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Credibility in a Post-Enron World

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Summary: The Enron scandal is likely to result in a more transparent disclosure of balance sheet liabilities. This panel discussion provides a professional/legislative update and offers pragmatic tips to valuation actuaries about how to respond effectively to increased scrutiny.

MR. JACK F. SULGER: My name is Jack Sulger, and I'm a senior consultant with PricewaterhouseCoopers. Prior to that, I worked at Travelers in the managed care employee benefits organization, and had a variety of responsibilities, including financial reporting, expense management and rating. Our first panelist will be Lauren Bloom. Lauren is director of professionalism and general counsel at the Academy. Another panelist is Donna Novak, who is going to talk about the impact of off-balance-sheet items. Donna has over 30 years of experience and is founder of her own consulting firm. Prior to that, she worked at three major insurance carriers, including the Blue Cross and Blue Shield Association, two of the big four accounting firms, and a major benefits consulting firm. She has held a variety of leadership positions within the Academy.

MS. LAUREN M. BLOOM: The situation in Washington is changing almost daily on the Corporate Accountability Act, so it's fun for me to do this because so rarely do I get to speak on a cutting edge topic.

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Let's address Enron, WorldCom, and related cases. All of a sudden accountants are all over the news. This may be a first. Enron and the related cases have triggered a variety of interesting effects which, of course, are reverberating all over Washington, all over the United States, and, to some degree, all over the world. There has been a lot of adverse media attention for the accounting profession, which I do think is regrettable. They're a good group of people. It's a shame that a couple of folk's actions have led to this situation.

There is strong shareholder anxiety. I heard someone suggest yesterday that the Arthur Andersen Company is single-handedly responsible for the recent fall in stock prices. I'm not sure that's true, but nevertheless it's an interesting point. It obviously triggered immediate and extremely strong congressional action in the form of the newly adopted Corporate Accountability Act.

We will not know for a number of years, and maybe more than a decade, exactly what this statute is going to do. Having read through it in preparation for this talk and having assisted the Academy in some of the work we've been doing on Capitol Hill, I can tell you that it is a very strong, very unique statute and that an awful lot of its provisions will need to be clarified by regulation. I have no doubt that both the statute itself and the accompanying regulations will be tested rather thoroughly through the courts.

Among other things, it establishes a brand new accounting oversight board, a federally chartered private corporation charged with responsibility for overseeing accountants who work on public company audits. It establishes enhanced auditor independence requirements. Auditors were already required to be independent, but they're required to be more independent now than they were before. It heightens management accountability to a degree that I think has yet to be determined. I would have hoped that before the Enron and company cases occurred, management took its reporting responsibilities seriously, that it was careful to ask questions and satisfy itself that financial statements were accurate, and that it worked honestly and independently with auditors. However, if they didn't before, they sure had better do so now.

It certainly enhances financial reporting requirements, and I'm still not sure again exactly how far that's going to go because we haven't seen the regulations and how they'll be applied in practice. It imposes stiffer penalties for misconduct by accountants, financial analysts, and management.

When one is faced with a massive new statute of this sort, there are always a million questions about how it will actually be implemented. It's going to be a long time before we know exactly how it's going to play out, but certainly it's going to have a tremendous impact on the accounting profession and on the actuarial profession as well. The place that the Academy has focused a lot of its attention right now is on the aspect of the Corporate Accountability Act that limits the ability of auditing firms to provide other services to their clients. It used to be that one could set up Chinese walls, do a variety of other things so that an audit firm could also provide other consulting services, apart from the audit, to the company that it was auditing. That is no longer the case.

Unless an accounting firm has advance approval from the audit committee of the company, the audit firm can no longer provide a wide range of consulting services. These include bookkeeping, financial information systems design, appraisal or valuation services, actuarial services, internal audit outsourcing, management, human resources, broker/dealer investment advisor, legal or expert services unrelated to the audit (heaven only knows what that means), or any other services prohibited by the new Accounting Oversight Board. The Board hasn't passed its regulations yet because it won't be established until October 1, 2002.

This is going to have an immediate effect on the actuaries who work in audit firms. Some of the questions the Academy had are: What do you mean by actuarial services? What do you mean by valuation services? What do you mean by expert services? As this bill was being developed, the Academy sent a letter up to the committee writing it asking how they were defining actuarial services. The SEC currently has regulations that set out a fairly clear definition of actuarial services within the meaning of the current accounting requirements (that is to say, the requirements that were in place before the statute was adopted). We suggested that that might be a good place for the accountancy board to start in terms of defining actuarial services for

purposes of the new law. It has been very apparent in Washington that Congress does not feel that the SEC has necessarily done an adequate job in overseeing audit firms to date. So while we think it is probable that the definition of actuarial services won't change very much, we won't know for a while.

What that means is that if you work in an audit firm right now, you may very well find that, absent advance approval from the audit committee of that firm, you will not be providing other services to that firm at all. I will also point out, by the way, that at least for a while, as management tries to struggle with its new responsibilities under the Act, as auditors struggle with their new responsibilities under the Act, as key financial officers struggle (and we'll get to that in a minute), I think it will be highly unlikely that audit committees will readily say, "Sure, come do other stuff for us."

