Editor's Note: The 1977 Annual Meeting of the Academy was not recorded. Accordingly, the record of the Annual Meeting is a reconstruction prepared in large measure by the participants. Their extra efforts are gratefully acknowledged.

NOTICE

The Academy is not responsible for statements made or opinions expressed in the record of the Annual Meeting published in the Journal.
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1977 JOURNAL

ANNUAL MEETING OF THE AMERICAN ACADEMY
OF ACTUARIES—NOVEMBER 21, 1977

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The Annual Meeting of the Academy was held in conjunction with the Annual Meeting of the Casualty Actuarial Society, whose President, George Morison, introduced Mr. Robert C. Winters.

MR. ROBERT C. WINTERS (President): Thank you, George. It is a real pleasure for me to be here and we appreciate the hospitality of the Casualty Actuarial Society. I now call the Annual Meeting of the American Academy of Actuaries to order. The Secretary informs me that we have a quorum.

Our program this morning is in two parts. In the first hour we will conduct the business meeting. Following that, we will have a panel discussion on the subject of actuarial opinions of statutory fire and casualty statements.

The first item of the business meeting is the report of our Secretary, Mr. Ralph Edwards. For the financial side of things, we then will hear from our Treasurer, Jim Webb. And after that, Steve Kellison, our Executive Director, will give you a summary of major activities of the Washington and Chicago Offices. I think you will be surprised and pleased at the range of the Academy's activities.
The Academy's Board of Directors and Executive Committee have each held four all-day meetings during the past year. The more significant nonroutine actions taken include:

- Authorization of the employment of a Director of Communications and Government Liaison in the Washington, D.C. office.

- Appointment of a task force whose Report on Risk Classification was published in August.

- Authorization of the filing of an amicus curiae brief with the U.S. Supreme Court in the Manhart case.

- In the matter of the reorganization of the actuarial profession, the President was authorized to appoint a Steering Committee to oversee discussions, negotiations, communicating the need for restructuring, and other communications. Also, the President was authorized to appoint three persons to a Joint Committee on Committees to study existing committee structures and how they may best be coordinated.

- Recommendation of language defining a qualified actuary, for use as the need arises in conjunction with the Fire and Casualty Statement, to be presented to the Committee on Blanks of the National Association of Insurance Commissioners.

- Agreement to notify Members and Affiliates that they are welcome to attend committee meetings, with the exception of the Executive, Discipline, Board and Nominating Committees. Any individual interested in the work of a particular committee should get in touch with its chairman.

- Authorization of additions to the Opinions as to Professional Conduct concerning (a) change of actuary, or appointment of an additional actuary, (b) responsibility for an actuarial report to a client, and (c) reference
to exposure drafts or to recommendations subject to re-
vision, of both the Committee on Actuarial Principles
and Practices in Connection with Pension Plans and the
Committee on Financial Reporting Principles.

- Consideration of the need to have the regular services
  of outside counsel, and making arrangements accordingly.

- Approval of appropriations to the Actuarial Education
  and Research Fund to meet organizing expense and to get
  its first project under way.

- Arrangement for the Council of Presidents to receive
  copies of Board and Executive Committee minutes, except
  for those relating to disciplinary matters or other
  confidential areas.

- Adoption, with revision, of resolutions proposed by the
  Ad Hoc Committee on Independence, which call for
  drafting Guides to Professional Conduct and other
  actions to clarify and promote financial and organiza-
  tional independence of the actuary in situations where
  such independence is appropriate.

- Change of the Bylaws, unless ten percent of the member-
  ship raises objection, (a) to improve the wording in a
  number of areas while this manner of changing the Bylaws
  remains in effect, and (b) in the amendment section, re-
  quire the presenting of a discussion of the issues to
  the members and the obtaining by ballot of the affirm-
  ative vote of two-thirds of those members voting.

- Approval of a discussion outline involving proposals to
  change the present membership requirements and cat-
  egories, and recognize specialties. These proposals
  will be taken to the membership for consideration and
  possible adoption through Bylaws changes.

- Adoption of a procedure for future joint handling of
  exposure drafts on guides and opinions as to profess-
  ional conduct.

- Adoption of recommendations of the Committee on Dis-
  cipline to provide warning that an actuary should not
  represent himself personally, or by his professional
  designation, as being qualified in an area in which he
  is not clearly qualified by training and experience.
In the last year, deaths of the following members of the American Academy of Actuaries have been reported:

Carl R. Ashman
Edwin L. Bartelson
Henry E. Belden
Harley N. Bruce
J. Douglas Churchill
Barrett N. Coates
William M. Corcoran
David L. S. Douglas
Charles C. Dubuar
Joseph H. Finnegan
John M. Fleming
Donald Fodaski
James W. Garey
David G. Halmstad
Floyd S. Harper
A. Douglas Hitchcox
Edward F. Holtzman
Wilmer A. Jenkins
Aubrey L. Joyce
Harold F. LaCroix
George S. Ling
Robert H. Little
Pak H. Louis
Gladstone Marshall
Edmund M. McConney
Frederick P. Perkins
George W. Shelly
Armand Sommer
James H. Van Dyke
Dennis N. Warters
Walter Young
BUSINESS SESSION
REPORT OF THE TREASURER
JAMES O. WEBB

During 1977, the scope of Academy activities and services con-
tinued to expand. The increased need for communications ex-
pertise was met by adding to the Academy's Washington staff
Mr. Fred Hunt, now serving as Director of Communications and
Government Liaison. In addition, it was decided that the
nature and extent of Board activities could be served by paid
legal counsel in Washington -- and these arrangements were
made. At its last meeting, the Academy Board, following the
lead of the Casualty Society, and responding to a request from
the Actuarial Education and Research Fund, contributed $3,000
to the development of a textbook on the distribution of losses
by size. These and other activities, though unanticipated, of
course impacted upon Academy finances and upon various
functions associated with Treasurer's Office.

The Treasurer's Report will now selectively and briefly focus
on the areas of membership, fiscal 1977 results, a change in
our fiscal year, and budget projections, in that order.

Academy membership increased from 3,963 as of the end of
September, 1976, to 4,409 on October 31, 1977. This change
reflects a net increase of 213 members and 234 affiliates.

Income for fiscal 1977, which ended October 31st, was approx-
imately $315,000, which was $33,000 greater than projected.
Expenses were approximately $220,000, which was $21,000 less
than budgeted. The net result is an addition of $112,000 to
the Academy fund balances, bringing the total fund as of
October 31st, to $225,000. A substantial portion of these
funds will be used to offset normal operating expenses during
the next few months, when dues income is minimal.

The Academy fiscal year has historically been November 1
through October 31, presumably designed to coincide as closely
as possible with the Academy's annual meetings. On
September 14, the Board approved changing the fiscal year to
calendar year beginning with fiscal year '78. We believe that
this action will simplify our accounting efforts in that the
fiscal year and dues year will coincide.

An interim budget has been approved by the Board to guide our
fiscal affairs between November 1 and December 31. Dues in-
come is of course very low during this two month period; there-
fore, we are projecting a net operating deficit of approximately
$38,000, which will reduce our fund balances as of December 31st
to $186,000.
Detailed financial reports have been reviewed by the Board and will appear in the 1978 Academy Yearbook.

In summary, the Academy will begin the year in a sound financial position and with resources adequate to support its 1978 objectives and plans.
BUSINESS SESSION

REPORT OF THE EXECUTIVE DIRECTOR

STEPHEN G. KELLISON

My report today as Executive Director is intended to provide a summary of major operational activities of the Academy since the 1976 Annual Meeting. The scope and volume of Academy activities has grown substantially during the past year. In the limited time available this morning, I can only briefly mention some of the more notable Academy activities.

The Academy maintains offices in both Washington, D.C. and Chicago. The Chicago office is an administrative office jointly operated for the Academy, the Society of Actuaries and the Conference of Actuaries in Public Practice. Routine membership services are provided through the Chicago office.

The executive office of the Academy is located in Washington and serves as a focal point for other Academy activities. The Washington office is involved with a number of public outreach activities for the actuarial profession, such as government relations, relations with other professions, and public relations. Since the Academy represents actuaries in all areas of specialization and practice, the scope of activities is becoming increasingly broad. The Academy believes that a high degree of visibility in Washington is vital in achieving greater recognition for the actuarial profession and fostering greater awareness of actuaries and their role by a variety of external audiences.

During the past year, the Academy has greatly expanded its capacity in the communications area with the appointment of Fred Hunt as Director of Communications and Government Liaison. Fred is here at this meeting and I hope you will have a chance to meet him.

The Academy is becoming better known in Washington. For example, in October, Senator Talmadge, Chairman of the Senate Agriculture Committee, requested comments from the Academy concerning studies on crop and disaster insurance legislation. As a result, the Academy presented its third statement of the year on this subject just last week.

Other legislative proposals have also involved the Academy. A major statement was present to both Houses of Congress on Social Security Financial proposals. Also, a number of suggested changes in ERISA submitted by enrolled actuaries have been transmitted to the House Labor Committee, in response to an invitation from the Chairman, Congressman Dent.
A variety of statements to regulatory agencies have also been presented during the past year. Among these were statements to the Joint Board for the Enrollment of Actuaries on post-1975 standards for enrollment under ERISA, a statement to the Department of Labor on the regulations of multiple employer trusts, a statement to the Bureau of Health Insurance on regulations involving hospital malpractice reimbursement under Medicare, a statement to the Public Health Service on Health Maintenance Organizations and a statement to the Securities and Exchange Commission in connection with independence of auditors.

The Academy has also been active in dealing with other professions. For example, the Academy has had a substantial positive impact on the work of the Committee on Unauthorized Practice of Law of the American Bar Association in clarifying the relative roles of actuaries and attorneys. Similarly, a number of statements involving the accounting profession have been presented. Among these are two statements to the AICPA on the Property and Liability Insurance Audit Guide and on the Hospital Audit Guide in connection with medical malpractice, two statements to the Financial Accounting Standards Board on exposure drafts entitled "Conceptual Framework for Financial Accounting and Reporting" and "Accounting and Reporting by Defined Benefit Pension Plans", and finally, a statement to the Commission on Auditors' Responsibilities concerning independence of auditors.

Another Academy initiative of special significance is the report of the Academy Task Force on Risk Classification which was distributed last August. This important document provides valuable background on and information about the issues involved in this most important subject which is of universal concern to all actuaries.

Many other Academy activities deserve to be mentioned, such as committee initiatives in a number of areas and the continued development of Academy publications, but, unfortunately, time is running short.

In summary, it has been an exciting year for the Academy. Although progress has been made on a number of fronts, many challenges face us during the year ahead. The staff of the Academy wishes to thank the officers and the general membership for the outstanding support which we have been afforded during the past year. The dedication of actuaries to become involved in professional activities is the key to our future as a profession.
BUSINESS SESSION
NOMINATION AND ELECTION OF DIRECTORS

MR. WINTERS: I would now like to introduce the Chairman of the Nominating Committee, Mr. Daniel McNamara.

MR. DANIEL J. McNAMARA: The Nominating Committee takes great pleasure in placing in nomination five Members and one Affiliate for election to the Board of Directors, to serve for three year terms, as follows:

Alan C. Curry, F.C.A.S.
Charles E. Holm, Enrolled Actuary
George D. Morison, F.C.A.S.
Bartley L. Munson, F.F.A.A., F.S.A.
Alan Richards, F.S.A.
George B. Swick, F.C.A., A.S.A.

Each of these has agreed to serve if elected.

(It was moved, seconded and carried that the nominations be closed. It was moved seconded and carried that the Secretary cast a unanimous ballot in favor of the six nominees, and they were declared elected.)

The Nominating Committee will be pleased to propose to the incoming Academy Board, at its organizational meeting, the election of the following slate of officers, each of whom has agreed to serve if elected:

President-Elect Dale R. Gustafson, F.S.A.
Vice Presidents Preston C. Bassett, F.S.A., F.C.A.S.
Charles C. Hewitt, Jr., F.C.A.S.
Treasurer James O. Webb, Jr., A.C.A.
Secretary Dwight K. Bartlett, III, F.S.A.
BUSINESS SESSION
REPORT OF THE PRESIDENT
ROBERT C. WINTERS

The remarks I am about to make are in the nature of a report from the president, rather than a presidential address as we have come to know them in the Casualty Actuarial Society and the Society of Actuaries. The American Academy of Actuaries is the actuarial organization whose focus is uniquely the contact between our profession and the publics it serves or should serve. The responsibility of the Academy is to keep our inward and outward aspects in tune. Most of us spend most of our time -- quite properly -- working as actuaries within the actuarial profession. The role of the Academy is to frame that activity in a wider context.

That charge has increasingly broad acceptance. From the internal viewpoint, more and more actuaries see the Academy as serving an important need for them. Ralph Edwards in his report covered some of these accomplishments of the Academy in the past year. From an external viewpoint, the Academy is achieving increasing recognition, as Steve Kellison's report demonstrated.

The Academy is fulfilling its role with increasing effectiveness. We are growing and yet maintaining an awareness of the needs and concerns of members with differing backgrounds. For example, we are expanding our services to Enrolled Actuaries. There are 2535 Enrolled Actuaries in the U.S. today. Some 180 belong to no actuarial organization. Of the remaining 2355, 2056 are members or affiliates of the Academy. In other words, looking at those Enrolled Actuaries who are associated with any actuarial organization, the Academy represents seven out of eight. We are providing a growing range of services to these Enrolled Actuaries, services which thus far have been more than financed by the proceeds of the special meetings which the Academy and the Conference of Actuaries in Public Practice have sponsored for those members of our profession.

The Academy's role is operational, as distinguished from the preeminently educational and scholarly functions of other actuarial organizations. As an operational organization, the Academy should report to its members in those terms. We owe you a program of action and a report of our achievements toward those objectives.

That's what Ed Boynton and I will be presenting to you this morning. This is essentially a report of management to the owners. I will review the past year, and Ed will present his ideas for next year.
The program for this year's operation appears in the Journal of the 1976 Annual Meeting. This report on how the Academy carried out that program should make you proud of your profession and your Academy's role in it.

The program for 1977 covered two broad areas. First was the one which I have referred to as operational: maintaining the actuarial profession's public role. The pages of the Newsletter, the reports of Ralph Edwards and Steve Kellison, the special mailings you have received, document the Academy's performance in that arena. Last week we had a major example. For the first time the Academy entered a legal proceeding, as a friend of the court. The court was the Supreme Court of the United States, and the case is a potential landmark in the risk classification debate, the Manhart case. The focus is sex discrimination, but the issue is constraints on collective risk ventures to recognize class characteristics affecting risk. The brief was developed jointly by the Academy and the Society of Actuaries. It is a credit to our profession, and provides important insights to the Court -- unduplicated by the other briefs we have seen.

Our presentation is an outstanding demonstration of how the roles of the specialized organizations and the Academy complement one another. The Society identified the need for us to act and provided much of the content. As a matter of fact, Jack Bragg, who presented a paper here yesterday, was a key force in the Society's initiative. The Academy furnished the machinery for developing a first-class brief on massively complex issues in three weeks, and also contributed a broadened context to the framing of the issues.

I dwell on this example because I believe it dramatizes the operational effectiveness of the Academy today. If the Manhart case had come up five years ago -- perhaps even three years ago -- the actuarial profession would not, could not, have become involved. Today it can and does. That fact testifies to our collective progress; I believe it testifies particularly to the Academy's progress as the organization which focuses our relations with that broad public outside our profession.

That progress reflects the growth of the Academy, growth which came from the dreams and hopes and plans of the people who have been building it. Dreams and hopes and plans for change, for improvement. That was the second broad area of the program for 1977: where do we go from here?

The program identified three elements, in terms of continuing to search for better answers to these questions:

1. Who are we? Who is an actuary, and what is the role of the actuary?
2. How shall we organize ourselves -- as the Academy of Actuaries today, and in broader terms of the total profession tomorrow -- to fulfill our role and responsibility?

3. How shall we regulate ourselves? How shall we provide assurance to the using public that they can rely on our performance?

Let's review the year's performance on each of these areas.

1. Who are we? We are indebted to Bill Halvorson, the current President of the Society of Actuaries, for that succinct expression of the issue. Taken in its future sense, who should we be, it states the primary concern of our profession. Taken in its present sense it summarizes a central issue of the Academy.

Two years ago the question took the form, are Enrolled Actuaries...actuaries? The Academy said yes. Actually, we said yes, but. We said yes, but the status of Enrolled Actuary is not alone sufficient to qualify an individual to be a Member (capital M) of the Academy.

We are now rethinking that answer. Ralph Edwards reported on the extensive Board discussions last Saturday on the subject of categories of membership. The decision which the Board reached is that we should ask the profession at large to join in these discussions. In asking for these broader discussions the Board made three commitments:

1. We will carry to the membership of the profession the thinking that we have been doing. We believe that we have identified a direction in which the Academy should be moving, but we arrive at that tentative conclusion after long discussion. We owe it to others to share that discussion.

2. We will listen to what other members of the profession have to say. The issues are not easy, and the judgment of the Board is by no means unanimous. We need the thoughtful reactions of other actuaries.

3. We will not of our own initiative take any action on these issues until the opportunity for a year's discussion has passed. I say of our own initiative in recognition of the possibility that external forces may require some recommendations from the Board in less than a year. But subject to that caveat, it is our determination to engage the broadest possible examination of what -- if anything -- we should do.
We recognize a responsibility to provide some initial direction for these discussions. The Board proposes as a basis for discussion a broadening of the Academy's umbrella. I want to say again that we have reached no conclusions. We need to know how the members of our profession think. But to kick off the discussions, we propose the following propositions:

* The Academy should have only one category of membership. We should represent everyone who has reasonable grounds for a claim to actuarial practice. Virtually all of us have limitations on our actuarial qualifications. But no matter how broad or limited an individual's qualifications may be, if they include a domain of actuarial practice the Academy should offer membership.

* Our requirements for membership should be based on a combination of education, experience and qualifications in a particular specialty. Tentatively, the Board believes that the education requirement is satisfied by completing the Associateship examinations of either the Casualty Actuarial Society or the Society of Actuaries. We also believe that for purposes of ERISA, these requirements are satisfied by meeting the standards to become an Enrolled Actuary.

2. How shall we organize ourselves?

I'm not going to comment much on this item. It has been partly covered by other reports at this meeting and will be the subject of a panel discussion tomorrow morning. The answer is to some degree implied by my remarks in connection with Item 1 and will be touched on again in the next item. This past year has been a busy one, the earlier part of it being largely preparation for some fairly rapidly developing possibilities which have emerged in the last few months. I suspect that the course will continue that way. We will see periods of apparent inactivity, while committees are dealing with some of the issues, followed by periods of quite visible progress. As one indicator of progress, I was very pleased by the development which Dave Hartman reported earlier today of the joint meeting of the Casualty Actuarial Society and the Society of Actuaries.

3. How shall we regulate ourselves?

The Academy has authorized a committee to study the requirements of professionalism. While any short statement of that committee's charge unduly circumscribes what we are looking for, our concern centers on the answer to that question.

The issues are not easy. As a private organization there is serious question of our legal capacity to regulate ourselves. We also need to take a hard look at the procedures by which
we develop constraints on the freedom of individual actuaries to practice their profession. I believe that I have the right, just as every one of you does, to ask: By what warrant does the actuarial profession tell me that I must do this, or that I may not do that? I also believe that as a public profession we do have the warrant, but it must be exercised thoughtfully.

It seems clear that self-regulation can work effectively only if all actuaries are subject to a single code of conduct and a single standard of discipline. That review is one reason for the Board's proposal on categories of membership.

In that connection a separate but related action of the Board last Saturday will be of particular interest to this group.

I would like to quote an extract of a resolution which the Board approved in that meeting:

That the Academy emphasize and communicate to its members:

a) A Member who undertakes an assignment in a risk category (e.g., casualty, life, pensions or property insurance) or in an area of actuarial theory or practice in which he is not clearly qualified by training and experience, may be subject to investigation and possibly penalty as the result of a complaint by another member or on the initiative of the Committee on Discipline.

b) Certain classes of insurance are clearly property/casualty lines and assignments in these areas are generally most appropriately undertaken by members of the Casualty Actuarial Society.

c) There is a need for an awareness of the possibility that, however unintentional, the use of a designation may mislead or misrepresent an individual's qualifications. No initials other than ACAS or FCAS serve as prima facie indication of professional actuarial qualifications in property/casualty matters.

So to summarize this report of management on the past year, it has been a year of real achievement. In our operational responsibilities we have advanced effectively the role of the actuarial profession. In looking towards the future we have made a substantial foundation for progress. Some items -- for example independence -- have been substantially completed. Others have moved forward, and some have scarcely begun.

That means there is still plenty of challenge left for the incoming administration. Before I introduce the man who will head that administration, I would like to make two other comments.
First, the Academy is extraordinarily well-served by its members and by its numerically limited staff. The officers, the Board, the committee chairmen and the committee members have contributed enormously to our profession. The enumeration of their accomplishments would be tedious, but they are great. I have had the opportunity to view what they are doing, and I can assure you that they do all actuaries credit. I would single out two: Ed Boynton, our President-to-be in another fifteen minutes, and Steve Kellison, our Executive Director. Any designation of individuals is unfair because it excludes others. But I think we should acknowledge a particular debt to the performance of these two individuals over the past year.

Second, on a much more personal note, I have been deeply honored by the opportunity which I have had this year. The job of the president in any of the actuarial organizations today is a very demanding one. But speaking on my own behalf, it is also enormously rewarding. It has meant a lot of work, but it has also been a lot of fun and a very satisfying opportunity to repay to our profession some part of the debt which I feel I owe it.

Darrell Ehler in his Secretary's Report this morning said, "The challenges have not changed, but we have made progress." I feel exactly the same way on behalf of the Academy of Actuaries and I am very pleased to introduce to you the man to carry forward our response to those challenges: Ed Boynton.
BUSINESS SESSION
ADDRESS OF THE PRESIDENT-ELECT
EDWIN F. BOYNTON

The past year has been a year of continued strengthening for the Academy. Under President Winters' leadership, the Academy has moved ahead in many areas - not the least important of which is a clearer concept and definition of the proper role of the Academy in the future of the profession in the U.S.

For a few minutes this morning I want to talk about some of the challenges being faced by the Academy in both the short term and long term which the Academy Board will be considering in the next year.

The Academy was not originally designed to produce direct services to its membership such as educational material, examinations, research studies, professional meetings and the like. However, in order to respond to the needs of the actuarial profession, we have moved into this area partially - by providing services to enrolled actuaries - in order to provide a service that no other organization was ready to fill. Unlike our meetings and other services for enrolled actuaries, most of the "services" of the Academy tend to be almost invisible to its members ... but vitally necessary. For example, the Washington office staff is in constant touch with a wide variety of government organizations in Washington - monitoring all those activities which seem to relate to the profession. Much of this activity may require no immediate or direct action by the Academy, but is all very necessary if the Academy is to remain alert to situations in which the government should be made aware of the actuarial implications of its activities.

Although the Academy is primarily an externally oriented organization, those external activities - the "interface" with the public if you will - can only come about through the development of an effective internal structure, an area in which our retiring president has devoted considerable energy with great success. In addition, the Academy has other problems, internal to the organization and inherent to the profession, which arise in any professional membership organization - those dealing with membership requirements, professional conduct, principles of practice, and discipline of those members who trespass against the rules of conduct.
Let me touch briefly on some of those challenges we face in the next few years which are of an internal nature — if not for the Academy, then for the actuarial profession generally.

1. RESTRUCTURING

First and foremost is the restructuring of the profession that President Winters has already touched upon. I cannot emphasize too strongly the importance of this step. Whether the profession in the U.S. will ever achieve full recognition as a profession, say, to the extent that the legal and accounting professions have in the United States, or that the Canadian Institute of actuaries has in Canada or the Institute of Actuaries in the United Kingdom, is less than certain. As an example of the prominence of the Institute in Great Britain, I have just returned from the Biennial Dinner of the Institute of Actuaries in London. The featured speaker was the Chancellor of the Exchequer. In attendance were the heads of most of the government agencies involved in commerce, industry and finance, as well as major industrial and financial leaders in England and Scotland. The recognition given the Institute at this formal dinner was impressive.

It is not certain that we can ever achieve the same degree of professional recognition in the United States because of the different political, economic and social environment in which we operate. In the past several years, however, I have had a fair degree of exposure to the problems of representing the Academy to the public. In my opinion, we can never hope to achieve a satisfactory degree of recognition as a profession in the United States until we can speak with one voice. This audience today is somewhat unique — in probably no other country is there an organization that is comparable to the Casualty Actuarial Society. But your Society is a significant part of the actuarial profession in the United States and a very important link in any restructuring. There are great advantages in being part of an autonomous, closely knit organization such as the Conference of Actuaries in Public Practice, the Fraternal Actuarial Association or the C.A.S. It is necessary that the advantages of a smaller, more informal organization can be preserved in the restructuring and that is certainly one of the objectives that will be kept in mind. However, to my mind, if we
are to survive as a profession, it is imperative that we simplify the structure of the profession, in the United States, even if it does involve trading-off some of the advantages of the separate organizations.

2. MEMBERSHIP REQUIREMENTS

President Winters has already covered rather adequately the proposed changes in the membership requirements which were discussed by the Board on Saturday. It is pertinent that the events which have triggered this discussion are directly related to problems of the Casualty Society. One of the critical areas is whether the supply of qualified casualty actuaries will meet the demand of state regulators, and the proposed change in membership requirement of the Academy will help solve the problem. If it does not then there may be more serious problems for both the Academy and the Casualty Actuarial Society. I need only remind this audience that one of the underlying problems that led to the present situation with respect to the standards for enrolled actuaries was the belief (probably correct) that there was an insufficient number of qualified pension actuaries to meet the qualification needs of ERISA. The answer by the government was simple from their standpoint ... lower the standards sufficiently to assure an adequate supply.

That is not a very satisfactory answer for the profession.

3. PROFESSIONAL CONDUCT AND DISCIPLINE

As the Academy and the profession have begun to achieve greater recognition, and greater responsibility under state and federal laws, our guides to professional conduct have become increasingly important. In the past few years, the number of alleged violations of those guides and principles of practice seems to be on the increase. If we are to be self-assertive and call ourselves a profession, we must stand behind the guides and principles and be ready to enforce them against the relatively few violators.
Many of the violations are innocent and such problems can be resolved rather easily. Some are more serious, and, like the action taken with respect to two actuaries involved in the Equity Funding scandal, may require the ultimate step of expulsion. Enforcement of our guides to conduct may be the single most important step to achieve credibility as a profession.

Let me switch over now to the other area - the external problems facing the Academy in the coming months. The list is by no means complete, but merely illustrative of the kinds of activities in which the Academy is involved.

1. OPINIONS ON CASUALTY LOSS RESERVES

I certainly do not need to describe this situation to this audience since you are all aware of the likelihood that opinions on the sufficiency of loss reserves for casualty companies will be required in the relatively near future. The panel immediately following will cover this in some depth.

2. RELATIONSHIPS WITH THE JOINT BOARD FOR ENROLLMENT OF ACTIVITIES

As most of you are aware, the situation with respect to many of our recommendations to the Joint Board established under ERISA has been less than satisfactory. This has been particularly true with respect to the post '75 enrollment standards. I might say that the "we" in this case includes not only the Academy, but the Society of Actuaries, the Casualty Society, and the Conference of Actuaries. We are unable to convince the Joint Board to accept any of the pension exams of the Society prior to those in 1976, and unable to get advance approval of future examinations. Unfortunately, the problems are compounded by the fact that the Society examinations have just gone through a major restructuring which is incompatible with the type of structure that would be suitable to meet the needs of the Joint Board. In the coming years, the Academy will stay in close contact with the Joint Board, and attempt
to convince them of the desirability of advance approval of the Society exams. More importantly, we will continue to encourage the Board to keep the examination standards of the Board at a high level.

3. RELATIONSHIPS WITH THE LEGAL PROFESSION

In the past year or so we have worked closely with the Committee on Unauthorized Practice of Law of the American Bar Association, in connection with the revision of its guides on the Unauthorized Practice of Law in Employee Benefit Planning. The Academy input played a major role in producing a much more realistic guide in this area. As a further step toward building a working relationship with the legal profession, we have recently been advised that the American Bar Association has agreed to establish a standing Conference (or Liaison Committee) with the actuarial profession. This will be similar to the Liaison Committee established with the AICPA a few years ago, which has been of great help in getting interprofessional problems identified and discussed in an open and cordial manner.

4. RISK CLASSIFICATION

I hope you have all read the fine report of the Academy's Committee on Risk Classification. It sets forth the problems relating to potential legal restraints on risk classification schemes which have enormous implications for the insurance industry, both life and casualty. The Academy must undertake a vigorous educational program to convince legislators, regulators and the judiciary that to prohibit some of the present classifications schemes based on age, sex and other factors would seriously undermine the entire foundation of the insurance industry and is clearly not in the public interest.

5. RELATIONSHIPS WITH THE ACCOUNTING PROFESSION, THE FINANCIAL ACCOUNTING STANDARDS BOARD AND THE SECURITIES AND EXCHANGE COMMISSION.

I have grouped these together because they are all interrelated, even though each of the three problem
areas must be dealt with separately. The general problem of the division of responsibility between the actuarial and accounting professions in the pension area is certainly one of our most urgent and perplexing problems. The exposure draft of the FASB relating to accounting for defined benefit plans touched off a controversy which had been simmering for a long time. It remains a very fundamental issue for the entire actuarial profession - not just pension actuaries. The issue is whether the responsibility for the determination of actuarial assumptions and methods will lie with the actuary or somewhere else. The Academy has responded emphatically that these are actuarial responsibilities and should not be set by an accounting standards board. We anticipate that this dialogue with the FASB will continue in the next year.

A glimmer of hope lies in the Academy's Liaison Committee with the AICPA. There is evidence from recent meetings that some progress is being made in convincing the AICPA that a possible way out is for the accounting profession to be able to express reliance on actuaries in their opinion paragraph without making it a qualified opinion. This single step would resolve many of the controversies now existing between the two professions.

There are a number of other areas of interest and activity of the Academy that call for considerable time and energy on the part of the staff, the Officers, the Board and the Committees.

In these few minutes I have simply tried to outline for you a few of the difficult, practical issues which the Academy is addressing. It is quite likely that we succeed totally in some of these endeavors, achieve partial success in a good many of them - and - perhaps, fail in achieving ideal objectives in others.
For any actuary who is accustomed to arriving at a unique and total solution to each problem, this is a difficult thing to admit. In our jobs, working largely in a technical area, in an environment that we understand and at least partly control, the success rate is high. Most of the problems with which the Academy deals, however, are related to the real world of public policy considerations and practical politics where we have considerably less influence over the final decision. Accordingly, while the Academy and the actuarial profession, in general, must continue to make our voices heard on public issues involving actuarial considerations, we must recognize that many of the problems in which we have an interest involve other considerations which will affect final decisions. In responding to these issues, we must keep in mind the interest of the various publics which the actuarial profession serves, and not just the self-interest of the actuarial profession. In short, if we want to be professionals, we must act like professionals and serve the public interest.

MR. WINTERS: Thank you, Ed, I think you can all see that the Academy is in good hands.

I now declare this Annual business meeting of the American Academy of Actuaries adjourned. We will play some marching music while we change the scenery for the panel presentation.
ACTUARIAL OPINIONS ON LOSS RESERVES
FOR CASUALTY COMPANIES

Moderator: DALE R. GUSTAFSON. Panelists: ROBERT A. BAILEY,
JAMES R. BERQUIST, DALE A. NELSON

MODERATOR DALE R. GUSTAFSON: This discussion will be based
on a questionnaire sent out by the NAIC Examinations (A5)
Subcommittee on the "Certification and/or Evaluation of Loss
Reserves". It is not the intention of this panel to insert
itself into the processes and deliberations of the NAIC either
speaking for itself or for the Academy or the Casualty
Society. Rather, we simply want to use the very fine question-
naire developed by the NAIC as the basis for our discussion.

It should be pointed out that while the NAIC used the term
certification and it will be appearing in our discussion as
well, it is preferable and more accurate to describe what we
are discussing as a Statement of Actuarial Opinion rather than
as a Certification.

The format of the following material is different from the
oral presentation for clarity. The substance is the same. In
the actual discussion, we discussed each question in turn,
but we believe some of the key points will be more easily
understood in this somewhat more formal structure.

First will be a general introductory statement prepared by
Mr. Bailey followed by a set of answers to the NAIC question-
naire by Mr. Berquist. Finally a set of answers prepared by a
special committee for the Casualty Actuarial Society's Board
will be presented. Dale Nelson, our third panalist, was a
member of that special committee and his oral discussion
essentially followed this material.

The following sentence appears in the CAS cover letter sub-
mitting the answers of this special committee to the NAIC:
"This material represents a consensus of the committee members' views - not necessarily those of the entire Board - and is
being submitted so that our thinking will be available to your
Subcommittee for its deliberations on this material."

It was not our intention to reach a consensus and you will see
that we didn't, although there is a broad base of general
agreement.

ROBERT A. BAILEY: The discussion at the American Academy of
Actuaries meeting in Boca Raton regarding actuarial opinions
on loss reserves of casualty companies, and especially the
questions of who should do it and how it should be done, made
it clear that the subject is not simply a matter of actuarial
principles and practice. It is complicated by the interests
of the many parties involved. Perhaps it would help us understand what the issues and problems are if we attempt to state the interests of the various parties -- the insurers, the regulators, the employed actuaries, the consulting actuaries, and last, and unfortunately also least, that nebulous abstraction, the actuarial profession.

The insurers want to retain the maximum flexibility to use the uncertainty associated with loss reserves as an area within which to manipulate their loss reserves, so as to stabilize reported profits and reported surplus and to minimize the impact of federal income taxes.

The regulators and the publics they serve want reliable information about the reserves and the degree of uncertainty about them so that the impact of the reserves and their associated uncertainty on profits and surplus can be evaluated.

The employed actuaries want to be eligible to provide an actuarial opinion if one is required. They believe they are more familiar with company practices that affect reserves than an outside consultant would be. Their eligibility would enhance and protect their role and status within their company. But they wish to avoid any conflict with their employers' desire to use the area of uncertainty as an area for manipulation.

The consulting actuaries want to be eligible and in fact believe they should be preferred over employed actuaries. They believe they are able to be more independent than employed actuaries and are able to draw on their experience with the reserves of a number of clients to help them gain a better perspective in dealing with each particular company. Consulting actuaries have been active in the loss reserve area and would like to become more active. They have successfully learned to deal with the range of uncertainty by estimating what the upper and lower bounds of that range are in many of their opinions.

But what of the actuarial profession? Does it have any interest in loss reserves as a profession? If it does, the voice of those who espouse it is hardly audible over the din of all the rest of us so busily espousing our own interests.

The statement by Ruskin often quoted by actuaries, "The work of science is to substitute facts for appearances and demonstrations for impressions" is quite appropriate for the actuarial role in loss reserves. Should not the actuarial profession's position be that loss reserves and the degree of uncertainty associated with them should be evaluated by competent professionals, namely actuaries? And shouldn't actuaries be the ones to establish the standards and principles, the content and scope of an actuarial opinion? Do we need to wait for company managements or government or accountants to tell us what we should do? We obviously have waited for a very
long time with the full knowledge that the public interest is not adequately served by the present hodgepodge in loss reserving.

Loss reserving is about as actuarial as any work can be because it involves an estimation of an unknown quantity which is subject to future contingencies (inflation, court settlements, etc.), based on past experience and informed judgment. But if estimating the value of unpaid claims is actuarial, certainly the appraisal of the degree of uncertainty associated with that estimate is at the very core of actuarial work. What could be closer to the theory of risk? If we succeed in avoiding the appraisal of the uncertainty in loss reserves, by simply stating that in our opinion the reserves are "reasonable," which means, I suppose, that the reserves have a 50% likelihood of being inadequate, don't we leave a vacuum to be filled by some other profession? Don't we surrender an important area of actuarial work to be done by someone who may eventually treat actuaries as clerks whose role is to prepare worksheets for analysis by others? Or do we think the public will be satisfied with no information on what the range of results are likely to be for unpaid claims, and where the company's reported reserve and surplus stand in relation to that range?

While we have waited due to conflicting pressures on actuaries as to what our role should be, another profession, the accounting profession, has actively sought a role in evaluating casualty loss reserves. After 11 years of experience since the publication of the first AICPA audit guide for casualty insurers in 1966, the accountants are amplifying and improving their audit guide with special attention to loss reserves. Accountants are already rendering opinions on about half of all casualty insurers, with very little actuarial involvement.

However, the accountants have not adequately dealt with the range of uncertainty in the loss reserves. They simply state that the reserves are "fairly" presented. The range of uncertainty can be material. In recent years, several major insurers have teetered on the brink of insolvency because their reserves, although "fairly" presented in the opinion of the CPA's, were subject to an undisclosed range of uncertainty that nearly wiped out their capital and surplus. So a need for more complete information still exists in an area which is clearly actuarial. But if the actuarial profession does not actively seek to fill that need, it will surrender another area of actuarial work to the accounting profession.

How we as actuaries respond to this complex situation will be a measure of our profession.
JAMES BERQUEST: 1. Who can best evaluate and certify the accuracy of loss reserves for state insurance regulatory authorities?

It is my belief that independent actuaries can best evaluate the accuracy of loss reserves for a casualty company only after indepth and lengthy analysis of the available data. Preparation for that analysis must include the development of a thorough understanding of the company's reserving and claims handling procedures as well as their data processing procedures. While both company and consulting actuaries are able to perform such analyses, the consultant has the advantage of an independent perspective.

2. What methods would they use?

Methods should include the estimation of total incurred losses both known and unknown. They should be statistical in nature but tailored to the data which has been carefully prepared by knowledgeable data processing and claims personnel. I believe it is necessary to utilize several actuarial estimating methods to predict the most likely reserve. Recognition must be given to the fact that no reserve estimation process can be precise! Therefore, the public and regulators alike must learn to accept "most probable estimates".

3. What would be the content of their opinion?

I believe the opinion should state that the actuary is presenting his best estimate of the ultimate incurred costs. However, his opinion must be written such that it does not imply a certainty with regard to the results developed.

4. How often should it be done:

I believe the public could be protected by in-depth independent reserve adequacy studies performed every two or three years by an independent actuary and updated by company personnel during the interim periods. (As a matter of fact, a number of our clients prefer annual and even quarterly analyses.)

5. Which insures should it be applied to?

I believe that all insurers should be subject to the independent reserve analysis. However, it must be recognized that statistical analysis becomes somewhat questionable for the very small companies. However, as a matter of practice, we have analyzed outstanding reserve liabilities of companies with liabilities less than one million dollars. In these situations, however, we have
insisted that our clients understand that the probability that our estimates are correct is decreased and, therefore, a larger range of potentially correct value around the best estimate is to be expected.

6. How can such certifications be best coordinated with state examinations?

Presumably, an independent reserve evaluation could become a part of the tri-annual examination procedure.

7. Is a certification from an independent auditor preferable to that of an employee?

I personally have great respect for the abilities of most of the independent auditing firms. I do believe, however, that loss reserve analysis is outside the field of expertise of most auditing firms. The only exceptions are those who have developed a staff of competent casualty actuaries. I further feel that actuaries employed by an independent actuarial firm are likely to be able to form more accurate and independent judgments than would be possible if those same actuaries were employed by an auditing firm.

8. Should the NAIC or its members adopt new or additional instructions regarding methods of evaluating the accuracy of loss reserves and the content of the certification?

If the members of the NAIC were to agree with the foregoing answers, then it would be necessary to develop appropriate instructions and regulations. The content of the actuaries' statement must be sufficiently binding but yet must recognize the variability inherent in such estimates.

9. How can insurance regulators best cope with differences that may occur between the amount of loss reserves reported to state insurance regulatory authorities and the amount reported to investors, policyholders and agencies of the federal government (e.g., SEC, IRS)?

I believe a form could be developed which would require companies to reconcile outstanding loss reserves reported in any public document issued by the company. For example, it could easily reconcile differences between the annual statement reserves and those reported to the SEC.

10. Any other pertinent comments?

The NAIC is to be congratulated for addressing this very difficult, important and ponderous problem of our industry. I am confident that rational approaches can be found which will be beneficial not only to the public (policyholders), the insurance commissioners who represent that public, but also to company managements and
investors as well. It will be necessary, however, to avoid the temptation to require absoluteness where none exists. It must be remembered, at all times, that payments for losses currently incurred will be affected by economic and social forces not yet precisely known. Thus, the best that can be hoped for is a statistical estimate of the effects of likely assumptions of those forces on current reserves. A simple example may help to clarify this point. Some Workers Compensation statutes already provide for the increase in future benefits in proportion to changes in various economic indices such as the CPI. While we can estimate those indices for the next few years, it is not possible to estimate them with a high degree of precision. Thus, it is not possible to precisely state the reserve which will be required for those payments.

DALE A. NELSON: 1. Who can best evaluate and certify the accuracy of loss reserves for state regulatory authorities?

Loss reserve evaluation and testing involves the analysis and projection of stochastic quantities, rather than accounting type items. Because of their training and examination in these areas, we feel that actuaries as a group are best equipped to handle these tasks. More specifically, members of the American Academy of Actuaries or the Casualty Actuarial Society who have passed the examinations prescribed by those bodies in the areas of casualty insurance coverages, ratemaking, and reserving (Parts 5, 6, and 7 of the current Society Syllabus) and who have experience in reserving seem to be the persons best qualified to evaluate loss reserves and render opinions concerning them.

In this connection, we must emphasize that any certification will necessarily be a "statement of opinion" - no more, no less. We do not believe it possible for anyone to certify, in any absolute way, as to the accuracy of loss reserves.

2. What methods would they use?

At the present time, beyond certain general principles, there are few methods available for establishing or evaluating reserves. It is still pretty much a matter of individual judgment. Accordingly, about all that can be expected is that the methods be based on reasonable assumptions and be applied consistently in accord with sound reserving principles.

Over the longer-term, the practitioners and professional organizations such as the Casualty Actuarial Society will need to conduct extensive research and analytical studies.
in the area of loss reserving, working towards the development of improved methods of reserving and testing, including the design of appropriate data bases.

3. What would be the content of their opinion?

Unlike the policy reserves being certified in Life Statements, casualty loss reserves are generally not calculable within very close limits of tolerance. The current state of the art is such that it would be impossible to certify in any absolute way as to the methods used or to the accuracy of the results. All that can practically be expected is that the individual signing the statement would offer his or her opinion as to the reasonableness of the reserves.

4. How often should it be done:

The primary purpose for any certification requirement, we feel, is to assist the Insurance Commissioners in regulating for solvency, specifically by resulting ultimately in improved reserving procedures by the individual insurers. Thus, an annual certification, in connection with the filing of the Fire and Casualty Statement, seems most appropriate.

5. Which insurers should it apply to?

Certification requirements should be applied to all companies. However, since most companies do not have actuaries on their staffs, and there are probably no more than 100 consulting casualty actuaries, it may be necessary initially to limit the requirements to a selected number of companies. For this purpose, we would suggest that a dual criterion be used, based on size (e.g., those companies having $25 million or more of Schedule P reserves) and solidity (e.g., any other company considered as Priority under the NAIC Early Warning System). We feel this would best serve the interests of the public, the industry, and the regulators until such time as the supply of qualified actuaries meets the demand.

6. How can such certifications be best coordinated with state examination?

We believe the certifications should be made in connection with the annual filing of Fire and Casualty Statements, and be independent of the examinations. The periodic examinations would, of course, serve as a means for reviewing and evaluating these certifications.
7. Is a certification from an independent auditor preferable to that of an employee?

Not necessarily; an adequate review and analysis of the reserves requires an intimate and detailed knowledge of the company's reserving practices as well as its claim handling and related operations. This generally would require either an employee with responsibilities in these areas or an outside consultant who works closely with the company on such matters.

On the other hand, an independent review by an outside individual would offer an element of objectivity and credibility to the opinion which would not otherwise be possible.

7(a). Would your answer be substantially the same whether or not the independent auditor was the same one retained by the company for other purposes?

Yes.

8. Should the NAIC or its members adopt new or additional instructions regarding methods of evaluating the accuracy of loss reserves and the content of the certification?

