



## Perspectives

**AJA Risk Management** is interested in sharing perspectives on risk management issues with their clients, colleagues and other interested readers. The following is an interview with AJA Risk Management founder and president Ben Silberstein.

### Auditors, Actuaries and Today's Business Climate

*Let's start with the basics. What is the difference between an auditor and an actuary?*

Auditors deal with the past—their job is to follow the paper trail of what has actually occurred. Auditors review business activities over specific time periods, such as a calendar year or fiscal year, and produce an income statement. Then they take a snapshot of the year-end result and produce a balance sheet.

The classical definition of an actuary is someone who “establishes the present value of future contingent events.” In other words, actuaries deal with the cost in today's dollars of an event that may or may not happen sometime in the future.

*So if the auditor is focused on the past and the actuary deals with the future, it would seem that certainty and uncertainty play a key role in the difference.*

Exactly so. Auditors care about certainty. They seek to eliminate judgment and uncertainty in their work. Auditors are like detectives. Just as conjecture isn't desirable in the courtroom, it isn't wanted in audit reports either. But actuaries live with uncertainty. If you can't deal with uncertainty, don't become an actuary.

Actuarial work is riddled with judgment, reasoned predictions and guesstimates. What will the rate of inflation be in 2010? How many truck drivers at the XYZ Corp. will have serious accidents leading to claims? Actuaries use the past to predict the future, because it is all we have. But the past is—at best—a weak indicator of future events. Thus judgment comes into play.

*Are there other key differences?*

Yes. Auditors and accountants are trained to focus on the asset side of the balance sheet. And for most companies that sell products or deliver services, assets are a more challenging issue. Auditors are concerned with the value of real estate, the worth of goodwill, the number of computers—all asset issues. For most corporations, liabilities aren't a challenging issue. They have issued debt instruments and bonds whose cost in the future is established.

But it's reversed in the insurance industry—the focus is on the liability side. The assets are fairly easy to identify and assess—cash reserves, mostly high-grade bonds, some equities and minimal real estate. But the liabilities are much less certain. Dealing with liabilities in an insurance environment introduces major uncertainty.

*And that uncertainty can be fatal, right?*

Actually, very rarely. Except in extreme cases, like the asbestos situation, liabilities don't put companies out of business. Even if their actuaries get it all wrong, the cost of risk usually runs to only 1% of revenues. For most Fortune 500 companies for example, the net sum total cost of workers' compensation, auto liability and property damage may be \$10 to \$20 million per year. While clearly a significant number, it's small compared to the billions in revenue that these companies achieve. Actually, the risk of major loss is more on the accounting and asset side. Major accounting irregularities can put companies out of business. Business improprieties and mistakes put companies out of business. Huge inventories that don't sell, unseen competition, uncollectible receivables all can be fatal. But uncertainty with respect to property and casualty losses, provided they are properly treated with a formal program of insurance and self-insurance, isn't usually fatal.

*What about those accounting irregularities? Has increased scrutiny of the audit process impacted actuaries?*

It has. The Sarbanes-Oxley Act of 2002 is, of course, a result of accounting irregularities and issues on the asset side of the books. But the increased scrutiny has washed over to the risk management side. Actuaries, especially in the remaining big accounting firms, are increasingly being questioned about their choices—the judgments they make. In this climate, tolerance for uncertainty is diminishing. And uncertainty, as we've already seen, is the lifeblood of actuarial work.

Sarbanes-Oxley prohibits registered public accounting firms from providing non-audit services—including actuarial services—contemporaneously with an audit. Because of Sarbanes-Oxley, actuaries who work for large public accounting firms are being expected to squeeze the actuarial process into the auditing mode. That is undoable by definition, as we have already explained.

*What does this mean to their clients?*

In the actuarial business, increased conservatism goes directly to the bottom line in the form of increased reserve requirements. For smaller companies or for larger companies that are self-insuring with captive insurance entities, this difference can be substantial. Let me give you an example. An independent actuarial firm is retained by the XYZ Corp. to do an actuarial study. They determine that the expected reserves are \$30 million. The VP of Finance of XYZ Corp. passes this report by his accounting firm and that organization's auditors review it. Formerly, they might have approved the study, but now, because of Sarbanes-Oxley, they are nervous. They question the assumptions and doubt the zone of reasonability. Result: XYZ Corp.'s reserves soar to \$45 million.

*So what's a company to do?*

The intent of Sarbanes-Oxley is to separate financial service functions that shouldn't be combined. In this case, a third party—the independent actuary—is the best provider of actuarial services. Honoring the difference between auditors and actuaries, independent actuaries are in the best position to give an independent opinion that is separate from both the organization buying the services and from that company's auditors.

*What other advice would you give to potential purchasers of actuarial services?*

Since the actuarial process is so dependent on good judgment, it's important to pick an organization that you trust. Independent third-party actuaries have honed their skills to particular elements of the business. For example, I am a property casualty actuary. Even though I know a little about it, I wouldn't take on a life or pension assignment. I refer those opportunities to other skilled actuaries in that field. On the other hand, I have a lot of experience with self-insurance strategies such as domestic and foreign captives. This is an arena in which my knowledge and experience can greatly benefit my clients.

*Please Contact Us with your comments on this Perspective and any other risk management issues of interest.*

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