

**Statutory Reserve Reports and
Opinions Working Party**

**Paper for 1997 General Insurance
Convention**

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General Insurance Convention**

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A. Introduction

Last year's working party put much work into the analytical techniques. This year, much more effort has been concentrated on what needs to be done and associated professional issues. Clearly, normal Institute standards apply but included in the attached paper is a detailed description of accounting procedures. This is of particular relevance in the area of restricted access to information which would lead to a qualified opinion. Other issues include inadequate data. We also covered the question of practising certificates and current practice in other areas. We have not attempted to make recommendations; merely to lay out the arguments.

We have taken as our brief an opinion on claims reserving rather than an opinion on the financial condition of a company. In general, we would have a preference for opining net of reinsurance as some smaller companies might not have a sufficient spread of business for stability at the gross level. One of the issues on which actuaries could opine is the bad debt provision. Another working party is reporting on this.

We have also highlighted claims reserving areas and techniques where we feel more documentation is required in the UK literature. Our aim has been to assemble sufficient information to allow the profession to form its views as to how to proceed.

We could have produced a draft guidance note but it should be noted that, at the time of going to press, it is anticipated that draft guidance notes will shortly be available from the Institute for both the UK and US Lloyd's Opinions. Consequently, the Working Party has done less work on this than would otherwise have been the case as it would merely have duplicated the effort.

It is of fundamental importance that these issues be debated by the profession so that a consensus can be formed and the profession can proceed on a united front. We would therefore very much welcome input and comment.

B. Practising Certificates

1. Introduction

- 1.1 Practising certificates are relatively new to the Institute and Faculty of Actuaries having recently been introduced for life actuaries and pension actuaries acting in a statutory role. They are also used by our peer professions to lend support to their members dealing directly with the public. The use of certificates is currently an issue of debate by actuarial societies world-wide.
- 1.2 Practising certificates do not increase the need for relevant experience to practise in a particular area as the Memorandum of Professional Conduct already places this requirement on members *"..before signing a statutory certificate or report an Actuary must consider carefully in the light of his previous experience and work whether doing so would be consistent with the proper professional behaviour and standards"*. They are required only by actuaries acting in a statutory role. By formalising the rule structure to allow actuaries to sign statutory reports they enhance the standing and credibility of the Institute and Faculty. The difference in using a practising certificate scheme is that an actuary's experience has to be justified to peers as well as themselves.
- 1.3 The profession as a whole is moving towards specialisation eg via the education system. Actuaries wishing to sign statutory opinions should be prepared to demonstrate their knowledge and ability to do the work needed to support the opinions. This does not limit an actuary's ability to devote time to other areas, but ensures that the knowledge in a specific area is balanced and up to date. Practising certificates are not currently used in general insurance but may be introduced if a statutory requirement is implemented. The purpose of this note is to outline what is currently in place and the requirements necessary to obtain a certificate.

2. Peer Groups

- 2.1 Practising certificates are common in peer professions and countries and have also been implemented recently for the life and pension areas of the actuarial profession in the UK.

- 2.2 Life and pension actuaries in the UK already have practising certificates as a requirement to support the statutory roles that they fulfil and similar structures are being proposed by other European countries such as Ireland. In the US a practising certificate is not required for non-life insurance, but an actuary providing an opinion on loss reserves in non-life insurance must be a member of the Casualty Actuarial Society or a member of the American Academy of Actuaries who has been approved as qualified for signing loss reserve opinions by the Casualty Practice Council. This supervision by the Casualty Society supports the need to have the necessary experience to sign a loss reserve report.
- 2.3 The chartered accountancy institute currently issues practising certificates to members. These certificates are renewed annually and they are general certificates not relating to specific practice areas. Two years' practical experience is required to obtain a certificate.
- 2.4 The Law Society also issues practising certificates. Again, these are general certificates and are applied for upon admittance to the role of a solicitor. These certificates are also renewable annually.

3. Certificate requirements

- 3.1 The granting of a certificate to an actuary is based on two main criteria:
- a. the actuary possessing the necessary experience and knowledge;
 - b. the actuary being of "good character".
- 3.2 The experience requirement is normally judged on the length and amount of experience which the actuary has had in the required area. It centres on being a fellow of the relevant society and having a minimum period of membership of that society together with a minimum period of time working in the specific area. This ensures that the broad knowledge and necessary experience required to sign a statutory report are present. In the case of an appointed actuary to a life assurance company there is also an age requirement. This age requirement has not been followed in proposed regulations by other countries.

- 3.3 An actuary's knowledge is also required to be up to date. CPD should therefore be current especially in relation to the chosen specialist area. The practical experience in this area should also be up to date. The different issues that are raised by the London Market and the Direct market could result in certification in the area in which the actuary has the relevant experience.
- 3.4 The requirement that the actuary is of "good character" is normally fulfilled by the actuary's being an approved member of the relevant society with no disciplinary hearings against him or her. The link to the "fit and proper" element would ensure that they had no significant criminal convictions or disciplinary actions relating to other professional bodies or previous offices of employment. It would also be advisable that the actuary had no links to bankrupt companies or to other forms of misconduct which might taint the opinion which they would be giving.
- 3.5 Practising certificates are often required by our peer actuarial bodies and peer professions. They support and lend credibility to the opinions offered by these groups. The introduction of practising certificates to support a statutory role would yield similar benefits to general insurance actuaries.

C. The Accounting Profession's Experience of Statutory Reporting Under Legislation

1. INTRODUCTION

The aim of this report is to outline an example of the method by which the Accounting profession regulates statutory reporting, primarily using the Institute of Chartered Accountants in England and Wales ("ICAEW") as the example regulatory body.

