell you there are major changes happening in the reinsurance area. I think the FASB will take a close look at reinsurance. Another good paper by an ICC subcommittee, on which my cohort, Mr. Farrell, was a member, concerns auditing loss reserves. Although it's a casualty industry paper, I think it has many applications that could be used in the life industry.

In February 1990, the subcommittee on oversight investigation issued its paper entitled "Failed Promises." That committee was chaired by Congressional Representative John Dingell of Michigan. You have to believe that the catharsis for that paper was the savings and loan industry, and there are many analogies in the paper that relate the insurance industry to the savings and loan industry. Dingell says very early in his paper that an insurer's willingness to pay is a function of two things, the insurer's access to the legal system and to the regulatory bodies. He says the insurer's ability to pay is a function of proper regulation. The area of proper regulation is where he appears to have some of his deepest concerns.

Another key issue is management's integrity. In the situations that he reviewed, he wasn't too impressed with the integrity of management. Over one and a half years, looking at basically four failures, he concluded that there was a tremendous potential for disaster. While he focused on property and casualty company failures, I think it's really important to look at some of the things that the subcommittee found in common with S&Ls, because I think that many of these things are the same things you're going to see on the life company side. The common elements were: rapid expansion (companies moving into lines of business very quickly when they really didn't have the infrastructure to support what they were doing); extensive and complex reinsurance arrangements; overreliance on managing general agents; and excessive underpricing and reserving problems. He specifically talked about actuaries, false reports, reckless management, gross incompetence, fraudulent activity, greed and self dealing, and the failure of early detection by regulators and independent audit firms. He concluded the most disturbing similarity was deplorable management attitudes. He said, when the fatal results of these outrageous attitudes reach the breaking point, the officers and directors of these companies simply walked away leaving somebody else to clean up the mess with no signs of remorse and many times moving over to other insurance companies where they were once again involved in very similar circumstances.

Regarding reinsurance, Dingell said nobody seemed to know where the chain began, nobody seemed to know where the chain ended. He said that the entire industry was counting on in the end that these reinsurers would pay, and many times there was absolutely no diligent research done to determine whether or not the reinsurers really had the ability to pay. Another point about reinsurance concerned regulation. Dingell said that state regulators had not developed any kind of system to monitor

reinsurance. Unreliable information he says was simply provided by the industry itself, most of the time it wasn't verified by independent auditors or qualified actuaries. He said the information was typically outdated, and based on guesstimates, omissions, or just outright bold-faced lies.

The General Accounting Office (GAO) had very similar concerns: multiple regulators, infrequent examinations, rapid growth, poor underwriting, extensive underpricing, and on and on. The GAO said that the regulators rely too heavily on information prepared by the insurance companies without periodic examination and filed on an untimely basis taking six weeks to three months to review. The GAO said that 35 states did not require audits. Of course, a new NAIC model rule will change that when it becomes effective. The GAO also said that field examinations only cover every three to five years and that a few states have no mandatory requirements even for those. The GAO pointed out that the accounting guides were old and outdated and not useful.

Since the GAO report, the Senate has commenced its hearings, and of course that's led by Metzenbaum. The Congress and the Senate feel like the savings and loan situation has left them with a real nasty impression from the public. I believe that they are determined to get out in front of the insurance problem. The NAIC and state regulators have had two years to try to get organized and to get some standard procedures put together. I believe that some time this year there will be new legislation that will be introduced by Dingell, and that it's very possible that that legislation will require federal oversight.

MR. ROD P. FARRELL: I want to cover four major areas: GAAS; the circumstances that require an audit to be performed; the types of audit reports accountant's can issue; and, finally, a summary of what the accounting and auditing literature says about the use of an actuary in the audit of an insurance company.

Generally accepted auditing standards, as David mentioned, are issued by the ASB of the AICPA, and our code of professional conduct mandates that we adhere to these standards. These standards are the rule book that we play by. I want to give you a brief overview of those standards. There are three basic areas of the auditing standards: the general standards, the standards of field work, and the standards of reporting. The first general standard deals with the qualifications of the auditors and the quality of their work and sets out the requirements that the auditors must have proper training, must have a formal education in the area of accounting and auditing, must receive proper supervision during the early years, and must have reviews of their work during their training period. The second general standard deals with the principle of independence. This principle of independence is something that the profession takes very seriously in order to maintain the confidence of the general public. This principle states that the accountant has to be independent in fact and in appearance. It's a pretty tough mandate. The third general standard deals with exercising due care in the audit process. Again, this standard requires a critical review at all levels on an audit so that all persons, whatever work they perform on the audit, must be reviewed by their superior, and all members of the audit team have a responsibility for performing their duties with diligence.

