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Australian Auditors and General Insurance Actuaries

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Abstract

This paper discusses the roles and responsibilities of the Approved Auditor and the Approved Actuary (or other Primary Actuary as may be the case) in the preparation and audit of a general insurer's financial statements. It further examines this topic in the specific context of data.

The paper explores the interaction between the roles, and aims to provide actuaries with a broad overview and understanding of the Auditor's responsibilities and requirements in relation to the actuarial work.

The new External Peer Review process is going to impact on both these roles, and the paper explores some of the impacts this may have during the valuation and audit cycle.

Keywords: auditors, audits, data, external peer review; peer review;

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1 Introduction

This paper has been written by an Auditor (Paul Harris) and two Actuaries (Susan Ley and Corinna Lueg). The two actuaries who authored this paper play a number of roles, including that of Audit Assist Actuary on an audit team, as well as Primary Actuary providing advice to insurers.

The genesis of our paper is an observation of a wide range of practices in the interaction between Auditors and Actuaries. With the increasing number of actuaries involved in the audit process, the boundaries between the role of the Auditor and the various Actuaries are at times blurred.

1.1 Aims of the paper

In writing this paper we aim to make a positive contribution to the debate about the roles of Auditors and Actuaries by:

- Providing an Auditor's view on the how and why of auditing insurance liabilities;
- Considering the regulatory backdrop to the preparation of the Insurance Liability Valuation ("ILV"), with a particular focus on the responsibility for data; and
- Considering the guidance available to Actuaries which highlights how they may become satisfied that the data relied on in preparing the ILV is reliable.

The paper seeks to highlight the similarities between the role of the Approved Auditor and the Approved Actuary (while acknowledging their differences), as it appears to the authors that these similarities are significant. Both roles involve:

- Personal responsibility as a statutory appointment under the Insurance Act; and
- The expression of an opinion for which the professional retains ultimate responsibility.

This paper does not seek to deal exhaustively with the full range of responsibilities of each role. Nor does it seek to set out protocols for interaction between the professions. Rather it seeks to draw together the various requirements, be they professional standards or regulation, as they pertain to a select number of issues. In pulling together the various sources of guidance, we have sought to interpret and extrapolate those requirements and to provide our view on what practice may be considered reasonable in the circumstances. Given the personal appointment of the Approved Actuary we believe it is important for Actuaries to be cognisant of the need for risk management, and it may be that the experience of Auditors in this area could be of interest to Actuaries.

The pace of regulatory development during the course of 2005 continues to be significant, and the paper also examines some of the implications of the External Peer Review, ("EPR") for both the Approved Actuary and the Approved Auditor.

In preparing this paper we have not deliberately sought to be controversial. However, we acknowledge that some of our views may be perceived as such. The statutory role of the Approved Actuary is a relatively new one, and with the introduction of the EPR and Financial Condition Reports (“FCR”), the Approved Actuary role continues to develop. We believe that debate about the boundaries of the actuarial role is an important component of increasing the awareness of the responsibilities of Approved Actuaries, and contributing to consistency in market practice.

1.2 Background Paper

Some of the basic and factual information in relation to the Auditor and Audits are given in a background paper jointly prepared by the authors of this paper together with Jefferson Gibbs, Samantha Hu and John Barker. This paper’s synopsis is as follows:

A Background to General Insurance Audits in Australia. This paper is factual in nature and is intended as a reference point for actuaries interacting with auditors in the context of a general insurance audit. It covers the relevant background to the role of the Auditor including relevant standards and regulations. It introduces key audit concepts and terms.

We have reproduced some of the background material in this paper to the extent that we feel it important in building the backdrop to the specific conclusions of our paper. We have sought to reduce the overlap between the papers as much as possible.

1.3 Acknowledgements

We would like to thank our peer reviewers Peter McCarthy, Andrew Mead, and Mark Raumer from Ernst & Young.

We would like to thank Jefferson Gibbs and Samantha Hu from KPMG Actuaries for their comments, and for their valuable assistance in challenging the positions which we have taken.

We would also like to thank all our colleagues who have provided us with time, input and valuable debate during the writing of this paper.

1.4 Limitations

Whist we acknowledge the contribution of the above, all the opinions expressed are our own, and not those of our employers Ernst & Young and Ernst & Young Actuarial Business Consultants, our clients, the peer reviewers, authors of the concurrent papers or of the Institute of Actuaries of Australia or the Institute of Chartered Accountants in Australia.

2 Who's who – a guide to actuaries involved in the audit process

2.1 Different roles, responsibilities and perspectives

In this section we take a brief look at the various actuaries who may be involved in an audit. At its simplest, there may only be one, the Primary Actuary. At its most complex, four or more actuaries may be involved, including the Primary or Approved Actuary, Company Actuary or Actuaries, the Audit Assist Actuary and in the future, the EPR Actuary.

The following diagrams aim to show how the Australian actuarial profession's involvement in general insurance has grown and evolved over the last 20 years. We particularly wish to highlight that the level of direct actuarial involvement within entities has increased, as well as the interaction of actuaries within the audit process. The nature of recent changes to the general insurance environment are very complex and the evolution has occurred in a very short period of time.

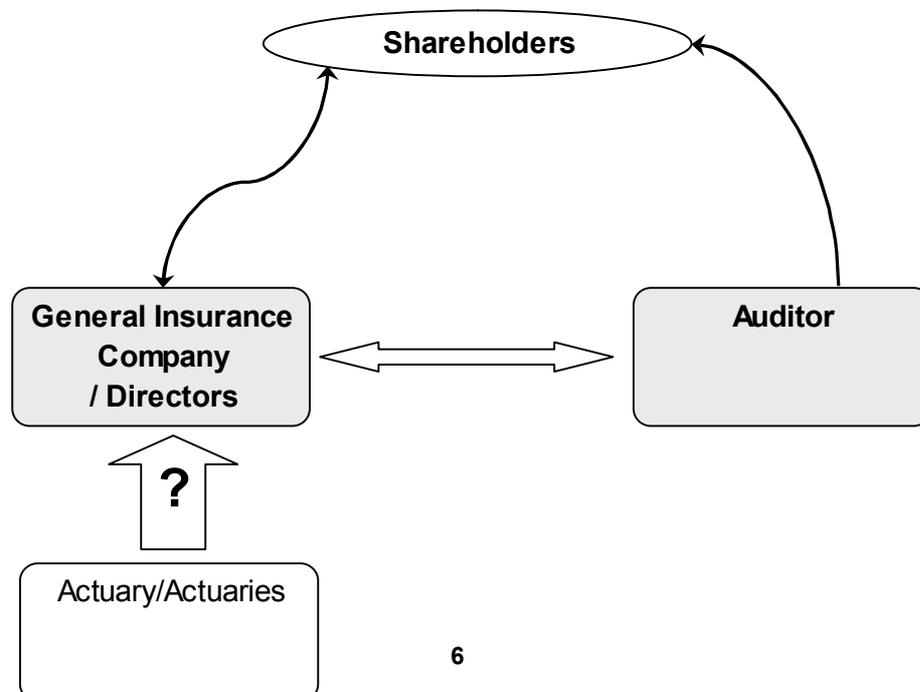
In the diagrams that follow

- a shaded grey box denotes a statutory role,
- a solid arrow denotes a statutory line of communication,
- a dashed line with a “?” denotes a non-statutory line of communication that may or may not exist
- a block arrow denotes a line of communication that exists (a “?” denotes a line that will only exist if the actuarial role exists)

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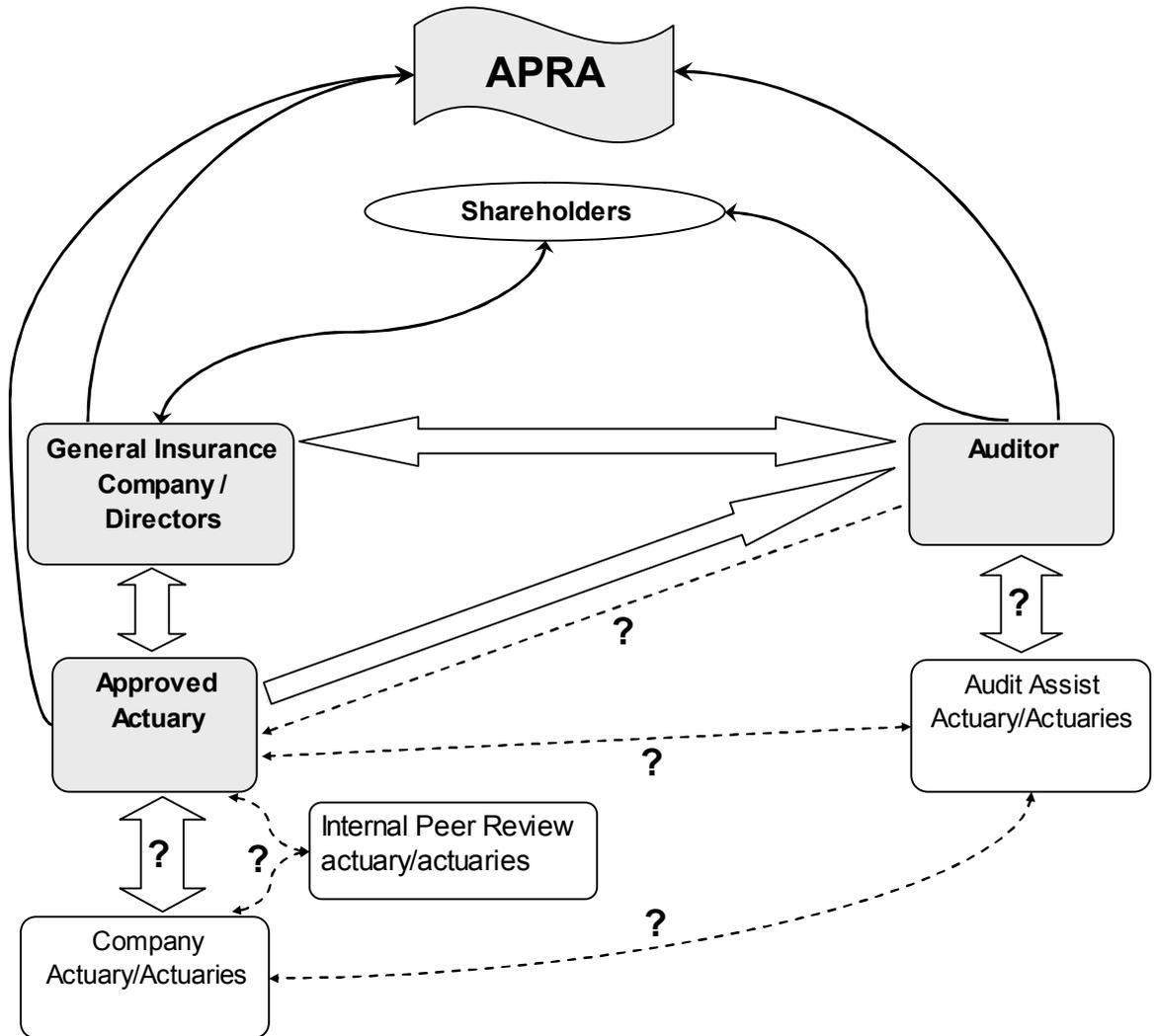
There were no statutory roles for actuaries in general insurance and it is unlikely that the Big 8 audit firms were routinely seeking actuarial input for their audits.

According to “The Future Managers”¹ there were 7 actuaries listed as working for general insurers in 1981. Not many to go round, although some of the consulting actuaries were also working in the field and are not captured in this number.



Since 2002

In July 2002 the Approved Actuary role came into force and this was the first time that there was a statutory role for general insurance actuaries within insurance companies. Most of the Big Five accounting firms (soon to be Big Four) had in-house actuarial capabilities although there is no statutory requirement for Audit Assist Actuaries.



As can be seen from the diagram there may be many actuaries involved in the valuation and audit process (and this will vary from entity to entity). The number of interactions between the entity, the regulator and the various professionals has necessarily become more complex.

For the actuarial roles above and others that may be involved in the process, we set out briefly

- the statutory nature (if any) of the role
- the broader role
- their interaction with the Auditor.

2.2 Primary Actuary

In this paper, we define the Primary Actuary as the actuary providing the advice that is the subject of audit and/or peer review. For licensed insurers, the Primary Actuary will also be the Approved Actuary. In other organisations that are not licensed, such as Mutual Discretionary Funds (MDF's) and Government insurance vehicles, the Primary Actuary will be the actuary appointed to value the insurance (or insurance-like) liabilities. The Primary Actuary role may be performed by someone in-house or by a consultant, and may or may not be governed by specific legislation.

