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QUESTIONS AND ANSWERS ON AuG-43

In December 2005, the AASB issued Assurance and Related Services Guideline AuG-43, *Audit of Policy Liabilities of Insurance Companies*, with an effective date of January 1, 2006. AuG-43 provides guidance on the application of generally accepted auditing standards to the audit of policy liabilities of insurance enterprises. The following questions and answers provide additional guidance to practitioners affected by the Guideline.

Actuarial Specialists

Q1 Should the actuarial specialist be a Fellow of the Canadian Institute of Actuaries (FCIA)?

AuG-43 explains that in almost all circumstances, the auditor can only accept an engagement to audit an insurance enterprise if there is actuarial expertise on the engagement team performing the audit. The qualifications required of the actuarial specialist depend somewhat on the complexity of the engagement. However, an FCIA is the professional qualification recognized and required in Canada to determine the actuarial liabilities of an insurance enterprise

Q2 How do I find an actuary with the appropriate qualifications to act as an actuarial specialist?

Particularly in the first year following the effective date of AuG-43, an auditor that has not previously used an actuarial specialist will need time to identify and engage an appropriate actuary, and arrange for that actuary to plan the work required. The auditor should anticipate this in his or her planning and allow adequate time to find the appropriate resources. The Canadian Institute of Actuaries (CIA) may be able to suggest some individuals to contact.

Q3 The Appointed Actuary for the insurance enterprise being audited is an independent consulting actuary. Would involving another actuarial specialist not be an unnecessary duplication?

Whether an actuary is an employee or an outside consultant is not the issue; it is the fact that the Appointed Actuary has determined the liabilities and they are an integral part of the financial statements. In particular, paragraph 53 of AuG-43 states the following:

> "The determination of policy liabilities… is performed by the appointed actuary. In this regard, the appointed actuary is functioning as management, whether or not the appointed actuary is an employee or an independent advisor. Because of this role, the work of the appointed actuary is precluded from meeting the requirement for the auditor to obtain objective evidence…"

The use of an outside consulting actuary is no different than any other outsourced management function, and should be subject to independent audit procedures.

Q4 Where an auditor engages an actuarial specialist from outside his or her firm to provide audit support, what independence standards is that actuarial specialist required to maintain with respect to the insurance enterprise being audited?

The auditor should follow the guidance set out in Section 5049, *Use of Specialists in Assurance Engagements*. Specifically, paragraph 5049.34 notes that the auditor should ask the specialist to confirm that he and his or her firm are free from relationships that would impair the specialist's objectivity. The auditor should also consider the matters bearing on independence discussed in Section 5751, *Communications With Those Having Oversight Responsibility for the Financial Reporting Process*.

Q5 What would happen if the actuarial specialist's estimate of the policy liabilities of the insurance enterprise differs materially from the amount recorded in the financial statements?

The policy liabilities of an insurance enterprise represent a complex estimate, and it is not unusual for different actuaries to arrive at different estimates within a reasonable range. If the actuarial specialist concludes, after receiving any necessary clarification, that the liability recorded by management differs from the actuarial specialist's best estimate but is within a reasonable range, he considers that there is no error or audit difference. An audit difference is considered to exist to the extent that the recorded liability is outside a reasonable range of estimates, and would be assessed and dealt with by the auditor in the same way as any other audit difference.

Independent Review of the Work of the Appointed Actuary in Accordance with OSFI Guideline E-15

Q6 *The actuarial specialist in a financial statement audit and the external review actuary carrying out an independent review of the Appointed Actuary of an insurance enterprise in accordance with OSFI Guideline E-15 could be the same individual. Does this create a problem with independence in the financial statement audit?*

No. Both the external audit and the independent review of the Appointed Actuary are attest functions and do not result in the possibility of the actuary effectively checking his or her own work. There are many common elements between the work of an actuarial specialist and that of an external review actuary. However, it should be noted that the audit and the independent review are two separate engagements. The auditor should ensure that the audit committee of the insurance enterprise being audited is aware of and accepts this arrangement, and that there is a separate and specific engagement of the actuarial specialist for the independent review. It is important to recognize that the actuarial specialist will need to prepare a separate report on the independent review, which will go to the Appointed Actuary and the regulator.