The standard of field work contains the most written material concerning GAAS. There's over 800 pages of small type that talks about all the different standards of field work. I picked out seven main areas to give you a flavor of the kind of rules accountants deal with. There's a standard on planning and supervision where every audit has to have documented planning before you start as to the overall strategy and scope of the audit, what each member of the audit team is going to do, and how each is going to be reviewed, how the work's going to be assigned. There has to be comprehensive planning documented for every audit and comprehensive instructions as to who provides the supervision.

There's also a standard on audit risk and materiality. Glen told me that I ought to give you a definition of materiality. Materiality is like beauty, it's in the eyes of the beholder. There's no formula that you can use to calculate materiality. In the auditing standards, it says that you've got to determine risk and materiality during the planning process and devise the auditing procedures that are appropriate based on your evaluation of each area of the audit. Also, we have to look at the internal controls of the company and consider how those controls will effect the procedures that we apply in the audit. Then there's the concept of evidential material. That concept states that the auditor will form his opinion based on the support of the management assertions in the financial statements that are documented by evidential material. We can't just go in and accept management's assertions. We have to get evidential material that supports management's assertions. Supporting management's assertions is clear-cut if you have a physical inventory of widgits sitting in a warehouse. You can count the widgits to document management's assertion that it had so many parts in the warehouse. With policy reserves, it's not quite that easy. The burden is on the auditor to include in his work papers sufficient evidential matter outside of the assertions of management to support the issuance of his opinion.

There's a whole section in the standards of field work concerning related party transactions. The profession has become very sensitive to related party transactions. There is required accounting disclosure for related party transactions, and this issue is something that auditors really focus on. As was mentioned earlier, SAS No. 11 deals with the use of the work of a specialist, and this standard is coming under increased scrutiny. David mentioned that I'm on the task force writing a paper on the audit of property and casualty loss reserves. That task force, in its preliminary draft, expanded on SAS No. 11, and the AICPA is not sure it is going to let us get away with that expansion. SAS No. 11 states that the auditor has to determine whether, in gathering the necessary evidential material, the auditor needs the assistance of a specialist in an area in which the auditor is not trained. In fact, the use of insurance actuaries is a specifically named example in the SAS No. 11 of circumstances in which a specialist should be used by the auditor. The standard provides guidance on the procedures that the auditor should use in selecting a specialist, and it provides general guidance on how to evaluate the findings of that specialist. To give you a preview of the audit guide on property and casualty loss reserves coming out, we're hoping to extend SAS No. 11 to say that it's mandatory that an actuary be involved. It will be interesting to see whether that guide makes it all the way through the system that David described.

There's also an auditing standard that deals with auditing estimates, and that standard applies very much to insurance reserves. It discusses management's responsibility in developing the estimates, and the auditor's procedures in evaluating these estimates

and whether you audit management's approach or whether an independent calculation should be performed.

The third area is the standards of reporting. Basically, these standards require an adherence to generally accepted accounting principles (GAAP) and require that the opinion must state that the financial statements are presented in accordance with GAAP. Further, the opinion must state that the financial statements are prepared on a consistent basis in the application of generally accepted accounting principles. This standard also states that there has to be adequate disclosure and that the auditor has to determine that all matters that are of a significant nature be disclosed. There are certain disclosures that GAAP dictates, and there are other disclosures that are left to the judgment of the auditor.

There's also a whole section on auditing standards that deals with the type of auditor's reports and under what circumstances you would issue what type of report. Further, there's a part of the auditing standards that deal with areas like special reports, interim financial information, compliance auditing, and auditing interpretations.

In addition to all the GAAS, there are industry audit guides, and those are another layer of standards on top of GAAS.

Who requires an audit? I came up with several different reasons why a company might have to be audited. First, if a company has traded securities, the SEC requires all publicly held companies to file audited financial statements on a GAAP basis, and this requirement is the primary driving force behind requiring audits. As you all know, there's a NAIC model rule that we think is going to go effective in 1991 in which the various regulatory authorities are going to require almost every company to have an audit. These audits are going to be required on a statutory basis, not GAAP. These rules are basically taking away the ability of the companies to file consolidated financial statements so that each entity will have to have a stand-alone statutory audit.

Another source of audit requirements are lenders. Many companies that have any kind of financing from financial institutions have loan agreements generally requiring that audited financial statements be submitted to the lender. While it's usually negotiable as to whether those are GAAP or statutory, most lenders want to see both, but particularly statutory. There are other governmental agencies that have gotten into the act, particularly the Department of Labor. It is starting to require some audited information on companies that are writing worker's compensation business. There are also other governmental agencies that get involved in requiring audited information. Even if a company doesn't meet any of the above requirements, a company's board of directors may decide that it wants an independent audit. For example, you may have absentee ownership requiring that the company be audited to increase its own comfort.