For more information on the legislation applying to companies with insurance or insurance-like liabilities who are not licensed, we refer the reader to the background paper "A Background to General Insurance Audits in Australia".

The scope of the work carried out by the Primary Actuary can vary from a full GPS210/PS300 compliant valuation to a rough estimate of liabilities depending on the nature of the company involved and the purpose of the work. Their interaction with the Auditor may also be limited, especially in those cases where a large organisation has a relatively small insurance liability that is below the Auditor's materiality threshold. Correspondingly, their interaction with a peer reviewer or an Audit Assist Actuary may vary.

2.3 Approved Actuary

This is currently the only General Insurance statutory role for actuaries. Every authorised insurer must have one or have an exemption from APRA. If the Approved Actuary is an in-house position, he/she may also have a position in the senior management team of the company.

The Approved Actuary has a number of responsibilities under APRA's prudential standards. At the current time, the Approved Actuary is responsible for producing a Liability Valuation Report (soon to be renamed ILV) encompassing both outstanding claims and premium liabilities. The Approved Actuary's role is set out under GPS 210 "Liability Valuation for General Insurers" issued by APRA. This will soon be replaced with GPS 310 "Audit and Actuarial Reporting and Valuation".

The Approved Actuary takes responsibility for the liability valuation even if the task is delegated to another actuary. The Approved Actuary is likely to be the first point of call for the Auditors and any Audit Assist Actuary, and will be heavily involved in answering any questions from the Auditor.

There is no limit to the number of Approved Actuary roles that an actuary may hold, although there may be a practical maximum to the number of appointments which may be held. A number of actuaries undertake the Approved Actuary role for more than one general insurer.

As the role of the Approved Actuary expands next year to include the FCR it may become increasingly difficult from a practical perspective for an actuary to be able to carry out the Approved Actuary role for more than one insurer.

APRA has introduced tripartite reviews performed by the Approved Auditor, and has introduced the capacity for similar reviews to be carried out in the future by the Approved Actuary.

2.4 Internal (In-house) Peer Review Actuary

This is not a statutory role but is one that most actuaries would include in their day-to-day work processes. The Internal Peer Review Actuary is the person who reviews the Primary Actuary's work prior to it being presented to the client (internal or external). They provide quality control and can act as a sounding board for ideas prior to a report being issued. The Institute of Actuaries of Australia ("IAAust") in the explanatory memorandum for the Exposure Draft of PS505 (External Peer Review) describes internal peer review as something they strongly encourage.

The scope of the internal peer review is at the discretion of the parties involved, and there is no standard which sets out the terms or scope of an internal peer review. It could be very wide and high level, or it may be focussed and in detail, or anywhere in between. It may be formal or informal. There may be written documentation or not.

The Auditor is unlikely to have any interactions with the in-house or internal peer reviewer, whether there is a formal report or not.

2.5 Audit Assist Actuary

There is no statutory role for an Audit Assist Actuary. The Auditor continues to have the discretion to use an Actuary to assist in the Audit and the scope and breadth of the actuarial audit review will be determined by the Auditor. The only specific actuarial guidance that applies to the Audit Assist Actuary is the IAAust's Code of Professional Conduct.

The EPR PS505 does not apply to the review performed by an Audit Assist Actuary. The Audit Assist Actuary takes his/her scope from the Auditor. However, the scope required by the Auditor will contain many items in common with the scope of an EPR and the Audit Assist Actuary will be able to look to the EPR standard for guidance, (although compliance by the Audit Assist Actuary will not be compulsory whilst performing only the Audit Assist role).

The EPR Standard, and indeed APRA's draft prudential standard, does not preclude the Audit Assist Actuary from performing the EPR. If the Audit Assist Actuary is engaged as the EPR Actuary, then compliance with PS505 would be mandatory for the EPR report.

In practice, for particular entities, an Auditor may not require a review as comprehensive as that described in the EPR, or alternatively, they may require a review with a wider scope and in more detail than that provided in the EPR. In cases where the EPR Actuary and the Audit Assist Actuary are not the same actuary, there may be overlap in the scope of work required by each.

2.6 External Peer Review Actuary

From 2006, the External Peer Review will be a statutory role for APRA regulated general insurers and is likely to be considered best practice for other organisations with insurance or insurance-like liabilities. The IAAust strongly encourages External Peer Review and the exposure draft of the PS505 standard has been drafted with a wider application than only for APRA regulated entities.

Currently the statutory role of the Peer Review Actuary is set out in the draft version of GPS 310. The Peer Review Actuary must meet similar qualification standards to the Approved Actuary. There is no APRA requirement for rotation of the EPR Actuary. The scope of the work does not extend to an independent valuation but rather to an assessment of the reasonableness of the results and that the work has been carried out in accordance with the standards.

Exposure Draft PS505 is similar to the draft APRA GGN310, however, it does not specify the qualifications required for the EPR Actuary. Draft PS 505 permits the EPR report to be addressed to the board, the Approved Actuary or the Auditor with the expectation that all these parties, and APRA, will receive copies. It requires rotation of the EPR Actuary every five years.

Similar to the APRA scope, the work of the EPR Actuary does not extend to an independent valuation, but rather is an assessment whether the methods, assumptions and results are 'not unreasonable'. The EPR will be a Professional Standard and therefore compliance will be mandatory.

It is probable that the report prepared by the EPR Actuary will also be considered by the Auditor.

2.7 Company Actuary

This category includes actuaries other than the Approved Actuary or Primary Actuary working for an insurer/self-insurer or other entity. In a large insurer there will be more than one actuary. The other actuaries may work for the Approved Actuary or in other capacities and may be involved in producing part of the valuation required under GPS 210. We refer to the latter group as Valuation Actuaries.

2.8 Other Actuaries

This may include actuaries working at overseas parent companies. We include these actuaries to remind our readers that subsidiaries and branches may be required to carry out valuations and supply other information to their parents in a different form to that required to meet Australian standards. The Other Actuary may review the Primary Actuary's work or may produce their own valuation. In either case, it should be remembered that the ILV and FCR may be read by a wider range of users than strictly the person to whom the report is addressed.

2.9 Interaction

The variety of actuaries who may be involved in the ILV and audit process is increasing. While in the near future only two will have a statutory role (in Australia) it should be remembered that it is likely that other actuaries will be involved. Given the increasingly complex nature of the liability valuation and audit processes, (as well as the overall business environment) the need for clear and frequent communication between the parties is obvious.

3 Role of the Auditor

3.1 Introduction to the insurance audit

The Insurance Act requires all licensed general insurers to appoint an Auditor who is approved by APRA². Although the Act and prudential standards allow for companies to apply for an exemption from appointing an Approved Actuary, there is no such exemption in relation to the appointment of an Approved Auditor.

The requirement to appoint an Auditor exists whether or not the appointment of an Auditor is required under the Corporations Act. For instance, insurers operating in Australia as a branch may not be required to produce audited financial statements, and so the requirement to appoint an Auditor arises solely from the provisions of the Insurance Act.

This paper does not draw a distinction between the financial audit performed under the Insurance Act as compared to the Corporations Act, as we do not believe that the responsibilities of Auditors differ significantly in either scenario

To help put the issues relating to the audit of general insurers in context, this section briefly explores the role of an Auditor, what an audit is, audit opinions and how an Auditor goes about conducting an audit of the insurance liabilities.

3.2 Role of the Auditor

What is an Audit?

Australian Auditing Standards define an audit as

“a service where the auditor’s objective is to provide a high level of assurance through:

- a) the issue of a positive expression of an opinion that enhances the credibility of a written assertion about an accountability matter (“attest audit”) or*
- b) the provision of relevant and reliable information and a positive expression of opinion about an accountability matter where the party responsible for the matter does not make a written assertion (“direct reporting audit”).”³*

The process of performing an audit involves the collation of evidence about a particular reporting matter in order to enable the expression of an opinion.

The comments in this paper relate to audits of:

- financial statements of general insurers prepared in accordance with the Corporations Act (financial statements), and
- annual statutory returns prepared pursuant to the Insurance Act (APRA returns).

The audits of both financial statements and APRA returns are attest audits – that is they seek to enhance the credibility of the governing body’s declaration that the financial statements, or APRA returns, present a true and fair view of:

- the financial position of the insurer at balance date;
- the financial performance of the insurer for the period ended on that date.

An additional task of the Approved Auditor is to report on certain compliance matters, however this component of their work is outside the scope of this paper.

3.3 Responsibilities of Auditors

The objective of the Auditor's work is to form an opinion on the truth and fairness of the financial information being audited. This derives from a number of sources, including the following.

Corporations Act

Section 307 of the Corporations Act requires, inter alia, that:

“An auditor who conducts an audit of the financial report for a financial year or half-year must form an opinion about:

(a) whether the financial report is in accordance with this Act, including:

- (i) section 296 or 304 (compliance with accounting standards); and*
- (ii) section 297 or 305 (true and fair view)”*

Insurance Act

Section 49J of the Insurance Act requires that:

“The auditor of a general insurer appointed in accordance with section 39 must:

- a) audit the insurer's yearly statutory accounts; and*
- b) perform for the insurer the functions of an auditor set out in the prudential standards; and*
- c) prepare, and give to the insurer, the reports (if any) required by the prudential standards to be prepared by the auditor.”*

APRA's Prudential Standards

GGN 220.1 Governance defines the role of the Auditor as follows:

“The Approved Auditor's primary role is to provide an independent and objective view on the truth and fairness of financial statements, and the Approved Auditor may also provide an assessment of the internal controls and processes within an insurer.”⁴

“The Approved Auditor must audit the yearly statutory accounts of an insurer as required by the Act.”⁵

3.4 Professional Scepticism - Onus of proof in an audit

The conduct of an audit is based on the Auditor adopting an attitude of professional scepticism. References to this concept are scattered throughout auditing standards, for example:

“The practitioner plans and performs an assurance engagement with an attitude of professional scepticism recognising that circumstances may exist that cause the subject matter information to be materially misstated.”⁶

AUS 108 Framework for Assurance Engagements defines professional scepticism as a requirement to

“make a critical assessment, with a questioning mind, of the validity of evidence obtained and [to be] alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party.”

We interpret professional scepticism to mean that the Auditor should not assume that the financial statements are fairly stated until such time as enough audit evidence has been obtained to justify that position. It is the responsibility of the preparers of the financial statements, in this case the insurer, to provide the Auditor with sufficient information to enable the formation of an opinion.

3.5 Overview of Audit Opinion

As noted above, the Approved Auditor’s report on various compliance matters are outside the scope of this paper. Rather we focus on the audit report prepared in respect of the insurer’s financial statements and APRA returns. We have appended generic audit reports in Appendix B and Appendix C.

The content of an audit report issued in relation to an insurer’s financial statements is mandated by the Corporations Act.

The content of an audit report issued in relation to an insurer’s regulatory returns is outlined in Auditing Guidance Statement AGS 1064 Audit Implications of Prudential Reporting Requirements for General Insurers. Whilst Auditing Guidance Statements are not mandatory, the content of AGS 1064, including the example reports appended to the AGS, were agreed through a consultation process between the auditing profession and APRA.

Audit reports contain two elements – a statement of scope, and an expression of opinion.

The scope paragraph:

- Identifies that the audit has been conducted in accordance with Australian Auditing and Assurance Standards;
- Identifies the basis on which the financial information has been prepared;
- Identifies the purpose for which the audit has been performed;
- Identifies the parties who are entitled to rely on the audit opinion;
- Provides an overview of the nature of an audit, in particular that the procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the yearly statutory accounts, and the evaluation of significant accounting estimates.

The audit report issued on the annual APRA return includes a statement of opinion that:

“the yearly statutory accounts of [insurer] in respect of the year ended [date] present fairly the results of operations for the year and financial position at year end, in accordance with the provisions of the Insurance Act 1973, the Financial Sector (Collection of Data) Act 2001, Prudential Standards, [other APRA correspondence as deemed necessary], and, to the extent that they do not contain any requirements to the contrary, Accounting Standards and other mandatory professional reporting requirements in Australia.”

The audit report issued on the Corporations Act financial statements includes a statement of opinion that:

“the financial report and the additional disclosures included in the directors report designated as audited of [insurer] are in accordance with:

- a) *the Corporations Act 2001, including:
giving a true and fair view of the financial position of [insurer] at balance date and of its performance for the year ended on that date; and
complying with Accounting Standards in Australia and the Corporations Regulations 2001; and*
- b) *other mandatory financial reporting requirements in Australia.”*

Whilst the Auditor does not express an opinion on individual components of the financial statements, the audit clearly involves being satisfied that the insurance liabilities are fairly presented in accordance with the relevant accounting framework. This framework includes:

- in respect of the Corporations Act financial statements, Australian Accounting Standard AASB 1023 Financial Reporting of General Insurance Activities (AASB 1023), or
- in respect of the regulatory returns, APRA’s prudential standard GPS 210 Liability Valuation for General Insurers (GPS 210).

