



## 7 Financial reporting and assurance

Financial reports that provide accurate, timely and comparable financial information about the underlying financial position and performance of a business are an important element of the effective operation of a modern economy. Such information allows investors and creditors to make informed decisions which assist the efficient flow of capital to its most productive uses.

Financial reports are mandated by the *Corporations Act 2001* and should reflect the application and interpretation of accounting standards. The overriding requirements of the Corporations Act are that financial reports must comply with the accounting standards and present a 'true and fair' view of the financial position and performance of the entity.

The preparation of financial reports has two main elements: first, the application and interpretation of the accounting standards pertaining to those reports (Section 7.1) and second, the assurance that those reports are true and fair. These requirements are the responsibility of the board of the company with the assistance of the auditor. The role of the auditor is considered in Section 7.2.

Under the *Insurance Act 1973* most insurers are now required to use the services of an actuary to provide advice on, amongst other things, the valuation of the insurer's outstanding claims provisions. Given the central role that provisioning plays in the business of a general insurer, the valuation of OCP is critical in providing accurate financial statements. The role of the actuary is addressed in Section 7.3.

### 7.1 Accounting standards

In Australia accounting standards are set by the Australian Accounting Standards Board. The AASB is overseen by the Financial Reporting Council. The FRC is responsible for determining the broad strategic direction of the AASB and for advising the government on the setting of accounting standards and on developments in international accounting standards. The FRC does not influence the AASB's technical deliberations or the content of particular accounting standards.

The FRC is also responsible for appointing part-time members to the AASB. The full-time chair of the AASB is appointed by the Treasurer. The AASB is largely comprised of accountants and accounting specialists.

The AASB is funded in part by appropriations by the Commonwealth (\$1.5 million in 2001–02), state and territory governments (\$0.5 million in 2001–02) and the accounting bodies (\$0.75 million) and the Australian Stock Exchange (\$0.06 million). The AASB also seeks funding contributions from large listed companies in Australia.

The primary objective of the AASB is to improve the quality of general purpose financial reports in Australia. The AASB also has an objective of harmonising Australian accounting standards with international standards. The Commonwealth Government has recently announced that entities subject to the Corporations Act will be required to comply with international accounting standards from 1 January 2005.

The development of accounting standards in Australia is a consultative process. In broad terms, the process involves the publication of exposure drafts by the AASB following discussion with a consultative group drawn from a wide cross-section of interest groups in the private, public and not-for-profit sectors. The AASB encourages comments from interested people and organisations on exposure drafts. These comments are taken into account when the AASB finalises accounting standards.

Accounting standards have the force of law under the Corporations Act. Entities subject to the Act are required to comply with accounting standards issued by the AASB.

Evidence emerged during the Commission that the interpretation of certain key accounting standards (including, for example, AASB 1002 'Events occurring after reporting date', AASB 1013 'Accounting for goodwill' and AASB 1023 'Financial reporting of general insurance activities') was not straightforward. Often this simply reflected an incorrect application of a relatively clear standard. At other times, however, the

meaning of the standard was not as clear as it could be.

Some hold the view that the problems that have been identified by this inquiry might reflect difficulties in financial reporting more broadly. Professors Dean, Clarke and Wolnizer, argued, for example that:

... the nature and scope of the financial reporting mechanisms in place to regulate corporate affairs are flawed ... In particular we submit that the regulation in respect to financial information regarding the wealth and progress of public companies is defective in design, inept in implementation, and the source of inherently misleading data.[1]

One reason why some accounting standards lack clarity is because the current consultative process of standard setting may involve compromise and inconsistency. Another reason might be the origins of the standards, which started out as guidelines rather than delegated legislation. In my view, poorly-worded standards that are subject to wide or inconsistent interpretation are incompatible with a system that gives them the force of law as the present standards have under the Corporations Act.

As such, I consider that the accounting standard setters, the AASB and the International Accounting Standards Board, need to pay close attention to clarity and ease of interpretation of standards as they are developed. I understand, for example, that when drafting new standards, the AASB is now looking to draw on legal drafting experience. This should be encouraged. Indeed, given that accounting standards are in effect delegated legislation and are of critical importance the utilisation of specialist legal assistance is imperative.

I also consider that wider participation in the standard-setting process would be beneficial. At present the AASB is largely made up of accounting professionals. Inclusion of people with other business or professional backgrounds would bring a broader perspective to bear on the principles and issues at stake. As noted above, the FRC has some role in shaping the AASB's agenda. But it has limited if any direct involvement in the actual formulation of standards. Broadening the membership of the AASB could help develop clearer and more robust standards. The preparation of accounting standards is too important to be left solely to accountants, just as the preparation of legislation is too important to be left solely to lawyers.

#### **Recommendation 3**

I recommend that the Commonwealth Government broaden the membership of the Australian Accounting Standards Board to include people with business or professional backgrounds beyond the accounting profession.

### **7.1.1 International accounting standards**

As noted above, the government has stated that Australia will adopt international accounting standards from 1 January 2005 for entities subject to the *Corporations Act 2001*. The decision to adopt international standards will mean that Australia will have less flexibility in developing standards that apply domestically. But it will likely increase comparability of financial reports across countries and may make Australia more attractive to international capital investment.

#### **Recommendation 4**

I recommend that Australia participate fully in the development of international accounting standards and pursue the adoption of high-quality, consistent and readily understood accounting standards.

The full implications of the government's decision to adopt international standards have not yet emerged. Adopting international standards may entail the application of those standards without amendment or addition. Or it may involve adopting the standards with some alteration for Australian conditions. In my view the standards adopted should reflect the full requirements of the international standards but Australia should reserve the right to extend the standards in certain areas (without affecting their application), for example in areas of disclosure.

#### **Recommendation 5**

I recommend that, in adopting international standards, Australia reserve the right to require more stringent standards that are not inconsistent with the relevant international standards. These would generally relate to disclosure requirements.

There may also be instances where the interpretation and application of a standard may require clarification.

Arguably, this should be achieved through changes to the standards themselves. But such changes may take some time to implement. As such, there may be a need for an Australian body to interpret the international standards in particular instances.

### 7.1.2 Interpreting accounting standards

A fundamental issue that arose in this inquiry was the interpretation and application of several Australian accounting standards. The misinterpretation of the standards and of the requirement of the Corporations Law to present financial statements that were 'true and fair' allowed HIH to publish financial statements that did not truly or fairly represent the financial position or performance of the HIH group.

Under s. 297 of the Corporations Act, annual financial statements and notes must give a true and fair view of the financial position and performance of an entity. This section does not affect the obligation imposed under s. 296 whereby a company's financial report must comply with accounting standards. If the financial statements and notes prepared in accordance with accounting standards would not give a true and fair view, additional information must be included in the notes to the financial statements under s. 295(3)(c) of the Act.

There has been some debate about whether the requirement to present a true and fair view should have primacy over the requirement to comply with the standards. The Corporations Act simply requires that both requirements be met. The obligations under the Act were recently summarised in a submission by Mark Leibler to the review of independent auditing by the Joint Committee on Public Accounts and Audit:

Nowhere in the [Corporations] Act is there a suggestion that accounting standards are to be treated as having primacy over 'a true and fair view'. The fact that differences between them are to be reconciled, in the case of 'a true and fair view', by way of a note to the financial statements, does not in any way suggest that 'a true and fair view' is to be treated as being in some way secondary to compliance with accounting standards.

There is no legal basis for the argument that compliance with accounting standards equates to 'a true and fair view'. On the contrary, the statutory framework specifically contemplates that accounting standards may not give 'a true and fair view'. Indeed, in one sense, looking at the financial report as a whole, it seems clear that the Act contemplates a 'true and fair view' override, albeit that the override is by way of a note rather than being included in the body of the accounts.[2]

I take the same view. It may be that because the accounting standards have the force of law those who are responsible for the preparation of accounts have, over time, effectively forgotten about the 'true and fair view' requirement. This may seem strange in view of the fact that both the directors' declaration and the audit opinion contain clear reference to the words. If, as I suspect, preparers of accounts have forgotten the significance of true and fair view, they ought to be reminded.

Following its review, the JCPAA made a recommendation[3] that the Corporations Act be amended by replacing the current footnote to s. 297 requiring that financial statements give a true and fair view with a separate section. In my view, this approach will clarify the effect of the Act and is worthwhile.

As the current requirements of the Corporations Act acknowledge, there will inevitably be circumstances where the correct application of the accounting standards is contentious. Fundamentally the accounting for a transaction should reflect the economic substance of that transaction. This approach is reflected in clause 4.1.8 of AASB 1001 'Accounting policies':

For financial information to satisfy both the relevance and reliability concepts, it is necessary that the substance rather than the form of a transaction or other event be reported where substance and form differ.

Problems concerning the interpretation of accounting standards need to be addressed by both compliance and the standards themselves to reduce the scope for misinterpretation or abuse.

#### ***Compliance with the accounting standards***

The resolution of urgent financial reporting issues is presently the domain of the AASB through the work of the Urgent Issues Group.

The role of the UIG, which is a committee of the AASB, is to provide timely guidance on urgent financial reporting issues. Accounting standard AASB 1001/AAS 6 'Accounting policies' states that accounting policies to be applied to many transactions or other events are specified in accounting standards, other

authoritative pronouncements of the AASB or UIG consensus views.

In my view, the UIG is the appropriate body to resolve important issues regarding the interpretation and application of the accounting standards in particular instances. For example, there were some concerns relating to the correct application of AASB 1023 to particular transactions entered into by HIH. If they had been dealt with by the UIG, a more appropriate application of the standard may have occurred.

Under its current charter, the UIG is arguably not equipped to address financial reporting concerns in a timely and efficient way.

The UIG is comprised of 15 part-time, unpaid members. It meets as required and attendance by all UIG members is expected. The UIG will not reach a view that conflicts with or changes either the accounting standards or statements of accounting concepts or an issue that is currently being addressed by the AASB. In addition, the AASB has the right to veto UIG consensus views. The UIG will also inform the AASB of any emerging issues that indicate inadequacies in the accounting standards or statements of accounting concepts.

To be accepted as a consensus view, at least 11 members of the UIG must vote in favour of and no more than three members vote against the treatment proposed. In addition, except when otherwise determined by the chair, the UIG must reach a consensus view within three meetings or the issue is deleted from the UIG agenda. Such unresolved issues are passed back to the AASB for consideration.

Issues are raised for the UIG's consideration either by UIG members or observers or other persons in writing to the chair of the UIG. All new issues are considered by the UIG agenda committee comprising the UIG chair and two members of the UIG. The agenda committee determines whether an issue should be included on the UIG agenda.

In short, the UIG comprises a relatively large group of people and is structured to consider issues brought before it in a considered and comprehensive fashion.

I consider that matters of the interpretation and application of the accounting standards would be more effectively resolved by a smaller more focused group than the UIG. Perhaps a sub-committee of the larger group can fulfil that role. This smaller group should not be limited to accounting professionals. It should include a larger representation of the users of financial reports (such as analysts and shareholders) and lawyers to provide appropriate legal and other advice.

The UIG's charter should be changed to ensure that where issues of the interpretation of the accounting standards are brought before it, they are resolved in a more timely fashion. In undertaking its function, the UIG should be required, for example, to issue interim but binding statements on the interpretation of accounting standards. Such statements should stand until they are confirmed or overturned by the AASB.

**Recommendation 6**

I recommend that the Australian Accounting Standards Board alter the Urgent Issues Group or create a separate group that is able promptly to issue binding rulings on important and urgent matters concerning the interpretation and application of the accounting standards.

The board should extend the constitution of the Urgent Issues Group or the separate group beyond accounting professionals and include lawyers and users of financial statements.

Obviously the UIG can only resolve questions of the interpretation of the accounting standards where issues are brought before it. At present, disputes between auditors and companies over the correct interpretation and application of accounting standards are usually resolved between the auditors and companies themselves. In the case of HIH, such issues were always 'resolved' by adopting the view of management which, on occasion, promoted an incorrect accounting treatment. This is clearly undesirable. One solution to this problem is to improve the effectiveness of the audit function. This is addressed in Section 7.2.

On occasion however there are genuine disagreements between auditors and the management of a company as to the correct application of an accounting standard. In these instances, auditors should be able to consult professional bodies such as the UIG. Encouraging auditors to take such action is, I believe, a responsibility of the professional accounting bodies and should be achieved through appropriate guidelines.

It is important that recourse to the UIG remains the exception rather than the rule. The UIG should not be seen

as a forum where all disputes between auditors and companies are resolved. The framing of guidelines for auditors should reflect the need to strike an appropriate balance in this area. This might be achieved by encouraging auditors, in the first instance, to consult with another accounting firm to provide advice on a particular matter of interpretation. Where disagreements cannot be resolved in this way, recourse to the UIG might then be pursued.

**Recommendation 7**

I recommend that the professional accounting bodies develop guidelines to encourage their members to consult independent third parties or the Urgent Issues Group when there is disagreement with the management of companies concerning the interpretation or application of accounting standards.

**7.1.3 Improving AASB 1023**

A major issue relating to the regulation of general insurance is the appropriate accounting treatment of insurance transactions. In Australia, the financial reporting of general insurance transactions is regulated by accounting standard AASB 1023 'Financial reporting of general insurance activities'.

Accurate financial information is particularly important in the case of a general insurer because insurance business involves significant uncertainties and risks that often have a major effect on the profitability and solvency of the insurer. Financial information that accurately reflects the position of an insurer is important both for shareholders and creditors, particularly policyholders, given their interest in the continued ability of the insurer to meet all valid claims as they arise.

Accurate financial information is even more important in cases of long-tail insurance where the payment of claims may occur some years after premium income has been received. In the absence of such information it is possible that a general insurer dealing in long-tail classes of business could be technically insolvent (in the sense that its true liabilities exceed its assets) but remain operational for a significant period of time because of the timing of receipts and payments in the business. This occurred in the case of HIH.

In this context it is worthwhile to consider whether the current accounting standard for insurance transactions is appropriate and, if not, what improvements might be made. The current arrangements for accounting standard AASB 1023 are outlined in the Commission's Background Paper No. 12.

In summary, AASB 1023 takes a 'deferral and matching' approach to the reporting of the financial information of general insurance transactions. That is, the recognition of premium revenue is deferred and matched to the recognition of claims liabilities. AASB 1023 also requires that liabilities be estimated based on the present value of the expected future cash flows associated with the claims. This ensures that liabilities are measured on a consistent basis to insurance assets, which are valued at present market prices.

***International approaches***

According to the AASB<sup>[4]</sup>, Australia is only one of three jurisdictions to have an accounting standard relating specifically to the general insurance industry. The United States has Statement 60 'Accounting and reporting by insurance enterprises' and New Zealand has FRS-35 'Financial reporting of general insurance activities', which is based on AASB 1023. The United Kingdom has a statement of recommended practice prepared by the Association of British Insurers which is recognised by the UK's Accounting Standards Board but it does not have the status of a standard.

The approaches taken in both the US standard and the UK statement of recommended practice are similar to that of AASB 1023. There are some differences, however. In both the United States and United Kingdom, discounting is generally not permitted in calculating the present value of expected future cash flows associated with settling claims. This has the effect of building an implicit prudential margin in valuing claims liabilities, especially in cases of long-tail insurance.

Like AASB 1023, the US and UK approaches do not permit the use of an explicit prudential margin, although in the United Kingdom a degree of caution is required to be used in setting provisions to ensure that the cost of highly uncertain events is not understated. The only other major difference is that the US standard requires the recognition of a premium deficiency if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortised acquisition costs and maintenance costs exceeds related unearned premiums.

