2003 VALUATION ACTUARY SYMPOSIUM
September 11–12, 2003
San Diego, California

Session 9PD
How Will Enron Affect Valuation Actuaries?

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Summary: The bankruptcies of Enron and WorldCom have raised issues with corporate governance and have eroded consumer confidence in U.S. company financial statements. This panel discussion addresses the following: legislative and regulatory overview; potential implications for the regulation of professions in the United States; and implications for valuation actuaries.

MS. STACY LAIFOOK: I'd like to welcome you to today's session, "How Will Enron Affect Valuation Actuaries?" I'm Stacy LaiFook, I'm a Consulting Actuary with Milliman USA, and I'll be the moderator for today's session.

Many of you may have seen on the news last night or in the papers this morning, Enron's former Treasurer, Ben Glisan, was indicted for conspiracy to commit fraud and was sentenced to five years in prison. He's the first of the Enron executives to receive a prison term. Now, what does this have to do with today's session? Honestly, very little. I am not going to draw any parallels between prison terms and valuation actuaries.

Rather, what we will talk about today are the corporate governance issues that have been raised by the Enron, WorldCom and other company bankruptcies in the past several years.

I think we have a very good panel to do that today. The first speaker will be Tom Kelly. He's with Debevoise & Plimpton, he's a partner with that firm and co-chair of

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†Mr. Thomas Kelly, not a member of the following organizations, is a partner at Debevoise & Plimpton and co-chair of its Insurance Industry Group.

its Insurance Industry Group. He regularly counsels life insurance companies, both public and mutuals, on capital raisings, mergers and acquisitions, and other corporate transactional and regulatory matters. Tom will be speaking with us today about Sarbanes-Oxley, what it encompasses and how some insurance companies are dealing with those issues.

Our next presenter will be Anthony Amodeo. He's vice president and senior actuary with Met Life. Anthony will tell us about some of his hands-on experiences with corporate governance issues and their requirements, and how he has dealt with them at his company.

Finally, we have Dan McCarthy, who is a consulting actuary with Milliman USA. Dan will discuss how these corporate governance issues will, in general, affect the actuarial profession. He'll also talk about some of his experiences working with mutual companies on these issues.

MR. THOMAS KELLY: Thank you, Stacy. When we talk about Sarbanes-Oxley, that's really a shorthand for a combination of rules and laws that come from a variety of different sources.

The Sarbanes-Oxley Act was passed by Congress and signed into law on July 30, 2002—a little more than a year ago. There is a whole flotilla of SEC rules promulgated pursuant to the law because there are some provisions that are self-operative in the statute; but there are many, many directives to the SEC to adopt rules and to implement provisions. The SEC has been very busy during the last year, and is just about done now—a very heavy year of rule-making, of issuing releases, getting comments—and much of it quite controversial.

The New York Stock Exchange has issued rules—and so has NASDAQ, relating to the companies listed on NASDAQ—relating to roles of audit committees and all manner of corporate governance.

There is a range of topics covered by Sarbanes-Oxley that could cover a two-day seminar, and we're going to be focusing on a narrow set of issues. The scope is very broad. It covers certification of financial reports by senior officers; certification of SEC filings (that actually is going to be the focus of today's discussion); reports as to internal controls; a greater focus on independent directors on corporate boards; a much heavier reliance on independent directors in corporate governance, on the audit committee, and other committees, charging them with greater oversight responsibility; and tighter definitions of what is an independent director.

A favorite topic: a set of rules imposing obligations on lawyers that are hotly debated as being perhaps in conflict with traditional ethical concepts; reporting noncompliance with law; loans to insiders; enhanced disclosure requirements; and a set of rules about auditor independence, tighter standards for auditor independence, the role of auditors in oversight; and prescribing the conduct of

audits and, for example, requiring the mandatory rotation of audit partners in public companies.

I think it will take probably a long time to determine whether the obvious purpose of Sarbanes-Oxley has been achieved, making it less likely that Enron and similar corporate scandals will occur in the future.

There are some things that have certainly happened that nobody can argue about. It is much harder to persuade people to become directors of public companies. D&O premiums, direct officer and liability insurance premiums, are way up. D&O carriers are much more sensitive and wary. There was a report recently of a West Virginia-based bank holding company that had a non-executive chairman who resigned. He had been in that job for something like a dozen years (he was a lawyer) and through all that time he provided legal services to the company. There had never been a problem. And it wasn't the board or the shareholders that asked him to resign, but the malpractice carrier of his law firm believed that he would be unusually exposed to shareholder litigation because of what might be perceived as a conflict of interest. That's an interesting case because what he was doing is not prohibited by Sarbanes-Oxley as long as he's not on the audit committee, which he was not.

Other effects: A number of non-U.S. companies have called off plans to list in the United States or do a U.S. public offering, and have cited the regulatory climate as a reason. There's a Bermuda-based reinsurer called the Benfield Group that did just that and listed on the London Stock Exchange instead, calling off a planned offering.

More anecdotally, it's kind of obvious that there's been a drought of IPOs for a couple of years. Some people believe that part of it is that companies are less willing to go public. It certainly doesn't have the glamour that it used to. There is abundant cash in the private equity sector, so that's an alternative. It is just not as appealing as a prospect. It is certainly more costly.

There was a recent survey of mid-cap companies that said the average cost of being a public company, the compliance cost, has gone from (on average for that sort of company) $1.5 million a year to $2.3 million a year. Audit fees are reported to be tripling for public companies in 2003, and specifically, the costs of compliance with Sarbanes-Oxley are still being calculated. They are substantial.

Particularly, we're going to talk later about Section 404 of Sarbanes-Oxley and the need to assess internal controls over financial reporting. It is thought that the costs of complying with just that provision are going to be substantial, even for companies that already have strong internal controls.

It's easy to criticize this law. It was obviously passed very hurriedly under great political pressure. The president called on Congress to give him the bill to sign

before the August recess last year. It raises more questions than it answers. Some of these have been answered in the ensuing year through SEC rule making and the like, but it's clear that many of the provisions were not thoroughly thought through.

