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Responsibilities Of The Actuary For Communicating Sarbanes-Oxley Control: Effectiveness In Accordance With Actuarial Standards of Practice

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Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) requires the company's annual report to contain an "internal control report" which includes an assessment, as of the end of the fiscal year, of the effectiveness of the internal control structure and procedures of the company for financial reporting. This assessment is presumably created by the company's internal audit staff and attested to by the company's independent auditors.

The process of estimating actuarial assets and liabilities for the financial statements is part mechanical and part judgmental. The mechanical part, such as gathering data, performing calculations and transmitting results, is easily evaluated with controls that record the successful completion of steps in the process and the assumptions used. The process of forming an opinion or making a judgment is not as easily captured in a series of auditable steps. SOX does not specifically require an actuary to attest to the actuarial items in the financial statements; however, in view of the fact that the most critical aspects of actuarial valuation, viz., selection of assumptions, adequacy of reserves, environmental factors affecting results, conformity with FAS 60, 97, etc., are not easily auditable by the internal auditors, the company's assessment report needs to rely on some kind of report or statement from an actuary.

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Since the actuarial valuation process is outside the area of expertise of the internal auditors, an actuary must attest to the fact that sufficient control procedures are in place to ensure the accuracy and appropriateness of the actuarial assets and liabilities, that they were followed at year-end, and that any significant changes in assumptions or methods are noted.
This article addresses the scope and form of the actuary's report. Several questions need to be answered. Which Actuarial Standards of Practice (ASOPs) apply and what do they require of the actuary? Is this a formal or informal communication? Is it, in fact, a Prescribed Statement of Actuarial Opinion (PSAO)? The viewpoint of the article assumes that the actuary's report is written by an actuary employed by the company. Many of the concepts also apply to an external actuary.

Existing Actuarial Guidance

ASOP No. 21 (second exposure draft 1/04): *Responding to or Assisting Auditors or Examiners in Connection with Financial Statements*. The company actuary acts as a "responding actuary" when dealing with the auditor. The responding actuary should prepare to discuss data, assumptions and methods; in particular a) the data used, b) the source of assumptions and c) the methods used. In addition, the responding actuary should prepare to discuss "known circumstances that had a significant effect on the preparation of those elements of the financial statement for which the actuary is the responding actuary." These include a) changes in the operating environment, b) trends in experience, c) product or plan changes and changes in product mix, d) changes in the company's methods, policies or procedures, or in statutory valuation bases and e) compliance with relevant new or revised accounting rules, laws and regulation or other government promulgations.

ASOP 21 does not require the actuary's work in conjunction with an auditor to result in a PSAO. However, ASOP 21 does not have the last word on this issue, because "law, regulation or accounting requirements" may apply, and as a result, the actuary's communication may be a PSAO. So SOX may, directly or indirectly, require an actuarial report to the auditors or to management, thus making it a PSAO.

ASOP No 41: A*ctuarial Communications.* This ASOP applies to written and oral communications, including communications to the actuary's employer. In determining whether the communication should be written or oral, the actuary should consider the complexity of the assignment, the actuary's perception of the significance of the actuarial findings and relevant communication guidance in other ASOPs. In addition, the form and content of the communication should be clear and appropriate to the particular circumstances. The communication will probably not be subject to the standards of an "actuarial report," even if it is written, if the intended audience does not include investors or regulators.

ASOP No 23: *Data Quality.* This ASOP does not require the actuary to audit data; it deals with the actuary's review of data and the disclosure of data issues. An actuary's report should include the following disclosures:

a) The source of the data.
b) The materiality of any potential biases of which the actuary is aware that are due to imperfect data.
c) Adjustments or modifications made because of imperfect data, other than routine corrections made by reference to source documents.
d) The extent of reliance on data supplied by others.
e) In the event the actuary has not sufficiently reviewed the data, any resulting limitation on the use of the actuarial work product.
f) Any unresolved concern the actuary may have about the data that could have a material effect on the actuarial work product.

The guidance cited in the three previously mentioned ASOPs is most commonly followed by company actuaries for informal internal reports. The primary exception is for statutory values that are covered in the annual Actuarial Opinion. There is no formal actuarial opinion required covering GAAP items that would include the disclosure items in the above ASOPs, or for that matter, covering the adequacy or appropriateness of reserves.