### ***Weaknesses in AASB 1023***

An important factor contributing to the failure of HIH was inaccurate reporting of financial information, particularly the valuation of outstanding claims provisions. This inaccurate reporting was caused partly by HIH officers and auditors misinterpreting the requirements and application of the existing accounting standards. But it was also caused by deficiencies in those standards. I believe that these deficiencies, which are discussed below, should be addressed by changing the requirements of AASB 1023.

The deficiencies in AASB 1023 are well illustrated by the accounting treatment given to a reinsurance contract entered into by HIH with a reinsurer and booked in the December 1997 accounts. This matter is dealt with in some detail in Section 16.3.5. The evidence led in relation to this contract demonstrated that there were several plausible interpretations of clause 7.1 of AASB 1023.

#### *Valuing insurance liabilities*

The largest liability of a general insurer is its liability for outstanding claims. Clause 5.1 of AASB 1023 requires that the liability for outstanding claims be recognised in respect of both direct business and inwards reinsurance business and be measured as the present value of the expected future payments. Clause 5.2 provides that the expected future payments must include amounts in relation to unpaid reported claims, claims incurred but not reported, adjustments in light of most recently available information for claims development and claims incurred but not enough reported, and costs that the insurer expects to incur in settling these claims. 'Liabilities' are defined in AASB 1023 to mean:

Future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events.

Statement of Accounting Concepts 4 provides (at paragraph 65) that a liability should be recognised in the statement of financial position when and only when:

- it is probable that the future sacrifice of economic benefits will be required
- the amount of the liability can be measured reliably.

The commentary to this statement (at paragraph 67) says that the word 'probable' means that the chance of the future sacrifice of economic benefits being required is more likely rather than less likely.

Apart from what I regard as an almost meaningless comparison which is implied by the expression 'more likely rather than less likely', the application of these principles to the recognition of outstanding claims liabilities of general insurers is fraught with difficulty. How can a general insurer reliably measure the amount of liabilities that it is probable (that is, more likely than not) that it has to policyholders for claims which have been incurred but which have not been reported, and therefore of which it has no knowledge? Is it necessary before any provision is made for such liabilities that in respect of each such claim there is a probability that the insurer will be required to pay the claim and the amount thereof can be reliably measured?

As the Institute of Actuaries observed in its submissions, in the case of insurance most of the events considered, looked at individually, have probabilities of occurring of much less than 50 per cent. If the only claims liabilities recognised by an insurer were for reported claims this would result in massive under-reporting of liabilities for those classes where lengthy reporting delays are common and substantial under-reporting in other classes.<sup>[5]</sup> As those submissions point out, the problem is partially addressed by accounting for liabilities in the aggregate, particularly by portfolio, rather than by requiring that each individual liability be identified and be considered probable.

The Institute submitted that the wording of the 'probable' test in SAC 4 allowed a loophole which should be closed. I agree that the standard should be clarified to ensure that it is not necessary to assess each individual claim liability as being probable and capable of reliable measurement before it can be recognised.

I am concerned in this respect by the language used in Chapter 2 of the International Standards Advisory Council's draft statement of principles (DSOP). It was summarised in the 'Project summary' prepared by the International Accounting Standards Board for its November 2002 meeting as follows:

16. Insurance assets and insurance liabilities are assets and liabilities arising under an insurance contract. An insurer ... would recognise:

...

(b)an insurance liability when, and only when, it has contractual obligations under an insurance contract that result in a liability.

I agree with the general thrust of Chapter 2 of the DSOP which favours an asset and liability measurement approach rather than the approach of deferring and matching costs and revenue. However, neither the current AASB 1023, nor principle 2.2 of the DSOP, give appropriate attention to how the uncertain claims liabilities of general insurers should be recognised and valued. In this context the Institute of Actuaries submits that insurance is stochastic, whereas accounting is deterministic. In other words, to measure a general insurer's claims liabilities is to measure different ranges of uncertainty. The concept of accounting, however, which underlies the SAC 4, and principle 2.2 of the ISAC's DSOP, assumes that liabilities have largely known and fixed values.

Thus, principle 2.2 of the ISAC's DSOP, which is reflected in the paragraph I have quoted, states that an insurer should recognise and measure each of its liabilities to its policyholders individually. It uses the singular: 'an insurance liability'. If this principle were read literally, at least in conjunction with the present SAC 4, it would result in a massive under-reporting of claims liabilities. It would be inconsistent with actuarial practice and the industry's practice as to how claims liabilities are reported. It would make no allowance for unknown claims.

In my view the accounting standards should require an insurer to determine the expected value of its outstanding claims liabilities not by reference to its liabilities to individual policyholders but by each class of business.

At any reporting date the true value of the liability of an insurer for outstanding claims which have been incurred to that date is uncertain. There is a range of possible values. The estimate of the value of an insurer's liabilities that is considered to have a 50 per cent chance of being sufficient is known as the central estimate. It is common industry practice for insurers to add a prudential margin to the central estimate in determining its outstanding claims liabilities. Actuarial Standard PS300 defines a prudential margin as an amount by which the provision set aside in the accounts for outstanding claims liabilities is greater than the actuarial central estimate of the liabilities 'due to the inherent uncertainty in the determination of the actuarial central estimate' [6] The Commission, with the assistance of the Insurance Council of Australia, sought information from a number of Australian general insurers as to the use made by them of prudential margins. Responses were received from seven insurers. All but one claimed to use prudential margins in the provision made for outstanding claims liabilities.

The Prudential Standard GSP210 requires that the valuation of outstanding claims liabilities, for each class of business, must comprise a central estimate at the value of those liabilities and risk margins that relate to the inherent uncertainty of the central estimate value.[7] The risk margin is required to ensure that the outstanding claims liability has a 75 per cent chance of sufficiency. It is to be not less than one half of the coefficient of variation of the insurance distributions.

There is a conflict between industry practice and Prudential Standard GSP210 on the one hand and the requirements of AASB 1023, when read with SAC 4, on the other. (See Chapter 5 for a further discussion of the general principles of provisioning). To the extent that there is a margin over the central estimate, it cannot be said that there is a 'probability' that a future sacrifice of economic benefits will be required to satisfy an existing obligation. There is nothing in AASB 1023 which says that a prudential margin, which works to reduce the uncertainty in the valuation of the OCL, can or should be valued and included as a liability. Yet the inclusion of that margin may profoundly affect the financial position of the insurer. One of the submissions, when referring to a statement made by HIH that its claims reserving process was underpinned by an actuarial review of future long-tail claims liabilities and historical data, said:

It suggests that an 'actuarial review ...' removes the uncertainty in the central estimate of the mean. Even if [this] were true then not including a security margin represents the antithesis of the fundamental statistical principle of insurance. It is well known that if you charge the (true) mean cost, it is statistically certain that you will eventually go bankrupt due to the process variability. But in practice you don't even know the mean cost precisely, so you need to allow for that uncertainty too ... [8] [emphasis in original]

In similar vein, an actuary retained by HIH reported to HIH that:

It is a well established law of insurance that one cannot sustain indefinitely reserving on a 50 per cent

probability basis, unless one has excess capital to burn.

Even if it were possible to derive a central estimate of an insurer's liabilities which had no uncertainty in it, the mean of all the possible values of an insurer's claims liabilities will almost certainly not represent the true amount which the insurer will have to pay to settle its existing liabilities. Capital in excess of the provision for outstanding claims (if the latter is assessed as a central estimate) is, on that account, excess capital which as a matter of prudence (or prudential regulation) an insurer should keep to ensure it can meet claims. Capital in excess of the central estimate will almost certainly be required from time to time to meet the existing claims.

#### *Fair value measurement*

International Accounting Standards define fair value as 'the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arms length transaction'. In paragraph 3.4 of the DSOP the fair value of a liability was described 'as the amount that the enterprise would have to pay a third party at the balance sheet date to take over the liability.' The IASC proposed that while IAS 39 is still in place insurance liabilities and insurance assets should be measured at 'entity-specific value, being the present value of the costs that the insurer will incur in settling the liability with policy holders in accordance with its contractual terms over the life of the liability'. The IASC further proposed that if a successor standard to IAS 39 introduced fair value measurement for the substantial majority of financial assets and liabilities, the IASB should consider introducing fair value measurement for all insurance liabilities and insurance assets.

The definition of 'fair value' in the international accounting standards is adopted in AASB 1033 for the valuing of assets and liabilities comprised in financial instruments, subject to those values being determined by an actual or hypothetical market. There seems to me to be a regrettable confusion about what the definition means. To repeat, paragraph 3.4 of the ISAC's DSOP says:

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arms length transaction. In particular, the fair value of a liability is the amount that the enterprise would have to pay a third party at the balance sheet date to take over the liability.

The second sentence is not a particular of the first.

What a liability can be settled for depends upon what the obligee would agree to accept in discharge of the obligation. What a person will pay to have their liabilities taken over will depend on what payment a third party will require to indemnify the obligor against its liability. Except with the authority of statute, an obligor cannot transfer a liability without the consent of the obligee.

It seems to me that it is this confusion about what the 'fair value' of the liability means which explains the debate as to whether the obligor's (that is, the insurer's) own credit standing would affect the fair value of its liabilities.

The Insurance Contracts (Phase II)—Project Summary observed in paragraph 19 that:

The DSOP describes entity-specific value as the value of an asset or liabilities to the enterprise that holds it. As in various IASC standards, fair value is 'the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arms-length transaction'. Entity-specific value differs from fair value in the following respects:

...

- (c) the entity-specific value of an insurance liability would not reflect the insurer's own credit standing. The Joint Working Group on Financial Instruments proposed in December 2000 that the fair value of financial liabilities would reflect the credit risk in the liability. Although this seems to be a logical extension of fair value, the former IASC Steering Committee had concerns about the practical implications of this approach and most commentators on the 1999 Insurance Issues Paper were strongly opposed to this idea.

The notion that the credit standing of an insurer should affect the value of its liabilities is a logical extension of the notion of fair value only if that is the amount for which the insurer's liabilities could be settled, rather than taken over.

There is and can be no market for the *settlement* of liabilities of an insurer. Necessarily, the only participants in the settlement of liabilities could be the insurer and its policyholders or their assignees.

The idea that a true and fair view of the value of HIH's liabilities to its policyholders could be obtained by asking what knowledgeable and willing parties (that is HIH and its policyholders) would pay to settle those liabilities is to my mind bizarre. If the policyholders would rationally accept \$0.20 in the dollar because HIH is insolvent, does that mean that HIH should report its liabilities as being a fifth of what they actually are? The proposition has only to be stated to be rejected.

As set out below, I also have no confidence in the notion that the fair value of liabilities can be based upon what, in an hypothetical market, someone will pay to 'take over those liabilities.'

But before considering that question, I should emphasise my disquiet that what appear to be contradictory notions of the 'fair value' of a liability (that is both the settlement value and what someone would pay to 'take them over') should be set out in the same definition as if they meant the same thing.

In my opinion, liabilities should not be valued according to the definition of 'fair value' contained in the various IAS standards and in AASB 1033 as 'the amount for which a liability could be settled between knowledgeable and willing parties in an arms' length transaction'.

In the rest of this chapter, I treat the concept of 'fair value' of liabilities as referring to what knowledgeable and willing parties would pay and require for a third party to 'take over' those liabilities. As I have said, this is apparently how the concept was understood by the IASC in its DSOP.

In a policy paper published in March 2001 entitled 'Prudential Supervision of General Insurance' APRA commented that it remained of the view that in the absence of clear accounting standards on 'fair value', a mandated risk margin was necessary to ensure sufficient objective, reliable and consistent valuation of insurance liabilities. It characterised the 75th percentile as an arbitrary proxy for 'fair value' and said that in APRA's view its simplicity more than off set any potential drawback from its general application. APRA went on to say that:

Once the accounting standards are updated to produce a more meaningful and rigorous means of establishing the fair value of a portfolio with insurance liabilities, APRA will look to incorporate these within its Prudential Standards.

The reason why the prudential margin might be seen as a 'proxy' for a 'fair value' measurement of liabilities appears to be that if a third party were to take over an insurer's claims liabilities, it would exact as part of its price both a profit margin and an amount to protect itself against any underestimate of the liabilities. That may be true. However, it is not necessary, and may not be desirable, to postulate a hypothetical 'transfer' of liabilities to a third party to justify providing for the cost of uncertainty.

An objection to valuing liabilities at a so-called market value is that there is no market for the transfer of liabilities. In the absence of statutory authority, it is not possible for an insurer to transfer the liabilities it has to its policyholders without their consent. Although it is theoretically possible to obtain a complete indemnity in respect of an insurer's claims liabilities, and in that sense for a third party to 'take over' liabilities, there is no developed market for the buying of such indemnities. Whilst accounting for assets according to their market values provides a logical reference point for valuing those assets, as the market represents how the company could realise its assets for cash, the same is not true of valuing liabilities. Thus a 'fair value' approach to the valuing of claims liabilities would require the construction of models and the making of assumptions which would build in the insurer's (or its adviser's) own expectations and assumptions.

It is also a matter of concern that there is little focus in the debate on the 'fair value' measurement of liabilities upon the potential for an insurer to manipulate its outstanding claims provision if the insurer were allowed or required to postulate what a hypothetical party might pay to take over its liabilities. Unless appropriate safeguards are incorporated into the standard, a general insurer may value its claims liabilities by reference to what a hypothetical third party would pay to 'take them over' and make provision for an amount which was less than its central estimate, and therefore less than what it estimated it would have to pay to settle its claims. That could be so for a number of reasons.

For example, the insurer might customarily not insist on strict compliance by its insureds with conditions precedent to the making of a claim, or might adopt a more lenient approach to the assessment and payment of claims than the hypothetical third party. The insurer may be under constraints, to which the hypothetical third party would not be subject, such as to preserve its reputation and market share or as a result of political or media pressure on the insurer. One could also postulate a hypothetical third party who would use cheaper and

more efficient processes for handling and settling claims than those available to the insurer. Management who believed that the actuary's central estimate was too conservative might postulate that the hypothetical third party would also take that view.

These possibilities are not fanciful. One aspect of the claims liabilities for which an insurer must provide is its future indirect claims settlement costs. From 1998 HIH required its actuary to prepare the valuation of liabilities using an allowance across the board of 2 per cent for future claims handling costs. This was a lower percentage than the actuary had previously adopted. HIH did not seek to justify that lower percentage by an analysis of its actual claims handling expenses. Instead it obtained a quote from a third party as to what that party would charge HIH to handle the settlement of HIH's claims liabilities, although it was never intended that the claims handling function would be transferred to that party. This approach would seem to accord with a 'fair value' measurement of this part of the claims liabilities, by referring to a hypothetical and willing acquirer. The third party's quote was affected by a number of matters, including savings which would be available to it from the centralisation of the claims handling but which did not reflect how HIH itself had in the past handled, or proposed to handle, its claims. There was evidence before the Commission that this approach resulted in a substantial underprovision for claims liabilities. There would also be scope for a third party, knowing that it would not in fact be taking over an insurer's liabilities, to under-quote the price it would demand to do so.

I therefore see no theoretical or practical advantage in the 'fair valuation' (meaning a value based on an hypothetical third party transaction) of an insurer's liabilities.

#### *Risk margins*

The IASC recommended that the value of insurance liabilities (and assets), whether determined as the 'entity-specific value' or the 'fair value', should always reflect risk and uncertainty (Principle 5.1). This is correct in principle but is not presently allowed for under AASB 1023. The IASC recommended that both diversifiable and undiversifiable risk should be reflected in the value of the liabilities (Principle 5.4). This was qualified by describing the classification of different risks as comprising:

- model risk (the risk that the insurer has chosen an incorrect model of future cash flows)
- parameter risk (the risk of error in the application of information about an underlying probability distribution)
- process risk (the risk of unavoidable random statistical fluctuations that will occur even if the model chosen is totally accurate and the estimate of the parameters of the distribution under the model is correct).