I think it's going to significantly change the roles of actuaries who are currently working in audit firms, but most of you don't do that. Most of you are probably consultants, and you are people who advise auditors, who work with auditors, who do things with auditors, but are not yourselves working in audit firms. So the question that is going to come up for you, and we'll talk about this some more in a few minutes, is, exactly how you are going to best work with auditors in the post-Enron world?

MR. SULGER: The focus of my talk was really going to be how valuation actuaries can better prepare themselves to handle this increased scrutiny that they're going to be under. We've heard a lot about how the analysts are going to be trying to find out more and more about what's happening with regard to reserves and how that impacts the balance sheet. Thinking about that particular question, I was wondering if in order to hold up to all that scrutiny it wouldn't be a good idea that we had a boot camp for actuaries. We'd send them to this boot camp to get toughened up to be able to respond to some of the questions. I was thinking about the movie, "An Officer and a Gentleman," in which Richard Gere is being quizzed by the drill instructor after he messed up. The question was, "Are you a steer or a queer?" I'm sure you can't ask that question today in the military. Certainly those kinds of questions, where there's really no good answer to give, are going to be similar to the questions that you might get as a valuation actuary.

In order to better prepare for answering those questions, you probably want to look at how you're doing the reserves and see if you can make improvements in that process.

My background is primarily in the health area, and I also do disability income. As a result, a lot of the questions that you're going to get asked aren't so much as to the adequacy of the reserves, but more or less to the change in reserves. In doing disability income, everybody's always afraid of that next valuation. The reserves always seem to be ratcheting up. Trying to explain why has always been difficult. So you need to have all the tools that you can in order to answer that question. If you're thinking about improvements, you want to look at all your systems. All the valuation actuaries are certainly dependent on many different systems, and it's often hard to get changes for those systems because it's not something that usually saves a lot of time or staff, or it doesn't provide any services. Generally, enhancements to financial systems get a lower priority, but in today's environment, your chances of getting approval for enhancements are much greater. You want to think about the additional data items that might help you to answer those questions about why reserves are changing so that you can provide an explanation to the financial officer, the president, or whoever is asking the question.

The other thing that you probably want to do is track your data sources back to the original source. In health care, you see a lot of triangles that depend on claims data and premium data, and you need to really understand how those data are being captured and being brought forward into your triangles or what other reports you might have, because a lot of things sometimes happen that just don't look right. You need to either investigate them or understand them better. Some of the things that I would think about, if you're looking at medical claims, is how different aspects are handled, like coordination of benefits (COB), overpayments, and exceptions, and how they get handled and brought forward into the process.

Another thing to do is look at some of the methods you use, and here I'm going to be a little bit contradictory. You need to keep things simple so that you can explain what's happening, but at the same time, you have to be careful and develop processes for determining reserves, which are what I would call all-weather. As time goes on, you're going to find that circumstances change.

For example, interest rates go up and down, and you'll have growth in the business and decline in the business. As these changes occur, it may have a different impact on your reserve than you really wanted to have happen.

The other thing is documentation. A lot of times when I'm out there and asking for documentation, I'm going to be expecting 10 pages, and I usually get one. You really have to have documentation that's more than just, "The valuation interest rate is 6%." You really need to go into why you are using 6%, what your portfolio is, and what kinds of assumptions you're making long term in terms of reinvestment. You really need to support that element.

The other thing that actuaries like to do even less than documentation is to work on financial controls and establish some reasonability checks. You need to do this to protect yourself so that you can get an idea, as things are changing, why they're changing and also to make sure that you're establishing reserves for all the claimants that you have. I know one of the suggestions I usually make, for disability income, is to compare the indemnity that you're establishing reserves for to the payments going out each month. When I mention this approach, everybody says "Well, that's never going to be exact," and they always come up with about six reasons as to why it's not going to be exact. In my mind, it is a security blanket to double check any controls that you might have in your systems to make sure that you're capturing information in all the claims and reserving for them.

After you get done with all those suggestions and you're looking for other things to do, I would also encourage everyone to enhance their understanding and recognition of how others are going to be viewing their financials, particularly the rating agencies and some of the financial analysts. I heard the other day that some analysts have a rule of thumb. If your incurred but not reported (IBNR) reserves for medical claims are less than two months of your paid claims, you're under-reserved. I don't have to tell anyone involved in health insurance that that's not likely to happen, but certainly there might be situations where your IBNR could be less than two months of paid claims, and there isn't anything wrong. But unless you really reach out and understand that these are some of the rules of thumb out there, you're not going to be as prepared as you could be when that kind of question comes back and you need to come up with a good response.

One of my clients hired a CFO, and they heard through the audit partner that when he looked at the financial statements and looked at the reserves, he thought the reserves were redundant just by looking at them. So I thought we must really be wasting our time if somebody can look at it and just tell they're redundant.

Similar to tracking down the sources of information, I would also encourage people to find out about the other operations within their organization, such as billing and collection and claims. I would look at the rating function and the underwriting function. A lot of actuaries, in the valuation area, tend to be in an ivory tower and don't necessarily try to understand some of these other functions. You need to really be able to know more than just the valuation function so that you can understand some of the implications when changes occur in these other areas.