The areas to be covered are:

- introduction to the Institute of Chartered Accountants;
- training;
- regulation of auditors;
- auditing standards; and
- audit reports.

2. INTRODUCTION TO THE INSTITUTE OF CHARTERED ACCOUNTANTS

Within the profession there are several professional bodies with whom an individual may qualify.

Included within these are the Institutes of Chartered Accountants in England and Wales, Scotland and Ireland.

Each of the Institutes are Recognised Qualifying Bodies (RQBs). Individuals gaining membership with an Institute, would qualify as a member holding an 'appropriate qualification' provided this was accompanied by suitable practical audit experience.

In addition, the Institutes are Recognised Supervisory Bodies (RSBs). RSBs issue a series of audit regulations which require all registered auditors to:

- complete work with integrity;
- maintain independence;
- comply with auditing standards;
- be fit and proper; and
- be competent.

The audit regulations aim to ensure that:

- a high standard of work is maintained;
- the reputation of auditors with the public is maintained; and
- regulations are applied fairly to all sizes of firm.

2.1 Committees

The ICAEW must ensure that all registered auditors comply with the regulations. In order to achieve this several committees have been established, which are outlined below:

a. Registration Committee:

- grants applications for registration;
- grants applications for registration subject to certain conditions and/or restrictions as deemed necessary;
- rejects applications for registration;
- withdraws registration;
- suspends registration;
- imposes restrictions and/or conditions;
- proposes penalties;
- grants/refuses dispensation from regulation requirements where appropriate;
- reviews annual returns and reports prepared by all registered auditors;
- investigates eligibility of applicant for registration;
- investigates compliance with regulations by registered auditors;
- publishes any orders or decisions; and
- compiles and maintains a list of registered auditors.

b. Investigation Committee:

This committee investigates any facts or matters notified by the Registration Committee which either suggest that a registered auditor may be liable to disciplinary action or need investigation.

c. Review Committee and Panel:

This committee reviews decisions made by the Registration Committee on the request of firms registered with the ICAEW.

d. Appeal Committee:

If a firm is dissatisfied with a decision by the Review Panel it may apply for the case to be heard by the Appeal Committee.

An appeal may only be made on the following grounds:

- The Review Committee was wrong with respect to law, relevant regulations or did not comply with proper procedures;
- The Review Committee made an order which would not have been made by any other tribunal; and
- The Review Committee did not take account of evidence which may have lead to a different decision.

e. Joint Disciplinary Scheme:

This consists of Disciplinary, Discipline and Investigations Committees. They are solely responsible for the discipline of firms or members within the disciplinary framework within the ICAEW's by-laws.

2.2 Joint Monitoring Unit (JMU) Ltd

The JMU is a company established by the ICAEW which monitors compliance with audit regulations by registered firms.

On site visits to the offices of registered auditors are made to review the work practices of firms to ensure that audit regulations and standards are being maintained.

2.3 Professional standards

A commitment is required to achieve and maintain high standards of professional work. Registered firms do this by:

- a. setting out procedures within a firm procedures manual which, if followed and properly documented, will ensure that assignments are completed in accordance with the firm's standards;
- b. ensuring that the firm's partners and staff have attained the skills and competence required to fulfil their responsibilities. This involves procedures relating to recruitment, technical training and updating, on-the-job training and professional development;
- c. establishing procedures for consultation. This includes a structured approach to audit file review, referral of technical problems to designated specialists within the firm and procedures for resolving matters of judgement; and
- d. monitoring the effectiveness of the application of these procedures.

2.4 Professional duties of staff

The ICAEW has a guide to professional ethics which each member must follow to ensure high standards of conduct are maintained.

Guidance is given in the form of fundamental principles and statements.

The fundamental principles are:

- a member should behave with integrity in all professional and business relationships. Integrity implies not merely honesty but fair dealing and truthfulness;
- a member should strive for objectivity in all professional and business judgements. Objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other;
- a member should not accept or perform work which he or she is not competent to undertake unless he obtains such advice and assistance as will enable him competently to carry out the work;

- a member should carry out his or her professional work with due skill, care, diligence and expedition and with proper regard for the technical and professional standards expected of him as a member; and
- a member should conduct himself or herself with courtesy and consideration towards all with whom he comes into contact during the course of performing his work.

The statements provide further details on how the fundamental principles can be achieved.

The power of the ICAEW to enforce ethical standards is entrusted to the Joint Disciplinary Scheme.

Finally, the ICAEW has also laid down ethical guidance on their members' responsibilities in relation to the discovery of a possible unlawful act committed by a client.

3. TRAINING

3.1 Introduction

The process of becoming a chartered accountant and qualified individual for the reporting purposes being addressed by this paper involves:

- gaining professional qualifications by undertaking approved training and professional examinations; and
- receiving confirmation of entitlement to practise;
- by entering a training contract with an authorised training organisation, successfully completing three levels of professional examinations and completing a period of approved practical experience.

3.2 Training organisations

A training organisation is one which has been authorised by the ICAEW, in its capacity as an RQB, to provide approved training.

There are two types of training organisations:

- *Single training organisation* - a single office of a practising firm, a body corporate engaging in public practice or an organisation outside public practice.
- *Training office group* - a group of offices of an organisation as above.

An approved organisation may be authorised to provide approved training and approved practical experience or just approved practical experience post qualification.

3.3 Criteria for becoming an approved training organisation

- An individual within the organisation who is a member of the ICAEW must be appointed as Member Responsible for Training; and
- The organisation must meet five specified training standards.