Enforcement Climate

One impact that is yet to be seen is what the enforcement climate is going to be, because there haven't yet been any SEC enforcement proceedings under Sarbanes-Oxley, but there clearly will be. The act substantially increased funding, almost doubled the funding, for the SEC. There's an enforcement infrastructure that's being created. It's going to be used, perhaps in test cases, against CEOs and CFOs based on certifications that they've given of SEC filings that contain financial reports. But, for better or worse, it's here and we all have to live with it. It's not likely to go away.

I'm going to go through just a few provisions of Sarbanes-Oxley, just to lay out what they are; those that I think would be of most interest and relevance to this audience.

Who Is Covered?

Who is covered? Basically every company that you would normally think of as a U.S. public company, a company that has securities listed on the stock exchange or more than a certain number of holders—that's about 15,000 companies in the United States. Also, non-U.S. companies that have done a registered public offering in the United States or those that have securities traded on a U.S. exchange, including through the very common method of American Depository Receipts (ADRs), where the primary shares are traded on a foreign exchange.

Individual Company Impact

On a kind of micro level, working with companies and corporate transactions, what has been the impact? I think, for example, of M&A transactions. Due diligence is much more critical, skeptical, intense and prolonged. There is simply less taking on faith of any financial reports.

Boards of directors are more active. They're certainly more conscious. Directors are more conscious of their personal potential exposure. At the strong urging of the SEC, companies have formed formal disclosure committees to review financial statements and SEC filings. The officers who sit on those committees, or who were asked in any way to pass on disclosure documents, have a highly heightened sense of personal exposure and obligation and a lot of questions as this is all being worked out. They're asking, "What is my responsibility?"

Something I think other panelists will talk about in more detail is that it's interestingly, in its impact, not at all limited to public companies, to companies that are directly subject to the statute. Mutual life insurance companies, for example, that don't have to file anything with the SEC are following, at least in spirit, the corporate governance prescriptions of Sarbanes-Oxley.

I think of one client, a mutual life insurance company that has publicly announced that it intends to do that, to follow the standards of Sarbanes-Oxley. It has formed a disclosure committee that reviews any capital-raising offering document and any filing with any regulator, even though they don't have to file 10-Qs and 10-Ks, obviously. It's simply part of the atmosphere. And there are other constituencies—stockholders, policyholders, investors, suppliers, and directors—who have different expectations now, even though the law doesn't specifically apply to those entities.

Sarbanes-Oxley Sections of Note

I'm going to talk about three specific sections of the Sarbanes-Oxley Law: 906, 302 and 404. They have to do with certification by officers of financial reports, internal controls over financial reporting and disclosure, controls over disclosure and the disclosure reporting process within a company.

Section 906. The first and the simplest one is Section 906. That's right in the statute. It didn't require any SEC rule making. It was effective immediately on enactment Aug. 1, 2002.

It requires the CEO and the CFO to certify, regarding 10-Ks and 10-Qs, (10-Ks are the annual report that a public company has to file, and 10-Qs are the quarterly reports) that the report fully complies with the requirements of the SEC rules and statute under which it is being filed. It must fairly present, in all material respects, the financial condition and results of operation of the issuer.

The statute doesn't prescribe the words of the certification beyond what I've just said, and it interestingly doesn't provide that the certification should say, "To the best of my knowledge." However, that's the liability standard. The sanctions under the statute are imposed only if the certification was incorrect, and the officer knew that it was, or acted willfully in making an incorrect certification.

Section 302. Section 302 also calls for a certification, but it didn't prescribe the content of it. It directed the SEC to adopt rules.

This is another example of things, if maybe more time were taken, that you wouldn't construct a system this way. It substantially overlaps with Section 906, but you still have to do both. Now that the SEC has adopted rules that implement Section 302, every 10-K, every 10-Q of a public company—and also the annual reports of foreign, private issuers is filed with the SEC on Forms 20F—have to contain both the 906 certification and the 302 certification. They both come from the same people, the CEO and the CFO. They both go to the accuracy of disclosure, substantially similar to what I just described, but 302 is broader. It just addresses the adequacy of the company's disclosure controls, and it also has internal controls over financial reporting.

The SEC prescribed the form, the exact words of the certification under 302. One interesting aspect is that, in the recitation of this report that fairly presents financial

condition results of operation and so forth, there is not permitted a qualification in accordance with GAAP. The SEC has said that that is intentional, that there is a broader standard of overall material accuracy and completeness intended.

And what does that mean? The SEC has said that it is not limited to GAAP presentation and GAAP adequacy. It includes, for example, "Have the appropriate accounting policies been selected? Is the disclosure of financial information informative, and does it reasonably reflect the underlying transactions that are being reported? Should there be included any additional disclosure in order to provide investors a materially accurate and complete picture?"

So, it's a little bit more like what lawyers call the 10B5 standard that you would apply to any document. You have the financial statements in an offering document, and they have footnotes, and they comply with a set of rules that apply to the accounting profession. But you have textual disclosure in an offering document that may go beyond what may need to be disclosed, for example, in a financial statement footnote.

Section 302 makes the CEO and the CFO responsible for establishing and maintaining disclosure controls and procedures and also, separately, internal controls over financial reporting. I'll talk in a moment about what's the difference between disclosure control and internal controls.

The SEC strongly recommends, in the release implementing this, that issuers form disclosure committees of senior officers to review every document that's filed, and most public companies that I know have done so, as well as I mentioned some companies that are not subject to Sarbanes-Oxley. These officers have to certify that they are responsible for the company's disclosure controls and that they've evaluated their effectiveness as of a date within 90 days prior to the filing. The officer also has to state his conclusions about their effectiveness. As to internal controls, they need to state that he has disclosed to the audit committee and the outside auditors any significant deficiencies in internal controls.

Section 404. Finally, the third section, Section 404, relates to a report on internal controls. This report has to come from management, and it has to state that management has the responsibility for maintaining adequate internal controls over financial reporting and to assess their effectiveness. This needs to be in the 10-K every year. And the outside auditors have to report on and attest to internal controls.

This is one of the later provisions to come into effect. Nobody has yet filed a 10-K including this disclosure, because it isn't going to become effective for a year. About a year from now you'll start to see this, because for most large companies, companies that have been public for more than a year and have more than $75 million in market cap, this requirement comes into effect for physical years that end on or after June 15, 2004.