The other suggestion I would make is to come up with an analysis that looks at the various sources of profit. At the Travelers, one of our venerable actuaries would always say there are really three sources of profit: one from investment, one from underwriting, and one from expenses. If you start to look at your bottom line, at your actual results, and if you come up with where you think they're coming from, it might be helpful if they're out of balance to know that you have to look a little bit farther into your reserves or other accruals to see if something is awry.

The other thing that I would encourage valuation actuaries to do would be to reach out to the planning process. In a lot of companies, the planning process is separate from the financial area. I'm never really sure how they can necessarily set the plan without consulting with the financial area, but you know that when you get into a situation where the reserves are much different than what was expected, you're going to be called upon to come up with the reasons. If you then go back and find out that the plan wasn't really based on anything, it's going to be very difficult to come up with that explanation. It would be incumbent upon you to help create the plan in the first place, so that you'd be able to know why the differences are there.

The last bit of advice I would offer is to look at other companies. There's a lot of information on the Internet that you can look at, and it actually includes footnotes. One of the interesting things

that I found is that when you look at different companies and their footnotes, you can definitely see that some do a lot better job of explaining things than others. If you can go out and contrast and compare, you can also help in that process. For health companies, there's a schedule H footnote on the GAAP statement, and the more information you can give there, or shape how the analysts should view that kind of footnote, the better off the company is going to be.

MS. DONNA C. NOVAK: I was asked to speak because I was involved in a project for the National Association of Insurance Commissioners on health liquidity. One aspect of the project was some off-balance sheet issues. It seemed like there would be a tie-in between off-balance sheets and Enron.

It occurred to me that there are a couple of things going on that would be important to this topic, so I'm going to go off my outline for a second. One is that I'm on the Actuarial Standards Board (ASB) general committee, and we are looking at revisions to an actuarial standard of practice on communication between accountants and actuaries. We have had some pretty interesting discussions on the role of the actuary in preparing for annual statements and for reviewing those either as part of an audit firm or as helping a regulator. A few things have been a recurring theme in those discussions: what is the role of the actuary, where do we think the profession is going, and where do we want it to go?

After the terrorist attack, it took about two-and-a-half months for the stock market to come back to where it had been. After Enron, it's taking a lot longer to get back, and it was a very small group of people who have tarnished the reputation of accountants and made people suspicious of the reports that have been put forth on the financial strength of companies. As actuaries, we have that same professional responsibility in our day-to-day activities. When you get the release of the rewrite of the standard on accountants and actuaries, look at it. Look at it from all of the perspectives of the preparing actuary and the reviewing actuary. There are a couple of aspects that we have had a bit of debate about. One is, who is responsible for the documentation? Our current standards say that the actuaries do not have to keep the documentation if it's in the audit file, but as actuarial professionals, do we want to keep our own documentation? Then, if something comes up later, we can show what we reviewed and what we didn't review. Think

about it, weigh it, and comment on it. Also, what responsibility do we have as actuaries if, in our opinion, we see something that isn't quite right? Maybe it's in that gray area of assumptions or in that gray area of conclusions. We take it to management, and management says, "Sit down, and be quiet. This is what we want to report." Where is our responsibility to bring that up to the auditors when they come in or the regulators when they come in? Do we have any responsibility? We asked management whether that is enough. We had some very interesting discussions on that. Again, think about it when you get this standard and weigh in on who is responsible for what type of communication.

As for Universal Valuation System (UVS), I was at a session where regulators were saying that American regulators are thinking more and more of going toward a Canadian system. A Canadian system leaves a lot more of the responsibility and the creativity in doing the valuations to the actuary, where the actuary does modeling. It isn't a tabular system. There's a lot more mathematical science that goes into their setting of reserves. It is a lot more of doing a dynamic financial analysis. So far the issue has been that our statutory statements are also our tax reserves. The IRS doesn't like all that creativity going into reserves or anything that affects the bottom line; therefore, for tax reasons, we haven't gone there. But if we get over that hurdle, then maybe the regulators are going to be asking more of us as a profession than what they have in the past. There are some actuaries who are comfortable with that; and there are some actuaries who don't want to go there. Again, it's something else to ponder for yourself, especially some of the younger people in the room who, over the next decade or two, may see some tremendous changes in this profession. Where do they want it to go?

Getting back on the original outline, the first topic is the National Association of Insurance Commissioners (NAIC) liquidity project. The NAIC, when they originally developed risk-based capital for health, experienced some push back from industry that said "Okay, this is solvency, but you can't pay claims with hospitals, you can't pay claims with some other assets, and RBC doesn't cover liquidity." The Academy of Actuaries originally did a project for them on liquidity. The NAIC accepted the project, accepted the paradigm, but put it on the back burner for a couple of years and has now started looking at it again. The liquidity paradigm is that there would be some safe harbor ratios. Originally it was just a quick ratio, and now we're looking at a

number of other ratios that would define a safe harbor. If a company met a certain benchmark of those ratios, they would have met the safe harbor and would not have to do any further asset adequacy or cash flow-type testing (the type of testing that now is going to be required by all blue book filers, but right now is not required by HMOs and health filers). If you did not pass that safe harbor, you could do some "off-balance sheet adjustments," such as parental guarantees and letters of credit. If you have an off-balance sheet asset, is there an off-balance sheet liability floating around here somewhere to balance that off? Of course, there is. There is an off-balance sheet liability from whomever has that parental guarantee or has that letter of credit.