In paragraph 5.10 the IASC said that to avoid undue subjectivity it was appropriate to exclude adjustments for model risk and parameter risk unless there is persuasive evidence that enables an insurer to quantify them by reference to observable market data. The IASC concluded that, so far as possible, estimates of liabilities should use observable market data to reflect the market's risk preferences using a consistent methodology over time. The data it proposed included prices for financial instruments with similar risk characteristics (to the liabilities being valued), current market insurance premiums, current market reinsurance premiums, and recent market prices for portfolio transfers. The IASC went on to say that 'in many cases' such data may need adjustment if it reflects transactions or instruments that differ in some, possibly material, respects from the insurance liability being measured. The IASC proposed that the reflection of overall risk preferences 'in the market' should be adopted because this creates comparability between different enterprises. It reports information using a reasonably common benchmark based on the degree of risk aversion present in the market as a whole (paragraph 5.24).

The IASC acknowledged that inferences about the market's risk preferences will inevitably be subjective. That must be true and it compromises the attempt to avoid subjectivity by recourse to so-called market data. One might ask how a value would be placed upon the uncertainty of the estimate of HIH's liability portfolio. According to the DSOP, the data from which the market's risk preferences may be inferred could include:

- prices for financial instruments with similar risk characteristics—although it is hard to bring to mind a financial instrument with risk characteristics similar to the liability portfolio
- current market insurance premiums—but insurance premiums price the perceived risks assumed under the policies in question. They do not contain a separate allowance for the uncertainty in the estimate of

## liability

- current market reinsurance premiums—the premium charged by reinsurers to provide unlimited excess-of-loss cover above the insurer's (reinsured's) central estimate would provide good evidence of the value (or cost) of the uncertainty of the central estimate. However, at least in Australia, there is no observable 'market data' of the premiums which would be charged. The evidence before the Commission suggests, as would naturally be expected, that reinsurers offering such reinsurance make their own analysis of the portfolio in pricing the risk of the claims liabilities exceeding the insurer's central estimate before settling on an appropriate premium for a limited amount of cover. It is not obvious how that process can yield a 'market' reinsurance premium for unlimited cover over a central estimate of a portfolio which has not been reviewed by a reinsurer. It is highly unlikely that any reinsurer would offer unlimited stop loss cover. It would also be necessary to take into account the creditworthiness of the reinsurer in being satisfied as to a quoted premium. Moreover, there would be a substantial risk that the true premium could be disguised, particularly if it were not proposed that unlimited stop-loss cover on the portfolio in fact be taken
- recent market prices for portfolio transfers—this assumes that there is such a market. It assumes that the market is for comparable portfolios. It assumes it would be possible to identify how much of a price charged by a third party to acquire a comparable loss portfolio was attributable to the uncertainty of the estimate of its liabilities. None of those assumptions can be made in Australia. The IASC's proposals to be useful would require the existence of a market of a depth and transparency that does not exist in Australia.

The IASC noted what was then APRA's proposal of a 75 per cent confidence level for general insurers. The DSOP said that it did not propose such a benchmark as it would be arbitrary. In one sense it is true that the 75 per cent confidence level is arbitrary. But it does have the merit of providing consistency and comparability to the extent insurers provide adequate data and the actuaries use consistent methodologies appropriate to the portfolio being valued.

Accordingly the position seems to be:

- uncertainty of the central estimate has a cost
- an appropriate allowance for uncertainty (risk margin) is required not only to impose implicit solvency or capital adequacy reserves, but to fairly reflect the cost to the insurer of the uncertainty in the amount of its claims liabilities
- such an allowance cannot presently be obtained from observable market data
- valuing liabilities by reference to an hypothetical transaction with a third party is unlikely to yield a more accurate provision for the insurer's actual liabilities
- any allowance for uncertainty, if it is to be applied consistently, must therefore be arbitrary. But if no allowance is made the insurer's accounts will not truly and fairly reflect its financial position
- there is general support for aligning AASB 1023 with the prudential standards
- the basis for the estimate of liabilities can and should be explained by a note to the accounts.

These considerations suggest that AASB 1023 should be amended to require the provision for outstanding claims to be made in accordance with the prudential standards (specifically GPS 210 'Liability valuation for general insurers'), with a note explaining that the provision is an estimate which is considered to have at least a 75 per cent chance of being sufficient, and if any higher prudential margin is used, explaining it.

In coming to this conclusion, I recognise that this approach may be seen as inconsistent with the view that in the absence of an appropriate fair value approach, estimating the insurance liabilities of an entity at a 75 per cent level of sufficiency is unlikely to represent a 'true and fair' representation of the financial position of that entity. For example, in its submission, the AALC concludes that:

The most appropriate margin for risk and uncertainty to be included in the outstanding claims and premium liabilities should be set on a market based model. The 75 per cent probability of sufficiency required by GPS 210 is restrictive and may not reflect a reasonable market based value allowance for

the risk characteristics of a particular insurer.<sup>[9]</sup>

Some may further argue that in being unable adequately to calculate an appropriate fair value of the risk and uncertainty associated with insurance liabilities, a central estimate of the present value of the expected future cash flows required to settle claims should be used instead. This view would have it that any margin for risk and uncertainty over and above the central estimate should be treated as capital rather than a liability.

In forming my view as to the appropriate approach to take in the valuation of insurance liabilities I have been cognisant of this view. For the reasons outlined above, however, I consider that valuing insurance liabilities on a central estimate would not truly and fairly represent the financial position of a general insurer. Some value must be made for risk and uncertainty and, in the absence of an adequate fair value approach to such valuations, I am of the view that including a pre-determined margin to represent the value of risk and uncertainty in the accounting standards is the best compromise. Given the desirability of maintaining consistency between the accounting and prudential standards, I believe that the margin adopted by APRA is the most appropriate for this purpose.

#### *Recognition of revenue and liabilities*

As noted above, AASB 1023 requires insurers to recognise premium revenue (and reinsurance expenses) in accordance with the pattern of insurance risk under relevant contracts. While the standard does provide guidance as to the interpretation of the statement 'in accordance with the pattern of the incidence of risk', it nevertheless allows entities to manipulate the timing of the recognition of premiums. If an entity considered that an insurance (or reinsurance) policy permitted it to recognise all premiums (or reinsurance recoveries) yet delay the recognition of liabilities (or reinsurance premium expenses) then this could result in the recognition of profit being brought forward artificially in the early period of such a contract.

It should be noted that while such an approach is arguably not consistent with the intent of AASB 1023, the approach of the prudential standards in requiring the immediate recognition of premium revenue and liabilities would disallow this treatment entirely.

In this regard, APRA argued in its submission that:

The prospective accounting approach that the concept of premium liabilities requires has another important benefit—it prevents some of the accounting practices that the Royal Commission has uncovered that allowed financial reinsurance to be used to distort reported profitability. By bringing to account in the current period all future obligations and expected claims under a policy (be it direct insurance or reinsurance), an insurer will no longer be permitted to recognise up-front benefits while at the same time deferring future costs. (Indeed, it could be argued that this should not have been permitted under existing accounting standards, but the new accounting framework should remove any discretion that is currently available).<sup>[10]</sup>

It is correct to say that the evidence before the Commission disclosed some undesirable accounting treatments having the effect mentioned in the APRA submission. The accounting standards should not sanction treatment of that nature.

#### *Definition of insurance*

As part of its project to develop an international accounting standard for general insurance activities, the IASB's Insurance Contracts Advisory Committee has suggested that a definition of an insurance contract be included in the proposed international standard for the financial reporting of general insurance activities. The definition of an insurance contract proposed by the IASB's Insurance Steering Committee is:

A contract under which one party (the insurer) accepts an insurance risk by agreeing with another party (the policyholder) to make payment if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.<sup>[11]</sup>

Similarly, I consider that inserting an appropriate definition into AASB 1023 is desirable. It would provide guidance on the appropriate classification of insurance contracts and financing transactions for accounting purposes. Financing transactions, which may include the various forms of financial and finite reinsurance transactions that were used by HHH, should be reported under AASB 1033 'Presentation and disclosure of financial instruments'.

A key difference between insurance and a financing transaction is the issue of risk transfer. In my view, an appropriate definition of insurance should recognise that in order for a transaction to be defined as an

insurance transaction it must involve a *material* transfer of insurance risk.

#### *Discounting*

AASB 1023 presently requires that insurance liabilities be measured as the *present value* of expected future costs related to those liabilities. This requires that expected future payments be discounted. As noted in clause 5.1.1 of AASB 1023, the rationale for this requirement is that ‘the liability for outstanding claims ought to reflect the amount which, if set aside as at the reporting date, would accumulate so as to enable the insurer to pay the amounts of claims as they fall due’.

Most foreign jurisdictions do not allow the discounting of expected future costs related to claims liabilities for general insurers, although the requirement to discount future cash flows is being introduced in some jurisdictions, such as Canada. The approach taken by the International Accounting Standards Board appears to be heading in the direction of requiring such cash flows be discounted. The appropriate discounting of cash flows associated with insurance liabilities is consistent with an approach that values assets at market values. For these reasons, it is appropriate that AASB 1023 continues to require that expected future cash flows related to insurance liabilities be discounted.

Clause 5.3 of AASB 1023 states that ‘the discount rate or rates must be determined by reference to market-determined risk-adjusted rates of return appropriate to the insurer’. Clause 5.4 of AASB 1023 elaborates by noting that ‘the rates earned on existing assets may be indicative of market-determined risk-adjusted rates of return appropriate to the insurer’. The standard does not explain what is meant by the expression ‘market-determined risk-adjusted rates of return appropriate to the insurer’.

In its submission the AASB stated that:

The notion underlying the market-determined risk-adjusted discount rate is that the liability for outstanding claims should be the amount an insurer would need to have today to meet existing claims and related costs. Since many of these costs need not be met until some time hence, discounting by an amount that is expected to be earned in the meantime can be considered appropriate.[12]

One consequence of this approach is that insurers that invest in high-risk/high-return classes of assets are able to discount their insurance liabilities at a higher rate than a more conservative insurer. This is a perverse outcome. The insurer who invests in higher risk assets with higher returns is allowed to adopt a lower provision for claims than a more conservative insurer would make for the same claims. AASB 1023 may therefore provide an inappropriate incentive for insurers to invest in higher risk assets than may be otherwise justified.

Higher risk investments are associated with higher returns primarily because they are associated with a higher risk of loss. The expected rate of return from such asset classes is on average therefore likely to be closer to a risk-free rate over the longer-term once these risks are taken into account, but no guidance is given as to what the expression means and how discount rates should be adjusted for risk. Present rates of return on existing assets are therefore unlikely to be an accurate proxy for long-term market-determined risk-adjusted rates of return.

It should be noted that the prudential standards require that insurers discount the expected future payments related to their insurance liabilities using a risk-free rate of an instrument (for example, a Commonwealth bond) of equivalent duration to the liability.

AASB 1023 could therefore be modified to require that insurance liabilities are discounted in a similar manner to that required by the prudential standards—that is, by using a risk-free (Commonwealth) bond rate of similar duration to the timing of the insurance liability being discounted.

In this regard, APRA in its submission argued that:

GPS 210 also seeks to reduce the flexibility in valuation techniques by mandating that the discounting of future liabilities is to occur at the *risk-free rate* (ie the government bond rate). While there are conceptual arguments why other discount rates might be superior (eg the rate of return on the insurer’s investment portfolio), we believe that, as a practical matter, the value of an insurer’s liabilities is typically independent of the value of the underlying assets. For this reason, a discount rate that is observable, market-based and objective is most appropriate. The choice of the Government bond rate provides a degree of transparency and consistency that outweighs the benefits of other options.[13]

The AALC, however, took the view that the accounting standard should not be prescriptive in terms of

discount rates:

The accounting standard should not be overly prescriptive in terms of specific discount rates, but specify that a fair value discount rate should be adopted.

The most appropriate ... discount rates ... should be set by reference to professional guidance external to the formal accounting standard.[14]

Nevertheless, the AALC also argued that:

... the discount rate adopted for the vast majority of Australian general insurance liabilities underwritten by solvent and licensed Australian insurers, should fall within the relative narrow range of:

‘Risk free’ market discount rates on equivalent sovereign securities (i.e. Government bond rates); to

Market discount rates on high grade equivalent duration corporate debt securities (i.e. S&P (or similar) rating of A or higher) net of the market price of default risk.[15]

IAAust argued for the requirement of a risk-free rate to be used for discounting under AASB 1023:

The principle changes ... which are needed to bring AASB 1023 into line with APRA Prudential Standards are ... substitution of the ‘risk-free rate’, as defined by APRA, for the less well defined ‘market determined risk adjusted rates of return appropriate to the insurer.’[16]

The ICA also supports the use of a risk-free rate in AASB 1023:

ICA considers that risk free rates should be used as the basis for discounting insurance liabilities.[17]

#### *The effect of underpricing*

As described above, AASB 1023 takes a ‘deferral and matching’ approach to the recognition and measurement of premium revenue and claims liabilities. This approach requires insurers to raise an unearned premium provision as a liability for the amount of premium they have received but not yet earned at the reporting date.

One consequence of this approach is that if an insurer prices its policies below cost, the unearned premium provision, by definition, will underestimate the claims liabilities arising from events that occur after the reporting date under existing policies. AASB 1023 requires that where this occurs, an insurer must write-down its deferred acquisition costs. But this may be inadequate to address the shortfall in liabilities, particularly in light of the commentary to clause 10.5 of AASB 1023. The commentary states that ‘the carrying amount of deferred acquisition costs will need to be written down to recoverable amount where this is less than the deferred costs, based on an assessment of the *aggregate* portfolio of insurance business written’, not where that is so for a particular class or classes of business. This means that if an insurer underprices its products by an amount of more than its deferred acquisitions costs, the financial statements will provide an overly optimistic picture of its financial position. Writing down deferred acquisition costs where an insurer underprices its products is also not a conceptually satisfactory approach. It would be preferable either to recognise a separate shortfall in the unearned premium provision *or* value liabilities separately from premiums altogether.

This problem does not arise under the prudential standards because the standards require that all insurance liabilities, including those relating to events that are expected to occur after the reporting date under existing policies (or premium liabilities) be estimated. AASB 1023 may therefore provide an incentive for insurers to underprice their products, at least from the perspective of the financial reports.

As argued by APRA:

In a market where significant under-pricing can often occur as insurers seek to maintain or build market share, we believe [the approach taken by AASB 1023] can significantly understate the potential liabilities of the insurer. GPS 210, by requiring an actuarial assessment of future potential claims, avoids this problem by immediately bringing to account any apparent under-pricing, ie an insurer that under-prices will need to bring to account the income, and the up-front recognition of future claims, in the current accounting period (rather than allowing the loss to be deferred into future periods when the actual claims emerge).[18]

#### *Inconsistencies between AASB 1023 and APRA’s prudential standards*

As noted above there are many differences between the prudential standards and AASB 1023. While the standards are obviously designed to address different objectives, inconsistencies between in the standards are likely to add to costs and confusion amongst insurance companies and the users of their financial reports.

Several organisations argued in submissions that the approach taken in the prudential standards is superior to that of the accounting standards, at least from a prudential perspective.