An application must be completed and sent to the ICAEW. This is followed by an appraisal of the training arrangements within the firm. The authorisation is then approved by the Training Standards Committee and notified to the organisation.

3.4 Approved training

In order to qualify an individual must complete a specified period of practical training prior to qualification.

Approved training can only be obtained under a training contract with a training organisation.

The ICAEW recommends minimum levels for technical content of the training received within the following categories:

- Accounting;
- Auditing;
- Taxation;
- Financial management;
- Insolvency; and
- Information technology.

3.5 Examinations

Whilst completing a training contract, students must also complete three levels of professional examinations:

- Conversion / Foundation;
- Intermediate; and
- Final.

Exemptions may be gained from the conversion stage if requirements have been met on the basis of academic qualifications.

There are time limits for sitting intermediate and final levels of four and six years respectively from the first day of the month in which the training contract commenced.

3.6 Approved practical experience

In order to become eligible to apply for confirmation of entitlement to practise a member of the ICAEW must complete a period of two years work experience post qualification.

This work experience can only be provided by a Training or Post Qualification training organisation.

3.7 Continuing Professional Education

Qualified members of the ICAEW have to comply with the guidelines set by the ICAEW regarding continuing professional education (CPE).

CPE is defined as attending technical courses, discussing technical issues and reading professional and technical matter.

The ICAEW recommends that 150 hours of CPE per year is undertaken by each member.

4. REGULATION OF AUDITORS

4.1 Registered auditor status

A pre-requisite to firms being permitted to perform audit assignments is gaining registered auditor status.

The Companies Act states that:

- only appropriately qualified firms may be appointed as Company Auditors; and
- RSBs must have rules governing ownership and control of registered auditors.

Therefore, to become a registered auditor a firm must:

- be fit and proper;
- have professional indemnity insurance; and
- have at least 75% of the voting rights held by Partners who are qualified individuals, registered auditors or both.

In order to retain registration the RSB issue a series of regulations with which each firm must comply. These regulations require all registered firms to have in place procedures which, inter alia, ensure:

- the firm's audit procedures comply with Statements of Auditing Standards; and
- partners and staff are competent to carry out audit work.

Having received registered status, firms are monitored by:

- completion of Annual Returns; and
- compliance visits from the JMU (Section 2.2).

Finally, an annual fee is payable each year on 1 January.

4.2 Qualified Individuals

A qualified individual is defined as the holder of an appropriate qualification and practising certificate.

This status may be gained by:

- holding a recognised accountancy qualification awarded by a RQB; or
- holding an approved overseas or other qualification and, where required, successfully completing an additional test.

4.3 Responsible Individuals

Within every firm of registered auditors there must be designated responsible individuals.

A responsible individual does not have to be a partner or director, but only responsible individuals can be responsible for an audit and sign the audit report.

5. AUDITING STANDARDS

A registered auditor must comply with Auditing Standards.

Guidance included within each standard and practice notes provide assistance on how to apply the standards.

The standards covering quality control, reliance on other specialist and various administration matters are outlined below. In addition, other standards deal with specific aspects of audit work such as:

- planning;
- controlling and recording;
- accounting systems and internal controls; and
- audit evidence.

5.1 Quality control

One of the requirements of a registered auditor is to have in place appropriate quality control procedures. Great emphasis is placed on the monitoring process, for which the responsibility rests with the Audit Compliance Principal in each firm.

The principal objectives of quality control reviews are to:

- establish the extent of compliance with the firm's standards and policies in auditing procedures, accounting and reporting principles, and working paper methods and practices;
- determine whether the scope and results of the audit work are adequate to support the audit opinion;
- review the performance of individual offices and the personnel who performed the audit;
- identify additional points where the firm's policy requires to be specified or existing policies need to be clarified;

- identify any recurring weaknesses so that they can be considered on training courses and in technical publications;
- report isolated weaknesses to the appropriate engagement partner;
- identify procedures which are unnecessary or alternative strategies and techniques which may improve efficiency;
- report on the findings of the review to the partners; and
- monitor the adequacy of any corrective action taken from previous reviews.

5.2 Reliance on other specialists

a. *The need for specialist evidence*

There will be occasions when outside experts should be called in to provide audit evidence in particular specialist areas, for example the valuation of property or stock. The need for specialist evidence should be anticipated at the planning stage of an audit. It will depend on:

- i. the materiality of, and risk involved in, the information being examined;
- ii. the complexity of the information and our knowledge of the area concerned; and
- iii. whether there are alternative sources of audit evidence.

b. *Responsibility*

Requests for specialist evidence should normally be made by the client. There is no responsibility to engage a specialist by the auditors and if it is not done and there is not sufficient alternative evidence, the audit report may be qualified on the grounds of limitation of scope.

c. *The Specialist*

The auditor should be satisfied as to certain qualities of the specialist, for example:

- i. competence and objectivity;
- ii. qualifications; and
- iii. relationship with the client.

Any reservations should be discussed with the client, as they will influence the extent to which reliance is placed on the specialist's evidence.

d. *Terms of reference*

The terms of reference of the specialist should be established after consultation between the auditors, the client and the specialist. They should be fully documented and reviewed annually as applicable.

e. *Evaluating the evidence*

The audit evidence provided by the specialist must be evaluated to ensure that it is sufficient, relevant and reliable enough to enable reasonable conclusions to be drawn. The auditors should establish whether:

- i. the data, assumptions and bases used by the specialist are the same as those used to prepare the financial statements;
- ii. the information supplied by the specialist has been prepared and presented in accordance with the terms of reference;
- iii. the specialist has qualified his opinion or expressed reservations;
- iv. the effective date of his findings is acceptable;
- v. the findings are fairly reflected in the financial statements; and
- vi. the findings appear reasonable.