Internal Controls
What do internal controls consist of? The SEC, in its release, has said that it includes maintaining records that accurately reflect transactions. You must provide reasonable assurance that transactions are recorded as they need to be to permit GAAP qualifying financial statements, and you need to provide reasonable assurance regarding prevention or timely detection of unauthorized use of assets that would have material effect on financial statements.

There has been a lot of questioning and confusion about what is the difference between internal controls over financial reporting and disclosure controls and procedures of a company. Disclosure controls and procedures is a concept that isn't in the Sarbanes-Oxley law anywhere. The SEC introduced it in one of its releases, and in a June 2003 release it clarified the differences and similarities between the two and basically admitted that they overlap substantially —disclosure controls really subsume internal controls.

Disclosure controls broadly go to how is information collected within the company and reported up the chain to make it possible that, on a timely basis, the reports that need to be filed with the SEC comply and contain the disclosure that they're required to. In particular, how do facts come to the attention of the CEO and CFO so they can review a filing before it's made and determine for themselves whether they believe that it's adequate?

The one element of internal control that isn't part of disclosure controls is the safeguarding of company assets prong that I mentioned earlier.

Sarbanes-Oxley's Impact on Valuation Actuaries
I'm trying to bring this down to the ground a little more. What impact does all this have on a valuation actuary within a life insurance company?

What I have seen, what I would imagine (and I very much am looking forward to the comments of Anthony as somebody who has to live with this within a company every day) the chief actuary commonly sits on the Disclosure Committee. He is one of several senior officers expected to review all filings before they're made. And whether he's on the committee or not, a senior actuary is the type of officer who is more and more commonly expected to give what are called sub-certifications to the CEO and CFO. These aren't certifications that need to be filed with the SEC like those produced by the CEOs and CFOs, but it's part of due diligence, if you will, to provide a basis for these officers in giving the certifications publicly that they have to give.

The questions that come up are, "What should be the scope of the certification? Shouldn't it be limited (I think it should) to the particular area of expertise of the officer?"

In the case of the actuary, I think that the certification is less valuable if it globally certifies. I don't know of anything that is defective in this filing. It is more valuable and more reasonable if the actuary certifies to the areas of the filing that are within his area of competence—actuarial matters. But I am very anxious to hear Anthony's comments on all this.

MR. ANTHONY AMODEO: I will address some of the things Tom said. I would point out that my viewpoint, as Tom said, is quite different. I'm the appointed actuary for this company, so my viewpoint would be different.

I want to approach building onto what Tom said from two different directions. One is the more general Enron situation and how it impacts valuation actuaries beyond Sarbanes-Oxley, and then specifically how Sarbanes-Oxley is being implemented, at least at my company.

Broad Enron Issues

I did a bit of research on what was in the newspapers during the Enron scandal, and I'm going to take a little informal survey here: How many actuaries in this room are involved in willfully misleading financials? OK, for the record since this is recorded, about half the people in the room.

Actually, nobody in the room would do that. We as actuaries have this feeling: "No, we don't do these Enron things. We don't publish misleading financials."

We think of ourselves, especially valuation actuaries, as working on the core business of our companies. We're not involved in all those ancillary things that are outside the core competence and the expertise that we, and our companies, have.

As far as auditor complicity, we as actuaries are generally dealing, not just with the accountants, but the actuarial staff of our outside auditors, and they certainly meet all the same professional standards that we do. Of course, we'd never be involved in shredding documents despite company rules on document retention. Our lawyers are very clear that if there is legal activity, we have to keep the documents around for a very long period of time.

We should feel very comfortable when we look at what happened with Enron and feel that it really can't happen here. However, there are some things that were involved in Enron that were a bit more subtle that I think we may find striking a bit closer to home.

For example, we know that Enron used sophisticated derivative accounting to hide losses and mislead investors. We would never do such a thing, of course. But look at FAS 133, and within it are embedded derivatives in insurance contracts, and try to say that you feel comfortable that you've been able to explain to investors, or other people, that you understand 133 and that you are applying it correctly. Then I would point out that a group of the AICPA just recently came out and said, "No,

you're not applying it correctly, because nobody is using it correctly for modified coinsurance and certain participating group contracts." We thought we had it nailed, and we found out that we didn't. It's very, very difficult for people to understand that we have a very complex set of things that we do, and it's very hard to explain this to people.

Once again, Enron had off-balance sheet liabilities that were not being adequately disclosed. But our industry has things like synthetic GICs and reinsurers; what balance sheet records the liability for these risks?

Aggressive accounting is something that you can only see after something goes wrong. I remember watching CNN during the Enron crisis and one of the commentators said that what Enron did in a lot of cases wasn't, at the time, considered overly aggressive. He summarized it by saying, "When the tide goes out you can see who is not wearing a bathing suit." It's really true. We may be just splashing around in the water having a great time right now, but if something goes wrong, people could be subsequently questioning things that we now consider to be acceptable.

The last thing I find pervasive (and I find it with the insurance departments, so I will talk about it a bit more later on) is the erosion of trust. I think that nobody trusts financial statements from public companies, and I think that has eroded the relationship that we have had with our regulators.

I think they've fallen into a feeling of distrust, and our business really is a trust business. Between reinsurers and direct companies, for example, it's always been a relationship based on trust. A lot of things hadn't been documented, and that goes to the heart of Sarbanes-Oxley, which is that we're now going to have to document them.

The Regulators

Let's talk about the regulators, just to expand on that a little bit. The new Actuarial Opinion and Memorandum (AO&M) regulation is really going toward giving a lot of discretion to the actuaries—based on the Canadian model. Now we're finding that regulators are saying, "You can use all your discretion, but we still want the New York 7. In fact, we want sensitivity tests on the New York 7." All this discretion that the actuaries had really is being more and more constrained by specific requirements that several insurance regulators are requiring.

This even applies to AG39. AG39 has stochastic methodology, and I'm not sure that it's very easy to explain. The regulators are asking for more and more information on how you did the modeling, what the basis for the modeling was. And so this concept of going toward stochastic, which the theoreticians like very much, is causing problems in that we now have to continually explain what it was that we did rather than having them rely on us.

The other thing, of course, is that AG39 as a stochastic method really shouldn't have the necessity for a specific minimum, but of course, the regulators have been asking for that. It is temporary; it will develop. But I think it's going to develop in such a way that we're going to see more requirements for full disclosure of everything that we do.