As indicated in our responses to the earlier questions, we feel it would be premature at this point to specify detailed requirements regarding the methods to be used or the content of the certification itself. Much work remains to be done by the regulators and industry, jointly, to develop meaningful and reasonable guidelines and instructions.

For the present, the requirement should be simply a statement as to the reasonableness of the overall reserves, attested to by a competent individual.

8(a). If so, briefly outline your views as to the nature and scope of such instructions.

Specifically, we would suggest a statement, signed by a qualified actuary, that

"In my opinion the actuarial items shown on the balance sheet

(i) are based on reasonable assumptions, consistently applied in accord with sound actuarial principles,

(ii) make reasonable, but conservative provision for all actuarially determined reserves and related statement items which ought to be established, and

(iii) meet the requirements of the insurance laws of (the state of domicile)."
For this purpose we would consider the actuarial items as including the reserves for unpaid losses and loss adjustment expenses and, to the extent these require actuarial determination, the reserves for unearned premiums and policyholder dividends.

9. How can insurance regulators best cope with differences that may occur between the amount of loss reserves reported to state regulatory authorities and the amount reported to investors, policyholders and agencies of the federal government (e.g., SEC, IRS)?

Since the various reports are intended for different purposes, we do not believe this problem can be solved by the adoption of uniform reporting requirements common to all reports. The Fire and Casualty Statement should reflect the requirements of the regulatory authorities charged with responsibility for maintaining the solvency of companies.

The problem is also somewhat broader than that of loss reserves; and the industry and regulators would be better served by promoting the idea that different reports are needed to measure different aspects of the insurance operation, emphasizing that these reports are based on a common source of data and generally trying to defuse the argument that companies operate using different "sets of books".

10. Any other pertinent comments?

At the present time there is not a sufficient number of actuaries qualified to certify the statements for all companies. There are some 2,000 property and casualty companies; but only about 100 have staff actuaries, and there are fewer than 100 consulting actuaries in the field. As the following table shows, the casualty actuarial profession has been growing rapidly in recent years, but it will be a number of years before the supply of qualified actuaries can meet the anticipated demand.

Membership of the Casualty Actuarial Society

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However, rather than solve this "numbers" problem by artificially increasing the apparent supply of qualified individuals by establishing a new category of "enrolled actuary", as was done by the federal government in connection with ERISA, we strongly urge that any certification requirements be initially limited to a selected number of companies, as suggested in our response to Question 5.

The Casualty Actuarial Society is prepared to assist in whatever way it can to help establish meaningful certification procedures. As reported in President Morison's letter of August 26 to Commissioner Bell, our Committee on Loss Reserves is already at work on preparing a compendium of loss reserving techniques and problems, hopefully culminating in a set of generally accepted reserving principles. Our Committee on Financial Reporting stands ready to help in preparing instruction and guidelines for use in certifying.
INTRODUCTION

Each year's Journal includes the full text of the Statements released by the Academy in that year. Although most of the Statements are self-explanatory, knowledge of the circumstances giving rise to the Statement helps provide perspective. The following Summary of Statements section provides background information, including any cross-references to previous Statements. For purposes of cross-referencing and indexing, Statements have been assigned numbers by calendar year and by order of release in that year, e.g., 1977-1 was the first statement released during 1977. The summary also gives the page number on which the full text begins.

Statements made before 1977 were not compiled, but copies of such statements may be requested from the Executive Office of the Academy, Suite 515, 1835 K Street, N. W., Washington, D. C. 20006.

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Statements of the Academy are not expressions of official positions embraced by the membership as a whole. Rather, they are intended as relevant responses to situations which appear to require a professional statement on actuarial matters.

SUMMARY OF 1977 STATEMENTS

Index Code: 1977-1
To: Department of Labor Advisory Council
Date: January 5, 1977
Length: 4 pages beginning on page 49
Concerning: Relative roles of actuaries and accountants under ERISA

Background: This proposal dated January 4, 1977, was presented at a January 5 meeting of the Department of Labor Advisory Council on Employee Welfare and Pension Benefit Plans. Certain recommended changes in Section 103 of ERISA were presented for consideration of and possible endorsement by the Advisory Council. These proposed statutory changes were designed to clarify the relative roles of actuaries and accountants under ERISA. The memorandum dated January 18, 1977 which follows
provides more background on this matter together with the proposed statutory changes.

Drafters: The proposal was prepared by Preston C. Bassett, the Academy representative on the Advisory Council. Mr. Bassett's proposal had been reviewed and commented upon by an extensive mailing list of interested actuaries.

Index Code: 1977-2

To: American Bar Association
Date: February 3, 1977
Length: 10 pages beginning on page 53
Concerning: Unauthorized practice of law

Background: This statement was submitted in response to the November 24, 1976 draft, prepared by the Standing Committee on Unauthorized Practice of the Law of the American Bar Association, entitled "Proposed Opinion on Employee Benefit Planning." This draft followed public hearings held by the ABA Committee on April 3, 1976. The Academy submitted a statement at the April 3, 1976 hearings, as well as a second submission dated April 28, 1976. The ABA Committee subsequently issued its final Employee Benefit Planning Informative Opinion A of 1977 on May 1, 1977, which is now in effect.

Drafters: A special task force chaired by Blackburn H. Hazlehurst

Index Code: 1977-3

To: American Institute of Certified Public Accountants
Date: February 17, 1977
Length: 4 pages beginning on page 63
Concerning: Hospital audit guide/medical malpractice insurance

Background: This letter was submitted to the AICPA in connection with proposed revisions in the Hospital Audit Guide. The comments were directed toward the treatment of medical malpractice insurance in the audit guide.

Drafters: Prepared by the Committee on Property and Liability Insurance Company Financial Reporting Principles chaired by Paul E. Singer, the Academy submission was commented on also by other interested actuaries.
SUMMARY OF 1977 STATEMENTS

Index Code: 1977-4
To: House Committee on Agriculture
Date: March 15, 1977
Length: 3 pages beginning on page 67
Concerning: Crop insurance
Background: This statement was submitted at a public hearing on crop insurance programs held by the Subcommittee on Conservation and Credit of the House Committee on Agriculture. The hearings were general in nature and not directed toward any specific proposed legislation.
Drafters: Executive Director Stephen G. Kellison in consultation with members of the Academy Executive Committee

Index Code: 1977-5
To: Joint Board Advisory Committee
Date: March 21, 1977
Length: 6 pages beginning on page 70
Concerning: Adequacy of organizational examinations for enrollment
Background: This statement was submitted at a public meeting of the Advisory Committee on Joint Board Actuarial Examinations. The Advisory Committee was in the process of developing its recommendations to the Joint Board concerning post-1975 standards for enrollment under ERISA. The Academy had previously made extensive comments on post-1975 enrollment standards during 1976 to the Joint Board. A statement on behalf of the Society of Actuaries was also submitted at this meeting.
Drafters: Executive Director Stephen G. Kellison

Index Code: 1977-6
To: Financial Accounting Standards Board
Date: March 25, 1977
Length: 5 pages beginning on page 76
Concerning: Accounting and reporting by defined benefit pension plans
Background: These comments were submitted to the FASB in response to an FASB request for a critique of the Hall-Landsittel method of
determining accrued liabilities under defined benefit pension plans for purposes of the financial statements of the plan. The FASB had been studying accounting for defined benefit pension plans during 1976 and the Hall-Landsittel method had been presented to the FASB in connection with their deliberations. Messrs. Hall and Landsittel are with the firm of Arthur Andersen & Co.

Drafters: President-elect Edwin F. Boynton

Index Code: 1977-7

To: Joint Board for the Enrollment of Actuaries

Date: April 13, 1977

Length: 3 pages beginning on page 81

Concerning: Annual review by OMB

Background: This statement was presented to the Joint Board in connection with the annual review of the Joint Board Advisory Committee by the Office of Management and Budget. Annual reviews of all advisory committees were instituted by the Carter Administration.

Drafters: This statement was jointly prepared and signed by representatives of the American Academy of Actuaries, Casualty Actuarial Society, Conference of Actuaries in Public Practice, and Society of Actuaries.

Index Code: 1977-8

To: Department of Labor

Date: April 20, 1977

Length: 2 pages beginning on page 84

Concerning: Multiple employer trusts

Background: This statement was presented at a conference on multiple employer trusts (METs) held by Department of Labor. The preemption of state law by ERISA created uncertainty about the regulatory environment for METs. The purpose of the conference was to comprehensively discuss a number of problems involving METs including the relative roles of Federal regulation under ERISA and state regulation of insurance.

Drafters: Executive Director Stephen G. Kellison
SUMMARY OF 1977 STATEMENTS

Index Code: 1977-9
To: Cost Accounting Standards Board
Date: May 16, 1977
Length: 3 pages beginning on page 86
Concerning: CASB standard on adjustment and allocation of pension cost
Background: This letter was sent to the CASB in connection with a revised CASB standard on the adjustment and allocation of pension cost. The Academy had previously commented on an earlier CASB draft in a submission dated September 3, 1976.
Drafters: A special task force chaired by William A. Dreher

Index Code: 1977-10
To: Bureau of Health Insurance/HEW
Date: June 3, 1977
Length: 4 pages beginning on page 89
Concerning: Self-insurance of medical malpractice insurance by hospitals
Drafters: Executive Director Stephen G. Rellison

Index Code: 1977-11
To: Department of Labor Advisory Council
Date: June 8, 1977
Length: 7 pages beginning on page 93
Concerning: Form 5500 Schedule B (Actuarial Information)
Background: This proposal was presented to the Reporting and Disclosure Work Group of the Department of Labor Advisory Council on
Employee Welfare and Pension Benefit Plans. The proposal involves proposed changes in Form 5500 Schedule B, which is the statement of actuarial information required to be signed by an enrolled actuary under ERISA.

Drafters: This proposal was prepared by Preston C. Bassett, the Academy representative on the Advisory Council. Mr. Bassett's proposal had been reviewed and commented upon by an extensive mailing list of interested actuaries.

Index Code: 1977-12

To: Commission on Auditors' Responsibilities ("Cohen Commission")

Date: June 21, 1977

Length: 10 pages beginning on page 100

Concerning: Independence/self-review

Background: This statement was submitted to the Commission on Auditors' Responsibilities, commonly referred to as the "Cohen Commission" in reference to its late chairman, Manuel F. Cohen. The Cohen Commission was an independent commission established by the AICPA in October, 1974. The Commission was charged to:

"...develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. It should consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved." 

After considerable study and investigation, the Commission released its 176-page Report of Tentative Conclusions in 1977. The Commission invited public comment on its report and the Academy filed its statement in response. The Academy statement is primarily directed toward Section 9 of the report entitled "Maintaining the Independence of Auditors." A copy of the Academy statement was also sent to the Securities and Exchange Commission.

Drafters: The statement was developed by the law firm of Shea and Gardner in conjunction with President-elect Edwin F. Boynton and other members of the Academy Executive Committee. The statement was ultimately endorsed by the Academy Board of Directors as a statement of the Board.
SUMMARY OF 1977 STATEMENTS

Index Code: 1977-13
To: Financial Accounting Standards Board
Date: June 24, 1977
Length: 11 pages beginning on page 110
Concerning: FASB study on the conceptual framework for financial accounting and reporting
Background: This statement was presented in response to the FASB report Tentative Conclusions on Objectives of Financial Statements and on Part 1 of the Discussion Memorandum on Elements of Financial Statements and Their Measurement. These two documents were the first phase of a major re-examination by the FASB of the "Conceptual Framework for Financial Accounting and Reporting."
Drafters: The Committee on Financial Reporting Principles chaired by Richard S. Robertson

Index Code: 1977-14
To: House Committee on Ways and Means
Date: July 18, 1977
Length: 13 pages beginning on page 121
Concerning: Social Security legislation
Background: This statement was submitted at a public hearing on Social Security legislation held by the Subcommittee on Social Security of the House Committee on Ways and Means. These hearings ultimately led to the adoption of the 1977 amendments to the Social Security Act (P.L. 95-216 adopted December 20, 1977).
Drafters: Committee on Social Insurance chaired by Robert F. Link
44 SUMMARY OF 1977 STATEMENTS

Index Code: 1977-15
To: Public Health Service/HEW
Date: August 8, 1977
Length: 8 pages beginning on page 134
Concerning: Health maintenance organizations

Background: This statement was submitted to the Public Health Service in the Department of Health, Education and Welfare in connection with interim regulations on health maintenance organizations which appeared in the Federal Register on June 8, 1977 (42 FR 29400-29416).

Drafters: A special task force chaired by William A. Halvorson

Index Code: 1977-16
To: Financial Accounting Standards Board
Date: August 12, 1977
Length: 49 pages beginning on page 142
Concerning: Accounting and reporting by defined benefit pension plans

Background: This major position paper was submitted to the FASB in response to its April 14, 1977 Exposure Draft on Accounting and Reporting by Defined Benefit Pension Plans. This exposure draft was developed to define "generally accepted accounting principles" for defined benefit pension plans. This exposure draft was an outgrowth of an earlier FASB Discussion Memorandum on Accounting and Reporting for Employee Benefit Plans dated October 6, 1975. The Academy had submitted a statement on this discussion memorandum in January, 1976 and had appeared at a public hearing held by the FASB in February, 1976.

Drafters: A special task force chaired by Edwin F. Boynton
SUMMARY OF 1977 STATEMENTS

Index Code: 1977-17
To: House Committee on Agriculture
Date: September 23, 1977
Length: 4 pages beginning on page 191
Concerning: Crop insurance

Background: This statement was presented at a public hearing held by the Subcommittee on Conservation and Credit of the House Committee on Agriculture on two bills to revamp Federal crop insurance programs; namely, HR 5011 and HR 7111. The primary focus of the hearings was on HR 7111, the Farm Production Protection Act of 1977. This statement derives from the March 15, 1977 statement submitted to the same committee (see statement 1977-4).

Drafters: Executive Director Stephen G. Kellison

Index Code: 1977-18
To: NAIC Accounting Practices and Procedures (A6) Subcommittee
Date: October 4, 1977
Length: 5 pages beginning on page 195
Concerning: Accounting for deferred income taxes

Background: This statement was presented to the NAIC (A6) Subcommittee in connection with a review by the Subcommittee of alternative methods of accounting for deferred Federal income taxes on statutory statements.

Index Code: 1977-19
To: Financial Accounting Standards Board
Date: October 27, 1977
Length: 7 pages beginning on page 200
Concerning: Accounting for foreign currency translations

Background: This statement was submitted to the FASB in connection with Interpretation No. 15 of FASB Statement No. 8 concerning accounting for foreign currency translations by stock life insurance companies. FASB Statement No. 8 is entitled "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements," while Interpretation No. 15 is entitled "Translation of Unamortized Policy Acquisition Costs by a Stock Life Insurance Company."


Index Code: 1977-20
To: Senate Committee on Agriculture, Nutrition, and Forestry
Date: November 15, 1977
Length: 5 pages beginning on page 207
Concerning: Crop insurance

Background: This statement was submitted for the record to the Senate Committee on Agriculture, Nutrition, and Forestry in connection with hearings on S.1575, the Farm Production Protection Act of 1977. This statement derives from previous statements on crop insurance dated March 15, 1977 and September 23, 1977 (see statements 1977-4 and 1977-17).

Drafters: Executive Director Stephen G. Kellison
SUMMARY OF 1977 STATEMENTS

Index Code: 1977-21
To: U.S. Supreme Court
Date: November 22, 1977
Length: 42 pages beginning on page 212
Concerning: Manhart case

Background: This amicus curiae brief was submitted to the U.S. Supreme Court in connection with City of Los Angeles v. Marie Manhart. The brief was jointly submitted on behalf of the American Academy of Actuaries and the Society of Actuaries.

Drafters: The brief was developed by the law firm of Shea and Gardner in conjunction with a special task force appointed by the Academy of Actuaries and the Society of Actuaries, chaired by Donald S. Grubbs, Jr. The statement was ultimately endorsed by the Academy Board of Directors and the Society of Actuaries Board of Governors.

Index Code: 1977-22
To: Financial Accounting Standards Board
Date: December 13, 1977
Length: 4 pages beginning on page 254
Concerning: FASB study on the conceptual framework for financial accounting and reporting

Background: This statement was presented in response to Parts 2 and 3 of the FASB Discussion Memorandum on Elements of Financial Statements and Their Measurement. On June 24, 1977 the Academy had previously commented on Part 1 of this Discussion Memorandum (see statement 1977-13).

Drafters: The Committee on Financial Reporting Principles chaired by Richard S. Robertson
Index Code: 1977-23
To: Securities and Exchange Commission
Date: December 16, 1977
Length: 30 pages beginning on page 258
Concerning: Independence/self-review
Background: This statement was submitted to the Securities and Exchange Commission on proposed rules concerning disclosure of relationships with independent public accountants released by the SEC in the Federal Register on October 3, 1977 (42 FR 53635-53637). The statement derives from the June 21, 1977 statement to the Commission on Auditors' Responsibilities (see statement 1977-12).
Drafters: The statement was developed by the law firm of Shea and Gardner in conjunction with President Edwin F. Boynton. The statement was ultimately endorsed by the Academy Board of Directors as a statement of the Board.

Index Code: 1977-24
To: American Institute of Certified Public Accountants
Date: December 27, 1977
Length: 10 pages beginning on page 288
Concerning: Accounting for property and liability insurance companies
Background: This statement was submitted to the AICPA in connection with its October 31, 1977 Exposure Draft of a Statement of Position on Accounting for Property and Liability Insurance Companies.
Title I
Part I
Sec. 103(a)(3):

(A) Except as provided in subparagraph (C), the administrator of an employee benefit plan shall engage, on behalf of all plan participants, an independent qualified public accountant, who shall conduct such an examination of any financial statements of the plan fund and of other books and records of the plan as the accountant may deem necessary to enable the accountant to form an opinion as to whether the financial statements of the fund and related and schedules required to be included in the annual report by subsection (b) of this section are presented fairly in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Such examination shall be conducted in accordance with generally accepted auditing standards, and shall involve such tests of the books and records of the plan fund as are considered necessary by the independent qualified public accountant. The independent qualified public accountant shall also offer his opinion as to whether the separate schedules specified in subsection (b)(3) of this section and the summary material required under section 104(b)(3) present fairly, and in all material respects the information contained in the annual report therein when considered in conjunction with the financial statements taken as a whole. The opinion by the independent qualified public accountant shall be made a part of the annual report. In a case where a plan is not required to file an annual report, the requirements of this paragraph shall not apply. In a case where by reason of section 104(a)(2) a plan is required only to file a simplified annual report, the Secretary may waive the requirements of this paragraph.

(B) In offering his opinion under this section the accountant may rely on the correctness of any actuarial matter certified to be an enrolled actuary, if he so states his reliance.

(B) The opinion of the accountant under this section is limited to the status and operations in respect to the assets of the fund and excludes actuarial matters certified to by the enrolled actuary. "Actuarial matters" may be further defined by regulation by the Secretary and shall include, with respect to a pension benefit plan, the items required to be included in the actuarial statement under paragraphs (3) through (11) of subsection (d) of this section.
Sec. 103(b)

An annual report under this section shall include a financial statement containing the following information:

(1) With respect to an employee welfare benefit plan: a statement of assets and non-actuarial liabilities of the fund; a statement of changes in fund balance; and a statement of changes in financial position. In the notes to financial statements, disclosures concerning the following items shall be considered by the accountant: a description of the plan including any significant changes in the plan made during the period and the impact of such changes on benefits; a description of material lease commitments, other commitments, and contingent liabilities; a description of agreements and transactions with persons known to be parties in interest; a general description of priorities upon termination of the plan; information concerning whether or not a tax ruling or determination letter has been obtained; and any other matters necessary to fully and fairly present the financial statements of the plan fund.

(2) With respect to an employee pension benefit plan: a statement of assets and non-actuarial liabilities of the fund; and a statement of changes in net assets available for plan benefits which shall include details of revenues and expenses and other changes aggregated by general source and application. In the notes to financial statements, disclosures concerning the following items shall be considered by the accountant: a description of the plan including any significant changes in the plan made during the period and the impact of such changes on benefits; the funding policy (including policy with respect to prior service cost), and any changes in such policies during the year; a description of any significant changes in plan benefits made during the period; a description of material lease commitments, other commitments, and contingent liabilities; a description of agreements and transactions with persons known to be parties in interest; a general description of priorities upon termination of the plan; information concerning whether or not a tax ruling or determination letter has been obtained; and any other matters necessary to fully and fairly present the financial statements of such pension plan fund.

(3) With respect to all employee benefit plans, the statement required under paragraph (1) or (2) shall have attached the following information in separate schedules: --
MEMORANDUM

TO: Selected Actuaries
FROM: Pres Bassett
SUBJECT: ERISA - Annual Reports - Title I, Part 1, Section 103

On December 15, I sent a memorandum to you setting forth my suggestion for an amendment to ERISA to more clearly define the respective obligations of the "qualified public accountant" and the "enrolled actuary." I included in the memorandum an attachment setting forth suggested changes. Also, I asked you to let me know your thoughts in regard to the position I was taking.

The purpose of this memorandum is to bring you up-to-date on the developments since December 15th.

I have attached to this memorandum the re-written proposal, dated January 4th, which is a result of the many fine comments I received from those who responded to my earlier memorandum. With the exception of one person, all the others who commented agreed with the position I had taken, but made good suggestions by way of clarification or strengthening.

The Task Force of the Advisory Council to the Department of Labor met on January 5th, at which time I distributed this revised proposal. This Task Force is charged with developing proposed amendments to ERISA for the Department of Labor. The representative from the accounting profession took strong exception to this proposal. A rather lively discussion followed and while I feel that most of the participants agreed with the position which the actuaries were taking, they did not feel that they should endorse this position without further discussion at the Advisory Council.

The Advisory Council met on Tuesday, January 11, at which time it was decided that a separate Task Force should be established to review the relative responsibilities of the qualified public accountant and the enrolled actuary. The purpose of this Task Force will be to make a specific recommendation to the Advisory Council on amendments to ERISA, if any, in this area.

This topic, therefore, will be placed on the agenda for the next meeting of the Advisory Council which is scheduled for March 22nd. Meetings of the Advisory Council are public and the public has a right to present statements at these meetings. I would not be surprised if the accounting profession will
have someone attend that meeting to give a statement on behalf of the AICPA. This is just speculation on my part. Bob Winters: You might want to have the American Academy of Actuaries prepared to give a statement at this March meeting.

If any of you who receive this memorandum have any suggestions, I would be pleased to receive them.
The American Academy of Actuaries has reviewed the November 24, 1976 Proposed Opinion on Employee Benefit Planning issued by the Standing Committee on Unauthorized Practice of the Law of the American Bar Association. It will be recalled that the Academy testified at the April 3, 1976 hearing of the Committee in New York, followed up by a written statement on the matter. While the draft opinion represents a substantial improvement over the 1961 Opinion by recognizing the necessary contributions of other professionals in the area of employee benefit planning, we feel that it leaves several issues of mutual interest unresolved.

The proposed opinion continues to lay claim to broad areas of activity as being the private preserve of independent legal counsel. While we do not challenge the authority of the Committee to promulgate such an opinion, we would note that if there were laws making it illegal to pursue the unauthorized practice of law, the unauthorized practice of accountancy, and the unauthorized practice of actuarial science, probably none of these three professions could do much of anything in the employee benefit field because of the wide area of overlap of their area of expertise and interest.

By way of example, we call attention to the following:

- The last paragraph of Section V of the proposed opinion notes that "Determining which type of plan and what particular provisions are best suited to the employer's objectives, circumstances, resources, calls for the exercise of professional
legal judgment on behalf of the employer. Such judgment should only be exercised by the employer's lawyer." We believe there are substantial and significant issues involving the financial implications of alternatives, the probable frequency of occurrence of alternatively described events, and the evaluation of the plan's resources and the participant group's present and future characteristics, etc., that call for judgments which fall clearly in the actuarial domain rather than in the legal domain. Benefit design per se involves employee relations, knowledge of industry patterns and cost considerations, none of which require any significant element of legal training.

Similarly, the last paragraph of Section VIII says that "Only a lawyer in the course of a lawyer-client relationship with an employer may: ... offer an opinion or an interpretation of existing trust instruments, contracts or other agreements ..." We believe that interpretations of documents often involve substantial issues of evaluation of the probability of occurrence of future events, evaluation of the worth of benefits flowing as a result of these events, and evaluation of similar aspects of reasonable alternative interpretations. In short, often these interpretations call for a balance of experience and judgment involving a wide range of input that comes more nearly within the training and expertise of the actuary than legal counsel. For legal counsel to flatly pre-empt this area of interpretation does not appear to be in the public interest whether or not it is consistent with various state laws (note, for example, the illustration attached to this letter).
We are not particularly interested in challenging existing pertinent state laws relative to the unauthorized practice of law, but since the proposed opinion will likely be a major factor in the interpretation of such laws, we believe it pertinent to point out several areas of the opinion which we believe need modification or clarification. First, however, we would like to suggest consideration of the establishment of a National Conference Group which would consider issues of mutual interest to members of the American Bar Association and members of the American Academy of Actuaries. These are issues of great public interest since they can affect significantly the ability of plan sponsors throughout the nation to comply in the best possible way with the complexities and unrealistic deadlines of ERISA. It would be a great disservice to these plan sponsors if the energies of both professions were diverted at this crucial time by any needless controversy. A statement of principles by a National Conference Group might be the best way to avoid needless controversy and to articulate the proper role of the two professions in the area of employee benefit plans.

Considering this area in which the legal and actuarial professions overlap, the following principles might serve as at least a starting point toward some final result, using the recently reported principles on lawyer-accountant relations in the field of estate planning as an analogy.

**Principle 1.** When a client is served by both a lawyer and an actuary, a good working relationship should be established at the earliest time practicable in order to provide the client with the best possible service at a fair cost.

**Principle 2.** When an actuary becomes involved in employee benefit planning, the client should be advised to engage the services of a lawyer at an early stage, since legal problems permeate
the entire employee benefit planning process and only the lawyer may give legal advice and prepare legal documents.

Principle 3. When a lawyer becomes involved in employee benefit planning, he should recognize that an actuary is necessary if the plan involved is a defined benefit pension plan or otherwise involves actuarial concepts, and that an actuary experienced in benefit plan consulting may plan an important role in the planning of such plans and should be engaged at an early stage.

These principles, and particularly Principle 3, try to reflect the concerns of professional actuaries that the skills they bring to employee benefit planning are difficult to allow for fully in an opinion of the Unauthorized Practice of Law Committee. Since such an opinion is directed towards defining what constitutes the unauthorized practice of law, it necessarily focuses on the legal relationship aspects of an employee plan. As essential as these legal relationships are, they are not, of course, the only aspects of a plan important to the sponsor and participants. In fact, the legal aspects of plan specifications generally set only broad limits that often play only a minimal role in the fundamental design of the plan. Within the scope of what is legally permissible there is a great range of possible alternatives, and selecting the correct combination of such alternatives can make the plan a success or failure. Whether the plan will be effective in motivating employee loyalty and productivity and can be afforded by the sponsor over a long period of time are equally as essential to the planning process as the plan's compliance with the law. It is perfectly possible to draft and implement an employee benefit plan which fully complies with all applicable laws, but which is anywhere from mediocre to disastrous in terms of employee motivation and long term financial effect. Indeed,
few, if any, of the plan failures which were much of the incentive to the passage
of ERISA were the result of failures of legal planning.

The necessity to take into account in employee benefit planning the
kinds of cost and other financial considerations which actuaries are trained to
provide appears in many different contexts, some of which have become mandatory
as a result of ERISA. With respect to defined benefit plans such areas include:

(a) Determination of the maximum tax deductible contribution, includ-
ing development and interpretation of the 10% past service base.

(b) Evaluating alternative means for integrating a plan's benefits
with Social Security.

(c) Interpreting the quantitative effects of a particular benefit
determination. (Attached is an example of a fairly common
instance in plan administration which illustrates, we believe,
that on some questions the correct legal determination cannot
be reached without the actuary's skills.)

(d) Computation of actuarial equivalents among various early re-
tirement, joint and survivor, lump sum and other options.

(e) Determining compliance with ERISA's minimum funding requirements.

(f) Determining compliance with ERISA's accrued benefit requirements.

(g) Determining compliance with ERISA's maximum benefit requirements.

(h) Advising in merger, consolidation and spin-off situations both as
to compliance with ERISA's anti-dilution provisions and as to the
financial impact of alternative methods.
In certain of these areas the duties which the "enrolled actuary" is required by ERISA to perform would seem clearly to require the enrolled actuary to interpret and apply the law to the specific facts of a client's situation, a practice which might be deemed the "practice of law" as defined by the Committee. For example, Section 103 of the Act requires a written opinion of the enrolled actuary as to, among other things, the minimum contribution required by the funding standards of the Act, the reasonableness of the actuarial methods and assumptions being used, the propriety of the valuation of plan assets, and the methods for appropriate allocation of plan assets among classes of participants in accordance with the Act's priorities. An opinion as to each of these matters cannot be rendered without first understanding the statutory and regulatory definitions involved, arriving at a judgment decision as to how to interpret the law in general and applying such judgment to the client's specific facts. Thus, enrolled actuaries, unlike the infinitely broader class of all non-attorneys, are required by federal law to perform functions which might be construed under state law (if not pre-empted) as the unauthorized practice of law.

The Committee has properly dwelt at some length on the subject of the preparation of plan drafts, as well as employee communications material (which would include employee booklets, summary plan descriptions, statements to plan participants, and similar items involving plan interpretations), and the report concludes (page 22) that "non-lawyers are not authorized to prepare nor draft any legal documents effectuating the adoption or the amendment of an employee benefit plan, nor may they assist other non-lawyers (...) in the drafting of such legal documents without engaging in the unauthorized practice of law." We are in basic agreement with the concepts behind this opinion; i.e., that employees, employers and the public need the protection of having the final plan documents approved by a qualified lawyer. However, in the preparation of a pension plan document, even a lawyer with experience in employee benefits will customarily request the
assistance of a skilled benefit consultant, either to make an initial draft of
the plan or to review the lawyer's draft. Put another way, drafting that segment
of a defined benefit plan constituting the benefit provisions (including eligi-
bility, benefit definition, etc.) requires the skills of a qualified benefit
consultant as much as it does purely legal skills.

The procedures involved in getting the plan drafted often put non-lawyer
benefit consultants in an awkward position. A client may request the non-lawyer
consultant to prepare a plan draft for review by legal counsel. Once done, the
consultant often does not know whether such review ever takes place, and, in any
event, is not in a position to require that the client company have such a review
made.

The opinion properly does allow for a high degree of participation by
the non-lawyer in the preparation of plan documents, with the ultimate responsi-
bility for the document resting with the qualified lawyer. We interpret the
opinion to allow, for example, a non-lawyer to prepare a plan draft for review
by outside legal counsel. It would seem equally acceptable for the non-lawyer
to prepare a plan draft for review by inside counsel, i.e., the lawyer-employee
of the company adopting the plan. However, the opinion does not specifically
address itself to this circumstance, which is fairly common. We see no reason
why the required degree of legal protection to beneficiaries and the company could
not be given by the lawyer-employee of the company adopting the plan.

The opinion includes a prohibition against non-lawyers drafting "mate-
rial explaining the plan to employees", which would include plan booklets, employee
benefit statements, slides, film strips, etc. ERISA requires plan descriptions
to be "written in a manner calculated to be understood by the average plan partici-
pant." Obviously, great care must be taken in trying to simplify a plan document
in laymen's terms without committing the plan sponsor to liabilities not included
in the plan document itself. On the one hand, then, a legal review of the plan
description by a lawyer may be even more critical than the preparation of the plan document itself. On the other hand, while in theory the responsibility for preparation of employee communications material by lawyers might seem ideal, in practice most lawyers appreciate having the first draft prepared by someone experienced in communicating the salient features of the plan likely to be meaningful to participants, and so have welcomed the assistance of non-lawyers. While we strongly endorse the desirability of a legal review of such material, the long history of development of employee communications materials is that it has traditionally been the responsibility of specialists in communications, with legal review often being omitted or as a brief final step generally to look for any potential "hidden" liabilities. With this background, and the existence of a large body of experienced non-lawyer practitioners in the field, we question whether the drafting of such materials should constitute the unauthorized practice of law. It does seem incongruous that such practice be deemed the "unauthorized practice of law" when in fact the legal profession has not significantly ever "practiced" in this area (i.e., in terms of original development of employee communications material, such as booklets, slides, film strips, benefit certificates, etc.) despite the tremendous growth and importance of employee communications in the last 20 years.

The proposed November 24, 1976 opinion recognizes some of these problems; however, we feel that Section XI does not go far enough to respond to public interest concerns.

In short, for actuaries to exercise their knowledge, training and insight in forecasting frequencies of events, values of events, and significance of plan benefit decisions, they must risk challenge as being engaged in unauthorized practice of law unless their skills are blended with those of a lawyer. Ideally, both professions will be called upon to advise on every significant
decision in the establishment and operation of an employee benefit plan, and the
Academy in no way suggests that such cooperation is not the ideal or that the
role of the lawyer be denigrated.

Clients, however, have an unfortunate habit of not following the ideal
where costs are involved. And this is particularly true as to questions which
arise in the administration and operation of a plan once established. By law
and necessity, the client must call upon the plan's enrolled actuary on a con-
tinuing basis, but the client faces no similar compulsion to bring in his lawyer
regularly even if advised by his actuary to do so. An overly broad opinion by
the Unauthorized Practice of Law Committee therefore can confront the conscien-
tious actuary serving as enrolled actuary of a plan with a difficult dilemma.
If, despite the actuary's disclaimers of legal expertise and recommendations to
employ counsel, the client refuses to employ a lawyer, the actuary must either
risk being accused of unauthorized practice of law or refuse to advise the plan
fiduciary at all and risk being accused of breach of fiduciary duty owed plan
participants.

Because members of the Academy who serve as enrolled actuaries face
unique problems not shared by accountants, insurance or mutual fund salesmen or
other non-lawyer advisors, we think that the possibility of a National Conference
Group limited to lawyers and actuaries should be explored as a potential vehicle
for finding a practical way for these two professions to work together at a time
when pension plans are in great need of skilled assistance.

February 3, 1977
EXAMPLE OF LEGAL PROBLEMS ARISING FROM
FAILURE TO APPRECIATE ACTUARIAL SKILLS

Suppose that the plan administrator comes to his legal counsel and explains that an individual has reached a point where there must be a benefit determination, but that the plan is not entirely clear as to how that determination should be made. An example of this might be a minimum benefit provision which was carried over from a prior plan, but described in rather general terms. The plan administrator indicates that his preference is to interpret the plan to provide the alternative that is slightly more liberal to the participant involved.

Legal counsel reviews the plan and concludes that the plan is indeed vague in this particular situation, and that the plan clearly provides that the plan administrator may interpret the plan. Legal counsel thinks ahead to potential litigation, and advises the plan administrator that his interpretation seems to be in order from a legal standpoint, although it would be helpful if the plan were amended to be specific on this point in due course.

Sometime later the enrolled actuary comes across this transaction, and he sits down with the plan administrator to point out several concerns that he has. First of all, he notes that the individual with respect to whom the interpretation was made is age 64, and that if this precedent is followed for other people at all ages, the increase in value as a result of this interpretation in preference to alternatives is likely to be quite significant indeed. Further, the actuary points out that as the plan matures, the frequency of this event is likely to rise. In fact, the actuary suggests that the interpretation made by the plan administrator is likely to lead to a noticeable cost strain on the plan, potential discrimination in favor of what is likely to be a highly paid group, and therefore probably a violation of his fiduciary duty and perhaps the tax laws, and thus creates exposure to serious legal as well as business risks.

There does not seem to be much point in debating whether the enrolled actuary is practicing law in this situation when he points out his understanding of the legal problems which will flow from the cost impact of a seemingly minor interpretation of plan language. Certainly, any rule that would constrain the actuary from voicing his concerns directly to the plan fiduciary most involved would be of questionable merit, especially since the actuary is either a fiduciary under ERISA or has similar responsibilities, so that he is under some direct obligation to use his best efforts in working with other fiduciaries.
February 17, 1977

Mr. Douglas R. Carmichael
Managing Director, Technical Services
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036

Dear Mr. Carmichael:

STATEMENT OF POSITION (DRAFT 11/15/76)

PRACTICES RELATING TO HOSPITAL MALPRACTICE INSURANCE
HOSPITAL AUDIT GUIDE

Dick Robertson, who I understand has had some recent discussions with you regarding comments on the above draft, has asked that I compile and transmit to you some observations that he, Ron Bohnheuter and I have collected from a number of interested actuaries. Most of these observations have been contributed by members of the Committees on Financial Reporting Principles of the American Academy of Actuaries and the Committee on Financial Reporting of the Casualty Actuarial Society. They are the observations of individual actuaries, rather than statements on behalf of the Academy or the Society, but we feel they may be useful to you as reflecting an actuarial perspective on this subject.

General Observations

The most significant concern expressed by many respondents was with the failure of the Draft to acknowledge the potential for application of probabilistic methods and other actuarial techniques to the estimation of liabilities that are not amenable to more conventional accounting evaluation. Although the reference at the top of page 4 to SFAS No. 5 appears to encourage the employment of such estimation processes, the subsequent sections on Accounting and Reporting not only fail to support such an approach but seem, in most of the illustrations given, to actively reject it. Where there is no more precise method for the measurement of liabilities available, the use of statistical estimates should be encouraged rather than discouraged. It is recognized, of course, that the employment of statistical estimates requires some explicit quantification of the uncertainty inherent in such estimates. However, uncertainty is not unique to statistical estimates; the kinds of judgment estimates that the Draft explicitly recommends also may be significantly in error.
With respect to the possible employment of actuarial methods in the estimation of hospitals' malpractice liabilities, it has been suggested that the Committee on Health Care Matters might find it useful to consult with the Insurance Companies Committee, which has had extensive experience with similar problems in insurance accounting and might well have suggestions that would be applicable in the hospital situation.

The Insurance Companies Committee might also be able to give some assistance in identifying distinctions that should be made between the hospital situation and the insurance situation, as well as identifying areas of commonality. It will be important to make certain that no conclusions predicated on the character of the hospital situation be incorrectly applied to the accounting of insurance companies as well; the standards applicable to insurance operations, including those of captive insurers, will necessarily differ from those applicable to self-insurance situations.

Specific Recommendations

A number of respondents have suggested specific text revisions. In most instances these arise from the general considerations described above. They should be considered as illustrative of the kind of revision that would be recommended, rather than exhaustive.

Page 2, paragraph 4: The text here does not seem to make clear the nature of the difficulty or to suggest any possible solution. Jim Crowley has recommended the following wording:

It appears that one of the reasons for the withdrawal of insurers from this business is the difficulty of estimating potential losses. The effects of monetary and social inflation represent additional variables which have complicated the process of estimating losses; their effects should tend to diminish as improved estimation techniques are developed and as claims settled under present conditions find their way into the body of experience for this class of business.

The rather imprecise reference to credibility considerations in the present text can be dealt with better later.

Page 4, paragraph 1: Following the citation from SFAS No. 5, it seems desirable to give greater emphasis to the possible role of experience-based estimation methods. This could be accomplished by deleting the balance of that paragraph and substituting the following, which is
basically a recommendation of Dick Robertson's, modified somewhat by Jarvis Farley and myself:

In determining the provision for unasserted claims, it would be appropriate to consider analyses of past claims in terms of frequency, distribution of loss size, secular trends of these variables, and other actuarial considerations. While the experience of an individual hospital may not have statistical significance, the experience of larger units of similar character or of aggregates of similar institutions may be a very useful guide. The assistance of a qualified actuary may be helpful in deriving estimates of losses from such data and in quantifying the uncertainties inherent in such estimates.

Reporting pages 5 to 9: There was considerable feeling that this section seems to encourage too many qualified opinions, and fails to distinguish for the general reader between qualifications based on the inherent uncertainty of estimates and qualifications based on the inadequacy of such estimates. In an effort to resolve this problem, Dick Robertson has suggested the following revised wording for Note X on page 5:

Malpractice suits totaling $________ in excess of insurance coverage have been filed against the hospital by various claimants and additional claims may be filed for incidents occurring through _____, 19XX. The actions are in various stages of processing and some may ultimately be tried before juries. The hospital has provided $______ as its estimate of the future cost of these suits. The amount ultimately paid may be more or less than this amount. Additional material claims may be asserted arising from services provided to patients in the past. The hospital has provided $______ as the estimated cost of the settlement of such claims. The ultimate cost may also be more or less than this amount. The hospital has terminated its malpractice coverage as of _____, 19XX. In the prior year, malpractice insurance premiums in the amount of $______ were charged to income. During the current year, no charges for premiums have been made, but charges for actual or potential claims totaled $______.
It was Dick's feeling that a Note of this character might, with appropriate modifications, serve the purposes intended by the present Notes shown on pages 6 and 8. In the situation discussed at the bottom of page 6 where the auditor considers that excessive provision has been made, Dick would suggest that "the auditor may also modify his opinion", and could state, in lieu of some of the present language in "middle paragraph" on page 7:

The amount which the hospital has charged income to provide for losses related to uninsured malpractice claims, discussed in Note X, appears to be in excess of the amount which can be reasonably estimated.

We have found it somewhat difficult to offer suggestions for the appropriate employment of actuarial methods in this situation, where frequently there simply will not exist an adequate statistical basis for estimation and the potential uncertainty is in fact the dominant consideration. Nevertheless, we consider it important to take notice of the fact that in such situations a probabilistic estimate could well have significant informative value, whereas a refusal to allow any provision because of the uncertainties involved would have no informational value whatever. We would like to encourage strongly the employment of appropriate actuarial methods for the estimation of unknown losses - together with appropriate qualifications of these estimates - in the interest of more meaningful financial reporting.

Sincerely,

[Signature]

PES:rc

cc: R. Robertson
    R. Bornhuetter
    S. Kellison
    J. Farley
    W. Hazam
    J. Crowley
Mr. Chairman, members of the Committee, my name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries. With me today is Mr. Frederick D. Hunt, Jr., who is our Director of Communications and Government Liaison. We maintain our Washington offices at 1775 K Street, N.W., Washington, D.C. 20006.

Mr. Chairman, members, we appreciate the opportunity to appear today. What we wish to say is probably unique among the testimony you have received or will receive. We are not appearing today in connection with many of the issues on which others have spoken. However, we would like to enter a few comments concerning the financial integrity of Federal crop and disaster insurance programs.

By way of background, the American Academy of Actuaries ("Academy") is a professional organization of actuaries which was formed in 1965 for purposes of the accreditation of actuaries to practice in the United States. The Academy includes members of four constituent organizations, the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, the Fraternal Actuarial Association and the Society of Actuaries. These organizations, or their predecessors, date back many years, one of them to the late 1800's, so that despite the relatively short duration of its formal existence, the Academy, its constituent organizations and their predecessors have represented the actuarial profession in the United States for over 80 years. The Academy is unique as the national accrediting actuarial organization for actuaries in all areas of specialization.

The requirements to become a Member of the Academy can be summarized under two broad headings: (1) education requirements and (2) experience requirements. An individual must satisfy both sets of requirements in order to be admitted as a Member. At the present time, the education requirement can be satisfied only by passing professional examinations given by either the Casualty Actuarial Society of the Society of Actuaries. The experience requirement consists of five years of responsible actuarial work.
One of the main functions of the Washington office of the Academy is to monitor governmental activities in both the legislative and executive branches which involve actuarial considerations. Our interests are to ensure that actuarial techniques are being properly applied where appropriate, that actuarial activity is identified as such, and that actuarial work is being performed by qualified actuaries. Our aim is no different than the laws and regulations, designed to protect the public, which assure that only qualified doctors practice medicine, and only qualified attorneys practice law.

Actuarial science involves the evaluation of the probabilities of uncertain future events, often over long periods of time, and the financial impact which these events involve. The computation of financial values for insurance and pension programs is a major application of actuarial techniques. The future economic security of both individuals and industry depends upon a high level of training and professional conduct for actuaries.