If the specialist's evidence is unsatisfactory this should be discussed with him and the client. In extreme circumstances it may be necessary to ask the client to obtain the opinion of another specialist.

5.3 Engagement letters

a. *Purpose*

The purpose of an engagement letter is to define clearly the extent of the firm's responsibilities and so minimise the possibility of any misunderstanding between the client and the auditor. It will help the client:

- i. to have written confirmation of the scope of the firm's work, the form of any report given and additional services provided;

- ii. to understand the extent of the directors' or management's responsibilities in the preparation of the financial statements, and the need for the auditors to receive written management representations;
- iii. to appreciate that the main purpose of the audit is not to detect or prevent fraud or other irregularities;
- iv. by setting out the basis on which the firm's fees are charged; and
- v. by setting out the formal complaints procedure.

b. *Client acknowledgement*

Two copies of the engagement letter should be sent to the client with a request that one should be approved by, and signed on behalf of, the board and returned to the firm to indicate understanding and acceptance of its contents. Where a client refuses to acknowledge a letter, the terms of the engagement should be discussed and a note of the discussions retained. Work should not be started without having agreed written terms of engagement.

c. *Updating*

The engagement letter should be reviewed at the planning stage of the audit to ensure it continues to reflect the client's circumstances and the services provided. A revised, or supplementary letter should be sent where necessary.

d. *Changes in nature of engagement*

If, during the course of an audit assignment, it is proposed to change the engagement to one which provides a different level of assurance, consideration should be taken as to whether it is appropriate to change the nature of the engagement. If it is considered appropriate, then a new engagement letter should be issued, obtaining agreement to the revised terms of the engagement.

5.4 Representations by management

a. *Preparation of the letter*

During the course of his work the auditor may identify matters requiring written representations. This should only be used for confirmation of matters for which alternative audit evidence is not

available and reliance needs to be placed on such representations by the auditor. The letter should be typed on the client's letterhead.

b. *Signatory*

The letter should usually be signed by two directors such as the managing director and the finance director. The letter should be considered and approved by the whole board at the same time as they approve the financial statements.

c. *Date*

Written representations should bear the same date as the directors' approval of the financial statements and wherever possible the auditors' report.

d. *Refusal by management*

Where management refuses to provide written representations, alternative procedures may be used, such as:

- i. management may be willing to minute their representations at a board meeting; or
- ii. a letter containing the principal representations may be sent to the client requesting confirmation.

Due to the requirement of SAS 120 that auditors obtain written confirmation concerning compliance by directors with laws and regulations these alternative procedures are not an acceptable alternative for that specific issue. If in any other case these courses of action are pursued and fail it may be necessary to qualify the audit opinion for lack of information and explanations received.

5.5 Reports to directors or management

a. *Purpose*

The principal purposes of preparing a report to the management of a company is to communicate points that have come to the auditors' attention during the audit on:

- i. operation of accounting and intended control procedures and suggestions for improvement;

- ii. constructive advice regarding potential economics or efficiency improvements; and
- iii. other matters arising.

b. *Management comments*

Comments by management on the points raised should be recorded indicating the actions they intend to take as a result.

Where points raised in previous years have not been acted upon these should be raised again and the reasons why the issue has not yet been effectively dealt with recorded.

c. *Addressees*

Normally it is appropriate to address the report to the Board of Directors, Audit Committee or similar body.

d. *Third parties*

The report is a confidential document and directors are normally required to obtain consent from the auditor prior to providing copies to third parties. It is appropriate to ensure that any third parties understand that this report was not prepared for their benefit.

Therefore the auditors will usually state in the report that:

- the report has been prepared for the sole use of the entity;
- it must not be disclosed to a third party or quoted if referred to without written consent of the auditors; and
- no responsibility is assumed by the auditors to any other person.

6. THE AUDIT REPORT

The Audit Report is the tool by which auditors express their opinion on the financial statements.

The general principles of reporting remain the same whatever the nature of the reporting entity or the type of opinion to be expressed. Audit reports will generally follow standard wordings. The main principle to follow is that of unambiguous communication.

6.1 Basic elements of the auditors' report

Auditors' reports on financial statements should include the following matters:

- a title identifying the person or persons to whom the report is addressed;
- an introductory passage identifying the financial statements audited;
- separate sections, appropriately headed, dealing with:
 - respective responsibilities of directors and auditors;
 - the basis of the auditors' opinion; and
 - the auditors' opinion;
- the manuscript or printed signature of the auditors; and
- the date of the auditors' report.

6.2 Responsibilities

a. *Responsibilities of directors*

Readers of financial statements need to be aware that it is the directors who are responsible for the preparation of the financial statements and the determination of the accounting policies which underlie them.

The financial statements should therefore include a statement of the directors' responsibilities. The audit report should state, briefly, that the directors are responsible for the preparation of the financial statements and cross refer to this statement.

b. *Responsibilities of auditors*

Having clarified the responsibilities of the directors our report briefly outlines our responsibilities, being the formation of an independent opinion and reporting to the shareholders.

6.3 Standard formats

The use of a standard format for auditors' reports assists the reader to follow the report's content.

Appendix 1 shows a standard audit report with an unqualified opinion.

6.4 Extensions of an unqualified opinion

There are occasions when additional information must be disclosed within the audit report, but the opinion remains unqualified.

a. *Fundamental uncertainty*

Where there is an inherent uncertainty at the time of approving the financial statements, this must be explained within the audit report, if the potential impact on the financial statements is fundamental.