Surplus notes have always been interesting to me, because, on the statutory side you can make surplus with surplus notes out of nowhere. You have two companies. You have a lender and a borrower, and the lender looks like they have the same surplus they did before. On a statutory basis, if what the borrower is borrowing is not booked as a liability, it's actually booked as surplus. There's a lot of regulatory approval that has to go with it, and the regulators are well aware of it. But on a statutory basis, a policyholder of other companies could look at this and, unless they really look carefully, it would look like the borrower actually had more surplus than they did. So really we're talking about three things: the parental guarantees, the letters of credit, and surplus notes. The statutory accounting for surplus notes shows this as surplus. GAAP accounting, though, which is focused on the stockholder, shows it as a liability. Just because it's statutory accounting instead of GAAP accounting, it doesn't affect the stock value, and it isn't an Enron-type issue. It's still an important issue though because other companies and regulators, if they're not careful, can be misled. Where would they look? In the accounting for surplus notes, the surplus note shows up as surplus in the capital and surplus part for the borrower. For the lender, it shows up as other long-term assets, so it shows up as an invested asset and shows up on schedule BA. That's the statutory accounting for surplus notes.

Parental guarantees show up as a note in the financial statement. A company can have a lot of parental guarantees out to its subsidiaries. The subsidiaries can be counting on those, and it actually is a potential liability of the parent. It doesn't show up on the balance sheet; therefore, a regulator looking at that balance sheet has to be pretty careful to look for those parental guarantees, and I think they are becoming more careful.

MS. BLOOM: Just as a general disclaimer, I am a Luddite. I don't really do tech, so I'm very grateful to Donna for having done that. Some of you are very fond of teasing me at various actuarial meetings about scaring you guys. You claim I come to meetings and scare you about liability and scare you about the Actuarial Board for Counseling and Discipline (ABCD). Oftentimes, it's very funny. We have a good chuckle, someone brings me another glass of wine, and we go on with life. But I'm not kidding. If it scares you, good, and if it doesn't, I have failed here today. Please listen to me very carefully because I'm not kidding. Behave yourselves, please. I have two words for you: Arthur Andersen. If you ever doubted that a single individual can change the world forever, imagine the auditor who put those documents into the shredder a year or so ago during the investigation of the Enron Corporation. One thing I can tell you is that the new Accountancy Oversight Board is not going to be dissolved as the accounting profession's reputation improves. It will improve because accountants by and large are very ethical people. Over time this will calm down. The good esteem in which the profession is held will be restored, at least to some degree, but the Accountancy Oversight Board will continue to be there for all of our professional careers and probably beyond that.

Let me ask you a question. Say you are an auditor. Someone tells you that, in addition to your professional association and the licensing boards of each of the several states in which you were licensed to practice, there would be a brand new federal board established which would basically be there to oversee your profession in ways that you could not yet imagine. It would have authority to invoke criminal penalties, to ensure that you would never work with an audit firm again if you were in fact found to have breached their rules, to adopt the accounting standards set by Financial Accounting Standards Board (FASB) or write their own if they chose. It would even have a broad range of authority that hasn't even been defined yet because they could write their own regulations. Would you have wanted that board to be established? Probably not, right?

I can tell you, having been in Washington when the Corporate Accountability Act was being developed, that no one in Washington, not the highest powered lobbyist, not the most well-connected political animals anywhere, could get in to directly meet with the legislators who were

developing that bill. Oxley and Sarbanes were behind closed doors, period. The accounting profession is much larger than you are, they have a lot of money, they have some very effective professional lobbyists, and that thing went through like a steamroller.

If an actuarial firm today in the current legislative environment were to do something comparable to what that particular auditor at Arthur Andersen was found in court to have done, and it made the press and someone on the Hill decided that it was necessary to set up a federal actuarial oversight board, I do not believe that the actuarial profession, which numbers about 16,000 people in the United States, has the grass roots numbers or the political clout to stop it. So, please, be careful, okay?

Having said that, let me say this. Auditors, chief financial services people, the management of publicly held companies, and even companies that are not necessarily publicly held, are very jittery right now, partially because there's a lot that's still unknown. The Accountancy Oversight Board has not yet been established. We don't really know what its regulations are going to be. We don't even know who's going to be on it. We know it's going to be there, and we know it's going to be there by October 1. We don't yet know exactly what it's going to do, what kind of oversight it's going to impose on the accounting profession, or what the rules are going to be, or how strongly it's really going to proceed. I do know that there's going to be a lot of pressure from Congress for it to be very, very aggressive, because one of the things that's built into the new provision is that the SEC can come down on the board if the board isn't strong enough. There's nothing in it that says that the SEC can come down on the new board if the board is too strong. This suggests a certain mindset.