Sarbanes-Oxley Itself

Getting specifically to Sarbanes-Oxley. When I first saw the requirements of Sarbanes-Oxley, I was comfortable that we had satisfactory internal financial controls. I was ready to agree that the Section 302 assertions by management were not a problem, and we could assure our auditors under Section 404. I really didn't think we had a lot of work to do.

Now, the first point—and I think a lot of companies have responded to this—in 1992, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission issued a report requiring documentation and assessment of the effectiveness of internal controls. That's what we did.

We have process maps for all of our valuation processes. As appointed actuaries, we have an existing reliance structure that we've used and demonstrated to the states, and we already signed a statutory opinion. So it doesn't seem that should really be a lot of work. But the COSO documentation turned out to be less than we had hoped for, and certainly didn't meet the standards of Sarbanes-Oxley.

The existing process maps, while very, very helpful as a starting point, were not sufficient for Sarbanes-Oxley. And we're finding that the existing reliance structure doesn't go far enough. There are things that we rely on (for example, the data reliance that we get) that are not meeting the standards of Sarbanes-Oxley. Certainly, we've always signed a statutory opinion, but now the stakes have been raised. We're talking about jail.

New Work Find Significant Accounts. What is the "new work" that we're starting under Sarbanes-Oxley? The first step is to identify the significant accounts. I think it's fair to say that the reserve accounts in our company can be viewed as significant accounts.

Now, we are using materiality rules so we can expend less effort on the processes that result in smaller reserves, but on the other hand, those processes are the ones that are probably less controlled. They're the ones that have more leeway and maybe more spreadsheets and hand-offs, so those can be the ones that have the most significant exposure. Even though you can apply a materiality standard, you may find that there are other processes that, in terms of risk, you want to focus on.

Next, you have to look at each step in the valuation process and identify the controls on the data and the calculations. Then you have to document the design of the significant controls and evaluate that the way they operate is effective.

The amount of work required to do this is large. We've hired an outside adviser, and it's been taking a lot of the time of our valuation people to explain our controls and processes.

The documentation of the calculation procedures is something that obviously the actuaries are in the best position to do. But if you have outside people who can do the documentation, you can save the time of the actuaries so that the people who are doing the documentation can use that skill set and allow the actuaries to continue doing what actuaries do.

Controls

In terms of controls, Sarbanes-Oxley requires you to evaluate the effectiveness. I would mention that there are two types of controls.

The first type of control is a typical accounting control. It is where you have processes that are not only documented but automatic in that there are data feeds —from one system to another or from the valuation system to the ledger—that are controlled, and they can't be manipulated by human hands. People can't touch the code and things like that. Those are called preventive controls.

There are also controls consisting of some things that we valuation actuaries do all the time. These are called detective controls. These are the analytics that we do all the time when we do our reserves. Certainly before we publish reserves, we want to make sure that there haven't been blocks of data dropped out of blocks of in-force, things like that. All of those analytics that we currently do qualify as detective controls. So that's helpful in responding to Sarbanes-Oxley.

There are some subtleties there. One of the things that you have to do to evaluate the effectiveness of internal controls is to sit down with each of the processes and determine the things that can go wrong. So the hand-off of data from one system to another is an obvious potential source of error. Another is a valuation process, such as a spreadsheet, which an actuary has on his computer and on which he could make a mistake or even willfully change something.

We're obviously comfortable that the people who we work with have no reason, or would not want to willfully change something in the spreadsheet. But I think you'll find that your accountants will be much happier if it's a documented process where such willful change just can't occur.

The reliance structure that we have, which we get under the statutory reliance structure, is something we rely on. For example, we get representations from the administrative people with respect to the integrity of the data. Of course, we have outside companies, such as those that cede business to us, or TPAs, that also get into our reliance structure. If you look at the requirements of Sarbanes-Oxley, you'll see that, in general, those reliances may not be sufficient. We'll have to beef

them up because of this cascading reliance of the CEO and CFO on valuation actuaries.

You're going to have to force the insiders and the outsiders to conform to that reliance structure. The insiders will be less of a problem because they also report to the CEO. The outsiders? I'm not exactly sure how that's going to work out in terms of strengthening that reliance structure.

SEC's Special Rules

I'm going to raise one other issue that Tom mentioned that you have to be aware of in the rules promulgated by the SEC.

There was a strange thing in the SEC meeting of May 27 of this year. They defined internal control over financial reporting to include assurance regarding the prevention of unauthorized disposition of the company's assets.

Our accounting people have interpreted that rather broadly. For example, as a valuation actuary, you consistently use premiums, you check unpaid items; you count advance premiums; you even use net premiums in the valuation process.

Just using the published and correct premiums may not be sufficient because the process of safeguarding the company's assets gets into the process of developing those premiums. So you will have to have a Sarbanes-Oxley-level reliance on the pricing actuaries. Not only that you're using the premiums that they calculated, but also that their method of calculation safeguards company assets. That sounds a little radical to me. It's obviously not a Day One issue on Sarbanes-Oxley compliance, but it is an issue that our accountants say we have to respond to.

Benefits of Sarbanes-Oxley

Not to be completely bleak with this, but I think that there are some benefits from Sarbanes-Oxley for us as valuation actuaries.

I think we've all had the kind of nagging concern that our administrative associates don't take their signatures quite as seriously as we actuaries do when we sign the Opinion. Now that the CEO, to whom they report, will be looking for this cascading reliance structure, I think they'll take it more seriously. And I think that we've already seen, at least in my company, involvement from the administrative people at a much higher, stronger and detailed level than we had ever seen before.

Third Party Administrators: This is another group of people who, like I said, whether they're true TPAs or whether they're ceding companies giving us information, will understand the importance of the Sarbanes-Oxley compliance and the statements that they will be giving us. I think it will be easier in the future to get a stronger and clearer detail on the data that they're giving us. The third one is third party software. This is an issue that I think also is going to have to be strengthened.

We recognize that we don't have the source code of a lot of the systems that we purchase, so what we do when we install them is check them generally. We look at the trend, we run sample cases, we do all those kinds of detective controls that we're talking about.