The explanation should include, where practicable, quantification. Where it is not possible to quantify the potential effects this must be stated.

b. *Exception reports*

There are five circumstances, required by the Companies Act 1985, which should be reported on by exception in the auditor's report. These are:

- where the directors report is not consistent with the financial statements;
- where proper accounting records have not been maintained;
- where the financial statements do not agree to the accounting records;
- where returns from branches have not been received; and
- where all necessary information and explanations have not been received.

c. *Additional disclosure*

Under the Companies Act 1985 the auditor's report must also include the following disclosure details if they have been omitted from the financial statements:

- directors emoluments; and
- loans and transactions with directors.

6.5 Circumstances giving rise to a qualification

A qualified opinion is issued when either:

- there is a limitation on the scope of the auditors' work; or
- the auditors disagree with the treatment or disclosure of a matter in the financial statements;

and the effect of the matter is or may be material to the financial statements. Qualified opinions are of two types; adverse opinion and disclaimer of opinion.

a. *Adverse opinions*

An adverse opinion is issued when the effect of a disagreement is so material or pervasive that the financial statements are deemed to be misleading.

An adverse opinion is expressed by stating that the financial statements do not give a true and fair view.

Where the disagreement is not so significant an opinion is expressed that the financial statements are true and fair except for the matter in disagreement. *See Appendix 2.*

b. *Disclaimer of opinion arising from a limitation of scope*

Where a scope limitation exists, auditors must attempt to carry out reasonable alternative procedures to obtain sufficient audit evidence to support an unqualified opinion.

In considering whether a limitation results in a lack of the evidence necessary to form such an opinion auditors should assess:

- i. the quantity and type of evidence which may reasonably be expected to be available to support the particular figure or disclosure in the financial statements; and
- ii. the possible effect on the financial statements of the matter for which insufficient evidence is available. When the possible effect is, in our opinion, material to the financial statements, there will be insufficient evidence to support an unqualified opinion.

When there has been a limitation on the scope of the auditor's work that prevents him from obtaining sufficient evidence to express an unqualified opinion:

- the audit report should include, in the opinion section, a description of the factors leading to the limitation;
- when the possible effect of a limitation on scope is so material or pervasive that it prevents the auditor forming an opinion on the financial statements, he should issue a disclaimer of opinion;
- when the effect of the limitation is not so material or pervasive as to require a disclaimer the wording of the opinion should indicate that it is qualified as to the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed. The opinion will start with the phrase "Except for ..." See *Appendix 3*.

A description of the factors leading to a limitation enables the reader to understand the reasons for the limitation and to distinguish between:

1. limitations imposed on the auditor (for example, where not all the accounting records are made available or where the directors prevent a particular procedure considered necessary from being carried out); and
2. limitations outside the auditor's control or that of the directors (for example, when the timing of the appointment was such that attendance at the entity's stock-take was not possible and there is no alternative form of evidence regarding the existence of stock).

When the proposed terms of an audit engagement include a limitation on the scope of our work such that at the outset that the auditor believes he will have to issue a disclaimer, he would normally not accept such a limited engagement as an audit engagement, unless required by statute to do so.

6.6 Addressees

In the case of a company, the addressees will normally be the shareholders. In other cases the relevant legislation, the constitution

of the entity concerned or the letter of engagement should specify the appropriate addressee(s).

If a client has a strong preference for the use of the term members this may be used instead of shareholders.

6.7 Date and signature of auditors' report

Auditors should not express an opinion on the financial statements until they have been approved by the directors and the auditors have considered all the necessary available evidence.

The date of the auditors' report is the date on which the auditors signed their report expressing their opinion.

APPENDIX 1

STANDARD FORMATS

1. **Example 1** - unqualified opinion: company incorporated in Great Britain

- 1.1 We have audited the financial statements on pages ... to ... which have been prepared following the accounting policies set out on page

a Respective responsibilities of directors and auditors

As described on page ... the company's directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

b. Basis of opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

c. Opinion

In our opinion the financial statements give a true and fair view of the state of the company's affairs as at 31 December 19. . and of its profit [loss] for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

CHARTERED ACCOUNTANTS

and Registered Auditors

Office

Date

2. Example 2 - unqualified opinion with explanatory paragraph describing a fundamental uncertainty

- 2.1 In forming our opinion, we have considered the adequacy of the disclosures made in the financial statements concerning the possible outcome to litigation against B Limited, a subsidiary of the company, for an alleged breach of environmental regulations. The future settlement of this litigation could result in additional liabilities and the closure of B Limited's business, whose net assets included in the consolidated balance sheet total £ . . . and whose profit before tax for the year is £ Details of the circumstances relating to this fundamental uncertainty are described in note Our opinion is not qualified in this respect.

3. Example 3 - unqualified opinion with directors' responsibilities set out in full

3.1 Respective responsibilities of directors and auditors

Company law requires the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing those financial statements, the directors are required to:

- a. select suitable accounting policies and then apply them consistently;
- b. make judgements and estimates that are reasonable and prudent;
- c. state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements*; and
- d. prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and to enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

- 4. Example 4 - unqualified opinion with fundamental uncertainty relating to going concern**

4.1 Going concern

In forming our opinion, we have considered the adequacy of the disclosures made in note 1 of the financial statements concerning the uncertainty as to the continuation and renewal of the company's bank overdraft facility. In view of the significance of this uncertainty we consider that it should be drawn to your attention but our opinion is not qualified in this respect.