3.6 How does an Auditor conduct an audit, particularly in relation to the audit of the insurance liabilities?

The Basics

An Auditor must conduct the audit in accordance with Australian Auditing Standards. This obligation is imposed by s307A of the Corporations Act (in relation to audits of financial statements) and the Institute of Chartered Accountants (ICAA) Professional Statement APS 1.1 Conformity with Auditing Standards in respect of all audit and audit related engagements.

It is important to note that from July 2006, Auditing Standards will have force of law under the Corporations Act, and currently have interim endorsement under that Act. A failure to conduct an audit of financial statements in accordance with Auditing Standards represents a breach of the Corporations Act and is an offence of strict liability.⁷

Auditing Standard AUS 502 Audit Evidence

The basic principle underlying the conduct of an audit is captured in AUS 502 Audit Evidence, which notes that:

“the auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.”⁸

In addition to providing guidance as to what evidence an Auditor might consider to be “sufficient” and “appropriate”, AUS 502 also outlines general methods which an Auditor may adopt to gather audit evidence. These may include a combination of:

- inspection of records or documents;
- inspection of tangible assets;
- observation (for example, of a process);
- inquiry of management and others;
- confirmation from independent sources;
- recalculation such as the deferral of premium income or cessions to reinsurance treaties;
- re-performance of a process or control (for instance the stratification of data)
- analytical procedures applied to the financial information.

The audit approach adopted for a particular entity will be a matter of professional judgement for the Auditor. It will include a combination of these general approaches as is considered most appropriate for the particular balance item being audited.

The remainder of this section focuses on the audit approach adopted in respect of insurance liabilities, comprising the outstanding claims provision for the financial statements, and the outstanding claims provision and premium liabilities for the APRA return.

Auditing Standards AUS 516 Audit of Accounting Estimates

Auditing standards define accounting estimates as those items in the financial statements which represent

“an approximation of an amount of an item in the absence of a precise means of measurement”⁹

Clearly insurance liabilities fall within this definition.

Auditing standards provide specific guidance on auditing accounting estimates in recognition of the particular uncertainty associated with them. Auditing Standards state that the Auditor should:

“obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances”¹⁰.

The assessment of whether an accounting estimate is “reasonable in the circumstances” is a matter of professional judgement for the Auditor.

AUS 516 Audit of Accounting Estimates provides guidance to Auditors on appropriate ways to gather audit evidence on the “reasonableness” of accounting estimates such as the insurance liabilities, which include three different audit approaches:

- a) “review and test the processes used by management to develop the estimate;
- b) use an independent estimate for comparison with that prepared by management; or
- c) review subsequent events which confirm the estimate made.”¹¹

The observation of subsequent events is not a realistic audit approach for the outstanding claims provision, since by the time the audit is finalised, only extremely short-tailed liabilities will have run-off. The observation of subsequent events approach will never be an option for premium liabilities.

The determination of an independent estimate would require the Auditor to perform a full independent valuation, or engage another specialist to perform a full valuation independent of the Approved Actuary. Clearly this is not an ideal approach as it duplicates the work of the Approved Actuary and is extremely costly and time consuming. This approach is only adopted in the audit of insurance liabilities when it is determined that the other two audit approaches are not appropriate.

The preferred and most commonly adopted approach in auditing insurance liabilities is to review and test the “processes used by management to develop the estimate”. This includes the valuation processes adopted by the Approved Actuary (or valuation actuaries) in forming their recommendation on the liabilities, as well as considering management’s approval procedures.

Steps to be undertaken in auditing the liability valuation process

AUS 516 provides further guidance to the Auditor as to the steps which should be undertaken in auditing the liability valuation process. These include:

<i>Ref</i>	<i>Procedure</i>
.11	<ul style="list-style-type: none"> a) evaluation of the data and consideration of assumptions on which the accounting estimate is based; b) testing of the calculations involved in the accounting estimate; c) comparison, where possible, of accounting estimates made for prior periods with actual results of those periods
.14	evaluate whether the data collected is appropriately analysed and projected to form a reasonable basis for determining the accounting estimate
.15	evaluate whether the entity has an appropriate base for the principal assumptions used in the accounting estimate
.16	<p>In evaluating the assumptions on which the accounting estimate is based, the Auditor would consider, among other things, whether they are:</p> <ul style="list-style-type: none"> • reasonable in light of actual results in prior periods; • consistent with those used for other accounting estimates; and • consistent with management’s plans which appear appropriate. <p>The Auditor would need to pay particular attention to assumptions which are subjective, or those which the insurance liability is sensitive to or which make the liability valuation susceptible to material misstatement.</p>

In order to discharge the obligations imposed by auditing standards, the Auditor should perform audit procedures to form an independent view on whether the valuation processes produce a reasonable estimate.

These procedures would include:

- Considering whether the data used by the Actuary is appropriate for the valuation, and consider the testing performed by the Actuary in determining the reliability of the data.
- Considering the adequacy and appropriateness of the analysis performed by the Actuary.
- Obtaining an understanding the assumptions on which the liability valuation is based, and form a view on their reasonableness.

Most importantly, the Auditor is not entitled to assume that the insurance liabilities are reasonable simply because they are provided by the Approved Actuary.

Audit Assist Actuary

The Auditor will often use actuarial specialists (Audit Assist Actuaries) in the audit team to assist the Auditor in assessing the reasonableness of the insurance liabilities. The use of Audit Assist Actuaries is not mandated, nor is it necessary in all circumstances.

However, it should be noted that when the Auditor engages an Audit Assist Actuary, the Audit Assist Actuary is performing in the audit role and not in the role of a peer reviewer, although they may also hold the EPR role.

Source of Evidence

The primary source of evidence in respect of the audit of insurance liabilities is the Primary Actuary's ILV report. We believe, therefore, that it is imperative from an audit perspective that the ILV fully capture the assumptions and analysis performed by the Primary Actuary.

Where matters are not covered in the ILV the Auditor must obtain this information in other ways. This would generally involve significant further discussions between the Auditor and/or Audit Assist Actuary and the Primary/Approved Actuary.

Clearly, the process of obtaining sufficient appropriate audit evidence requires a high degree of interaction between the audit team and the various actuaries involved in the valuation process.

Assessment of Audit Differences

The Auditor needs to “*make a final assessment of the reasonableness of the accounting estimate based on the auditor's knowledge of the business and whether the accounting estimate is consistent with other audit evidence obtained during the audit.*”¹²

Where the Auditor believes a different accounting estimate is supported by the audit evidence, the Auditor considers whether that difference requires adjustment in the financial statements. This requires the consideration of whether the adopted valuation is “reasonable”, or lies within a reasonable range of outcomes. Where the recommended liabilities lie within that reasonable range, the accounting estimate would not require adjustment in order to continue to present a true and fair view of the financial position of the insurer. Where the accounting estimate lies outside that reasonable range, the Auditor considers the amount by which the accounting estimate is outside the reasonable range as an audit difference, and considers its impact on the truth and fairness of the financial statements.¹³

Materiality

Auditors consider the aggregate amount of identified misstatements to the financial statements using the concept of materiality. Materiality represents the aggregate of audit errors which could exist within a set of financial statements before the Auditor would form the opinion that they no longer present a true and fair view of the financial position and performance of the insurer. Material misstatements are those which would “*adversely affect decisions about the allocation of scarce resources made by users of the financial report.*”¹⁴

Auditing standards provide guidelines in assessing quantitative thresholds for determining materiality. It is likely in many, if not most, scenarios, that the reasonable range in respect of insurance liabilities will be significantly larger than the identified materiality thresholds. A good example of this would be where the liabilities include exposure to asbestos. In this case a reasonable range may well be several times the Auditor’s materiality threshold. Importantly, it should be remembered that the determination of what range is reasonable is for the professional judgement of the Auditor. Auditing standards do not provide guidance in this area.

3.7 AUS 606 – Using the Work of an Expert

Clearly, the audit approach described above envisages placing reliance on the work of the Primary Actuary, and the Auditor must therefore perform certain additional procedures in order to justify being able to rely on that work. These procedures are outlined in AUS 606 Using the Work of an Expert, and the specific application of these general rules in AUS 524 – The Auditor’s Use of the Work of the Actuary and the Actuary’s Use of the Work of the Auditor in Connection with the Preparation and Audit of a Financial Report.

As noted above, should the Auditor not be able to rely on the actuarial valuation process, the Auditor would need to determine an independent estimate of the insurance liabilities (or issue a qualified audit opinion).

In order to have a reasonable basis for relying on the work of the expert, the Auditor should:

- assess the professional competence of the expert¹⁵
- assess the objectivity of the expert¹⁶
- obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purposes of the audit.¹⁷
- assess the appropriateness of the expert's work as audit evidence regarding the financial report assertion being considered.¹⁸
- obtain an understanding of the assumptions and methods used and consider whether they are reasonable, based on the Auditor's knowledge of the business and the results of other audit procedures.¹⁹ This requirement is consistent with the basic audit approach to accounting estimates outlined in AUS 516 and discussed above.

3.8 What are the sanctions which can be applied against auditors if things go wrong?

The Auditor's role, as a statutory appointment under the Corporations Act and the Insurance Act, involves personal responsibility and liability. Users of the financial statements may have a right to take action against the Auditor if they suffer a loss as a result of the Auditor's negligence.

Additionally, there are statutory sanctions from numerous sources that may be applied against the Auditor including:

- **Corporations Act** – failure to conduct an audit in accordance with auditing standards is a breach of the Corporations Act²⁰.
- **Insurance Act:**
 - a) APRA may disqualify an auditor should it be determined that he/she “has failed to perform adequately and properly the functions and duties” of his/her appointment;²¹
 - b) APRA may refer the Auditor to the Companies Auditors and Liquidators Disciplinary Board²² or the disciplinary committee of the ICAA²³
- Professional Standards of the ICAA, which may result in disciplinary action or revocation of membership of the Institute.

4 General Insurance Actuaries in the Audit: Part 1 - Data

4.1 Background

In this section we consider the issue of data in the context of the ILV and the audit. In relation to the actuarial process, we focus on the statutory role of the Approved Actuary under GPS 210. We acknowledge that different data considerations will apply to actuarial services performed outside the Approved Actuary's statutory role preparing the ILV, and do not seek to consider those matters in this paper.

We consider:

- The responsibilities of the Approved Actuary for the reliability of data;
- Comparing and contrasting those responsibilities with the role of the Approved Auditor; and
- Possible mechanisms through which the Approved Actuary's responsibilities may be discharged, including the interactions between the Approved Actuary and Approved Auditor, in this process.

We contend that the statutory role of the Approved Actuary entails many similar responsibilities to those of the statutory role of the Approved Auditor. The primary responsibility to ensure that the APRA returns are fairly stated (and that the value of insurance liabilities is appropriate) rests with the governing body of the insurer. However, both the Approved Actuary and the Approved Auditor play important roles in strengthening the financial reporting process.

4.2 The Approved Actuary's role

The Approved Actuary's ILV is written advice to the Board of the Insurer on the value of insurance liabilities in accordance with GPS 210 (soon to be GPS 310). Whilst the value of insurance liabilities adopted in the financial statements and APRA returns is the responsibility of the Board of Directors, the Board clearly relies on the advice of the Approved Actuary in determining the level of provision required. The Board may adopt a figure other than the Approved Actuary's for the value of the Insurance Liabilities, but this must be notified to APRA and disclosed in the insurer's accounts²⁴.

APRA's prudential standards acknowledge that the estimation of insurance liabilities requires the exercise of professional judgement. For instance, GPS 210 at paragraph 12 states:

"The principles for determining the central estimate values of the Outstanding Claims Liabilities and the Premiums Liabilities are, subject to considerations of materiality and the professional judgement of the Approved Actuary, to be applied to each class of business of the insurer."

The statement of advice contained in the ILV is that the recommended insurance liabilities *"Are in accordance with [GPS 210]"*²⁵

Similar to the audit report, the ILV is an expression of the opinion of the Approved Actuary, as noted in GGN 210.1.4:

"The nature of the advice required from the Approved Actuary, and from other actuaries assisting in the preparation of insurance liabilities for inclusion in this opinion, places a high level of responsibility on the actuarial profession."

Given the inherent uncertainty in the estimation of insurance liabilities (uncertainty which is recognised in the prudential standards) we would draw parallels between this statement of advice (expression of opinion) and the auditing standards discussed previously – that the accounting estimate be “reasonable in the circumstances”.