According to APRA, for example:

... the new Prudential Standard—GPS 210 ‘Liability valuation for general insurers’—seeks to deal with many of the weaknesses that we perceive, from a prudential perspective, in AASB 1023.[19]

APRA also argued that:

... notwithstanding the need to continue to work to improve the ability of actuaries to perform their important duties, we believe the GPS 210 is a significant improvement on the requirements of AASB 1023, and should materially strengthen the consistency, reliability and transparency of insurance liability valuation from a prudential perspective.[20]

The Australian Accountants and Actuaries Liaison Committee argued that:

... in general terms, AALC considers that the financial statements under AASB 1023 and GPS 210 should be prepared on a consistent basis with GPS 210 to minimise differences in financial reporting frameworks. However, we consider that the liabilities should be determined on a ‘fair value’ or other market based model.[21]

The Australian Accounting Standards Board argued that:

... it is desirable that the AASB and APRA reporting requirements be harmonised to the extent feasible to help minimise costs of reporting by the industry. However, the AASB sets accounting standards for general purpose financial reporting and its role is not to automatically change in response to changes in regulatory reporting by APRA.[22]

The Australian Institute of Actuaries argued that:

The IAAust believes that a net present value approach should be imported into the Australian general insurance accounting standard, AASB 1023 and into general insurance taxation law.[23]

Finally, the Insurance Council of Australia argued that:

AASB, in conjunction with APRA and ASIC, should revise AASB 1023 to ensure consistency of methodology with the new prudential standards for general insurance. This will reduce reporting costs and confusion and improve the transparency of insurance reports.[24]

The ICA has also argued that:

ICA considers that GPS 210 is adequate for the purposes of prescribing the basis of insurance (premium and claims) liability valuations for regulatory purposes.[25]

In summary, there appears to be strong support amongst the insurance industry and relevant accounting bodies to align AASB 1023 as far as possible with APRA’s prudential standards. There also appears to be a view that the prudential standards offer a superior measurement basis to that of AASB 1023 and should therefore be the preferred basis of measurement.

### *Disclosure*

One of the most important factors in assessing the overall solvency of a general insurer is the accuracy of the estimate of its outstanding claims provisions. One way of achieving this outcome is significantly to increase the amount of disclosure relating to provisioning practices of the insurer. In this regard, I make a number of recommendations for the greater disclosure of financial and other information by general insurers. It is also worth considering, however, whether specific requirements related to the disclosure of claims provisions should be included in the annual financial report.

When AASB 1023 was introduced in 1990 it required insurers to disclose details on the accuracy of previous estimates of claims through the publication of a ten-year net claims development table. This requirement was removed from the standard in 1996 because ‘some general insurers and users of their financial reports considered [it] too complex and not particularly useful for analysing the financial position and performance of

general insurers'.<sup>[26]</sup>

At least part of the reason that the tables were considered to be too complex was because they presented information on a discounted basis and so changes in an insurer's estimates of its outstanding claims liabilities resulted from changes in discount rates as well as changes in the underlying expected cost of claims.

The aim of releasing information included in a claims development table is to enable users of a financial report to assess the accuracy of past claims estimates. In particular, such tables should shed light on whether a company's past estimates of the cost of future claims liabilities contained a systematic bias underestimating the cost of claims. Such a past bias may indicate that the company's estimate of its future claims liabilities may also be subject to bias.

I consider that the AASB should reintroduce a requirement to disclose details of a ten-year development table in AASB 1023. To address some of the complexities of the previous arrangements that led to the removal of this requirement from AASB 1023 in 1996, the information in the claims development table should be provided on an undiscounted rather than discounted basis. In addition, insurers should be required to present claims development information both net and gross of expected reinsurance recoveries.

### ***The direction of the international accounting standards***

As noted above, the Australian government and the Financial Reporting Council have announced that Australia will adopt International Accounting Standards from 1 January 2005.

There is presently no agreed international accounting standard for insurance transactions, although an early (incomplete) standard is expected to be promulgated in 2004 with a complete standard following some time later, possibly by 2007. While an international accounting standard has not yet been set, the international standards settings bodies have had a project under way since 1997 and it is well developed.

The work of international standard setting bodies thus far indicates that the standard eventually adopted by the IASB will differ from AASB 1023. Indeed, in many respects it will match the model proposed under APRA's prudential standards. The main areas of difference between the current direction of the international standard (as embodied in the IASC 1999 DSOP) and AASB 1023 are:

- the DSOP would require the immediate recognition of premium revenue and claims liabilities on the commencement of a contract of insurance, whereas AASB 1023 requires that premium revenue and liabilities be recognised in accordance with the pattern of insurance risk under the contract
- the DSOP would require future cash flows to be discounted using a risk-free discount rate rather than the risk-adjusted market rate required by AASB 1023
- the DSOP would not permit overstatement of insurance liabilities to impose implicit solvency or capital adequacy requirements, but it would require an adjustment for risk and uncertainty. AASB 1023 is generally interpreted to allow neither a margin for prudence nor one for risk and uncertainty. APRA's prudential standards require an in-built prudential margin based on insurance liabilities being valued at a 75 per cent level of sufficiency.

No submissions speculated on the direction of the international accounting standards, although the AASB argued that:

... it would be inappropriate to fundamentally change the requirements of AASB 1023 in the short run only to possibly change them fundamentally once again in harmonising with the IASB. It was considered that this would be likely to create confusion among users and preparers of financial reports.  
<sup>[27]</sup>

This argument, while valid, depends on the implementation date of the international accounting standard for insurance transactions. In this regard, it is noteworthy that the introduction of accounting standards has generally lagged proposed timetables. Even if the IASB meets its proposed timetable, it is likely that a complete international accounting standard for insurance transactions will not be in place until 2007. This means that Australia may have to depend on AASB 1023 for at least another four years, although changes will presumably be made by Phase I of the international accounting standards project on insurance accounting.

The current direction of the international accounting standards for insurance transactions appears to suggest that AASB 1023 will eventually face substantial changes. Early adoption of likely approaches taken in the

proposed international standard may aid insurers in complying with the international standards when they are eventually adopted.

#### **Recommendation 8**

I recommend that the Australian Accounting Standards Board amend accounting standard AASB 1023 to include the following:

- a definition of insurance that includes the requirement for a material transfer of insurance risk
- a requirement that insurance liabilities be valued at a level of sufficiency of at least 75 per cent, as required by APRA's prudential standards. Companies should be explicitly permitted to set prudential margins in excess of 75 per cent if the company's board considers that appropriately reflects a true and fair view of the financial position of the insurer
- a requirement that entities disclose in their financial statements
  - the valuation of their insurance liabilities at a central estimate
  - a 75 per cent level of sufficiency
  - the margin ultimately adopted by the entity
- a requirement that premium revenue and insurance liabilities be recognised on the commencement of a contract of insurance. This will require the recognition of premium liabilities
- a requirement that, in estimating the present value of liabilities, future cash flows be discounted using a risk-free rate similar to that required by the prudential standards
- a requirement that companies subject to the standard disclose a 10-year claims-development table that includes past estimates of claims on an undiscounted basis as well as the actual costs of settling claims. This information should be provided both net and gross of reinsurance.

These changes should be adopted as soon as is practical and in advance of the adoption of an international accounting standard for insurance. While the eventual adoption of an international standard may override AASB 1023, Australian authorities should actively encourage the IASB to adopt the approach to accounting for general insurance activities that I have recommended.

The changes that I have recommended will also require some consequential changes to the income taxation treatment of general insurance transactions. This issue is discussed in Chapter 10.

#### **7.1.4 Other accounting standards**

In the case of HIH there were several other accounting standards that, in my view, were misinterpreted or misapplied. These related to the treatment of reinsurance contracts (specifically the Swiss Re and Hannover contracts), the treatment of certain reinsurance contracts entered into after the end of a reporting period and the treatment of the issue of preference shares in FAI. Details on these transactions are provided in Sections 16.2, 16.3 and 23.9.

Of these examples, the accounting for the issue of preference shares in FAI and the treatment of events that occurred after the end of the reporting period, occurred because of a misapplication of accounting standard AASB 1002 'Events occurring after reporting date'. I consider that this standard is clear and does not require amendment. This issue is discussed further in Section 23.9.

While I consider that the accounting treatment of the Swiss Re and Hannover contracts also represented a misinterpretation of AASB 1023, the changes I have recommended to AASB 1023 in Section 7.1 above should reduce the chance of similar abuse in future.

I also consider that AASB 1013 'Accounting for goodwill' contains ambiguity and may lead to an incorrect treatment of goodwill in the financial statements of relevant entities.

The amount of goodwill recognised by HIH as an asset in respect of the FAI acquisition was \$275 million as at 30 June 1999. Whilst goodwill is defined in AASB 1013 in rather conceptual terms as future benefits from unidentifiable assets<sup>[28]</sup>, in practice goodwill is customarily measured simply as a residual figure, calculated as the excess of the cost of acquisition (\$300 million) over FAI's net assets at acquisition (\$25 million).<sup>[29]</sup> By 30 June 2000, the amount of goodwill had increased to \$438 million in consequence of a series of further adjustments which reduced FAI's net assets at acquisition.

Clause 5.8 of AASB 1013 stated as follows:

To the extent that the cost of acquisition incurred by the entity exceeds the fair value of the identifiable net assets acquired but the difference does not constitute goodwill, such difference must be recognised immediately as an expense in the profit and loss account.

In my opinion, the provisions of AASB 1013 discussed above gave rise to the following difficulties in its application:

- There was no specific guidance as to how an assessment may be undertaken to establish that the amount of excess of the cost of acquisition over net assets at the date of acquisition represented future benefits from unidentifiable assets.
- There tended to be an increased emphasis upon the measurement of the residual amount said to represent goodwill and a decreased emphasis upon a consideration of the manner in which the future benefits from unidentifiable assets may be realised.

Further, with respect to AASB 1013, in Section 21.5.7 below I have discussed the differing interpretations with respect to clause 7.1 of that standard.

I am not proposing any changes to AASB 1013 however because the AASB has recently released an exposure draft of proposed amendments to IAS 38 *Intangible Assets* which is likely to lead to significant changes in the treatment of goodwill.

## **7.2 The audit function**

It is the responsibility of the directors of a company to produce accounts that are in accordance with the requirements of the *Corporations Act 2001*. The financial reports prepared by the directors must be in accordance with accounting standards (s. 296) and must present a true and fair view of the financial position and performance of the company (s. 297).

The financial reporting system is underpinned in the case of public and large private companies by a requirement that their accounts be audited by a registered auditor. A company has to obtain from its auditor a report to shareholders on whether its financial report is in accordance with those requirements of the *Corporations Act*.

While the auditor's services are normally procured by a company's board or management, the appointment of the auditor is a matter for the annual general meeting.<sup>[30]</sup> Once appointed the auditor holds office until death, removal or resignation from office.<sup>[31]</sup> An auditor can be removed by resolution of the company in general meeting<sup>[32]</sup> or can resign as auditor of the company with the consent of ASIC.<sup>[33]</sup>

As a practical matter great store is placed by directors, as well as by shareholders, creditors and others with an interest in the financial position of a company, in the fact that its accounts have been audited. The fact remains however that a company's financial report is the responsibility of the directors by whom it is signed and presented.

The point of an audit is to provide independent assurance of the integrity of the way in which the company has reported. It follows that shareholders in particular have an interest in the proper functioning of the audit process as it provides them with comfort in making investment decisions. This element of assurance is of course also relevant to the directors themselves, so far as they rely on management in the preparation of the accounts as well as to others with an interest.

Recent high-profile corporate collapses, including that of HIH, have given rise to public concerns about the efficacy of the audit function, as well as about other aspects of the financial reporting system. These concerns in turn have led to a series of reports and proposals for changes in this area.

In September 2002 the Commonwealth Government issued a chapter of its Corporate Law Economic Reform Program entitled 'Corporate disclosure— Strengthening the Financial Reporting Framework'. CLERP 9, as it is known, set out a series of reform proposals with a view to achieving further improvement in audit regulation and the wider corporate disclosure framework. An earlier report to the Minister for Financial Services and Regulation entitled 'Independence of Australian Company Auditors. Review of Current Australian Requirements and Proposals for Reform' by Professor Ian Ramsay in October 2001 was followed

by Report 391 of the Joint Standing Committee on Public Accounts and Audit 'Review of Independent Auditing by Registered Company Auditors' in August 2002.

My inquiry into the failure of HIH necessarily dealt with HIH's audit process and the role of its auditor. Drawing on that experience as well as other developments I turn to policy questions relevant to the audit function.

### 7.2.1 Auditor independence

Auditor independence is a critical element going to the credibility and reliability of an auditor's reports.<sup>[34]</sup> Audited financial statements play a key role promoting the efficiency of capital markets and the independent auditor constitutes the principal external check on the integrity of financial statements.<sup>[35]</sup> The Ramsay report recognised the following four functions of an independent audit in relation to capital market efficiency<sup>[36]</sup>:

- adding value to financial statements
- adding value to the capital markets by enhancing the credibility of financial statements
- enhancing the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements
- assisting to lower the cost of capital to those using audited financial statements by reducing information risk.

In addition to the above functions noted in the Ramsay report, an independent audit contributes to capital market efficiency by enhancing the consistency and comparability of reported financial information in Australia.

It is widely accepted that the auditor must be, and be seen to be, free of any interest which is incompatible with objectivity.<sup>[37]</sup> There must be public confidence in the auditor for an audit to fulfil its functions.

The responsibility of auditors to maintain independence in the carrying out of their function was stated by the US Supreme Court:

The independent public accountant performing this special function owes allegiance to the corporation's creditors and stockholders, as well as the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>[38]</sup>

In the absence of a competently and independently performed audit, there is increased risk to the efficiency of capital markets. There is a danger that the audit report will lure users into a false sense of security that there has been an independent scrutiny of the financial report when there has not.

While auditors perform a statutory function, the work is generally carried out by private professional services firms. Although it is the shareholders to whom the audit report is addressed, and it is the shareholders who usually appoint and remove the auditor, it is management who have the day-to-day interaction with the auditor. The processes of appointment and removal of an auditor will generally follow the recommendations of management.

CLERP 9 noted these factors may lead to apparent conflicts for auditors:

- the audit function has a significant public interest element, yet auditors are paid by the entity they are overseeing (management)
- there is a personal relationship between auditor and client
- audit partners, managers and staff may have career and financial incentives to comply with audit client wishes on the presentation of financial reports
- lower level audit staff may have career and financial incentives to acquiesce in audit partner wishes
- audit staff may see themselves more as business consultants
- audit firms rely on non-audit services for their revenue and profit growth

- corporate clients may view audit as a dead compliance cost and want to capitalise on the knowledge of audit firm professionals.[39]

CLERP 9 stated that the difficulties which arise from these matters are that:

- only company management has direct fee payment, contract and personal contact relationships with the auditor
- other incentives such as regulatory penalties, professional rules, the protection of auditor reputation, and personal career development may in some cases not be as strong as those relationships
- this can lead to market perceptions of auditors acting for profit rather than the public interest.[40]

### ***Regulation of audit independence***

The current regulation of audit independence derives from:

- the *Corporations Act 2001*
- professional standards and guidance issued by the professional accounting bodies.

The relevant requirements of the Corporations Act are concerned with such matters as indebtedness and employment relationships between a company and its auditor.[41] These provisions are directed to specific indicia of independence.

The standards and guidance issued by the professional accounting bodies are more comprehensive. The enforcement of these requirements is generally undertaken by the professional bodies themselves.

### ***Reform proposals***

Various definitions and tests of audit independence have been proposed in the current round of reform proposals including by the Ramsay report and the JSCPA report.

Paragraph 10 of Professional Statement F1 'Professional Independence' issued by the Institute of Chartered Accountants and CPA Australia states:

In determining whether a member in public practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should be whether a reasonable person, having knowledge of the relevant facts and taking into account the conduct of the member and the member's behaviour under the circumstances, *could conclude* that the member has placed himself or herself in a position where his or her objectivity *would or could be impaired*. [emphasis added]

In contrast, the definition of independence contained in paragraph 14 of Professional Statement F1 is:

- (a) *Independence of mind*—the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism; and
- (b) *Independence in appearance*—the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, *would reasonably conclude* a firm's, or a member of the firm's, integrity, objectivity or professional scepticism *had been compromised*. [emphasis added]

The two definitions contained within Professional Statement F1 are inconsistent. It can be seen that the definition in paragraph 14 contains a test that requires a higher standard of certainty as to the compromise of independence than does the test in paragraph 10.