APPENDIX 2

ADVERSE OPINION

1. AUDITORS' REPORT TO THE SHAREHOLDERS OF XYZ PLC

We have audited the financial statements on pages . . . to . . . which have been prepared under the historical cost convention (as modified by the revaluation of certain fixed assets) and the accounting policies set out on page

1.1 Respective responsibilities of directors and auditors

As described on page . . . the company's directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

1.2 Basis of opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

1.3 Adverse opinion

As more fully explained in note . . . no provision has been made for losses expected to arise on certain long-term contracts currently in progress, as the directors consider that such losses should be

offset against amounts recoverable on other long-term contracts. In our opinion, provision should be made for foreseeable losses on individual contracts as required by Statement of Standard Accounting Practice 9. If losses had been so recognised the effect would have been to reduce the profit before and after tax for the year and the contract work in progress at 31 December 19 . . by £

In view of the effect of the failure to provide for the losses referred to above, in our opinion the financial statements do not give a true and fair view of the state of the company's affairs as at 31 December 19 . . and of its profit [loss] for the year then ended. In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Companies Act 1985.

Registered auditors
Date

Address

APPENDIX 3

DISCLAIMER OF OPINION

1. AUDITORS' REPORT TO THE SHAREHOLDERS OF XYZ PLC

We have audited the financial statements on pages . . . to . . . which have been prepared under the historical cost convention [as modified by the revaluation of certain fixed assets] and the accounting policies set out on page

1.1 Respective responsibilities of directors and auditors

As described on page . . . the company's directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

1.2 Basis of opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board, except that the scope of our work was limited as explained below.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. However, the evidence available to us was limited because we were appointed auditors on (date) and in consequence we were unable to carry out auditing procedures necessary to obtain adequate assurance regarding the quantities and condition of stock and work in progress, appearing in the balance sheet at £... Any adjustment to

this figure would have a consequential significant effect on the profit for the year.

In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

1.3 Opinion: disclaimer on view given by financial statements

Because of the possible effect of the limitation in evidence available to us, we are unable to form an opinion as to whether the financial statements give a true and fair view of the state of the company's affairs as at 31 December 19.. or of its profit [loss] for the year then ended. In all other respects, in our opinion the financial statements have been properly prepared in accordance with the Companies Act 1985.

In respect alone of the limitation on our work relating to stock and work-in-progress:

- a. we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and
- b. we were unable to determine whether proper accounting records had been maintained.

Registered auditors
Date

Address

APPENDIX 4

SOURCES

- Members Handbook, 1997 - ICAEW
- Audit Regulations and Guidance, 1995 - ICAEW, ICAS, ICAI
- Education and Training Handbook, 1995-6 - ICAEW
- Statements of Auditing Standards - The Auditing Practices Board

D. Methodology Paper

Proposed Structure

It is envisaged that, if statutory reserve opinions were introduced for non-life insurance in the UK, an advisory paper on methodology would be produced to supplement the guidance note that would be issued at the time. The methodology paper would provide more guidance on the approach that an actuary should adopt in conducting a reserve review for the purpose of a statutory opinion.

This note sets out a proposed structure for such a paper. The Working Party would welcome feedback on these proposals. Following this year's convention, the intention is to review the feedback received and to prepare a full draft of the paper for consideration at the 1998 General Insurance Convention.

The proposed structure of such a methodology paper is as follows:

1. Introduction

This section will state that the purpose of the paper is to assist actuaries in providing statutory reserve opinions under any possible future regulatory environment, by providing guidance as to the approach they should adopt. It will cover reserve opinions in respect of outstanding and IBNR claims only. It is not intended to prescribe the use of particular methodologies.

This section will also mention how the paper ties in with other documents produced by the Working Party (eg the paper on Outwards Reinsurance produced for the 1996 General Insurance Convention).

2. Data

It is proposed that this section will include some general guidelines, such as:

- The relationship with the auditor should be clarified.
- Relevant data should be obtained.
- Sources of data should be investigated.

- Familiarisation should be gained with the data available before beginning the analysis.
- To the extent possible, data should be validated and checked for internal consistency.
- The reasonableness of the data should be checked.
- The reliability of the data should be investigated (eg has the data been audited?).
- Consideration should be given to whether any reasonable conclusions can be drawn when the volume of data is small.
- Consideration should be given to whether any reasonable conclusions can be drawn from data whose reliability is doubtful.
- Written assurances should be obtained from the client or their auditors or both as to the accuracy and completeness of the information provided.

It is not intended to include a specimen list of data requirements in this section.

3. Methodology

It is proposed that this section will include a set of general guidelines. These will include such things as:

- Business should be split between homogeneous groups for analysis.
- Where possible, a number of methods should be tried in order to validate the results.
- Consideration should be given to the approach adopted at previous reviews.
- The choice of methods should take into account the form and quality of the data.
- The choice of methods should take into account the class or nature of the business.
- The choice of methods should take into account the number of years of experience.
- The choice of methods should take into account the age of the year of origin being developed.
- Discussions should take place with company personnel, eg
 - Underwriters.
 - Claims managers.
 - Reinsurance staff.

- Account should be taken of changes in payment strategies.
- Account should be taken of changes in reserving approaches.
- Account should be taken of changes in accounting practices.
- Account should be taken of relevant changes in the law.
- Account should be taken of changes in policy terms.
- Any claims, claim types or sources of claims that are significant and are likely to develop very differently from the remainder of a class should be removed from the data and projected separately, eg:
 - Latent claims.
 - Catastrophe claims.
 - Special contracts such as the Minets Professional Indemnity Lineslip.
 - Large losses.
- Consideration should be given to the appropriateness of any benchmarks used.
- Consideration should be given to the effects of reinsurance.
- Consideration should be given to the credibility of the result if the volume of data is small.
- Consideration should be given to the credibility of the result if the reliability of the data is doubtful.

