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What Actuaries can Learn from Accountants

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In a previous article I patted us actuaries on the back collectively for the positive influence that we have had on accounting standards. Accountants listen to actuaries, and they have taken on the messages that we have delivered. But isn't the reverse direction also important? Can actuaries learn from accountants? The answer again is "yes." Actuaries can and have learned from accountants. I think it is good to reflect on what we have learned and how we have benefited from listening to accountants.

The influence that actuaries have had on accountants is evident in the development of accounting standards. The influence of accountants on actuaries is less apparent, and is more in the nature of behavioral change. This article is written from my own observations and experience, which I believe to be shared by many actuaries who have spent time with accountants. And spend time with accountants, I did. I was with a major accounting firm for 28 years, and before that much of my work was related to accounting for insurance contracts and required extensive interaction with accountants.

To make my point I will recount some of my personal experiences and comment on what I think I and others have learned. Each experience can be framed by a descriptive caption. My apologies in advance—I go on a bit about opinions. It's something that the actuarial profession has given a lot of thought to, but has not focused enough on one key aspect.

WHAT'S THE ENTRY?

More than once I delivered actuarial figures to accountants and expected heaps of praise, only to receive instead a quizzical look and to be asked, "How do you make the entry?" For accountants, having a single number is like trying to stand on one leg; you can't do it for long. It's important to know, for example, what the liability is, but it's equally important to know how to get from the previously recorded amount to the current amount; e.g., how does the change in the liability affect other accounts, such as revenue and expense.

Context is everything. You can't simply have an updated liability figure; you must know how the change in the liability affects the financial statements. I think actuaries have learned this lesson well and know that there is more to valuation than the liability number; there are all the other pieces of information that the accountants need to make the entries. Which brings me to my next thought.

"THERE IS NO SUCH THING AS GAAP RESERVES"

This statement came from the mouth of one of my mentors from the accounting side. I was incredulous. When he saw my incredulity—it was apparent on my face—he took the time to explain. The objective of financial reporting is to produce financial statements in accordance with the stated basis (GAAP in this instance). The figures that we produce must be appropriate for inclusion in a GAAP-basis financial statement. By themselves, they are piece-meal financial information, and have limited usefulness. They are important mainly in the context of the financial statements taken as a whole. In other words, we should refer to GAAP in relation to financial statements, taken as a whole.

We continue to use the term "GAAP reserves" because it is convenient. No one wants to go around saying things like, "I've finished calculating the actuarial liabilities that are appropriate for inclusion in the GAAP financial statement." We'll stick to calling them GAAP reserves, but we know what we mean.

WHAT WAS THE EFFECT OF THE CHANGE?

Actuaries are always looking to refine their valuations or improve their estimates. This can be through model refinements, changes in assumptions, or any number of things. Accountants are not averse to improvements, but anything that represents a difference or an inconsistency, has to be disposed of (see **What's the entry?** above). The difference may be characterized as a change in accounting policy, a change in estimate, or a correction of an error. Each of these has different financial reporting implications and determining which it is can sometimes be tricky. More importantly, it is a good practice to identify and quantify differences. It's important to know the effect of the changes on the financial information, regardless of how they affect the financial statements. It's part of understanding the information and the measurement techniques. Over the years I have seen actuaries become more aware of the need to understand the effects of the changes and the quantification of the differences seems to be standard practice now.

THE WORD "OPINION" IS A TERM OF ART

Doing audits of financial statements is a multi-billion dollar business. Needless to say, accountants know a lot about what it means to give an opinion.

What is means, in the usual case, is that the object of the review, the financial statements, conform to the standards that apply,

such as GAAP. The auditor gives an unqualified opinion, if he concludes that the conformity is there, or a qualified opinion if he finds some areas of nonconformity. To reach his conclusion, the auditor uses generally accepted auditing standards. The opinion is not a personal view, such as a restaurant review, but rather a professional opinion, one that reflects the standards. The value of the opinion stems from the robustness of the standards.

Actuaries often give opinions. In fact, many statements by actuaries are not based on a review of, for example, reserves, but are representations made by the actuary who is responsible for preparing the reserves. The word "opinion" is often used anyway. Furthermore, the actuary who gives the opinion does not have to be independent. The emphasis in the state regulations is on the need for a qualified actuary to have been involved, either as preparer or as reviewer. By contrast, an audit opinion must come from a CPA who is independent.

But what is important are the similarities. There are at least two important, not mutually exclusive, attributes that opinions from actuaries and accountants share.