Actuarial techniques are applicable to a variety of programs in both the private sector and the public sector. Examples of governmental activity which involve actuarial projections and valuations include, among many others, Social Security cost projections, governmental retirement systems such as Civil Service and the military, evaluation of appropriate reserve levels for income tax purposes for insurance companies, and the proper financing of the federal flood insurance program. Actuarial techniques are invaluable in a number of governmental programs in ensuring that current costs of such programs are properly determined and identified and that anticipated future trends in costs are recognized.

Our attention was first brought to the Omnibus Farm Bill when Secretary Bergland was quoted several weeks ago in some informal remarks as having recommended a good crop insurance program which must be actuarially sound (emphasis added). This led us to investigate the programs of the Federal Crop Insurance Corporation and various proposals for disaster insurance. We understand that one or more members of the House Committee on Agriculture and several of the crop insurance administrators have also mentioned their desire for an actuarially sound program.

We address the Omnibus Farm Bill specifically in the areas of the Federal Crop Insurance Corporation and proposals for disaster insurance. We do not record a view on the pros and cons of how the costs of these programs should be borne by various individuals and groups in the private or the public sectors. We do urge that these programs be funded according to
actuarial principles, that current costs be properly and clearly identified as such, that appropriate reserve levels be established, and that projections of costs for future years be made. This information will be valuable to Congress, Secretary Bergland and the crop insurance administrators in making informed decisions in the best interest of the farmers, the taxpayer and the national economy.

We express concern that certain proposals have apparently been made which would involve a governmental subsidy of an unknown magnitude for these programs. We recommend that a governmental subsidy, if any is to be involved, be clearly identified as such and its probable magnitude established in advance.

We also encourage the Federal Crop Insurance Corporation to make use of qualified actuaries in its actuarial work. As previously mentioned, the Academy was originally established as the national accrediting actuarial organization for actuaries in all areas of specialization. Membership in the Academy, or its equivalent, should be recognized in establishing actuarial qualifications.

The American Academy of Actuaries wishes to express its gratitude for the opportunity to appear today. We stand ready to be of service to the Congress and the Administration in matters of actuarial concern. If we can be of further assistance in connection with the crop and disaster insurance programs, please do not hesitate to call upon us.
The American Academy of Actuaries ("Academy") is pleased to submit this statement of comments and recommendations to the Advisory Committee on Joint Board Actuarial Examinations ("Advisory Committee"). This statement is in response to the open meeting announcement of the Advisory Committee which appeared in the Federal Register on March 3, 1977.

More specifically, this statement is addressed to the following purpose listed by the Advisory Committee:

"To review other actuarial examinations in order to make recommendations regarding such examinations' adequacy to demonstrate the education and training in actuarial mathematics and methodology required for enrollment by Title 29 U.S. Code, Section 1242(a)(1)."

The Academy appreciates this opportunity to present a statement on the adequacy of organizational examinations to the Advisory Committee. The Academy has maintained an active interest in the activities of the Joint Board for the Enrollment of Actuaries ("Joint Board") since its inception and has filed a number of written statements and appeared at a number of public hearings of the Joint Board.
The Academy filed a statement dated June 17, 1976 with the Joint Board concerning the standards of enrollment for individuals applying for enrollment on or after January 1, 1976 (Section 901.13 of the Joint Board regulations). Copies of this statement have been widely distributed and additional copies are available on request.

The position taken by the Academy in its June 17, 1976 statement remains unchanged. The balance of this statement represents a reiteration and a summary of the portions of the June 17, 1976 statement pertinent to the determination of the adequacy of organizational examinations. As indicated in the June 17, 1976 Academy statement, satisfaction of the education requirement for Member status in the Academy has been achievable since 1970 only by passing some or all of the professional examinations given by the Casualty Actuarial Society and the Society of Actuaries. Thus, in a very real sense, it can be said that today the education and examination systems of the Casualty Actuarial Society and the Society of Actuaries comprise the education and examination system of the Academy. The Academy also has an Affiliate status open to enrolled actuaries who are not Members of the Academy.

Since the enrollment of actuaries by the Federal Government impacts on the education and examination of actuaries in the United States, both the Casualty Actuarial Society and
the Society of Actuaries filed written statements with the Joint Board on June 17, 1976. Also, the Conference of Actuaries in Public Practice filed a statement with the Joint Board, in view of the high percentage of its members that are enrolled actuaries or aspire to become so. The Academy wishes to reiterate its endorsement of the statements of June 17, 1976 made by these three organizations and furthermore wishes to endorse any written or oral statements made by these organizations to the Advisory Committee at the present time.

In the interests of brevity, the following is a recapitulation of the position of the Academy as contained in its June 17, 1976 statement which is pertinent to the issues before the Advisory Committee at this time:

1. The Academy believes that the legislative history, of ERISA as well as the current public interest require post-1975 standards of enrollment to be substantially higher than pre-1976 standards. In this regard, the Academy commends the explicit statement of policy by the Joint Board in the preamble to Section 901.13:

"Consistent with the legislative history of ERISA, #901.13 would require individuals applying for enrollment on or after January 1, 1976 to meet more stringent requirements than those applying for enrollment before January 1, 1976."
The Academy believes this statement of policy to be important in the determination of adequacy of organizational examinations, as well as in the setting of Joint Board examinations and the evaluation of college and university actuarial programs.

2. A significant portion of the June 17, 1976 Academy statement was devoted to a discussion of the concepts of "adequacy" vs. "equivalency" of organizational examinations in comparison with Joint Board examinations. The Academy is gratified that the final regulations released subsequently to June 17, 1976 recognized the points contained in the Academy statement and significantly clarified the confusion which had arisen concerning the concepts of "adequacy" and "equivalency".

The Academy wishes to reemphasize that its arguments for "adequacy" instead of "equivalency" are in no way arguments for a less rigorous standard. However, they are arguments for a more workable standard which avoids some of the extreme complexities involved in an "equivalency" standard, as well as being consistent with Congressional intent.

3. The June 17, 1976 Academy statement recommended that the Joint Board draw upon the extensive
resources and expertise available within the actuarial profession in helping to implement the enrollment process. The very creation of the Advisory Committee itself is a major step in this direction and the Academy commends the Joint Board for this action. The Academy believes that the long term health and vitality of the actuarial profession in the United States require a total commitment by the actuarial profession in the qualification process for actuaries.

4. The Academy has cautioned against an overemphasis on the testing of specific ERISA details, which are ever in a state of flux, and instead has recommended that more emphasis be placed on the overall professional level of examinations. The purpose of the education requirement for enrollment is to demonstrate a mastery of basic principles and practices, not to demonstrate a detailed memorization of the minutiae of laws and regulations. The purpose of the experience requirement for enrollment is to demonstrate that these principles and practices have been applied in a professional manner and this does involve ERISA knowledge for applicants on or after January 1, 1976.

The Academy specifically recommends that those individuals who passed organizational examinations
prior to January 1, 1976 that did not contain ERISA material not be denied enrollment solely because these examinations did not contain such material. The important point is that these examinations adequately covered and tested upon the state of knowledge at the time they were taken.

5. The Academy reiterates its recommendation that passage of the Associateship examinations of either the Casualty Actuarial Society or the Society of Actuaries be deemed to be adequate to meet the basic actuarial knowledge requirement, independent of specialty, pursuant to Section 3042(a)(1)(C) of ERISA.

6. The Academy also reiterates its recommendation that Fellows of the Society of Actuaries be deemed to have met the pension actuarial knowledge requirement, as well as the basic actuarial knowledge requirement, pursuant to Section 3042(a)(1)(C) of ERISA.

In summary, the Academy appreciates the opportunity to present this statement and would be pleased to answer any questions concerning the statement or expand upon the views expressed herein. More generally, the Academy stands ready to give whatever assistance the Joint Board and the Advisory Committee may require in implementing post-1975 enrollment standards.
The Financial Accounting Standards Board (FASB) has invited comments of the American Academy on the recommendations of Mr. Hall of Arthur Andersen & Co. regarding a proposed method of defining an "accrued liability" under a pension plan for purposes of the plan's financial statements, as presented in a series of correspondence between Mr. Hall and Mr. Cassel of the FASB. The basic questions raised in the material presented deal with alternative methods of measuring and reporting information pertaining to the value of the participants' accrued benefits that might be included in a financial statement of a pension plan in accordance with generally accepted accounting principles. Although we will comment later on the purely technical aspects of the alternative solutions presented, we would first like to respond to a different and more fundamental question underlying the issue which was raised in the FASB's 1975 Discussion Memorandum on the subject. That is, should any statement pertaining to the value of accrued benefits, or some measurement of the "accrued actuarial liability", be presented in the pension plan's financial statement required by Section 103(b) of ERISA? Reference is made to the response of the Academy on January 9, 1976 by President Thomas P. Bowles, Jr. (copy enclosed) in response to the FASB's Discussion Memorandum. The basic thrust of our response to the questions raised in the Discussion Memorandum was that GAAP rules for accounting and reporting with respect to financial statements of pension plans should be limited to the pension fund and not be expanded to relate to the actuarial liabilities of the pension plan.

Our response to Basic Issue 1 stated that "the natural reporting entity for accounting and audit purposes is the 'fund'." It further stated, in response
to Basic Issue 5, that: "the appropriate item on the liability and surplus side of a financial balance sheet is a showing of an equity interest available for future benefits," and also: "Such a number is not, of course, a measure of the obligation for plan benefits, whether vested or accrued, and for any such measure reference can be made to an actuarial statement." In further response to Implemental Issue D under Basic Issue 5, which raised the question as to the degree of specificity to which an FASB statement should prescribe the actuarial basis for measuring an obligation, the Academy responded: "There is really no need for the financial statement of the plan to deal with actuarial liabilities and thus no need to prescribe an actuarial basis. If one particular basis were prescribed, it would generally add to, rather than replace, the actuarial statement produced by the plan's enrolled actuary, and hence be confusing and expensive."

The Academy position at that time, and remaining so today, is that the basic role of the accountant and GAAP rules is to deal with a financial statement of the fund and not the plan in its entirety. The actuary under ERISA was given the responsibility for the determination and presentation of the actuarial liability figures; his presentation of the actuarial status of the plan therefore incorporates the appropriate financial statements (i.e., the fund) which are the subject of the accountant's responsibility under the law. While it is true that the actuarial valuation results used to determine annual contributions to the fund may not necessarily represent the best measurement of the "accrued obligation" under the plan at any point in time, the determination and presentation of supplemental actuarial values to represent such accrued obligation should be the responsibility of the enrolled actuary.

Accordingly, the Academy views the extensive correspondence with Mr. Hall as pursuing a course of action which we have already recommended need not be given further consideration for GAAP purposes, since we do not believe the accounting profession need be concerned with the presentation of actuarial liability figures
which ERISA states is the responsibility of the enrolled actuary.

However, recognizing that the FASB is still exploring the various points of view on this subject, and in order to respond to the specific questions raised, we would like to comment on the technical aspects of the "Hall method" of presenting the value of accrued benefits, wherever such measurement might be considered.

Over the years, members of the actuarial profession through books, research papers, discussions and other means, have developed and presented a number of alternative actuarial funding methods which are appropriate to different sets of circumstances. The wide range of methods available are sufficient to present appropriate actuarial values for almost any conceivable need, although the profession welcomes and encourages the development of other sound approaches to the funding or measurement of actuarial liabilities. To be frank, however, we do not view the Hall approach as presenting a valid or logical measurement of actuarial present values. It consists of a blend of certain actuarial values with other mathematical derivations which results in the development of what we view as an artificial quantity which is of little value in the measurement or presentation of actuarial liabilities. Among the defects we see in the Hall approach are the following:

1. We are puzzled as to what audience would be assisted by the development of the present value produced by the Hall approach. It is unrelated to the actuarial liability developed by the plan's actuary for funding purposes and hence does not assist the plan sponsor or the participants in assessing the progress in meeting the funding objectives. It does not measure either the value of vested accrued benefits, or the value of all accrued benefits to give the participant an indication of the degree of benefit security. It neither shows plan participants the extent of protected or guaranteed benefits in the event of plan termination, nor shows the employer his potential liability (invasion of net worth) in such termination. It will likely misrepresent the value of accrued benefits to anyone.
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except an informed reader who fully understands how it was developed.

(2) It fails to recognize the differences in rates of benefit accrual for different plans and different companies. Because of the proration technique used which is related to accumulative pay history, the "number" developed by this method could not validly be used as a measurement of the accrued actuarial liability for a career average plan, any type of flat dollar benefit plan, a future service only plan, a plan with limits on past service credit, or more generally, any plan that has different rates of benefit accrual applicable to any prior period of service from those applicable to future service. Taken altogether, the types of plan described in the preceding sentence for which the method is inapplicable certainly represent a substantial percentage of the private pension plans in existence (and a large majority of plans with, say, more than 50 or 100 participants). A securities analyst, for example, in looking at the unfunded accrued liabilities for two different corporations measured by such a method could be totally misled because of the fact that the method masks completely the differences in the rates of benefit accrual under the different plans.

(3) Related to the previous item is the confusion to which plan participants would be exposed because of the development of yet another number purported to represent an actuarial liability of the plan. One of the problems leading to the development of ERISA was the lack of adequate communication to plan participants. The development of a present value figure following the Hall approach would add to the confusion, since it would be different from the actuarial figures prepared by the plan's actuary for any other purpose.

(4) Finally, from a purely practical standpoint, the collection of data to develop the proposed present value would be impossible for most companies today without a thorough, extremely expensive overhaul and redesign of their data processing systems or other employee recordkeeping systems. One of the most difficult problems faced by pension actuaries today is the need to cope with inconsistencies
in the actuarial valuation results from year to year because of the poor quality of employee records maintained by many employers. The proposed methods would require the development of a procedure to maintain (in machine processable form for any significant sized employer) the complete pay history of every individual employee. That may sound simple, but it poses enormous difficulties in view of the incomplete records kept by most employers today, and an extremely small number of employers would be in a position to establish such information without a substantial investment.

In summary, the Academy believes that the Hall approach to development of the "accrued liability" item for pension statement purposes is inferior to existing actuarial methods and will simply add to the confusion of those parties reviewing plan financial and actuarial statements. Accordingly, we hope that the FASB will not suggest it as a method of measuring actuarial liabilities of a pension plan.

We have been fairly general in our comments on the substance of the material presented to us because of fundamental flaws which we perceive in the approach which makes any detailed technical critique somewhat irrelevant. In addition, the Academy continues to believe that the FASB, in preparing GAAP rules for pension plans, should not be concerned with the development of actuarial liabilities. However, the Academy stands ready to discuss any of these issues further.

March 25, 1977
STATEMENT TO THE
JOINT BOARD FOR THE ENROLLMENT OF ACTUARIES

April 13, 1977

The American Academy of Actuaries, the Casualty Actuarial Society, the Conference of Actuaries in Public Practice and the Society of Actuaries are pleased to submit this joint statement in connection with the annual review of the Advisory Committee on Joint Board Actuarial Examinations ("Advisory Committee").

This statement has been prepared in response to the announcement of the annual review of the Advisory Committee pursuant to the directive of the Office of Management and Budget (OMB) that appeared in the Federal Register on April 5, 1977. This announcement also included the full text of the proposed "Justification Statement" prepared by the Joint Board in response to the OMB directive.

The four above-mentioned organizations have been active in submitting written statements and presenting oral statements at public hearings to both the Joint Board and the Advisory Committee. These statements have covered a variety of topics, including the creation of the Advisory Committee.

These organizations have long been supportive of the concept of an Advisory Committee to the Joint Board. Such an Advisory Committee is of substantial value to the Joint Board.
in efficiently handling the large volume of work required in implementing post-1975 enrollment standards. It also brings to the Joint Board the benefit of the expertise of enrolled actuaries with a wide variety of backgrounds and experience in pension actuarial matters.

As the Justification Statement of the Joint Board indicates, the Advisory Committee has been in existence for only a very short period of time. However, it has been extremely active during that period and already is engaged in several initiatives which should result in a substantial reduction of effort that would otherwise be required on the part of the Joint Board.

If the Advisory Committee were discontinued at the present time, a severe disruption would result and the workload of the Joint Board would increase sharply. The net effect could be a considerable delay in implementing post-1975 enrollment standards. This would be unfair to those prospective future enrolled actuaries who are waiting to become enrolled and is not in the public interest in meeting the requirements of ERISA.

It is in the public interest as well as the interest of the Joint Board and the actuarial profession that the work
of the Advisory Committee be allowed to proceed. Therefore, the four organizations wish to go on record in support of the proposed Justification Statement prepared by the Joint Board referred to above.

Peter W. Plumley  
Executive Director  
Society of Actuaries

Stephen G. Kellison  
Executive Director  
American Academy of Actuaries

Charles F. Cook  
General Chairman  
Education and Examination Committee  
Casualty Actuarial Society

Charles H. Watson  
President-Elect  
Conference of Actuaries in Public Practice
On behalf of the American Academy of Actuaries, I would like to thank the Department of Labor for the invitation to attend this conference and to appear here today. As Dallas Salisbury mentioned, my name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries.

We have heard many references yesterday and today to actuaries and their work. I was gratified to hear that most of them were favorable. However, since there have been so many references to actuaries and their role in connection with MET's, the Academy would like to make a few comments for the record. We believe that the actuarial role in the sound management of a MET is vital.

By way of background, the American Academy of Actuaries is a professional organization of actuaries which was formed in 1965 for the purposes of accreditation of actuaries to practice in the United States. The Academy includes members of four constituent organizations, the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, the Fraternal Actuarial Association and the Society of Actuaries. These organizations, or their predecessors, date back many years, one of them to the late 1800's, so that despite the relatively short duration of its formal existence, the Academy, its constituent organizations and their predecessors have represented the actuarial profession in the United States for over 80 years. The Academy is unique as the national accrediting actuarial organization for actuaries in all areas of specialization.

Actuarial science involves the evaluation of the probabilities of uncertain future events, often over long periods of time, and the financial impact which these events involve. The computation of financial values for insurance and pension programs is a major application of actuarial techniques. The future economic security of both individuals and industry depends upon a high level of training and professional conduct for actuaries. Actuarial science is a well-developed discipline which has proven to be fundamental to the sound financing of a variety of financial enterprises, such as insurance companies, non-insured pension plans, and MET's.

The role of the actuary in the regulation of such enterprises has been broadly recognized on both the state and federal levels. For example, at the state level, the National Association of Insurance Commissioners now requires an actuarial statement on opinion in connection with the Convention.
Blank filed by life insurance companies. This actuarial statement of opinion contains several items, including a statement that "the amounts carried in the balance sheet on account of the actuarial items...make a good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies." The NAIC has formally recognized Members of the American Academy of Actuaries as qualified to render such statements of opinion.

As an example at the federal level, ERISA places a number of requirements on the enrolled actuary under defined benefit pension plans. Under ERISA, actuaries must use "actuarial assumptions and methods which, in the aggregate, are reasonable and which, in combination, offer the actuary's best estimate of anticipated experience under the plan."

At this point, I would like to clarify that the Academy has no position concerning how broad or narrow the so-called "ERISA pre-emption" is, i.e. what constitutes a bona fide "employee welfare benefit plan". Nor do we have any position on the related question of state versus federal regulation in this or any other area.

In the regulation of MET's, the role of the actuary should be recognized in assuring the sound financing of such programs. The Academy is aware that some MET's have voluntarily used actuarial expertise and some have not, but we have no idea of the relative numbers involved.

There are a number of areas in the operation of a MET in which the actuarial element is essential. An obvious example is the setting of initial rates and the continued monitoring and updating of rates. However, rate setting alone is not sufficient. The setting of appropriate reserve levels, both for active participants in the plan and for those participants and beneficiaries who are in claim status, is another important actuarial function. Also, the establishment of appropriate contingency reserves is vital to protect against adverse deviation of experience from that anticipated. Even the largest MET's are subject to the considerable fluctuation in experience which is inherent in any risk enterprise. The actuary involved must determine an appropriate contingency reserve such that participants can feel confident that benefits will continue to be paid even if the experience deviates substantially from that expected. Actuaries also make other contributions to the sound operation of MET's, but the above examples describe some of the major areas of actuarial activity.

The American Academy of Actuaries stands ready to work with regulators at either the federal or state level in developing an effective regulatory environment for MET's. Such activity, on our part, would be directed toward the development of the actuarial requirements involved in the regulatory system and the definition of the qualified actuaries for this purpose. We would be happy to be of whatever service we can to the regulators in helping to assure the financial integrity of MET's and protecting the interests of participants and beneficiaries.

I would like to again thank the Department of Labor for inviting us to participate in this conference. I would be happy to entertain questions at this time, if there are any.
May 16, 1977

Cost Accounting Standards Board

RE: Proposed Cost Accounting Standard: Adjustment and Allocation of Pension Cost

Gentlemen:

The following comments are submitted on behalf of the Academy of Actuaries by our Task Force.

The proposed standard has adequately resolved several major problem areas contained in the initial Exposure Draft. We believe that the end result is workable, if not ideal.

Our suggestions for further revision, some of which were noted in our letter of September 3, 1976, are:

1. 413.50(a)(2). ERISA prescribes 15-year amortization of gains and losses only for the purpose of computing charges and credits to the minimum funding standard account. Employers who fund past service liabilities more rapidly than the ERISA minimum have freedom to amortize gains and losses over longer periods, subject only to satisfying the minimum funding test on a cumulative basis. The same latitude should be available to government contractors, so long as the accounting treatment is consistent from period-to-period.

Amortization of gains and losses over longer periods contributes to stability in the pattern of pension costs. This is desirable not only for the contractor, but for the government agency.
2. 413.50(b)(2). We do not oppose the 80%/120% corridor method as an acceptable expression of the principles described in the standard. However, other methods, which might from time-to-time produce an actuarial value outside of the 80%/120% corridor limits, will also achieve the stated objectives. Since it is desirable to use the same valuation method for government accounting and for ERISA purposes, we suggest that the third sentence be expanded by the phrase, "unless the impact on pension cost will not be material".

This revision would avoid specific reference to ERISA. On the presumption that ERISA's approved methods are not going to differ greatly in their financial impact from the 80%/120% method, the test of immateriality should be satisfied in most instances.

3. The amount of pension cost attributable to past periods may be affected by the provisions of Title IV of ERISA. Any charges against the residual net worth of a corporation due to the operation of Title IV should be recognized as a contract expense.

4. 413.50(c)(9). This section mandates a transfer of actuarial liability and a related amount of assets when an employee becomes inactive. It should be acceptable for the contractor to elect an alternative procedure, namely, to retain the assets and liabilities within the segment and to charge that segment for period benefit payments as they come due.

If it would be useful to the Board and the project director, we would be pleased to meet with you for an informal technical review of any changes in the
proposed standard that you may be considering
as a result of comments received from our Task
Force and other commentators. Please let us
know if we may be of further assistance.

Very truly yours,

American Academy of Actuaries
Cost Accounting Standards Board

William A. Dreher, Chairman
James J. Cryan
Avon G. Shannon, Jr.

c: Messrs. Kellison
    Gustafson
June 3, 1977

Mr. Melvin Blumenthal
Social Security Administration
Bureau of Health Insurance
Room 700, East Bldg.
6401 Security Blvd.
Baltimore, Maryland 21235

Dear Mr. Blumenthal:

It was a real pleasure meeting you on May 19, 1977 and discussing Provider Reimbursement Manual Revision HIM-15-1. The American Academy of Actuaries appreciates the opportunity you afforded me to discuss HIM-15-1 with the Bureau of Health Insurance. I am taking this opportunity to put in writing and summarize the items of interest to the Academy that we discussed in your office.

By way of background, the first draft of HIM-15-1 released in the summer of 1976 required "... an annual independently certified statement from an actuary". The draft included no definition of "independent".

In response to this draft, the Academy filed a statement dated August 6, 1976 with BHI. The Academy statement included the following points:

1. There was strong endorsement of the need for qualified actuaries to provide the certifications being considered by BHI. The actuarial role is vital in assuring the financial integrity of these various arrangements by which malpractice coverage is provided other than through commercial insurance companies.

2. Some definition of "independent" was required. It appeared that the type of independence BHI had in mind was financial and control independence between the actuary and the hospital.

3. Some qualification of "actuary" was needed, since a number of actuaries do not possess expertise in medical malpractice insurance.
For example, the concern was expressed that "enrolled actuaries" under the Employee Retirement Income Security Act of 1974 (ERISA) might attempt to practice in this area because they are "enrolled" by the Federal Government (Department of Labor and Internal Revenue Service), despite the fact that "enrollment" only applies to certain specific functions under ERISA and is not generally licensing as a qualified actuary. This concern is particularly relevant since very few "enrolled actuaries" possess education and experience in malpractice matters.

4. Membership in the American Academy of Actuaries is the hallmark of a qualified actuary practicing in the United States. The Academy was originally formed for purposes of accreditation of actuaries and includes actuaries in all areas of specialization within the actuarial profession. As we discussed in your office, well over 90% of the actuaries in the United States who meet the education and experience requirements of the Academy are, in fact, members.

The second draft of HIM-15-1 was released in November 1976 and required "... an annual certified statement from an independent actuary experienced in the field of medical malpractice and general liability insurance." If went ahead to define "independent" as not having "... any financial ownership or control either directly or indirectly in the provider." This draft represented a substantial improvement over the first draft in that it more completely defined the qualifications of the actuary rendering the certification and it defined "independent".

The third draft of HIM-15-1 was released in April 1977 and required "... an annual certified statement from an independent actuary, insurance company, or broker that has actuarial personnel experienced in the field of medical malpractice and general liability insurance." This provision represented a major departure from either of the first two drafts. The third draft also included a definition of "independent" which was virtually identical to the second draft, with only slight editorial differences.

This third draft has been disturbing to a number of actuaries because it potentially opens the door to a broader group of practitioners, many with lesser qualifications than required in the second draft, and because there were no indications on either the first or second drafts that such a major revision was in the offing.

Although the Academy would have preferred the language in the second draft to the third draft, we can understand the reasons you expressed for the revisions. I would like to elaborate on several points which we discussed verbally relating to the third draft:
1. The Academy has no concern with the employer affiliation of the actuary, as long as the "independence" requirement of BHI is met. The important point is the qualifications of the actuary rendering the certification, not whether the actuary is an independent consultant, an employee of an insurance company, an employee of a brokerage firm, or an individual with some other affiliation. I am not certain whether you are using the word "actuary" as relating only to self-employed actuaries or in actuarial firms, but we view any qualified actuary as being technically competent regardless of employment status.

2. There should be an interpretation of the phrase "... broker that has actuarial personnel ..." (emphasis added) to be certain that the "actuarial personnel" are substantively involved in the certifications. For example, consider a situation in which a brokerage firm has "actuarial personnel" in its New York office, but none in its Kansas City office. If a broker in the Kansas City office provides a certification for a hospital group in Missouri with no involvement of the "actuarial personnel" in New York (or any other office), then the spirit, if not the letter, of the regulations have been violated. The point is that not only should the broker have "actuarial personnel", but that such "actuarial personnel" should be substantively involved in the certifications and should be as professionally qualified as is required of actuaries not associated with a broker.

3. You indicated the intention of BHI to monitor certifications being provided and rigorously enforce the regulations to weed out unqualified certifiers. The Academy strongly endorses this statement of intent and recommends constant vigilance to ensure that only certifications from qualified individuals are accepted by BHI.

4. We would hope that any insurance company that is acceptable to BHI should be one that has experience in the field of medical malpractice and general liability insurance.

5. We are concerned that there is no requirement that the self-employed actuary must have experience in the field of medical malpractice and general liability insurance. Such an actuary who is a member of the Academy would have to have such experience or else, under the Guides to Professional Conduct, he could not undertake the assignment. However, other actuaries might not have such a constraint and might do such work even though they were not sufficiently qualified in this field (although perhaps being well qualified in other areas).
In closing, I would like to reiterate my offer that the Academy would be happy to work further with BHI on the qualifications of actuaries providing certifications and on the content of the certification itself. The Academy has a Task Force on Medical Malpractice composed of highly qualified actuaries with education and experience in the malpractice area that stand ready to be of service to ensure that the actuarial requirements of HIM-15-1 are properly implemented.

Again, I would like to thank you for your thoughtful consideration of our views.

Best personal wishes,

Stephen G. Kellison

SGK:cb
STATEMENT 1977-11

MEMORANDUM

DATE: June 8, 1977

TO: Members of the Reporting and Disclosure Work Group
Advisory Council to Department of Labor

SUBJECT: Revision of Form 5500, Schedule B of Title I

I have enclosed with this memorandum recommendations from two actuarial committees representing the American Academy of Actuaries and the Conference of Actuaries in Public Practice for revisions in Schedule B of Form 5500. The purpose of these recommendations is to offer to the Department of Labor a proposal for compliance with Section 103(d)(6) of Title I.

You will recall that this Section requires the actuary to provide the present value of all the plan's liabilities for nonforfeitable pension benefits allocated by termination priority categories. The Secretary of Labor is to establish regulations defining termination priority categories and acceptable methods, including approximate methods, for allocating the plan's liabilities to such categories. In accordance with Section 104(a)(2)(A) the Secretary has waived the requirements of this subparagraph for both last year and this year.

We would prefer that the provisions of this Section continue to be waived for all future years as we believe that the preparation of this information will be expensive, particularly in relation to the value that will be provided to plan participants. The cost for compliance probably well exceeds the value of the information. However, we recognize that the Secretary may decide that compliance is necessary and, therefore, the actuaries have proposed the enclosed revisions of Schedule B.

These actuaries believe that providing figures to plan participants showing present values of benefits by category without sufficient explanation will be misleading and could lead to unfortunate circumstances (e.g., participants expecting more or less protection than would actually be provided on plan termination). Thus
the instructions for completing the proposed Schedule B include explanatory footnotes setting forth in considerable detail how the estimates were prepared, their limitations and certain cautions to those using the information. Also, because many of the participants will be protected by the PBGC, information in this regard is required to be included in the notes to the Schedule.

As mentioned above, the actuaries feel that this may still be a costly item under some circumstances. While many of the actuarial valuations of pension plans currently include this information, there may be many others where this is not the case. Because of the cost problems, I would like to suggest some additional items for consideration by our Task Force.

First, we might want to omit this information for plans with less than 100 participants. Already small plans are under a tremendous burden to provide the information required by ERISA and perhaps this information can be omitted. I believe the information is just as valuable to the participant in a small plan as in a large plan, but yet we have to consider the cost implications.

Second, another possibility would be to omit the requirement to provide any figures whatsoever if the actuary can make a statement that all of the nonforfeitable benefits are covered either by the assets in the fund or by insurance through the PBGC.

You will notice that the two Committees already have made several suggestions in order to keep costs within reasonable bounds. They suggest approximations be used and, of course, explained in the footnotes. Also, they suggest that the data be given as of the same date of the last actuarial valuation, thus not requiring a special valuation just for this purpose. Finally, the classifications that they have listed are ones that generally are easily defined and for which benefits can be readily determined.

It is my recommendation that our Task Force adopt this proposal and recommend it for adoption by the entire Advisory Council for recommendation to the Department of Labor.

Sincerely,

PCB:rc
Enclosures
Amplications of Schedule B of Form 5500 Recommended
by the Special Pension Task Force of
The American Academy of Actuaries
and by the Committee on Pensions of
The Conference of Actuaries in Public Practice

Section 103(d)(6) of ERISA requires that the actuarial statement included in the annual report of the Plan Administrator contain (a) the present value of the plan's liabilities for nonforfeitable pension benefits allocated by "termination priority categories" of Section 4044 and (b) a statement of the assumptions used. Regulations are to define "termination priority categories" and acceptable methods for allocating liabilities to such categories.

Temporary Solution

In view of the inordinate expense that would result under continuing plans from the need to determine such present value for all priority classifications of Section 4044 each year, the Secretary of Labor has temporarily waived the required calculations under the authority of Section 104(a)(2)(A) of ERISA. Plan sponsors, actuaries, and other pension professionals appreciate this temporary solution to a problem that could evolve into a major administrative burden.

However, ERISA clearly mandates not only that the Schedule B Actuarial Information serve as a means of administration of the excise tax provisions of the law by Internal Revenue but also that the Schedule B indicate each year both the assets that would be available at plan termination and the value of nonforfeitable plan benefits, with appropriate breakdowns. This indication of funding under ERISA is an important measure of benefit security that will necessarily be included in the summary annual report distributed to participants each year under Section 104(b)(3) of the Act.

Accordingly, the actuarial profession has given extensive consideration to the various alternative approaches that might provide a practical means of satisfying the requirements of Section 103(d)(6) on a permanent basis.

Objectives

We believe that two important objectives shared by the Department of Labor, Internal Revenue Service, Pension Benefit Guaranty Corporation, plan sponsors, and the actuarial profession are: (1) to provide information that is useful to plan participants and (2) to provide information which can be developed at reasonable expense.
We also note the following important practical considerations: (1) The excessive expense of determining present values for all priority classifications under Section 4044 arises primarily from the distinction within the major priorities between benefits which are and are not guaranteed under Title IV of ERISA and (2) actuaries generally are now accustomed to calculating "nonforfeitable benefits" on the basis defined in Section 3(19) of ERISA in order to determine the "vested liabilities" defined in Section 3(25) of ERISA.

Recommendation

Based on our knowledge of the problems plan sponsors face in communicating with their employees and of the expense of actuarial valuations, we are suggesting changes in the Schedule B which we believe can meet the objectives described above. We are recommending that the unfunded value of vested liabilities that is now typically computed be utilized in the ERISA annual report, subject to the amplifications described below.

An important consideration in arriving at this recommendation, and at the suggested amplifications which follow, is the need to compare the present value of nonforfeitable benefits with the market value of the fund assets that is used under Section 103(b) and Section 4044 of ERISA. The possible fluctuation in market values between the computation date and the distribution date to employees is generally more important than the difference between the recommended procedure for calculation of the value of nonforfeitable benefits and other procedures of valuing the same benefits which have been found to be practical by the actuarial profession. This is true whether the calculation date is the beginning or end of the plan year.

Amplification No. 1

We recommend that the statement of the value of vested benefits now entered in Item 4(e) of Schedule B be expanded to provide a breakdown of such value into important subdivisions which we believe can be made available at nominal increase in expense. The proposed breakdown is provided in a new suggested Item 5 for the Schedule B. The breakdown closely parallels the categories of Section 4044, with the value for employees eligible for retirement substituted for the unavailable values of guaranteed as opposed to non-guaranteed benefits. On the basis recommended, the regulations under Section 103 (d)(6) could be relatively brief.

Amplification No. 2

We recommend the Department of Labor require that certain footnotes be included whenever the values proposed for Item 5 are included in a statement to participants. These notes are needed to avoid misunderstanding on the
part of plan participants which could result since the average plan participant might otherwise attach an unwarranted degree of accuracy to the actuarial present values. The notes would describe:

1. The major reasons for possible change in the unfunded value of vested benefits between the computation date and the date of the distribution of the report to the participants.

2. The guarantees afforded by the PBGC. (These guarantees should logically lead to less required reporting to participants than may have been desirable pre-ERISA in the absence of a program of plan termination insurance.)

These notes as well as additional notes that would frequently be appropriate are described more fully in the remainder of this recommendation, which includes the following:

1. A suggested revised Schedule B. All suggested changes are directed at a reorganization that seems logical to accommodate the information to be added in new Item 5 with these exceptions:

   a. We suggest a change in new Item 8 to read "full funding limitation credit" would be a useful clarification.

   b. We suggest a clarification in 4(d)(i) to indicate that the entries should state the amounts being amortized for purposes of the funding standard account. On this basis we suggest that the instructions for Item 4(d)(i) be deleted.

2. Suggested additions and changes in the instructions for completion of the Schedule B which indicate the basis we recommend for the completion of the information in new Item 5.
**Actuarial Information**

This schedule is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974, as amended by section 602(c)(1) of the Internal Revenue Code, referred to as ERISA, and section 5059(a) of the Internal Revenue Code, referred to as MCLA. This form is Open to Public Inspection.

For plan year beginning 1976 and ending 1977.

- File this schedule with DOL and IRS.
- Please complete every applicable item on this form. If an item does not apply, enter "N/A."
- Round off money amounts to nearest dollar.

Name of plan sponsor as shown on line 1(a) of Form 5500, 5500-C or 5500-K.

<table>
<thead>
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<th>Item</th>
<th>Amount</th>
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<td>2.</td>
<td>Yes or No</td>
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<tr>
<td>3.</td>
<td>Yes or No</td>
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<td>4.</td>
<td>Yes or No</td>
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<td>5.</td>
<td>Yes or No</td>
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<td>Yes or No</td>
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<td>7.</td>
<td>Yes or No</td>
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**Exclusions and Other Information**

- Enter most recent actuarial valuation date.
- Enter rates and amount of contributions received this plan year for prior plan years and not previously reported.

Date(s) and amount of contribution received this plan year for prior plan years and not previously reported:

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<thead>
<tr>
<th>Date(s) and amount of contribution</th>
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<tbody>
<tr>
<td>1976 and 1977</td>
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</table>

- Value of assets as determined for funding standard account.
- Unfunded vested liabilities as of January 1, 1977.

**Statements by Actuary**

- Attach a statement of the actuarial assumptions used to determine the present value shown in paragraph 5 above, if different than 6(a).

The statement is to describe any approximations used and include the notes described in the instructions.

**Contributions made to the plan for the plan year by employer(s) and employees:**

<table>
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<th>Month</th>
<th>Year</th>
<th>Amount paid to employer</th>
<th>Amount paid by employer</th>
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</tr>
<tr>
<td>Dec</td>
<td>1976</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total

Statement by actuary (use instructions before signing):
STATIONMENT 1977-11

PAGE 2

8 If funding standard account statement for plan year ending

Charges to funding standard accounts:
(a) Prior year funding deficiency, if any.
(b) Normal cost for plan year.
(c) Amortization charges (outstanding balance at beginning of plan year entered in item 4).
(d) Interest on (a), (b) and (c).
(e) Total charges, sum of (a) through (d).

Credits to funding standard accounts:
(f) Prior year credit balance, if any.
(g) Employer contributions (total from column (b) of item 8).
(h) Amortization credits (outstanding balance at beginning of plan year entered in item 4).
(i) Interest on (f), (g) and (h).
(j) Show balance (see note to funding standard account). Full funding credit or other (specify)
(k) Total credits, sum of (f) through (j).

Balance
d) Credit balance, excess, if any, of (k) over (e).

9 Alternative minimum funding standard account (omit if not used):
(a) Was the entry age normal cost method used to determine entries in item 4 as above? No
(b) Normal cost.
(c) Normal cost.
(d) Show balance (see note to funding standard account).
(e) Interest on (a) and (c).
(f) Employer contributions (total from column (b) of item 8).
(g) Total credits, sum of (a) through (f).

Instructions

Who Must File.—The employer or plan administrator of a defined benefit plan that is subject to the minimum funding standards (see section 412 of the Code and Part 3 of Title I of ERISA) must file this schedule as an attachment to the annual report filed for plan years beginning on or after January 1, 1979. Pursuant to Section 401(a)(19) of the Code, each plan must be considered as one unit of a single insurer, so that if one or more collective bargaining agreements entered into before September 2, 1974, are not subject to the minimum funding standards for plan years before the earlier of the termination of the last such agreement or January 1, 1981, the most recent actuarial valuation was made, if amounts shown were how the amounts in 4(d) were determined. 7(a) It the entry age normal cost method was not used to determine entries in item 4 as above.

4(c) Insert amount from item 5(b).

4(b) Not applicable to the first plan year to which the minimum funding standards apply.

4(d) Insert amount from item 8.

4(e) Not applicable to the first plan year to which the minimum funding standards apply.

4(f) Interest on (e).

4(g) Employer contributions (total from column (b) of item 8).

4(h) Total credits, sum of (e) through (g).

4(i) Interest on (f) and (g).

4(j) Determine the full funding credit under Section 412(c)(8)(A) of IRC as of the valuation date with interest adjustments to the end of the plan year.

5 Estimate nonforfeitable benefits of Section 3(19) of ERISA as of date in 4(d) using participants' history of pay and service on calculation date. Use actuarial assumptions consistent with the current value of assets for an active plan with respect to expected commencement of benefits, mortality, investment return, etc. Include any benefit to which an employee becomes entitled only by advancement in age or service and increases in Social Security benefits or covered earnings after the calculation date.

If the entry age normal cost method was not used to determine the entries in item 4 as above, the minimum funding standard account may not be used.

5(a) and 5(b) Include interest credited on participant contributions.

5(c) Include all former employees with benefits in pay status.

5(d) Include all former employees with benefits not in pay status.

5(e) Use current assets as of date used for liabilities under item 5.

6(a) Include the following notes: (1) Describe important changes that may occur in unfunded vested liability as a result of possible changes in current values of assets, plan assumptions, or for other reasons, between the calculation date and the date of the distribution of any report to participants.

6(b) Describe in general terms added benefit security provided by IRC guarantees, indicating benefits now included in calculation of the maximum benefit insured and the plan's share in the pool of Liabilities under title IV of ERISA.

6(c) When appropriate, indicate that contributions under the plan equal or exceed those required under Section 414 of IRC, and the accrued liabilities being amortized for purposes of Section 412(c)(9) of IRC.

6(d) When appropriate, describe any plan benefit features not included in present value of vested benefits determined for item 5.

4(c) Determine the full funding credit under Section 412(c)(8)(A) of IRC as of the valuation date with interest adjustments to the end of the plan year.
The American Academy of Actuaries is pleased to submit this statement of comments and recommendations in response to the invitation in the Commission's "Report of Tentative Conclusions" for interested parties to comment on the Commission's report.

By way of background, the American Academy of Actuaries was formed in 1965 as an umbrella organization for the four existing national actuarial organizations -- Society of Actuaries, Casualty Actuarial Society, Conference of Actuaries in Public Practice, and Fraternal Actuarial Association (the "constituent organizations"). These actuarial organizations, or their predecessors, date back many years, one of them to the late 1800's, so that despite the relatively short duration of its formal existence, the Academy and its predecessor and constituent organizations have represented the actuarial profession in the United States for over 80 years. As a part of our statement, there is enclosed a copy of the 1977 Year Book of the Academy; the brief historical statement commencing on page 2 of the Year Book, and the Bylaws, Membership requirements, and Guides and Opinions as to Professional Conduct beginning on page 155 may be of particular interest.

There are over 4,100 members of the Academy, most of whom are employed by insurance companies, independent consulting actuarial organizations, government departments and agencies, or in institutions of higher learning in academic roles. A significant number of members are employed by accounting firms and smaller numbers by management consulting firms or industrial corporations.
This statement is submitted in response to the invitation set forth on page 96 of the Commission's Report of Tentative Conclusions ("Report"), requesting "other examples in which respondents to this report believe that an auditor's independence was impaired by the performance of other services, or in which the potential risk of impaired independence is greater than the benefits provided."

Section 9 of the Report discusses the problems relating to the practices of some accounting firms to provide management advisory and other services to clients for whom they also act as auditors, and the extent to which such ancillary services may create unacceptable conflicts of interest or impair the required independence of the accountants. This Section 9 does not refer specifically to the provision of actuarial services by accountants -- a practice that has become increasingly widespread in recent years by some of the major accounting firms. This area is one that deserves careful and particularized consideration by the Commission.

I. The Need for Independence of Actuaries

As is true of the work done by accountants, the services performed by actuaries involve professional judgments that can be made reliably only by persons with the necessary competence, integrity and objectivity. In the same fashion that many members of the accounting profession render their professional services to their employers directly rather than through independent accounting firms, many actuaries are also engaged as employees of the company for which their professional services are rendered. Many significant actuarial determinations, particularly in the insurance industry, are satisfactorily and appropriately made by actuaries who are not "independent" of the companies for whom the services are rendered. By contrast, and due to the historical pattern of the manner in which the "pension industry" developed, the overwhelming percentage of actuarial
determinations in the pension area are made by actuaries who are independent of the organization for whom such determinations are made.

However, it should be pointed out that the need for independence in both the accounting and actuarial professions arises in the audit function, not in the area of the original determinations. Thus it is entirely appropriate for accountants and actuaries to be providing their professional services in making original determinations without consideration of the independence criterion. The importance of independence arises in the audit function.