It is not intended that this section should contain details of any particular methods or a list of acceptable techniques.

4. Discounting

This section is intended to include some general comments on the use of appropriate discount rates and payment patterns.

5. Uncertainty

This section will contain a discussion on the need to appreciate the level of uncertainty attaching to the estimates. It will discuss some of the drivers of this uncertainty, such as:

- The quality of the available data.
- The volume of data available.
- How developed the business is.
- The type of business.

- Exposure to any sources of claims that give rise to increased uncertainty, eg:
 - Latent claims.
 - Catastrophe claims.
 - Special contracts such as the Minets Professional Indemnity Lineslip.

It will also include a discussion on the merits and uses of ranges and sensitivity analyses. This will refer to and be consistent with the paper "Reserve Variability - Issues Paper" that has been produced by the Working Party and is included elsewhere in this section.

6. Documentation

It is anticipated that the revised GN12 will cover various aspects of the documentation associated with reports, and it is not intended to repeat what is said in that document. Instead, this section is likely to be restricted to comments that relate specifically to reports that accompany a statutory reserve opinion. In particular, this section will discuss the need for the report to be sufficiently detailed to allow a competent person to follow what was done. It will include comments on the areas that would normally be expected to be included in the report, such as:

- The need for the report to document the background and purpose of the review.
- The need for the report to include a description of the data that were used.
- The need for the report to document the methodology fully.
- The need for the report to document the assumptions fully.
- The need for the report to document the conclusions fully.
- The need for the report to explain the uncertainty attaching to the estimates and to highlight any areas of particular uncertainty.

This section will also discuss the need for the report, together with the working papers retained by the actuary, to contain sufficient details to allow any other competent actuary to form a view on the reasonableness or otherwise of the work carried out and of the conclusions reached. To this end, the working files would need to include, amongst other things, copies of sufficient data to allow such a view to be formed. They would need to be accessible and to be retained for a reasonable period of time.

E. Reserve Variability

Issues Paper

1. The question of reserve uncertainty is one which has been briefly addressed by actuaries. It leads to the contemplation of the variability inherent in our reserve estimates and the ways in which we communicate this variability to clients in the widest sense be they regulators - who are generally looking for us for some guide to the interpretation of the words "reasonable estimates". In my opinion, there are two main interpretations which can be placed on the words reasonable estimates as follows:-
 - would a competent person, experienced in the setting of reserves, have come up with reserves in that range - given the data; and
 - would the anticipated possible claims deterioration be sufficient to eliminate any solvency margin retained by the company.
2. The initial interpretation is quite subjective and requires considerable knowledge of reserving methodology and the underlying data and the second is quite complex and requires the ability to quantify the variability leading to a circular position.
3. I have therefore attempted in this paper to identify the sources of variability and then extend this to a wider contemplation of the interpretation of this variability to clients.

Sources of variability

4. Textbooks typically talk about three types of error in predicting future outcomes, namely:-
 - (a) *stochastic error*, due to the occurrence of unlikely events in the future;
 - (b) *parameter error*, due to the past not being a guide to the likely future;

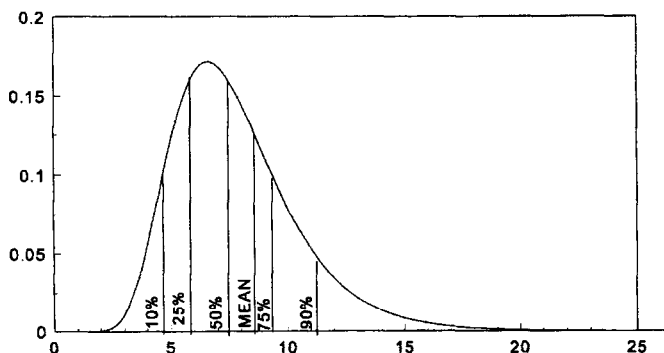
- (c) *model error*, due to not fully grasping or specifying the processes at work (underlying distribution).
5. Any estimation exercise will encounter these errors in the reverse order to that set out above.
 6. Clients would like us to be able to put accurate probability ranges around our best estimates. This could be done if and only if the only errors were stochastic. In the real world we also have to deal with parameter and model error.
 7. The first issue is that of understanding the processes at work, for which we need **data**. Data quality is the single biggest driver of uncertainty. The availability of data split in a manner appropriate for enabling reserving exercises to be conducted reliably - for example distinguishing between lines of business and separating out latent claims or large losses - should be the first consideration when assessing the reasonableness or otherwise of reserve estimates.
 8. We should distinguish between *good* data where an opinion can be formed with confidence and that any other competent person could also form an opinion with confidence when given that data and *barely adequate* where an opinion can only be formulated with extreme difficulty.
 9. The next contributor to model error is the methodology adopted. The work may be *detailed* and therefore we can be reasonably confident of the opinion or *less detailed* in which case divergence from the central estimates may be increasingly likely. When providing an opinion on a company's estimates of reserves we could further comment that the company's approach was:-
 - similar to the approach we would have adopted to evaluate the account;
 - over-mechanical or otherwise unresponsive to features exhibited by the business;
 - over-simplified or otherwise ignoring salient features of the business.
 10. Underlying the methodology and contributing even more to the uncertainty emerging are the assumptions being used. They could be