What that means is that if you are an auditor today, you know there's a new oversight board, but you don't know what it's going to do to you. You just know you're not likely to enjoy it if it does. There are going to be a lot of new and untested regulations imposed by that board, new penalties, new potential criminal liabilities, and heightened scrutiny from the press. Everyone in the financial press, from *The Wall Street Journal* on down, is watching the accounting profession and waiting to pounce, because Enron has broken, WorldCom has broken, and the reporters who broke those stories are instant celebrities. Every reporter wants to be a celebrity; that's why he or

she goes into journalism, which means they want to break the next story. They're all watching the accountants just waiting for a foot to slip.

Then, of course, there's management. We all know now that all of the major companies are required by law to have their management sign off on the accuracy of the financial statements. I was absolutely delighted when the signature requirement time came and went, and the signed financials went in. Thank heavens, there were no enormous bombs dropped. It would have been very bad if there had been. If I am the president of a company, the chief financial services officer, or the CEO, and I have to sign the financial statements and submit them to the FCC, five years from now, I may do that fairly calmly. But today, I'm going to have questions, which means I am going to be driving my auditors absolutely crazy. I can also tell you that the audit committees of the firms who are going to be responsible for the clean audits, the good financial statements, are going to be asking auditors a whole lot of questions, and there are going to be increased potential penalties. The state accountancy boards are going to be looking harder at accountants. You have the new oversight board. One of the questions that I am sure will come up in court over the new accountability act is whether there is a private cause of action on behalf of shareholders against auditors who make mistakes under the statute. That's going to have to be resolved too. So there are a variety of ways that auditors can get hit right now, and they're not sure where it's going to come from or how hard. You can more or less expect them to be walking on the ceiling with anxiety when they deal with you.

By the same token, management faces new challenges. The SEC has gotten the message loud and clear from Congress that they have not been as aggressive as Congress thinks they should have been. Expect the SEC to come down a lot harder on management than they have before. Again, heightened media scrutiny exists. The reporters are out there salivating for new stories, and they are going to be watching every major company, looking for the chief executive officer or the chief financial officer who has made a mistake.

One of the more interesting little side provisions of the new statute, by the way, is that it now requires companies to certify every year either that their chief financial officer has signed off on a code of conduct or that he or she hasn't and to explain why. I don't think there's a company in

America that wants to file a document with the SEC that says, "Our chief financial officer hasn't signed off on the code of conduct because we didn't think it was important." That means all the chief financial officers are suddenly going to have to say "code of conduct." If they're accountants, great. If they're actuaries, they're all set, you've got a great one, this is good stuff. But that means there are going to be a lot of chief financial officers who were suddenly having to work under a code of conduct that they may never have seen before and may not have thought through. It may or may not be artfully written, so that's going to be a problem. Congress really is watching.

We have a mid-term election coming up; we have a presidential election coming up in two years, and I can tell you Congress was livid. Right now nothing gets through Congress because it's a very closely divided legislature, as you know. You have one house barely going one way and the other barely going another way. It's very, very difficult to get anything passed in Washington. It was just amazing how quickly that bill went through. Of course, the other problem with the bill is that because it went through so quickly, there's no legislative history. There are no committee reports. There aren't the kinds of documents that help inform and explain these statutes. So management again is operating under a very strong new statute that imposes significant penalties without a lot of guidance as to what it really means.

Shareholders have lost a lot of money, not only in the companies where there have been scandals, but as the market has tanked in the first place. They're anxious. They're asking a lot of questions, and, of course, management now faces personal culpability on those signature lines in places where it hadn't before. There is a place where actuaries might be most vulnerable. With shareholder anxiety high and with auditors and accountants absolutely refusing to do any of the very creative things that have been done in the past, there will nevertheless continue to be pressure on management to generate profits. I was talking with one of your colleagues recently who pointed out, and I think he's right, that we moved to a world where people expect instantaneous results all the time.

People want to know why you're not generating profits every quarter. One way to generate those profits used to be to do interesting things with the bookkeeping, so that quarterly financial

statements were registered in such a way that the profits were controlled. We've already seen the SEC staff say that they didn't like that with the white paper that was issued on materiality. We now have a statute that says don't play games at all. Nevertheless, that pressure to generate regular profits is not going to go away. I am concerned that one of the places that management may look is to actuaries and start saying, "Why is it exactly that these reserves are so high? You don't really need to keep them there, do you? Isn't that assumption unreasonable? Can't you take a different technique?" I think you are going to find yourselves under significantly increased pressure.

I did a panel with an attorney named Ralph Levy who is absolutely wonderful. Ralph works out of King & Spalding in Atlanta and does litigation work for Tillinghast, among other things. Ralph made the point that it is management's responsibility to be controlling. After all, they're there to control the business, which means they're going to ask a lot of tough questions, and they're going to apply a lot of pressure. It is also the responsibility of professionals to resist those controls. Your value as actuaries, as professionals, is that you bring unfettered, unbiased, professional judgment to bear on your work. When pressure occurs, you will find that you do your best work for your clients and your companies if you resist that pressure. It's their job to push you, and it's your job to push back. It's not always pleasant, but it is what they pay you for.