Now, I'm not talking about the Sarbanes-Oxley financial controls that a software vendor may have. What I'm talking about is this cascading reliance. If the CEO is coming to you and saying, "All the processes that lead up to the numbers that you're publishing, are they correct?" What if you have a big black hole for some third-party software? Will it be sufficient for you to say, "I've looked at it, and it looks like it's right. I did some sample cases." I don't expect to have the source code shared with me, but what I do expect is a stronger reliance that what I'll get from software vendors is consistent with the level of Sarbanes-Oxley.

MR. DANIEL MC CARTHY: You've already heard, and I would certainly support, the notion that Enron is really a metaphor for a change in the way financial statements and both users and preparers of financial statements are viewed. So we'll construe it in that broad way. Stacy has already told you that we've had the first guilty plea and jail sentence applied yesterday and reported in this morning's press. It's very sobering.

So as a result the first thing I would say is: "How will Enron affect valuation actuaries?" This is the title of today's session. Never mind "will"; we're not talking about "will." You've already heard from Anthony and from Tom of things that have had direct effects, and I would stress to you that this is only the beginning. It doesn't necessarily mean there will be new legislation, Sarbanes-Oxley II. Though I suppose there could be. But quite apart from that we are just beginning, I think, to see and understand the new environment in which we find ourselves.

What I want to talk about, although I'll allude to Sarbanes-Oxley briefly, is some of the other effects that we have begun to see and that you should be aware of as you think about your role as a valuation actuary or in the valuation process.

Trust

The basic message is, "We don't trust you." Who is we, and who is you? "We" is the user of financial information; and, of course, the SEC and the federal lawmakers in Sarbanes-Oxley were focusing on investors and their use of financial information. But there are lots of other users of financial information as well.

I would suggest to you, in particular, that we should focus on financial solvency regulators. They are users of financial information in the public interest. Their perception is not the perception of an investor. Their perception is the perception of a public safeguard, typically for the people who bought the products of a company. That is a different perspective, but they are, as Anthony alluded to, beginning to have some of the same focus, and I say that without criticism. This is an

environmental thing. It's not Regulator A who is doing it, or Person B. It's spreading broadly. So that's we.

Who is "You?" You is a provider of information. You, friends, is us – we are you. Get used to it. And you is, in general, management, advisory professionals, that sort of thing. So that is the focus. We is they. If there's a regulator in the room, I guess we is you. But in any event, the focus here is on the fact that providers of financial information to outside audiences—be they solvency regulators, investor audiences or other kinds of audiences—that focus is very, very different from what it has been. And it will continue to change.

I'm not going to talk a lot about Sarbanes-Oxley, but I think it's important to crystallize just a couple of things that were said so we can then take a somewhat broader view as to Sarbanes-Oxley.

First of all, you've heard about the chain of certifications; you've heard about the focus on data and controls. Strictly speaking as Tom pointed out, the law only applies if the company is a registrant. Many of you work for companies, or consult to companies, that are not registrants, and so strictly speaking, the law does not apply to you. And strictly speaking, it applies to GAAP financial statements; those are investor statements.

Obviously, many of the controls that drive statutory reporting also drive GAAP reporting; but strictly speaking, the focus is narrow in the two senses that I've pointed out. But, the marketplace has taken a much broader focus on that. Let me go back for just one thing. There is one thing I want to say.

Actuaries get involved here in a way other than in a valuation. There are a number of of actuaries, for example, who sit on company boards of directors. These are often senior people. They have been senior officers; they're on company boards. A number of them are now on boards of companies of which they are not officers.

A question that arose, which might be of interest to you in the course of Sarbanes-Oxley, is the so-called Financial Expert designation. That is to say, audit committees are supposed to have at least one person who is designated as a financial expert. And in the original SEC draft rule, it would have been very difficult for somebody who had not been in a public audit capacity for a company to qualify as a financial expert. The American Academy of Actuaries wrote a letter to the SEC, and a lot of other people did, too. The Academy's letter said, "By the way, in certain areas, insurance companies being a good example, we think that actuaries with certain kinds of experience are probably as good a financial expert as you might have." The SEC's final rule on the subject of "financial expert" is considerably broader than their draft. Of course as Tom pointed out, that leaves the question, "Do people want to be directors anyway?" That's another matter. Nonetheless, the rule, as it's written, does allow recognition of actuaries in a broad financial sense.

One other thing about Sarbanes-Oxley. In establishing the Public Accounting Oversight Board—which we've not talked about this morning—it said, "The Public Accounting Oversight Board should be thinking about the usefulness and accuracy of financial statements in a GAAP concept." But it also said, "The Board is to study the implications of introducing a so-called 'principles-based accounting system.'"

"Principles-based," by the way, is a very popular term. It's very hard to be against something that's principles-based. Nobody knows quite what it means and quite where the line is between principles and implementation, although if I had the FASB books here, which I didn't feel like lugging from the East Coast to the West Coast, I'd suggest they cross the line. Nonetheless, principles-based is out there, and it's a subject, as Anthony pointed out, which in Actuarial Guideline 39 is at least given lip service in terms of discretion—that you're supposed to look to the underlying principle.

Effects On Marketplace
Let's go back to the marketplace. The effects on the marketplace are, as has already been said, far broader than the Sarbanes-Oxley legal requirements. They are already affecting actions of boards, they are affecting actions of management; they are, and I will discuss some specifics on this, affecting actions of other regulators. And as Tom pointed out, it's more difficult to get people to be directors.

And they affect non-registrants as well as registrants. I've seen this in my practice. Many of you have probably seen it in your employers or companies for whom you consult. The intensity that is being brought to the question of data control, to the question of independence, to who's doing what and is there a conflict of interest, is much stronger than it was. And to a degree, I think that's really quite healthy. Obviously the question is: "What is the extent of that degree?"

The focus is on auditability, processes and controls, conflicts of interest, and driven basically, among other things, by fear. Fear is a motivator. When people read, as Anthony said, about folks going to jail, that's a motivator to say, "Quite apart from the fact that I'd like to do the right thing anyway, I particularly want to be perceived as doing the right thing here. Because it seems like people who are perceived as doing the wrong thing have a problem for the next few years of their lives."

Risk
With change of environment comes risk. I want to talk a little bit about risk.

First of all, litigation on actuarial matters has been on the rise. It has been on the rise for roughly the last decade, so that preceded some of the things we're talking about here. That's been happening anyway.