In CLERP 9 the Commonwealth Government put forward a proposal to amend the Corporations Act to include a general statement of principle requiring the independence of auditors:[42]

The general statement of principle will also establish a general standard of independence that an auditor is not independent with respect to an audit client if the auditor *is not*, or a reasonable person with full knowledge of all relevant facts and circumstances *would conclude* that the auditor *is not, capable of* exercising objective and impartial judgment on all issues encompassed within the auditor's engagement. In determining whether an auditor is independent all relevant circumstances should be considered, including all relationships between the auditor and audit client. [emphasis added][43]

CLERP 9 further proposed that the law be amended to require the auditor to make an annual declaration, addressed to the board of directors, that the auditor has maintained independence in accordance with the Corporations Act and the rules of the professional accounting bodies.<sup>[44]</sup>

### ***Difficulties with CLERP 9 proposals***

In my opinion, there are certain difficulties inherent in the standard of independence proposed in CLERP 9. The proposed standard of independence requires the independence of 'the auditor'. It will be important to clarify in the Corporations Act that the requirement of audit independence applies equally to both individual auditors and their firm (if any). Since both the individual auditor and the firm sign the audit report<sup>[45]</sup>, it follows that both should be required to be, and be seen to be, independent. There may be some circumstances where one is independent, but the other is not. For example, I have discussed in Chapter 21 the change of the HIH audit engagement partner in 1999. Despite my conclusion that the circumstances surrounding that change gave rise to the perception that Andersen was not independent, I drew no such conclusion in relation to the new engagement partner's actual independence as a result of his appointment.

The proposed standard of independence in CLERP 9 imposes a high standard of certainty of the lack of independence by requiring that a reasonable person *would conclude* that the auditor is not independent. That test appears to require a higher degree of satisfaction than is required in civil proceedings. In my opinion, the high standard adopted in the CLERP 9 proposals does not pay sufficient regard to the importance of auditors being seen to be exercising impartial and objective judgment. For reasons that are discussed below, I consider that the importance of audit independence is such that the test should be stated in terms of *might* rather than *would*. Neither CLERP 9, the Ramsay report nor SEC Rule 210-01 (upon which the proposed definition is based) provide any explanation for or discussion of the high standard of the proposed definition. I am proposing an alternative standard of audit independence which deals with the difficulties I perceive in the CLERP 9 proposals.

### ***Matters for an audit independence standard***

In framing an alternative standard of audit independence, there is a particular need to consider: the difficulty of identifying any actual breach of independence; the manner in which the auditor undertakes his or her task; the interaction between the company, users of the financial reports and regulatory bodies; and the relationship an auditor has with management.

Inadequate independence on the part of an auditor will usually be difficult to discern. Suspicions might be excited but definite conclusions could be drawn only in extreme circumstances. Rarely would an auditor deliberately or even consciously compromise their independence. More often, as was the case with HIH, the auditor will deny that their independence was in any way compromised, even where an objective consideration might point to the opposite conclusion. Rarely will there be unequivocal evidence that conclusively establishes for example a connection between influence exerted by management upon the auditor and the provision by the auditor of an unqualified audit opinion. The existence of such a connection from a range of surrounding circumstances can usually only be inferred.

The difficulties associated with identifying a compromise of audit independence are inherent in the nature of the audit process. Most of the decisions of an auditor are made behind closed doors, either internally within the audit firm or in conjunction with management. In the case of HIH only selected matters were taken to the audit committee because Andersen and HIH management often resolved issues before the audit committee meetings. Users of the financial statements are not aware of the reasons for the auditor's decisions nor the extent to which the auditor has relied on management representations. Nor are users of the financial statements aware of any pressure which might have been exerted on the auditor by management, such as obtaining an opinion from another audit firm on a technical issue which supports management's view that a judgmental or controversial item accords with accounting standards. Such an initiative by management may leave the auditor feeling constrained to accept that opinion and put aside his or her own opinion on the issue as being merely a difference of professional judgment.

In addition, the form of the audit certificate is largely standard and does not provide any reasoned analysis of the basis for the opinion expressed. Adopting the words of Brooking J in the *Phosphate Co-operative Co of Australia Ltd. v Shears (No.3)* case (which considered the independence of a report required to be prepared by an independent expert) '[t]he calm, reflective air of the report in no way suggests its long period of gestation or the travail which accompanied its birth'.

The users of the financial statements are not privy to the information that is received by the auditor or the process by which the auditor exercises skill and judgment to reach conclusions on that information. The company, users of the financial reports and regulatory bodies place significant reliance upon the integrity of auditors. Auditors have an obligation to ensure that they are, and are seen to be, maintaining high standards of honesty and probity, acting in the interests of the shareholders of the company to whom they are reporting and exercising independence of mind to ensure that financial reports provide a true and fair view of the financial position and performance of the company.

Absent independence, shareholders, creditors and other users of the financial statements can have no assurance or comfort as to the truth or fairness of the financial report of the economic entity with which they deal. Such assurance adds value to capital market efficiency because it enhances the credibility of financial statements. It is in those circumstances that the *perception* that an auditor is independent takes on greater importance.

The primary purpose of the audit is to provide an independent and objective review of the company's financial statements. Corporate resources are expended on an audit for that purpose. An independent and objective audit, conducted with an appropriate degree of professional scepticism, is required. Management, in particular senior management, might have a natural interest in presenting the results of the company in the most favourable light and having the auditors sign off on that form of presentation. That interest of management can give rise to tension in the performance of an independent and objective review. In these circumstances, if the auditor is under pressure to conform with management's expectations, the rationale for the expenditure of corporate resources upon audit may be undermined. Where personal relationships between the auditor and management undermine professional independence and objectivity in any way, good corporate governance is imperilled.

In light of the above, it is critical that the auditor should be seen to be exercising impartial and objective judgment in addition to the actual exercise of that impartial and objective judgment. Any standard of audit independence must reflect this requirement.

Further, the difficulties referred to in discerning any actual lack of independence, coupled with a reluctance on the part of auditors to confront their own lack of independence, supports the introduction of an objective standard of independence. The CLERP 9 proposals acknowledge the need for such an objective standard.

### ***Other models for dealing with conflict***

The issue of audit independence does not normally arise in the course of litigation. Where an audit is undertaken incompetently it is often said that a lack of independence adds nothing to what is otherwise a complete cause of action based upon a breach of duty. Where an audit is not undertaken incompetently, a lack of independence will not cause any loss of itself.

There are many situations where the law imposes obligations upon people who face conflicts between their interests and their duties. In determining what I consider to be an appropriate standard of audit independence I have had regard to certain of those situations, namely the imposition of fiduciary obligations, the independence of directors, requirements in respect of related party transactions, and disqualification of members of the judiciary on the grounds of bias or apprehended bias, which are discussed below.

### ***Fiduciary obligations***

The primary elements of a fiduciary relationship are that:

- the fiduciary has undertaken to act in the interests of another
- that undertaking gives to the fiduciary the power to affect the interests of the other party
- the person to whom the fiduciary duty is owed is vulnerable to the fiduciary's abuse of his or her position.<sup>[46]</sup>

The vulnerability of one party to the other party with power or discretion was emphasised by Dawson J in *Hospital Products Ltd v United States Surgical Corp*:

There is, however, the notion underlying all the cases of fiduciary obligation that inherent in the nature of the relationship itself is a position of disadvantage or vulnerability on the part of one of the parties which causes him to place reliance on the other and requires the protection of equity acting upon the conscience of that other.<sup>[47]</sup>

Vulnerable in this context does not mean intrinsic weakness but rather disadvantage due to the superior knowledge or power of the trusted party.[48] A fiduciary relationship exists where one party is in a position of reliance upon the other because of the nature of the relationship.[49]

It has been said that there are three purposes of the law of fiduciary obligations, namely:

- the maintenance of high standards of honesty and propriety by those who are under a duty to act in the interests of others
- the confiscation of gains arising from the abuse of a relationship of trust
- the protection of one person's reasonable expectations that the other will act in her or his interests, and not in pursuance of a contrary self-interest or conflicting duty.[50]

The fiduciary has a duty to account to the person to whom the fiduciary obligation is owed for any benefit or gain:

- which has been obtained or received in circumstances where a conflict or significant possibility of conflict existed between the fiduciary's duty and their personal interest in the pursuit or possible receipt of such a benefit or gain
- which was obtained or received by use or by reason of the fiduciary's position or by reason of opportunity or knowledge resulting from the position.[51]

As Lord Herschell stated in *Bray v Ford*[52] in relation to the conflict between duty and interest:

It is an inflexible rule of a Court of Equity that a person in a fiduciary position is not, unless expressly otherwise provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is founded upon principles of morality. I regard it rather as based on the consideration that human nature being what it is, there is a danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than duty, and thus prejudicing those whom he was bound to protect.

Several tests have been proposed to determine whether a fiduciary has a conflict of interest, including whether there is a 'real sensible possibility of conflict'[53], or a 'significant possibility of conflict' between duty and interest.[54]

#### *Directors*

In addition to the fiduciary obligations of a director discussed above, directors also have a statutory obligation to avoid conflicts of interest and duty.

#### *Related Parties*

Chapter 2E of the Corporations Act requires that transactions between a public company and any related party [55] that give a financial benefit to the related party on other than arm's length terms be approved by the company's shareholders. The purpose of the chapter is to protect the interests of a public company's shareholders as a whole, by requiring shareholder approval for giving financial benefits to related parties that could endanger those interests.[56]

In order for shareholders to make an informed decision about the related party transaction, the company is required to distribute an explanatory statement which sets out certain specified information.[57]

#### *Judicial bias*

The test laid down by the High Court to determine whether a judge is disqualified by reason of the appearance of bias is whether a fair-minded lay observer might reasonably apprehend that the judge might not bring an impartial and unprejudiced mind to the resolution of the question the judge is required to decide.[58]

The majority of the High Court stated:

That test has been adopted, in preference to a differently expressed test that has been applied in England, for the reason that it gives due recognition to the fundamental principle that justice must both be done, and be seen to be done. It is based upon the need for public confidence in the administration of justice. 'If fair-minded people reasonably apprehend or suspect that the tribunal has prejudged the case, they cannot have confidence in the decision.' The hypothetical reasonable observer of the judge's conduct is postulated in order to emphasise that the test is objective, is founded in the need for public

confidence in the judiciary, and is not based purely upon the assessment of some judges of the capacity or performance of their colleagues.<sup>[59]</sup>

The parties to the litigation in question can waive an objection on the ground of bias, even where it is a question of the public apprehension of bias.<sup>[60]</sup>

***ASX Corporate Governance Council—Test for independent directors***

By way of comparison, the ASX Corporate Governance Council has defined an independent director as one who is independent of management and free from any business or other relationship that could materially interfere with, or could reasonably be perceived to materially interfere with, the director’s ability to act in the best interests of the company.

***Proposed standard of audit independence***

I have concluded that a general standard of independence for auditors should be adapted from the test laid down to determine whether a judge is disqualified by reason of the appearance of bias. While judges and auditors perform different functions there is a common element. Both functions involve an exercise of judgment which results in the public expression of an important opinion which is capable of affecting society widely.

Just as the requirement that a judge be seen to be free from bias is based on a need for public confidence in the administration of justice<sup>[61]</sup>, the requirement that an auditor be seen to be independent is based on a need for public confidence in the credibility and reliability of reported financial information.<sup>[62]</sup>

**Recommendation 9**

I recommend that all standards of independence of auditors in Australia, including those contained in legislation and professional standards such as Professional Statement F1, be consistent with the standard of independence defined as follows:

- An auditor is not independent with respect to an audit client if the auditor might be impaired—or a reasonable person with full knowledge of all relevant facts and circumstances might apprehend that the auditor might be impaired—in the auditor’s exercise of objective and impartial judgment on all matters arising out of the auditor’s engagement.
- A reference to an auditor includes both an individual auditor and an audit firm. In determining whether an auditor or an audit firm is independent, all relevant circumstances should be considered, including all pre-existing relationships between the auditor, the audit firm and the audit client, including its management and directors.

**7.2.2 Audit independence—non-audit work**

The subject of audit independence is both important and difficult. Nowhere is this more so than in considering the degree to which audit firms should be able to provide non-audit services to an audit client.

Proposal six of CLERP 9 dealt with the performance of non-audit work:

The Government supports the immediate application of Professional Statement F1 on Professional Independence, which forms part of the Joint Code of Professional Conduct of the ICAA and CPAA.

- Statement F1 is based on the independence standard adopted by the International Federation of Accountants. It requires auditors to identify and evaluate threats to independence and apply safeguards to reduce any threats to an acceptable level.
- Where the provision of non-audit services to an audit client poses a threat that cannot be reduced to an acceptable level, statement F1 prohibits the provision of that service.<sup>[63]</sup>

The standard of independence that I have proposed should, if accepted, be adopted in professional standards such as Professional Statement F1.

Proposal seven of CLERP 9 stated further:

The Government will implement a series of measures to deal with non-audit services. It will:

- amend the law to require mandatory disclosure in the annual report of fees paid for the categories of non-audit services provided;

- amend the law to require a statement in the annual report of whether the audit committee is satisfied that the provision of non-audit services is compatible with auditor independence. This disclosure would include an explanation as to why the following non-audit services referred to in Professional Statement F1, if contracted, do not compromise audit independence:
  - preparing accounting records and financial statements of the audit client;
  - valuation services;
  - internal audit services;
  - IT systems services;
  - temporary staff assignments;
  - litigation support services;
  - legal services;
  - recruitment of senior management for the audit client; and
  - corporate finance and similar activities.<sup>[64]</sup>

The authors of the CLERP 9 report recommended against a blanket prohibition on the provision of non-audit services by an audit firm. The arguments in favour of that stance include the following:

- a prohibition on the provision of non-audit services to audit clients may result in increased audit costs as costs cannot be spread across business lines. It may also lead to severe difficulty for major listed clients seeking competitive non-audit services, particularly in Australia with its high level concentration in audit and non-audit services
- a prohibition on the provision of non-audit services to audit clients may lead to the development of separate incorporated entities for non-audit services, with no real separation in substance
- a prohibition on the provision of non-audit services to audit clients may result in the inclusion of some non-audit services in audit engagement contracts and the dominance of form over substance on independence issues
- there is no solid evidence of any specific link between audit failures and the provision of non-audit services, and non-audit services have been provided by audit firms to their clients for many years
- many non-audit services are both in the public interest and beneficial to audit effectiveness. For example, a company may seek the assistance of its auditors to correct control weaknesses identified during the audit
- audit firms increasingly need specialists such as information technology specialists to provide critical audit support. Attracting and retaining these specialists, and motivating them to provide direct audit support, may be hampered if they were to be prohibited from providing non-audit services to clients.

In announcing the CLERP 9 proposals the government said:

The Government does not agree with the view that a blanket prohibition should be imposed on all non-audit services to audit clients. The Government agrees with the force of the argument in the Ramsay report that this would place Australia out of step with the position in every other developed capital market. Even the harder legislative stance that has been adopted in the new corporate governance legislation in the United States does not contemplate the imposition of a blanket prohibition in relation to all non-audit services. The UK Co-ordinating Group on Audit and Accounting Issues has stated in its Interim Report of July 2002 that it does not favour a blanket ban on the provision of non-audit services.