Let's talk about some things you can expect to face. I think you're going to expect to face a lot more questions. Why are you doing it this way? What are your assumptions? Why did you choose that one? What are the facts underlying your assumptions? Be patient. These are very tense people you're dealing with, so try to stay calm; it will help. If you have to move to decaf, do it. You will also find that you may suddenly be faced with ethical requirements that are imposed, in addition to the code of professional conduct. I am a great one for saying, "Know the code. Follow the code. Work with the code. Use the code." That's still there. But you may well find that the chief financial officer with his or her own brand new code of professional conduct is going to look at you and say, "Well, I want you to follow this too." You may well find, if you're working as consultants, that your own firm imposed ethical requirements that

weren't there before. They may be identical to the code and they may not be. What it means is you may find yourself with a variety of different sources of ethical obligations. If they're well written, they'll probably look a lot like the code.

There are basically two fundamentals of professional ethics: (1) act honestly and with integrity; and (2) do your work skillfully. That is to say, dedicate the time, the resources, and the talent you need to do a professional job. In fact, that's exactly what precept one of your code of professional conduct already says. Nevertheless, you may find that there are other rules that are imposed on you, and you are going to have to follow them. I would not be at all surprised to see additional documentation requirements. One of the things in the new Corporate Accountability Act is that audit documents have to be kept for seven years, period, by law. You will find that they're going to be asking for more documentation than you've been asked for in the past, and, as I said, there may very well be more pressure than you already face to keep reserves low.

So what do you do? First, be very, very, very careful to comply with applicable actuarial standards of practice. The standards that apply are going to be those that are published by the Actuarial Standards Board, assuming you're working in the United States. If you're working internationally, it's going to be trickier. I would strongly urge you to call the ABCD with questions, if you have them. Document your work products. If you're not careful about documentation now, get careful and make sure that you retain your documentation as required by law. One of the things you're going to need to be careful about is what you keep and how you keep it. Work papers need to be kept for seven years, but there are things you probably don't want to keep in your files: back of the envelope calculations, anything done on the back of a cocktail napkin, that's one of my rules. Jokes are bad. One of the problems with being an extraordinarily intelligent person is that extraordinarily intelligent people tend to enjoy their own humor enormously. The snide comment you write in the margin of the document today is not going to be so funny if it's found in litigation, if it's used against you when you're sitting on the stand, or, heaven forbid, if one of those financial reporters gets a hold of it. Some of you may remember the dust-up that your pension colleagues had over cash-balance plans a few years ago. Much of what was troubling about that incident to the American public and to the press was the laughter that accompanied the jokes that were made by actuaries in meetings like this one.

Interestingly enough, the worst comments didn't come from actuaries; they came from attorneys. I'm not going to tell you my profession is stainless either, but they were attributed to actuaries. What happened was there were panels at SOA meetings and enrolled actuaries meetings where people were talking, they thought, among family, and they made a few jokes off the cuff. Those tapes were taken and run across the national news, and all anyone heard was actuaries laughing at plan participants. It hurt the profession, so don't keep jokes around. Be prepared to respond to questions calmly, carefully, rationally, and as many times as you have to.

The other thing to be aware of is that auditors have a lot going on. Management has a lot going on. They're going to have questions. They may not remember what you told them the first time. Take a deep breath, tell them again, and do anticipate that the new rules may take years to sort out because it's likely to happen in litigation and that's not an efficient way to solve problems. It's going to be a while, and there's going to be a lot of uncertainty, so be prepared to ride it out.

The question of which standards apply depends on what you're doing. There are a few, if you're working in financial reporting or working with auditors, that are always going to apply. One is ASOP 10, which is the one on Financial Reporting for Life and Health Companies. Another is ASOP 21, Actuaries Responsibilities to Auditors. It's currently under revision by the standards board. The Actuarial Standards Board will be looking at a proposed revision exposure draft very soon. The exposure draft that's going to the standards board is different than the current standard insofar as it expands responsibilities not only to auditors, but also to financial examiners. I don't know what the standards board will do when it gets this draft. I've learned to try not to predict. Please read it and comment on it.

If you don't volunteer at the SOA or the Academy, and if you don't even read contingencies, and if you don't donate money to the foundation or the Actuarial Education and Research Fund (AERF), that's fine. In other words, if you really just practice and come to these meetings to get continuing education and go home, and you don't do service within the profession, that's fine because that's your choice. The single biggest service you can provide to the profession, in some respects, is to read exposure drafts of standards and comment on them because you are the practitioners. You are the ones who are out in the field working in this area. While the people

who draft the standards are also experienced practitioners, every one of them is, to some degree, limited by the amount of experience they have. You may well have had something happen to you that no one on the drafting committee or the standards board necessarily had, and your insights will be important. I can tell you having worked with the committees and the standards board now for almost 11 years that every comment letter gets read carefully and thought through like mad. Individual words can be chewed over for hours. The results are better if the standards board and the drafting committees have the benefits of your comments, so please look at the draft and get your thoughts back.

Another one is ASOP 23 on Data Quality. Does anyone here do actuarial work that doesn't involve the use of data? I didn't think so. The data quality standard is not practice specific. It applies whenever you work with data. I can tell you it does get used in litigation occasionally. What it says is you are not required to audit data, but, for heaven's sakes, think about the data you're using. As practicable, look at it, check it for reasonableness and consistency, and recognize that there are other aspects of other standards that deal with data as well. ASOP 23 will apply just about whenever you work.