The focus that we are seeing now is one more factor, but it is a big factor. Do not think that litigation involving actuaries applies only to consultants. The high-profile

cases have been basically consulting firm cases; but do not think that it applies only to consultants. If you were an actuary with a company—and particularly if you were an actuarial officer with those responsibilities—I would, if I were you, take a healthy interest in your company's directors' and officers' liability coverage and make sure that you're designated as an individual covered person. That's a good thing to be.

The defense in all this is documentation. The levels of documentation that you need internally (never mind the regulators for the moment) have risen substantially, whether or not you are a registrant.

I was thinking about this the other day. This was a regulatory example, but I'll give it because I think the company would have done some of the same things anyway. One of the companies for which I am an appointed actuary—and it's a smallish company; its assets are in the hundreds of millions, not in the billions—prepares every year, or we prepare for them as their appointed actuary, the Actuarial Memorandum that goes with the opinion.

Now, the scope of operations of this company has not changed materially in the last four years. They've gotten bigger and so forth; they're not doing any new things. The length of the memorandum has increased by about 80 percent in four years, because every year, either we are asked internally or regulators are asking, "What about this, what about that, what about that?" We answer the questions, and then we incorporate those things in the memorandum for the next year. Of course, nothing ever gets taken out of the memorandum because you would surely be asked why it was taken out. As a result, I have found—and you probably found, too—that the level of that kind of documentation and the extent to which assumptions must be explained and documented just continues to increase.

Tom cited some figures on costs of being a public company, and if you were just to take the ratio of the numbers he cited and apply it to financial reporting generally, you've probably got a pretty good estimate. It's there. Obviously we need to try to do it efficiently—this isn't burning money for burning money's sake. But the environment is there; it's not going to change and we have to get used to it.

Documentation, as I said, is the key defense. The quality of documentation that I see in companies is improving. It still has a long way to go, and I would highlight particularly for you something Anthony said when he pointed out that his auditors are asking questions not just about valuation, but about things that go to pricing and other activities. My perception is that the documentation of valuation in companies, by and large, is far better than the pricing documentation. It's probably a good thing, anyway, to improve the level of pricing documentation. But now the spotlight is on it.

Reliance is important. Anthony talked about a chain of reliance. But reliance is not everything. Reliance is not blind reliance, and there are some things I want to talk about there. Let's look at some regulatory concerns here.

There's a new requirement. The focus for it came from the property casualty area, but the issue is not casualty-specific. I would encourage you, if you have not done so, to look at the August 2003 issue of the Academy's monthly mailing, "The Actuarial Update." The heading says, "NAIC Suggests Actuaries Audit Data Quality." The headline is a little loose.
First of all, they are focusing on the things auditors look at when reaching their conclusion as to whether controls are appropriate or not, do not necessarily cover the full scope of the data that actuaries use in preparing reserves. In the casualty area—or for that matter, in the health area—think about incurred dates. The incurred dates really matter if you're doing run-out reserves of any kind. Do auditors look at that coding? Well, they care about the claim dollars, obviously. Is that an aspect being looked at?

There's a potential here to make the actuary an auditor. The NAIC says that's not what they're trying to do, and I hope they're not. But at least there are some issues here, and let's take a look at them in a little bit of detail.

The NAIC guide says that, "The actuary must identify data that are significant for use in determining reserve projections (the word "projections," by the way, I don't think is well-chosen, but let's just say reserves for this purpose), but have not been audited." If you're using something that has not been audited, and it is material to what you're doing, you had better say so, and you better let the auditor know.

Also, the auditor must obtain an understanding of the data that the actuary views as significant. The audit scope must include that the data tested is fairly stated in all material respects. What it encourages, and virtually mandates, is that the actuary and the auditor engage in conversation as to the data the actuary uses that are material to the development of the reserves. If those are not already in the audit plan, they're going to have to be in the audit plan.

Frankly, there's nothing there you can really argue with if that's the way this is actually implemented, but I raise it to point out that regulators are becoming attentive to questions of, "What can go wrong? Where can it go wrong? And what doesn't the audit cover that is relevant in one way or another to the financial statements?" This is one of those things again where we're seeing the beginning, not the end.

Financial Risks to Actuaries
Now, financial risk of the actuary: this is from the Standard Valuation Law. The Standard Valuation Law says that unless the actuary has engaged in fraud or willful misconduct, the actuary is not liable to anybody except the company or the commissioner for any act or omission, decision or conduct. That seems to about cover it.

There has been discussion as to whether that should continue. I don't know where that discussion is going to go. There is no comparable protection today, by the way, for casualty actuaries. The Standard Valuation Law does not apply to them. Questions have now been raised at the NAIC level about whether that protection from liability is appropriate, whether indemnification for actuaries engaged in preparing actuarial opinions is appropriate. This really raises the question, "Is the actuarial opinion an audit opinion?" Well, so far it's really not. It's not an audit opinion. I think that if anything, it's a management opinion. It's an opinion prepared by, or on behalf of, the company. As Anthony pointed out, outside auditors look at it; they kick the tires of it. That's part of the audit work.

But the discussion—and it's in an early stage—is raising the question, "Should we have the same requirements for actuarial opinions that we do for audit opinions?" The implications of that, by the way, would be extremely significant and frankly, would raise a question, "If that's an audit opinion, what is the management opinion?" You keep backing up one step at a time.

I raise this not to offer an answer, but to make two points: No. 1, the ball is in play; and No. 2, we're still at the beginning of these discussions, and you need to be attentive to them. Hold that for just a minute. I want to talk about data for a minute.

Data and Reliance

Data and reliance are a key. This has already been pointed out. The chain of reliance is important. People understand that reliance is significant.

Actuaries think about data—or should, in part—in relation to Actuarial Standard of Practice 23, which deals with data quality. I want to talk about data quality, that Standard of Practice, and issues that are being raised by regulators.

In the meantime, I want to do this. The upside is it is now easier than it used to be to take a position and hold to it on something that you believe. "It's really got to be this way and I can demonstrate why it's got to be this way." It is easier. I'm not seeing the kind of pushback on issues that I used to see. I think that's just because people are saying, "This is the world we are in," and gradually people are waking up to that. Requests for data, background information and so forth, are better understood and better responded to, and that includes information from outside sources, third-party administrators.