The audit function has long been associated with the accounting profession, although "actuarial audits" in connection with statutory reserves of life insurance companies have been performed successfully for many decades by state insurance department actuaries, a procedure that obviously satisfies independence requirements. In recent years, however, there have been other demands for actuarial audits which have raised the independence question anew. For example, the development of GAAP statements for stock life insurance companies has created new needs for actuarial audits of such statements. In addition, the Employee Retirement Income Security Act of 1974 (ERISA), although not specifically requiring actuarial audits of pension plans, has in many instances created a demand for actuarial audits of pension fund valuations.

With these developments, the actuarial profession felt that the subject of possible requirements for independence of the actuary needed to be examined. Accordingly, some three years ago the actuarial profession established a Joint Committee on Independence of the Actuary (Independence Committee), the function of which, among other things, was to explore and identify the circumstances under which independence might be desirable or required and to determine whether and how independence might be defined in these contexts. The Independence Committee published two exposure drafts, receiving extensive comment thereon from the profession, and has recently submitted a formal report. The actuarial organizations are currently
engaged in considering the recommendations made in this Independence Committee report. It has not been formally published, but it has been given rather widespread distribution.

In the course of its study, the Independence Committee considered the situation of actuaries affiliated with accounting firms. This consideration led to the conclusion that methods of operation of accounting firms providing actuarial services could lead to actuaries of such firms being directly or indirectly involved in self-audit. Although the Independence Committee did not and could not deal with problems of independence for accountant/auditors, its conclusions regarding self-audit by actuaries in accounting firms inevitably raises similar questions with respect to accountants in these same firms. Therefore, while the Academy is concerned directly and exclusively with actuaries and with the performance of actuarial services, there is an evident need for closer scrutiny by the accounting profession of the work done by auditors in these contexts.

II.

The Rendering and Review of Actuarial Services

While actuarial services are provided in a great many situations, it is sufficient for present purposes to refer only to two that are the most frequent the most significant. First, the determination of the reserve liabilities of insurance companies can be made only through the application of actuarial principles. Second, the determination of the appropriate level and timing of contributions by a plan sponsor to a defined benefit pension plan for its employees, and of the actuarial reserves for said plan, also can be made only by a qualified actuary. Both of these determinations are usually reviewed by persons or a firm other than the one that made them initially. In many cases this review is made in connection with the furnishing of an opinion by an accounting firm of the
financial statements of the corporation, where the statements rest in part upon
the initial actuarial determination. In some cases the review may call for the
participation of another actuary; in other cases it does not.

The attention of the Independence Committee has focused to some extent
upon the relationships that may impair the independence or the appearance of inde-
pendence of both the actuary who makes the initial actuarial determination and
the actuary who may participate in the reviewing process. The Committee has not
undertaken to reach any judgment or opinion about the appropriateness of relation-
ships of the accountant or accounting firm that participates in the reviewing proc-
есс. These are matters that are obviously of primary concern for the accounting
profession and for the regulatory agencies to which it may be subject. However,
the Academy does have an obvious interest in the matter, and it seems entirely
proper for us to raise this issue in response to the Commission's invitation.

The issue simply stated is this: Is the independence of the accounting
firm impaired when an actuarial determination has been made by an actuary employed
by an accounting firm (or by a firm of actuaries that is affiliated with an account-
ing firm, either by reason of ownership or other close working relationship) and
the same accounting firm then audits the adequacy or sufficiency of that actuarial
determination in connection with its rendering of an opinion on any financial state-
ment that incorporates or is based in part upon the actuarial determination?

III.

Earlier Consideration of This Issue

While the Commission in its report of tentative conclusions suggests
that no fundamental change is necessary in existing practices involving the pro-
vision of management advisory and other services, it does state on page 100 that:

"While the Commission is not suggesting that any
particular services should be eliminated, avoidance of
certain services will improve the reality or the appearance of independence. Firms should not expand their offerings of other services without careful consideration of the tradeoffs involved."

There is evidently considerable difference of opinion within the accounting profession with respect to the provision of such services. In its testimony to the Senate Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, published under the title, Professional Responsibilities in a Time of Change, Arthur Young & Co. views the provision of management advisory services as a natural and historical part of the work of the accounting profession. A vigorous view to the contrary was expressed by Mr. Norman H. Stavisky, managing partner of Stavisky, Shapiro & Whyte:

"Under a concept of total service, some sell their clients whatever the client will buy. This has undermined my profession's reputation for integrity and independence in the delivery of our main function in society -- auditing and the rendering of opinions on financial statements."

Mr. Harvey Kapnick, Chairman of Arthur Andersen & Co., speaking for his firm, has said that, in order to assure that independent auditors are operating in a way "that meets their public-interest responsibilities," the following services should be eliminated by accounting firms:

"Executive recruitment; plant layout; product analysis; actuarial services; and marketing studies that involve interviewing the general buying public, analyzing psychological behavior, or making sales forecasts. It is the policy of Arthur Andersen & Co. not to practice in these areas. If there are similar peripheral areas that should be eliminated because they are determined not to be in the public interest, we will voluntarily eliminate them." 1/

Mr. William R. Mette, Jr., Executive Partner of Alexander Grant & Co., speaking on behalf of his firm, expressed a similar view:

"We have not provided actuarial services to clients and will not do so in the future because in our judgment such services result in decision making which places the auditor in the troublesome position of appearing to audit his own work." 2/

We note that the Arthur Andersen statement appears to reflect a decision on the part of that firm to limit its activities to those directly related to its principal business of auditing. It should be clear that we are not raising any question of whether a similar decision should be made by other accounting firms. The Academy has no grounds for objecting to the provision of actuarial services by accounting firms or to the establishment of affiliations between actuarial consulting firms and accounting firms. However, we do question whether actuarial services may be provided by the accountant or an affiliate to auditing clients of the firm without impairing the independence of the accounting firm, unless arrangements are made for an independent actuarial audit of these services.

During 1976 the Executive Committee of the Ethics Division of the AICPA made the following ruling that is published in ET Section 191:

"54. Member Providing Actuarial Services

.107 Question—If a member's firm renders actuarial services to a client, may the member also express an opinion on the client's financial statements?

.108 Answer—Even though the member's firm provides actuarial services (the results of which are incorporated in the client's financial statements), if all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results, the member's independence would not be impaired by such activities."

We do not have available the exchange of letters or other background material that underlie this published ruling. It may be that the Ethics Committee carried out an elaborate investigation into the nature of the actuarial services that were

provided in that case and into the extent to which the client was "in a position to have an informed judgment on the results." Without an opportunity to examine the files, we can only say that this ruling appears to us to treat a difficult and complex issue in a simplistic and offhand way.

First, with all due respect to the judgment of the AICPA Committee which arrived at this conclusion, we would seriously question whether the definition of independence can be stretched so far as to allow an audit to be deemed independent when the auditor and the actuary are working for the same firm -- "informed judgment" of the client notwithstanding. Nor is the questionable validity of the interpretation assisted by the fact that it happens to support continuation of the current practice of a few of the large accounting firms to engage in what we believe is a self-audit of actuarial services. The decision can thus be characterized as a self-serving interpretation.

By this interpretation, Actuary A, working for an accounting firm, might carry out the actuarial valuation of the pension plan of Company XYZ, an audit client of the accounting firm. Once these results have been "accepted" by Company XYZ using "informed judgment", then the accountant/auditor can bring in Actuary A to "independently" audit (actuarially) his own work and report back to the accountant that everything is satisfactory. We do not understand how any reasonable person or group could maintain that Actuary A is independent of the work he is supposed to be auditing. No matter how well informed the client might be, the case appears to be self-audit, pure and simple. Nor would we view the matter any differently if the review were performed by Actuary B, a colleague or business associate of Actuary A. It would be interesting to know how often a reviewing auditor has raised questions in the past about the adequacy of balance sheet items that rest essentially upon the work of actuaries employed by or affiliated with the auditing firm.
As a second point, even assuming for the moment that the concept expressed in the AICPA ruling is a valid one, in most cases the management of the company is not capable of making an informed judgment with regard to actuarial matters. For example, because of the highly complex nature of an actuarial valuation of a pension plan, the client would have to include an actuary on his staff in order to make an informed judgment on the acceptability of the results of such valuation. Only a handful of organizations outside the insurance industry have actuaries on their staff, often in non-actuarial roles, since it is generally not economically feasible to do so. Similarly, calculation of reserves for small life insurance companies is often done by outside consulting actuaries because there is no staff actuary at such small companies, again making it unlikely that management could make an informed judgment in this highly complex, technical area. Thus, even if the concept of informed judgment were accepted, informed judgment by management is generally impossible in the actuarial services area.

Presumably, the ruling leaves open for each auditor in a comparable position to decide for himself the delicate questions involving (1) which of the many judgments that are part of the actuarial determination are "significant"; (2) the extent to which a client is genuinely capable of deciding whether the actuary's judgments as to these significant items are satisfactory and should in effect be adopted by the client as its own judgments; (3) whether a client that has the requisite capability has in fact exercised its own informed judgment concerning the actuarial determination, or whether it has simply accepted the results, confident that the determination is acceptable and will be found satisfactory during the auditing process.

One can speculate whether an auditor can bring the necessary objectivity to the task of answering such questions, where the wrong answer may require his firm to give up profitable business. At the very least, it would seem essential that the Commission consider whether this "self-review" practice involves an
inevitable compromise of independence, or the appearance of independence. Such a judgment can be made only after the Commission acquires a thorough knowledge and appreciation of (1) the kind of judgments that are involved in the actuarial determinations, (2) how clients in fact rather than in theory respond to and utilize these actuarial determinations, and (3) what kind of auditing procedures are customarily employed in the reviewing process.

IV.

Conclusion

It is obvious that we are questioning the validity of the quoted ruling of the Ethics Division of the AICPA and have serious doubts that accounting firms can render actuarial services and then make an "independent" audit of financial statements which depend upon those services. We would acknowledge that there is much on the subject of accountants' independence with which we are unfamiliar and which may be directly relevant to this issue. We do believe that this issue is one that falls squarely within the charge to the Commission, that is, is important, that it involves significant and continuing relationships between the accounting and actuarial professions, and that the Commission should explore the issue with the care and attention that it plainly warrants. We would be pleased to cooperate with the Commission and its staff and to provide whatever factual data and resource material that can be readily obtained.
Outline of Presentation

I. Introduction

II. Comments on "Tentative Conclusions on Objectives of Financial Statements of Business Enterprises"
   A. Conclusion
   B. Application to Entities Without Investors
   C. Alternative Wording for Paragraph 13

III. Comments on "Elements of Financial Statements and Their Measurement" (Part 1)
   A. Conclusions
   B. Application to Entities Without Investors
   C. Application to Investor-owned Entities

Appendix: Special Financial Characteristics of Life Insurance Companies
   A. Nature of the Life Insurance Business
   B. Implications of Nature of the Insurance Business as Regards its Financial Statements
I. Introduction

We appreciate this opportunity to comment on the two portions of the conceptual framework study on which public opinion is currently being sought. We have prepared comments on the "Tentative Conclusions on Objectives of Financial Statements" and on the discussion memorandum, "Elements of Financial Statements and Their Measurement". These comments are contained in Sections II and III of this presentation.

A problem which actuaries have with present accounting standards is that standards which have been developed to recognize the needs of other types of organizations occasionally are inappropriate when applied to insurance companies, pension plans, and other entities with which actuaries are especially concerned. Examples of standards which produce inappropriate results are the accounting for deferred taxes in stock life insurance companies, consideration of the cost of acquiring life insurance policies as a "prepaid expense" asset rather than as a component of the aggregate policy reserve liability, the implications of FASB Statement 5 when applied to casualty risks, and the application of FASB Statement 8 to stock life insurance companies (Interpretation 15).

Because of problems such as these and because of the significant differences between insurance companies and other entities, we considered
the question of whether the accounting principles which apply to insurance companies should differ from those applicable to other types of organizations. We concluded that, at least for financial statements of stock insurance companies, it is in the interest of investors that accounting principles applicable to other investor-owned companies be sufficiently broad to be adaptable to the special nature of stock insurance companies.

In the past, we believe that the special nature of insurance companies has not been given sufficient recognition in the formulation of accounting principles. If such recognition had been given, the problems previously cited would not have developed. We believe that, as accounting standards are developed and articulated, one test of their generality should be whether they produce reasonable and meaningful results when applied to a stock insurance company.

We are also concerned about financial principles which apply to entities which are not investor owned. Accounting standards developed to meet the needs of investors may not be meaningful or appropriate if applied in these circumstances. We urge that the conceptual framework explicitly recognize that standards developed to meet the needs of investors and creditors cannot be assumed to apply to entities which are not investor owned. We therefore ask the FASB to reconsider the presumption expressed in Paragraph 4 of the "Tentative Conclusions".

With the hope that it would be useful to you as a future reference, we have prepared an appendix discussing some of the major characteristics of life insurance company financial reporting. Although it does not bear directly on the two documents currently being considered, we offer it as background
for some of our comments on the two documents and for use in future aspects
of the Conceptual Study.

II. Comments on "Tentative Conclusions on Objectives of Financial Statements
   of Business Enterprises"

A. Conclusion

As applied to investor-owned enterprises, the "Tentative Conclusions"
reached by the Financial Accounting Standards Board appear reasonable
to us. We disagree with the statement in Paragraph 4 that these con-
cclusions can presumably be applied to entities which are not investor
owned. We also have a suggestion for modifying Paragraph 18 to avoid
a possible conclusion which we do not think is proper.

B. Application to Entities Without Investors

The conclusion that the primary objective of financial statements of
business enterprises is to provide useful information to investors
and creditors will provide a worthwhile standard for judging proposed
statements of accounting principles applicable to investor-owned
entities. However, principles developed to meet the needs of investors
and creditors will not necessarily be applicable to entities without
investors and where creditors do not have a significant interest.
Several of the entities which actuaries are especially concerned with
fall in this category including, but not limited to, mutual life
insurance companies, mutual property-casualty insurance companies,
pension plans, other employee benefit plans, many forms of self-
insurance programs, and social insurance programs. In the past, it
has generally been recognized that financial statements of these
entities frequently take a different form from financial statements
of investor-owned businesses.
We believe that it should be explicitly stated that accounting principles developed to apply to statements of investor-owned enterprises can not be presumed to be appropriate for the financial statements of entities which are not investor-owned.

C. Alternative Wording for Paragraph 18

We are concerned over a possible misinterpretation of the first sentence of Paragraph 18. That sentence reads, "Financial accounting cannot directly measure the value of a business enterprise—the present value of expected value of expected net cash receipts—because of the uncertainty of expected cash receipts and payments, particularly those expected far in the future."

While this statement is true insofar as future sales are concerned, the measurement of the present value of future cash receipts is unavoidable in reporting the financial effects of existing life insurance contracts. Particularly in life insurance companies, a substantial portion of the current cash flow must typically be set aside for future costs under existing contracts. Such reserves are necessary to provide for the excess of the present value of future benefits and expenses over the present value of future premium income. In recognition of this situation, it might be appropriate to change the final phrase of the sentence quoted above from "particularly those expected far in the future" to "particularly those expected from future sales efforts" or some similar phrase.
It would appear that similar problems may also exist with many entities other than life insurance companies and that our suggestion would have general application.

III. Comments on "Elements of Financial Statements and Their Measurement"

(Part 1)

A. Conclusions

In the case of financial statements prepared primarily to meet the needs of investors and creditors, we recognize the values of both the asset and liability approach and the revenue and expense approach. Both of the alternatives listed are compatible with actuarial concepts and each provides information useful to investors and creditors. In choosing between the two alternatives, actuaries generally prefer the asset and liability approach. Regardless of the approach taken, we recommend that net income should be separated into a component representing operating earnings and one or more components representing other gains and losses.

We intend to comment later on Parts 2 and 3. Especially in Part 3, actuarial concepts are very much involved. If the attributes of financial statement elements which are to be measured involve future expectations or interest discounts of future amounts, the actuarial profession can make a very substantial contribution to the final rules and guidelines.

B. Application to Entities Without Investors

If financial statements are prepared for certain entities which are not investor-owned, such as mutual insurance companies, pension
plans, and other entities mentioned earlier, the revenue and expense approach may have little meaning. Similarly, if financial statements are prepared for primary users other than investors, such as insurance regulators or insurance buyers, the asset and liability approach may be appropriate. If it is intended that the principles developed for statements used by investors and creditors also be applied under these circumstances, the asset and liability approach would appear to be the only meaningful one.

C. Application to Investor-Owned Entities

While both the asset and liability approach and the revenue and expense approach are compatible with actuarial concepts, actuaries generally prefer a greater emphasis on the asset and liability approach. This is partly because the asset and liability approach lends itself to probabilistic considerations and evaluation of the financial effect of contingencies which the actuary is trained to study. Another reason is that the fiduciary nature of insurance companies and pension plans gives special emphasis to the balance sheets.

Regardless of which approach is taken, we believe that gains and losses should be defined as components of earnings separate from revenue and expenses. We believe that revenues and expenses so defined provide important information relating to events which tend to recur.

THE AMERICAN ACADEMY OF ACTUARIES
Appendix: The Special Financial Characteristics of Life Insurance Companies

This memorandum has been written to identify those characteristics of life insurance companies which differ from other business enterprises, to the extent these differences might affect the accounting standards applicable to life insurance companies.

A. Nature of the Life Insurance Business

1. The business is long term. At the time a life insurance sale is made, the service performed by the selling company has not been complete (as is usually the case in servicing, manufacturing, or merchandising). In fact, the service performed by the company in connection with that transaction is just beginning. The service to be performed by the company may stretch out as much as 100 years. With respect to sales of individual insurance completed within any calendar year, the average time over which the company must perform services in connection with those contracts may extend 7, 10, or even 20 or more years depending upon the nature of the type of insurance, the insurance company making the sale, and other factors.

While the fact that life insurance is a long-term undertaking is generally recognized, the full consequences of this are frequently not realized. We are encouraged by the fact that the AICPA explicitly took account of this characteristic of the life insurance business in formulating the industry Audit Guide. We trust that recognition of this characteristic will continue.

While many industries today possess long term characteristics, the long-term nature of the undertaking is often an internal matter. For example, an industry may invest considerable funds to develop products or explore raw materials and not sell those products or raw materials until a much later date. In such instances, the long-term activity of the business is not between the company and the consumer. While there are some businesses which consummate external transactions with consumers which lead to services which are extended over a considerable period of time, we are aware of no industry that engages in such transactions to the same extent as the life insurance industry.

2. The right to terminate life insurance contracts is unilateral. The contracts are continuable upon performance of the buyer. This characteristic also is reasonably well recognized but the consequences of it are frequently not understood. In particular, premium rates are guaranteed at issue for the duration of the life insurance contract, regardless of future experience.
3. **Life insurance companies are fiduciary organizations.** Investor-owned companies operate at a profit. However, even investor companies, because of their long-term unilateral obligations to consumers, must be constantly aware of their ability to carry out these obligations. In the case of mutual companies, there are no investors.

An insight to the importance of consumer orientation of the insurance business can be gained by considering the impact on consumers of the failure of different types of organizations. If a merchandising firm fails, there is usually little, if any, impact upon customers who have made purchases from the organization prior to the date of failure. The same is probably true in the case of a manufacturer. In both cases, there may be some impact on prior consumers, but we find no evidence that it reaches the proportion of the impact on purchasers of insurance in the event of a life insurance company failure.

In the event of the failure of a life insurance company, all those customers holding contracts with that company are affected. In some cases, the effect extends to removing from a household the means of support of the family on the death or disability of the breadwinner, or the loss of a considerable portion of anticipated retirement benefits. The impact is of far different magnitude than the impact upon the purchaser of a suit or of a car in the event of failure of the seller or manufacturer.

4. **The life insurance industry is a financial institution.** This characteristic is well recognized. However, the consequences of a combination of this characteristic and the long-term nature of the business are often not fully understood. The combination of these characteristics leads to life insurance company financial structures which are relatively free of conventional debt.

5. Most liabilities are long term and equal 70-90 percent of assets. This characteristic arises from the special industry characteristics previously mentioned. We know of no other industry that, by its nature, leads to a balance sheet with the amount of long-term liabilities appropriately being so large in relation to assets.

6. The life insurance business is based upon probabilities and risks. One consequence is that the liabilities (which are such a high proportion of assets, and which relate to such long-term unilateral obligations) are themselves based upon risk and probabilities. The management, consumers, and regulatory authorities, as well as investors, are among the parties most interested in the amount of these liabilities.
7. The life insurance business is based on the time value of money. Pricing and policy provisions assume that assets will be accumulated and will earn interest.

B. Implications of the Nature of the Insurance Business as Regards Its Financial Statements

1. The financial statements must be based on probabilistic evaluation of future contingencies. In addition to estimates of future mortality and morbidity, the financial statements must recognize the expected settlement value of outstanding claims, rates of termination of policies in force, rates of conversion of term and group life policies to permanent insurance, the expected future expense of administering existing contracts, and many other contingencies.

2. The financial statements must recognize the time value of money. The expected amount of policyholder obligations normally substantially exceeds the expected amount of premiums to fund those obligations. Only by appropriately discounting expected future cash flows can meaningful financial reports be prepared.

3. A statement of resources and obligations to transfer resources is the most meaningful financial statement available to management, investors, consumers, and others concerning the economic well being of a life insurance company. This is because the economic health of a life insurance company at a given point in time, clearly depends on its ability to complete its unilateral guarantees of services under long-term contracts. Further, the determination of the value of a company's liabilities at a given point in time is a matter of utmost importance. This is because these liabilities are a large percentage of total assets, and perhaps even more importantly, are a relatively high multiple of the excess of assets over liabilities. Also, the liabilities are determined by use of calculations involving probabilities and discounts, and variations in methodology of determining the values of the probability and discount parameters can have a significant impact on the excess of assets over liabilities. This is not to say that the determination of net income for an accounting period is not important. We desire simply to point out that the nature of the insurance industry places strong emphasis on the balance sheet as the principal indicator of the company's financial health.

4. Assets and liabilities must be accounted for consistently. As mentioned above, the liabilities which generally equal a large percentage of the amount of assets are based on future expectations. Both assets and liability amounts represent essentially present values of future cash flows arising from existing contracts and investments. It is essential that the bases of determining assets and liabilities be consistent.
5. Limitations imposed by insurance regulators have a substantial bearing on the investor's interest in the company. While financial information measured on the regulatory basis is not appropriate as the primary measure of the investor's interest in a stock life insurance company, the regulatory limitations represent important restrictions on the amount of the insurer's net worth which may be used for the benefit of investors.
INTRODUCTION

STEPHEN G. KELLISON, Executive Director of the American Academy of Actuaries:

Mr. Chairman, members of the Committee, my name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries. The Academy maintains its Washington offices at 1775 K Street, N.W., Washington, D.C., 20006.

By way of background, the American Academy of Actuaries is a professional organization of actuaries which was formed in 1965 by the four constituent actuarial organizations in the United States as an organization for the accreditation and public recognition of actuaries, regardless of areas of specialization. Despite the relatively short duration of the Academy's formal existence, the Academy and its constituent organizations have represented the actuarial profession in the United States for over eighty years.

As of December 31, 1976, the membership of the Academy stood at 4,137. These actuaries have a variety of types of employment including insurance organizations, consulting firms, government and academic institutions. Full membership in the Academy can be attained only by satisfying both extensive education and experience requirements. Well over 90% of those eligible to join the Academy do, in fact, do so. The entire Academy membership is subject to rigorous guides to
professional conduct and standards of practice.

Actuarial science involves the evaluation of the probabilities of uncertain future events, often over long periods of time, and the financial impact which these events involve. The computation of financial values for insurance and pension programs in both the public and private sectors is a major application of actuarial techniques. The actuarial nature of the financing arrangements for Social Security has been recognized since the inception of the program in 1935. In recognition of the extreme importance to society of maintaining the financial integrity of the Social Security system the Academy formed its Committee on Social Insurance several years ago. The Committee includes some of the most eminent actuaries in the United States with a wealth of experience in both the public and private insurance and pension programs.

With me today is the chairman of that committee, Robert F. Link. Mr. Link is also Vice President and Actuary of The Equitable Life Assurance Society in New York. He will now present a statement for inclusion in the record of these hearings on Social Security funding.

STATEMENT

ROBERT F. LINK:

Mr. Chairman and members of the Committee, I appreciate the opportunity to comment on the Social Security issues that Congress must currently deal with. Many actuaries have an intense interest in and concern with these issues. They are largely political: Should benefits be larger or smaller? Should the burden of paying for them fall more heavily on one group or another? And so forth.
Actuarial expertise can illuminate the consequences of one or another course of action; however, other talents may be needed to judge whether such consequences are good or bad. My comments are offered in this spirit. You will understand that, though many actuaries would agree with what I have to say, others may not; I do not represent a consensus or vote of actuaries. I do reflect the desire of actuaries to be helpful in the resolution of these difficult issues.

Specifically, I would like to address questions of strategy -- rather than detail -- in four subject areas. These are (a) decoupling, (b) decisions on benefit levels, (c) solution of financing problems, and (d) universal coverage and "opting out." The OASDI system is essentially an income replacement system. For simplicity, I'll be talking today as if it were a retirement system, mainly ignoring the disability and survivors' benefits except where I refer to them specifically, and completely ignoring health benefits.

Any discussion of what to do about Social Security has to start with some agreed upon understanding of the context, the purposes of Social Security, and the complementary or competing roles of other income replacement systems. My context is the whole range of income replacement systems, where Social Security provides a basic floor of retirement protection; private arrangements supplement basic floor Social Security benefits for those who have the necessary financial means or employment context, and various forms of welfare fill in where neither Social Security nor private arrangements are doing the job.

Where income security is to be provided by public programs, there is an interesting interplay between welfare and Social Security. Welfare uses a means test. This makes it more "efficient"; dollars spent on welfare go by and large where they are needed to do the job and generally not where they are not needed.
Thus, attaining minimum income objectives through welfare should cost less than attaining them through Social Security. There's no means test in Social Security, which makes it a more dignified approach from the viewpoint of beneficiaries.

What about the private arrangements? Private pensions have done an immense job. They have not escaped legitimate criticism, and ERISA is generally a step in the direction of improvement, though not without its critics. However, private arrangements do one thing that the other systems by and large don't do. They accumulate capital. This capital is taken out of current consumption and then re-enters the consumption stream at a later point. Not only that, but what re-enters exceeds in real value what is taken out. Unlike Social Security, private arrangements tend not to put a burden on future workers, because the burden has already been paid by current workers. And the capital that is generated helps to build and sustain the economy.

I review this familiar material to underline a point. OASDI is an income replacement system. Decisions concerning it should be made within the context of all major national income replacement systems, with careful attention to interrelated impacts. This interrelationship comes back again and again as we consider specific issues.

**DECOUPLING**

Decoupling is apparently non-controversial. Everybody wants to do it. The only questions have to do with how and to some extent with initial benefit levels. Actuaries have participated in the development of the Advisory Council approach to decoupling, on which the proposals of the Administration and the American Council of Life Insurance are based. They have also participated in the work of the Panel of the Congressional Research Service, which developed an alternative approach. In early 1976, the American Academy of Actuaries issued a position paper favoring decoupling. A copy is attached to this testimony.
Actuaries have no united position as to whether the Advisory Council approach or the Panel approach would be preferable. However, in approaching this question, it is helpful to have several points in mind.

1. There are some differences between the two approaches relating to transition arrangements, initial benefit levels, formula breakpoints, and so forth. The crucial difference is the basis for indexing the wage history -- by average wages or by the CPI. Unless a new method surfaces, a decision should be made on the indexing basis. The other features can then be tacked on.

2. With reasonable assumptions, the standard of living for successive waves of newly retired persons will rise under either approach. Under the Advisory Council approach, it will rise as fast as it does for workers. Under the Panel approach, it will rise more slowly than it does for workers.

3. The Advisory Council approach intends to fix a scale of replacement ratios that will remain level in the future. The Panel approach expects replacement ratios to decline, leaving room for Congress to adjust the system from time to time in accordance with currently perceived benefit standards.

4. These adjustments can be technically troublesome. Trying to make sensible changes that are consistent for people who have just retired and people who are about to retire leads to benefit formulas that are complicated and messy.

In the remainder of this discussion, when considering benefit levels and financing, I am assuming that replacement ratios will be stabilized at some level, rather than permitted to drift upward or downward. This doesn't indicate a preference for the Advisory Council approach; it merely recognizes that one likely result under the Hsiao panel approach would be that benefits would be adjusted from time to time to restore replacement ratios.
There is a vast lore of guidance and instruction as to appropriate benefit levels in income replacement systems. However, there is one universal principle. The replacing income under all programs should generally not be higher than that necessary to provide the individual or household with a net purchasing power comparable to that of the replaced income. This will mean in most cases that the objective for dollar income after retirement will be less than the income before retirement, to take account, for example, of reductions in living expenses and taxes. Turning for a moment to disability coverages, providing too much income puts the temptation on the side of being disabled rather than working. Some believe that excessive benefit levels may have something to do with the serious upward drift in disability experience under Social Security in recent years.

This principle should be observed in the Social Security system as well as in the broader complex of systems of which it is a part. However, beyond this, Social Security must be considered in the light of its particular nature as a contributory system and its relationship to other income replacement systems. This leads me to suggest five criteria that might be used when Social Security benefit levels are under consideration. These are as follows:

1. **Benefit levels should continue to be based on the earnings record in covered employment.**

2. **The benefit formula tilt in favor of the lower paid should be retained.** However, I think the benefit formula needs to be fixed to remove some anomalies that I will point out shortly.

3. **If workers are willing to pay the necessary taxes, the benefits should be made sufficient so that an individual or family not requiring welfare before entitlement should on the average not require welfare after entitlement.** "On the average" means we might do more than enough in a
low-cost area and not enough in a high-cost area. I'm sorry that I don't have good information on the benefit levels needed to meet this criterion. Some research is needed. However, note the proviso: if workers are willing to pay the necessary taxes, it may turn out that they won't be, in which case some benefit load will be shifted to welfare -- and will be a lower cost as a result.

4. **The benefit level should not be higher than necessary to provide the same net purchasing power that would be provided by earned income in covered employment before retirement.** This principle fits somewhat with the preceding one. As long as we have an earnings-based system, the benefits in relation to earnings should be reasonable.

5. **For persons with significantly less than full term of covered service, benefits should be proportionately reduced.** This is clearly not the case at present. People with short periods of covered employment get their wages spread over a long period for purposes of calculating benefits. In this way, the system treats them as long service low paid persons rather than shorter service higher paid persons. Thus, the benefit tilt in favor of low paid persons operates in favor of higher paid persons with short coverage. This result is aggravated by the minimum benefit, which is not justified by any of the principles that I've just stated.

The benefit formulas and the law should be designed to eliminate the anomalous excess benefits for persons with very low average wages and persons with short histories of covered employment. I'd be delighted to discuss with your staff some possible approaches to accomplishing these results in an orderly way, if you desire that.

**FINANCING STRATEGY - SHORT-TERM**

Our Social Security system has traditionally been financed by a payroll tax imposed essentially equally on employees and employers. The amount of
financing has been controlled in two ways: first, by adjustments in the tax rate from time to time as the system matured and more beneficiaries came on the rolls; and second, by upward adjustments in the dollar amount of maximum covered wages as average wages increased through the years under the force of rises in the cost and standard of living. Originally, the maximum was set at a point where 97% of covered persons were taxed on all of their wages. This percentage drifted down to a level of 64% in 1965. Increases since then have brought the percentage back to about 85% currently.

Some are now suggesting that this traditional system of equal employee-employer taxes on a wage base that moves roughly with general wage levels will no longer do the job. This has led to much greater pressure than formerly for such steps as increasing the maximum wage beyond the now automatic increases in the law, taking the maximum off entirely for employer contributions, and resorting in various ways to general revenues. Choices among the various alternatives do not present primarily actuarial issues; the issues are those of politics and policy. However, it is clear that these recent proposals involve important changes in our view of the system, raising issues of whether Social Security is a welfare system or not, what its role should be relative to other systems, and so on. The conservative approach would be to stick as long as we can with the traditional financing mechanisms before moving into new mechanisms.

Actuaries have something to say on this subject. We often observe the widespread human tendency in connection with benefit plans of all kinds to understate, minimize, or even conceal the costs while nevertheless providing or increasing the benefits. This is bad enough when it happens in the private sector. As we all know, it has also happened in the public sector. The one lesson in the developing financing problems of the municipal and other public systems is, keep the real costs visible. Only in this way can those who pay the costs be provided with an occasion to bring their influence to bear on benefit levels.
The great virtue of the traditional financing system is that it does this. The other suggested methods of financing won't do it as well, because they put added costs in places where there is less visibility and voting power. This is certainly true when you go to general revenues. It is also true when costs are placed disproportionately on employers. It is true when the maximum is raised for employees. And remember: raising the employee maximum ultimately raises benefits and is thus self-defeating.

It has been suggested that an increase in employer taxes will come out of profits. My economist friends tell me that an increase will most probably translate into lower wage increases or higher prices. If so, the cost would be paid either by employed persons or by consumers.

Here's a suggested strategy for dealing with the short-range financing problems. The strategy is to stick with the traditional methods as long as possible, hope that these will work, and don't break new ground that changes the nature of the system until you have to. Maybe it will turn out that you don't have to. We haven't yet exhausted the tax rate as a resource. Even the Administration proposals contemplate significant tax rate increases, only they come at the back end of the changes. Is it possible that some could be put up front? And let the automatics take care of the traditional base increases? The present employer-employee tax rate for OASDI is 4.95%. It has been estimated that the benefits proposed by the Administration could be financed by a tax rate of about 5.5% in 1980 and 5.71% in 1986. If the American Council of Life Insurance proposal were followed, with its phased reduction of about 10% in replacement ratios, the corresponding tax rates would be about 5.4% in those years. These rates assume no further decline in trust funds before 1980 and trust fund increases thereafter equal to one-half the annual increase in benefits. None of the rates appears to be impossibly high.
The central fact that must be reckoned with in addressing long-term financing is the change in population mix. There are currently about thirty-one beneficiaries per hundred workers. In the early 21st Century, that will rise to fifty beneficiaries per hundred workers. Social Security benefits as a percentage of GNP in 1979 are projected at 4.57%; under decoupling as proposed by the Administration, they would rise to 7.8% in the early 21st Century. The questions transcend Social Security. How are we going to provide for all those retired people without imposing unduly on workers? There are only four basic strategies: (i) reduce the relative benefits for retired persons; (ii) keep people in the work force longer (i.e., raise the retirement age); (iii) let a heavier burden rest on future workers than we have today; or (iv) increase the total pie of goods and services so as to make up the difference.

Here are a few thoughts on how to address the long-term problem. First, recognize that it is really long-term. There is lots of time to turn the Social Security ship in the direction we want to go. Lots of time to make studies and reach for integrated, broad-scale solutions.

Second, while the ratio of Social Security beneficiaries to workers is increasing from thirty-one to fifty per hundred, the corresponding ratio for dependent children is falling off. This change may contribute to a greater capacity to support the retired aged.

Third, don't forget private pensions and personal savings, which take goods and services out of consumption now so as to deliver them in larger measure when needed later. By transferring resources between generations, private pensions reduce the inequities that would otherwise be present. And they accumulate all that capital that we need so badly.

The real issue is a basic philosophical one: shall Social Security be a basic floor of protection, or do we want it to meet the full retirement need of a major segment of the population? If we want the first, then we should be
looking for more ways to foster and encourage the private arrangements.

Fourth, consider the retirement age question. If the medical advances that some are predicting should come to pass, this is an absolute must at some point. It's not too soon to start doing some long range thinking about it. Remember that the retirement age issue ties in with our current problems of unemployment and under-employment.

Fifth, people have proposed that the index for retired beneficiaries should be something other than the CPI. I suspect that some of those who make the proposal expect it to produce larger benefits, while others believe it will produce smaller benefits. If we are going to do anything about it, we should do the work as a preliminary to designing ultimate solutions for the long-term financing problems.

UNIVERSAL COVERAGE AND OPTING OUT

There is one aspect of the Social Security system that many observers find concerning. It is the position of government employees with respect to the Social Security system. Let's take permanent Federal employees first. They are not covered by Social Security. However, many government employees retire on full benefits, work for a period in the private sector, and get a Social Security benefit.

Furthermore, because their short earnings record is spread over a long period of potential coverage, the system mistakenly regards them as low-income persons and they benefit from the features of the system that favor low-income persons. This appears to be an unwarranted windfall at the expense of Social Security taxpayers generally. It must cost other taxpayers something. This is significant in relation to the current discussion of financing problems.

The natural way to fix this up would be first, to change the law so that Federal government employees are covered under Social Security, and second,
amend the various government retirement systems to take appropriate account of
this coverage. This is how it is typically done in private sector pension plans.
If permanent Federal employees were covered by Social Security, average benefit
costs over the next seventy-five years would be reduced by about 0.11% of
covered payroll. More importantly, because benefit liabilities build up slowly,
such a step could in effect put an extra $30 billion or so into the trust funds
in five years, if initiated in 1980.

If we don't include these Federal employees in Social Security, we should
at least amend the benefit provisions of Social Security in ways that I suggest-
ed earlier, so that a person with a short history of covered employment would
have his benefits figured on the basis of his average for that short period
with a pro-rating downward to recognize the fraction of actual coverage to full
career coverage. I don't have any estimate of the cost effects.

In the case of groups of state and local employees and certain other groups
where Social Security is optional, there is a much worse situation. Some have
elected not to be covered by Social Security. These groups present the same
problem and extra costs as do Federal employees. Those who have elected to
be covered are increasingly considering the option to terminate coverage.

These termination situations are of deep concern to actuaries. In certain
situations, the pressures to terminate are very strong because of the Social
Security tax expense. Actuaries are being asked to give consultation on the
relative merits of continuing or terminating coverage. The considerations are
extremely complex. The private sector can't really duplicate Social Security
benefits very well. The comparison involves the unknown future development of
Social Security.
However, there is an expectation that in many cases it will be on balance financially advantageous for a unit to opt out. The withdrawal in these cases would therefore be expected to raise the taxes for everybody else. Actuaries are distressed that their obligation to give consulting advice can contribute to an exacerbation of the financing problems of Social Security.

It would be desirable to find some way of achieving universal coverage of the groups for whom Social Security is now optional. I realize that the Constitutional separation of powers creates a problem; however, I would hope the obstacles are not outside the power of Congress to overcome if it wishes to.

CONCLUSION

I appreciate greatly the opportunity to express these views. Actuaries are vitally interested in the subject, and a number of them have participated in various ways in recent developments. If you see any other way that we can help, we'd be delighted to be asked.
In response to the invitation to comment on the proposed interim regulations for Health Maintenance Organizations, the American Academy of Actuaries' HMO Task Force recommends that the HEW require HMO's seeking qualification to submit a statement by a qualified actuary "that the rates to be charged are consistent with 110.101 (1) and together with other projected sources of income, make adequate provision for a reasonable estimate of future benefits and operating expenses". Specific suggested wording is attached.

If HMO's are to develop as viable health care financing and delivery systems, they must have sufficient income to meet health care costs and administrative expenses. In this regard, they must meet the same requirements for survival that all successful financial enterprises must face.

There is a grave danger that new HMO's will fail to anticipate their true costs during their early years of existence:

First, because the particular HMO is a new venture, they seldom have any past experience of their own on which they can base their estimates of physician and hospital utilization and price levels.
Second, because the HMO is required to provide substantially more comprehensive benefits than non-HMO group insurance plans, they are often confronted with very difficult marketing problems in terms of monthly price. Consequently, the marketing arm of the HMO asserts pressure to keep subscription rates at levels which can be lower than initial actual costs. On the other hand, very high rates on a dual option basis will result in low penetration, low enrollment and anti-selection, deferring or preventing a profitable operation.

Third, even the HMO qualification review offices from HEW exert pressures on new HMO’s to match or be below the general level of competition from regular group insurance programs or from fully established and operating prepaid group practice plans in the area, possibly unnecessarily. The apparent policy seems to be that deficits due to inadequate initial rates should be planned for, and supported by HEW loans. The presumption of such a policy is that in the long run, the HMO will be able to deliver its services at a lower level of cost, and initial underpricing is a reasonable and necessary business expedient.

Under these circumstances, a high degree of professional competence is required of the HMO’s staff to properly price the HMO’s health care services, taking into consideration initial working capital and projected changes in health care delivery patterns over a period of time. Lacking professional counsel, it is quite possible that a new HMO will have to be overly optimistic in its pricing. The services of a qualified actuary experienced in the development of capitation or premium rates
under an HMO environment is highly desirable or necessary.

The requirement that the services of actuaries are necessary to the successful operation of prepaid health plans has long been recognized by insurance carriers and Blue Cross and Blue Shield programs. Similarly, many self-insured health plans have recognized the need.

Currently, the Department of Labor is recognizing that the so-called ERISA trusts, providing health benefits for smaller employer groups on a non-insured basis, need the services of qualified actuarial supervision of their pricing and reserves. The all-too-common failure of many of these plans can be traced to inadequate regard to proper pricing of their products.

If the HMO's are to minimize the chance of financial failure, the HEW should require that each HMO seeking qualification submit an opinion signed by a qualified actuary that rates have been calculated based on his best estimates of probable health care costs, administrative and marketing expenses, inflation, and other factors, that sufficient capital will be available for the long-term viability, including development of reasonable contingency reserves (surplus) within a period of three to seven years.

We believe that the actuary submitting such an opinion should be a Member of the American Academy of Actuaries who is experienced in the pricing of group health programs, or a person who can provide evidence to the HEW of having education and
experience comparable to those who meet the requirements of the American Academy of Actuaries.

While we recognize that many developing HMO programs currently use the services of actuaries and that many HUS regional offices request an independent actuarial review for their grantees, we would suggest including specific language in the Regulations making such a review mandatory, both for continued grant funding, or for qualification - loan eligibility.

Rationale For Requiring Membership In The Academy

The most widely recognized hallmark of the qualified actuary practicing in the United States is Membership in the American Academy of Actuaries. The Academy includes qualified actuaries in all areas of actuarial specialization, whether it be life insurance, health insurance, casualty insurance, pensions, or some other area of practice. Admission as a Member of the Academy is achieved only by satisfying the rigorous education and experience requirements described in the next section of this statement. Membership as of December 31, 1976 stood at 4,137.

It is important to note that all Members of the Academy are bound by Guide to Professional Conduct 1(b): "The actuary will bear in mind that he acts as an expert when he gives actuarial advice, and he will give such advice only when he is qualified to do so". Thus, any Member of the Academy must be able to demonstrate his or her competence to supply statements and opinions for HMO assumptions and rates on the basis of training and experience.
Actuaries are accustomed to presenting opinions on the soundness and reserves for prepaid health programs underwritten by insurance carriers. The insurance industry is regulated by the states and Membership in the Academy is widely recognized for practice in this area.

For example, the Life and Accident and Health Annual Statement Blank developed by the National Association of Insurance Commissioners contains the following instruction:

There is to be included on or attached to page 1 of the annual statement the statement of a qualified actuary setting forth his or her opinion relating to policy reserves and other actuarial items. "Qualified actuary" as used here means a member in good standing of the American Academy of Actuaries, or a person who has otherwise demonstrated his or her actuarial competence to the satisfaction of the insurance regulatory official of the domiciliary state.

This requirement is now applicable in all 50 states. In addition, 21 states have promulgated regulations further requiring any representation by an actuary to be prepared by an actuary with these qualifications.

Background Information On The American Academy Of Actuaries

The American Academy of Actuaries is a professional organization of actuaries
which was formed in 1965 for purposes of accreditation and certification of actuaries to practice in the United States. The Academy includes members of four constituent organizations, viz. the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, the Fraternal Actuarial Association, and the Society of Actuaries. These organizations, or their predecessors, date back many years, one of them to the late 1800's, so that despite the relatively short duration of its formal existence, the Academy, its constituent organizations, and their predecessors have represented the actuarial profession in the United States for over 80 years. The Academy is unique as the national accrediting actuarial organization for actuaries in all areas of specialization.

The requirements for Membership can be summarized under two broad headings:

1. Education requirements

2. Experience requirements

An individual must satisfy both sets of requirements in order to be admitted as a Member. At the present time, the education requirement can be satisfied only by passing professional examinations given by either the Casualty Actuarial Society or by the Society of Actuaries. The experience requirement consists of five years of responsible actuarial work.