There are basically four different opinions that the auditor can issue on financial statements, and there are subsets within each one of those. Obviously, the objective when you start an audit is to issue what is called an unqualified opinion. An unqualified opinion is an opinion that states that the audit has been performed in conformity with GAAS. It implies that there's been an agreement on the accounting principles

used within the financial statements, that the financial statements have been prepared on a consistent basis, that the entity being audited is a going concern and that all of the disclosures that are necessary are included in the financial statements.

Today, it's becoming more common for accountants to issue opinions other than unqualified opinions. There are several options. One option is to include what is called explanatory language to an unqualified opinion. There are circumstances when such explanatory language is appropriate. The first is when part of the audit is performed by another auditor (e.g., in the case of a holding company structure), and the auditor that is issuing the opinion on the holding company is relying on another auditor. In such cases, you have to evaluate the materiality of the companies that have been audited by the other auditor relative to the consolidated financial statements. There's also explanatory language that deals with areas of uncertainty. For example, at the time of issuing the financial statements, the outcome of certain future events cannot be determined and therefore cannot be reflected in the financial statements. In the area of litigation, where the company may be involved in a lawsuit in which the outcome is not determinable at the time that the financial statements are issued, an explanatory paragraph that describes the facts and circumstances and states that the company believes it is going to prevail but settlement has not been reflected in the financial statements, gives the reader some idea of the magnitude of the potential exposure to the company. In the property and casualty area where you've got a start up company, or where the company has just started a significant new line of business, or where there are not enough data to accurately determine the reserve liability, the auditor could use an explanatory paragraph to indicate that the company has insufficient data to estimate the claim reserves, and that the ultimate development of the reserves may be more or less than those stated in the financial statement.

Another example of explanatory language is related to this going concern concept. If you determine as an auditor that the entity may not survive another year, then you are required to issue what we call a going concern qualification. In this case you state the reasons for your evaluation why the company may not continue as a going concern in the explanatory paragraph.

Another type of opinion is called a qualified opinion and states that the financial statements fairly present the financial position of the company except for the effects of a particular matter. So the key words in a qualified opinion are "except for." Those qualifying words are placed in the opinion paragraph in front of the statement that the financial statements present fairly. Such an opinion might be issued if there's been a scope limitation in conducting the audit or if there's insufficient evidential matter to allow you to audit a particular area. You would also issue such an opinion where there's a departure from GAAP or where there's been inadequate disclosure. Inadequate disclosures might arise where the independent accountant and the company can't reach an agreement on what should be disclosed.

A third type of opinion is what we call an adverse opinion. That opinion states that the financial statements do not present fairly in accordance with GAAP the financial position of the company. When your opinion gets to this point, the company's got some pretty serious problems. This opinion states the reasons the company's not

following GAAP, in what area it is not following them, and the effect on the financial statements due to the deviation.

The fourth type of opinion is called a disclaimer. This type does not express any opinion on the financial statements and generally results from a significant scope limitation or lack of independence. An example of issuing such an opinion is when audited statutory statements are issued in connection with a stock life insurer. The auditor will issue basically two opinions in one. In such an opinion there would be a paragraph stating that the financials are in accordance with statutory accounting principles and that GAAP have not been applied or haven't been determined and that, therefore, an opinion as to whether the financial statements reflect the financial position of the company in accordance with GAAP has not been issued. The next paragraph states that such financials are fairly presented in accordance with statutory accounting principles. The first paragraph is what is called a disclaimer when GAAP has not been determined.

There are also various special reports that the auditor can issue. One report is on what is called a comprehensive basis of accounting other than GAAP. For example, when a statutory opinion is going to be used for filing with the regulatory agencies only. It's been determined by the accounting profession that there is a separate comprehensive basis of accounting for regulatory purposes and a disclaimer in those financial statements does not need to be included. We can also issue what are called agreed upon procedures reports in connection with performing certain specific procedures on financial information that have been agreed on with the client.

Finally, I'd like to address briefly what the industry audit guides say about the actuarial role in the audit process. The life industry audit guide states that the auditor will need the advice of a qualified actuary to audit a life insurance company and that the actuary should be utilized as a specialist to assist the auditor in expressing his opinion on the financial statements. Further, it says that the auditor can determine to what extent he uses the actuary based on the auditor's own education and professional experience. A key consideration is that the auditor cannot refer to the actuary in his opinion letter. It's the auditor's responsibility to reach a level of understanding and a level of comfort on the financial statements as a whole before issuing his opinion. The use of the actuary is just a tool that the auditor uses to reach that level of comfort. Clearly it's the responsibility of the auditor to have enough understanding of the actuarial issues in order to sign the opinion letter. Now, I'll turn the podium over to Bruce.