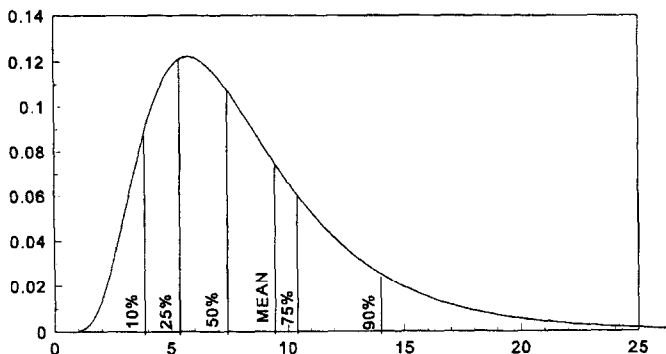
derived wholly from the data, be tempered by wider market knowledge or derived entirely from other sources. The source and appropriateness of the assumptions therefore must be commented upon in any discussion of potential variability.

11. Straddling all the categories of error are the uncertainties inherent among various classes of business and claim types, such as motor versus employer's liability or APH versus property. Uncertainty is additionally increased when the exposure arises from reinsurance or retrocessional business and is also affected by the maturity/immaturity of the underwriting/accident year concerned.

Nature of the future claims run-off cost distribution

12. It can be agreed that the (future claims cost) distributions we are dealing with are skewed to the right, in that the upside is limited but the downside is almost unlimited.
13. Illustrative examples of the probability distribution of a skew distribution are shown below. The x-axis is the value of the random variable, the y-axis represents the probability of each x-value. Vertical lines have been incorporated to show the mean of the distribution as well as various percentiles, namely 10%, 25%, 50% (median), 75%, 90%.





14. Actuarial estimates are generally interpreted as the median of the above distribution, at least, that is my interpretation of a reserve designed to have a broadly neutral outcome from the company concerned in that they have as much chance of being too high as too low.
15. One advantage of targeting the median is that it is much less sensitive than the mean to the size of the tail. While it is true that the median is less than the mean for a right-skewed distribution, this should not pose any problem.
16. Another feature of skew distributions has been referred to above, namely that in a range of equal probability about the median, the top end is further to the right than the bottom end is to the left.
17. In a related fashion, for any given level of probability, the smallest confidence range will be roughly "centred" on the mode (most "popular" value) rather than the around the median.
18. The main problem with the median is that the median of the sum of two independent right-skewed distributions is greater than the sum of the medians of the individual distributions. In symbols, if X and Y denote random variables and $m(X)$ denotes the median of the X distribution, then $m(X+Y) > m(X) + m(Y)$. This implies that when we consider the reserves of a company as the sum of our "median" reserves at a class of business level the actuary could be producing a

reserve which is an underestimate of the median reserve for the whole company. I am yet to solve this conundrum!

Ranges of Variability

19. Consider the case where the actuary has conducted an independent detailed review. In circumstances where the data is good, the business is largely short-tail and latent claims are largely absent, a reserve estimate in the range of 95% to 105% of the actuary's own estimate can be intuitively considered to be a "reasonable reserve", and a run-off outcome of 90% to 115% of the actuary's reserve estimate to be a "reasonably likely outcome".
20. This logic can be extended to those situations where the data, methodology and assumptions vary from the above happy situation. Note that the "reasonably likely" range is always skewed to the right *because of consistency with the underlying claims distribution.*
21. The profession could then contemplate developing a framework similar to the above which could be targeted at quantifying the variability implied by any statutory opinion. For example:-
 - If the methodologies and assumptions used by the company are broadly similar to those which we would have used and their reserve estimates are in accordance with the results of the actuary's estimates the above range might be considered appropriate.
 - If we are in agreement with the company's methodology but believe the assumptions to be optimistic/pessimistic, we could add/subtract a constant x% to the upper and lower end of each of the ranges above, according to our assessment of the likely effect of the divergent assumptions.
 - If we believe the Company's methodology to be overly mechanical we might increase each of the ranges by 5% at either end, rising to 10% for the larger ranges.

F. Reserving Areas and Methods Not Adequately Covered in the Actuarial Literature

Discussion Note

A list has been compiled of reserving areas and techniques that are not felt to be adequately covered by the current actuarial literature and where more research or documentation may be helpful. Some of the items on this list might be appropriate topics for working parties for the 1998 General Insurance Convention. The list as it stands is not intended to be exhaustive and the Working Party would welcome any additions.

Although this note has been issued prior to the release of the revised version of the Claims Reserving Manual, it is understood that the amendments to the manual would not give grounds for the removal of any of the areas or methods on the list.

It should be noted that the inclusion of a method on this list is in no way intended to imply that the method should be used in all reserve reviews.

To date, the following areas have been identified:

Sources of Claims

- Asbestos, Pollution and Health Hazard liabilities, including reserving for latent claims that have yet to emerge - for both the US and elsewhere.
- Catastrophes.
- Special contracts such as the Minets Professional Indemnity Lineslip and the EW Payne Casualty XL Lineslip.
- Personal injury claims.
- Subsidence.
- Mortgage guarantee.
- Other economically-driven losses.

Techniques

- Stochastic methods.
- Fitting models.
- Bornhuetter-Ferguson method.
- Pinto-Gogol method and reserving by layer.
- Harry Reid's method.
- Benchmarking methods.
- Graphical methods.
- Methods developed by Hovinen.
- Additive versus multiplicative methods.

Reinsurance

- Allowance for reinsurance recoveries.
- Reinsurance bad debts.
- Financial reinsurance.

Other

- Expense reserves.
- Reserving issues for captives.
- Issues arising from one-year accounting versus three-year accounting.
- Ranges