Enclosed with this statement is a copy of "Bylaws, Guides to Professional Conduct, Standards of Practice" which prescribe all the requirements placed upon those practicing as Members of the Academy. Also enclosed are copies of the examination syllabuses of both the Casualty Actuarial Society and the Society of Actuaries.
Summation

The American Academy of Actuaries is pleased to submit these comments in connection with the proposed HMO regulations. The Academy will be pleased to answer any questions about our recommendations or to provide any additional information required.
Interim Regulations Concerning Health Maintenance Organizations

Following are some suggested changes in the Regulations published in the FEDERAL REGISTER dated June 8, 1977:

110.101 - Add (t) "qualified actuary means a person who is a member of the American Academy of Actuaries, or a person who has otherwise demonstrated comparable actuarial education and experience to the satisfaction of the Secretary of HEW".

110.108 (a) - Add (5) "includes a statement by a qualified actuary that the rates to be charged are consistent with 110.101 (1) and together with other projected sources of income, make adequate provision for a reasonable estimate of future health care services operating expenses.

110.108 (e) - Add in line 5, after the word documentation - "prepared by a qualified actuary".

110.403 (e) (5) (1) - Add after word estimate "prepared by a qualified actuary".

110.504 - Add (f) "includes a statement by a qualified actuary that the rates to be charged are adequate, reasonable and consistent with 110.101 (1)".

Submitted by American Academy of Actuaries HMO Task Force

David Norton
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William Halvorson, Chairman
1. BACKGROUND OF STATEMENT

In October of 1975, the Financial Accounting Standards Board (FASB) issued its lengthy Discussion Memorandum dealing with the subject of Accounting and Reporting for Employee Benefit Plans. The American Academy of Actuaries (Academy) responded in this Discussion Memorandum in writing and appeared at the hearings held by the FASB in February of 1976. Among the major points made by this original Academy response to the Discussion Memorandum were:

(1) The financial statements of employee benefit plans should be prepared to provide information to plan participants and beneficiaries in simple, understandable form. The usual form of financial statement aimed at more sophisticated audiences might need to be simplified for such purposes.

(2) ERISA requires a substantial amount of reporting to the government and disclosure to plan participants at significant cost to the plan sponsor. Because of such expanded reporting requirements, caution should be exercised before expanding such reporting and disclosure requirements, unless such information is clearly of such value to the plan participants to be worth the additional cost of producing it.

(3) The financial statement required by Section 103(b) of ERISA should be a financial statement only of the assets of the plan without any statement as to the value of future benefit payments, inasmuch as ERISA
establishes that the determination of the actuarial liabilities of the plan is the sole responsibility of the plan actuary and not of the accountant/auditor who is preparing or auditing such financial statements.

This original submission and testimony of the Academy was supplemented by a further memorandum dated May 27, 1976, dealing with the potential effects of ERISA on the relationships between the accounting and actuarial professions regarding pension plans, a copy of which was sent to the FASB in June of 1976. This latter presentation discussed two major topics. The first dealt with the legislative history establishing the respective reporting requirements of accountants and actuaries under ERISA. The second part of the statement discussed the recommendations made by the AICPA on the FASB Discussion Memorandum which seemed to be inconsistent with the expressed intent of Congress in establishing reporting requirements.

The Academy is pleased to have the opportunity to comment on this Exposure Draft which has so many interrelationships with the actuary's responsibility.

II. GENERAL COMMENTS ON THE EXPOSURE DRAFT

The Academy shares the objective of the FASB to establish procedures to improve communications to plan participants concerning the security of their anticipated benefits under defined benefit pension plans. We do not agree, however, that the best method to accomplish this desirable objective is by expanding significantly the scope of the financial statements to include information beyond that required by Section 103(b) of ERISA. We refer, of course, to the proposal in the Exposure Draft that there should be included as part of the financial statements a statement of accrued
"accumulated") benefits together with a technical analysis of the changes therein. The decision to include such a statement is based largely on the conclusion of the FASB (par.7) that "financial statements of a pension plan should provide information within the limits of financial accounting that is useful to plan participants in assessing the security with respect to receipt of their accumulated benefits." The Exposure Draft accepts without question the premise that such information should be a part of the financial statements.

The validity of this premise, however, is in fact gravely questionable. To say that plan participants should be furnished with certain information is not at all to say that the best way for them to get it is as part of the plan's financial statements. We explain below why it is not the best way and why to do so would be likely to give rise to confusion and to unnecessary and undesirable conflict.

Before discussing the reasons why we do not believe the approach taken in the Exposure Draft represents the best solution to the problems, we might first comment on the employee communication problems in the benefit area generally. Experience has indicated, both with respect to the Welfare and Pension Plan Disclosure Act since 1960 or so and, more recently, with the distribution of summary annual reports and other disclosure material to plan participants, that the overwhelming percentage of participants have paid little attention either to the availability of information about their plans or to information that is given to them personally. Numerous examples of this could be cited, and the FASB has presented no factual evidence to the contrary.

This is not to suggest, however, that because participants in the past have exhibited a notable lack of interest in financial statements of
pension plans that no effort should be made to provide it. Obviously at least some of the participants do have such interest and there are probably other interested parties as well. Moreover, if the communication is made more comprehensible, more persons may find it interesting and useful. Bearing in mind, however, this demonstrated lack of interest by many plan participants in a lot of detailed financial information, it is reasonable to conclude that: (1) such information should be presented in as simple form as possible to be understood (pointing out that more detailed information is available upon request), and, (2) the costs of providing such information should be reasonable in relation to the value thereof to plan participants.

With this in mind, we would summarize our general areas of concern about the proposals in the Exposure Draft as follows:

(1) The FASB, by adopting an unnecessarily broad interpretation of the responsibilities of an auditor of the financial statements of a defined benefit pension plan, as well as of what constitutes generally accepted accounting principles in this respect, has ignored the structure established by ERISA, with the probable result that many annual reports (and conceivably many disclosure statements to participants) will contain two conflicting statements about the current value of the accrued benefits of the pension plan.

(2) The existence of guarantees of the Pension Benefit Guarantee Corporation (PBGC) has been underplayed considerably, and is too important to be so treated.

(3) The proposed information dealing with actuarial values is too complex to be understood by the average plan participant.
(4) There are a number of technical flaws or inconsistencies in the specifics of the Exposure Draft.

(5) The costs of actuarial services alone to provide some of the required information is unreasonable in relation to the value of such information.

The last four items relating more to technical and cost problems are covered in a separate Appendix A. Section III, below, discusses the respective problems relating to actuary's and accountant's responsibilities under ERISA. Section IV then explores certain problems for the actuary related to guides to professional conduct. Section V next following presents an alternative proposal which we feel meets the basic objectives of the FASB proposal for adequate communication to plan participants, while avoiding the problems we have raised, and finally Section VI presents a brief summary of certain recommendations.

III. ERISA REQUIREMENTS AND LEGISLATIVE HISTORY

In the early development of this pension legislation, the distinctive role of the actuary, as contracted with that of the accountant, was clearly brought out by the Comptroller General of the United States, who, in commenting on S. 3598 in his letter of August 31, 1972, addressed to Senator Harrison Williams (as Chairman of the Senate Committee on Labor and Public Welfare) stated as follows:

"It is recognized, of course, that an accountant who is not a qualified actuary with training and experience in pension plans should not be expected to express an opinion on the actuarial liabilities of the annual cost figures included in financial statements and reports for pension plans. He will have to qualify his opinion by stating that costs and liabilities are presented as stated by the actuary."
While this suggests the use of a qualified opinion, these comments were made prior to the development of the present form of actuarial statement, so that a currently available and preferable alternative to the use of a qualified opinion is the presentation of actuarial values in a separate statement (e.g., Schedule 8 of Form 5500).

While a number of pension plans, principally in the public employee plan area, are not subject to the requirements of ERISA, a matter that is addressed below, the substantial majority of defined benefit pension plans are subject to regulation under that Act. It is of critical importance, therefore, that so far as possible the financial reporting by pension plans should be consistent with the requirements of the Act. The Exposure Draft, however, makes no effort to achieve such consistency and in fact proposes a form of reporting that would inevitably lead to conflict.

Section 103 of ERISA contains elaborate provisions for the making of annual reports and disclosure statements by the administrators of defined benefit pension plans as well as of other types of plans subject to the Act. Section 103(a) requires an annual report which must contain both a financial statement reported upon by an independent qualified public accountant and an actuarial statement made by a qualified enrolled actuary. The requirements relating to what must be included as part of the financial statements are set forth in Section 103(b). The requirements as to what must be included in the actuarial report are set forth in Section 103(d). The Secretary of Labor is authorized by Section 103(c)(5) to require additional financial and actuarial information to be included in the report. Section 104 sets forth the requirements for the filing of the annual report and also for the furnishing of certain information to plan participants and beneficiaries.
It is evident from the structure of the Act itself, and this is confirmed by the legislative history, as well as by the regulations, that the Congress recognized the special nature of employee pension plans was such that a full report of their status called for the services of two different kinds of experts. Accordingly, the Act established a distinct division of responsibility between accountants and actuaries with respect to reporting by or on behalf of the plans. Matters within the special competence and expertise of accountants were assigned to them. Correspondingly, matters within the special competence and expertise of actuaries were assigned to them.

Section 103(b) expressly requires the financial statements to include a "statement of assets and liabilities" with respect to an employee benefit pension plan. The question naturally arises whether "liabilities" includes the liability for the payment of future benefits or what is sometimes referred to as the "actuarial liability." It seems quite clear, for the reasons given below, that it does not.

Section 103(b) (3) sets forth in considerable detail the schedules to be attached to the financial statements, so much so that it covers approximately six pages in the final bill. There is no reference at all to liabilities relating to the payment of benefits. It is difficult to believe that, if Congress intended actuarial liabilities to be included in the financial statement of 103(b), it would have gone into such detail on the financial transactions and assets of the plan and totally ignore any reference to actuarial liabilities.

In contrast, the required actuarial report explicitly includes, pursuant to Sections 103(c) (3) and (6), information concerning the "accrued liabilities" with respect to the plan with "an identification of benefits
not included in the calculation" and the "value of all of the plan's liabilities for non-forfeitable pension benefits. . . ." Since the amount of these liabilities would frequently greatly exceed the amount of the plan's assets, it is impossible to believe that the allocation of responsibility for their determination was not made consciously and deliberately when Sections 103(b) and 103(d) were being drafted.

The extent of "authority" granted by the GAAP provision seems well-defined in the law. Section 103(a)(3)(A) provides for retention by the plan administrator of a qualified public accountant, "to form an opinion as to whether the financial statements and schedules required to be included in the annual report by subsection (b) of this section are presented fairly in conformity with generally accepted accounting principles. . . ." (underscoring added). Clearly, this states that the GAAP principles involved relate to the specific requirements of Section 103(b), not the creation of a whole new statement.

The legislative history makes it clear that Congress understood that by allocating this responsibility to the Enrolled Actuary it was at the same time making it clear that this information should not appear in the financial statements. An earlier version of Section 103(b) included in a bill which passed the House of Representatives in 1974 did require certain actuarial values and a description of the assumptions and methods to be included in the financial statements. The Conference Committee (representing four House and Senate Committees) specifically deleted such requirements in the final version of the bill. There could hardly be a clearer indication of a Congressional intention that actuarial values should not be included in the financial statements submitted pursuant to
Section 103(b) and included only in the actuarial report prepared to Section 103(d).*

At the same time the references to actuarial values were deleted from Section 103(b), language was added in Sections 103(a) (3) (B) and 103(A) (4) (B) that the accountant could rely upon the correctness of any actuarial matter certified to by an Enrolled Actuary and that the actuary could, on his part, rely on the correctness of any accounting matter as to which the retained public accountant had expressed his opinion. This is a further indication that the Congress intended to allocate the responsibilities rather than to provide for dual responsibility.

There is an obvious reason why the information concerning accrued benefit liabilities should be prepared under the guidance of one of the parties rather than by both. Great confusion would result if there were presented to the public simultaneously two different conclusions. This was recognized by the Congress in its discussion of actuarial assumptions. The Conference Report accompanying ERISA states:

"In addition, under the Conference substitute, the actuarial assumptions in combination are to offer the actuary's best estimate of anticipated experience under this plan. The conferees intend that under this provision a single set of actuarial assumptions will be required for all purposes (e.g., for the minimum funding standard, reporting to the Department of Labor and to participants and beneficiaries, financial reporting to stockholders, etc.)"

* We have heard it argued that the deletion of the reference to actuarial values in Section 103(b) does not support the implication stated above because language was added authorizing the accountant to require financial statements to be presented in conformity with generally accepted accounting principles and that this provided the basis for including a statement of accumulated benefits. The references to GAAP in Section 103(b), however, were part of that section long before the references to actuarial values or liabilities, and so this argument is without foundation.
The joint recommendations of four committees of Congress involved in developing ERISA that the same assumptions should be used for all purposes, including reports to participants and beneficiaries, has thus either been ignored or rejected by the FASB. But the Exposure Draft recommends a set of actuarial assumptions and methodology for determining the value of accrued benefits which is likely to be different than those employed in the preparation of the actuarial report.

What, then, would be the result if the Exposure Draft were to be adopted in its present form? The annual report filed by a pension administrator pursuant to Section 104(a) would have as one part thereof financial statements that include a "statement of accumulated benefits." Another part of the administrator's report would be the actuarial report which also includes a statement of accrued benefits. As stated above, the values might be the same but would more likely be different.

The plan administrator, pursuant to Section 104(b)(3), must furnish plan participants annually with certain information. While this section does not expressly require more than the information set forth in the schedules described in subparagraphs 103(b)(3)(A) and (B), the proposed inclusion of a statement of accumulated benefits in the financial statements reflects the opinion of the FASB that this information ought to be available to plan participants. As we have stated earlier, this is an eminently sensible opinion. A conscientious administrator, therefore, would wish also to include such information in his report to participants, since Section 104(b)(3) calls also for such other material as is necessary to fairly summarize the latest annual report. Such a conscientious administrator, however, would then be in the position of having to explain to plan participants that his annual report to the Secretary of Labor also included an actuarial report which suggests that the information included as part of
the financial statements may not be correct. This can hardly be said to be an arrangement that furthers the goals of improved communication to plan participants and enhances the comprehensibility of the information that is furnished to them.

The correct, and indeed the only sensible, conclusion, in our view, is to follow the decision already reached by the Labor Department. In the instructions for the annual report on Form 5500, the statement of assets and liabilities required by Item 13 explicitly provides that the term "liabilities" in Items 13 (j), (k), and (l) does not include "the value of future pension payments." That information is to be provided in Exhibit B, and the schedule in Item 13 is only to include due and unpaid claims, unpaid expenses and similar items. As we explain below, we believe that Exhibit B can be significantly improved, and we have made and will continue to make suggestions for its improvement. For present purposes it is enough to recognize that it is the actuarial report and not the financial statements to which reference should be made for information about the value of accrued benefits and about the adequacy of the plan's funding.

We recognized at the outset that there are plans that are excluded from regulation under ERISA. The total number of non-covered plans is relatively small in comparison with the total, but the coverage is relatively larger in terms of plan participants because it includes municipal, state and federal plans. As to these plans there will be no required actuarial report at the present time. But we see no reason why the FASB cannot require that such a report be prepared and appended to the financial statements with a suitable qualifying statement that the information is included because it is useful but that it is not a part of the financial statements. It is also a distinct possibility (several bills now
have been introduced in Congress) that reporting and disclosure requirements will soon also be required for many of these public employee plans, which could then provide for comparable treatment to ERISA-covered plans.

With this background in mind, we should note that there is a serious question as to whether an Enrolled Actuary can prepare the actuarial information in the form recommended in the Exposure Draft without being in violation of his responsibilities under ERISA. That is, it is obvious (see Appendix) that many actuaries do not believe that the use of the PBGC actuarial assumptions "offer the actuary's best estimate of anticipated experience under the plan." It is, therefore, questionable whether the Enrolled Actuary engaged "on behalf of all plan participants" can provide the actuarial information on the basis proposed in the Exposure Draft without being in violation of his legal responsibilities under ERISA. If the final FASB report retains this approach, a serious legal review of the actuary's responsibilities would be in order.

IV. PROFESSIONAL RESPONSIBILITIES OF THE ACTUARY

Most Enrolled Actuaries are members of one or more national professional organizations. Specifically, out of slightly over 2,500 Enrolled Actuaries, almost 2,000 or 79%, are members of the Academy, and 85% are members of either the American Academy of Actuaries, the Society of Actuaries, or the Conference of Actuaries in Public Practice (including many with multiple memberships). All members of these organizations are bound to observe certain guides and opinions as to professional conduct, enforceable by disciplinary procedures. All three of these organizations have almost identical professional guidelines and opinions, and it is appropriate to quote from certain guides and opinions of the Academy which are pertinent (a complete copy of such guides and opinions is enclosed herewith).
Under Guides to Professional Conduct, Guide 2 (c) states:

"The actuary will recognize his ethical responsibilities to the person or organization whose actions may be influenced by his actuarial opinions or findings. When it is not feasible for the actuary to render his opinions or findings directly to such person or organization, he will act in such a manner as to leave no doubt that he is the source of the opinions or findings and to indicate clearly his personal availability to provide supplemental advice and explanation. If such opinions or findings are submitted to another actuary for review, either he or the other actuary will be available for supplemental advice and explanation."

Guides 4(b) and 4(c) state:

4(b) "The actuary will exercise his best judgment to ensure that any calculations or recommendations made by him or under his direction are based on sufficient and reliable data, that any assumptions made are adequate and appropriate, and that the methods employed are consistent with the sound principles established by precedents or common usage within the profession.

4(c) If, nevertheless, a client or employer requests the actuary to prepare a study which in his opinion deviates from this practice, any resulting report, recommendation, or certificate submitted by him will include an appropriate and explicit qualification of his findings."

The Opinions as to Professional Conduct are designed as interpretations of the Guides in more specific circumstances. Opinions A-3 and A-4 in the enclosed booklet contain many segments pertinent to this situation. For example, one paragraph of Opinion A-4 reads as follows:

"When an actuary prepares a report including cost or contribution figures in relation to a non-insured pension plan, Guides 2(c) and 4(a) apply. Thus, if the report is delivered by a non-actuarial associate of the actuary, or through a bank or trust company, the Committee believes that the actuary should recognize the risk of misinterpretation or misuse, and he should guard against it by application of the procedures indicated by the Guide 2(c). This can be done where the actuary does not sign or deliver the report, by the concurrent use of a supplemental statement, signed by the actuary, covering the actuarial portions of the material included."

The effect of these Guides and Opinions is that if a member of one of these organizations is requested or directed to prepare an actuarial statement based
on assumptions and/or methods which he feels are inappropriate (disregarding for the moment, the potential legal risks under ERISA described above), he must qualify such statement so as not to mislead any potential users of such statement. Further, it is his obligation to be sure that such qualification is included as a part of the total actuarial statement presented to the ultimate user of such statement. If such assurance is not forthcoming, he should refuse to provide the requested information.

As applied in this situation, we believe that any member of the Academy who did not believe that the actuarial basis prescribed in the FASB recommendation was appropriate would be forced to include a supplemental statement or qualification in his presentation of the actuarial values to the effect that they did not, in his professional judgment, represent the appropriate actuarial basis to measure benefit security. He would also have to insist that such qualification be included in any subsequent use of the information, such as being a part of the financial statement. Such qualification would hardly be reassuring to plan participants.

V. ALTERNATIVE TO PROPOSED STATEMENTS RELATING TO ACCUMULATED BENEFITS

The Academy concurs with the Exposure Draft recommendation that information should be provided to plan participants which is useful "in assessing the security with respect to receipt of their accumulated benefits." However, since experience has shown that only a small percentage of plan participants have any real interest in such financial and actuarial figures, such information must be of a nature that can be provided at reasonable cost. Most importantly, the information provided for this purpose must be kept simple and should not mislead the plan participants with respect to the value
of the plan on a continuing basis. It is our considered judgment, however, that the proposed statement of Accumulated Benefits and Statement of Changes in Accumulated Benefits do not meet these objectives.

As described in the Appendix to this statement, the Labor Department has recognized that the information required in Section 103(d) (6) of ERISA, which is the breakdown of actuarial liabilities pursuant to the termination priority categories of Section 4044 of ERISA, is extremely complex and expensive to produce. Accordingly, this requirement was waived for 1976, but in May of 1977, the actuarial profession was requested by the Advisory Council on Employee Welfare and Pension Benefit Plans of the Department of Labor to suggest revisions in Schedule B of Form 5500 which would comply with the intent of Section 103(d) (6) of ERISA, at least in approximate fashion.

In arriving at the suggested revisions in Schedule B of Form 5500, the actuarial profession carefully considered two important objectives which it believed to be shared by the Department of Labor, Internal Revenue Service, Pension Benefit Guaranty Corporation and plan sponsors; namely:

(1) To provide information that is useful to plan participants, and

(2) To provide information which can be developed at reasonable expense.

We believe that the intent of the FASB Exposure Draft indicates concurrence with these two objectives.

Attached (as Exhibit A) please find the resulting revised Schedule B which, on June 28, 1977, was recommended for adoption by the Department of Labor and the Internal Revenue Service by the Advisory Council of the
Department of Labor. It provides for a presentation of actuarial liabilities by priority categories, which typically are, or can be, a by-product of the regular actuarial valuation. We believe it represents an acceptable alternate to the Section 4044-type breakdown at considerably less expense.

We call to your attention five significant elements of the recommended revision in Schedule B:

1. Item 4(d) sets forth information with respect to progress towards meeting the funding goals established for the purpose of meeting the minimum funding requirements of ERISA, in relation to the valuation of assets used by the actuary for such funding purposes.

2. Item 5 sets forth the "value of nonforfeitable benefits," with an alternative breakdown for purposes of meeting the disclosure requirement of Section 103(d) (5) of ERISA, in relation to the market value of assets.

3. Footnotes to Item 5 are required as follows:
   (a) Describe important changes that may occur in unfunded vested liability as a result of possible changes in current values of assets, plan amendments, or for other reasons, between the calculation date and the date of the distribution of any report to participants.
   (b) Describe in general terms added benefit security provided by PBGC guarantees, indicating benefits not guaranteed on the calculation date as a result of the maximums insured and the phase-in of liabilities under Title IV of ERISA.
(c) When appropriate, indicate that contributions under the plan equal or exceed those required under Section 412 of IRC, and the accrued liabilities being amortized for purposes of the funding standard account.

(d) When appropriate, describe any plan benefit features not included in present value of vested benefits determined for Item 5.

(4) Actuarial calculations are to be made as of the latest actuarial valuation date used for purposes of determining minimum funding.

(5) With respect to Item 5, the actuary is to use "actuarial assumptions consistent with the current value of assets for an active plan with respect to expected commencement of benefits, mortality, investment income return, etc."

The proposal to use the information on a revised Schedule B does not mean that the Academy believes this is necessarily the best long-range solution to the problem of communicating benefit security information to plan participants. It may well be that an even simpler form of presentation will be desirable in the report to plan participants. However, at the moment we believe it is a satisfactory approach that can be developed at a reasonable cost on an actuarial basis consistent with the actuarial funding structure of the plan. The Academy Committee on Actuarial Principles and Practices in Connection with Pension Plans is actively considering the development of an appropriate format for the presentation of the actuarial status of a pension plan. When their work is finalized, it may produce desirable changes for Schedule B of Form 5500 and in other actuarial reports.
VI. **SUMMARY**

We believe that additional calculations, as proposed by the FASB, would increase actuarial service fees unnecessarily, without necessarily providing meaningful information as to benefit security to plan participants.

We believe that the requirements of Schedule B, as revised, will not add significantly to the cost of existing actuarial services.

We believe the actuarial profession should have responsibility for developing disclosure material of an actuarial nature, since the Enrolled Actuary has responsibility under ERISA for making his own best estimates.

We believe the selection of appropriate actuarial assumptions should rest exclusively with the Enrolled Actuary, since he is charged with this responsibility under ERISA.

It is the recommendation of the actuarial profession that the Board reconsider the conclusion reached in paragraph 105, as follows:

1. Eliminate any "measure of benefits" in the financial statements.

2. Recognize that Schedule B of Form 5500, as revised, includes both:
   (a) a measurement of progress towards meeting funding goals established for the purpose of meeting the minimum funding requirements of ERISA, and
   (b) a measurement of the "value of nonforfeitable benefits" suitable for comparison with the market value of assets.
The FASB obviously does not decide what information should go to plan participants; that is the responsibility of the Labor Department. However, the Academy believes that with respect to pension plans subject to ERISA, it would be desirable to make the revised Schedule B of Form 5500 a part of the Summary Annual Report distributed to plan participants (or alternatively, be appended to the financial statement, with full reliance upon the opinion of the Enrolled Actuary, as allowed under ERISA).

With respect to pension plans not subject to ERISA, require a comparable Statement of Actuarial Information, with an opinion by a qualified actuary (see Exhibit B).

The issues raised in this memorandum involve some fundamental interrelationships between the actuarial and accounting professions. Members of the Task Force and officers of the Academy would be pleased to meet with the FASB members and staff, as well as with representatives of the accounting profession, to help arrive at mutually satisfactory solutions.

Respectfully submitted,
Task Force on FASB Exposure Draft:
Preston C. Bassett
Douglas C. Borton
Blackburn H. Hazlehurst
Walter L. Grace
A. Charles Howell
Richard C. Keating
Barry L. Shemin
George B. Swick
Edwin F. Boynton, Chairman
Additional Comments Relating to Employee Communications, Technical Problems and Additional Actuarial Costs

The purpose of this Appendix is to present detailed comments on the Exposure Draft recommendations that we believe would tend to lead to misunderstanding or confusion on the part of the plan participants or present technical problems or inconsistencies. In addition, it presents estimates of the potential increases in the cost of actuarial service fees to comply with the proposals, based upon a survey made of a number of actuarial firms. This supplemental material has been presented in appendix form so as not to give the appearance of diluting the principal arguments presented in the main body of the statement—namely, that the determination of actuarial values generally, and under ERISA specifically, is the responsibility of actuaries. The comments made in this Appendix should therefore not in any way be interpreted as a modification of our basic position and, if anything, the presentation of these many technical problems can be viewed as evidence which reinforces our position that the determination of actuarial values is the responsibility of the actuarial profession.

Significance of Guarantees of the Pension Benefit Guaranty Corporation (PBGC)

The FASB has rightfully taken the position that the principal audience for the plan financial statements is the plan participant. Bearing in mind the lack of sophistication in reading financial statements among the audience, the usual content and format of the financial statements needs to be appropriately modified. The two most important elements affecting the long-range
security of benefits are (1) the continued viability of the plan sponsor as an organization willing and able to meet the funding commitments of the plan and, (2) the guarantees provided by the PBGC. The former point will be discussed later.

With respect to the latter point, we believe that the Exposure Draft underplays considerably the significance of the guarantees of the Pension Benefit Guarantee Corporation (PBGC), being given only brief mention near the end. One must realize that, in fact, virtually all private pension plans are required to participate in the PBGC program. This results in substantially all vested accrued benefits from private plans being guaranteed by the PBGC. It seems to us that the vested plan participant would be far more assured of the security of his benefits if he is advised that his total accrued benefits are in fact guaranteed by an agency of the Federal Government. He will certainly understand this far better than comparing actuarial values of accrued benefits under the plan with a fluctuating market value of assets. Thus, if the summary annual report to plan participants does include the market value of assets and some actuarial value of accrued benefits, it would be particularly important to explain and to give strong emphasis to the guarantees of the PBGC.

Communications with Plan Participants

Recognizing that the plan participants are not the sole audience of the financial statement, the FASB should nevertheless bear in mind that it is the principal audience. Because of the lack of financial sophistication of this audience, making the financial statement, or at least the part of it which would be included in the summary annual report, too lengthy or complicated will
have a reverse effect. A quick glance will convince the participant that he does not understand it, and he will put it aside.

There are several areas in the Exposure Draft which we believe should be simplified in the interest of communication to employees, enumerated in the following paragraphs:

1. As indicated earlier, one of the two key factors involved in the benefit security of pension plans is the fact that the employer is meeting his funding commitments. Such information should be given plan participants in some form. The proposed revisions in Schedule B discussed in the accompanying document would provide this information.

2. Typical accounting practice seems to require that when the balance sheet includes certain asset and liability items, it automatically requires that changes in such values during the accounting period be traced through. While this does make sense from the standpoint of the assets of the fund, it is of little value to trace through the complex and technical reasons for changes in the value of accumulated benefits. In addition to being extremely expensive to trace, it adds little to anyone's knowledge and produces a series of meaningless numbers for plan participants. Each valuation of a pension plan presents a "snapshot" picture of the obligations as of that date, and for most plans it is a useless but expensive exercise to trace through the technical reasons for the changes. It is a good example of the comment above, that giving participants too much detail will be counterproductive.

3. The requirement that the financial statement include an outline or a description of the plan or agreement is a duplication of the summary plan description already required by law to be furnished each participant. While it may meet the need for a complete financial statement, it would be a needless expense to distribute to plan participants another plan description.
(as part of the financial statement) which they already have in the summary plan description.

(4) The Exposure Draft implies that for many plans the value of accumulated benefits (par 173) might have to be subdivided into the termination priority categories set forth in Section 4044 of ERISA. It is doubtful if plan participants will understand the significance of this unusual and complex breakdown and, considering the complexities and expense (both administrative and actuarial) of doing this, this type of breakdown is just not worth doing. Further, the use of termination-of-plan categories in an annual statement to employees might needlessly give rise to apprehensions about the continued survival of the plan.

(5) There will be further confusion to plan participants by using the PBGC assumptions for determination of the values. This will produce a different value of accrued benefits than that produced by the plan actuaries, which is reported in Schedule B and available to plan participants. As noted, the Conference Committee report very explicitly stated that information given to plan participants should be based upon the same set of actuarial assumptions and methods for all purposes. In accordance with the law and expressed intent in the Committee Report, we believe that any actuarial assumptions should be selected by the Enrolled Actuary, and be consistent with the funding assumptions. In many cases, the PBGC assumptions will produce a liability figure which exceeds a realistic estimate made by an actuary for an ongoing plan and, therefore, will underestimate the true degree of benefit security.

(6) Another factor leading to potential misinterpretations on the part of plan beneficiaries is the use of market value of assets to contrast with the statement of accumulated benefits which are often determined on assumptions
which are independent of, and inconsistent with, the market value of a particular fund on any given valuation date. The experience in the past few years with widely fluctuating market values over short periods of time indicates the problems involved. Employee misunderstanding could arise in a period of temporary down markets at the valuation date because the security of benefits would appear to be threatened when, in fact, there may be no change in the true security of the benefits. Not only are the market values likely to rise before that is any benefit security problem, but there are the underlying guarantees of the PBGC.

(7) The Exposure Draft discusses the issue of whether all accrued benefits, or just vested accrued benefits, should be included in the value of accumulated benefits. While the Academy supports the concept of providing all participants with meaningful benefit security information, this approach can lead to confusion or apprehension on the part of employees as to their true benefit security. Unfortunately, the non-vested benefits fall into a highly "leveraged" position in the priority categories of actuarial liabilities, which, coupled with the use of market values of assets, will result in wide fluctuations in the supposed "security" of their benefits. Benefit security ratios for non-vested benefits could easily fluctuate over a period of a few years from 0 percent to 100 percent and back to 0 percent. In addition, there are no PBGC guarantees with respect to such benefit category. Although the benefit security (from the fund) for vested benefits would also appear to be threatened by market value changes, vested employees could still be assured by the guarantee provided by a government agency.

The following example, based on actual investment experience of a plan, will illustrate the fluctuations of benefit security ratios which can arise
using market values in conjunction with stable actuarial assumptions. It illustrates dramatically how the ratio of the market value of assets available to fund the present value of vested benefits, and of non-vested benefits, can change rapidly, up or down.

### Example of Variability of Benefit Security Measurement

**Based on FASB Exposure Draft Proposal**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Market Value of Assets</td>
<td>$68,957</td>
<td>$55,708</td>
<td>$43,402</td>
<td>$54,632</td>
<td>$65,331</td>
</tr>
<tr>
<td>2. Retired Life Liabilities</td>
<td>17,754</td>
<td>18,123</td>
<td>18,577</td>
<td>19,835</td>
<td>20,346</td>
</tr>
<tr>
<td>3. Assets Available for All Active Employees and Deferred Vested (1-2)</td>
<td>51,203</td>
<td>37,585</td>
<td>24,825</td>
<td>34,797</td>
<td>44,985</td>
</tr>
<tr>
<td>4. Liability for Vested Employees</td>
<td>25,833</td>
<td>28,069</td>
<td>34,085</td>
<td>35,344</td>
<td>40,974</td>
</tr>
<tr>
<td>5. Percentage of Vested Liabilities Funded</td>
<td>198%</td>
<td>134%</td>
<td>73%</td>
<td>99%</td>
<td>110%</td>
</tr>
<tr>
<td>6. Assets Available for Non-Vested Employees (3-4)</td>
<td>25,370</td>
<td>9,516</td>
<td>(9,260)</td>
<td>(547)</td>
<td>4,011</td>
</tr>
<tr>
<td>7. Non-Vested Employees</td>
<td>4,966</td>
<td>4,931</td>
<td>5,250</td>
<td>5,325</td>
<td>4,805</td>
</tr>
<tr>
<td>8. Percentage of Non-Vested Liabilities Funded</td>
<td>511%</td>
<td>193%</td>
<td>0%</td>
<td>0%</td>
<td>84%</td>
</tr>
</tbody>
</table>

This happened to be a well-funded plan, so that even in the worst years of 1973-74, vested benefits remained well-funded from plan assets (but would, with similar circumstances in the future, be 100 percent guaranteed by the PBGC). But how does one attempt to explain to the non-vested employee the apparent dramatic worsening of his "security" from 500 in 1972 to 0 in 1974, followed by a turn back to a well-funded position in 1976?
Technical Problems with Exposure Draft

In addition to the fundamental questions as to whether the specific information proposed to be included in the financial statement will truly be of value to the plan participants, there are a number of technical and practical problems inherent in the recommendations in the Exposure Draft.

(1) The problems of communicating pension-related information have always been made more complex by a lack of uniform terminology. The Exposure Draft does not help matters by creating new terms when it appears that some commonly accepted terminology would suffice. The terms "accumulated benefits" and "statement of accumulated benefits" are cases in point, when "accrued benefits" and "actuarial liability for (or even "present value of") accrued benefits" would be much more understandable. The term "accrued benefit" would particularly be more meaningful since it is defined in ERISA and every covered plan must meet the ERISA definition. Using "accumulated benefit" instead of "accrued benefit" implies that it is something different. Similarly, using "statement" in lieu of "actuarial liability" or "present value" simply adds to an already confusing terminology problem.

(2) The proposed method of determining the "current value of accumulated benefits" not only involves different assumptions than the regular valuation by the actuary, but different techniques as well. Thus even if the same actuarial assumptions are used, the value of vested accrued benefits for APB #8 purposes could differ significantly from such value determined pursuant to the Exposure Draft. Methods for determining these values should be consistent.

(3) Paragraph 19c states that no recognition be given to the cost-of-living features in the plan. We believe that this concept is totally misleading and distorts materially the picture of benefit security. Cost-of-living features, which are common in public plans, may add 25%-50% to the cost of
plans, and ignoring such features would make any analysis of the funded position of a plan meaningless. Any member of the Academy, in order to comply with the guides to professional conduct, would either have to refuse to calculate the actuarial value on that basis, or be required to qualify his determination with a statement that the values were not calculated in accordance with accepted actuarial practice.

(4) For most plans, data are collected as of the beginning of a plan year and actuarial valuations are performed during the plan year. The Exposure Draft contemplates using year-end values. Year-end projected values can be estimated at the time only if PBGC's year-end rates are then known, which is not likely to be the case. As yet, PBGC has only been able to furnish its rates retroactively by a few months and has not been able to furnish them prospectively or even currently. Aside from this, projection of year-end values would require estimates of changes in the employee census, pay changes, etc., all leading to additional expenses merely to make estimates. If the financial statements are to be prepared on time, there would have to be guidance as to an acceptable cut-off date regarding "subsequent events," with due recognition to the necessary time requirements for an actuarial determination of the effects of such events on the current value of accumulated benefits.

The Board should be aware of the practical reality for many plans of having the required information in final form available within seven months following the end of the plan year.

(5) The calculation of the accrued liabilities by plan termination category set forth in Section 4044 of ERISA is not a by-product of the regular actuarial valuations. It requires breakdowns which are not normally
made and different assumptions from those used in the regular valuations. Although the calculation would be needed upon plan termination, it would involve a significant but needless expense to require it annually for all plans. The additional expense would occur because of the need to calculate benefits based on the eligibility status and plan provisions that were in effect several years before the valuation date. As indicated later, herein, the calculation of the value of the benefits so determined is one of the significant factors leading to an increase in the cost of the actuarial valuations. For many plans, securing and maintaining the proper data to make these determinations annually just cannot be justified under the guise of disclosure. ERISA, however, gave the Department of Labor the right to waive this calculation. Because of the extreme difficulty and expense in preparing the calculation for an ongoing plan as compared to the value of this information for an ongoing plan, the Department of Labor decided to waive this requirement in the law, temporarily at least. We believe the FASB should accept the government's position. With respect to paragraph 178, it would be almost impossible to determine whether the information is useful to a class of participants without making the detailed calculation.

(6) The proposed statement also would require an analysis of the year-to-year changes in the value of accumulated benefits, which, as indicated earlier, is of little value or interest to plan participants or anyone else. This would necessitate actuarial gains and loss determinations, as well as double valuations to determine the effects of plan amendments and assumption changes. It must be expected that PBGC's rates will change every year, requiring a double valuation for that purpose alone.
(7) The requirement of retroactive restatement of prior years' figures and interim changes is impractical and not justified from a cost standpoint. Since the accumulated benefit information being presented has never been presented before, it would require revaluing all plans just to establish a starting point if the analysis of changes were retained. Regardless of expense, it may be impossible for many plans to make retroactive calculations of required items for past years since the necessary information to make the calculation has not been collected in the past or retained. In many cases, it is not available.

Furthermore, the large year-to-year changes in the value of the accumulated benefits, which would reflect changes in PBGC rates and other factors, diminish the value of such year-to-year comparisons. Any requirement for retroactive changes seems unwarranted from a practical standpoint.

(8) The statement of accumulated benefits, as technically defined by the Exposure Draft, presents to participants a measure that has no precedent of either demand or usefulness. It differs from the determination of the APB #8 vested liabilities and from any other measure of the value of accrued benefits for an ongoing plan. In the ongoing situation, the level of assets is related to the funding method used and the funding goals established, not to the value of accumulated benefits as defined in the Exposure Draft. In addition, the liabilities for an ongoing plan are affected by such factors as salary increases, turnover and rates of retirement, as well as by interest and mortality.

As indicated in paragraph 47, the information in the financial statements would have to be adjusted in the termination situation, since the statements of accumulated liabilities would not reflect the plan's liabilities under this circumstance, nor would it reflect the impact of PBGC
guarantees. Thus, the concept used in the Exposure Draft is meaningless for either an ongoing plan or a terminated plan.

(9) As indicated earlier, we do not believe that participants would gain much from the detailed explanation of causes of changes in accumulated benefits. From a technical standpoint, the largest changes will occur due to amendments, changes in interest rates if PBGC rates are used and changes in benefits accumulated due to the passage of time, pay increases, etc. There also is a significant technical question regarding how to allocate the changes to the various sources specified in paragraph 28. The allocation to the sources of change will vary considerably depending upon the order in which they are taken (e.g., is the value of amendments determined before or after the effect of the interest rate change?). We believe that the "statement of Changes in Accumulated Benefits" is impractical, costly, and of little value to anyone.

(10) PBGC rates should not be required to measure the value of accrued benefits. Instead, rates should be applied as determined by the actuary to reflect a proper comparison with assets at current market values, consistent with intent of ERISA as previously described.

We would question the statement in paragraph 147 that the measure best meets the needs of participants for financial information about the plan. PBGC rates are, in fact, particularly inappropriate for the type of measurement which is the apparent objective of the financial statement proposed in the Exposure Draft. The PBGC rates reflect an actuarial basis derived from averaging rates at which several insurance companies would guarantee benefit payments for as long as the next 50-60 years. While such basis may be realistic in the predictable short term, it becomes unduly conservative for the long term, since it represents a guarantee basis,
not a "best estimate" basis called for by ERISA. As such, it is only appropriate for clear termination situations and not as a measurement of accrued obligations for an ongoing plan. In addition to conservative long-range interest rates, the PBGC rates include a contingency reserve element that is not required for the type of analysis proposed.

It should be noted that the main advantage of a single standard - that of comparability - is defeated by the frequency with which the PBGC has changed interest rates - making a comparison from year to year, or even between plans several months apart, much less meaningful.

For example, the following table illustrates actual PBGC rates that have been used since ERISA became law:

<table>
<thead>
<tr>
<th>Date of Plan Termination</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/2/74 - 9/30/75</td>
<td>$2.0490</td>
<td>$2.4870</td>
</tr>
<tr>
<td>10/1/75 - 12/31/75</td>
<td>2.1104</td>
<td>2.5666</td>
</tr>
<tr>
<td>1/1/76 - 2/29/76</td>
<td>2.1030</td>
<td>2.5526</td>
</tr>
<tr>
<td>3/1/76 - 5/31/76</td>
<td>2.2928</td>
<td>2.8000</td>
</tr>
<tr>
<td>6/1/76 - 8/31/76</td>
<td>2.4217</td>
<td>2.9573</td>
</tr>
<tr>
<td>9/1/76 - 11/30/76</td>
<td>2.5239</td>
<td>3.0888</td>
</tr>
<tr>
<td>12/1/76 - 2/28/77</td>
<td>2.5242</td>
<td>3.0992</td>
</tr>
</tbody>
</table>

Percentage Increase:

<table>
<thead>
<tr>
<th>Year End</th>
<th>Male</th>
<th>Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974 to 1975</td>
<td>3.0%</td>
<td>3.2%</td>
</tr>
<tr>
<td>1975 to 1976</td>
<td>19.6</td>
<td>20.4</td>
</tr>
<tr>
<td>1974 to 1976</td>
<td>23.2</td>
<td>24.2</td>
</tr>
</tbody>
</table>

The sharp increase in these rates over this short time span, coupled with the effects of a volatile market value of assets, could lead to unnecessary concern on the part of participants as to the funded security of their plan. Again, the fundamental problem is one of using short term, inconsistent values of assets and actuarial liabilities, whereas the funding of a pension
plan is a long-term proposition and should be valued as such.

(11) The statement in paragraph 163 that actuarially equivalent early retirement benefits need not be measured is inconsistent with the required use of PBGC mortality and interest rates, since plans do not use the PBGC rates when determining early retirement reductions. In fact, PBGC itself does not use them to adjust the maximum guaranteed benefits on early retirement.

(12) In certain circumstances, the exclusion of deferred group annuity reserves can significantly alter the purported benefit security of the plan, and the decision to exclude them should be reconsidered. Individual participants generally will not know what part, if any of their benefits are covered by the contract in the many plans which have a suspended group annuity contract. Also, in some cases, premium payments may not yet have been completed for the purchase of all accrued benefits to be provided by the contract.

The suggestion in paragraph 192 that the aggregate annual amount of such benefits under excluded insurance contracts would be an appropriate disclosure seems pointless. Nowhere else in the statement is any information presented regarding the annual amount of accumulated benefits under the plan. Therefore, this information would be of no value.

(13) The assumptions regarding the commencement of early retirement benefits, the inclusion or exclusion of various death benefits, and the exclusion of disability benefits, are major requirements of disclosure for a proper understanding by participants of the information being presented to them. Neither paragraph 189 nor illustrative footnote 82 of Appendix D mentions any of these.
It is proposed that the current value of accumulated benefits would include death benefits (because the value has been discounted for mortality) but would exclude benefits related to future disablements (because such benefits require the participants to be rendering service at the time of his disablement). Some death benefits—such as many pre-retirement surviving spouse pensions—require that death occur during service for the pension to be payable. For the reason applicable to future disablements, such death benefits should be excluded.