ASOP 41, Actuarial Communications, will also apply. This is a relatively new standard. Again, it is not practice specific. I believe ASOP 41 replaces the old interpretative opinion number three. It has been in place since long before I started at the Academy and was very much outdated (and had been superseded in spots by the new code of conduct). ASOP 41 was written. Be aware, if you're not already, that ASOP 41 applies to oral as well as written communications. This is important. One of the things I've seen come up in litigation against actuaries has to do with something that transpires when actuaries will be sitting in meetings with people. They may even be daydreaming or having a second cup of coffee. People might turn, asks them a question, and off the top of the head, they fire off an answer. If it's an answer that's based on actuarial considerations, and if you're being asked in your capacity as an actuary, or if you're otherwise providing professional services, ASOP 41 is likely to apply to that, so be careful.

There are also going to be standards that are relevant to the particular task at hand. For instance, if you're doing an annual statement opinion, ASOPs 7 and 22 are relevant. If you're doing an

illustration opinion, that's number 24, so be careful. How do you know which standards apply to which assignment because they don't all apply to every one? If you go to the Academy website, you will find a document called the applicability guidelines. Those are developed by the Council on Professionalism of the Academy. They are very, very helpful, and I find that no one in the profession knows that they exist, which is really frustrating because I keep talking about them. I can also tell you, however, the plaintiff's bar knows that they're out there, so if they're using them, you might as well too. The applicability guidelines are a list of tasks that actuaries routinely perform, broken down by practice area. For each of those tasks, there's a list of standards that is likely to apply to that particular task. You may find you want to take guidance from something else. You may find that, in a given instance, the standard isn't quite right, and you need to deviate from it. Nevertheless, the applicability guidelines are a good starting point for picking the standards and working with them.

If you don't already have one, please consider establishing a peer review program in your office. Peer review is not mandatory; you don't have to do it, but I strongly recommend that you do. The simple way to say it is, two sets of eyes are better than one. When you are working on a project, particularly a project of any magnitude, what tends to happen is you work on it long enough and you don't see it objectively anymore. Or you develop a mindset or a focus on where you want to take it, and you don't think about another factor. But if a colleague looks at the work, he or she may say, "Hey, have you thought about...," and that's going to improve your work. On the Academy website, you will also find a white paper on peer review that was published by the Academy's Committee on Professional Responsibility. It is a very useful document. It doesn't mandate peer review, but it does tell you how to set up a program if you want one. It talks about the different kinds of peer review. Different levels of peer review are probably appropriate, depending on the magnitude of the project. Please look at the paper, and feel very free to use it. I really encourage that.

Also consider doing engagement letters with limited liability provisions attached. Work with your lawyers on your engagement letters. The laws of every state are different. Some allow for different things than others, but an engagement letter doesn't have to be a 30-page contract. An engagement letter should clearly lay out the scope of what you're going to do. The amount and

form of compensation you can expect, who from the company will work with you, the person who will provide you with other information, the company's responsibility for giving you accurate information, what the scope of your liability is if something goes wrong, and whether or not the company's willing to hold you harmless if your work somehow injures a third party. All those kinds of issues can be enormously helpful if you find your work getting challenged later.

Also, make sure that you and your client are on the same page about what it is exactly that you're going to do and what your responsibilities are. Talk to your attorney and think very seriously about using engagement letters. Questions will come up in your practice, and I think under the new statute there are going to be a lot of questions. Please take advantage of the resources that the profession has made available to you in the form of the ABCD. I can tell you that no matter what you've heard, the ABCD is not the KGB. These are nine very thoughtful, intelligent, careful people who have worked very hard in actuarial science for many years. They want you to keep out of trouble, and they are very happy to talk to you on a confidential basis to help you walk through problems as they arise.

It's also going to be very important that you keep current. As I mentioned, the audit situation right now is a very fluid one because so many rules have been set without definition, and common practice has not yet grown up around them. Over the next while, there's going to be a whole lot of catching up for everyone who works in the financial services area to do, so make sure you keep coming to seminars like this, keeping current on your publications. Do what you need to to make sure that you are where the practice is as it evolves.

MS. NOVAK: I have one comment before we go to questions. I know of a couple of situations where reserves are being set too high. The point is that whenever you set reserves, they should be appropriate and not misleading. So they can go in both directions. If you're in a situation where you don't think what's being done is appropriate and you've communicated it in some way, it's not bad to send a copy of the communications to your attorney so that it is protected under attorney/client privilege, but it's there for the record if you think there's going to be a problem in the future.

MS. BLOOM: I would really encourage you to do that. Donna makes a good point. It is possible to over-reserve as well. That's not necessarily a pressure you're going to be quite as likely to face, but it is a possibility, and it's important to set reserves within a reasonable range without going too far in either direction.

MR. JOHN FINLEY: Jack, I just wanted to give a comment. You know your two-month rule for health reserves.

My company has a great deal of capitation, which is combined with claim expense. Of course, there are no reserves on capitation, so we're always getting questioned about why our ratio is so low, and, if they would carve the capitation out, it would look very normal. That's just a comment.

MR. SULGER: The more you learn about the process that the rating agencies and the analysts go through, the better prepared you'll be. Obviously they're not actuaries, and they look through a lot of different companies, so they invariably come up with these benchmarks. If you can find them out and understand them, at least you're prepared. You won't need to set your reserves at two months just to satisfy the analysts, but at least you know the question may be coming.