The provision of non-audit services has serious ramifications for the perception, and possibly also the actuality of independence. In my view there is a respectable argument in favour of a blanket prohibition notwithstanding the propositions advanced in favour of a more benign regime. I do not pause to develop those arguments because, in the end, I have decided against recommending a blanket prohibition. There are two reasons.

First, I take the statement set out above to be a reflection of a considered government policy that, in this area

at least, it would be unwise for Australia to be 'out of step with the position in every other developed capital market'. If that is the case individual reforms ought not fragment that policy. Second, this inquiry did not examine the possible market implications of a blanket prohibition. It is not difficult to see how an outright ban could result, at least initially, in some disruption as firms supplying non-audit services to their audit clients withdraw from one or other service. The longer term effects are more difficult to determine. There must also be at least a possibility that competition in the provision of audit services may decline. Without a thorough examination of the practical effects that a blanket prohibition would have on the marketplace I do not feel able to make a recommendation. The remainder of the discussion in this section has to be seen against those general comments.

In my opinion, the provision of non-audit services for audit clients raises two significant issues in the context of audit independence:

- the impact upon independence when, as a necessary part of the statutory audit, the auditor comes to review non-audit work that has been performed by the auditor or by the auditor's firm. This situation is inconsistent with the exercise of impartial and objective judgment
- the pressure upon audit personnel to procure non-audit work by maintaining a strong relationship with management. Again, this situation is inconsistent with the exercise of impartial and objective judgment. CLERP 9 identified that non-audit services usually account for more than half of an audit firm's revenue and that audit firm projections show non-audit services are the engine for their business growth.<sup>[65]</sup>

Proposal seven of CLERP 9 addressed the first of these issues.

As set out above, CLERP 9 proposed that audit committees should state annually that they are satisfied that the provision of certain non-audit services is compatible with audit independence. I agree that the audit committee is best placed to make that statement. However, on the basis that audit independence necessarily impacts upon the credibility and reliability of financial information reported by the entity, I consider that there are obligations on all directors to understand the nature and extent of all services provided by the audit firm engaged by the entity and to assess the impact of those services upon audit independence.

I note that the proposed disclosure requirement in CLERP 9 is based upon a categorisation of non-audit services and that, with respect to specific categories of non-audit services, it is proposed that the audit committee must state annually why provision of those services does not compromise audit independence. In my opinion such categorisation is likely to give rise to difficulties. For example, provision of non-audit services categorised as 'taxation' is unlikely to assist a user of financial reports as to the effect of non-audit work on independence. Strategic tax advice is inherently more likely to compromise audit independence than tax compliance services due to its impact upon income tax balances subject to the statutory audit.

The provision of tax advice by Andersen raised one issue that was considered in the inquiry. It is discussed in Section 16.2.15 and I will not repeat what I have there said. The tax arm of Andersen knew certain features of the arrangement while the audit arm did not. Those features were material to the audit. It is a matter of speculation whether the auditors would or might have discovered the existence of the documents had the tax advice been given by a third party and had the Andersen audit team inquired of the third party as part of the process.

In my opinion the audit committee should provide a statement in the annual report identifying all non-audit services provided by the audit firm and the fees applicable to each item and provide an explanation why these non-audit services do not compromise audit independence.

There is recognition in CLERP 9 of the pressure upon audit personnel to procure non-audit work by maintaining a strong relationship with management:

Systems of compensation within audit firms may not give adequate weight to performing the audit function and may in fact adversely impact audit effectiveness. Success in marketing an audit firm's consulting services is often a significant factor in firms' compensation systems. The skills that make one successful in marketing non-audit services to management are not generally consistent with the professional demands on an auditor to be persistently sceptical, cautious and questioning in regard to management's financial representations, thereby creating a tension counter-productive to audit excellence.<sup>[66]</sup>

The potential compromise to independence that such pressure entails is not addressed by the CLERP 9

proposals for disclosure of non-audit work. Professional Statement F1 does not directly address such point either.

As discussed in Chapter 21, at the time of the 1999 and 2000 audits of HIH the performance of Andersen audit personnel was evaluated (and in turn their remuneration and career progression was determined) by reference to various ‘cornerstones’, one of which was their success in facilitating the use by their audit clients of Andersen’s non-audit services. One of the engagement partners said that if he was called upon to exercise independence and professional scepticism by resisting management’s proposals, that may well have adversely affected his ability to sell or promote the supply of non-audit services to HIH. It would follow that he would fail on one of the ‘cornerstones’ on which his career and remuneration were determined.

In my opinion, such a performance evaluation process might give rise to a reasonable apprehension that audit partners would prefer the maintenance of their relationship with management over their professional obligations and, as such, they might be impaired in the exercise of objective and impartial judgment.

It follows that performance evaluation criteria of this sort should form no part of the evaluation of audit partners and personnel. Such criteria provide an incentive to use the audit for ulterior purposes, such as professional advancement, by selling non-audit services to audit clients. This is a matter which should be addressed by the audit firms themselves and by the professional accounting bodies.

#### **Recommendation 10**

I recommend that the *Corporations Act 2001* should be amended to require the board to provide a statement in the annual report that identifies all non-audit services provided by the audit firm and the fees applicable to each item of work and explains why those non-audit services do not compromise audit independence.

In my view, performance evaluation criteria that include facilitating the audit clients’ use of non-audit services of the audit firm compromise audit independence and should not apply in respect of audit partners and personnel. Use of a performance evaluation process of this kind should amount to professional misconduct by the audit firm and be subject to the disciplinary regime of the professional accounting bodies.

### **7.2.3 Audit independence—employment associations**

Proposal four of CLERP 9 was that:

The Government will amend the law to strengthen restrictions on employment relationships between an auditor and the audit client.

- This will include a mandatory period of *two years* following resignation from an audit firm before a *former partner* who was *directly involved* in the audit of a client can become a director of the client or take a position with the client involving responsibility for fundamental management decisions.<sup>[67]</sup> [emphasis added]

The issue of former partners of the auditor being appointed to the board of, or otherwise employed by, an audit client arose directly in the case of HIH and is discussed in Chapter 21. Three former partners of Andersen were appointed to the board of HIH. One was appointed as the chair of the board and appointed to the audit committee 17 months after his retirement from Andersen. Another joined HIH as the chief financial officer the day after he resigned from Andersen, where he had been the engagement partner on the HIH audit. A third former partner was appointed to the board of HIH approximately five months after his retirement from Andersen, where he had played a significant role in the audit of HIH for twenty-five years.

Analysts and the financial press highlighted these associations of Andersen with HIH and Andersen’s independence was questioned publicly. The extent to which the perceived credibility and reliability of the published financial reports of HIH was impaired cannot be measured accurately.

As discussed in Chapter 21, I consider that those circumstances resulted in the perception that Andersen were not independent of HIH. One of the primary reasons for my conclusion was that the cumulative effect of three former partners on the HIH board affected the perception that Andersen’s independence had been compromised more than the presence of one former partner would have done. I note that CLERP 9 did not address that situation. I consider that it is appropriate to limit the number of former partners who can be appointed as a director of an audit client or to senior management positions to one.

Further, in my opinion, the proposed mandatory ‘waiting period’ of two years might not be sufficient to arrest a reasonable apprehension that former partners retain an influence over members of the audit team. This is particularly so if those with whom they may have worked for a number of years (and in respect of whom they may have acted as mentor) are members of the audit team. In my opinion, an appropriate ‘waiting period’ would be four years.

I note that one former partner was never ‘directly involved’ in the HIH audit whilst he was a partner of Andersen, and so would not be caught by the restriction envisaged by CLERP 9. I consider that having as a director a former partner who was not a member of the audit team might still lead to a reasonable apprehension that an audit firm is not independent. That perception would be enhanced by the knowledge that a partnership involves the carrying on of business together for profit.

I note that the restriction proposed by CLERP 9 applies only to former members (that is partners) of an audit firm. I consider that the employment by an audit client of other key senior personnel in the audit team might also lead to the compromise of the independence of the audit firm, or at least the perception of such a compromise. This is because of the close relationships they are likely to have forged with other members of the audit team. Those relationships increase the possibility of management being able to exert influence over the auditor. Serious consideration should be given to expanding the restriction to key senior audit personnel.

It should be noted that Professional Statement F1 recognises the situations above as presenting a ‘familiarity threat’ to independence.<sup>[68]</sup> Within the framework of Professional Statement F1 such threats must be identified and the significance of those threats must be evaluated. Where the threats are other than clearly insignificant, safeguards must be identified and applied to eliminate the threats or reduce them to an acceptable level such that independence is not compromised.<sup>[69]</sup> Notwithstanding Professional State FI, the government has proposed a more prescriptive approach to dealing with such a threat.

Finally, I consider that the restrictions should be enforceable against both the audit firm and the relevant former partner or key audit team member. Accordingly, the restriction should be included amongst the other circumstances in which a director cannot be appointed to the board<sup>[70]</sup> and an auditor cannot accept an audit engagement.<sup>[71]</sup>

#### **Recommendation 11**

I recommend that, in implementing the CLERP 9 proposal for restrictions on employment relationships between an auditor and the audit client, the amendments provide for the following:

- a mandatory period of four years following resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client or take a senior management position with the client. This restriction should be extended to include key senior audit personnel
- an extension of the restriction to a former partner who was not directly involved in the audit of a client. In my opinion, the current proposed period of two years would be appropriate for such a partner
- a prohibition on any more than one former partner of an audit firm, at any time, being a director of or taking a senior management position with the client

These restrictions should be enforceable against both the audit firm and the relevant former partner or senior audit team member.

CLERP 9 stated that its proposal ‘attempted to achieve an appropriate balance between promoting auditor independence and not unduly impeding audit professionals joining companies and bringing with them valuable financial expertise’.<sup>[72]</sup> The recommendation set out above does not inhibit professionals from joining companies other than those audited by their former audit firm. Accordingly, I regard the proposal as achieving an appropriate balance, having regard to the paramount importance of audit independence and the evidence in relation to the impact on perceived audit independence of the presence of former Andersen partners on the board of HIH.

I note that the CLERP 9 proposal referred to a senior management position in terms of a ‘position with the client involving responsibility for fundamental management decisions’. An officer is defined in similar terms under the Corporations Act. I have discussed the difficulties inherent in defining an officer in Chapter 6. I recommend that the restrictions upon former partners (and if applicable key senior audit personnel) be

expressed in the terms of whatever definition is ultimately adopted in respect of an ‘officer’ for the purposes of the Corporations Act.

#### **7.2.4 Rotation of audit personnel and firms**

Proposal nine of CLERP 9 stated:

The Government will make audit partner rotation compulsory after five years.

- The new requirement will apply to the lead engagement partner and the review partner. To maintain continuity of knowledge, the appointment of these partners could be staggered.[73]

In evaluating the appropriateness of that proposal in light of the HIH experience, two factors must be considered, namely the rotation of audit personnel and the rotation of audit firms.

##### ***Audit personnel***

I note that the CLERP proposal would only apply to the ‘lead engagement partner and the review partner’. I consider that a longstanding involvement of key senior personnel in the audit team with an audit client might also lead to the compromise of the independence of the audit firm, or at least the perception of such a compromise. There is a risk that such key senior audit personnel may become too sympathetic to a client’s interests, particularly if their long-term career aspirations become linked to their continued material role in the conduct of the audit. Those relationships increase the possibility of management being able to exert undue influence over the auditor.

Again, Professional Statement F1 recognises such a situation creates a possible ‘familiarity threat’ to independence.[74] Notwithstanding Professional Statement F1, the government has proposed a more prescriptive approach to dealing with such a threat. I consider that the requirement of compulsory rotation every five years should be extended to key senior audit personnel.

##### ***Audit firms***

One aspect of the question of Andersen’s independence of HIH was the length and closeness of their relationship. In particular, Andersen had been HIH’s auditor since 1971. In that time, HIH had become one of the Sydney audit practice’s most significant clients. That situation would not have been affected by the CLERP 9 proposal.

The length of a relationship between auditor or audit firm and client presents clear risks with respect to audit independence. An auditor must not become subject to potential compromise of their objective and impartial judgment by reason of a long-standing relationship with management or a tendency to prefer a particular accounting position because of a previous commitment to that position.

There is a potential tendency of an auditor to refrain from questioning a particular accounting position because of a previous commitment to that position. This may not be cured by the rotation of audit personnel alone. New audit personnel from the same audit firm as the previous audit personnel may feel a sense of loyalty to their firm, partners and colleagues. This may be motivated at least in part by remuneration, professional advancement and a shared professional indemnity liability amongst partners. And it might result in the new audit personnel being less likely to report concerns about previous audits to the client and more likely to adhere to positions communicated to the client by the previous audit personnel.

If nothing else, the long-standing appointment of an audit firm might adversely affect the perception of the audit firm’s independence, since the public will not be informed about, or may be sceptical of, the efficacy of internal rotation of personnel.

I must have regard however to the realities of the market for professional services in Australia. CLERP 9 noted that companies face a restricted pool of audit firms with experience in auditing listed companies. Where one of the major audit firms is providing non-audit services to a company, the pool of possible providers of audit services may be even more limited. Choice would be further restricted if a company did not wish to contract audit services from a firm that audited a major competitor.[75]

On balance, the implementation of other measures put forward in CLERP 9 and by me on audit independence (in particular the standard of independence discussed above) would mitigate threats to independence to such a degree that the rotation of audit firms could be seen as a measure of lesser importance. I am also concerned as to the impact of implementing such a measure in what is currently a limited market of professional services

firms in addition to the other measures.

If the other proposals were not to be implemented, the risks to independence arising from longstanding relationships with clients are such that I would recommend that serious consideration be given to the mandatory rotation of audit firms.

**Recommendation 12**

I recommend that, in implementing the CLERP 9 proposal for rotation of audit personnel, the requirement for rotation of the lead engagement partner and review partner be extended to key senior audit personnel.

**7.2.5 Audit committees**

There is a discussion of the principles relevant to the effective operation of an audit committee in Chapter 23. My findings relevant to the function of the HIH audit committee are found in that chapter and Chapter 21.

The Ramsay report concluded that having an audit committee alone is not sufficient. It is essential that the audit committee have the necessary attributes to enable it to function as an effective corporate governance mechanism.<sup>[76]</sup> I entirely agree.

As of 1 January 2003, the ASX amended its Listing Rules to require an audit committee for the top 500 listed entities by market capitalisation.<sup>[77]</sup> These requirements apply to the first financial year of the entity commencing after 1 January 2003, which for most entities will be the year ended 30 June 2004.

The Listing Rules provide that the composition, operation and responsibility of the audit committee must comply with the best practice recommendations set by the ASX Corporate Governance Council. Those best practice recommendations were released on 31 March 2003. The requirement for an audit committee is mandatory. To the extent that there are departures from the other recommendations, those departures must be explained in the company's annual report.<sup>[78]</sup>

I have not been able fully to consider the recommendations and related guidance notes. But they deal with a number of the deficiencies which I have noted elsewhere in this report with respect to the HIH audit committee. In particular:

- The recommendations call for audit committees to be constituted by non-executive directors and to have a majority of independent directors. The related guidance encourages companies to move towards an audit committee comprising solely independent directors.
- The recommendations provide for an independent chairperson who is not chair of the board.
- The recommendations call for a formal operating charter. Guidance provides that the audit committee should be given the necessary power and resources to meet its charter, which includes rights of access to management and to auditors without management present and rights to seek explanations and additional information.
- A guidance note provides that the audit committee's report to the board should include an assessment of the performance and independence of the external auditors.