(14) Some plans provide subsidized optional forms of pension. Should the value of such subsidy be included? Actuarial cost valuations include such subsidies, where material, on the basis of assumed utilization. However, in an actual plan termination, PBGC doesn’t cover the option unless it has been elected prior to plan termination or it is an automatic option that can be regarded as the normal form of pension for the participants affected by it. The matter is further complicated by the fact that ERISA requires all covered plans to pay an equivalent joint and survivor pension to a married participant, unless the participant elects otherwise. Since most plans will not be using joint and survivor equivalencies based on the PBGC mortality and interest rates which are to be used in valuing accumulated benefits, the current values to be reported will differ if married participants are to be included in the ERISA-required joint and survivor pension.

Cost Impact of Exposure Draft

The actuarial profession is vitally concerned with the impact of increases in actuarial fees on sponsors of defined benefit pension plans if it becomes necessary for them to supply the information called for by the Exposure Draft. The cost-value relationship of the information to be provided appears to be
unreasonable. Under optimum conditions the increase in actuarial fees is estimated at around 20 percent, but for some plans the increases might be in the 200 percent range. These estimates are for actuarial services only and do not cover the additional internal cost for recordkeeping and reporting or the increase in the accountant's fees. The additional internal costs of recordkeeping for many companies would be greater than the increase in actuarial fees.

The increase in actuarial fees as a percentage increase over normal actuarial fees will vary greatly by size of the plan, but will be much greater proportionately for the small pension plans. These plans are already under heavy financial strain from the additional administrative costs as a result of ERISA. Many have been terminated. A PBGC report indicates that over 35 percent (over 2500 plans) of the plans terminating in 1976 (up from 22 percent, or 900 plans in 1975) gave ERISA as a reason for terminating the plan. Over 20 percent gave ERISA as the sole reason for terminating.

One large underwriter of small insured plans estimates a 49 percent increase in their work if accurate information is required by the accounting profession to comply with this Exposure Draft. If reasonable estimates of the benefit amounts and actuarial figures are permitted, the increase may be cut in half—still a significant amount.

Where do these increases in costs come from? We list below the more significant items in the Exposure Draft that will increase the cost of preparing the additional benefit and actuarial information.
A. The requirement to determine annually the accumulated benefit for each plan participant.

1. The amount of the accumulated benefit is not customarily determined each year for each plan participant by many plan sponsors. ERISA requires that this information be furnished only on request from the participant. The determination of the accumulated benefits is particularly unlikely in respect to young employees with short service who have no vested benefits. These employees may even be excluded from the regular actuarial valuations if the turnover rate for this group is high. This is contemplated as an acceptable procedure under A.P.B. Opinion #8 (and apparently under ERISA). Frequently, multi-employer plans do not maintain sufficient data for determining accumulated benefits.

2. For actuarial valuations, the plan actuary is concerned with total overall estimates and often does not work with detailed data such as years, months and days of credited service. For total plan cost purposes all that is generally necessary is the year employed (or years of credited service) in order to measure service. This is not satisfactory for determining an individual's accumulated benefit. While many plan sponsors do maintain such data, the important point is that many do not.

3. Similarly, for actuarial valuation purposes, the plan actuary generally does not require a history of the individual's earnings which would be necessary to determine accumulated benefits. For example, if the plan benefits are based on the average of the last five years' earnings, there is obtained from the client only the current annualized rate of pay which is then projected for actuarial valuation purposes. To determine an individual's accumulated benefit at any point of time, the actual earnings used in the benefit formula would have to be obtained; in many cases
this might be the highest 60 months average of the last 120 months earnings. This earnings history is generally not available without considerable additional preparation by the plan sponsor and the actuary.

(4) Obviously, if detailed accurate information is going to be required to determine each individual's accumulated benefit where this is not already being done, it could be a significant cost item. The additional cost to make such determination will vary greatly by plan and could range from a low of perhaps 5 percent increase in cost to a 40 percent increase in cost for the actuarial work. If it is decided that rough approximations could be used as to now done for actuarial valuations, the increase in cost might be cut in half.

B. The requirement to value the accumulated benefits and to analyze the change in values from year-end to year-end.

(1) For most plans the actuary does not determine the value of the accumulated benefits for both vested and non-vested participants. The actuaries usually determine the present value of vested benefits only. However, even in this situation he is unlikely to use PBGC rates. Thus, even if the accumulated benefits are determined as outlined in paragraph A above, it would still be necessary to apply new rates to these benefits, with such rates probably changing more frequently than annually.

(2) Of even more concern to the actuary than the calculation of the value of the accumulated benefits is the breakdown into significant classes. This is left somewhat vague in the Exposure Draft, but implies that if all accrued benefits are not fully funded, then the breakdown must be in accordance with the categories set forth in Section 4044 of ERISA.
If such a breakdown is required, it would add significantly to the cost of the calculations, probably more than all the other costs combined.

Guaranteed benefits are not the type usually valued and have many peculiarities. For example, benefits guaranteed by the PBGC phase in over a period of five years. There are limitations on the dollar amount of guaranteed benefits. Even pay histories may have to be set back three years and, for a final 10-year average pay plan, the complete pay history for the past 13 years may be required to be maintained in machine processable form.

It is difficult to estimate how much this would add to the cost of valuation, but if it were to be broken down by all of the various categories listed in Title IV of ERISA, the cost increase could be as much as 40 percent.

(3) Finally, there would be an increase in the cost of the valuation to prepare a statement of the changes in the values from the beginning of the year to the end of the year. This is a new concept for many pension plan valuations. It is, of course, feasible but would require significant further calculations to determine the cost impact of the various changes.

C. The necessity to prepare a special report to be given to the accountant covering the various items. This would probably add 5 percent to 20 percent to the actuary's cost, which is still not an insignificant item.

D. The probability that the actuary would have to meet with the client and, also the accountant, to review this report and explain its meaning. This, too, would be an additional expense.

E. Putting this all together would mean that the client would have additional actuarial costs if detailed information is required anywhere in the range of 40 percent to over 200 percent. If approximations can be used, these
costs could be cut in half. In the case of small plans, the increases could be even greater.

The above cost estimates all assume that the calculations the actuaries are required to make can be done on a routine basis along with regular actuarial valuation. However, because of the time requirements suggested in the Exposure Draft, it may be necessary to make a completely independent computation separate from the regular valuation report. Estimates of the additional cost to do a special study range from 10 percent to 40 percent.

There also seems to be the possibility that it would be necessary to do a retroactive valuation to the beginning of the year in 1977 in order to prepare a consistent report showing changes during the year. If this were necessary, it would add more expense and this would be a significant duplication because these plans have already been valued in most cases. To do the retroactive valuation could mean an additional 20 percent to 75 percent increase in cost.

In looking over these cost estimates, one might get the feeling that these must be exaggerated. We do not believe this to be the case. The Task Force preparing this response sent a questionnaire to 31 actuaries prominent in the consulting and insurance pension fields, asking them independently to fill out a questionnaire indicating the cost impact of this Exposure Draft (approximately one-half responded). The range in estimated cost increases was wide, but even the lowest was significant. Exhibit C, attached, summarizes the results that were received from this questionnaire. Even if we assume that the actuaries were pessimistic, the increase in costs
would still be so significant to raise a serious question as to whether the cost is worth the specific information that would be provided in the financial statements. This holds true even if the AICPA issues accounting standards which allow for reasonable estimates of the figures required by this Exposure Draft.

Considering the value to plan participants of the information to be provided, we believe the cost impact to be so serious that the FASB would be doing a disservice to plan participants, clients, and the entire private pension system to go forward with this Exposure Draft recommendation.

* * * * * * *
STATEMENT 1977-16

Schedule B

Form 5500-C

Actuarial Information

This schedule is required to be filed under section 104 of the Employee Retirement Income Security Act of 1974, referred to as ERISA, and section 6056(a) of the Internal Revenue Code, referred to as the Code.

Instructions

Who Must File—The employer or plan administrator of a defined benefit plan that is subject to the minimum funding standards of section 412 of the Employee Retirement Income Security Act of 1974 (ERISA) must file this schedule as an attachment to the annual return/report for plan years beginning on or after January 1, 1976. Plans maintained on January 1, 1974, pursuant to one or more collective bargaining agreements entered into before September 2, 1974, are not subject to the minimum funding standards for plan years beginning before the earlier of the termination of the collective bargaining agreement(s) or January 1, 1981.

For unfunded plans, the costs and contributions reported on Schedule B should include those relating to both trust funds and separately maintained funding accounts.

Specific Instructions

(References are to line items on the form.)

4(a) The valuation for a plan year shall be as of any date in the year, including the first and last. Valuations must be performed within the period specified by section 412(g) of ERISA and section 6.09(a) of the Code.

4(b) Not applicable to the first plan year to which the minimum funding standards apply.

4(c) Interest adjustment on $5 and $6. If an alternative method is elected, enter the amount from $7(c).

4(d) Amounts in 4(g) should all be of the same date which should be as of the valuation date or the most recent actuarial valuation date, whichever is later. If the amounts are for the entire year, interest may be used in the statement of actuarial assumptions and methods but should not be shown on the statement of Schedule B. Plans using the aggregate cost method should include $4(d)(i) and (ii).

5(a) If the plan is not funded, or funded under a CSM, the employer must file a Statement by enrolled actuary. In lieu of signing the statement, an enrolled actuary may attach a signed statement containing the name, address, employer, number, telephone number, and the actuary's opinion that the assumptions used in preparing Schedule B are in the aggregate reasonably related to the experience of the plan and to reasonable market expectations, and represent his or her best estimate of anticipated experience under the plan and to the best of his or her knowledge that the report is complete and accurate. In addition, the actuary may either incorporate or reference any other documents related to the information contained in the schedule.

6(a) If the valuation was made for the current year, enter the normal cost calculated in the most recent actuarial valuation. If the estimated cost for the current year based on such valuation is $6(a), then enter the estimated cost in the column for $6(a). The estimated cost in the column for $6(a) is determined by the amount shown in $6(a).

5(a) A valuation is current when calculated within the last year and is based on the most recent actuarial valuation, and the actuary's statement on Schedule B indicates that the assumptions used in preparing Schedule B are in the aggregate reasonably related to the experience of the plan and to reasonable market expectations, and represent his or her best estimate of anticipated experience under the plan.

6(a) If the entry for normal cost method was not used to determine the amounts in item 6(a), the alternative minimum fund- ing standard account may not be used.

7(a) The value of accrued benefits should be determined by the amount of any contributions for the current plan year.

46(d)(i) Determine the value of assets in accordance with section 412(c)(2) of the Code or 302(c)(2) of ERISA.

46(d)(ii) Determine the value of benefits in accordance with section 412(c)(3) of the Code or 302(c)(3) of ERISA.

46(d)(iii) Compute the aggregate cost method deficit or surplus, if any, as determined under section 412(c)(4) of the Code and section 302(c)(4) of ERISA, at the end of the plan year.
STATEMENT OF ACTUARIAL INFORMATION

For plan year beginning _____________, 19__ and ending _____________, 19__

--Please complete every applicable item on this form. If an item does not apply enter "N/A."
--Round off money amounts to nearest dollar.

Name of plan sponsor

Name of plan

1. Actuarial method and operational information:
   (a) Enter most recent actuarial valuation date, ____________________________.
   (b) Enter date(s) and amount of contributions received this plan year for prior plan years and not previously reported:
      Date(s) Amount
      ____________________________
   (c) (i) Accrued liabilities being amortized for purposes of funding as of ____________________________.
       (ii) Value of assets as determined for funding ____________________________.
       (iii) Unfunded accrued liability ____________________________.
   (d) Current annual cost and contribution:
      (i) Normal cost for plan year ____________________________.
      (ii) Amortization of item (c)(iii) over ___ years ____________________________.
      (iii) Adjustment for gains or losses ____________________________.
      (iv) Total annual cost: (i) + (ii) - (iii) ____________________________.
      (v) Contribution for the plan year: Item 5(b) ____________________________.

2. (a) Number of persons covered (included in the most recent actuarial valuation):
      (i) Active employees ____________________________.
      (ii) Terminated participants with vested benefits ____________________________.
      (iii) Retired participants and beneficiaries of deceased participants ____________________________.
      (b) Actuarial gains or (losses) for period ending ____________________________.

3. Value of nonforfeitable benefits and current assets.
   Estimated present value (as of ____________________________):
   (a) Accumulated voluntary contributions by active participants ____________________________.
   (b) Accumulated mandatory contributions by active participants ____________________________.
   (c) Value of benefits for retired participants and beneficiaries of deceased participants ____________________________.
   (d) Value of benefits for participants eligible to retire (if calculated) ____________________________.
   (e) Value of all other nonforfeitable (vested) benefits ____________________________.
   (f) Total vested liabilities ____________________________.
   (g) Current value of assets ____________________________.
   (h) Unfunded vested liabilities as of ____________________________ (attach required rules).
4. (a) Attach a statement of actuarial assumptions and methods used to determine
(i) the liabilities and normal cost shown on lines I(c) and I(d), and,
(ii) the value of assets shown on line I(c)(ii). The statement is to
include a summary of the principal eligibility and benefit provisions
upon which the valuation was based, an identification of benefits not
included in the calculation, and other facts, such as, any change in
actuarial assumptions or cost methods and justifications for any such
change. Include also such other information, if any, needed to fully
and fairly disclose the actuarial position of the plan.
(b) Attach a statement of the actuarial assumptions used to determine the
present values shown in paragraph 3 above, if different than 4(a).
The statement is to describe any approximations used and include the
notes described in the instructions.

5. Contributions made to the plan for the plan year by employer(s) and employees:

<table>
<thead>
<tr>
<th>Month Year</th>
<th>Amount paid by employer</th>
<th>Amount paid by employees</th>
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</thead>
<tbody>
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</table>

STATEMENT BY ACTUARY (SEE INSTRUCTIONS BEFORE SIGNING)

To the best of my knowledge, the information supplied in this schedule and
on the accompanying statement, if any, is complete and accurate, and in my
opinion the assumptions used in the aggregate (a) are reasonably related to the
experience of the plan and to reasonable expectations, and (b) represent my
estimate of anticipated experience under the plan.

Signature of actuary

Print or type name of actuary

Enrollment number

Address

Telephone number
INSTRUCTIONS

1(c) Amounts in (c) and (d) should all be of the same date which should be the date of the end of the plan year or date as of which the most recent actuarial valuation was made. If amounts are not as of the date of the most recent actuarial valuation, indicate in the statement of actuarial assumptions and methods (as required by 4(a)) how the amounts in (c) and (d) were determined. Liabilities fully funded by annuity and insurance contracts other than any contract funds not allocated to individuals may be omitted from both items (c)(i) and (c)(ii). Plans using the aggregate cost method should omit (c)(i), (c)(iii), (d)(ii) and (d)(iii).

2(b) If the aggregate cost or frozen initial liability method is used, enter "N/A."

3 Estimate nonforfeitable benefits as of date in (c) using participants history of pay and service on calculation date. Use actuarial assumptions consistent with the current value of assets for an active plan with respect to expected commencement of benefits, mortality, investment return, etc. Exclude any benefit to which an employee becomes entitled only by advancement in age or service and increases in Social Security benefits or covered earnings after the calculation date. If date differs from Item I(a), indicate in 4(b) differences in eligibility and benefit provisions between dates.

3(a) and 3(b) Include interest credited on participant contributions.

3(c) Include all former employees with benefits in pay status.

3(e) Include former employees with benefits not in pay status.

3(g) Use current assets as of date used for liabilities under Item 3.

4(a) A summary of one page or less of plan provisions will ordinarily be adequate.

4(b) Include the following notes: (1) Describe important changes that may occur in unfunded vested liability as a result of possible changes in current values, of assets, plan amendments, or for other reasons, between the calculation date and the date of the distribution of any report to participants. (2) When appropriate, describe any plan benefit features not included in present value of vested benefits determined for Item 5.

5 Show all employer and employee contributions for the plan year.

Statement of actuary — In lieu of signing the Statement, an actuary may attach a signed statement containing the name, address, enrollment number (if applicable), telephone number and the actuary's opinion that the assumptions used in preparing this Statement are in the aggregate reasonably related to the experience of the plan and to the best of his or her knowledge the report is complete and accurate. In addition, the actuary may offer any other comments related to the information contained in this Schedule.
The American Academy of Actuaries has set up a special Task Force to prepare a response to the Financial Accounting Standards Board on their Exposure Draft on "Accounting and Reporting by Defined Benefit Pension Plans." For more details see the Academy's Newsletter, June 1977 Supplement.

As part of our presentation we would like to include some estimate of the cost impact of compliance with this Exposure Draft. Time does not permit a detailed study so that rough estimates must do. The purpose of this letter is to ask you to give us your estimates. It will be included, and perhaps averaged, along with others we receive to provide a composite estimate or range of estimates.

Please complete the table (on the next two pages) with your "best estimates."

Keep in mind:

1. This is the percentage increase in the actuarial valuation cost for the plan sponsor.
2. Include only the increases caused by compliance with the Exposure Draft.
3. Do not include any increase the auditor will charge for his review.
4. The percentage increase is related to your normal routine actuarial valuation charge.
5. Assume all work is done concurrently with regular valuation, except item 5.
6. Assume the plan already complies with ERISA so these estimates are over ERISA requirements.
7. For those who can, repeat the table for plans which are not subject to ERISA such as state and municipal plans.
8. If you believe certain costs would vary for small plans (100-200 participants) or for multi-employer plans your comments will be helpful.
9. Use your own judgment as to the meaning of "Reasonable Estimate." The accountant would probably say "material."
Summary of Responses Showing Range of Percentage Increase in Actuarial Costs

<table>
<thead>
<tr>
<th></th>
<th>Start-up Costs</th>
<th>Continuing Costs</th>
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<tbody>
<tr>
<td></td>
<td>Detailed</td>
<td>Reasonable</td>
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<tr>
<td></td>
<td>Information</td>
<td>Estimate</td>
</tr>
<tr>
<td>a. Data on each</td>
<td>0%–10%</td>
<td>0%–10%</td>
</tr>
<tr>
<td>participant</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. Credited service</td>
<td>0%–13%</td>
<td>0%–10%</td>
</tr>
<tr>
<td>c. Earnings histories</td>
<td>5%–40%</td>
<td>2%–30%</td>
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<tr>
<td>for accumulated</td>
<td></td>
<td></td>
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<tr>
<td>benefits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d. Other</td>
<td>0%–20%</td>
<td>0%–20%</td>
</tr>
</tbody>
</table>

Determination of accumulated benefits (paragraphs 17–19)

Value of accumulated benefits (paragraphs 20–28)

a. Calculation of values 0%–40% 0%–40% 0%–20% 0%–20%

b. Segregation into significant classes 0%–40% 0%–40% 0%–20% 0%–15%

c. Statement of changes (paragraph 28) 10%–60% 10%–60% 10%–30% 5%–30%

Preparation of report 3%–30% 3%–20% 2%–20% 2%–10%

Meetings with client and/or accountant 1%–25% 1%–25% 0%–10% 0%–10%
Summary of Responses Showing Range of Percentage Increase in Actuarial Costs

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<td>Information</td>
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<td>Reasonable</td>
<td>Reasonable</td>
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<td>Estimate</td>
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<td>10%-40%</td>
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<td>4%-40%</td>
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<td>18 -75</td>
<td>10 -50</td>
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<tr>
<td>40-230</td>
<td>20-147</td>
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<td>67-320</td>
<td>30-195</td>
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</table>

5. Other

a. If values are computed independent of regular valuation report

b. If retroactive values are required

6. Total percent increase

a. Items 1-4

b. Items 1-5
### Summary of Responses Showing Average Percentage Increase in Actuarial Costs

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<tr>
<td>paragraphs 17-19</td>
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<tr>
<td>a. Data on each</td>
<td>7%</td>
<td>4%</td>
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<td>b. Credited service</td>
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<td>4</td>
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<td>c. Earnings histories</td>
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<td>10</td>
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<td>d. Other</td>
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<td>12</td>
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<tr>
<td>Value of accumulated</td>
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<td>a. Calculation of</td>
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<td>b. Segregation into</td>
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<td>significant classes</td>
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<td>c. Statement of</td>
<td>23</td>
<td>19</td>
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<tr>
<td>changes (paragraph 28)</td>
<td></td>
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<tr>
<td>Preparation of report</td>
<td>10</td>
<td>10</td>
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<tr>
<td>Meetings with client</td>
<td>8</td>
<td>8</td>
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<td>and/or accountant</td>
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<td>22%</td>
<td>19%</td>
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<td>19%</td>
<td>16%</td>
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<td>36</td>
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<td>58</td>
<td>45</td>
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<tr>
<td>72</td>
<td>57</td>
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</tbody>
</table>

5. Other

a. If values are computed independent of regular valuation report

   22% 19%

b. If retroactive values are required

   36 25

6. Total percent increase

a. Items 1-4

   92 74

b. Items 1-5

   143 113
Mr. Chairman, members of the Committee, my name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries. With me today is Mr. Frederick D. Hunt, Jr., who is our Director of Communications and Government Liaison.

Mr. Chairman, members, we appreciate the opportunity to appear today at these hearings on H.R. 7111, the Farm Production Protection Act of 1977, and on H.R. 5011. Our comments are specifically directed toward H.R. 7111, but because of the similarity between these two bills, are equally applicable to H.R. 5011.

By way of background, the American Academy of Actuaries is a professional organization of actuaries formed for purposes of the accreditation of actuaries to practice in the United States. Attached to this statement is an appendix which provides additional background information on the Academy.

Actuarial science involves the evaluation of the probabilities of uncertain future events, often over long periods of time, and the financial impact which these events involve. Actuarial techniques are applicable to a variety of insurance and pension programs in both the private sector and the public sector. Examples of governmental activity which involves actuarial projections and valuations include, among many others, Social Security cost projections, governmental retirement systems such as Civil Service and the military, evaluation of appropriate reserve levels of insurance companies for income tax purposes, and the proper financing of the Federal Flood Insurance program.

Actuarial techniques are invaluable in ensuring the financial integrity of both public and private programs by providing the
methodology according to which current costs are determined, appropriate reserve levels are established and projections of future trends in costs are recognized.

This Academy statement is intended to be constructive in producing legislation by which the financing of crop insurance programs is based on sound actuarial principles. The interests of farmers, consumers, taxpayers and the national economy are all best served if financially sound crop insurance programs are available to American farmers.

The Academy wishes to emphasize that the interest of the actuarial profession is concerned with the proper financing of these programs and not with the allocation of costs among various parties. Thus, as a professional organization, we do not record a view on how the costs should be borne by various individuals or groups in the private or public sectors.

As you remember, Mr. Chairman and members of the Committee, we appeared before you on March 15th of this year in connection with hearings on the drought situation and the unexpected depletion of funds in the Federal Crop Insurance Corporation. From these earlier hearings and from recommendations of Secretary Bergland for a "good, comprehensive crop insurance program which must be actuarially sound", it is apparent that strong support exists for a crop insurance program which would cover both more crops and more counties. We believe that proper recognition of actuarial principles is an essential ingredient in developing such an expanded program.

We wish to commend the sponsors of H.R. 7111 for the substantial recognition of actuarial requirements which the bill contains. The following excerpts from the bill demonstrate the need for qualified actuaries to be involved in the crop insurance program:

1. Section 105(h), lines 16-19, p. 6, indicates that the Corporation:

   "may conduct researches, surveys and investigations relating to farm production protection and shall assemble data for the purpose of establishing actuarial bases for farm production protection."

2. Section 107(a), lines 14-17, p. 8, spells out the conditions under which farm production protection is provided:

   "... for the purpose of determining the most practical plan, terms, and conditions of protection for the agricultural products, if sufficient actuarial data are available as determined by the Board...."
3. Section 107(b), pp. 9-10, discuss fixing premiums which is widely acknowledged to be an actuarial function.

4. Section 117(i), p. 19, lines 1-4, defines an actuarial determination to be made by the Board:

"Normal production level' is the amount of production for a given unit as determined by the Board using actuarial data and principles for a previous representative period."

These excerpts clearly indicate the legislative intent to require the application of appropriate actuarial techniques by qualified actuaries in the financing and administration of the new program. If this proposed legislation is enacted into law, appropriate recognition of this legislative intent by the U.S. Department of Agriculture is essential for a successful implementation of the act.

Appropriate actuarial guidance to the Board of Directors of the new Farm Production Protection Corporation will be needed, since the Board is required by the four excerpts above to make actuarial determinations. This is particularly vital, since only one of the seven members of the Board is specifically required by statute to be "experienced in the insurance business". By way of contrast, the current statute for the Federal Crop Insurance Corporation requires that two members of the five person Board shall have such qualifications.

The American Academy of Actuaries wishes to express its gratitude for the opportunity to appear today. We stand ready to be of service to the Congress and the Administration in matters of actuarial concern. If we can be of further assistance in connection with crop insurance programs, please do not hesitate to call upon us.
The American Academy of Actuaries is a professional organization of actuaries which was formed in 1965 for the purposes of the accreditation of actuaries to practice in the United States. The Academy includes members of four constituent organizations, the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, the Fraternal Actuarial Association and the Society of Actuaries. These organizations, or their predecessors, date back many years, one of them to the late 1800's, so that despite the relatively short duration of its formal existence, the Academy, its constituent organizations and their predecessors have represented the actuarial profession in the United States for over 80 years. The Academy is unique as the national accrediting actuarial organization for actuaries in all areas of specialization.

The requirements to become a Member of the Academy can be summarized under two broad headings: (1) education requirements and (2) experience requirements. An individual must satisfy both sets of requirements in order to be admitted as a Member. At the present time, the education requirement can be satisfied only by passing professional examinations given by either the Casualty Actuarial Society or the Society of Actuaries. The experience requirement consists of five years of responsible actuarial work.

As of December 31, 1976, the membership of the Academy stood at 4137. These actuaries have a variety of types of employment including insurance organizations, consulting firms, government, and academic institutions. Well over 90% of those individuals who have satisfied the rigorous education and experience requirements of the Academy do, in fact, join the Academy. The entire Academy membership is subject to rigorous guides to professional conduct and standards of practice.

The Academy recommends that membership in the Academy, or its equivalent in education and experience, be recognized in determining the qualifications of actuaries to practice in the United States.

Additional information about the Academy can be obtained by contacting:

American Academy of Actuaries
1775 K Street, N.W. - Suite 215
Washington, D.C. 20006
(202) 223-8196
To comment on an item in the N.A.I.C. statutory statement is it necessary to consider the intended purpose and nature of the statement.

The N.A.I.C. Statement has been termed a "solvency" statement, a "liquidity" statement of financial strength. Regardless of the label used, we believe the intention is to report on the ability of the company to meet its contractual obligations with only secondary importance given to periodic income statements.

Balance sheet liabilities have traditionally been determined in a conservative manner. Conservative, in this context, means that policy reserves should anticipate a fairly wide range of contingencies. However, to hold liabilities so great that a company could withstand any conceivable circumstances, no matter how adverse, would imply an excessive level of pricing of the insurance product and good business practice does not encompass such a degree of conservatism. Likewise, a reserve for future taxes should not attempt to provide for all unlikely happenings.

Based on the above concept of the statutory balance sheet, it is our opinion, that, if a tax reserve is required in statutory statements, the appropriate calculation method for such reserves is the liability method where the value is based on the probability of payment and the time value of money. The cumulative deferred credit method used under generally accepted accounting principles is totally inappropriate for statutory statements.

Whenever an asset or liability is carried on a different basis for statutory statement and federal income tax purposes a possibility of a future tax effect exists. A discussion of some items which are common to many companies and which are carried on different bases follows:

1. Life Insurance Reserves
   For tax purposes life insurance reserves may be calculated on a net level basis (or an approximation thereto), while for statutory statement purposes they may be calculated on a modified preliminary term basis. Deficiency reserves required for statutory statements are not recognized as liabilities for tax purposes.

   The reserve increase deduction reported in the statutory statement in any particular year may be greater than or less
than the reserve increase reported in the tax return. These differences will depend on the rate of growth of new business, the type of new business written, and the overall persistency of the business.

If the future reserve increase deductions on the tax return are greater than those on the statutory statement, surplus will not be reduced as a result of this difference. Any tax paid on the company's gain from operations from this business will be less than its statutory earnings from this business (assuming no other differences exist).

Even if the future reserve increase deductions on the tax return are less than those on the statutory statement, the tax on the business may still not exceed current earnings. The possibility that taxes exceed current earnings will depend on the tax situation in which the company finds itself in those future years.

Most mutual and many stock companies are taxed only on investment income so that differences in future reserve increase deductions between tax and statutory statements would not have any effect on the tax paid.

Based on the above, it is our opinion that to require all companies to set up uniformly calculated liabilities with respect to this item is neither appropriate nor feasible.

2. Phase III Taxes.
Phase III taxes may result if a withdrawal is made from the "policyholders' surplus account", a memorandum account for tax purposes. Such withdrawals will occur if a dividend to stockholders is declared which exceeds the amount available in the "shareholders' surplus account" (another memorandum account), or if the "policyholders' surplus account" exceeds certain maximums.

It appears that no reserve for future taxes should be necessary for withdrawal caused by dividend declaration since that action is entirely elective. Most companies plan their dividend actions so that such phase III taxes will not be paid.

The possibility of a phase III tax resulting from exceeding the maximum limits is also rare. However, if the payment of such a tax is likely or imminent it seems that a reserve for this tax should be established.

3. Bonds or Mortgages Purchased at Premium or Discount
Differing amortization methods can produce differences in tax and statement income. These differences could have a positive or negative impact on future taxes. If material, this impact should
be recognized in the reserve for future taxes in the statutory balance sheet.

Probably the illustration of this situation where materiality is most apparent is the one submitted by the Guardian Life Insurance Company relative to deep discount bonds. Here the annual accrual of market discounts in the statutory statement is not reflected in the tax return. At maturity the company may be required to pay a capital gains tax on the amount of the discounts, resulting in a realized value which is less than book by the amount of the tax. Consequently, the statutory surplus would be overstated by the amount of the tax to be paid on the cumulative increase in book value at any given time.

To avoid that overstatement, the impact of the expected future tax could be reflected in an aggregate tax reserve. The impact of the future tax could be set up with due consideration given to possible offsets. Reasonable offsets include losses already recognized through write down of other assets to a level below the tax basis and timely loss carry forwards.

Some methods for calculation of the liability which might be considered are as follows:

A. The Deferred Credit Method - This method would apply the capital gains tax rate each year to the amount of accrual in that year and carry the cumulative amount as a deferred credit. We have previously expressed our opinion that the deferred credit method is inappropriate for statutory statements. We consider the deferred credit method to be inappropriate because (1) it fails to recognize the time value of money and the probability of payment; (2) it fails to recognize the future tax rates and situations that will apply; and (3) it gives primacy to the income statement and the matching of income and expense rather than the measurement of company solvency on the statement date.

B. Straight Line Method - This is the method used in the illustration submitted with the Guardian Life presentation. Under this method the accrual of discount is taken to be a level annual amount. The credit to the tax reserve would be the capital gains tax rate applied to this straight line accrual. Since the statutory statement accrual does not follow a straight line, this approach should be limited to rough approximation or illustration of the principle.
C. After-Tax Yield Accrual - Under this method amortized values would be calculated as the present value of future after-tax receipts. The difference each year between the statutory value and the value calculated on this basis would be the credit to the tax reserve. Consideration would have to be given to determining the appropriate rates of tax to be used.

D. Current Liability Method - Rather than attempting to determine the tax which may be paid at the time the bond matures, it would be possible to set up a current liability for the tax which would be paid if the bond were sold immediately after the date of the annual statement for a consideration equal to the statement value. Such a liability would recognize the current capital gains tax rate times the cumulative past statutory statement accruals.

4. Investment Real Estate Depreciation - Real estate does mature, forcing a gain or loss. However, a different value is carried for statutory statements and tax statements when accelerated depreciation is used for tax purposes. Where such accelerated depreciation has been claimed, the difference in value will be brought into future years' ordinary taxable income and, if material, the impact should be reflected by a credit to the aggregate tax reserve, subject to an appropriate discount for interest.

5. Unrealized Common or Preferred Stock Gains and Losses - Since preferred stocks are generally held on the same basis for both statutory statements and tax returns, no need for deferred tax calculations is apparent barring unusual circumstances. In the case of common stocks the gains or losses are offset dollar for dollar within the limits of the common stock component of the MSVR. The effect of this is to adjust the net statutory asset value to no more than cost. Since the tax basis is cost there is no impact on the aggregate tax reserve. This would not be true if the MSVR is either at zero or at its maximum. In these special cases a credit to aggregate tax reserve may be necessary.

6. Investment Tax Credit - In view of the apparent intent of Congress to encourage capital investment, the full benefit of this credit should be allowed to flow through surplus with no further consideration of future years' tax impact.

7. Not Admitted Assets - Certain assets such as furniture and equipment and agents' balances must be written down to zero in the statutory statement but are not permitted to be recognized as deductions from ordinary tax income until future years. The
future tax effect, appropriately discounted, should be allowed as an offset to the aggregate tax reserve.

The items discussed here do not constitute an exhaustive list, nor is the discussion meant to cover every possible consideration. Most situations will require individual consideration based on the merits of the particular case and the materiality of the future tax effect. While our discussion includes guidelines we believe to be reasonable, we recognize that there are different viewpoints on this most complex subject among members of both the actuarial profession and among members of other professions.

The American Academy of Actuaries
Committee on Life Insurance Financial Reporting Principles
This memorandum sets forth the position of the Academy of Actuaries Committee on Life Insurance Financial Reporting Principles regarding Interpretation 15 of FASB Statement No. 8.

FASB Statement No. 8 defines the procedures to be used in translating foreign currency financial statements into U.S. dollars. Interpretation 15 states that, for a life insurance company, reserves for policyholder benefits are to be translated on the basis of the current exchange rate, whereas deferred acquisition costs are to be translated on the basis of historical exchange rates.

The Committee believes that this treatment is erroneous in that it does not conform to the accounting principles set forth in the Audit Guide for Stock Life Insurance Companies or the actuarial principles set forth in Recommendation 1 of the Academy of Actuaries Committee on Financial Reporting Principles.

**DESCRIPTION OF LIFE INSURANCE COMPANY FINANCIAL REPORTING SYSTEM.**

The deferred acquisition cost asset for life insurance companies is calculated as the present value of a portion of the future gross premiums expected to be collected from the policyholders, discounted for interest and probability of payment. The portion of the premiums is so determined that its present value, at the date a policy is issued, is equal to the present value of the deferrable acquisition expenses associated with that policy.

The reserve for policyholder benefits is calculated as the present value of future benefits and expenses, less the present value of another portion of the gross premium on each policy, discounted for interest and probability of payment. This portion of the premium is so determined that its present value on the date a policy is issued is equal to the present value of all benefits and non-acquisition expenses associated with the policy.

Before deferred acquisition costs can meet the test of recoverability, it is necessary that the total of these two portions of the premiums not be greater than the actual gross premiums. If the total does exceed the gross premiums, the premiums used in the valuation process must be reduced to the extent necessary to avoid the deficiency. The reduction is first applied to the portion of premiums used to determine the deferred acquisition cost asset, and thereafter is applied to reduce the portion of the premiums used to determine benefit reserves.

Since the deferred acquisition cost asset is recoverable from identically the same gross premium revenues which are used in valuing the reserve for policyholder benefits, the recoverability test requires the use of the same actuarial assumptions as to interest and probability of payment as are used in calculating the benefit reserve.
Under this procedure a primary source of expected profits of a stock life insurance company is typically the excess of gross premiums collected over the valuation premiums used to determine benefit reserves and deferred acquisition costs. The procedure is deemed necessary to satisfy the accounting principle of matching revenue and costs. As a result of this matching, profits from this source are expected to be a constant percent of gross premiums each year.

Application of Interpretation 15.

1. It is obvious that the principle of matching revenue and costs will not be satisfied in foreign currency translation if benefit reserves and deferred acquisition costs are not converted at the same rate of exchange. Under Interpretation 15 of FASB Statement No. 8, collected gross premiums and the portion applied to benefit reserves would be converted at current exchange rates, whereas the portion of the collected premiums applied to deferred acquisition costs would be converted at historical exchange rates. As a result the expected profits will be a different percentage of premiums each year that the current exchange rate changes. An example of the type of fluctuation to be expected is as follows:

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Collected Premiums</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Foreign Currency</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>-Current Exchange Rate</td>
<td>1.00</td>
<td>.80</td>
<td>1.20</td>
</tr>
<tr>
<td>-U.S. Currency</td>
<td>100</td>
<td>80</td>
<td>120</td>
</tr>
<tr>
<td>Premiums Applied to Benefit Reserves</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Foreign Currency</td>
<td>60</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>-Current Exchange Rate</td>
<td>1.00</td>
<td>.80</td>
<td>1.20</td>
</tr>
<tr>
<td>-U.S. Currency</td>
<td>60</td>
<td>48</td>
<td>72</td>
</tr>
<tr>
<td>Premiums Applied to Deferred Acquisition Costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Foreign Currency</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>-Historical Exchange Rate</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>-U.S. Currency</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Profits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Foreign Currency</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>-U.S. Currency</td>
<td>10</td>
<td>2</td>
<td>18</td>
</tr>
<tr>
<td>-$ of Premium</td>
<td>10%</td>
<td>2%</td>
<td>15%</td>
</tr>
</tbody>
</table>

Though cost is matched with revenue in terms of foreign currency, Interpretation 15 produces a mismatch in terms of U.S. currency. If deferred acquisition costs were adjusted in the same manner as benefit reserves, a proper matching would be achieved, as shown below:

<table>
<thead>
<tr>
<th>U.S. Currency</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Collected Premiums</td>
<td>100</td>
<td>80</td>
<td>120</td>
</tr>
<tr>
<td>Applied to Benefit Reserves</td>
<td>60</td>
<td>48</td>
<td>72</td>
</tr>
<tr>
<td>Applied to Deferred Acquisition Costs</td>
<td>30</td>
<td>24</td>
<td>36</td>
</tr>
<tr>
<td>Profit</td>
<td>10</td>
<td>8</td>
<td>12</td>
</tr>
<tr>
<td>-$ of Premium</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
</tr>
</tbody>
</table>
2. The application of Interpretation 15 also produces an immediate charge or credit to earnings which is completely unrelated to revenue and likely to be material.

When a foreign currency is devalued in relation to the U.S. dollar, for example, one would normally conclude that the U.S. investor in a foreign corporation has incurred a loss. Under Interpretation 15, however, a gain may frequently be reported. This will occur if the reduction in liabilities exceeds the reduction in invested assets, and deferred acquisition costs are left unchanged. An example of this situation is as follows:

<table>
<thead>
<tr>
<th>End of Calendar Year</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Foreign Currency</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invested Assets</td>
<td>1,000</td>
<td>1,100</td>
<td>1,200</td>
<td>1,300</td>
</tr>
<tr>
<td>Deferred Acquisition Costs</td>
<td>200</td>
<td>170</td>
<td>140</td>
<td>110</td>
</tr>
<tr>
<td></td>
<td>1,200</td>
<td>1,270</td>
<td>1,340</td>
<td>1,410</td>
</tr>
<tr>
<td>Benefit Reserves</td>
<td>1,110</td>
<td>1,160</td>
<td>1,220</td>
<td>1,280</td>
</tr>
<tr>
<td>Surplus</td>
<td>100</td>
<td>110</td>
<td>120</td>
<td>130</td>
</tr>
<tr>
<td></td>
<td>1,210</td>
<td>1,270</td>
<td>1,340</td>
<td>1,410</td>
</tr>
<tr>
<td><strong>Exchange Rate</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>1.00</td>
<td>1.00</td>
<td>0.80</td>
<td>1.20</td>
</tr>
<tr>
<td>Historical</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td><strong>U.S. CURRENCY</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invested Assets</td>
<td>1,000</td>
<td>1,100</td>
<td>960</td>
<td>1,560</td>
</tr>
<tr>
<td>Deferred Acquisition Costs</td>
<td>200</td>
<td>170</td>
<td>140</td>
<td>110</td>
</tr>
<tr>
<td></td>
<td>1,200</td>
<td>1,270</td>
<td>1,100</td>
<td>1,670</td>
</tr>
<tr>
<td>Benefit Reserves</td>
<td>1,100</td>
<td>1,160</td>
<td>976</td>
<td>1,536</td>
</tr>
<tr>
<td>Surplus</td>
<td>100</td>
<td>110</td>
<td>124</td>
<td>134</td>
</tr>
<tr>
<td></td>
<td>1,200</td>
<td>1,270</td>
<td>1,100</td>
<td>1,670</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>10</td>
<td>2</td>
<td>18</td>
<td></td>
</tr>
<tr>
<td>Foreign Exchange Adjustment</td>
<td>0</td>
<td>12</td>
<td>-8</td>
<td></td>
</tr>
<tr>
<td>Total Surplus Change</td>
<td>10</td>
<td>14</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>
If deferred acquisition costs were translated at current rates, the foreign exchange adjustment would be reasonably related to the change in the exchange rate, as follows:

<table>
<thead>
<tr>
<th></th>
<th>End of Calendar Year</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>U.S. CURRENCY</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Invested Assets</td>
<td>1,000</td>
<td>1,100</td>
<td>960</td>
<td>1,560</td>
</tr>
<tr>
<td>Deferred Acquisition Costs</td>
<td>200</td>
<td>170</td>
<td>112</td>
<td>132</td>
</tr>
<tr>
<td></td>
<td>1,200</td>
<td>1,270</td>
<td>1,072</td>
<td>1,692</td>
</tr>
<tr>
<td>Benefit Reserves</td>
<td>1,100</td>
<td>1,160</td>
<td>976</td>
<td>1,536</td>
</tr>
<tr>
<td>Surplus</td>
<td>100</td>
<td>110</td>
<td>96</td>
<td>156</td>
</tr>
<tr>
<td></td>
<td>1,200</td>
<td>1,270</td>
<td>1,072</td>
<td>1,692</td>
</tr>
<tr>
<td>Operating Profit</td>
<td></td>
<td>10</td>
<td>8</td>
<td>12</td>
</tr>
<tr>
<td>Foreign Exchange Adjustment</td>
<td>0</td>
<td>-22</td>
<td>48</td>
<td></td>
</tr>
<tr>
<td>Total Surplus Change</td>
<td></td>
<td>10</td>
<td>-14</td>
<td>60</td>
</tr>
</tbody>
</table>

3. Reserves used in financial statements prepared in the manner set forth by Interpretation 15 will not be computed in accordance with sound actuarial principles.

Sound actuarial practice requires that the policyholder reserve be an amount which indicates the portion of a company's invested assets which should be held in "reserve" for future obligations to policyholders, as opposed to being currently available for other purposes, such as distribution to stockholders or present policyholders. Therefore it is essential that reserves be computed in a manner consistent with the valuation of assets.

Recommendation One of the Academy of Actuaries Committee on Financial Reporting Principles defines such reserves for GAAP statements as the present value of future costs less the present value of future valuation premiums, where valuation premiums are the portion of gross premiums necessary to provide for both benefits and expenses. Present values are determined by assumptions chosen as of the date of issue of each policy. This method is consistent with the method of valuing assets in GAAP statements, since most assets are carried at amortized cost.
To be consistent with actuarial principles, if the unitary reserve defined above is to be split for balance sheet presentation, the difference between the amount carried as a benefit reserve liability and the amount carried as a deferred charge on account of unamortized acquisition expense must be substantially equal to the unitary reserve.

If benefit reserves and deferred acquisition costs are translated into U.S. currency at different rates of exchange, the difference will not be equal to the reserves defined by Recommendation One. Furthermore, the method of determining reserves will not be consistent with the method of valuing assets. Accordingly the financial statements should not be represented as containing reserves which are computed in accordance with sound actuarial principles.

Conclusion.

For the reasons recited above, the Committee believes that Interpretation 15 should be revised or withdrawn.
time and the risk of unfavorable variations (adverse deviations) from such assumptions and estimates” (pages 63-64). The Audit Guide goes on to say, “However, as contemplated by generally accepted accounting principles, such conservatism must be reasonable and realistic.”