GPS 210 refers to this in the following terms (at paragraph 8)”
“the valuations of an insurer’s Outstanding Claims Liabilities and its Premiums Liabilities must be realistic estimates”.

APRA’s guidance note GGN 210.1.6 states that
“Approved Actuaries must ... take full responsibility for their advice and reports”

Whilst this concept is not further discussed in the APRA Guidance Notes, GGN 210.1 does provide some commentary about related issues:

“Where the principal requires the actuary to use specific assumptions or the actuary is relying on the interpretation of legislation, standards or rulings supplied by the principal or its other advisers, the actuary must clearly state the circumstances, discuss whether or not the assumptions are reasonable and consistent with this Guidance Note, GPS 210 and other relevant professional standards, and discuss the implications of any divergence from this Guidance Note, GPS 210 and professional standards.”²⁶

In this context, the concept of “full responsibility” means that the actuary cannot simply apply assumptions or interpretations provided by the insurer, but must form a view on the reasonableness and appropriateness of those matters.

In the context of data, it is our contention that the concept of “full responsibility” requires the actuary to form their own view on the appropriateness and accuracy of the data provided by the insurer. We examine this concept further below.

4.3 The Approved Actuary and the reliability of data

APRA’s guidance note GGN 210.1 states that:
“Approved Actuaries must ... take full responsibility for their advice and reports and must therefore be satisfied as to the validity of information provided to them or work undertaken for them.”²⁷

The impact of the quality of data

At this point we believe it is appropriate to draw a distinction between the ‘accuracy’ of available data and the ‘quality’ of available data. The very nature of actuarial projections means that judgement is required, and the actuary is not working with ‘perfect’ data. In many situations the data available to the actuary will be imperfect or incomplete. An example would include a relatively new underwriter where portfolio specific data is simply not available. The Guidance Notes provide commentary as to how these data imperfections are to be dealt with and these imperfections are not the subject of this paper. Allowing for data imperfections in accordance with the Guidance Notes would continue to produce an estimate of insurance liabilities which is “reasonable in the circumstances”.

APRA describes this issue in the following terms:

“The appropriate compromise between the cost of better data and the benefit, in terms of more reliable estimation, is a matter for actuarial judgement, which should take into account the materiality of the reduction in uncertainty that might result.”²⁸

The accuracy and validity of data used.

Given the Approved Actuary’s responsibility for the advice contained in their ILV, it follows that the Actuary should also be satisfied that the data relied upon in the valuation are not inconsistent with the recommendation of a value of insurance liabilities which is “reasonable in the circumstances”. This requirement is captured in the quote from GGN 210.1 above. We have reproduced other sections of the guidance notes which reinforce this perspective.

GGN 210.1.14 “It is an actuary’s responsibility to ensure that the data used gives an appropriate basis for estimating the insurance liabilities. This includes the insurer’s own exposure and experience data, but should extend to industry data where the insurer’s own data is not sufficient to reduce uncertainty to an acceptable level.”

GGN 210.1.15 “An actuary should take reasonable steps to verify the consistency, completeness and accuracy of the data collated, against the company’s financial records. The degree to which an actuary relies upon the data provided by the company or upon earlier or later testing of the data by the company’s Auditors, and the resulting limitations that this reliance places on the actuary’s confidence in the data, should be commented upon in the report.”

The consideration of what constitutes “reasonable steps” will involve the exercise of professional judgement, and we consider in Section 4.6 a range of procedures which may be appropriate.

The Guidance Notes clearly countenance the reliance of the actuary on the work of others in relation to data, however, we believe that the over-riding principle is that contained in paragraph 6 that states:

“Approved Actuaries must ... take full responsibility for their advice and reports and must therefore be satisfied as to the validity of information provided to them or work undertaken for them”.

We ask the reader to consider similarities between the expression by the Actuary of a limitation about their confidence in the accuracy of data, and the Auditor claiming an inability to form an opinion about a matter. Audit opinions qualified for an inability to form an opinion are reserved for the rare cases where all reasonable attempts to obtain the necessary level of assurance have failed.

4.4 Who is responsible for Data ?

We examined the role of the Approved Auditor in an earlier section. To recap, the role of the Approved Auditor is to form a view on the truth and fairness of the financial statements in accordance with the relevant reporting framework (in the case of APRA Returns this framework is APRA’s Prudential Standards).

We also discussed the process through which the Approved Auditor conducts an audit of accounting estimates such as insurance liabilities, and identified that the audit approach envisaged by Australian Auditing Standards entails relying on the work of an expert (the Approved Actuary).

While the Auditor clearly considers the basis on which the actuarial valuation has been performed (including the reliability of data), we believe that the Actuary cannot delegate (explicitly or implicitly) all responsibility for the reliability of data to the Approved Auditor. Rather the Approved Actuary, in taking full responsibility for their opinion contained in the ILV, must have considered and formed a positive view on the reliability of the data on which the opinion is based.

The use of inaccurate or unreliable data is unlikely to generate a “realistic estimate” of insurance liabilities as required by GPS 210.8.

If the Auditor is to rely on the work of the Approved Actuary (as discussed above), the actuarial process must be complete. Deficiencies in the actuarial process (such as inadequate consideration of the reliability of data) will inhibit the capacity of the Auditor to rely on that process and will require the Auditor to address deficiencies in that process through the performance of additional testing.

4.5 Implications of Draft Prudential Standard GPS 310 Audit and Actuarial Reporting and Valuation on data

GPS 310 does not significantly change the responsibilities of the Approved Auditor or Approved Actuary in the area of data.

“The ILV must, in respect of each class of business underwritten by the insurer, provide details of theavailability and appropriateness of the data”²⁹

However, the guidance note GGN310.1 goes further on the subject of data.

“The Approved Actuary must take reasonable steps to verify the consistency, completeness and accuracy of the data provided by the insurer with the insurer’s financial and other records. Any discrepancies that cannot be resolved with the insurer must be outlined in the ILV together with any consequent limitations of the ILV as a result.”

4.6 What might be considered “reasonable steps” in respect of data?

GGN 210.1 notes that the Approved Actuary should take “reasonable steps” to verify the data. GGN 210.1 provides further guidance to Actuaries in respect of specific aspects of data which require consideration. These include:

Australian Auditors and General Insurance Actuaries

Ref	Requirement
GGN 210.1.11	<i>“an actuary should be familiar with administration and accounting procedures for policies and claims”</i>
GGN 210.1.12	<i>“an actuary should be conversant with the characteristics of the insurance policies and claim processes that may materially impact upon the estimation of insurance liabilities, including:</i> <ol style="list-style-type: none"> <i>1. Nature of coverage</i> <i>2. Underwriting strategy, and nature and mix of risks underwritten</i> <i>3. Benefits payable, including deductibles and limits, and</i> <i>4. Reinsurance arrangements”</i>
GGN 210.1.13	<i>“an actuary should be familiar with economic, technological, medical, legal and social trends that may impact on the value of insurance liabilities”</i>
GGN 210.1.14	<i>“It is an actuary’s responsibility to ensure that the data used gives an appropriate basis for estimating the insurance liabilities. This includes the insurer’s own exposure and experience data, but should extend to industry data where the insurer’s own data is not sufficient to reduce uncertainty to an acceptable level.”</i>
GGN 210.1.15	<i>“An actuary should take reasonable steps to verify the consistency, completeness and accuracy of the data collated, against the company’s financial records. The degree to which an actuary relies upon the data provided by the company or upon earlier or later testing of the data by the company’s Auditors, and the resulting limitations that this reliance places on the actuary’s confidence in the data, should be commented upon in the report.”</i>

These are not inconsistent with PS300 as it currently stands.

Specific areas for consideration and understanding by the Approved Actuary might include:

- the reliability of the insurer’s controls in ensuring the:
 - a. complete and accurate capture on policy systems or documentation of the key features of the policies written by the insurer;
 - b. complete and accurate capture of claims notified to the insurer, including management’s current case estimate;
 - c. accurate attachment of premiums and claims to various reinsurance arrangements, such as surplus and other treaties;
 - d. accurate capture of non-financial fields which may have a material impact on the valuation. Examples include:
 - for workers compensation classes, stratification of claims between dust disease and other injury types;
 - for public liability claims, stratification between material damage and personal injury;
 - claims which have been re-opened;
 - the adequacy of management’s internal processes for monitoring and controlling adherence to underwriting and claims handling guidelines. For example, how can the Approved Actuary be certain that:

- i) negotiated products in the one class have broadly similar terms and conditions;
- ii) products classified on the underwriting system as short tail, are not in reality something different;
- iii) the exposure on the underwriting system accurately captures the true limits under the policy;
- iv) whether changes in claims development are in fact caused by the outworkings of management's claims processes/procedures and audits.

In scenarios where the Actuary is performing a valuation for the first time, these obligations may be particularly onerous. Accordingly actuaries may need to prioritise their investigations based on an opinion of those data sources most material to the valuation. However, the level of responsibility assumed by the Approved Actuary through the issue of an ILV is identical, whether it is their first or subsequent ILV.

4.7 How can the Approved Actuary obtain comfort over inputs

The scope of work which may be required to form a view on these diverse matters is potentially significant.

Whilst GGN 210.1.15 notes that *“the actuary should take reasonable steps to verify the consistency, completeness and accuracy of the data collated, against the company's financial records”* the data relied upon in the actuarial valuation is significantly greater than the company's financial records.

This appears to have been acknowledged in GGN 310.1 which now makes reference to verifying data against the insurers financial and other records.

Additional data validation procedures might include:

- Performing a walkthrough of underwriting and claims transactions to understand the process by which information is recorded on the product system, and posted to the general ledger.
- Identifying controls in those processes whereby management ensure the completeness and accuracy of information recorded on the product system.
- Obtaining copies of internal audit reports, claims and underwriting technical audits and any other internal control activity for the purposes of:
 - Identifying control exceptions which may have an impact on the Approved Actuary's liability valuation
 - Forming a view on the effectiveness of the control activities in ensuring the completeness and accuracy of product system data. A control activity which does not identify exceptions is unlikely to be reliable.

4.8 Reliance on the work of others

Relying on the Work of the Approved Auditor

GGN 210.1 clearly anticipates the Approved Actuary relying on the work of others in validating data. For example GGN 210.1.15 anticipates the actuary relying on work performed by the Approved Auditor.

Anticipating instances in which Actuaries may seek to rely on the work of the Auditors, the auditing and actuarial professions have established protocols governing such reliance (AUS 524, replicated as IAAust GN 551). These protocols have been discussed earlier in Section 3.7 above.

Should the Approved Actuary seek to rely on the work of the Approved Auditor in becoming satisfied that “*that the data used gives an appropriate basis for estimating the insurance liabilities*” IAAust GN 551 outlines the procedures which the actuary should consider to determine whether that reliance is reasonable. These procedures are the criteria by which the Approved Actuary satisfies him/herself that reliance on the work of the Approved Auditor is appropriate. According to IAAust GN 551, the Approved Actuary should form a view on:

- the professional competence, objectivity and integrity of the Approved Auditor;
- the appropriateness of the Approved Auditor’s work for the Approved Actuary’s purposes;
- the findings and opinions of the Approved Auditor in performing the work.

In those situations where the Approved Actuary seeks to rely on the work of the Approved Auditor, IAAust GN 551 provides other guidance as to how the Auditor and the actuary should interact:

When determining the basis for using the specialist professional's work, the reporting Professional [the Actuary] should communicate with the specialist professional [the Auditor] to establish an understanding of the work to be performed by each professional and of the nature and extent of reliance to be placed by each professional on the work of the other.³⁰

The reporting professional would ordinarily: make the specialist professional aware of the reporting professional's needs³¹.

The specialist professional would ordinarily: affirm that the reporting professional will be using the work of the specialist professional.³²

One view of these components of GN 551 is that:

- the Approved Actuary should inform the Approved Auditor of the intended reliance on the audit work;
- the Approved Auditor should acknowledge this reliance;
- the Approved Actuary should identify differences in scope which may make reliance on the Auditor’s work inappropriate;
- the Approved Actuary should obtain an understanding of the findings of the audit procedures, and their implications for the actuarial valuation.

Relevant considerations in this aspect may include:

- the reliance on non-financial data in the actuarial valuation, and whether these data are within the scope of testing performed by the Approved Auditor; and
- the use of data extracted at an interim date

Where the Auditor’s procedures do not cover the full range of matters which are important to the Actuary, this view would require the Actuary to obtain assurance of those aspects of the data through other means, such as independent testing.

It is unlikely that the Approved Actuary will be able to form an opinion about the scope and findings of the Approved Auditor's work without having access to the Auditor's work papers, or at least meetings with the Auditor to discuss this issue.