There are however two points relevant to the effective operation of audit committees. The question of independence with respect to an audit committee is usually concerned with the relationship of its members with management. In the case of HIH, an issue arose as to the independence of the audit committee from the external auditors due to the presence of ex-Andersen partners as members of the audit committee. The best practice recommendations should clarify that the audit committee is required to be independent of both management and the external auditors to ensure that the audit committee's assessment of the performance and the independence of the external auditors is, and is seen to be, effective.

The system of reporting to the board should allow sufficient time for the audit committee adequately to consider the operating results of the entity and its financial position prior to being reported to shareholders and the public.

In Chapter 6 I have made general observations about the dangers which attend attempts to be overly prescriptive in the area of corporate governance, and the vital need regularly to assess the actual performance

of key corporate governance mechanisms. Those comments apply with equal force to audit committees.

### 7.2.6 Audit reports

CLERP 9 identified concerns as to the content and presentation of audit reports. Information identified for possible inclusion in audit reports included:

- internal audit processes
- risk management
- corporate governance processes
- the quality of forward-looking data
- the validity of measures of management performance
- critical accounting policies
- non-financial data such as environmental and social responsibility reports
- the effect on the financial statements of changing critical accounting assumptions.<sup>[79]</sup>

Such disclosures are said to improve shareholder, regulator and investor understanding of the real financial position of the reporting entity, make better use of skills and positions of auditors and increase confidence in financial statements.<sup>[80]</sup> CLERP 9 did not however make any proposals with respect to the content of audit reports.

I support the general proposition that audit reports should provide more information to enable a better understanding of an entity's financial position.

In particular, where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material, the impact of the position taken by the reporting entity should be explained in the audit report.

For example, additional pre-acquisition claims deterioration that had been identified as a result of management or actuarial reviews resulted in a substantial increase in the amount of goodwill brought to account in respect of the acquisition of FAI at 30 June 2000. This treatment was said to be in accordance with mandatory accounting standards. Evidence before the Commission suggested that on an alternative and appropriate view of the same accounting standards the deterioration should have been recognised as an expense for the year ended 30 June 2000, which would have resulted in HIH reporting substantial operating losses.

In addition, I am of the opinion that an audit report ought to provide commentary upon other significant matters arising in the statutory audit process.<sup>[81]</sup> The current standard form unqualified audit report sets out a scope section followed by the audit opinion. In my opinion, an understanding of the significant matters dealt with by the auditor in arriving at the opinion would enhance the functionality of the audit report. Items that I would expect to be included in such a commentary are:

- material one-off transactions entered into on or about reporting date
- the material effect of events occurring after reporting date reflected in the financial report.

It is imperative that all matters to be disclosed in the audit report are expressed in plain English, comprehensible to readers who lack accounting qualifications.

A further approach was recommended in the UK Company Law Review. This approach required public and large private companies to publish an operating and financial review as a part of their annual report. The review would contain such information as the directors decide is necessary to obtain an understanding of the business. It would include details of the company's performance, plans, opportunities, corporate governance and management risks. The Company Law Review recommended that the auditor should review the operating and financial review. I am of the opinion that such a document, which would be the subject of audit, would significantly assist in addressing the short-comings of audited accounts presented in accordance with the historical cost convention and other standards which can impede the utility of the accounts as a transparent

assessment of the financial progress of the company. Such an approach would enhance the increased audit report disclosure which I have discussed above.

CLERP 9 notes that many submissions were received from audit firms and professional bodies expressing a willingness to provide more information in the audit report. However, this was on the basis there is liability reform to protect them from 'unwarranted litigation'.<sup>[82]</sup>

The JSCPA report acknowledged that broader commentary in audit reports had the potential to expose auditors to legal action where their comments have a negative impact on share prices and the value of companies. It was also suggested that any proposal for an expansion in the scope of audit reporting could not be reasonably addressed in the light of the present unlimited liability situation.<sup>[83]</sup>

It is difficult to see why expanded audit reporting has been linked to the issue of audit liability in this way. It is not suggested that the inclusion of additional matters in the audit report would require the application of a higher duties of skill or care in the conduct of the audit. Further, in presenting audit reports, auditors are generally not liable to third parties who rely on the financial reports to make investment or other financial decisions, even if the likelihood of such reliance is foreseeable or known to the auditors.<sup>[84]</sup> To the extent that there are aspects of the audit work which, if made out, could give rise to liability, there would be nothing unwarranted about any litigation arising. It is inappropriate to trade off expanded audit reporting with issues of audit liability.

#### **Recommendation 13**

I recommend that the *Corporations Act 2001* be amended to require the disclosure in audit reports of the following:

- the impact of the position taken by the reporting entity where alternative accounting treatments are reasonably open from the reading of an accounting standard and the difference between those accounting treatments is material
- the significant matters arising in the audit process.

The Corporations Act should be amended to require audit reports to be presented in plain English and to require the inclusion of an operating and financial review as part of an annual report, which would be the subject of audit.

### **7.2.7 The scope of the audit and the audit expectation gap**

In recent years there has been considerable debate about the nature and scope of audit services and the so-called 'audit expectation gap', namely the difference between what auditors actually do when they conduct an audit and what shareholders and others think auditors do, or should do, in conducting the audit.

My experience (confirmed by the evidence before the Commission) has been that audit reports are uninformative about the nature and scope of the audit services performed by the auditor. The terms of a standard audit report are quite formulaic and would not assist a reader to understand the nature or scope of the audit.

I consider that the best way to narrow, possibly to close, the audit expectation gap would be to summarise briefly in plain English in the annual report the nature and scope of the audit services provided. The summary could be included in the body of the audit opinion itself or in another section of the annual report describing the audit. This would also enable listed public companies and readers of their annual reports to compare the nature and scope of the audit services provided to them with those provided to other companies. This would promote efficiency and competition in the market for audit services.

#### **Recommendation 14**

I recommend that the *Corporations Act 2001* be amended to require public listed companies to include a brief, plain English summary of the nature and scope of the audit services provided by their auditor each year.

## **7.3 The actuarial function**

### **7.3.1 Role of the actuary**

Actuaries play an important role in the management and financial reporting of general insurers. In particular,

they play an important role in estimating the outstanding claims liabilities of a general insurer. Although inevitably an estimate, accuracy insofar as it is possible in relation to the OCL, is critical to the financial well-being of an insurer.

The actuarial profession is supported by the Institute of Actuaries of Australia. The IAAust provides recognition, professional guidance, support and training for actuaries. It sets minimum qualifications for recognition as an actuary. It has also published a code of conduct for actuaries generally, and professional standards in relation to the work of actuaries within specific fields. In relation to general insurance, an actuary's work is subject to Professional Standard PS 300, Actuarial Reports and Advice and General Insurance Technical Liabilities. A number of the specific provisions of PS 300 have been considered in Chapters 5 and 15.

Prior to the collapse of HIH the actuary had no formal or statutory role in the regulatory framework of the general insurance industry. It was left to the individual general insurer to determine:

- whether (and if so to what extent) it sought or relied upon actuarial advice
- the terms of retainer (including instructions as to assumptions to be made in the valuation exercise) of any actuary retained to provide advice
- to whom that advice was disclosed.

As will become apparent from a reading of Chapter 15, this approach was problematic and on occasions undermined the utility of actuarial assistance.

A number of the problems which arose in the case of HIH have been addressed by the APRA Prudential Standards which became operative on 1 July 2002. I will commence with a brief consideration of some of the relevant provisions of those standards before addressing some concerns which remain. The following consideration of those prudential standards is limited to the aspects dealing with the actuarial function. A more general consideration of the prudential standards is in Chapter 8.

### **7.3.2 The APRA prudential standards**

In addition to amendments to the *Insurance Act 1973* which give actuaries a formal regulatory status, Prudential Standards GPS 210, Liability Valuation for General Insurers, and GPS 220, Risk Management for General Insurers, deal extensively with the role and responsibilities of actuaries. APRA has also published a series of guidance notes to these prudential standards. Of particular note in this context are GGN 210.1, Actuarial Opinions and Reports on General Insurance Liabilities, and GGN 220.1, Governance.

The Insurance Act contains a requirement (subject to limited exemptions) that general insurers appoint an approved actuary, and have this appointment approved by APRA.<sup>[85]</sup> The primary function of the approved actuary is to provide the board of a general insurer with written advice on the valuation of its insurance liabilities to ensure the board is adequately informed. The approved actuary must provide this advice at a 75 per cent probability of sufficiency. Ultimately it remains for the board to determine the appropriate provision in the insurer's accounts. But where the board decides not to accept the approved actuary's advice, this must be disclosed to APRA and in the insurer's accounts.

The prudential standards and guidance notes then deal with a number of further matters of significance to the actuarial function. These matters can be separated into those relating to the role of the approved actuary (including the actuary's qualifications, independence and relationship with the other organs of a general insurer) and those relating to the approach to the valuation of the insurer's insurance liabilities.

#### ***The role of the approved actuary***

GPS 220 requires that the approved actuary be a fit and proper person.<sup>[86]</sup> It requires, amongst other things, that the actuary:

- has appropriate formal qualifications and is a member of a suitable professional body<sup>[87]</sup>
- has no actual or potential conflicts of interest that are likely to influence their ability to carry out their role and functions with appropriate probity and competence.<sup>[88]</sup> As part of the approval process, the actuary must disclose to APRA details of their pecuniary interests in the insurer, including details of the remuneration which they or their firm receive from the insurer<sup>[89]</sup>

- is not the chief executive officer or director of the insurer or a related body corporate<sup>[90]</sup>
- is not the approved auditor.<sup>[91]</sup> This is said to reflect the importance of the two positions of approved actuary and approved auditor, and to demonstrate independence and avoid potential conflicts of interest.

From Chapter 15 it is apparent that neither the board nor the auditors gave any detailed consideration to the independence of HIH's consulting actuary. These provisions should assist in formalising the consideration which ought to be given to the fitness and propriety of the actuary, including his or her independence.

The prudential standards represent a fundamental change in the obligations and relationships between the approved actuary, the insurer and APRA. Under the new regime the approved actuary must prepare a report on the value of the insurer's insurance liabilities (in accordance with GPS 210, discussed below). This report must be supplied to the insurer's board, and must be submitted by the insurer to APRA with its yearly accounts.<sup>[92]</sup> This may be contrasted with the very limited circulation of the reports of HIH's consulting actuary.

It remains the responsibility of the board to determine the appropriate valuation of the insurance liabilities. However, as I have mentioned, where the board decides not to accept the approved actuary's advice, this must be disclosed to APRA and detailed in the insurer's published financial accounts.<sup>[93]</sup> Again, this is a welcome reform in that it will ensure that the actuary's advice is given the serious consideration it requires. Justification will be needed for any departure from that advice.

Guidance Note GGN 210.1 acknowledges that the relationships between the board, management, auditors, internal actuaries and consulting actuaries can be very complex. It provides that it is the responsibility of the approved actuary to clarify the relationship between these parties for the purpose of preparing advice on the value of the insurer's insurance liabilities. The extent to which the actuary obtains information from, or relies upon work undertaken by, others must be disclosed in the report.<sup>[94]</sup> It also provides that it is the role of the approved actuary to make clear that he or she may require access to, and information from, management, underwriters, other employees of the company and the company's auditors. The approved actuary however retains full responsibility for their advice and reports, and must therefore be satisfied as to the validity of the information provided to them, and work carried out for them.<sup>[95]</sup>

The Insurance Act requires that an insurer make arrangements to enable the approved actuary to carry out their function. This includes ensuring the actuary has access to all relevant data and people within the insurer which the actuary reasonably believes is necessary to fulfil their obligations.<sup>[96]</sup>

In Chapter 15 I recorded my surprise at the lack of direct communication between HIH's actuary and auditors. HIH's actuary made some efforts to establish a channel of communication, but his offers were not taken up by those within HIH responsible for providing him with instructions. I would expect the above provisions to go some way towards resolving this difficulty.

Guidance note CGN 220.1 paragraph 15 requires the audit committee to invite both the approved auditor and the approved actuary to meetings of the committee. This will overcome a major deficiency that I detected in the functioning of the HIH audit committee, namely that the actuary never attended a committee meeting. It will also provide a forum for the auditor and actuary to meet and engage in dialogue. It is a welcome reform and a vast improvement on the previous system.

These requirements should also go some way to addressing some of the breakdowns in the flow of provisioning information and data which I have considered in Chapter 15. While responsibility is placed upon the actuary to ensure the adequacy of the information, the company is also obliged to comply with the actuary's reasonable requests for access to information and personnel. The actuary should no longer be constrained by his or her individual terms of retainer.

I note that in addition to preparing the regular valuation reports, the approved actuary may be required to provide other information to APRA upon request by APRA.<sup>[97]</sup> He or she may also initiate meetings with the insurer and APRA, or just with APRA.<sup>[98]</sup> Finally, the approved actuary must report to APRA any instances identified where prudential requirements may be breached or policyholders' interests may be threatened.<sup>[99]</sup>

### ***The valuation of insurance liabilities***

I have mentioned that the new prudential regime requires that the board of a general insurer obtain a report from an approved actuary in relation to the valuation of its insurance liabilities. Prudential Standard GPS 210

establishes a set of principles for the consistent measurement and reporting of the insurance liabilities.

In providing his or her report on the insurance liabilities, the approved actuary has a legal responsibility to provide advice that complies with the Insurance Act and Prudential Standard GPS 210, and a professional responsibility to provide advice that complies with the Guidance Notes and the professional standards of the IAAust. These responsibilities override any responsibility as an employee of, or consultant to, the insurer.  
[100]

Insurance liabilities are defined as including both the insurer's outstanding claims liabilities (an estimate of future payments on all claims incurred prior to the calculation date, whether or not reported) and premium liabilities (an estimate of future claim payments arising from future events insured under existing policies, assessed on a prospective basis). [101] The valuation report must include central estimates of the OCL and the premiums liabilities, and risk margins that relate to the inherent uncertainty in each of these central estimate values. The risk margins should be established on a basis that is intended to provide a 75 per cent probability of sufficiency. [102] The value of the insurance liabilities is the sum of the two central estimates and risk margins. [103] The actuary should provide central estimates and risk margins shown separately for each class of business. [104]

Earlier in this chapter I have considered the desirability of the inclusion of a risk or prudential margin within an insurer's outstanding claims provision. But regardless of the merits of this proposal, I regard the requirement that the board of an insurer obtain actuarial advice in relation to the level of uncertainty in the central estimate as a welcome reform. Without this advice directors are disadvantaged in determining how and whether this risk is being adequately dealt with, whether through a prudential margin, a reinsurance programme, a capital surplus or otherwise.

The value of the insurance liabilities must be discounted. [105] I have referred earlier in this chapter (and in Chapter 15) to the problems which have arisen in the interpretation of the requirement under AASB 1023 that the insurance liabilities be discounted at a market-determined risk-adjusted rate of return. This has encouraged discounting at a rate of return which it is expected the insurer might earn on its assets. This approach was described in the expert actuarial evidence during the Commission as aggressive. When taken to its logical extreme, it can lead to perverse consequences with risk-taking insurers able to achieve a larger discount on their OCL. In the case of HIH, the actuary was asked to assume a particular discount rate for each of his valuations, and those rates were generally in excess of the rate of return on risk-free securities of a term matching the mean term of HIH's OCL.

Under the new prudential regime, the actuary's dilemma in this respect is resolved. GPS 210 recognises that the value of an insurer's liabilities is typically independent of the value of the underlying assets, and that for this reason a discount rate that is observable, market-based and objective is more appropriate. [106] It provides that the rate to be used in discounting future claim payments for a class of business is the gross redemption yield of a portfolio of sovereign risk securities with a similar expected payment profile to the insurance liabilities for that class (for example Commonwealth Government securities for Australian dollar liabilities).  
[107]

Guidance Note GGN 210.1 deals with a number of matters relating both to the content of the valuation report to be provided by the approved actuary and the methodologies to be adopted in carrying out the valuation. The guidance note is intended to provide interim guidance pending release by the IAAust of its own professional standards and guidance notes. I note that some consequential amendments have already been made to PS 300.