2. The theory which underlies Recommendation #1 provides a way by which quantitative concepts can be used in discussions of the indefinite concept “conservatism”. It does so by recognizing the principle that no portion of the actual gross premium should be available as a specific loading for profit unless the risks of adverse deviation have been duly provided for in the valuation premium.

3. With respect to each assumption, provisions for adverse deviation should be made in such a way as to not decrease the valuation premium. The provisions for adverse deviation should be distributed among the assumptions and among policy years by considering the degree of uncertainty associated with the assumption and the financial effect on the company of deviation from the valuation assumptions. For all durations, the aggregate reserve should equal or exceed the amount the aggregate reserve would equal if no provision were made for adverse deviation. In general, the conditions described in this paragraph relating to the level of the valuation premium and the level of the aggregate reserve should be satisfied for all issues of a calendar year for a line of business. It is not necessary that the relationships hold for each plan and each age at issue. The valuation premium condition is to be satisfied by the provision for adverse deviation made in each actuarial assumption. The aggregate reserve condition is for the provision for adverse deviation in all assumptions combined and is to be satisfied by the difference between the amount carried on the balance sheet as reserve liability and the amount carried as a deferred charge on account of unamortized acquisition expense, not on these two reserve components separately (see paragraph (2), Interpretation 1-c).

4. It would not be reasonable to use current market yields, at a time when current yield rates are high in historical perspective, as the long term interest assumption for Type One premiums. Whatever interest assumption may be justifiable for early policy years, a conservative interest assumption for distant policy years should take into account the historical perspective.

5. The choice of actuarial assumptions for old blocks of business involves special considerations when a company is preparing its first financial reports in accordance with generally accepted accounting principles. The usual procedure for existing business would be to base actuarial assumptions on those underlying the actual gross premiums, subject to appropriate testing of the adequacy of the gross premiums in the light of current most likely assumptions. In principle, the degree of conservatism adopted for old blocks of business, with respect to assumptions considered appropriate for the time that such business was issued, should be consistent with the degree of conservatism considered appropriate
for new business at the time of transition. The use of a greater degree of conservatism in choosing assumptions for the valuation of business existing at the time of transition would normally increase the stated earnings in the years after the transition and would be inappropriate.

INTERPRETATION 1-C: EXPENSES

(Published October, 1973 by the Committee on Life Insurance Company Financial Reporting Principles)

1. Generally Accepted Accounting Principles require that the cost of insurance benefits and the expenses associated with acquiring and maintaining insurance business be recognized in relation to premium revenue. For long-term policies of individual life insurance and individual health insurance the reserve system is the actuarial technique for achieving such matching of insurance costs to revenue.

2. The Audit Guide's requirement that the negative reserve component reflecting prepaid and unamortized acquisition expenses be shown separately as a deferred charge is based on accounting principles, not on actuarial principles. The choice of methods for determining the amount of such deferred charge is not necessarily governed by actuarial principles, but actuarial techniques may be employed for such determination and must be employed to test recoverability of the amount of unamortized acquisition expense. To be consistent with actuarial principles, the difference between the amount carried on the balance sheet as reserve liability and the amount carried as deferred charge on account of unamortized acquisition expense must be substantially equal to the present value of future costs less the present value of future valuation premiums, based on actuarial assumptions determined in accordance with Recommendation 1.

3. Sound actuarial practice takes account of all elements of future cost, including all maintenance expenses, when testing the adequacy of premiums and reserves to carry policies to completion, and it is good actuarial practice to include actuarial assumptions for level maintenance expenses in reserve computations. For those policies for which level premiums are payable throughout the term of the policy, it is true, as the Audit Guide suggests, that the actuarial assumption for level maintenance expenses does not affect the reserve. The reserve for other types of policies may be affected, however, and any maintenance expense assumption which is not level will always affect the reserve. Similarly, unlevel renewal commissions will affect either the reserve or the amount of unamortized acquisition expenses.

4. Although actuarial principles might recognize other alternatives, the Audit Guide requires that the amount of provision for deferred acquisition expenses taken into the reserve system for any accounting period not differ materially from the actual recoverable deferrable acquisition expenses of that period. Thus, if actual deferrable acquisition expenses are materially greater than the provision made in the valuation premium
We appreciate the invitation from Senator Talmadge to present suggestions or recommendations in connection with the Committee's indepth review of crop insurance and disaster programs related to American agriculture.

The American Academy of Actuaries is a professional organization of actuaries in all areas of specialization and employment. Its constituent organizations and their predecessors have represented the actuarial profession in the United States for over 80 years. Attached to this statement is an appendix which provides additional background information on the Academy.

I. Actuarial science involves the evaluation of the probabilities of uncertain future events, often over long periods of time, and the financial impact which these events involve. This obviously applies to crop insurance just as any other form of insurance or other long-range financial planning. Actuarial techniques are invaluable in ensuring the financial integrity of both public and private programs by providing the methodology according to which current costs are determined, appropriate reserve levels are established and projections of future trends in costs are recognized.
II. The Academy wishes to emphasize that the interest of the actuarial profession is concerned with the proper financing of these programs and not with the allocation of costs among various parties. Thus, as a professional organization, the Academy does not record a view on how the costs should be borne by various individuals or groups in the private or public sectors.

III. The Academy wishes to be constructive in the process of producing legislation by which the financing of crop insurance and other appropriate related programs is based on sound actuarial principles. This interest continues after programs are established by Congress to the extent that the responsible agencies need to make decisions which require the application of appropriate actuarial techniques and expertise.

IV. Any major change in the existing crop insurance and disaster programs will involve significant amounts of money. It is important that alternatives be considered and that for each a reasonably accurate estimate be made of the costs to be borne by producers and the government.

V. In order to do this, the programs and their alternatives need to be defined in a manner which allows proper actuarial analysis.
As an example, the costs involved under the proposed Farm Production Protection Act of 1977, S. 1575, would be difficult to estimate until a precise formulation is made of the meaning of "normal production level" and its relation to "normal production loss" and "catastrophic production loss" of individual producers.

Care must also be taken in attempting to evaluate the costs of a proposed program such as S. 1575 by extrapolating directly from current programs. Change in programs over time require adjustment of past experience to current benefits. Further, the revised scope of new programs requires careful analysis.

As an example, the scope of S. 1575 differs from the current Federal Crop Insurance program in that:

1. It appears that the definition of production costs has been significantly expanded. Since production costs are fully insured under the new program, it seems likely that the amount of risk will be considerably more than under the present Federal Crop Insurance Act which limits insurance to 75% of the average yield.

2. The addition of livestock and poultry as agricultural products adds complexity to the crop insurance program.

VI. In the interest of establishing on an actuarially sound basis those agricultural programs involving an element
of insurance, the American Academy of Actuaries would be happy to identify the names of leading actuaries familiar with crop insurance. We are confident that there are a number who would be willing to assist in any manner deemed appropriate in evaluating proposed and established forecasting likely monetary outcomes and helping in the application of sound insurance principles. This could also include consideration of catastrophe reinsurance of crop insurance written by private insurance companies, if the Committee so desired.

Of course, any such Academy involvement would be structured on a basis most comfortable to the Committee. The actuaries so involved would be willing to work cooperatively with any governmental entity and, indeed, would of necessity need cooperation and access to data and information in the possession of these agencies.
APPENDIX

BACKGROUND INFORMATION ON THE
AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is a professional organization of actuaries which was formed in 1965 for the purposes of the accreditation of actuaries to practice in the United States. The Academy includes members of four constituent organizations, the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, the Fraternal Actuarial Association and the Society of Actuaries. These organizations, or their predecessors, date back many years, one of them to the late 1800's, so that despite the relatively short duration of its formal existence, the Academy, its constituent organizations and their predecessors have represented the actuarial profession in the United States for over 80 years. The Academy is unique as the national accrediting actuarial organization for actuaries in all areas of specialization.

The requirements to become a Member of the Academy can be summarized under two broad headings: (1) education requirements and (2) experience requirements. An individual must satisfy both sets of requirements in order to be admitted as a Member. At the present time, the education requirement can be satisfied only by passing professional examinations given by either the Casualty Actuarial Society or the Society of Actuaries. The experience requirement consists of five years of responsible actuarial work.

As of December 31, 1976, the membership of the Academy stood at 4,137. These actuaries have a variety of types of employment, including insurance organizations, consulting firms, government and academic institutions. Well over 90% of those individuals who have satisfied the rigorous education and experience requirements of the Academy do, in fact, join the Academy. The entire Academy membership is subject to rigorous guides to professional conduct and standards of practice.

The Academy recommends that membership in the Academy, or its equivalent in education and experience, be recognized in determining the qualifications of actuaries to practice in the United States.

Additional information about the Academy can be obtained by contacting:

American Academy of Actuaries
1775 K Street, N.W. - Suite 215
Washington, D.C. 20006
(202) 223-8196
BRIEF FOR THE SOCIETY OF ACTUARIES AND THE AMERICAN ACADEMY OF ACTUARIES AS AMICI CURIAE

INTEREST OF THE AMICI CURIAE

This brief is submitted by two professional actuarial organizations, the Society of Actuaries and the American Academy of Actuaries.

1 The parties' letters of consent to the filing of this brief have been filed with the Clerk pursuant to Rule 42(2).
The Society of Actuaries was formed in 1949 by a merger of the Actuarial Society of America (founded in 1889) and the American Institute of Actuaries (founded in 1909). Members are either Associates or Fellows. To become an Associate of the Society, it is necessary to pass a series of five examinations, except where a waiver is granted for distinguished foreign actuaries. Admission as a Fellow of the Society requires passing four additional examinations.

These examinations are given by the Society and cover a broad range of topics involving actuarial considerations. In addition to general actuarial theory, the examinations cover a number of applications of actuarial theory, including extensive training in employee retirement plans. Passage of these examinations is widely recognized as denoting high professional stature as an actuary.

The American Academy of Actuaries was formed in 1965 as a national accrediting organization by the four existing national actuarial organizations—Casualty Actuarial Society, Conference of Actuaries in Public Practice, Fraternal Actuarial Association, and Society of Actuaries (the “constituent organizations”). The Academy and its constituent organizations, or their predecessors, have represented the actuarial profession in the United States for nearly 90 years.

The accreditation role of the Academy fills a void, since the states do not license actuaries in a fashion similar to most other professions. The Academy membership today encompasses qualified actuaries in all areas of specialization and practice within the profession. Entry into the Academy involves both education and experience requirements. Over 90% of those actuaries in the United States who have satisfied the entrance requirements of the Academy have become members.

There are currently over 7,000 members of the Academy and the four constituent organizations. These actuaries
are employed by independent consulting actuarial firms, insurance companies, governmental departments and agencies, and institutions of higher learning in academic roles. In recent years actuaries have also been employed by accounting firms, management consulting firms, industrial corporations and labor unions.

The actuarial profession, as one of its major and most significant activities, plays a central and necessary role in the design and administration of employee retirement plans. In that connection actuaries perform computations and make recommendations without which these plans could not be sensibly and effectively administered. In many cases these computations and recommendations take into account the sex of the employees that participate in or are covered by the retirement plans. Our work has made us familiar with the day-to-day operation of retirement programs. The work requires special training and experience and an understanding of a branch of mathematics—the theory of probabilities—without which anyone treating with averages and the classification of risks can fall rather easily into serious error.

We believe, accordingly, that we are in the unique position of being able to offer the Court information that will supply a contextual background that should be helpful in its consideration of this case. We shall, for the most part, leave to the parties and the other amici discussion and analysis of the legal materials that bear upon the proper interpretation in this context of the prohibition in Title VII of the Civil Rights Act of 1964 of discrimination against any individual “with respect to his compensation, terms, conditions or privileges of employment because of such individual’s . . . sex . . . .” Actuaries have no special expertise to offer in this regard. We can, however, help to inform the Court about the extent to which the sex of covered employees is and will continue to be taken into account in the administration
of retirement plans, about the manner and extent to which present practices might have to be changed if all or some sex classification were prohibited in connection with the fixing of contribution rates and benefit levels, what the principal effects of requiring such changes would be, and in general what the impact of the Court’s decision might be in an area that affects hundreds of thousands of employers and many millions of employees. We shall, in the course of that discussion, try to expose as fully as possible the premises that have been accepted by actuaries and which are in substantial part the bases for the opinions and recommendations that they have offered to plan sponsors and to insurance companies in the past.

We note at the outset that from the narrow viewpoint of the economic self-interest of the members of the actuarial profession there is no reason for us to support either affirmance or reversal of the judgment below. We believe we have the obligation to bring to the attention of the Court data acquired by us in the course of our work and to explain the principles and concepts that we employ in that connection.

INTRODUCTION AND SUMMARY

In 1976 over 40 million Americans were participants in some form of non-governmental retirement plan, of which there were about 500,000 then in effect. Putting aside the persons entitled to benefits under the Old Age Survivors and Disability Insurance Program (Social Security), there were, in addition, another 15 million persons covered under retirement plans administered by federal, state and local governments. During 1976, approximately $48 billion was set aside for the payment of future benefits, and at the end of that year approximately $413 billion was held for that purpose.2

2 AMERICAN COUNCIL OF LIFE INSURANCE, PENSION FACTS 1977, 21, 30, 39-40, 41, 43 (1977) (publication of this booklet is due in
Retirement plans can be broadly divided into different categories in several different ways according to: (1) whether the plan is drawn primarily in terms of the benefits that will be payable to employees upon retirement ("defined benefit plans") or in terms of the contributions that are made to provide those benefits ("defined contribution plans"); (2) whether contributions are made only by the employer ("non-contributory plans") or by the employer and the employees ("contributory plans"); (3) whether the benefits are provided by an insurance company which accumulates and invests the contributions and in certain circumstances also assumes the legal obligation to pay the benefits ("insured plans") or by a trustee that performs the same functions but without assuming such an obligation ("trusteed plans" or "non-insured plans"); and (4) by the form in which the benefits will be paid, as, for example, annuities (monthly amounts for life, or for a stated number of years), or in a lump sum, or in some other manner. Thus, there could be a non-contributory defined benefit insured plan which provides for an election between a monthly payment for life or a lump sum.

Under defined benefit plans the central objective is the payment of a pre-determined annual benefit for each employee reaching normal retirement age, which amount will be payable for the life of the retiring employee. The amount of the annual benefit, with exceptions not relevant here, is the same for a female employee as it is for a male with a comparable earnings and service record. Under defined contribution plans, a specified amount of money is set aside for each employee, whether male or female, and such amounts are accumulated until normal late 1977 or early 1978; the figures are from a preliminary draft made available by the Council). Corresponding figures for the end of 1975 are at id., PENSION FACTS 1976, 17, 19, 21, 26-27, 29, 31 (1976).
retirement age. At normal retirement age, the employee is often given the option of receiving the accumulation in a lump sum or having it used to purchase a life annuity.\(^3\)

Women, as a class, live longer than men, as a class. A group made up of a reasonably large number of women will survive for a greater number of years than will an equal number of men, if all other factors that affect longevity, primarily age distribution and health, are identical. The difference is substantial.\(^4\)

As a consequence, if a lifetime pension in the same monthly or annual amount is to be provided for an equal number of men and women of the same ages, a larger amount will have to be expended to pay the pensions to the women than to pay the pensions to the men. Also as a consequence, if an amount of money is to be completely liquidated by the payment of lifetime pensions to a number of women, the annual amount that can be paid to each will be less than can be paid to each of an equal number of men of identical ages in order to completely liquidate an identical initial amount of money. These inexorable facts of life, death and arithmetic, which cannot be changed by any Act of Congress or judgment of this Court, give rise to the narrow issue presented in this case as well as to a number of other analogous issues which may well be affected by the decision.

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\(^3\) A more detailed summary of the principal types and features of retirement plans is set forth in Appendix A.

\(^4\) A discussion of the difference in longevity between men and women and of the probable reasons therefor is set forth in Appendix B.
I. The Pooling and Classification of Risks

A fundamental question in this case involves the determination of when individuals may be treated as members of a class to which they belong (and which classes are permissible and which impermissible) and when they must be treated solely as individuals. Since the business of providing and guaranteeing retirement annuities and insurance necessarily involves the pooling and classification of persons and risks, some discussion of why this is so and how it is done is appropriate before we turn to how and why classification on the basis of sex is employed in the administration of pension plans.

As this Court noted in Helvering v. Le Gierse, 312 U.S. 531, 539 (1941), persons who purchase life insurance seek "to shift and distribute risk of loss from premature death." The risk of loss referred to was that the funds accumulated to meet the needs of dependents would be insufficient if early death occurred. Those who provide annuities seek to shift and distribute the risk that the annuitants will live on unexpectedly for a long time and thereby exhaust the amounts set aside for their retirement years. The actuarial principles and the methods that are employed in those instances are the same as they are in providing insurance against other risks, and may be illustrated by a hypothetical example.

Suppose 10,000 individuals of varying ages have each accumulated $100,000 savings which they wish to use (together with the earnings on the diminishing amounts) to provide level monthly amounts with which to meet their living expenses and which will continue as long as they live. Since no one of them can know how long he or she will live, no one of them can decide how much can prudently be used each month. If all are willing to pool their savings and to receive a level monthly amount that will cease upon their deaths, whether early or late, this
uncertainty can be eliminated. Although it cannot be known at the outset how long any one person will live, the accumulation and analysis of a large body of data permit a very accurate prediction about the rate at which the entire class will die in the future. From this it can be readily determined what periodic installment payments may be made to each of them so that the initial amount of one billion dollars (and the earnings thereon as it is liquidated) will be used up at approximately the time when the last payment is made to the last survivor. Thus the uncertainty faced by each individual can, to a high degree of accuracy, be largely eliminated for the entire group without risk of loss, by pooling the risks and dealing with classes of persons rather than individuals.

Before turning to the question of whether and why the group should be divided into smaller classes when determining the amount that each individual should receive, it should be noted that if it were decided at the outset that all persons in the group should receive exactly the same periodic amount, it is readily determinable, on the basis of the predicted longevity of the persons in the group, what that amount should be. To determine the longevity of the group the characteristics that affect its longevity must be known. If the determination were to be made without taking the ages of the members of the group into account, the result would be grossly inaccurate, if the computation could be made at all, since some guess about the age distribution of the persons in the group would be necessary, and the result would depend significantly upon the accuracy of the guess. This is because any reasonably large number of persons of a given age will, as a group, survive for more years than will an equal number of persons who are, say, ten years older. Similarly, if the determination of the amount to be paid were made without reference to the sexes of the individuals in the group, the result would be seriously and unacceptably erroneous. This is because a large number of women will
survive for a total number of years that is greater than the total number of years that the same number of men of the same ages will survive.

It has been almost universally accepted, however, without serious dispute, that in any arrangement of this kind each person should receive an amount that, within the limits of administrative feasibility, is equal to a proportionate share of the amount that will be paid to the identifiable sub-class of persons to which he or she belongs, the class which most nearly reflects his or her mortality. The validity of this principle that each member of the group should be charged in proportion to the risk that he or she contributes to the pool of risks may be defended on either or both of two related grounds.

The first is that, when annuity arrangements of this kind are sold by a business, then, without reaching the question whether this principle is "fair" or "equitable," it is essential to the successful operation of the business that persons who transfer higher risks to the group than others should be charged more. A well known practice or phenomenon, of great significance to the annuity and insurance business, is known as "adverse selection." It has been the experience of the industry that, if a particular form of benefit is made available to the market at a price that is materially lower than its actual cost, that product will be bought in substantial quantities by the public. Correspondingly, a product that is over-priced will tend to disappear.

To take an extreme example, if an insurance company that is currently charging 65-year-old women $10,000 for a lifetime annuity of $65 per month and charging

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Although annuity and insurance contracts contain a number of standard provisions required by law, they also vary greatly from company to company and over time. Contractholders are offered a variety of options, and different features are combined in different ways, reflecting the opinions of different companies about the needs and desires of the market. Each of these options must be priced to reflect approximately their respective costs.
55-year-old women $14,000 for the same annuity were to seek to simplify its procedures while obtaining the same revenue by charging both groups $12,000, it would not be long before there was a substantial increase in the number of its young customers and a decrease or the disappearance of its older customers. The result of such a development would be substantial losses. The business simply cannot sensibly be conducted in this fashion. For this reason new products are intensely scrutinized by actuaries to guard against the possibility of adverse selection, and, even so, dramatic examples of the practice continue to occur. It is this principle of adverse selection that explains why age and sex alone have been the significant factors in pricing annuities.

Second, many of the members of our profession also believe that there is a concept of “actuarial equity” that is sound, and that the value judgment can be made that it is “fair” to take into account differences in the risk contributed by an individual or group of individuals whenever there is sufficient statistical experience to make reliable predictions about those differences. They believe that where it is probable that a person or class of persons will receive a larger share of the total benefits to be disbursed, the person or class (or those contributing on their behalf) should contribute a larger share of the

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6 Some 200 years ago in England, merchants and professionals formed insurance societies that exacted assessments independently of age, sex, or other factors, and these societies failed as members aged, died, collected benefits, and thrust the costs onto the prospective young members, who therefore refused to join. R. MITCHELL, FROM ACTUARIUS TO ACTUARY 1, 2 (1974) (booklet published by Society of Actuaries).

7 Additional factors such as health and occupation are significant in pricing life insurance: if a person knows that he or she is likely to die sooner than the average (say, because of diagnosed disease or a hazardous occupation), then that person is not likely to purchase an annuity. The person “self-selects” out of the pool of participants. In the case of life insurance, however, the prospective purchaser has the opposite motivation; thus the insurance company must take the applicant’s health and occupation into account.
amount needed to pay the benefits, even though it is not certain at the outset that they will actually receive a higher amount. "Actuarial equity" thus requires not only that persons with similar risks be treated alike but that persons with dissimilar risks not be treated alike. This view has probably played a large role in many state non-discrimination laws that prohibit only "unfair" discrimination among persons in different classes.

Two qualifications must be noted. Actuaries recognize that it is not only impossible to quantify the risk contributed by each individual, it is also not necessary to extend the classification process to its ultimate limit. Two classes with observable differences may nonetheless be lumped together and treated as a single class if the relevant differences, though identifiable, are relatively small. The minor "unfairness" may be outweighed by the added expense involved in treating the two cases differently. Moreover, small differences do not give rise to significant adverse selection and so are acceptable. Second, certain classifications which may be perfectly feasible from an actuarial standpoint may be barred by others for reasons of social policy. For example, black persons exhibit shorter longevity than white persons, but they are not charged a lower amount when they purchase annuities or a higher amount when they purchase life insurance.

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9 See, e.g., IOWA CODE § 507 B.4.7(a), (b) (1975), Md. ANN. CODE art. 48A, § 223(a) (1972); VA. CODE ANN. § 38-715 (1977 Supp.) But see D.C. CODE ANN. § 35-715 (1973) ("unfair" qualification omitted). For citations to the corresponding provisions of all the states, see Bailey, Hutchison, & Narber, The Regulatory Challenge to Life Insurance Classification, 25 DRAKE L. REV. 779, 782 n. 17 (1976).

10 Over the last 40 years the difference in mortality between black and white persons has been narrowing. Moreover, at the higher ages which are of primary concern in retirement plans the differences have become virtually nonexistent. U.S. DEPT. OF HEALTH, EDUCATION AND WELFARE, PUBLIC HEALTH SERVICE, NATIONAL CENTER FOR
If any classification that is actuarially sensible is to be prohibited by law, it must be done by persons responsible for making and interpreting the law. Such a decision will ordinarily be accompanied by an increase in cost or by a change in the manner in which total cost is divided, and ideally the persons responsible for the prohibition should decide how the division of costs should be made.

II. Classification on the Basis of Sex in the Administration of Retirement Programs and the Effects of Prohibiting This Practice

We turn now to the examination of the extent to which sex differences are currently taken into account in the administration of retirement plans and to the types of problems posed if current practices are required to be substantially revised. We believe it would be more helpful to the Court if we treat this subject in an organized way and discuss the specific type of plan that is at issue in the case at bar when it arises naturally in the discussion rather than at the outset. In the discussion that follows, the comparisons assume that the men and women involved are similarly situated, that is, such factors as salary, age, and length of service are identical.

A. Defined Benefit Plans

1. Non-contributory plans. Most defined benefit plans in effect today are non-contributory, that is, the employer pays the entire cost of the plan. Such plans ordinarily provide for the payment of equal monthly pensions as a single life annuity at retirement, without regard to the sex of the retiring employees. Such a non-contributory defined benefit plan provides a monthly (or other per-
iodic) payment that is identical for both sexes, assuming, as we have said, that all other applicable factors are the same.\(^{11}\) So far as we know no one has suggested that such a plan discriminates unlawfully or unfairly on the basis of sex. Upon a closer look, however, it becomes evident that the issue is not as simple as might at first blush appear.

Many, and perhaps most, defined benefit plans permit employees to elect to receive their benefits in a different form than in equal installments payable for life. Indeed, ERISA now requires that, unless a married employee elects otherwise, the benefit must take the form of a "joint and survivor annuity" (installments payable so long as either spouse remains alive). The question immediately arises, if for example the "normal" pension is equal to $1,000 per month for a retiring employee regardless of sex, what the monthly payments should be under a joint and survivor annuity, to take into account the fact that the benefits will be paid over a longer period of time. A similar question arises if the plan permits its employees to elect, instead of a joint and survivor annuity, an annuity for the period of the employee's life with a minimum payment period of ten years or if the plan permits the benefit to be paid in a lump sum upon retirement.\(^{12}\)

Employers have great flexibility in deciding what the benefit formulae shall be, and so we cannot describe any current universal practice. (App. A, p. A-1.)\(^*\) In the majority of cases, the ages and sexes of the participants

\(^{11}\) In practice, the employer's cost as a percentage of pay may be higher or lower for the class of female employees, than for the class of male employees, depending upon the number of persons in each class and upon differences in mortality rates, disability rates, withdrawal rates, rates of salary increase, average retirement age and other factors.

\(^{12}\) Only a minority of defined benefit plans permit a lump sum to be elected but there is no legal restriction against such a provision.

\(^*\)Journal page 242
and spouses have been taken into account. Under a typical trusteed plan, for example, where a 65-year-old man who retires with a wife who is also 65 years old chooses a 50% joint and survivor annuity (payments to a spouse who survives the employee will be one-half of the initial installment payments), the monthly benefit is reduced from $1,000 to take account of the fact that the benefit may be paid over a longer number of years. The $1,000 per month might be reduced to $870 per month. If the retiring employee is a woman and her husband is 65 years old and she makes the same election, her $1,000 monthly pension might be reduced to $940 for a monthly difference of $70. The $70 difference reflects the fact that the beneficiaries added in each case have different life expectancies. The female employee has less reduction because there is less chance that her husband would collect payments after her death than there is in the case of a male employee with a wife age 65. The pensions are thus kept equal in cost, and, although the monthly amounts of pension differ, their values are equal if the length of time during which they are expected to be paid is taken into account.

If the two employees choose instead a lifetime annuity with payments to be made for no less than ten years ("ten years certain"), then the installment payments may be reduced to $910 for the retiring male employee and $960 for the retiring female. Finally, if a lump sum is chosen by each of them under a plan that allows such lump sum distributions, the man will receive $111,000 and the woman $130,000. Thus, women would receive a significantly larger payment after completing the same work tour as men.

The principle that is followed in determining the foregoing amounts is that the amount to be received by a retiring employee and the employee's beneficiaries, regardless of the form in which the benefits are taken, should,
under assumptions of mortality and interest rates, be the actuarial equivalent of the "normal" or "primary" benefit. In more functional terms the amount of the benefit is determined so that, if the actual interest rate and the actual mortality of the employees are the same as that anticipated at the time of retirement, the cost of the benefit to the employer will be the same, regardless of the form in which the employee elects to receive the benefit.

Some plans determine the amount of joint and survivor benefits by the application of factors which do not take sex into account. Some plans have done so in order to reduce employee dissatisfaction which occurs because employees do not understand the reason for differing actuarial factors. In the joint and survivor example given above, instead of a payment of $870 for male employees and $940 for female employees, such an employer might shift to $900 regardless of sex. This would result in a reduction in cost for the employer to the extent that female employees elect the joint and survivor annuity. On the other hand, the plan would have an increased cost for male employees who make such an election. Some plans also do not take the sex of the retiree into account when converting a lifetime annuity into an annuity with ten years certain, although many do so. We know of no plans which do not take sex into account if lump sum payments are to be made.

The use of factors that do not take sex into account has been possible only in a plan where the gain or loss is borne by the employer. As is explained more fully below, under certain insured plans where the obligation to pay the benefit has by contract been assumed by an insurance company, the contracts in current use require the use of conversion factors that include sex as a factor, and it would not currently be possible for an employer to
shift to unisex tables in determining joint and survivor benefits.

Another very commonly found provision permits the early or deferred retirement by an employee. Some plans provide for no change in the pension if such an election is made, and some plans provide for a change in the benefit by the application of retirement factors that do not take sex into consideration.\(^1\) Other pension plans include early retirement factors which do reflect the separate mortality experience of males and females, and these provide a lesser reduction for women than for men.\(^2\) Here again this is obligatory under certain kinds of insured plans.

Since there are many plans already in existence which do not provide for a reduction which differs by sex, it obviously would not be impossible for most plans to comply with a requirement that early retirement factors be independent of sex. Depending on the revised early retirement factors adopted and the extent to which early retirement is elected by persons of different sex, the change might increase or decrease the cost to employers. Some employers might choose to offset any such change by making approximately corresponding changes in other features of the plan. A similar analysis can be made of provisions that prescribe how the amount of a pension will change in the event of deferred retirement.

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\(^1\) In at least one case it has been held that a plan that provides a reduction for men in the case of early retirement and for a lesser reduction for women for reasons unrelated to differences in longevity violates Title VII. *Rosen v. Public Service Electric and Gas Co.*, 328 F. Supp. 454 (D.N.J. 1970), on remand from 409 F.2d 775 (3d Cir. 1969).

\(^2\) The EEOC has held that such a plan provision violates Title VII. EEOC Decision No. 72-1919, June 6, 1972, CCH EEOC Decisions (1973) ¶6370. We suggest respectfully that, while the decision may or may not be correct, the opinion does not reflect an appreciation of what we regard as the genuine difficulty of the issue that was presented.
What would be the result if it were to be held that Title VII or some other Act of Congress requires that all benefits, in whatever form elected, must be numerically identical rather than actuarially equivalent for employees of different sexes who are otherwise similarly situated? Such a requirement might be met in a variety of ways. To simplify the discussion, we shall change the above example to a plan with only the alternatives of a monthly lifetime pension and a lump sum. The employer might agree to pay all male employees who elect a lump sum $130,000 instead of $111,000. This, of course, would increase the cost to the employer and some employers might not be willing to assume this additional cost. There is no legal requirement concerning the overall level of benefits that must be provided, and some plans are far more generous than others. Accordingly, some employers might decide instead to reduce the lump sum payable to retiring female employees who elect that benefit to $111,000. That would reduce the employer's cost, but it would hardly be of any benefit either to male or female employees. It would also raise questions about whether already vested benefits could be "reduced" in this fashion. Finally, the employer might try to keep its costs unchanged, at least prospectively, by providing that a pension benefit of $1,000 per month could be converted, for both male and female employees, into a lump sum of $120,000. The difficulty with this solution is that, if it were adopted, male employees who were well advised and who actually desired a lifetime pension might be able to elect a lump sum benefit, buy an annuity of $1,000 per month from an insurance company for less than $120,000 and pocket the difference. This would raise anew the question of whether equality between male and female employees had in fact been achieved. The added benefit provided to male employees in this illustration would come partly from the employer and partly from
those women employees who had uneconomically elected a lump-sum benefit.

Another solution, and one that many expect would be the result, would be the determination by some employers to eliminate certain options, particularly the lump sum distribution option. This would be disadvantageous to the class of both women and men who might find the lump sum option attractive for such reasons as major illness.

2. Contributory plans. Most defined benefit plans are noncontributory, but a substantial minority requires employee contributions. Employee contributions are almost always—unlike the plan in the case at bar—unrelated to age or sex. To the extent that employee contributions are related to age or sex, they are found in plans adopted by governmental bodies and not by private institutions.\(^ {15}\) Under most contributory plans the employer's aggregate contributions will be substantially greater than the aggregate contributions made by employees.

Since defined benefit plans which provide for different contribution rates for male and female employees are exceedingly rare, there would not be a widespread effect if equal employee contribution rates were to be required in the case at bar. Significant problems would arise, however, if the sex of the employees could not be taken into account in determining amounts of benefits or amounts of employer contributions in contexts that have already been described and in others yet to be described. In particular, a determination that the amount of employee benefits in any form must be identical for both sexes would have a dramatic impact.

It should be made clear that whatever decision may be made concerning the permissibility of taking sex into

\(^ {15}\) Note 18, infra, provides a possible explanation for the origin of this type of plan.
account in fixing the contributions or the benefits under a defined benefit plan, actuaries must be able to continue to take the sex of employees into account in connection with their determination of what probable costs must be borne by the employers under such plans. The actual cost, of course, will be determined by what is in fact paid, the expenses of administration, and the earnings rate. The job of the actuary is to help the employer make an accurate estimate of how much should be contributed annually, without imposing an excessive strain in any given year, in order to produce an amount sufficient to pay all of the promised benefits. In determining what contributions should be made, the actuary must take account of the expected experience concerning mortality, disability, turnover, salary increases and other factors which studies have shown differ by sex. If the actuary does not do so, the determinations will be less accurate, and we can hardly believe that any provision of law requiring non-discrimination among persons will be interpreted to prohibit an employer that would like to have as accurate information as possible from obtaining it from a person who is able to provide it.

3. Insurance contract plans. Some plans are funded exclusively with individual insurance and annuity contracts with level annual premiums. If such plans meet the requirements of Section 301(b) of the Employee Retirement Income Security Act of 1974 ("ERISA"), they are known as "insurance contract plans." For insurance contract plans and certain other insured plans,

16 Since defined benefit plans provide primarily for the benefits that will be payable, it is not necessary, as it is under a defined contribution plan, to establish individual accounts or to make contributions for individual employees, so that the question of whether equal contributions are being made for male and female employees, while an appropriate one to ask, does not have as evident an answer.

any general requirement that contributions must always be equal or that benefits for persons of different sexes must be identical rather than actuarially equivalent would create far more difficult problems than those generally faced by other plans. To the extent that only some of the existing practices are invalidated and others found to be acceptable, the difficulties, of course, would be correspondingly reduced.

The reason for the greater difficulty arises from the fact that under insurance contract plans and some other insured plans the obligation to pay pension benefits has been transferred from the employer or the plan to the insurance company, and the insurance company’s contractual obligations run directly to the individual employees. Those contractual obligations are normally cast in terms that provide for actuarial equivalence, if an employee elects to change the form of the benefits. If only numerically equal payments are to be deemed to be satisfactory, that is, if males and females must be entitled to the same monthly or other periodic payment, or alternatively to the same lump-sum payment, and if such a decision is made retroactive, the result—in our carefully and thoroughly considered opinion—would be chaotic, if not impossible, under these insured plans. The revision and adjustment of the existing relationships involving millions of persons would be a monumental and very probably impossible task. Even if a decision of this kind were expressly given only prospective effect, compliance by insurance contract plans would still present exceedingly difficult problems. The terms of the sale of annuity contracts and insurance policies by life insurance companies have not been directly or indirectly subject to Title VII of the Civil Rights Act of 1964, and, since an essential aspect of the insurance business involves setting charges at levels that are accurately related to the nature and extent of the risks involved, any ruling that creates
disparities between the amount and the cost of certain benefits would necessarily result in the most serious problems for insurance contract plans. We would not even attempt to predict, at this time, what the response of the industry would be to such a decision.

It has been widely suggested that classification on the basis of sex could satisfactorily be eliminated in future contracts by prohibiting life insurance companies from making different charges for lifetime annuities to men and women despite the longevity differences that the two groups display. This would be accomplished by combining the experience of men and women and constructing a single "unisex" mortality table. Whether this would be an acceptable solution is a matter that is exceedingly complex, and an accurate explanation of the problems that would be created and the manner in which they might be solved would require careful and detailed analysis at least as lengthy as that already set forth in this brief. The problems are related but in many respects are quite different. The question of the extent to which adverse selection would result is one that particularly requires examination and analysis of the actual numbers that are involved. In order to avoid extending unduly the length of this brief, we shall not undertake to discuss any of those problems here. In fact, there is no legislation currently pending to require the adoption of unisex tables by all life insurance companies. If such a requirement were imposed upon some but not all insurers, the competitive impact would be most severe. In the circumstances it seems advisable to deal with the situation as it exists today and not to treat with problems that might arise if hypothetical changes were to be made in federal or state law.

It is important to note, however, that in some respects the purchase of insurance or annuities offers greater advantages to employers that have relatively few em-
ployees than to large employers, although some of the country's largest corporations have adopted insured funding for a variety of reasons. The probability that the mortality experience of a relatively small group of persons will diverge from what is anticipated is very much greater than it is for a large group of persons. For a smaller pension plan the purchase of annuities for retired members may provide greater assurance that the promised pensions will actually be paid, no matter how long the pensioners live. The burden of any major change resulting from the prohibition of risk classification by sex is thus more likely to fall more heavily upon smaller employers than upon larger employers. Many small employers currently use insured rather than trusteed plans.

In some respects a given pension plan may present a greater appearance of unwarranted discrimination if it is an insurance contract plan. A trusteed non-contributory defined benefit plan that provides only equal pension benefits will require, as we have pointed out, a determination of the amounts that must be contributed annually to provide proper funding. These amounts are not allocated to any particular employees; all that is readily observable is the total amount contributed each year. If the plan were one established by an employer with relatively few employees it might be funded by the purchase, for each employee, of individual retirement income or annuity contracts. The aggregate contribution might be about the same as under the trusteed plan but it would be made up of contributions under separate contracts, the amount of which would be larger for female employees than for identically situated male employees. Thus it would be easier to raise the question of compliance with Title VII because the employer seems plainly to be making larger aggregate pay-
ments for salary and pension benefits for female employees than for identically situated male employees.  

B. Defined Contribution Plans

It is extraordinarily rare for a defined contribution plan (except for the target benefit plans discussed at Part C) to provide that different contributions will be made for male and female employees who are otherwise similarly situated. And, since these plans do provide that separate contributions shall be made for each employee which will be accumulated and used to provide the benefits for that particular employee upon his or her retirement, the issue of discrimination on the basis of sex would not seem even to arise. Indeed it does not arise for a plan that provides benefits only in the form of a lump sum or in the form of installments over a stated period of years. Under such a plan there is no pooling of risks. This is true whether the plan is insured or non-insured, and in either case there is no necessity for classification on the basis of sex. Where, however, the plan does provide for a form of benefit that involves life contingencies, the issue arises. This would occur if a lifetime annuity were to be offered as an alternative to, or instead of, the payment of benefits in a lump sum.

Providing the option of life annuity payments plays an important role in meeting the needs for an adequate

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18 It may be of interest to know how plans of the type in the case at bar came to be adopted. When state and local governments first began to adopt retirement plans for their employees, it was quite common for a decision to be reached that they should be provided for by equal contributions by the employer and the employee. Since the cost of funding pensions for female employees who remained to normal retirement was higher than for similarly situated male employees, and since half the amount was paid by the employee and half by the employer, higher contributions were required for female employees. This practice has become less common over time and is now quite rare.
retirement income for employees. If the individual retiree receives his or her account balance as a lump-sum payment, the retiree may spend it all before death and spend his or her final years in poverty. Similarly, if the retiree elects installments for a fixed period of years, even if that period equals the life expectancy, the retiree may outlive the payments and have no income in later years. Guaranteeing payments for life, or as long as either the retiree or spouse lives under a joint and survivor annuity, provides an important social role in meeting the needs of retired people.

If it were not allowable to apply the account balance to purchase annuities unless identical monthly benefits were paid to both males and females, employers that had adopted insurance contract plans could not supply the annuities. Their only currently available alternative would be to eliminate entirely the option to obtain life annuity payments and require all participants to take their distribution in a lump-sum payment or in installments not guaranteed to last for life.

Some defined contribution plans do not allow payment of the account balance as a lump-sum payment, but require that it be applied instead to provide only for a lifetime income or for a choice among several types of annuities, each involving life contingencies. The latter type of plan is not common, but it is used by many colleges and universities and by many non-profit health and welfare agencies. Under a defined contribution plan the value of the plan benefit is equal to whatever dollar amount is credited to the employee's account on the date of retirement. In a plan that provides only for annuity benefits, the question is how that value is to be lawfully converted into installment lifetime payments of the "correct" amount, in order to comply with Title VII of the Civil Rights Act of 1964.
Since every insurance company offers to provide annuities in amounts that are different for men and women if an identical single purchase payment is made, the issue arises whether the use of two identical account balances to provide unequal installment payments for men and women constitutes an unacceptable discrimination on the basis of sex. If it were to be held that, under Title VII, a plan may lawfully provide for an election between identical lump-sum benefits for men and women and monthly installment payments for life that are higher for men than for women, then, in our view, it would be thoroughly inconsistent to hold that a plan that provides only the differing monthly lifetime benefits violates the Act. The cost and the value of the benefits provided by both plans are the same. If both types of plan were held to violate the Act, this could only mean that plans of this kind would simply have to be abandoned, with the probable result that employees, male and female, who would otherwise be covered by such plans would have to look elsewhere for their retirement incomes.

Some plans provide for part of the equal contributions made for men and women to be used for the purchase of life insurance. (App. A, p. A-5.) Virtually all major insurance companies charge lower life insurance premiums for females than for males. If a male employee and a female employee for whom the same annual contribution is being made each chooses to have an identical portion of that contribution used for the purchase of life insurance, the female employee will be provided with a larger face amount of insurance. If she survives to retirement, the insurance policy will probably have a larger cash surrender value than the policy purchased for the man, while the rest of their accounts will be identical. Thus, the female employee will receive a higher benefit than a male employee if both elect a lump sum, although the man will still be given higher monthly lifetime payments if this form is elected. Similarly, if the two employees should
each choose to have an identical amount of life insurance purchased for them, the woman would probably receive a larger total lump sum benefit upon retirement.

The question in either case is whether this would constitute a violation of Title VII and, if so, whether it discriminates unfairly against men or against women. The only method for an employer to eliminate such differences by sex would be to provide only a lump-sum benefit or to find an insurance company which uses the same premiums for both sexes. This would probably reduce the benefits available for females without increasing the benefits for males, a result contrary to the interests of participants.

The problems that might arise under a contributory defined contribution plan in this connection are the same as those problems that arise under a non-contributory plan.

C. Target Benefit Plans

There are retirement plans which have some aspects of a defined benefit and some aspects of a defined contribution plan, the principal one of which is known as a target benefit plan. (App. A, p. A-5.) These plans have as a goal a specified defined benefit and employ actuarial computations to determine what the contribution should be to provide that benefit. On the other hand, as is the case with defined contribution plans, individual accounts are established which are then used for each employee to provide benefits which may or may not be approximately equal to the original objective. Some target benefit plans take the sex of employees into account in determining the contribution levels and others do not. Inevitably, those plans which take sex differences into account result in higher employer contributions for the class of female employees than for the class of male employees to the extent other factors are equal, and the

*Journal page 246
The lump-sum payment available at retirement is therefore higher for females than for males, although if an annuity is purchased the amount of the installment payments might be more or less for females than for males.

On the other hand, if sex differences are not taken into account in determining the contribution levels, then the contributions are equal for both sexes, the lump-sum amount available upon retirement is identical, and the target benefit will necessarily not be reached in both cases since the monthly installment payment that can be provided with the identical balances will be lower for women than for men. Here again the question arises whether one or the other of these approaches is required by the provisions of Title VII and, if so, which one it is.

III. The Intent of Congress

We stated earlier that we would leave to others the conventional analysis of the legal materials that may bear upon the decision of this case. Here we depart slightly from that commitment to refer briefly to one action of the Congress that occurred well after the enactment of the Civil Rights Act of 1964.