Some of the companies I work for, for example, have their investments administered by and held in custody by outside investment firms. Getting reliance information from those folks, which used to be hard, has now gotten very easy. They've had to wake up and say, "This is the world." So it's just gotten easier to do all this stuff; and there is a much better understanding that the opinion itself really means something. That helps us. It puts us in a position, not of being God, but it puts us in a position of getting good support for reasonable activities.

The Future of All This

Now, the future: I want to talk about Actuarial Standard of Practice 23. It's a very important standard that was written 10 years ago. It must have been very good at the time, because I was on the Actuarial Standards Board at the time, so it had to be good. But time passes.

First of all, the standard says, "Data are never going to be perfect." And that's not going to change. It also says, "Sometimes data can be so bad that you can't do your job, and you've got to be able to figure that out." And that's not going to change either.

But then it says that when you get reliance statements—obviously you get them, you disclose them—and it says the accuracy and comprehensiveness of data supplied by others are the responsibility of those who supply the data. However, the actuary should, when practicable—and I'll come back to that phrase in a moment—review the data for reasonableness and consistency. It says the nature and the extent of the review should be based on the circumstances of the actuarial assignment. It goes on to talk about review "when practicable" or, in another case, "if practicable." It says if you can't review the data for some reason, you ought to say so.

What we have recently seen regulators say, and I first got this in response to an actuarial opinion I submitted last year, "'If practicable' doesn't cut it; 'when practicable' doesn't cut it. Get those words out of there."

My first reaction (after about five seconds of mature deliberation) was, "What's the matter? Don't you guys read the Standards of Practice?" However, on thinking about it, I think the underlying message is, for things that are this important, for an opinion that covers 90+ percent of what's on the liability side of an insurance company, it's going to be practicable. It's got to be practicable. You've got to do it. You've got to do it to the extent that you can make yourself comfortable.

Again, as I say, although this is a question that's been kind of bouncing around at this point, I think the regulators are simply following the environment that they see. They're saying, "If it's that important, if the work you do is that important, and if the results you get are that important to the solvency of the company, in that particular case, we're going to tell you, because it's going to have to be practicable."

ASOP 23, by the way, is up for rewriting anyway. I expect that within the next year you will see a draft. It is extremely important. When it was circulated 10 years ago, it had statements that were far-reaching for their time and, in fact, were watered down a little bit by adverse comment from the profession. I think the next time around it's going to be a tougher standard in terms of actuarial obligations on data

quality. It won't get away from the concept of reliance, but it will make very clear that anything even approaching blind reliance is absolutely not acceptable.

ASOP 23 is important; it's being reviewed; pay attention. Actuarial-auditor relationships are going to be more complex, more important. Those conversations about data are going to have to take place, and they are of use, I think, to both the actuary and the auditor. In the meantime, folks are going to be looking at us. It's going to be that way; it's not going to go away. Let's get used to it and react to it constructively.

MS. LAIFOOK: We have time now for questions.

FROM THE FLOOR: My name is Val Smith. I'm the Chief Actuary at Citizens Insurance Company of America and a half dozen others that are held by their holding company. I just have two comments.

The first comment is that when we talk about the chain of reliance, sometimes it goes more than just an actuarial certification. Not only do we have to provide a separate actuarial certification for GAAP reserves in addition to our statutory reserves now, but our CFO refuses to sign the management letter for the SEC unless I sign it, too. That was one of the things. He says the reserves are the largest liability on the statement and he says, "I'm not going to sign it unless he does, too." So my name is actually on there.

The other comment is that we had a history of acquiring some of the smaller companies as part of our growth strategy, and we filed to acquire another company this year. We've heard that the SEC is going to start reviewing company's financials every three years and they chose us because of this filing. I want you to know that it's taken me three iterations now to explain some of the things that we said in the MDNA, first quarter in the 10-Q and year end in the 10-Q.

I've only been at the company for a year, and I was looking at last year's 10-Q for second quarter just to kind of give me an idea of what they said about reserves and there's absolutely nothing at all. Now I have to give details about why the reserves changed, getting into duration and persistency by duration and all kinds of things like that now as a result.

Part of the thing that I'm dealing with also is that it's obvious when it keeps coming back for a second iteration (where you answer the question and the SEC comes back and says, "What do you mean by this? What do you mean by that?") that they don't understand insurance. That was another thing I dealt with. They kept asking me why we released some reserves, because we non-renewed some medical business; and they kept saying, "How can you release future reserves; that has to be claim reserves." No, it was future reserves. They didn't follow even what was going on to a certain extent.

MR. MC CARTHY: I think that's a very helpful comment. I know Tom and I have had the experience of reading the SEC comments in various categories. To be sure, sometimes they don't understand things, but the thing about the SEC is, they keep asking until they do. They keep asking until you can produce an answer that they understand, and sometimes that is several iterations.

MR. KELLY: We certainly feel your pain. And that resonates. I'm afraid that is going to be more a part of the landscape. The law actually requires more frequent reviews by the SEC, and it's going to lead them to delve into areas that they really have an imperfect understanding of.

MR. MC CARTHY: On the other side, I think that closer relationships between the actuary and the CFO are all positive. I think the fact that that's happening, and it is happening, is very positive for the operation of the company.

FROM THE FLOOR: I'm Roger Smith from Poly Systems. I'd like to look ahead just a bit concerning another accounting system that I recently read is described as a principles-based one that's coming to the international arena.

They again have chosen a great name of fair value, because who can be against that? The question is in studying it, some of the material that's come out, it would seem that if certain individuals were deciding that they wanted to be deceptive or mislead people, this accounting system seems to offer even greater opportunities for that to happen. I'm wondering what the panel might comment on that, or how all the Sarbanes-Oxley versus a brand-new system will rely heavily on our own assumptions and our own internally calculated values for many reserves and financial statement entries.

MR. MC CARTHY: I agree with you that no matter what one thinks theoretically of a fair-value system, I think a fair-value system has the potential to be a more manipulatable system than GAAP as we know it now, let's say.

In addition, in terms of sale of insurance contracts, in particular a fair-value system, which has some similarity to a Canadian system without the provisions for adverse deviation in it, has the effect of front-ending profits or losses. So basically you're booking everything at issue. By the way, Enron did that with energy contracts. I think quite apart from manipulation, even if you go right down the middle, it front-ends and that gives you considerably more swings in financial results.