Data extracted at a date other than the balance date

The Actuary typically obtains data prior to the balance date due to increasingly tight reporting timeframes. It is not uncommon for the Actuary to be working on the ILV prior to the Auditor commencing any systems testing. Similarly the Auditor will not have audited the trial balance or financial statements of the insurer at that interim date. This may have implications for the capacity of the Actuary to rely on the work of the Auditor in respect of certain data.

Data from Non-company sources

It should be noted that an Actuary may be relying on additional data provided directly by external sources, for example, data provided by a reinsurer (eg bordereaux or similar). In such cases, the data may not have been provided to the company, and in such cases, the Auditor may not be aware of that data, and therefore would not form part of any audit testing or review. In these circumstance, Actuaries should consider the consequences for their confidence in that specific data.

Relying on the Work of Others

The IAAust guidance notes do not have established protocols for the reliance on the work of experts other than the Auditor. However, the protocols established between the auditing and actuarial professions represent established and documented guidance as to one basis on which actuaries may place reliance on the work of others. These protocols may provide useful guidance to actuaries in other scenarios.

5 External Peer Review and Audit Review

With the development of Peer Review standards, comments have been put forward that pose the question of whether the adoption of External Peer Review will replace Actuarial Audit reviews, or alternatively, whether an Audit Review is already an External Peer Review. In this section we consider the EPR in the context of the audit review, highlighting similarities and differences. In addition we present some common ‘review’ issues facing audit teams which may be of interest to future EPR Actuaries.

5.1 Why External Peer Review?

“Promoting the highest standards for the provision of actuarial advice, appropriate to the significance of the particular piece of advice, is a primary concern of the Institute. Internal and external peer review of actuarial work have a part to play in helping achieve these high standards of advice, and need to be understood in the context of other requirements of the Institute on members.” (IAAust, Policy on Internal and External Peer Review)

The need to conduct peer review of actuarial work to ensure quality and maintain the profession’s reputation is being recognised and increasingly seen as a necessity rather than just a good idea.

The IAAust’s move towards a formal requirement for peer review started after the HIH Royal Commission. The IAAust has also commenced a program to tighten Professional Standards, to improve the drafting of standards, and consider the framework in which they are set. Three instruments relevant to general insurance (Code of Professional Conduct, FCR and EPR) have already been presented at IAAust Horizons meetings and have been the subject of vigorous debate.

5.2 Peer Review worldwide

The IAAust’s move towards peer review is consistent with recent developments in the both the UK and Canada. The quotes below from the Morris, Baird and Corley reviews (UK), as well as one from the US, show that similar concerns have arisen worldwide:

“external peer review can have value and could strengthen the effectiveness of the Appointed Actuary system” (Corley Review, UK)

“the reliance on one individual with no external, detailed checks of his work inevitably poses risks. We recommend that the Appointed Actuary should be subject to independent external review [which] may be carried out by FSA or by independent firms, but must be conducted to a level which could provide comfort equivalent to that of an external audit.” (Baird Review – Life Insurance, UK)

“Given the confidentiality limitations on reporting to the Profession, the review believes that the most effective means of ensuring compliance with professional standards is by requiring independent external scrutiny of actuarial advice, through increased regulatory supervision, peer review or audit.”(Morris Report, UK)

“The absence of published standards does not prevent litigation. The profession can mitigate its litigation risk through active participation in the standard-setting process.” and *“Actuaries can mitigate their risk of liability through ... - peer review.... (amongst other items)”* (Lauren Bloom, General Counsel of the American Academy of Actuaries in her presentation “Professionalism: A Legal Perspective”)

5.3 Responsibilities of the EPR

Our discussion and our interpretation in this section are based on the IAAust Exposure Draft PS 505 distributed to members at the end of August 2005. The final PS 505 will take into account submissions from the wider profession, and therefore the comments in this section may not apply when the IAAust issues the final PS 505.

Reporting and opinions under EPR

The EPR Actuary is not performing a second valuation, and therefore is not providing a second opinion. The EPR Actuary is not being asked to verify that the central estimate and final liability recommendation is the same one that the EPR Actuary might have advised independently.

Rather, the EPR’s opinion is limited to confirmation that the Primary Actuary complied with all the relevant standards (IAA and legislation and sub-legislation as applies) and that the final recommendation is ‘not unreasonable’.

In forming an opinion on whether the final result is ‘not unreasonable’, it is likely that the EPR Actuary will need to determine whether the building blocks (ie the data used, the methods adopted, the assumptions adopted, etc) are reasonable, internally consistent, and consistent with industry trends. In doing so, the EPR Actuary will need to made an assessment of the professional judgements that lead to the recommended liability being ‘not unreasonable’.

The EPR Actuary does not take any responsibility for the advice of the Primary Actuary. However they do take responsibility for the EPR report which they provide.

Adherence to Standards

As stated previously, the IAAust Professional Standards are being updated. The FCR Standard and PS 300 Actuarial Reports and Advice on General Insurance Technical Liabilities will be amongst the first standards that reflect the new drafting guidelines. Of note is that the standards will contain “**musts**” rather than “**shoulds**”. Consequently, the exposure draft EPR PS 505 states:

*“The Reviewing Actuary **must consider** whether the work complies with applicable legislation, including regulations and subordinate legislation, relevant Institute Professional Standards and takes regard of Guidance Notes with appropriate disclosures”.* (Exposure Draft PS 505)

Assessing the compliance with applicable standards may form part of the scope of the Audit Assist Actuary. That is, in order to form a view on the reasonableness of the insurance liabilities the Auditor may consider whether the Approved Actuary has adhered to applicable standards. The Audit Assist Actuary will give the Auditor their opinion (probably not item by item, but in general and overall) on whether the relevant standards have been followed, and then the Auditor makes a decision on whether

items of concern raised (if any) are considered material for the purposes of the audit. Any recommendations for improvement, however, would generally be captured in the Auditor's management letter.

The EPR requirement appears to be more explicit, as Exposure Draft PS 505 appears to say that any non-compliance with the relevant professional and/or legislative standards will need to be disclosed. Given this specific responsibility, the EPR Actuary is likely to have a 'checklist' of items that fall under each of the standards, and will confirm that the report complies at each point.

5.4 Judgement – How do you audit / review it?

Actuarial work requires skill and 'judgement' – and 'judgement' is mentioned in various parts of most of the IAAust Professional Standards, as well as the prudential standards. Currently, there is no definition of 'judgement' in the Professional Standards. However, one dictionary defines judgement as "*An assertion of something believed; idea; opinion; thought.*" Is that definition sufficient in the complex actuarial environment? Is 'professional judgement' different from 'judgement'? In the actuarial context, and in view of our profession's desire to promote the highest standards, we would argue that whenever the word 'judgement' (or 'professional judgement') is used in a Standard, it should be interpreted as 'reasonable and reasoned judgement'. Auditors refer to this as 'reasonable in the circumstances'.

When is judgement reasonable and reasoned?

As there is no clear definition of "judgement" in our standards (either actuarial or auditing standards), it is useful to see how other actuarial bodies and other professional bodies deal with the concept of "judgement".

The Canadian Standard of Practice 1130.05 states

"A judgement which is completely subjective would not be reasonable even though it may be based on honest belief. A reasonable judgement would be objective and demonstrably take account of the criteria in the recommendation:

- (i) spirit and intent of standards*
- (ii) Institute's Guiding Principle No 1 – A strained interpretation of a rule or recommendation is inappropriate.*
- (iii) the rules (ie CIA Professional Code of Conduct)*
- (iv) common sense*
- (v) constraints on time and resources"* (Canadian Actuarial Standard of Practice)

Another interesting Code of Conduct for Actuaries and Auditors to reflect on, is the Australian Public Service's "Values and Code of Conduct in practice" that states:

"Fair Decision Making

Compliance with the law is a fundamental requirement of good decision making. The APS functions within an administrative law framework to ensure, among other things, that individuals and groups within the community receive fair and equitable treatment. One of the aims of this framework is to ensure that administrative decisions are correct, in the sense that they are made according to the law (and any guidelines and directions deriving from it), and preferable, in the sense that the best decision is made on the facts if there is range of outcomes that are lawfully correct. Decision makers should also be able to demonstrate that their decisions are 'fair and reasonable' in the circumstances, that the powers they exercise are properly authorised and used

appropriately, that procedural fairness has been observed and they are able to provide reasons to explain and justify their decisions, ensuring fairness, transparency, consistency and accountability.” (Australian Public Service Code of Conduct)

And

“Explaining the reasons for decisions

The responsibility to make fair and equitable decisions is complemented by an expectation that APS employees will be reasonable and consider only the merits of the case in making decisions. These responsibilities are supported by the AD(JR) Act which enables an aggrieved person to request a written statement explaining the basis and reasons for a decision made under an enactment (subject to various exemptions). Also, s.25D of the Acts Interpretation Act 1901 (AI Act) provides that where written reasons are required by an Act, the instrument giving the reasons must set out the findings on material questions of fact and refer to the evidence or other material on which those findings were based. A written record of decisions should be kept. The facts and evidence should be systematically recorded and should support the decision.” (Australian Public Service Code of Conduct)

How do you demonstrate Reasonable and Reasoned Judgement?

Based on our current experience as an Auditor and Audit Assist Actuaries, we would consider that in terms of the assumptions, reasonable and reasoned judgement can be demonstrated if an assumption follows from the results of the tests and analysis performed during the valuation, and takes into account the wider economic and industry environment.

However, simply stating the assumption adopted, without a formal and complete documentation of the tests and analysis performed, makes it difficult to assess if the judgement followed from reasoned steps. An actuary may well have performed all the right tests, asked the correct questions, analysed the past experience, etc, but if that work is not sufficiently documented in the ILV report, it is difficult for an external reviewer (audit or EPR) to make an assessment of whether the assumption is reasonable, particularly if the assumption is at either end of what would be a reasonable range, or outside industry averages or not reflective of industry trends.

Ideally, all assumptions that require judgement would be fully described – including the tests and analysis performed to reach that judgement. Some judgements require greater care and consideration, and we would argue that these types of judgements should have the greatest disclosure. Examples of “difficult” matters of judgement might include the level of superimposed inflation or the adopted risk margin. It will be those difficult judgements – little data, new portfolio, changing legislation – that could be questioned in 10 years time in the unfortunate event of a future adverse development.

The level of documentation regarding these key judgements would appear to fall within the scope of the EPR, with the IAAust Policy on Internal and External Review stating that *“An external peer reviewer should consider the quality of the communication about the possible variability of results.”*

5.5 Outside “Accepted Actuarial Practice”?

What if an assumption or method is outside ‘accepted actuarial practice’? This is difficult because there is no clear definition of ‘accepted actuarial practice’ for every method or assumption. And accepted actuarial practice in general insurance is a moving and evolving group of ideas.

It should be expected that if uncommon, non-traditional, or new methods are used, then the Auditor (and in future, the EPR Actuary) will want more information and description in order to be able to satisfy themselves that the method is reasoned and reasonable in the circumstance. This is particularly true for new and developing methods which have no history, but which may very well become common and standard in five years time.

We include a few quotes from the US actuarial profession which illustrate some approaches to adopting non-standard procedures.

“Deviation from Standard – An actuary must be prepared to justify the use of any procedures that depart materially from those set forth in this standard and must include, in any actuarial communication disclosing the results of the procedures, an appropriate statement with respect to the nature, rationale, and effect of such use.” (USA Actuarial Standards Board, Standards of Practice 21 – Responding to Auditor]

And Lauren Bloom, General Counsel of the American Academy of Actuaries in her presentation “Professionalism: A Legal Perspective” states:

“Professional standards (the Code, Actuarial Standards Of Practice (ASOP) and Qualification Standards) are strong evidence of generally accepted practice. Failure to comply with the Code, Qualification Standards and ASOPs may be considered malpractice. To comply:

- identify and read all applicable professional standards;*
- conform work to the standards;*
- OR, deviate and be prepared to explain;*
- and*
- Document, Document, Document.”*

and

“If you deviate:

- describe the nature, rationale and effect of the deviation in an appropriate actuarial communication; and*
- be prepared to defend it;*
- deviations can cause special problems in litigation.”*

5.6 Dealing with differences of professional opinion

Audit Reviews

With ‘professional judgement’ there will always be honest differences of opinion between professionals. How are these handled in the current audit environment?

The Audit Assist Actuary is reporting to the Auditor. The Auditor ultimately forms his/her own opinion on any differences noted, and this opinion is formed in the context of the financial statements in their entirety.

It is not the Audit Assist Actuary's responsibility to provide an implicit "peer review" for the Primary/Approved Actuary or the Company.