MR. BRUCE D. BENGTSON: One of the most important things to recognize is the great difference between the typical company actuary and the audit partner of that company's audit firm. The audit partner has a very broad, financial background. That audit partner may not be as deep into the particulars of a reserve calculation as the actuary but that broad financial background is important from an audit perspective. When that audit partner's broad background is combined with the depth of understanding of an actuary, a more reliable audit process emerges. If the insurance company's valuation actuary can discuss actuarial issues with the audit firm's actuary, bearing in mind the overall perspective of the audit partner, the audit process will be more valuable to the company.

In general terms, the actuary's role in an independent audit relates to reserves. Fundamentally, the financial statement items that would be included in the actuary's responsibilities would be benefit reserves, claim reserves, retrospective rate credit calculations, premium deficiency reserves, due and deferred premiums, unamortized deferred acquisition costs, present value future profits under purchase GAAP, and any other material actuarial items. The actuary should also be playing a role in the proposal, planning and conduct stages of the audit. As the actuary participates in the audit process, it is important to communicate with his audit partner and with his client as to how things are going. There's nothing worse than surprises after February 28 has come and gone. Consequently, when we take a look at the audit planning and proposal process, I think it's important for the actuary to work closely with the client and the audit partner. The actuary needs to be involved in bringing high risk items to the attention of the audit partner throughout the proposal and planning process. Obviously, if an accounting firm is going to offer to perform an audit, the planning process needs to necessarily precede the proposal so that reasonable fees can be quoted. In addition, if you're proposing to do a GAAP audit, you'll need to evaluate the various applications of SFAS No. 60 or SFAS No. 97, and you'll have to consider whether you have any purchased blocks of business. If you're auditing statutory, you'll need to evaluate whether the company has a significant amount of deferred annuity business, and you'll need to understand the application of the Commissioners' Annuity Reserve Valuation Method (CARVM) to the company's annuity business in force. If the company has a lot of universal life, there may be some tricks in applying the Commissioners' Reserve Valuation Method (CRVM) to its life business in force. If the company's licensed in New York, you'll need to evaluate what role Reg. 126 is going to play in the audit process and the extent to which cash-flow testing is appropriate for that company's actuary to provide a statement of actuarial opinion to the company. Cash-flow testing is covered in the Actuarial Standards of Practice Nos. 7 and 14. Finally, if the client has assets and liabilities that appear to be substantially mismatched, it may be a situation requiring greater resources in forming the appropriate opinion. The actuary should work closely with the audit partner to help him to evaluate the reliability of the actuarial, accounting and systems areas. In addition, certain members of the client's actuarial and audit function can contribute to the audit process by assisting in preparing working papers and providing analytical working papers.

What is the actuary's role in actually performing the audit? There are three areas that immediately come to mind in the process of conducting the audit. First is figuring out who's going to staff the job. Typically, in the first year, the actuarial input for a life company audit is as much as five times the normal audit input. For example, there's a tremendous amount of background information that needs to be gathered and organized as "permanent files" for the audit team. There's also a lot of time spent by the actuary in getting the audit staff up to speed with regard to some of the nuances of statutory accounting or GAAP accounting as they relate to actuarial items. Second, the actuary should play a role in determining what time of year certain audit procedures are to be performed. By working with the audit staff, many issues can be headed off at the pass by conducting preliminary reviews in the second, third or early fourth quarter of the year instead of leaving the whole job to January, February and March. Finally, the precise scope of the actuary's involvement in the audit needs to be communicated to the audit partner. The audit partner should have a clear understanding of the procedures that the actuary is going to be involved in and an

expectation of what kind of an end product he's going to get from that involvement. Will it be a handwritten memorandum stating everything looks fine? Will it be a verbal discussion with that partner? Or will it be a formal memorandum prepared in advance of the overall audit opinion to allow the audit partner an opportunity to deal with any significant actuarial issues before the overall audit opinion is issued? It's important for the audit actuary to have continuing dialogue with the audit partner so that there are no last minute surprises.