The guidance note deals, for example, with future claims handling costs. It states that the allowance for FCHC should be made after a consideration of historical levels of costs, organisational structure, internal and outsourced functions and future administrative developments. [108] Not only does the guidance note make clear the need to have regard to the insurer's likely actual costs, it places an onus on the actuary to consider the above matters.

The new prudential regime also places a greater onus on the actuary in terms of satisfying him or herself as to the reasonableness of any estimates supplied by the insurer [109], and to consider the insurer's reinsurance arrangements. [110]

Each of the matters referred to in the previous two paragraphs are the subject of some consideration in Chapter 15. An approach which allows an insurer to instruct an actuary to make assumptions about these

matters, without the actuary being given an opportunity to test the appropriateness of these assumptions, is problematic. The new prudential regime clarifies the actuary's obligations, and limits the insurer's ability to subject the actuary's advice to some of the constraints to which HIH's actuary was subjected.

### **Summary**

In my view the new prudential regime represents a substantial improvement upon the regime in place during HIH's time. It recognises the crucial role which actuaries play in the accurate valuation of what will ordinarily be the largest single item on the insurer's balance sheet. It both ensures that actuarial advice is obtained and considered, and clarifies the relationship between the actuary, the insurer (including its board, management and employees), the auditors and APRA.

I note that those who made submissions in relation prudential regime broadly supported the measures relating to the actuarial function.

### **7.3.3 Other potential reforms**

A number of further suggested reforms were referred to in both the evidence and submissions before the Commission. I will consider briefly some of what I regard as the more meritorious suggestions.

#### **Data certificates**

In Chapter 15 I have outlined a number of the data problems which confronted HIH's consulting actuary. The new prudential standards go some way towards addressing the concerns I identified. I have already mentioned the obligation upon an actuary to identify the data he or she needs, and the obligation of the insurer to provide access to that data. This enhances the ability of the actuary to demand better or additional data from the insurer. There are further more detailed provisions dealing with the actuary's obligations in relation to data. [111] They provide, for example, that it is an actuary's responsibility to ensure that the data used gives an appropriate basis for estimating the insurance liabilities. This is said to include exposure data and claims experience data where the other data is not sufficient to reduce uncertainty to an acceptable level. They also provide that an actuary should take reasonable steps to verify the consistency, completeness and accuracy of the data collated against the insurer's financial records. The actuary should identify in his report the degree to which reliance has been placed upon data supplied by the company and the testing of that data by the auditors, and comment upon the limitations these matters place upon the actuary's confidence.

These measures will no doubt assist in reducing the incidence of the breakdowns in the flow of provisioning information and data of the kind which I have found occurred in the case of HIH. But in my view it would be worth considering whether the reforms might be taken further. For example, Richard Wilkinson (an actuary from the London office of KPMG) referred in his evidence to a practice in the United Kingdom of obtaining data certificates from management of the insurer. While such certificates will not guarantee the accuracy or completeness of the data supplied to the actuaries, in my view they are likely to focus the minds of management. Although there is always a risk of a 'box-ticking' mentality, nevertheless the process of completing the certificates (and in particular identifying the person who takes responsibility for the data in signing the certificate) is likely to underscore the importance of ensuring the accuracy and completeness of the data supplied to the actuary.

#### **Recommendation 15**

I recommend that both the Australian Prudential Regulation Authority and the Institute of Actuaries of Australia introduce compulsory certification of the completeness and accuracy of data.

#### **Peer review**

The IAAust submitted that it was desirable that the approved actuary's annual report on the valuation of the insurer's insurance liabilities be subject to independent review by another actuary. [112] It was further submitted that in view of the dominant influence of the claim and premium provisions on an insurer's solvency and profitability, it was not possible for the auditor to form a soundly based view of its accounts without actuarial input. The IAAust added that where the auditor had access to actuarial advice within the same firm, it was natural for an independent review to take place within the audit process. Its understanding was that this was normal audit practice in the general insurance industry.

In my view, peer review will often be a worthwhile exercise. In the case of HIH, the auditor's review of the

company's provisions did not involve any actuarial input. The review would have been improved by that input. But I can also envisage situations where a formal requirement of peer review would be an unnecessary impost which would be costly and productive of delay. Thus while I would encourage insurers and their auditors to consider carefully the need for actuarial input in the review of the actuarial advice (or particular aspects of that advice) received by the company, I am not inclined to recommend that a formal process of peer review of the actuary's report be made mandatory.

### ***Actuarial methodologies***

Responsibility for the selection of an appropriate valuation model or methodology lies with the actuary. As I have mentioned, Guidance Note GGN 210.1 provides some guidance.

I do not propose to consider the relative merits of the various methodologies of which I have become aware during the course of the Commission. However, I do wish to make some more general observations. They arise in part at least from the submissions of Dr Ben Zehnirith, who was critical of the methodologies adopted by a number of actuaries, including those advising HIH. In essence his criticisms were directed towards the over reliance upon subjective judgment (for example, in determining an appropriate allowance for future claims inflation) at the expense of reliance upon properly constructed probabilistic models and analysis of the trends and variability found in historical experience.

The actuarial science is still developing. It may well be that over time a greater consensus is reached as to the merits of particular methodologies and models for particular types of insurance business. But it seems to me that there will inevitably remain a need for the exercise of subjective judgment on the part of the actuary. To me the concern is not so much with the existence of subjective judgment as with the identification of the judgments that have been made and their impact upon the valuation.

From my consideration of HIH's actuarial valuations in Chapter 15 it is clear they involved a significant level of subjective judgment—for example, in selecting rates of superimposed inflation which were inconsistent with the historical experience, and in making assumptions about the impact of particular changes in the business being written. HIH's actuary referred often to the past experience for particular lines of HIH business not being a useful indicator of the future. But often I found it difficult from a reading of the actuarial reports to discern precisely what subjective judgments had been made, let alone the impact of those judgments upon the valuation outcome.

In my view the usefulness of the actuarial advice provided to general insurers would be enhanced by clear disclosure of the existence and impact of such judgments and departures from historical experience. The resulting transparency of the actuarial advice should assist readers (including the board, auditors and APRA) in identifying, testing and assessing the appropriateness of such judgments.

#### **Recommendation 16**

I recommend that the Institute of Actuaries of Australia and the Australian Prudential Regulation Authority introduce a requirement for more detailed disclosure of the exercise, incidence and impact of subjective judgment and departure from historical experience.

### ***Independence of actuary and auditor***

Under the new prudential regime, the approved actuary may be an employee of the insurer (but not the chief executive or a director). The approved actuary may not be the approved auditor, but there is nothing to prevent the approved actuary being an employee or partner of the same organisation as the approved auditor of the insurer.

IAAust addressed these matters in its submissions.<sup>[113]</sup> It supported the appropriateness of permitting the approved actuary to be an employee of the insurer on the basis that the experience of its members was that an actuary who is an employee of the company concerned is often better placed to undertake a detailed analysis and valuation of that company's insurance liabilities than an actuary external to the company. It added that the former often has a more detailed understanding than the latter of the nature of the company's insurance contracts and liabilities.

The IAAust however was of the view that the approved actuary should not be an employee or partner of the same organisation as the approved auditor of the insurer. It submitted that if the approved actuary and

approved auditor were employees of the same organisation, the necessary degree of independence of these roles from each other might not be achieved.

I see some force in these submissions. They are consistent not only with the new requirement that the approved actuary not be the approved auditor, but also with my views in relation to the scope of services to be provided by auditors. In addressing this concern, care should be taken to ensure that the approved auditor and approved actuary are *independent* of each other whether they are from the same or different but related firms.

**Recommendation 17**

I recommend that the Australian Prudential Regulation Authority extend the qualifications of the approved actuary to require that they not be an employee or partner of the organisation to which the approved auditor belongs.

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[1] [CMCO.0047.001](#) at 002.

[2] Submission by Mr Mark Leibler to the Joint Committee on Public Accounts and Audit review of independent auditing by registered company auditors (July 2002), page 6.

[3] Recommendation 6, Joint Committee on Public Accounts and Audit review of independent auditing by registered company auditors (July 2002).

[4] [CMCO.0048.001](#) at 005.

[5] [CMCO.0044.008](#) at 019.

[6] PS300 pars 47 and 48.

[7] GPS210 pars 5 and 9.

[8] Dr Ben Zehnwrith, [CMCO.0037.295](#) at 309.

[9] [CMCO.0057.001](#) at 014.

[10] [CMCO.0056.001](#) at 018 to 019.

[11] Minutes of the Standards Advisory Committee on Insurance Contracts (Phase I), Hong Kong, November 2002.

[12] [CMCO.0048.001](#) at 016.

[13] [CMCO.0056.001](#) at 018.

[14] [CMCO.0057.001](#) at 014.

[15] [CMCO.0057.001](#) at 013.

[16] [CMCO.0044.008](#) at 023.

[17] [CMCO.0049.004](#) at 035.

[18] [CMCO.0056.001](#) at 018.

[19] [CMCO.0056.001](#) at 017.

[20] [CMCO.0056.001](#) at 019.

[21] [CMCO.0057.001](#).

[22] [CMCO.0048.001](#) at 006.

[23] [CMCO.0044.008](#) at 011.

[24] [CMCO.0049.004](#) at 012.

[25] [CMCO.0049.004](#) at 026.

[26] AASB 1023, *Financial Reporting of General Insurance Activities*, background to revision.

[27] [CMCO.0048.001](#) at 006.

[28] AASB 1013 par. 13.1.

[29] AASB 1013 par. 5.7.

[30] *Corporations Act 2001*, ss. 327(1), (2) and (3).

[31] *Corporations Act 2001*, s. 327(4).

[32] *Corporations Act 2001*, s. 329(1).

[33] *Corporations Act 2001*, s. 329(5).

[34] CLERP 9 at 4.2 page 42.

[35] CLERP 9 at 4.2 page 42.

[36] I Ramsay, 'Independence of Australian Company Auditors. Review of Current Australian Requirements and Proposals for Reform. Report to the Minister for Financial Services and Regulation' (2001) at par. 4.02 page 20.

[37] See Professional Statement F1 'Professional Independence' issued by the Institute of Chartered Accountants and CPA Australia at par. 10.

[38] *United States v Arthur Young*, 465 US 805, 817–818 (1984).

[39] CLERP 9 at 3.3.1 page 33.

[40] CLERP 9 at 3.3 page 34.

[41] *Corporations Act 2001*.

[42] CLERP 9 at 4.6.3 page 46.

[43] CLERP 9 at 4.6.3 page 46.

[44] CLERP 9 at 4.6.3 page 47.

[45] See *Corporations Act 2001* s. 324(10).

[46] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 97 (Mason J).

- [47] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 142 (Dawson J).
- [48] *Canson Enterprises v Boughton & Co* (1991) 85 DLR (4th) 129 at 155 (McLachlin J).
- [49] *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 141 (Dawson J).
- [50] Parkinson *The Principles of Equity* (1996) at 362.
- [51] *Chan v Zacharia* (1984) 154 CLR 178 at 199 (Deane J).
- [52] *Bray v Ford* [1896] AC 44 at 51 to 52 (Herschell LJ).
- [53] *Boardman v Phipps* [1967] 2 AC 46 at 124 (Upjohn LJ); *Queensland Mines Ltd v Hudson* (1978) 18 ALR 1 at 3 (Privy Council).
- [54] *Chan v Zacharia* (1984) 154 CLR 178 at 198 to 199 (Deane J).
- [55] ‘Related party’ is defined in section 228 of the *Corporations Act 2001*.
- [56] *Corporations Act 2001*, s. 207.
- [57] *Corporations Act 2001*, s. 219.
- [58] *Johnson v Johnson* (2000) 201 CLR 488 at 493 (Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ).
- [59] *Johnson v Johnson* (2000) 201 CLR 488 at 493 (Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ).
- [60] *Vakuata v Kelly* (1989) 167 CLR 568 at 577 (Dawson J).
- [61] *Johnson v Johnson* (2000) 201 CLR 488 at 493 (Gleeson CJ, Gaudron, McHugh, Gummow and Hayne JJ).
- [62] see I Ramsay, ‘Independence of Australian Company Auditors. Review of Current Australian Requirements and Proposals for Reform. Report to the Minister for Financial Services and Regulation’ (2001) at 4.01 and 4.02 page 20
- [63] CLERP 9 at 4.9.3 page 68.
- [64] CLERP 9 at 4.9.3 page 69.
- [65] CLERP 9 at 3.1 page 29.
- [66] CLERP 9 at 4.9.1 page 64.
- [67] CLERP 9 at 4.7.3 page 49.
- [68] Professional Statement F1, Appendix 1 par. 1.26.
- [69] Professional Statement F1, Appendix 1 par. 1.10.
- [70] *Corporations Act 2001* s. 201B.
- [71] *Corporations Act 2001* s. 324.
- [72] CLERP 9 at 4.7.3 page 51.
- [73] CLERP 9 at 4.11.3 page 83.
- [74] Professional Statement F1, Appendix 1 par. 1.26.

- [75] CLERP 9 at 3.1 page 29.
- [76] CLERP 9 at 4.10.1 pages 75 to 76.
- [77] Listing Rules 1.1 (Condition 13) and 12.7.
- [78] Listing Rule 4.10.3.
- [79] CLERP 9 at 3.4.1 pages 35 to 37.
- [80] CLERP 9 at 3.4.1 pages 35 to 37.
- [81] see JSCPAA report at par. 4.118 page 117.
- [82] CLERP 9 at 3.4.1 pages 35 to 37.
- [83] JSCPAA report pars 4.122 and 4.123 page 118.
- [84] *Esanda Finance Corporation Limited v Peat Marwick Hungerfords* (1997) 188 CLR 241; see Greinke 'Auditors' Liability to Third Parties: The View of the High Court' (1997) 15 C&SLJ 309 at 312.
- [85] Insurance Act ss. 39 and 40.
- [86] GPS 220 par. 2.
- [87] GPS 220 par. 8.
- [88] GPS 220 par. 6.
- [89] GN 220.1 par. 22.
- [90] GPS 220 par. 6.
- [91] GPS 220 par. 10.
- [92] GPS 220 par. 30; Insurance Act, s. 9.
- [93] GPS 210 par. 4.
- [94] GGN 210.1 par. 5.
- [95] GGN 210.1 par. 6.
- [96] Insurance Act, s. 49K; GPS 220 pars 31 to 32.
- [97] GPS 220 par. 30; Insurance Act, s. 9.
- [98] GPS 220 par. 34.
- [99] GGN 220.1 pars 35 to 40.
- [100] GGN 210.1 par. 7.
- [101] GPS 210 pars 6 and 7.
- [102] GPS 210 par. 10. The risk margin should be not less than one half of the coefficient of variation for the insurance liabilities, which in the case of highly skewed insurance distributions, may require greater than 75 per cent level of sufficiency – GPS 210 par. 11.

[103] GPS 210 par. 9.

[104] GPS 210 par. 13.

[105] GPS 210 par. 19.

[106] GPS 210 par. 29.

[107] GPS 210 par. 30.

[108] GGN 210.1 par. 39.

[109] See, for example, GGN 210.1 par. 40, which makes it clear that the actuary is responsible for ensuring the valuation process and estimates are reasonable.

[110] GPS 210 pars 37 to 41; GGN 210.1 pars 23 to 24.

[111] GGN 210.1 pars 11 to 16.

[112] [CMCO.0044.008](#) at 015.

[113] [CMCO.0044.008](#) at 014 to 015.