The Auditor forms his/her own opinion on the results based on the Primary Actuary's report **and** the comments from the Audit Assist Actuary, in addition to the Auditor's own investigations. Depending on the nature of any disagreements or differences, the Auditor may or may not report them to the Company via the Management Letter.

EPR

The External Peer Review will be different to the Actuarial Audit Review. Although there may be much overlap in the content of what is reviewed, the EPR is a formal peer review of the Approved Actuary's work and reporting will have to comply with PS 505 (and GN 310). The EPR Actuary must formally report on any differences of opinion (difference of judgement), and whether the ILV followed all applicable standards. The EPR's report will be available to the Approved Actuary.

Therefore, in the case of the EPR (compared to audit) there will be a formal documentation of unresolved differences of opinion (differences of judgement) available to at least APRA, the Approved Actuary, the Approved Auditor and the Board.

"External peer review should be approached recognising that there is scope for genuine and acceptable difference of professional opinion. Where such difference of opinion arises and remains unresolved, the reasons and consequences for the advice should be openly and constructively communicated to the client." (IAAust Policy on Internal and External Peer Review)

How should differences be presented in an EPR report?

The IAAust exposure draft Code of Professional Conduct states:

"4.3.3 There is room for honest differences of opinion between Members on many professional matters. Where such differences occur, a Member must avoid unjustifiable or improper criticism or malicious injury to the reputation of another Member."

Other professions and jurisdictions that commonly encounter differences of opinion, often have formal processes and codes of conduct about how two professionals should deal with differences of professional opinion. . In Canada, the actuarial exposure draft for Peer Review has attempted to document a protocol for dealing with differences. And in Australia for example, the Australian Family Court has protocols and guidelines on how two opposing experts should communicate and deal with differences. As the Australian EPR regime progresses, it may be that the IAAust may have to provide more specific guidance on how actuaries should report on honest differences of opinion.

The Auditor may have a different view to the Company on the value of insurance liabilities, based on all of the audit evidence. The EPR is not a point of arbitration or mediation between the conflicting views of the Approved Actuary and the Approved Auditor. The Auditor must be satisfied that the insurance liabilities booked by the

insurer are reasonable. Should none of the interested parties be able to convince the Auditor of the appropriateness of the booked provision, then the insurer will not have satisfied its onus of proof in relation to the financial statements, and the audit opinion should be modified accordingly³³.

EPR for general insurance is new to Australia. Whilst some other countries may already have degrees of formal peer review, we are stepping into unfamiliar territory. There will be some trial and error. However, with a deeper understanding of the roles each professional is required to undertake, as well as a review of our own processes and reporting, we can expect that the introduction of EPR will lead to better transparency and higher quality work.

“Promoting the highest standards for the provision of actuarial advice, appropriate to the significance of the particular piece of advice, is a primary concern of the Institute.” (IAAust Policy on Internal and External Peer Review)

5.7 The difference between an External Peer Reviewer’s role and an Audit Assist Actuary’s role

The EPR is designed to ensure that each element of the actuarial valuation is derived by following the statutory and actuarial standards, and that the result is not unreasonable. The Audit is designed to enable the expression of an audit opinion on the truth and fairness of the financial statements in aggregate. The role of the Audit Assist Actuary is to enable the Auditor to form a view whether the insurance liabilities are ‘reasonable in the circumstances’.

The EPR and Audit Assist Actuary roles have much in common and may be identical in some circumstances, however, it is worth noting where differences in the scope of the roles may arise. The table below summarises some differences.

Item	External Peer Review Standard	Actuarial/ Audit Scope and Requirements
Scope of Reviewing Actuary	Specified in IAAust exposure draft PS 505 and APRA draft GPS 310	Specific to each audit depending on audit issues and it may have a greater or lesser scope than PS 505 or cover different issues
Scope / Result	1.3.6 EPR does not provide a guarantee of Primary Actuary Advice	An audit does not provide a guarantee of the Primary Actuary’s advice, but the Auditor must still form their OWN opinion of it, and still may choose not rely on EPR Actuary without doing further work to satisfy themselves that the EPR advice is reasonable.
When used	Only mandatory for licensed General Insurers (GPS 310) and licensed self-insurers upon regulator request.	Specific to each entity, and may involve review of other actuarial and financial calculations (eg LSL, self-insured liabilities)
Materiality	What a Primary or Review Actuary thinks is material, may or may not be consistent with Audit definition.	Materiality varies from entity to entity.
Scope	Does not extend to performing an independent	In very rare circumstances may be asked to perform an independent assessment

Item	External Peer Review Standard	Actuarial/ Audit Scope and Requirements
	valuation.	(using own assumptions/ methods, etc)
Conclusions	Negative Assurance	The audit opinion involves the expression of positive assurance.
Risk Margins Diversification, etc	Section 1.3.1 Appendix A4, A7	A key audit point is whether there is enough identification and documentation by the Primary Actuary of the key risks. The Auditor may have noted other risks and will use this to make their OWN assessment of the adequacy of the risk margins.

5.8 Some practicalities

Complexity

The EPR process will inevitably involve additional cost to insurers. Even if the Audit Assist Actuary carries out the EPR role, any differences in scope between the EPR and the Auditor's requirements will increase the time taken. These scope differences will include the preparation of a formal report which may go beyond the current memorandums to the Auditor.

Clearly the EPR process will involve greater discussion between the various actuaries, and all the relevant parties will need to adopt a co-operative approach throughout the process.

If the EPR is not carried out by the Audit Assist Actuary, the Auditor will generally still require the input of an Audit Assist Actuary to assist in the audit. In these cases, the EPR report may be an additional document (audit evidence) requiring review.

Materiality definition

The auditing and IAAust standards each have their own definitions. Each party will need to understand the other's definition of materiality and where possible the EPR review should make reference to the auditing definition in addition to any different level agreed between the EPR and the Primary Actuary.

5.9 Who can be the EPR Actuary?

In the following table, we consider the differences between the various guidance on the qualifications an EPR Actuary must possess.

Who	What	Requirement
APRA	GN310	A Reviewing Actuary must meet the eligibility and fit and proper criteria required to be met by Approved Actuaries which are specified in draft GPS 520. These include that the actuary has a minimum of 5 years relevant experience in the provision of actuarial services to insurers that has been sufficiently recent to ensure that the person is familiar with current issues in the provision of actuarial services to insurers. (as at 20 September 05).
IAAust	PS505	Actuaries accepting appointment to conduct an External Peer Review must satisfy themselves that they have the relevant expertise and experience consistent with the IAAust's Code of Conduct and meet the definition of External in PS 505.
Auditor	n/a	Has no influence. Auditors will generally only accept their own in-house actuaries as Audit Assist Actuaries. As noted previously the EPR cannot replace the performance of audit procedures by the Auditor.

5.10 What happens when there is an EPR from outside the audit firm and the Auditor wants to use an Audit Assist Actuary too?

Once again, with a better understanding of the Auditor's responsibilities, and an understanding that each party (Primary Actuary, Peer Review Actuary and Auditor) is simply trying to discharge their responsibilities, then with good communication there should be no or little friction.

Given that two actuaries can have honest differences of opinion, the probability of having differences of opinion when there are three actuaries involved, will necessarily be greater. As a profession we may have to consider how to deal with these.

5.11 An Audit(or's) opinion on EPR

It should be noted that the undertaking of an EPR will not remove the responsibilities imposed by Auditing Standards. Auditors will always be required under Auditing Standards to understand, challenge and form their own view on the reasonableness of methodologies and assumptions adopted in the estimation of the insurance liabilities. This obligation cannot be met simply by interposing another actuary in the valuation process.

The IAAust Exposure Draft PS 505 envisages the EPR being addressed to one of a number of parties, including the Auditor. However addressing the report to the Auditor will not enable the EPR to act as a substitute for the conduct of audit procedures. If the Auditor seeks to rely on the EPR report as part of the audit evidence, that reliance will need to be justified in the same manner as when the Auditor relies on the work of the Primary Actuary. This will require audit procedures to be carried out on the EPR report as described in the previous section of the paper in relation to the conduct of an audit.

The Audit Assist Actuary's primary role is to assist the Auditor audit the insurance liabilities in accordance with auditing standards. However, there are many areas of overlap between this role and the scope of the External Peer Review. Accordingly, the EPR role may be a relatively minor extension of the scope of work performed by the Audit Assist Actuary. The incremental effort required for an additional actuary to perform this role may be significantly greater.

6 GI Actuaries in the Audit: Practical Observations

“Corporate Governance is not just about regulatory or structural remedies. It’s about a culture. A culture in which there is a common understanding of the roles of various parties. A culture in which all parties respect each other’s role.” ³⁴

6.1 Background

Under the new APRA and EPR regime, there will be increasing interaction and inter-relationships between actuaries performing the various roles. An Approved Actuary of one company may also be a Reviewing Actuary of another company under EPR. An Audit Assist Actuary may also be an Approved Actuary. A Reviewing Actuary may also be a Primary Actuary and/or Approved Actuary. Each actuary may well wear several hats at once, for different entities.

In the past, Audit Assist Actuaries have performed the non-regulatory role of reviewing other actuaries’ reports to assist the Auditors in forming their opinion on the financial statements. Therefore, Audit Assist Actuaries have encountered situations and constraints that are likely to be faced by EPR Actuaries in the new regime. Some may have already been in the situation where there is an External Peer Reviewer other than the Audit Assist Actuary. In this section we raise some non-data related issues that we have experienced, in the hope of providing some food for thought for actuaries involved in the process, no matter what their current or future role may be.

6.2 Timing – it’s tight!

Consider the work to be done in a very short time frame at year end:

- Insurance Liability Valuation
- Financial Condition Report (much of the work will be done in advance but there will still be significant work to do)
- EPR report
- Financial Statements (possibly for several different reporting regimes, internal, US, Australian etc),
- APRA returns and others

The EPR report will need to be provided in the same timeframe as the ILV.

Anyone who has been involved with an insurer’s year end process, whether as an actuary working for an insurer in-house, or as a consultant, or as an Audit Assist Actuary will appreciate that the timing is already very tight. Statutory deadlines have to be met so any delay in reports or information being provided by the Primary Actuary to the Auditor or EPR can prevent them from being able to meet their responsibilities.

The challenges presented by adding an extra report, and possibly extra actuaries, to the mix should not be underestimated.

Current Practices

Timing has always been an issue in the past in terms of the deadlines for completion of the Primary Actuary's report, the Audit, and the completion of financial statements and the APRA returns. Due to the timing issues, the Audit Assist Actuary will often review a draft report, rather than the final report.

On occasion the Primary Actuary may send the draft report direct to the Auditor /Audit Assist Actuary at the same time as the Company. In some cases, the Primary Actuary may be relying (intentionally or not) on the Auditor/Audit Assist Actuary for its 'internal review'.

In the ideal world, the Primary Actuary would prepare the report for the Company, the Company would read it, fully understand it and accept it. It then becomes audit evidence, and is reviewed by the audit team including the Audit Assist Actuary who has a defined scope for review.

Drafts

It is not uncommon for the audit review to be performed on a Draft Report. This in itself causes a problem depending on "how draft?" Receiving Draft 2 and Draft 3 during the process, is difficult and adds to uncertainty, particular if there are major changes to assumptions and/or method between drafts.

From the point of view of *the process of EPR* being of value to the Primary Actuary (and Company), then performing the majority of the EPR on the "Final Draft" (or each class/portfolio/company as it is being valued) may be best. This provides scope for any feedback or changes recommended by the EPR, and agreed by the Primary Actuary, to be incorporated into the final report that goes to Company and APRA. As long as the Primary Actuary has provided a 'complete draft' (complete being defined as, if there are no issues identified it could be finalised without changes) then this might be a good strategy to adopt.

Ideally the EPR's final report would be based on the final report by the Primary Actuary, not a draft. However in those cases where it is necessary to submit both the Primary Actuary's final report and the EPR Report at the same time, the approach above based on the "complete draft" may be the way forward.

At present, the Auditor often looks at both the draft and the final report, and has to review reasons for any changes between the two. This would still be the case under the new regime incorporating EPR, but it is hoped that communication between the Primary Actuary and the EPR would prevent any surprises between the final draft the EPR reviews and the final ILV report.

At the present time, an Audit Assist Actuary may not see the final report. All drafts are considered and reviewed as final unless they are superseded by the final. So if a draft has been supplied, the Audit Assist Actuary will review the draft to the standard of a final, and only change their opinion if a subsequent draft or final is issued that differs from that reviewed, or the Primary Actuary provides further information. The Exposure Draft of PS 505 presumes that the EPR Actuary will be involved at most stages of the valuation process, so presumably they will be involved in reviewing drafts to varying degrees.