Finally, what about the conclusions that the audit actuary will reach? These conclusions may have some caveats stating that the actuary is relying upon someone else, either a consulting actuary or some other expert, in forming his or her opinion with regard to the reserves. Very frequently the audit staff will be relied on by the audit actuary. For example, the audit staff often performs the mechanical recomputations of the account values for universal life or deferred annuity products. The actuary will be expected to review the formulas associated with such products and to ascertain that they are appropriate. In addition, the actuary will be expected to conclude that the actuarial methodologies and assumptions are consistent with prior periods, and that they are consistent with the appropriate actuarial elements of the various pronouncements of the FASB and the Recommendations and Interpretations of the American Academy of Actuaries, and the appropriate actuarial standards of practice promulgated by the Actuarial Standards Board.

I think statutory accounting issues are going to become more and more important over the next couple of years, and I hope we'll get a greater level of uniformity between the various states, the NAIC, and the Actuarial Standards of Practice.

In conclusion, I believe that company actuaries can make the whole audit process more efficient by bearing in mind the global perspective of the audit partner. Also, if you can assist the audit partner's actuary to understand the details of what your assumptions and methodologies are early in the year, then surprises can be avoided and an appropriate conclusion can be reached during the audit.

MS. CYNTHIA S. MILLER: I had a question on independence. With more and more of the national accounting firms opening up actuarial practices, how do such practices impact those firms' independence? I've been aware of several situations where an auditor for a company had its actuarial staff offer to do consulting work. Doesn't that pose a conflict?

MR. FARRELL: There's been a concern for years, not only in this area but also in all areas of consulting, by the CPA firms as to how close you walk the line before violating your audit independence. In the actuarial area, we have formulated a policy that we can do consulting with a company to the extent that we are not dictating the policies and procedures and the calculations that the company uses to determine its reserves. We can provide the company with the expertise and present it with various alternatives as to what impact different assumptions would have on the reserves and on the company's financial statements, but we can't go in and say this is the way you must set the reserves. We provide the company with alternatives, advise it to make sure that its assumptions are not unreasonable; but in the end, it's the company that determines the assumptions it uses and the factors that are developed.

MR. REAL: Independence and lack of independence is on a very fine line. It depends on what functions are being performed. If an audit client makes an acquisition and the auditor plays a major role in determining the purchase price, then if you come back and audit the values assigned to that acquisition, you have to be very careful to remain in an advisory role only.

MR. GAMMILL: Of course, a classic example of this independence issue would be the initial GAAP conversions done in the 1970s where most of the companies converting to GAAP were assisted by their own auditing firms. Our independence antennas go up very high whenever we get close to jeopardizing our independence from an appearance point of view.

One question I had concerns the types of opinions. How many times have you seen the other types of opinions issued other than unqualified?

MR. REAL: I have never in 16 years of public accounting seen an adverse opinion issued because by that time the attorneys take over. I have seen all the other types issued.

MR. FARRELL: I've seen an adverse in one circumstance where we were issuing an opinion on statutory and the company had also developed GAAP and GAAP was materially different. We issued an adverse as to GAAP and then issued an unqualified as to statutory, but that's the only time I've seen it.

MR. GAMMILL: In terms of mandatory use of casualty actuaries, the number of casualty actuaries is small relative to the number of companies that are audited. How do you see that imbalance sorting its way out?

MR. FARRELL: What we've done in the paper I mentioned earlier is to describe situations. In the paper, we define a loss reserve specialist, and we've mandated that the auditor must use a loss reserve specialist in evaluating the reserves. Situation one in our paper is where the company does not use a loss reserve specialist. In that circumstance, we say the auditor must use a loss reserve specialist and that the auditor must make independent determinations of the loss reserves using that loss reserve specialist. Situation two is where the company has an internal loss reserve specialist that develops the reserves. In that situation, we say that the auditor still has to use an independent loss reserve specialist and cannot rely on the internal loss reserve specialist of the company. Situation three is where the company employs a consulting loss reserve specialist to review the reserves. In situation three, the company has an internal loss reserve specialist and also employs a consulting loss reserve specialist. Again, we've said that the auditor must use an independent loss reserve specialist to review the work of the consultant retained by the company. Situation four is where the independent consulting loss reserve specialist actually computes the reserves. The paper states that the auditor can use that same independent consulting loss reserve specialist. I think the paper used the term "outside" instead of "independent" because the word independent has different meanings in the actuarial world than it does in the accounting world.

MR. GAMMILL: What's been your experience in terms of how much of the audit you're able to accomplish at interim dates as opposed to dates following the year-end close?

MR. BENGTSON: For those situations where we are the recurring auditor, a relationship is generally established with the actuarial department of the audit client, and a majority of the audit, the actuarial support, for the big issues can be resolved at interim dates. Nevertheless, there always seems like there's fourth quarter surprises, but at least we're able to cut through some of them.