Q7 *Where an insurer engages an external review actuary to conduct an independent review of the work of its Appointed Actuary in accordance with OSFI Guideline E-15, and this external review actuary is not the actuarial specialist, may the auditor use the work of the external review actuary as audit evidence?*

Yes, although the use of an external review actuary's work is affected significantly by the timing and coverage of the independent review. An independent review may be completed on a rotational basis and may not cover all significant areas in any one year, particularly for larger insurers. In addition, an independent review report as of year end will not necessarily be completed in time to be used for the audit results. Nevertheless, an independent review completed as of a prior year end may provide useful evidence regarding assumptions and methodologies that remain in use in the current year. The auditor should consider co-ordinating with the external review actuary, and determine whether it is possible and appropriate to engage him or her as the actuarial specialist or to use the auditor's own actuarial specialist to supplement the work of the external review actuary as needed.

The auditor may use the work of the external review actuary, having regard to the Recommendations and guidance set out in Section 5049, *Use of Specialists in Assurance Engagements*. The auditor would need to obtain an understanding of the scope and timing of work of the external review actuary and determine whether it is sufficient to address the auditor's assessed risks of a material misstatement.

For example, a review in accordance with OSFI Guideline E-15 includes a review of methods and assumptions used in the valuation of the policy liabilities, but may not encompass tests of underlying data, an evaluation of the controls relating to the valuation process or tests to corroborate the Appointed Actuary's calculations of policy liabilities. In such instances, the auditor will need to perform additional procedures.

Q8 *From a professional disciplinary viewpoint, what would happen in a scenario where an external review actuary or an actuarial specialist found the work of the Appointed Actuary to be deficient?*

It may be sufficient for the external review actuary or the actuarial specialist to report the deficiencies to the Appointed Actuary. The independent review is meant to be educational for the Appointed Actuary, and its objectives are described in OSFI Guideline E-15 as follows:

- maintaining and strengthening confidence in the work of the Appointed Actuary by the public, by insurance company management and directors and by supervisory authorities;
- narrowing the range of practice by Appointed Actuaries;
- improving the quality of the Appointed Actuary's work; and
- providing significant professional education for the Appointed Actuary.

The objectives of an actuarial specialist are to support the auditor in forming an opinion on the financial statements or financial information under audit, but he or she may still have professional obligations. Depending on the nature of the deficiency of the work, the external review actuary may consider referring the matter to the CIA disciplinary committee for further investigation.

Q9 *What communications should take place between the auditor and the external review actuary?*

Neither AuG-43 nor the Joint Policy Statement addresses communications between the auditor and an external review actuary. However, OSFI Guideline E-15 specifies the requirement for an external review (previously known as a peer review) by an external review actuary every three years for federally registered insurers. This external review does not necessarily duplicate the work done by the auditor. Ideally, the auditor should be willing to discuss the scope of the audit work done with the external reviewer in order to avoid unnecessary duplication of work. However, this is not required. Similarly, the auditor may wish to disclose any findings dealing with the valuation process, but is not required to do so.

Audit Approach and Procedures

Q10 Many insurance enterprises in Canada use consulting actuaries as their Appointed Actuaries (or to advise management where there is no Appointed Actuary requirement). How should the auditor approach the audit of an insurance enterprise when the actuarial consulting firm is conducting valuations for various different insurance enterprises with various different auditors?

The auditor will need to discuss its planned audit approach to addressing the guidance in AuG-43 with management of the insurance enterprise being audited and its consulting actuary. The auditor and management may find it efficient to request that the consulting actuary document the procedures and controls relating to the actuarial valuation and make this available to the auditor. If it is available, the auditor could also make use of a service auditor's report under Section 5970, *Auditor's Report on Controls at a Service Organization*, with respect to controls at the consulting actuary.

Q11 Does the guidance in AuG-43 mean that the substantive procedures carried out by the auditor would include reperforming the Appointed Actuary's calculations of the insurance enterprise being audited?