The Meaning of Internal Controls

In order to determine which valuation functions, processes, activities, etc., fall within the scope of Sarbanes-Oxley, we first need to understand what "internal controls" means in the context of SOX and by what criteria management will assess the effectiveness of the internal controls.

First, some history:

In 1985 a private sector initiative, known as the Treadway Commission, was formed to study the financial reporting system in the United States. In response to a 1987 report issued by the Treadway Commission, a committee of sponsoring organizations of the Treadway Commission (known as COSO), undertook an extensive study of internal controls. In 1992, COSO published Internal Control-Integrated Framework, which defined internal control as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in three categories—effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations. The scope of internal control, according to COSO, extends to policies, plans, procedures, processes, systems, activities, functions, projects, initiatives and endeavors of all types at all levels of a company. In 1995 the AICPA incorporated the definition of internal control set forth in the COSO report in Statement of Auditing Standards No. 79 (codified as AU 319).

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The COSO definition of internal control is broad and would, in my opinion, include most aspects of the actuary's work in the valuation process, including adequacy of reserves and conformity to FAS 60 and 97, etc. However, the SEC adopted a more limited definition of internal control in its final rule to implement Section 404. The COSO definition could still come into play in the assessment process, as I shall explain later.

The final SEC rule adopts the term "internal control over financial reporting" in place of the broader "internal control." In Exchange Act Rules 13a-14(d) and 15d-14(d), it then defines this term to mean:

"A process… to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant.
(2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are made only in accordance with authorizations of management and directors of the registrant.
(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements."

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COSO is not required, ... because "…other evaluative standards exist outside the United States and that frameworks other than COSO may be developed within the United States in the future."

This definition is obviously only a subset of the COSO definition. The final rule on management's annual assessment of and report on the internal controls over financial reporting states, however, that management must base its evaluation of the effectiveness of internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. "The COSO Framework satisfies our criteria," they go on to say. COSO is not required, they continue, because "…other evaluative standards exist outside the United States and that frameworks other than COSO may be developed within the United States in the future.[1]"

So it looks like COSO is the standard to use <u>in the United States</u> for the time being.

Actuarial Valuation Processes Falling within the Scope of Sarbanes-Oxley

Table 1 shows a list of valuation processes and steps (not exhaustive by any means) with an indication of whether (in my opinion) they fall under the COSO or the SEC definition of control.

These are broad categories. Actual controls would be much more detailed. Of course, there will be differing opinions on my "Yes/No" indications above.

Who Attests to Actuarial Controls and What Form Should it Take?

Assuming that the COSO definition is the operative one, what does the assessment of the internal control report imply with respect to actuarial values in the financial statements? At a minimum, I think the following is implied:

That…

Table 1

Process	SEC	COSO
Validation of input data	Yes	Yes
File/Data security measures	Yes	Yes
Appropriateness and accuracy of algorithms	No	Yes
Adequecy of reserves	No	Yes
Conformity with law (including taxes)	No	Yes
Appropriateness of assumptions	No	Yes
Follow documented workflow	Yes	Yes
Identify change in assumptions/methods	Yes	Yes
Document assumptions/methods	Yes	Yes
Analysis, review and approval process	Yes	Yes
Worksheet checks and balances	Yes	Yes

1) The valuation input data has been reconciled to the underlying records of the company with the following material adjustments and concerns.
2) The manipulation of data, including calculations, was performed within a framework that included checks and balances on the accuracy of the result and included measures to prevent unauthorized access or modifications.
3) The actuarial methods and assumptions used conform to accepted actuarial standards and generally accepted accounting principles and are consistent with the previous year, with exceptions.
4) The net actuarial liability together with anticipated future premiums are sufficient to pay all future benefit obligations for the policies in force.

All of the above are evidenced by controls, which may take the form of a sign-off or a process followed. It seems to me that the annual assessment of the internal controls contains within itself an actuarial opinion, namely, items 1 through 4 above (at a minimum). Does this opinion call for a formal "actuarial report?" And does this actuarial report constitute a prescribed statement of actuarial opinion, since it forms, in essence, a part of a required SEC disclosure? I think there is a strong case for an answer in the affirmative. If that is the case, the actuary should prepare such a report and submit it to the CEO and CFO (who ultimately must make the assurances concerning the financials) or at least to the internal auditor for inclusion in the assessment report. $

[1]*Final Rule: Management's Reports on Internal control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic reports II B. 1.*