MR. SANFORD HERMAN: I have a question about actuarial services relative to auditing. If you're dealing with a publicly traded insurance company, or even a mutual company, is the review of reserves considered an actuarial service that is supposed to be outside of an audit or is that still permissible as part of the audit function, recognizing that the biggest part of looking at an insurance company is the reserve piece?

MS. BLOOM: I am so sorry to have to tell you I'm not sure. The reason I'm not sure is that I don't know what the definition of actuarial services under the law is going to be. My sense is that it's probably going to be what it currently is under the current SEC rules and that, yes, you probably will be considered part of the audit function, which means it's probably going to be something where you can't do the reserving in addition to the audit if you're working as the auditor's actuary. But I won't know until the regulations are adopted.

FROM THE FLOOR: Let me expand on that from the role of somebody who does work for an accounting firm. I have spoken to my counterparts in the other firms, and I think that at least the position going in is very much as Lauren stated it. Until things are clarified, which may be nine months, a year, or longer from now, the old rules that were set up and the interpretations in 2000 are going to prevail. Theoretically, it's business as usual until it's clarified. We can do anything that we have been doing in the past until that's clarified. However, let me go on to say that even before these rules came out, we've been very, very careful, and I speak for everybody who is in the final four accounting firms who I've spoken to. Watch for appearance sake. When you say reviewing reserves, you can look at any of the engagement letters that I send out, or that I have to approve to send out, and they're very, very carefully worded. You mentioned some things, and I believe that those procedures are almost standard in all the firms that I'm aware of. There are standard terms and conditions. The letters have to be defined. We actually have a review program, as do all the other firms, that not only do we have these rules, but the rules are being followed. Also, I think that the firms are very, very careful, and I would include the major actuarial consulting firms (I have no knowledge of the smaller firms), to define their engagements. If you're talking about doing a reserve review, you make very clear what you're doing. If you are doing a reserve opinion, I would encourage you to consider, if you are worried about potential liability, to put in an additional line and say right there in your opinions, "These reserves are the responsibility of management." You, the actuary, if you're a consultant, are not setting the reserves. If you're an actuary with a company, you may or may not have that role, but most consultants and most of the letters and most of the work that we do will try to make it very, very clear that we are coming up with a reasonable range. In fact, we will not do an engagement unless there is a responsible person within management who can take responsibility for certain numbers in the statement.

MS. BLOOM: I think that's excellent advice. I'm delighted to hear that this is being done and being followed. I certainly know it's true with the large firms. I'm a little concerned about some of the consultants in the smaller firms only because it's a resource issue, but I want to emphasize something here. When I said I wanted to scare you folks today, I meant it, but I also know you

can do this. I have a lot of confidence in the actuarial profession. In fact, in various conversations with friends and folks around Washington, I have said actuaries don't shred. As a group, you are collectively very ethical, very cautious people. You've got the temperament, you've got the skills, you've got the tools, and you can do this.

MS. NOVAK: I can speak to the smaller firms since I'm part of a network of smaller firms and have my own smaller firm. We all came from the bigger firms, and we pretty much do things the way we did there. We network a lot together, and we do a lot of subcontracting and peer reviewing each other's work. It's the best of all worlds.

MR. KENNY KAN: Jack, many Wall Street analysts are fixated on a the days of the paid claims statistic. Over time, that statistic, the number of days that you hope in terms of reserves, will come down because of improvements in technology and processes. Obviously there are some analysts who may not be knowledgeable enough about that, and when they see swings in that metric, they get concerned. I'm curious about your experience with your clients about what you tell them about how to communicate to the analyst with respect to this statistic.

MR. SULGER: The first step is to make sure you know where the benchmarks are, because of appreciation, and then be prepared. As you noted, there are going to be swings just because there are improvements in the claim processing. You have to make sure that that message gets communicated because there's really no one right answer. You might have a different situation where there's a capitation. There might even be situations where you're converting your claims process over and the metric's going to go way up for a short period of time, or hopefully a short period of time. It's really meant to make sure you stress the fact, or be proactive about it, as opposed to letting them draw their own conclusions. I think that's where you really run the most risk.

MR. ALLAN RYAN: I just wanted to follow up on the comment you made, Lauren, and what Bud followed up with. An audit firm provides an audit. Obviously if the work the actuary does in reviewing the reserves for the audit is not allowed, we're out of a job.

MS. BLOOM: No. I think they can do it as part of the audit. If you do it as part of the audit, then you can't go back and do the annual statement.

MR. RYAN: Right. I think what Bud was trying to say was that when you do other work that's related, you have to make sure that the management is taking responsibility, which always was the case. Interestingly, though, I think more on the property & casualty (P&C) side than on the life side, there are situations where audit firms audit the P&C company, but an actuary with the audit firm is also the appointed actuary for that company. It's pretty common because there are so many small companies that don't have an actuary. That could be a more difficult situation, and I think there was even some controversy about it before all of this because you really have to make sure that management is taking responsibility. When there's no credentialed actuary as part of management, it's a little hard to do that convincingly. That's typically not a problem with the life companies, at least the larger ones.