- An opinion provides assurance that the subject matter meets standards. By extension of this thought, the information is reliable; that is, it is what it is represented to be. The opinion does not mean more than this; e.g., it does not mean that the company is sound or has good prospects.

- An opinion is not a warranty. The opinion provides a high-level of assurance that the information is reliable, but it does not provide absolute assurance.

The actuary's opinion on reserves states that the reserves meet the requirements of the valuation laws and regulations. For opinions with asset adequacy testing, the actuary states that the reserves, "… make adequate provision, according to presently accepted actuarial standards of practice, for the anticipated cash flows required by the contractual obligations and related expenses of the company." Note the qualifying language making reference to the actuarial standards. The actuarial standards, in particular ASOP 22 *Statements of Opinion Based on Asset Adequacy Analysis by Actuaries for Life or Health Insurers*, do not anticipate that the actuary provides absolute assurance that reserves are sufficient in all circumstance; rather, the actuary provides assurance that reserves will provide for the obligations in moderately adverse situations.

So, again, the value of the opinion depends on the robustness of the standards. In the case of an audit opinion these are both the financial reporting standards and the auditing standards. In the case of an actuary giving an opinion on reserves, these are both the valuation laws and regulations and the actuarial standards. Anyone who has followed or participated in the development of financial reporting standards, auditing standards, valuation laws or actuarial standards can tell you that they are robust.

"Readers of financial statements rightfully expect that the opinion is based on standards."

But the actuary is sometimes put in a situation where there are not robust standards. In the past I have been asked to give an opinion that a certain HMO's rates were "adequate, but not excessive, and equitable." This was a requirement of a state insurance regulator. The regulator that made this requirement did not provide any other guidance, and there were no actuarial standards to refer to. What to do?

In consultation with my colleagues, both actuaries and accountants, I decided that I could give an opinion, but the opinion itself would be longer than usual. The opinion wording included a description of what review procedures I had performed, how I had construed the terms "adequate," "not excessive," and "equitable." I limited the distribution of the opinion. In effect, I was pushing back to the regulator the responsibility to conclude that what I had done served the purposes of the regulation.

This was a satisfactory resolution to the problem of what to do in this situation, but it would not be satisfactory for an audit or a reserve opinion. Readers of financial statements and regulators reading reserve opinions rightfully expect that the opinion is based on standards, not just what the opinion-giver has done in the circumstances, which may differ from what a different opinion-giver might do.

While development of standards is driven by standard setters, the process is robust in part because there is extensive involvement of all stakeholders. Hence development of standards can be viewed as a community effort. By contrast, the benchmarks I used in the HMO rate opinion were ones that I alone deemed appropriate in the circumstance.

Providing actuarial opinions may not be a multi-billion dollar business, but the profession has given the topic a lot of attention. In particular the American Academy of Actuaries (the Academy) has promulgated standards for an actuary to be deemed qualified to give an actuarial statement of opinion (SAO). This is the *Qualification Standards for Actuaries Issuing Statements of Actuarial Opinion in the United States (QS)*, which is the source for continuing education requirements for members of the Academy. The

QS defines an SAO as "an opinion expressed by an actuary in the course of performing Actuarial Services and intended by that actuary to be relied upon by the person or organization to which the opinion is addressed."

The QS identifies no fewer than 55 SAOs. Some of them, such as reserve opinions, have specific standards that relate to the opinion. Others, such as life insurance pricing opinions, do not have specific guidance in the actuarial standards. The QS does not describe a pricing opinion, but presumably it refers to the pricing actuary representing to management or the board of a company that a product is priced to be profitable. Many years ago an actuary might simply have said that a product is profitable. In my experience, the current practice is to state that the product meets the pricing criteria set by the company. So there is a de *facto* standard, not an actuarial standard of practice, but something that provides a common understanding between the actuary and the users of the opinion about what is meant.

While not necessarily articulated somewhere, the reference in the pricing example to the company's pricing criteria shows an understanding of what an opinion is. It is unfortunate that the QS defines an SAO as a type of opinion, but does not discuss what it means to give an opinion.

"What is needed is not necessarily more professional guidance, but perhaps only practical advice."

I believe that actuaries can learn from accountants, and should give some thought about what it means to give an opinion. What is needed is not necessarily more professional guidance, but perhaps only practical advice. When someone asks for an opinion, e.g., that HMO rates are equitable, what should you do? If someone asks if, in your opinion, products are profitable, how should you respond? I hope that this becomes a topic that gets some attention from actuaries. ■

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