Substantive procedures include tests of details of classes of transactions, account balances and disclosures, and substantive analytical procedures. The auditor will need to consider whether the risk of material misstatement at the assertion level is a significant risk. In such cases, the auditor is required to design and perform substantive procedures that are specifically responsive to the risk. Further, for significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient Based on these considerations, the auditor could reperform the calculations of the insurance enterprise being audited, or check or reperform certain actuarial calculations on a test basis (tests of details). Alternatively, the auditor could employ analytical procedures to address assessed risks that are not significant risks. This could include preparing an independent overall actuarial projection of policy liabilities, and comparing the auditor's expectations to those of the actuary of the insurance enterprise being audited.

Q12 My actuarial specialist tells me it's not possible to recalculate liabilities determined using the Canadian Asset-Liability Method (CALM) for life insurance liabilities. What do I do now?

AuG-43 does not suggest that an entire recalculation of the liabilities is appropriate, but does provide guidance on specific testing. Further to the specific testing, the auditor would need to ask the actuarial specialist whether some interim critical steps in the valuation process could be recalculated, for example, the asset and liability cash flows going into the CALM valuation. The auditor would also ask the actuarial specialist to review the CALM process and results. Often there may be an approximate method that can be used on a sample of policies to determine the reasonableness of the result.

Q13 Many insurance enterprises in Canada are branches of foreign companies where the actuarial function is based outside of Canada. How should the auditor approach the audit of actuarial liabilities in such circumstances?

The fact that the actuarial function of the insurance enterprise being audited is located outside of Canada does not relieve the auditor of his or her duty to be aware of and consider AuG-43. In such circumstances, the auditor will need to arrange appropriate access to information and personnel, and may need to visit the overseas location of the insurance enterprise being audited to gather sufficient and appropriate audit evidence.

Q14 How do I apply AuG 43 to audits of workers' compensation enterprises, as some of the terminology is not applicable or relevant?

AuG-43 is applicable to workers' compensation enterprises. There are some instances throughout the Guideline where the relevant terms and procedures applicable specifically to workers' compensation enterprises are used. The concepts in the Guideline should be read and applied to the particular situation as appropriate.

Q15 Some insurance enterprises do not have an Appointed Actuary and are not required to have one by law or regulation. Does AuG-43 suggest that such an insurance enterprise would need to appoint an actuary to perform a valuation?

Requirements to appoint an actuary as an Appointed Actuary, or to complete a valuation, are set by law or regulation. Where there is no legal or regulatory requirement for such an appointment, management of an insurance enterprise may nevertheless conclude that it requires the assistance of an actuary to estimate policy liabilities. AuG-43 relates only to the work that an auditor needs to do in order to express an audit opinion related to policy liabilities of an insurance enterprise.

AuG-43 frequently refers to the role of an Appointed Actuary or Valuation Actuary, since that is required for most regulated insurance enterprises, but it applies to all insurance enterprises. It should be noted that the Appointed Actuary position does not exist widely outside Canada, and that policy liabilities are a management estimate, which may or may not be arrived at with the assistance of an actuary. For example, some provincially registered companies are not required by statute or regulation to have an Appointed Actuary, based on prudential regulatory requirements that reflect the availability of certain reinsurance and guarantee fund arrangements to protect policyholders.

An insurance enterprise that does not use an actuary to determine insurance policy liabilities still needs to have a reasonable basis for its estimation of policy liabilities. In these circumstances, an auditor would apply the guidance in AuG-43.

Q16 If an insurance enterprise has not used an Appointed Actuary or consulting actuary to complete a valuation of policy liabilities, how should an auditor approach the audit of the policy liabilities? Can an actuarial specialist be used if an actuary does not first value the liabilities?

An insurance enterprise needs to have a reasonable basis for its estimation of policy liabilities, whether or not an actuary is employed to make that estimate.

Where an actuary has not performed the estimation of policy liabilities, an actuarial specialist may well be even more useful in providing an assessment of whether the basis of estimation used by management is adequate based on current circumstances, including available data and market conditions.

In some circumstances, analysis may indicate that management's estimation is insufficient without further analysis by management, possibly requiring the assistance of an actuary other than the actuarial specialist.