In addition, my own view is that the advocates of fair value say correctly that it would produce, if you could get it exactly right, a balance sheet that would reflect current conditions all the time. They kind of leave out that it doesn't give you much in the way of an income statement that's a real performance measure. I think one of the reasons the move to fair value has slowed down is that all that's been done on the performance measure side there really hasn't been satisfactory. You

probably know it's been pushed back now a couple of years, and that basically put it in a political arena that it wasn't in before. So I don't think we know where it's going, but I agreed with your fundamental thought.

MR. AMODEO: And I'll just point again to our experience on the statutory side, where as you move to principle-based valuations, the regulators are just totally uncomfortable. They just keep coming back with more and more constraints, and I think rightly so; they should be. I don't mean to be critical on that. It's very difficult to take a black box and just say that you know how it was applied.

What they're doing is applying minima and specifying the scenarios that you have to use to the point where the only way these principle-based approaches could add value is by increasing reserves above the minimum, which is going to be pretty strong anyway. So I think just like they're delaying the principle-based things on the statutory side, I agree with Dan that I can't see the IASB moving forward either.

MR. MC CARTHY: I didn't quite say that, Anthony.

MR. AMODEO: I didn't mean that.

MR. MC CARTHY: This is being recorded. I've got to be careful.

MR. AMODEO: I wanted to ask since we have a lull here. We agreed we were allowed to ask each other questions. Tom, you commented (and I've seen and heard it, too) about the fact that it has been more difficult to get people to serve as directors in some situations. There's also been a lot written about people who have been directors of large numbers of companies, and this will force them to cut that down. My own view is that that's probably good. It's hard to be a good director of 15 companies. I'm interested in what you see from that sort of thing.

MR. KELLY: I think it is a good thing. I think there's been a lot written about sort of professional directors, former government official types who may be on a dozen boards and have cut that down to maybe three or four boards that they're really spending more time on.

I got a request that I've never gotten before in my life about a year ago. A client, an individual, who was asked to be on a public company board and wanted our advice as her counsel to review the D&O insurance of the company, not imagining that she could influence it or make the company enhance it, but just to understand whether they had the strongest coverage that was available. I don't think that, before Enron, candidates ever thought about that kind of thing at all; so I think those who have worked with boards have certainly seen examples in the past of inattentive directors, and you see a great deal less of that now. I think the job is taken much more seriously, and I think that has to be a positive thing.

MR. MC CARTHY: I would add, by the way, even with small, privately held or mutual companies, some of which have tended to have passive boards in the past, the level of questioning I see in board presentations has just ramped up very sharply. People have really woken up to it, and that's only good. So there are a lot of pluses in this.

FROM THE FLOOR: I'm Mary Simmons with Protective Life. I was just wondering if you could comment a little bit more on Sarbanes-Oxley and the product actuaries and that process—where you see that going. Is that going to go all the way down to experience study levels to makes sure that they're using a solid basis for their pricing, or how that might affect them?

MR. AMODEO: I think that's exactly it. For the product actuaries to say that they're protecting the company's assets, they're going to have to document the process of developing premiums, and the process is going to have to be more than looking at what other companies do in taking off 10 percent.

That was no particular company. That's a valuation actuary joke about pricing actuaries. To continue the process, they're going to have to define the process and the experience studies; and they're going to have to say, similar to what we valuation actuaries say in the opinion and in the memorandum. We talk about the experience studies, when we last did them, why we're comfortable with them and all that.

I think that the pricing actuaries are going to have to do that, and especially when they're making projections going forward. They're going to have to say why they expect trends to be continuing and whatever assumptions that they're making. They're going to have to define all the assumptions. They're going to have to give the basis for why they think they're right, which is something that they're really not generally questioned on. In my company, we have documentation of the pricing and the methodologies. It's there. But all I'm saying is the bar is being raised under Sarbanes-Oxley.

MR. MC CARTHY: In many respects, those experience studies will be the kinds of things you'd want to have for asset adequacy testing anyway. I've always felt that in some companies the poorest-documented aspect of asset adequacy testing is the studies underlying the assumptions. And I think we have seen already a significant improvement in that. And if it turns out that some of that stuff is needed for pricing as well as valuation, those guys may talk to each other.

FROM THE FLOOR: As you know, the trend on the reserving side is to move away from the formula theory to more of a stochastic approach, which on the surface seems to be almost counter to what you're saying. We trust you more, we're going to put greater reliance on the actuary to certify the appropriateness of the reserves rather than this formula sort of black box approach. Would you just comment on if

that, on the surface, is counter to what we're talking about here, or how do you fit that in?

MR. AMODEO: I think you're right. It's absolutely counter, and what we're seeing once you get on the statutory side—and obviously as a New York company we deal mostly with New York, so it was pretty clear—that New York has sent out letters. What they're saying is that they're terribly uncomfortable with all the discretion that we're talking about here.

If it's a stochastic methodology, they want a lot more detail on what the method is all about. And they still want a minimum floor—a formulaic minimum—on not just accumulated charges, but a formulaic minimum on a present value basis of a lot of things that we're now moving towards valuing stochastically.

Then again, even on the sensitivity test, they're defining the level and the breadth of the sensitivity tests, so they're getting very uncomfortable with basically everything that is under the actuary's discretion. What they're asking for is a justification of that, which is fine, because we do put that into the memoranda. But they're also asking, in addition to that, do it our way so we can see what the answer would be if you used our mortality and if you used our other experience assumptions.

MR. MC CARTHY: Given your point, on which I agree, that seems counter to the things we've been talking about this morning. You might ask, "How do we get to things like Actuarial Guideline 39 and so forth?" The answer is that the other side of all this is that, with product complexity and features that are very nonstandard from company to company, the folks just couldn't keep up writing rules fast enough to keep up with the product features. As a result you have this dichotomy. On the one hand you say that the only way to get a reasonable answer given that the products are different and developing rapidly, is to give some discretion. On the other hand, as Anthony said, they want to put some boundaries around that. So that to me is the tension, and we're not at the end of that tension yet.

MS. LAIFOOK: Since there are no more questions, please join me in thanking our panel of speakers.