Another consideration regarding drafts is highlighted by Lauren Bloom, General Counsel of the American Academy of Actuaries in her presentation “Professionalism: A Legal Perspective”:

“Documentation can be critical to successful malpractice defence. Documentation should (usually) include:

- a description of what was done and why;*
- sufficiently detailed work papers for another qualified actuary to review the work for reasonableness;*
- a record of what the principal was told and when*
- proof that open questions were asked and answered.”*

“Documentation should (usually) not include:

- Rough drafts of finished documents;*
- back of envelope calculations;*
- evidence that outstanding questions were never asked or answered.’*

The timing issues and timing constraints should be recognised and are ultimately unavoidable. However, more forward planning and more discussion about the timing and the requirements of each party before the statutory valuation and FCR work begins will help the process.

6.3 Communication during Audit and EPR review

Communication between various parties (Primary Actuary, Auditors, EPR Actuary and Audit Assist Actuary) will have to start earlier than in the past, if the EPR Actuary and Auditor are to have any chance of meeting their deadlines.

Current Situation

In our experience the Approved Actuary and Approved Auditor often do not communicate at the earliest point in the process, and sometimes not at all until the final stages. This is often true even in those cases where an Approved Actuary is relying on the Approved Auditor for data verification. This can put additional pressure on all parties during the later stages of the Audit.

Lines of Communication – who gets to talk to who and when?

In our experience this depends and varies from audit to audit. In most cases, the Audit Assist Actuary is given direct access to the Primary Actuary. However, in some rare cases, restrictions are placed on the lines of communication and the Audit Assist Actuary is restricted to passing questions to the Approved Actuary through the Company via the Auditor.

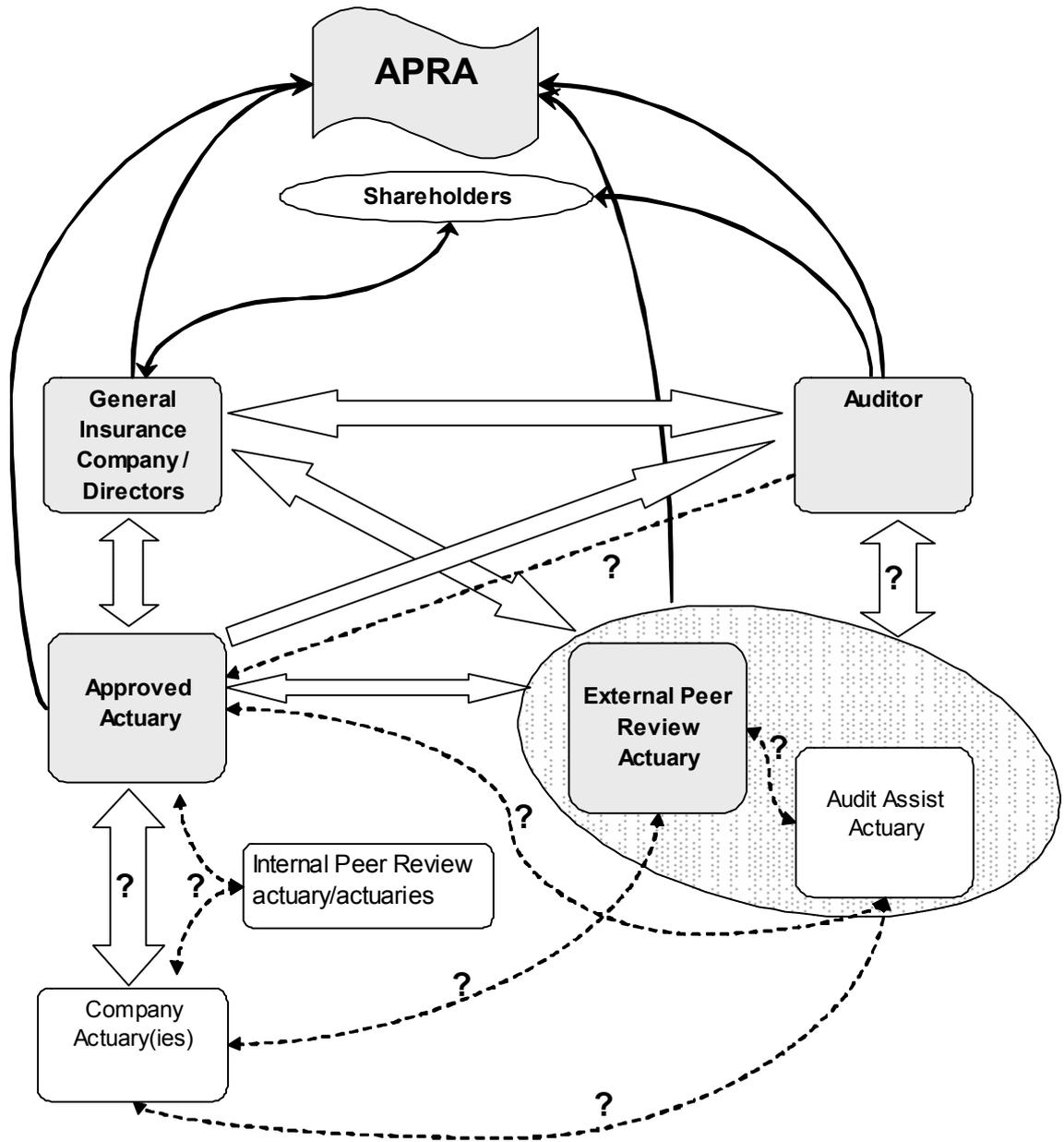
Direct communication between Primary Actuary and Audit Assist Actuary is preferable. Given the complex nature of the valuation, any communication via a non-actuary may be misinterpreted. However, it must be remembered that whatever communication occurs between the Primary Actuary and the Audit Assist Actuary, the Audit Assist Actuary is not performing a peer review, but is assisting the Auditor to conduct an audit of the insurance liabilities.

An important point that we would like to highlight is that both the Auditor’s task and in future, the EPR Actuary’s task, can be made considerably more efficient if the valuation evidence (ie the ILV report) is clear and comprehensive, and documents, not

only the methods and assumptions, but incorporates the broader explanations needed to show professional skill and reasoned judgement.

The Lines of Communication in 2006

Who's going to be talking to who and when? Remember the picture from earlier in the paper. Here is the update to include the EPR Actuary



With the addition of the External Peer Reviewer role, we could envisage a situation with two actuaries with statutory roles, and a number of other Company Actuaries with non-statutory roles, who play a part in producing the advice used in the Approved Actuary's and External Peer Reviewer's report, and all of whom the Audit Assist Actuary may need to speak to in the course of their audit work.

What will, or should be, the communication protocols?

One of the first communications in the audit of insurance liabilities should be formal communication between the Approved Auditor and the Approved Actuary (or Primary Actuary). We consider that the discussion should include an agreement on the preferred lines of communication between the two, and also, the communication with the EPR Actuary.

In addition, it should be recognised that much of the communication between the various Actuaries is likely to be oral. The Approved Auditor and Approved Actuary should agree on the protocols for oral and other communication (for example, emails of oral discussions, who gets copied in, etc) since both Approved Actuary and the Audit Assist Actuary will have to meet the documentation standards of their respective employers, APRA and the actuarial profession.

There will be at least two actuaries, or possibly three or more actuaries, involved. In order to avoid duplications of requests for information and further explanations, open communication should be permitted between all actuaries – Primary, EPR and Audit Assist. After the Approved Auditor and Approved Actuary have agreed on the communication protocols, it would be preferable that the Approved Actuary meet with the other actuaries (EPR and Audit Assist Actuary) at an early stage and discuss the timing requirements and the preferred protocols.

6.4 Reporting

Intended User/Audience

A report must always state for whom it is being prepared, and in most cases will be the company. However, we believe that the Actuary should give due consideration to the fact that the report may be read by other users, and whilst the Actuary cannot write the report in such a manner that it satisfies all possible users or readers (ie policyholders, mutual fund participants, etc) it would be good practice, in writing the report, to consider that the ILV report should satisfy the purposes of at least the regulator and the Auditor (and from 2006, the EPR), and include sufficient information for those users to discharge their duties and responsibilities.

Audit User

From an audit point of view, the report should be detailed enough to demonstrate to the audit reviewer (Audit Assist Actuary) how the Primary Actuary has exercised skill and reasoned judgement to determine the method, assumptions and results, and to demonstrate that the relevant standards (professional and APRA) had been followed.

Consider the following quote from one of the US actuarial standards of practice: *“Actuarial Report – In addition to the actuarial findings, an actuarial report should identify the data, assumptions and methods used by the actuary with sufficient clarity that another actuary qualified in the same practice area could make an objective appraisal of the reasonableness of the actuary’s work as presented in the actuary’s report.”* (USA Actuarial Standards Board , Standard of Practice 41, 3.3.3)

And our own (exposure draft) Code of Professional Conduct:

“6.1.2: An Actuary must ensure that sufficient detail is available in the Actuarial Report to enable another Actuary to determine whether or not the Standard had been followed and, if given access to the data, to check the results in the Actuarial Report.”
(IAAust Exposure Draft – Code of Professional Conduct)

If the work requires adherence to a professional or statutory standard, then there should be enough documentation and disclosure in the report so that a third party reviewer (Audit and APRA) can make an assessment and provide an opinion on whether or not the standard has been followed.

EPR User

The EPR Actuary will be required to follow PS 505 when it is finalised. The EPR Actuary will have to confirm that the ILV adheres to the APRA and Professional Standards. And as stated earlier in the paper, the IAAust Professional Standards are being tightened.

All Users

A simple solution will satisfy and help all ‘informed’ users – DOCUMENT DOCUMENT DOCUMENT! It has been our experience that Actuaries are doing the work – the analysis, the testing, the research – that is required by our professionalism, Code of Professional Conduct and Professional Standards. However, we need to ensure that our ILV reports are stand alone documents that can be the full and complete evidence of our work, our skill and our professional judgement.

6.5 How can we get some value out of the EPR and Audit processes?

“Consistent with Council’s continuing strong endorsement of the Corporate Governance Taskforce’s original recommendation of independent peer review, the policy statement encourages independent peer review beyond statutory work, for “key actuarial work which is complex, high profile, politically sensitive or contentious, or is advice that impacts many stakeholders”. It is important that the potential benefits of independent peer review are considered for key work beyond that for which it is mandated.” (IAAust, Explanatory Memorandum, Exposure Draft PS505, IAAust Policy Statement on Internal and External Peer Review)

Given that there may be limited changes to the Audit review requirements and that inclusion of EPR will likely increase overall costs, how can the company and actuaries get value from an EPR?

Actuaries

Some of the benefits for actuaries involved in the process include:

- (1) Contribution to professional development of both actuaries. For the EPR Actuary, they gain exposure to different methods and approaches as well as a broader knowledge of what is happening in our industry. For the Primary Actuary they may be asked to explain the more judgemental of their assumptions, which may well be a foretaste of the questions from management.

- (2) Improved reporting – if you know your work is going to be reviewed and you know to what standard it will be reviewed, it tends to focus your attention on details that may previously have been overlooked.
- (3) The process of the EPR is implied to be over the time frame of the valuation (ie the EPR is involved throughout and not just at the end) and therefore, any intermediate feedback can improve the reviewed work and final report.
- (4) If the culture of EPR develops positively, then the exchanges between the various actuaries on a regular basis at balance date can be viewed as a development exercise. Particularly for in-house actuaries and smaller consultancies, the scope to discuss broader issues facing the industry, or to gain exposure to what the industry and other actuaries are doing should be positive.
- (5) Introducing a degree of external critique and challenge should be seen as positive, and part of a procedure of ensuring that our profession does not become complacent with our documentation and communication. It assists in the public perception of objectivity of advice and should enhance the perception of quality.
- (6) Probably less time and follow up queries during the Audit. If EPR can lead to improvements in documentation and clarity of reports, then follow up questions from the audit team are likely to reduce.
- (7) Compulsory External Peer Review may provide some support to the Approved Actuary, either internal or external, in the event of pressure from the company's management or Board.

Company

- (1) Improved reporting – there may be more information provided to the Company in the ILV. Enhanced reports more readily support Audit and Peer Review.
- (2) An independent view. An objective, external review of the Approved Actuary's work may provide insights not previously considered.
- (3) Probably a much tighter timeframe for actuarial reporting, but less follow up queries during the Audit.

6.6 Additional changes

Some other potential changes to the process to bear in mind:

Smaller entities

Smaller companies may not be used to large actuarial bills. The EPR is possibly broader in scope than the current audit reviews, and may well be in addition to substantially unchanged audit fees.

Increase in Audit Scope

The Audit review could also increase in scope to encompass the Peer Review Actuary's report. The Auditor may want to review of both the Primary Actuary's report and the EPR report if the Audit Assist Actuary is not preparing it. There are often time/cost constraints and the audit review work will usually be very specifically scoped.

Regulatory Deadlines

Can deadlines realistically all be met? EPR, Audit, APRA and (much of the work for) FCR will occur at year end. Will this lead to more valuations being carried out at dates prior to year end and then rolled forward? What might the implications be for financial statements and possible last minute changes? What are the implications for data verification?

6.7 Peer review - what next?

At the moment, the EPR role is limited to reviewing the ILV prepared in accordance with GPS 310. What may happen in the future? Might we see the EPR expanded to other facets of the Approved Actuary's work such as the FCR or interim valuations performed for financial statement purposes?

At the time of writing, the applicable standards are still draft and there may yet be changes before they are finalised. No doubt many of the issues we raise will be resolved within the first round of EPR's, but it is likely that new issues will arise. We believe the best way to approach EPR is with an open mind and a willingness to open the channels of communication at the earliest stage of the process.

7 Conclusion

Whilst this paper has covered a wide range of issues, we have tried to emphasise a few key themes throughout.

The starting point for our paper has been that the roles of the Approved Auditor and Approved Actuary contain many areas of similarity. We have sought to demonstrate this through an examination of the ILV and its standing under GPS 210. It will be recalled that GPS 210 treats the ILV as the expression of an opinion about the value of insurance liabilities, and that the Approved Actuary retains full responsibility for the opinion expressed therein. The audit opinion similarly is an expression of opinion for which the Auditor retains full responsibility.

We felt it important in the context of the paper to provide an Auditor's view on the audit of insurance liabilities through:

- Detailing the legislative, prudential and professional requirements of auditors;
- Highlighting the mechanisms which Auditing Standards envisage being adopted in the audit of insurance liabilities; and
- Provide an Auditor's perspective for an actuarial audience on why the Auditor may question and challenge their work.

In preparing this paper we observed that the data relied upon in the actuarial valuation was an area where the responsibilities between the Auditor and Actuary appeared at times to be blurred. We concluded that:

- GPS 210 explicitly made the Actuary responsible for the opinion expressed in the ILV, and for being satisfied as to the appropriateness of data on which the ILV was based; and
- The audit approach to insurance liabilities was based upon the Auditor placing reliance on the work of the Actuary.
- The Actuary could not transfer responsibility for the data underlying the ILV to a third party, be it the Auditor or some other party. Rather, the Actuary needed to positively form a view on the appropriateness of the data on which the actuarial opinion relies.

Finally we considered the implications of the External Peer Review on:

- Actuaries' interactions with Auditors; and
- Actuaries preparing either the ILV or the EPR.

Clearly the EPR is a significant, and in our view positive, development for the actuarial profession. However, it will add another layer of complexity to the audit and actuarial relationships. The EPR may be similar to the role of the Audit Assist Actuary in some areas of review. However, the performance of an EPR will not remove the need for the Auditor to conduct audit procedures on insurance liabilities.

Appendix A. The shifting sands of regulation

1.1 Introduction

We live in interesting times. In Australia, we have seen the collapse of HIH and the subsequent shocks in the general insurance market; in the United Kingdom, the collapse of Equitable Life and the impact on policyholders; and in the United States, the collapse of Enron and WorldCom. All of these events have led to stronger corporate governance requirements worldwide. The actuarial profession has not been immune from this new era of external review and critique.

In most cases, the full impact of changing regulation has yet to be felt. We have more supervision of general insurers by APRA, increasingly stringent requirements for corporate governance, changing accounting rules and moves by the Institute of Actuaries of Australia to strengthen our professional standards. Even though these areas can never remain static for long periods, we are in the middle of one of the most significant periods of change for a long time, and the issues addressed in this paper must be considered against this backdrop.

At the time of writing, APRA had not released its final stage 2 reform standards, and in August and September the IAAust released exposure drafts for the Code of Conduct, Professional Standard 305 (Financial Condition Reports for General Insurance) and Professional Standard 505 (External Peer Review). Other standards, including PS300, are also being updated.

Brave New APRA world

In November 2003, APRA released a discussion paper on stage 2 reforms. These are intended to take effect from 1 January 2006. The latest set of draft standards and discussion papers was published in May 2005 and comments on these closed in August (Risk and Financial Management) and October (Corporate groups involving authorised general insurers). We hope to be able to provide an update on the status of these standards at the conference.

The main prudential standards that are linked to this paper are

- GPS 310 – Audit and Actuarial Reporting and Valuation
This standard will replace the existing GPS 210
- GGN 310.1 – Financial Condition Report and
- GGN 310.2 – Liability Valuation.

APRA is also introducing a corporate governance standard (GPS 510) which covers:

- size and composition of the board, independence of directors
- the establishment of board audit and risk committees
- requiring insurers to have a dedicated internal audit function
- independence requirements for auditors consistent with the Corporations Act 2001 and
- a policy on board renewal

and a standard (GPS 520) setting out the fit and proper person tests that an insurer must apply in determining the fitness and propriety of individuals to hold responsible person positions.

IFRS

For financial years commencing on or after 1 January 2005, companies are required to adopt Australian Equivalents to International Financial Reporting Standards (AIFRS) and must apply these in their financial statements. Reporting under AIFRS has widespread implications for companies. General Insurers are not immune. A revised version of AASB1023 (General Insurance Contracts) has been issued with a number of changes including the liability adequacy test (“LAT”), increased disclosure requirements and the requirement to use risk free rates to discount liabilities.

Appendix B. Audit Report on Annual APRA Return

Date

The Board of Directors
[General Insurer]

Scope

We have audited the attached yearly statutory accounts, being a special purpose financial report, of [general insurer] for the financial year ended [date]. The yearly statutory accounts comprise [specify form numbers] [.....]. The directors of [general insurer] are responsible for the preparation of the yearly statutory accounts and the information they contain, in accordance with the requirements of the Insurance Act 1973, the Financial Sector (Collection of Data) Act 2001 and Prudential Standard GPS 220 as set down by the Australian Prudential Regulation Authority (“Prudential Standards”) and, to the extent that they do not contain any requirements to the contrary, Accounting Standards and other mandatory professional reporting requirements in Australia. We have conducted an independent audit of the yearly statutory accounts in order to express an opinion on them to the Board of Directors.

The yearly statutory accounts have been prepared for the purpose of fulfilling the reporting requirements of [general insurer] under the Insurance Act 1973, Section 13 of the Financial Sector (Collection of Data) Act 2001 and the Prudential Standards. We disclaim any assumption of responsibility for any reliance on this report or on the yearly statutory accounts to which it relates to any person other than the Australian Prudential Regulation Authority, or for any purpose other than that for which it was prepared.

Our audit has been conducted in accordance with Australian Auditing and Assurance Standards. Our procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the yearly statutory accounts, and the evaluation of significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the yearly statutory accounts present fairly the results of operations for the year and financial position at year-end in accordance with the provisions of the Insurance Act 1973, the Prudential Standards, to the extent that they do not contain any requirements to the contrary, Accounting Standards and other mandatory professional reporting requirements in Australia. The *Insurance Act 1973* and Prudential Standards do not require the application of all Accounting Standards and other mandatory professional reporting requirements in Australia.

The audit opinion expressed in this report has been formed on the above basis.

Audit Opinion

In accordance with Section 49J of the *Insurance Act 1973*, we report that in our opinion, [except for the matters referred to in the qualification paragraph(*)] the yearly statutory accounts of [general insurer] in respect of the year ended [date] present fairly the results of operations for the year and financial position at year end, in accordance with the provisions of the *Insurance Act 1973*, the *Financial Sector (Collection of Data) Act 2001*, Prudential Standards, [other APRA correspondence as deemed necessary], and, to the extent that they do not contain any requirements to the contrary, Accounting Standards and other mandatory professional reporting requirements in Australia.

Appendix C. Audit Report on Statutory Financial Statements

Independent audit report to members of [insurer]

Scope

The financial report and directors' responsibility

The financial report comprises the statement of financial position, statement of financial performance, statement of cash flows, accompanying notes to the financial statements, and the directors' declaration for [insurer] (the company), for the year ended [balance date].

The directors of the company are responsible for preparing a financial report and the additional disclosures [*list the disclosures in accordance with AASB 1046 – Director and Executive Disclosures by Disclosing Entities for example; 2.1 Remuneration Policy, Table 2.4.3, Table 2.4.5 etc*] included in the directors report designated as audited ('the additional disclosures') that gives a true and fair view of the financial position and performance of the company, and that complies with Accounting Standards in Australia, in accordance with the *Corporations Act 2001*. This includes responsibility for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial report.

Audit approach

We conducted an independent audit of the financial report and the additional disclosures in order to express an opinion on them to the members of the company. Our audit was conducted in accordance with Australian Auditing Standards [and International Standards on Auditing,] in order to provide reasonable assurance as to whether the financial report and the additional disclosures are free of material misstatement. The nature of an audit is influenced by factors such as the use of professional judgement, selective testing, the inherent limitations of internal control, and the availability of persuasive rather than conclusive evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

We performed procedures to assess whether in all material respects the financial report and the additional disclosures present fairly, in accordance with the *Corporations Act 2001*, including compliance with Accounting Standards in Australia, and other mandatory financial reporting requirements in Australia, a view which is consistent with our understanding of the company's financial position, and of its performance as represented by the results of its operations and cash flows.

We formed our audit opinion on the basis of these procedures, which included:

- examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial report and the additional disclosures, and
- assessing the appropriateness of the accounting policies and disclosures used and the reasonableness of significant accounting estimates made by the directors.

While we considered the effectiveness of management's internal controls over financial reporting when determining the nature and extent of our procedures, our audit was not designed to provide assurance on internal controls.

We performed procedures to assess whether the substance of business transactions was accurately reflected in the financial report and the additional disclosures. These and our other procedures did not include consideration or judgement of the appropriateness or reasonableness of the business plans or strategies adopted by the directors and management of the company.

Independence

We are independent of the company, and have met the independence requirements of Australian professional ethical pronouncements and the *Corporations Act 2001*. We have given to the directors of the company a written Auditor's Independence Declaration, [a copy of which is included in the Directors' Report]. The Auditors' Independence Declaration would have been expressed in the same terms if it had been given to the directors at the date this audit report was signed. [In addition to our audit of the financial report and the additional disclosures, we were engaged to undertake the services disclosed in the notes to the financial statements. The provision of these services has not impaired our independence.]

Audit opinion

In our opinion, the financial report and the additional disclosures included in the directors report designated as audited of [insurer] are in accordance with:

- a) the Corporations Act 2001, including:
 - i) giving a true and fair view of the financial position of [insurer] at balance date and of its performance for the year ended on that date; and
 - ii) complying with Accounting Standards in Australia and the *Corporations Regulations 2001*; and
- b) other mandatory financial reporting requirements in Australia.”

Appendix D. References

- ¹ Bellis C, 1997, *The Future Managers – Actuaries in Australia 1853-1997*, The Institute of Actuaries of Australia.
- ² Insurance Act section 39(1)(a)
- ³ AUS 104 Glossary of Terms
- ⁴ AUS 108 Framework for Assurance Engagements, paragraph 18
- ⁵ AUS 108 Framework for Assurance Engagements, paragraph 24
- ⁶ AUS 108 Framework for Assurance Engagements, paragraph. 40
- ⁷ Corporations Act s307A
- ⁸ paragraph 02
- ⁹ AUS 516.03
- ¹⁰ AUS 516.08
- ¹¹ AUS 516.10
- ¹² AUS 516.24
- ¹³ AUS 516.26
- ¹⁴ AUS 306.03
- ¹⁵ AUS 606.09
- ¹⁶ AUS 606.10
- ¹⁷ AUS 606.13
- ¹⁸ AUS 606.14
- ¹⁹ AUS 606.16
- ²⁰ Corporations Act, section 307A
- ²¹ Insurance Act, section 44(2)(a)
- ²² Insurance Act section 48(2)(a)
- ²³ Insurance Act section 48(2)(b)
- ²⁴ GPS 210 paragraph 4
- ²⁵ GPS 210.3
- ²⁶ GGN 210.1.75
- ²⁷ GGN 210.1.6
- ²⁸ GGN 210.1.14
- ²⁹ GPS 310.47(c)
- ³⁰ GN 551.12
- ³¹ GN 551.15(d)
- ³² GN 551.16(d)
- ³³ AUS 104 Glossary of Terms defines a qualified audit opinion as one that “indicates that an auditor is not satisfied in all material respects that the subject matter is in accordance with an identified framework.”
- ³⁴ David Smith, President and CEO of the Canadian Institute of Chartered Accountants, Statement to the Standing Committee on Banking Trade and Commerce.