So far as the views of the Congress which adopted the 1964 Act are concerned, we think it reasonably clear that neither the members of that Congress nor the members of the committee that drafted and considered the legislation ever focused in any meaningful way upon what was meant by the meaning of the term "discrimination" in this intricate context. There does not seem to have been even scant consideration, when that Act was adopted, of the extent and the manner to which classification on the basis of sex had been previously employed in connection with the determination of contributions and benefit levels for employee retirement plans and to what extent, if any, then current practices might have to be modified as the result of passage of the Act.
Ten years later, in the Employee Retirement Income Security Act of 1974, Congress established minimum amounts that must be paid to participants under defined benefit plans who terminate their employment prior to retirement. The terminology employed speaks of the "accrued" benefit which the employee must receive. Section 204(b)(1)(F) states that, if a plan is funded exclusively by the purchase of insurance contracts which satisfy the requirements of § 301(b)(2) and (3) of the Act, the requirement for a minimum payment will be satisfied by the payment to the employee of the cash surrender value of the insurance contract. In this instance the members of the committee that drafted and considered the legislation were quite knowledgeable about the subject matter and did understand that the type of contract described in § 301 of the Act would provide cash surrender values for female employees that were higher than the corresponding values provided for male employees with identical employment histories, although we must point out that we know of no statement in the legislative history that reflects this understanding. One may speculate over whether the persons involved gave any thought at the time to the consistency of what they were then doing with the provisions of Title VII of the Civil Rights Act of 1964. There is no doubt, however, that they expressly authorized the adoption and funding method of a plan that included provisions resulting in the payment of numerically unequal benefits to men and women upon termination of employment.19

19 The Pension Benefit Guaranty Corporation, the governmental agency which administers the plan termination insurance program under Title IV of ERISA, has issued regulations containing factors which must be used for allocations of pension plan assets under certain circumstances. These actuarial factors published by the Pension Benefit Guaranty Corporation vary by age and sex and result in more assets being allocated to provide benefits for a female than for a male. 41 Fed. Reg. 48484, 48489-91 (1976).
In a related context, on the other hand, the same statute includes a provision that indicates that the use of a "unisex" table is appropriate in certain circumstances, also related to the amount of accrued benefits under a contributory defined benefit plan. Under such a plan, the monthly benefit payable at retirement is usually unrelated to the amount of employee contributions. Thus a plan might provide for employee contributions of 4% of pay and monthly benefits at age 65 of 1 1/2% of pay times years of service, and there is no need to determine upon retirement what portion of the benefit is regarded as having been derived from employee contributions and what portion is regarded as having been provided by employer contributions.

The portion of the employee's accrued benefits which is derived from his own contributions is always 100% vested, while the portion derived from employer contributions is not usually vested before 10 years of service. If the employee terminates employment before the employer-derived benefit fully vested, ERISA requires the total accrued benefit to be divided into the employee-derived portion and the employer-derived portion. The Act sets forth explicitly how this shall be done and, in determining the employee-derived portion, requires the accumulated employee contributions to be multiplied by an appropriate actuarial conversion factor. The conversion factor in the statute and supplemental factors published by the Internal Revenue Service are unisex factors. A plan is permitted to use sex-differentiated factors if these result in a larger employee-derived benefit,

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and some plans have done so, but most contributory plans have adopted the unisex approach.

CONCLUSION

The foregoing discussion is illustrative rather than exhaustive; it is over-simplified and omits what we hope is only irrelevant detail. We should be glad to amplify it in any way if that should be thought helpful.

We believe that any sweeping decision that only numerical identity is permissible in making contributions and in the payment of benefits would have a deeply disturbing effect upon the current methods of providing retirement benefits and might adversely affect millions of participants. We respectfully suggest that this Court render a decision that will not have widespread and unintended adverse effects.

Respectfully submitted,

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PRINCIPAL TYPES AND FEATURES OF RETIREMENT PLANS

Until the adoption of the Employee Retirement Income Security Act of 1974, the principal regulation of retirement plans by the federal government arose out of the necessity for such plans to meet the requirements for "qualification" under § 401 of the Internal Revenue Code. Contributions made by an employer are deductible in the year in which made if the plans are "qualified," while the employees are taxed, not in that year but in the year in which their benefits are received. In addition, the earnings on the accumulated contributions are not taxable.

One of the more significant requirements for qualification is that the plan must be non-discriminatory, that is, that the plan may not explicitly by its terms, or in practice, provide more desirable pensions for officers, shareholders, and highly compensated employees than it does for other classes of employees. The regulations adopted to insure that this requirement is met are often quite complex, but prior to ERISA, plan sponsors (employers and joint boards of trustees) had broad flexibility with respect to the design of such retirement plans, more specifically with respect to the nature and amount of benefits to be provided, contribution formulas to be employed, eligibility requirements and vesting provisions, and the inclusion of a wide variety of optional features.¹

Since the effective date of ERISA many more substantive requirements must now be met, but the freedom of the plan sponsor to fashion the terms of the plan still remains very broad. In consequence it is not possible

¹ In many cases, of course, the terms of the plan were the subject of collective bargaining between the employer and union representatives.
within reasonable page limitations to provide a comprehensive or exhaustive account of the great variety of provisions found in retirement plans and of the number and kind of individual variations. With this qualification, however, we can describe the major categories into which such plans can be divided and describe in adequate detail the major features that are relevant to the issues before the Court. There are so many different kinds of plans and so many diverse features, that there are likely always to be exceptions to any unqualified general statements in this area.

A. Defined Benefit Plans

A defined benefit plan, as the name implies, promises a benefit that is determinable by the use of a stated formula set forth in the plan. Typical examples might be: (1) an annual pension equal to 2% of the sum of the annual amounts earned in each year of employment; (2) 1 1/4% of the final year's earnings multiplied by the number of years of employment; (3) 2% of the average earnings during the last five years of employment multiplied by the number of years of employment; and (4) $20 per month for each year of employment without reference to the amount earned. Thus, for these plans, while the exact amount of any person's pension cannot be known until retirement, the manner in which it will be determined is known in advance. Defined benefit plans generally provide the same annual pensions for retiring men and women who retire at the same age with identical employment histories.

An important requirement added by ERISA in 1974 is that a plan which provides for a pension that is payable for the lifetime of the employee must also provide

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2 The Bankers Trust Company of New York periodically publishes studies of the retirement plans of large United States corporations which include useful information not available elsewhere.
that for married employees, in the absence of an election by the employee to the contrary, payments must continue until the deaths of both the employee and his or her spouse.

A defined benefit plan may provide that all of the costs of providing the benefits will be borne by the employer, and it may also provide for some part of the cost to be borne by contributions by the employees. A substantial minority of defined benefit plans includes such a requirement. Usually the portion provided by the employees is less than the amount contributed by the employer. Probably the largest plan of this kind is that provided by the federal government for its Civil Service employees. A contributory plan will contain provisions for the return, at a minimum, of the employee's contributions plus interest if his or her employment is terminated before the anticipated retirement age. Usually the benefits payable upon retirement do not depend upon how the funds held by the plan are invested or whether the investment results are good or bad.

Defined benefit plans often provide that the amount of the pension will be offset by all or part of the benefits payable under the Social Security system. For example, the plan might provide that the amount of the pension at age 65 shall be reduced by 50% of the amount of the Social Security benefit. Defined benefit plans may provide, and ordinarily do provide, for elections by the retiring employee with respect to the form in which the benefits shall be paid, i.e., (a) in a monthly amount payable over the lifetime of the employee, (b) in a monthly amount payable over the lifetime of the employee but with a minimum of payments for a 10-year period, (c) in a monthly amount over a stated number of years, or (d) in a lump sum. The plan may provide for earlier retirement than the "normal retirement age" or for deferred retirement. In each case the plan will provide
whether and how the benefits will be affected by these elections and events.

**B. Defined Contribution Plans**

Defined contribution plans focus initially upon the amount of contributions rather than the determination of benefits. They provide for contributions on behalf of each employee. Under some plans of this type, known as money purchase pension plans, the contribution for each employee is defined, often in terms of a stated percentage of annual salary. For other plans of this type, known as profit-sharing plans, the amount of the employer's contribution for each year may be determined by reference to a formula related to profits, or may be entirely at the employer's discretion. This amount is then allocated to each of the employees by a stated formula ordinarily in proportion to annual compensation. Under such a plan, it is quite possible that in some years no contribution at all will be made.

Under a defined contribution plan, individual accounts are kept for each employee during the period while he or she is still working, and an amount is credited annually to each of those individual accounts. The funds are invested and the earnings or the losses serve to increase or decrease the amount in the account. Since the amount in each individual employee's account is used to provide benefits for that employee upon retirement, the investment experience affects quite significantly the amount of the benefits that will be received. Defined contribution plans may or may not provide for employee contributions. In one type of defined contribution plan, the "thrift" or "savings" plan, the amount of the employer's contribution is determined by the amount of the employee's contribution, and each employee may elect whether to participate in the plan at all.
A plan may provide that part of the contributions will be used to purchase life insurance payable to designated beneficiaries if the employee should die prior to retirement and for the use of the cash surrender value under these life insurance policies to supplement the amounts in the employee's account to provide retirement benefits.

As is the case under defined benefit plans, the benefits may be in the form of a lump sum or installment payments over a designated period, or the plan may provide for the purchase of an annuity payable over the lifetime of the employee. Variations in the form of annuities are also often available. The annuity may be purchased at the date of retirement, or through installment payments to an insurance company while the employee is still actively employed. The plan may include provision for early retirement or for withdrawal of all or part of the account prior to retirement but, unlike the case with defined benefit plans, there is no need to provide how the amount of the benefit will vary depending upon what form of benefit is chosen by the employee or the date on which benefits are taken or commenced. The employee will receive benefits equivalent in value to what is credited to his or her account.

C. Other Types of Plans

There are some plans that do not fall comfortably into one or the other of these two categories. A target benefit plan is a special type of defined contribution plan. Such a plan employs a formula which establishes a "target benefit" that the employer desires to provide. That might be, for example, 1% of the employee's final year's salary multiplied by the number of years of employment. A computation is then made of the amount of annual contribution needed to provide the target benefit, and these contributions are then made by the employer and employees. Unlike the case under defined benefit plans, how-
ever, these contributions are then allocated to individual accounts for each employee, and the plan is then administered as a defined contribution plan. That is, the amount of the target benefit is not guaranteed by the employer or by the plan, and the employee receives whatever benefit can be provided with the amount in this account. This may be more or less than the target benefit, depending upon whether the rate of actual investment income has been equal to the rate assumed in the determination of the contributions that were made, and upon other factors. Some plans take the sex of the employee into account when determining what annual contributions shall be made, and some do not.

In some industries collective-bargained multi-employer plans have been established that accumulate the contributions of several employers and provide retirement credits to persons who may work for one or more of them over their working lives. These plans also do not fit easily into one or the other of the two major categories, and there is currently pending an active dispute over whether they should be treated for certain purposes as defined benefit or defined contribution plans.

Since 1962, self-employed persons have been able to establish tax favored plans for themselves and their employees, and, for the most part, these plans have been defined contribution plans, although it is quite feasible for a partnership with many partners to adopt a defined benefit plan, and several large law and accounting firms have done so.

A special type of plan known as a tax deferred annuity plan may be established by a public educational institution or by a charitable organization for its employees, and these plans are provided favorable tax treatment similar to that available to qualified plans. The contributions are nominally and sometimes actually made by the employers, but in most cases they are derived from
reductions in salary voluntarily agreed to by the employees. These plans are invariably defined contribution plans.

Finally, since 1974 individuals who are not self-employed but are not covered under employer established retirement plans may establish individual retirement plans of their own, and these are also and necessarily defined contribution plans.

D. The Funding and Administration of Retirement Plans

Another important method of categorizing retirement plans, and one which is highly relevant to the issues in this case, relates to how and by whom the plans are administered. All retirement plans may be divided into insured plans or non-insured trusteed plans, although many plans use a combination of these two approaches. Both defined benefit plans and defined contribution plans may be either trusteed or insured. Under a trusteed plan, the employer makes annual contributions to a trustee, which in the overwhelming number of cases is a bank or trust company although this is not required by law. Those amounts are held and invested by the trustee and used to pay the employee benefits provided by the plan.

Under an insured plan, the employer enters into a contract with an insurance company (ordinarily a group annuity contract and sometimes individual insurance or annuity contracts for each employee). The employer pays contributions (also called premiums) to the insurance company which holds and invests the funds and agrees to disburse them for the purpose of paying the promised benefits to the employees in the manner provided by the plan and the contract. In many cases the insurance company will assume a contractual liability directly to the employees, sometimes upon the retirement of each employee and sometimes at an earlier date, to
assume the employer’s obligations to pay the plan benefits. If this is done, the relationships that are created are quite different from those under a trusteed plan, where the trustee agrees only to use the funds held in the trust to pay the benefits and does not assume an independent obligation—as an insurance company does under many insured plans—to continue to pay benefits whether the amounts contributed by the employer turn out to be more or less than required for that purpose.

An employer that has adopted a trusteed plan may decide to direct the trustee to provide some or all of the promised pensions by purchasing annuities from an insurance company as the employees retire. In that case, the plan will in fact be _pro tanto_ an insured plan, but it will usually continue to be spoken of as a trusteed plan.
I. The Observed Data

Women have lived longer than men both in the United States and throughout the world. U.S. Census Bureau, Social Security Administration, and United Nations references support this observation. Swedish records recount the observation as early as 1780. Longevity experience among insureds has been recorded by the Society of Actuaries or its predecessors since 1892. The tables of the Society have consistently shown higher female longevity, for both women working inside and outside the home. Thirty year-old women are observed to live 6.2 years, on the average, longer than their male counterparts.


2 Bayo, Mortality of the Aged, 24 TRANSACTIONS, SOCIETY OF ACTUARIES, Pt. 1 at 1-24 (1972).

3 UNITED NATIONS, DEMOGRAPHIC YEARBOOK 700-26 (23d ed. 1971).


5 M'Clintock, Special Tables for the Estimation of Mortality Among Annuities, 6 TRANSACTIONS OF THE ACTUARIAL SOCIETY OF AMERICA, 13, 22-23 (1900). With regard to both women working inside and outside the home, greater longevity is shown by life expectancies calculated from data in Peterson, Group Annuity Mortality, 4 TRANSACTIONS, SOCIETY OF ACTUARIES 246, 262-67 (1952). This was confirmed by calculations of life expectancies from data in Greenlee & Keh, The 1971 Group Annuity Mortality Table, 23 TRANSACTIONS, SOCIETY OF ACTUARIES, Pt. 1 at 569, 583-96 (1972) (hereinafter cited as 1971 Group Annuity Table). Analysis of current data as to populations that include both women working inside and outside the home also show greater female longevity. Report of the Committee on Group Annuities, Group Annuity Mortality in Transactions, Society of Actuaries, 1975 REPORTS 287, 289-316 (1976).
counterparts, 50 year-old women live 5.7 years longer, and 65 year-old women live 4.1 years longer. This observed data, as recorded by actuaries, is used as the best available predictor for the longevity of groups of persons insured under pension plans of employers.

II. The Reasons for Greater Female Longevity

Two principal factors have been suggested as explanations for greater female longevity: the biological factor and social and economic factors. We include a brief summary of part of that discussion, not because we believe it relevant to the issues in this case—a matter about which there is a difference of opinion—but because it may be of interest to the Court.

Amram Scheinfeld’s book, *Your Heredity and Environment* (1965), discusses the question of biological factors. At pages 217-21 he asserts that bodily makeup and chemical functioning differ between women and men, and that these differences give women advantages in resisting or overcoming most diseases. He also observes that when male and female infants suffer the same accidents, the chances for death are greater for the males. As a reason for the longevity difference, he suggests that females originate with two X chromosomes and males originate with only one. If a female inherits an X chromosome that includes a recessive gene, a normal gene in the other X chromosome can compensate; males

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Calculated from *1971 Group Annuity Table*, supra, note 5 at 585-96. The insurance tables for persons insured under individual annuity contracts also show similar results: life expectancies for females are 5 years more at 30, 4.4 more at 50, and 2.9 more at 65. Calculated from data in Cherry, *The 1971 Individual Annuity Mortality Table*, 23 TRANSACTIONS, SOCIETY OF ACTUARIES, Pt. 1 at 475, 496-99 (1972). The group and individual mortalities differ because of the different populations that are covered by the two types of annuities. However, both exhibit a longer female longevity. Under individual annuities longer female longevity was also exhibited in life expectancies calculated from earlier data in Jenkins & Lew, *A New Mortality Basis for Annuities*, 1 TRANSACTIONS, SOCIETY OF
have no such compensating possibility. He cites as some evidence for his view the observation that in poultry, where the chromosome pattern is reversed, embryonic deaths are much higher among females. He writes that, since such factors as childbearing have become less hazardous, and as the habits and ways of living of both sexes have become more similar, "under like conditions, females are better adapted to cope with most human afflictions because they are genetically better constructed and have a more efficient chemical system." (Emphasis in original.)

Additional literature bearing on female longevity relates to prostaglandins, which effect the output and contractibility of the heart and tension in blood vessels. Women produce significantly less of this substance than men, and the substance is said by some to affect, in the greatest degree, the bodily functions associated with the causes of death that account for most of the variation in mortality by sex.  

One feature of the observed data warrants separate mention: it appears that, even during the present period when more women are entering work outside the home, the longevity advantage of women over men is increasing. One study indicates that since 1920 the overall ratio of male to female mortality has increased by over 60%. The reasons for this apparent trend are not clear.

Actuaries 369, 386-89 (1949); Current data under individual annuity contracts also confirm this. Mortality Differentials by Sex, in Transactions, Society of Actuaries, 1973 Reports 225, 228 (1974).


8 Metropolitan Life Insurance Co., Sex Differentials in Mortality Widening, 52 Statistical Bulletin 2, 3 (Dec. 1971). See also Mortality Differentials by Sex, in Transactions, Society of Actuaries, 1973 Reports 225 (1974); Metropolitan Life Insurance Co., Sex Dif-
A possible explanation is that recently expressed by Barbara J. Lautzenheiser, Vice President and Actuary, Bankers Life Insurance Company of Nebraska:

"... as socio-economic conditions of the sexes are equalized, the biological differences are more apparent and the differences between mortality become greater."

A factor lending some weight to this view is that perinatal mortality rates (stillbirths occurring beyond the 20th week after conception and deaths in the first week of infancy) are over 20% higher for males. Such differences cannot be explained by other than biological differences, and current data indicates that the differences may continue to widen.

On the other side, it has been pointed out that past working experience of women has contained few high tension jobs, and with women entering more of these jobs it is contended that in due course the observed differences in longevity will either be reduced or be explained as attributable to other causes.

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*See, e.g., "Fewer Heart Disease Deaths," Wall St. J., July 26, 1977, at 1, col. 3 (decline in heart disease projected by the Census Bureau to prolong women's lives by 4 years and men's lives by 3 years by next century).

The American Academy of Actuaries would like, at this time, to extend our June 24, 1977 commentary on Part 1 of the FASB Conceptual Framework study to include our reactions to Parts 2 and 3. On June 24 we said "if the attributes of financial statement elements which are to be measured involve future expectations or interest discounts of future amounts, the actuarial profession can make a very substantial contribution to the final rules and guidelines." Our comments on uncertainty, on the time value of money, and on consistency between assets and liabilities should be read in the context of this statement.

A. Uncertainty

The Discussion Memorandum, in common with accounting principles in general, appears to have difficulties in measuring an item which may not be paid on a well defined date, or may not be paid at all. In FASB Statement 15, for example, there is a tendency to avoid recognizing an amount that cannot be measured with reasonable certainty. It is suggested elsewhere that disclosures under Statement 15 may be expressed as a range of values. In each case, the criterion of objectivity is given priority over the relevance of the financial information. The problem of disclosing the effects of uncertainty is one to which actuarial professional judgment has been directed over many decades.

We recommend application of the following general principles to the quantification of the effects of uncertainty.

1. If an estimate is derived from historical data, the financial statement should highlight any reason for believing that future results will deviate materially from past experience.

2. A single value should be presented, not a range or a median. This single value should be a mean, weighted by probabilities.

The use of a range tends to imply that the expected value is at or near the mid-point of the range. This frequently is not the case. There is also a tendency to assume that by adding a series of items, each of which has its own range, one gets a sum whose range is the sum of the individual ranges. This is not necessarily true.

If homogeneous uncertain items can be properly combined under appropriate circumstances, the degree of uncertainty will be reduced because the resultant item will more closely approximate the law of large numbers. Such combination will reduce the expected variability by approaching more closely the expected result. A similar combination of median values would have no such effect.
3. A standard statistical method of reporting variability such as variance or standard deviation should be used when such information is relevant and material.

4. Release from Risk, the actuarial technique of adding a margin for fluctuation to an expected benefit cost and then gradually releasing that margin as actual experience emerges, should be considered as a tool to "cope with measurement problems stemming from uncertainty" (paragraph 353).

B. Time Value of Money

Financial information which fails to consider the time value of money loses both relevance and comparability. To assign the same value to an amount which will be paid or received in the future as to a comparable item which will be paid currently misstates the substance of the item accounted for. If a life insurance company or a pension entity fails to recognize the time value of money, any financial information promulgated by that entity becomes meaningless. While the distortion may not be as great for other entities whose method of operation does not include the same degree of reliance on the future flow of funds, a substantial amount of distortion can, nevertheless, arise. The Discussion Memorandum, while it recognizes this principle (e.g. paragraphs 523, 538-39, and 555) tends to tolerate failure to recognize the time value of money when the interval between the statement date and the payment date is short and when the method of quantifying such time value is not readily apparent.

When the time interval is short, interest may be ignored if the preparer of the financial statement is prepared to demonstrate the immateriality of the interest to the user of that statement.

We are more concerned about the tendency not to recognize the time value of money when the method of recognition is not readily apparent (e.g. paragraphs 486, 504, 519 and 575). Nonrecognition appears to result from problems of technique and not of principle. We favor explicit over implicit recognition of interest in every situation where it is material to the financial statement. Actuarial techniques are employed in a variety of situations in which neither the amount nor the time of an expected future payment is known. These techniques appear to us to have application beyond the financial statements of insurance companies and pension funds. FASB, by adopting a strong stance on the time value of money, will stimulate thought and discussion of more effective techniques for calculating present values. The American Academy of Actuaries would be pleased to participate in such a program.

The problem of selecting an appropriate interest rate and the relatively lower objectivity of that rate have been used as arguments against the recognition of the time value of money. To fail to recognize such time value, however, is to assume an interest rate of zero percent, an inapplicable assumption. Considerably more relevant, reliable, and unbiased assumptions can be made with little loss of consistency or objectivity.
C. Consistency Between Assets and Liabilities

Assets and liabilities frequently result from the same set of transactions. An insurance company accumulates assets in order to meet its contractual obligations as they mature. An industrial concern borrows money in order to acquire productive assets. Failure to maintain consistency in the definition of assets and liabilities, or in the definition of revenue and expenses which give rise to assets and liabilities, distorts the significance and reduces the relevance and comparability of financial statements that have been prepared without maintaining such consistency.

The arguments in paragraphs 526-33, which suggest that different approaches can be taken to the measurement of assets and liabilities, are, in our opinion, inappropriate. We do not say that the measurement of assets and liabilities must be identical; we do say that it must be consistent.

The necessity of consistent measurement is particularly apparent for financial entities. For example, the fundamental activity of an insurance company is the acquisition of liabilities, i.e., obligations to pay contractual benefits at some time in the future. In order to do so, the company must accumulate and retain the necessary assets. A meaningful analysis of the financial condition of such a company must include a balance sheet calculated by consistent valuation of both the liabilities and the underlying assets. Policy reserves, for example, should be determined on a basis that recognizes the expected yield on assets currently held as well as the need to invest and reinvest subsequent insurance and investment cash flow. If the specification of the attributes to be measured for each class of assets and liabilities is based on an independent consideration of the characteristics of that class, this essential financial comparison may well be invalidated.

D. Other Concerns

We also stated on June 24 that "it is in the interest of investors that accounting principles applicable to other investor-owned companies be sufficiently broad to be adaptable to the special nature of stock insurance companies" and that "the conceptual framework explicitly recognizes that standards developed to meet the needs of investor and creditors cannot be assumed to apply to entities which are not investor owned". Consequently, we are pleased with the statement (paragraph 363) that "to force all enterprises in all situations into the same mold would often result not in comparability but in noncomparability because some differences in enterprises and circumstances are significant". We hope that any binding statement of accounting philosophy or procedure will recognize the unique financial characteristics of the entities with which actuaries are involved.

In the discussion of the concept of "Expected Exit Values in Due Course of Business", we recognize two familiar concepts. We recognize "Current Value" to be the present value of a sum due or payable in the future when that sum is discounted to reflect
the time value of money and the contingency of payment or collection. We recognize "Current Exit Value" as being a market value resulting from a current date orderly liquidation transaction between a willing buyer and a willing seller. We find, however, that "Expected Exit Value" is an inappropriate concept. As defined in the Discussion Memorandum it appears to be the Current Value absent discount for interest and contingency. For reasons previously stated, we do not think that this concept meets the required standards of financial information reporting.

We are also concerned about the statement (paragraph 443) that "the present values of receivables...be measured using current interest rates applicable to similar receivables". It is inconsistent to prescribe the application of current interest rates to some, and not to all, balance sheet items.

The paragraph 448 proposal, taken by itself, could be misconstrued as requiring that all future policy premiums be discounted at a current interest rate, rather than at the rate at which the contractual benefits have been valued from the effective date(s) of the contract or groups of contracts.

We feel strongly that the actuarial profession must be involved in any formulation of the principles of current value accounting including, but not limited to, the rules governing the selection of interest rates. In that way, we can help to assure that financial statements of entities with which actuaries deal will be meaningful to their users.
December 16, 1977

Mr. George A. Fitzsimmons
Secretary
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Re: File No. S7-721

Dear Mr. Fitzsimmons:

The American Academy of Actuaries is pleased to submit this statement in response to the Commission's invitation for comment in connection with proposed rules regarding disclosure of relationships with independent public accountants.

The American Academy of Actuaries was formed in 1965 as an umbrella organization for the four existing national actuarial organizations -- the Society of Actuaries, Casualty Actuarial Society, Conference of Actuaries in Public Practice and Fraternal Actuarial Association (the "constituent organizations"). These actuarial organizations, or their predecessors, date back many years, one of them to the late 1800's, so that despite the relatively short duration of its formal existence,
the Academy and its predecessor and constituent organizations have represented the actuarial profession in the United States for over 80 years.

There are over 7,000 members of the Academy and its constituent organizations, most of whom are employed by insurance companies, independent consulting actuarial organizations, government departments and agencies, or in institutions of higher learning in academic roles. A significant number of members are employed by accounting firms and smaller numbers by management consulting firms or industrial corporations. One major function of the Academy is establishing and enforcing Guides to Professional Conduct that must be observed by its members.

This comment is addressed primarily to the Commission's invitation to supply information relating to ancillary services rendered by auditors to their clients and to the effect of rendering such services, in specific areas, on the maintenance of the necessary independence. We have no helpful information or opinion to offer with respect to the desirability of the proposed amendments to Schedule 14A, but we are deeply concerned whether these amendments, if adopted, will actually carry out the Commission's expressed objective to "strengthen the independence of auditors." Our concern is that the increased disclosure that is being proposed may unjustifiably be regarded an adequate substitute for the strict prohibition of relationships that do impair the existence or appearance of independence.

This concern is important enough to warrant restate-
ment at greater length and emphasis. The Commission and the Office of the Chief Accountant have rendered a signal service to the community by responding to requests for interpretation of the generalized language of Rule 2-01 of Regulation S-X and by providing clarification as to how the requirement of independence applies in particular fact situations. The periodic publication of the more important of these interpretations has served not only to give meaning to the independence requirement but also to assist the accounting profession to maintain its proud reputation of objectivity and high professional standards. While the Academy strongly supports the concept of self-regulation, the Commission has filled a salutary role in preventing the natural self-interest of the accountants from having too much influence when borderline questions are presented. We hope that the Commission does not intend to reduce its role in this respect in any way. In short we believe it would be most helpful if, in the release adopting the proposed amendment, the Commission would make it clear that the standards of what constitutes independence are not being relaxed in any way. The release should state explicitly that disclosure is being required only of relationships that may not categorically impair the independence of the auditor, because such information is of interest to and may be the basis for action by shareholders and other affected persons.

The Academy's present concern is with a course of conduct by some accounting firms -- which may well be more widely
adopted in the future -- that plainly does raise the most serious questions about independence. The remainder of this comment deals with this issue.

I. AUDIT BY ACCOUNTANTS OF ACTUARIAL DETERMINATIONS

While auditors may find it necessary in a number of different circumstances to verify the accuracy of items included in financial reports that depend upon actuarial determinations, or the accuracy of book entries that support such financial statement items, the need to do so arises most often in two situations. First, auditors may be called upon to report upon the financial statements of an insurance company. Second, auditors are often required to report upon the financial statements of a company that has adopted an employee retirement plan. The soundness of such a plan and the contributions which may or must be made depend significantly upon computations and determinations that can be made only by an actuary. The auditors may also be asked to report on the financial statements of the plan itself.

The services performed by actuaries involve professional judgments that can be made reliably only by persons with the necessary competence, integrity and objectivity, just as is true of the work done by accountants. And, in the same fashion that many members of the accounting profession render their professional services to their employers directly rather than through independent accounting firms, many actuaries are also
engaged as employees of the company for which their professional services are rendered. Many significant actuarial determinations, particularly in the insurance industry, are satisfactorily and appropriately made by actuaries who are not employed independently of the companies for whom the services are rendered. By contrast, and due to the historical pattern of the manner in which the pension industry has developed, the overwhelming percentage of actuarial determinations in the pension area is made by actuaries who are unaffiliated with the organization for whom such determinations are made.

The need for independence in both the actuarial and accounting professions arises generally in the audit function, and less frequently in the area of the original determinations. Thus it is entirely appropriate for actuaries to provide most of their professional services in making original determinations without consideration of the independence criterion.

In recent years some accounting firms have employed actuaries or have become affiliated with firms of actuarial consultants, and this has given rise to two questions: (a) May an accounting firm undertake an independent audit of a company to which it regularly furnishes actuarial services in the form of original determinations? (b) Even if it may undertake such an audit, is the requirement of independence observed where the auditing accounting firm itself reviews and verifies the accuracy of the determinations made by an actuary employed by or affiliated with the same audit firm? This latter practice has
come to be known as "self-review."

A. Should Accountants Furnish Any Actuarial Services to Their Audit Clients?

Some three years ago the Academy and its constituent organizations established a Joint Committee on Independence of the Actuary (Independence Committee), the function of which, among other things, was to explore and identify the circumstances under which independence on the part of actuaries might be desirable or required and to determine whether and how independence might be defined in these contexts. The Independence Committee published two exposure drafts, received extensive comment thereon from the profession, and has recently submitted a formal report to the boards of directors of the participating actuarial organizations. Those organizations are currently engaged in considering and implementing certain of the recommendations made by the Independence Committee.

In the course of its study, the Independence Committee considered the situation of actuaries affiliated with accounting firms. This consideration led to the conclusion that methods of operation of accounting firms providing actuarial services could lead to actuaries of such firms being directly or indirectly involved in self-review. Although the Independence Committee did not and could not deal with the issue of when the independence of accountants would be compromised, it concluded that actuaries ought not to participate in a procedure that includes self-review as one of its elements.
The Independence Committee did not conclude that an actuary cannot, under any circumstances, render actuarial services to an audit client of an accounting firm with which he is affiliated. Similarly, the Academy is not prepared to say that an accounting firm cannot under any circumstances be independent of any company for which it has rendered or is actually rendering actuarial services, so as to bar it from auditing the statements of such company. For example, an accounting firm might be asked by an audit client to use its actuarial capability to help the client revise its pension plan and to obtain a ruling from the Internal Revenue Service that the plan is qualified. This work might be in process at the time an audit is undertaken. The Academy is not fully apprised of the principles that the Commission has followed in similar situations, and accordingly we prefer not to offer an opinion as to whether there should be a complete prohibition against acting both as an actuary and as an auditor. 1/

1/ The principles are set forth in Accounting Series Release No. 126:

"Certain concurrent occupations of certified public accountants engaged in the practice of public accounting involve relationships with clients which may jeopardize the certified public accountant's objectivity and, therefore, his independence. In general, this situation arises because the relationships and activities customarily associated with this occupation are not compatible with the auditor's appearance of complete objectivity or because the primary objectives of such occupations are fundamentally different from those of a public accountant. Acting as counsel or as a broker-dealer, or actively engaging in direct competition in a commercial enterprise are examples of occupations so classified...."

It is not immediately evident whether application of these prin-
We note, of course, the Commission's conclusion that an attorney-accountant may not perform an independent audit for a person or organization for whom it is concurrently rendering legal services. We can conceive of many situations in which the nature of the legal services would not call for review in the course of a conventional audit. A lawyer who is also an accountant might be asked, for example, to advise a company whether computer software programs could be copyrighted or to review its marketing programs so as to ensure compliance with the Robinson-Patman Act, situations clearly not associated with the audit process. Although such situations do not involve self review, the Commission has apparently decided that the existence of any attorney-client relationship is inconsistent with an independent accountant-client relationship, so that a lawyer performing such functions cannot make an independent audit. Whether a similar disability should be imposed upon an accountant that has furnished actuarial services we leave to the Commission to decide. We would be glad to provide any factual information about the nature of the work or the relationship that the Commission might find helpful.

The Academy does, on the other hand, have a strong opinion that an accountant cannot review the work of an actuary affiliated with the same firm and still maintain that it is independent. This opinion is apparently shared by at least part

1/ [continued]
of the accounting profession.

B. Should Accountants Review Actuarial Determinations Made By Themselves or Affiliates?

1. The AICPA Ethics Committee Interpretation. The AICPA's independence requirement, set forth as Rule 101 of its Rules of Conduct, is similar to, although more elaborately

2/ Mr. William R. Mette, Jr., Executive Partner of Alexander Grant & Co., speaking on behalf of his firm, has said:

"We have not provided actuarial services to clients and will not do so in the future because in our judgment such services result in decisionmaking which places the auditor in the troublesome position of appearing to audit his own work."


Mr. Harvey Kapnick, Chairman of Arthur Andersen & Co., speaking for his firm, has said that, in order to assure that independent auditors are operating in a way "that meets their public-interest responsibilities," the following services should be eliminated by accounting firms:

"[E]xecutive recruitment; plant layout; product analysis; actuarial services; and marketing studies that involve interviewing the general buying public, analyzing psychological behavior, or making sales forecasts. It is the policy of Arthur Andersen & Co. not to practice in these areas. If there are similar peripheral areas that should be eliminated because they are determined not to be in the public interest, we will voluntarily eliminate them."

stated that Rule 2-01 (b) of Regulation S-X. In May 1975 the Executive Committee of the Ethics Division of the AICPA published the following interpretation under Rule 101, now set forth at ET Section 191:

"54. Member Providing Actuarial Services

.107 Question—If a member’s firm renders actuarial services to a client, may the member also express an opinion on the client’s financial statements?

.108 Answer—Even though the member’s firm provides actuarial services (the results of which are incorporated in the client’s financial statements), if all of the significant matters of judgment involved are determined or approved by the client and the client is in a position to have an informed judgment on the results, the member’s independence would not be impaired by such activities."

This interpretation appears to be a republication of an early interpretation, included in the 1970 edition of the AICPA’s Summaries of Ethics Rulings. At that time, the significance of actuarial determinations was not as fully perceived or as well understood as it is today. We do not have available the exchange of letters or other background material that underlie this published ruling. It may be that the Ethics Committee carried out an elaborate investigation into the nature of the actuarial services that were provided in that case and into the extent to which the client was "in a position to have an informed judgment on the results." In any event, without an opportunity to examine the files, we can only say that this ruling appears to us to treat a difficult and complex issue in a simplistic and offhand way and, of far greater importance, to reach the wrong answer.
By this interpretation, Actuary A, working for an accounting firm, might carry out a determination of the reserve liabilities of the ABC Insurance Company or an actuarial valuation of the pension plan of Company XYZ. Once the results have been approved by the company, using its "informed judgment," the accountant auditor can bring in the very same actuary to review "independently" the accuracy of his own work and report back to the accountant that everything is satisfactory. We do not understand how any reasonable person or group could maintain that this procedure is an acceptable one. No matter how well informed the client might be, the accuracy of the work will simply not have the benefit of independent scrutiny. Nor would we view the matter any differently if the review were performed by Actuary B, a colleague or business associate of Actuary A. The conflict of interest is apparent, and it is no answer to say that upright persons are often capable of performing satisfactorily where they have some incentive to do otherwise. All our experience tells us that the better way is to prevent the conflict from arising in the first place.

The condition that the actuarial judgments must be approved by a client who has an "informed judgment" has its apparent genesis in the "Accounting Services" opinion published by the AICPA as Rule 101-3. There it is explained that while an auditor may provide bookkeeping services for a client:
"The client must accept the responsibility for the financial statements as his own. A small client may not have anyone in his employ to maintain accounting records and may rely on the CPA for this purpose. Nevertheless, the client must be sufficiently knowledgeable of the enterprise's activities and financial condition and the applicable accounting principles so that he can reasonably accept such responsibility, including, specifically, fairness of valuation and presentation and adequacy of disclosure. When necessary, the CPA must discuss accounting matters with the client to be sure that the client has the required degree of understanding."

This proposition, that the bookkeeping work of the accountant can be adopted by a client and thereby changed into the client's "own" work product that can then be audited by the "independent" person who did the work in the first place, has been rejected by the Commission. Accounting Series Release 126 states, under the heading "EDP and Bookkeeping Services":

"The Commission is of the opinion that an accountant cannot objectively audit books and records which he has maintained for a client. The performance of these services, whether accomplished manually or by means of computers and other mechanized instruments, ultimately places the accountant in the position of evaluating and attesting to his own recordkeeping."

The AICPA acknowledges this bookkeeping rule at ET §101.04 where it states that when "a client's securities become subject to regulation by the Securities and Exchange Commission or other federal or state regulatory body, responsibility for maintenance of the accounting records . . . must be assumed by accounting personnel employed by the client." 3/

3/ The provision continues, "the assumption of this responsibility must commence with the first fiscal year after which the client's securities qualify for such regulation."
2. The AICPA Interpretation is Unsound. The conclusion of the executive committee of the AICPA's professional ethics committee that as a practical matter it is possible for a knowledgeable client to accept responsibility for financial records and statements proposed by an accountant so as to permit the accountant to make an independent audit has even less justification as applied to actuarial services than it does as applied to bookkeeping and accounting services. Many individual employers or corporate officers have acquired a reasonably satisfactory knowledge and understanding of accounting practices and principles, particularly of those that might be applicable to a small and simple business. Quite the reverse is true, however, about the actuarial determinations that are customarily made in connection with the establishment and administration of a pension plan. And, in the case of the financial statements of an insurance company, the significance and materiality of the actuarial determinations make it wildly imprudent to countenance self-review in this context.

(a) Insurance company financial statements. Since the determination of the reserve liabilities of an insurance company -- ordinarily the most significant items on that side of the balance sheet and in determining income from operations -- involves technical actuarial expertise, it is hard to see how it can be sensibly asserted that an auditor can satisfactorily perform its functions if the original actuarial determinations under review were made by an actuary employed by or affiliated
with the same audit firm. What is involved here is not merely one aspect of a financial report devoted primarily to non-actuarial determinations. The very solvency of the company turns on the accuracy of those determinations. Even, therefore, if the executives of a small insurance company that does not have an actuary on its staff may have a better understanding of the principles of reserve determination than most businessmen, the determinations involved are simply too important to leave the extent and sufficiency of their knowledge to be decided — perhaps incorrectly — on a case to case basis. And in fact, the training and experience of many insurance executives is in marketing or law and the extent of their actuarial knowledge may be much less than adequate. Self-review in these circumstances is thoroughly incompatible with independence.

(b). Actuarial services relating to retirement plans.

Actuaries must analyze a broad range of factors in order to establish the assumptions to use in making the actuarial determinations required for an employee retirement plan and the level of contributions required thereunder. These assumptions can vary depending upon the anticipated future experience under the plan, and they dramatically affect the assessment of the plan's condition and needs. The selection, testing, and revision of assumptions is typically far more complex than the selection of various accounting treatments for different transaction entries, and the substantive impact of the assumptions on registrant com-
Companies can be far greater than the impact of accounting choices, for the actuary's work usually directly causes major allocations of funds, rather than affecting the treatment of allocations already made or pending. Examples of the assumptions which must typically be studied and determined, depending on the program or plan involved, are mortality, incidence of personal or property injury, employee turnover, return on investment, rates of retirement, rates of compensation increase, rate of inflation, and effect of government programs (such as social security). This work requires significant practical professional experience and knowledge in working with the type of plan involved.

That an audit of a company's financial condition requires review and disclosure of the results of actuarial determinations is not a matter of dispute. Opinion 8 of the Accounting Principles Board, "Accounting for the Cost of Pension Plans" (November 1966) states, for example, at p. 84 that the "Board believes that pension plans are of sufficient importance to an understanding of financial position and results of operations" to require disclosure of the "excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance sheet pension accruals, less any pension prepayments or deferred charges." 4/ In the process of perform-

4/ The following disclosures are also required: a statement that such plans exist, identifying or describing the employee groups covered; a statement of the company's accounting and funding policies; the provision for pension cost of the period; and the nature and effect of significant matters affecting comparability for all periods presented, such as changes in accounting methods ("actuarial cost method, amortization of past and prior service cost, treatment of actuarial gains and losses, etc.") and changes in circumstances ("actuarial assumptions, etc.") or adoption or amendment of a plan.
ing an audit of a company that has a pension plan, an accountant thus is called on to make a close appraisal of the validity of the underlying actuarial work, using standards set forth in AICPA S.A.S. 11 relative to the use of an expert.

It is evident that, except for unusual cases, (e.g., a few very large plan sponsors employ actuaries) employers that have their own businesses to worry about will not have the knowledge or capacity to adopt the actuarial determinations as their own. The 1975 AICPA interpretation on actuarial services rests upon a fiction and imposes an intolerable burden upon the accountant who takes seriously and conscientiously the independence requirement.

The AICPA interpretation leaves open for each accountant to decide for itself the delicate questions involving (1) which of the many judgments that are part of the actuarial determination are "significant"; (2) the extent to which a client is genuinely capable of deciding whether the actuary's judgments as to these significant items are satisfactory and should in effect be adopted by the client as its own judgments; (3) whether a client that has the requisite capability has in fact exercised its own informed judgment concerning the actuarial determination, or whether it has simply accepted the results confident that the determination is acceptable and will be found satisfactory during the auditing process.

One may well ask whether an auditor can bring the necessary objectivity to the task of answering such questions,
where the wrong answer may require his firm to give up profitable business. Our experience has been that, with the rarest exceptions, it is a charade to impute to actuarial clients knowledge sufficient to have an "informed judgment on the results." Yet it is on this shaky basis that the AICPA asserts that the responsibility and accountability for the actuarial work can be shifted from the shoulders of the firm that did the work to the client, so that the firm can then turn around and serve as "independent" auditor.

Our view is reinforced by The Report of Tentative Conclusions of the AICPA's Commission on Auditors' Responsibilities on page 100 that:

"While the Commission is not suggesting that any particular services should be eliminated, avoidance of certain services will improve the reality or the appearance of independence. Firms should not expand their offerings of other services without careful consideration of the tradeoffs involved."

Additionally, the Senate Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs released in November, 1977, a report entitled "Improving the Accountability of Publicly Owned Corporations and their Auditors." The report culminates a substantial set of hearings and analysis and addresses itself to "actions which can be taken by the accounting profession and the SEC to perform their respective functions more effectively." (p. 1).

The Subcommittee, after reviewing the tentative findings and recommendations of the AICPA's Commission on Auditors'
Responsibilities, concludes, at pages 16-17:

"The best policy in this area—and the policy which is presently followed by most accounting firms—is to require that independent auditors of publicly owned corporations perform only services directly related to accounting. Non-accounting management services such as executive recruitment, marketing analysis, plant layout, product analysis, and actuarial services are incompatible with the public responsibilities of independent auditors, and should be discontinued."

3. Interpretation of the Department of Labor. We call to the attention of the Commission an interpretation by the Department of Labor, adopted pursuant to the Employee Retirement Income Security Act of 1974 ("ERISA"), which on the surface may appear to be inconsistent with the position taken here and, we believe, with the principles consistently applied in the past by the Commission. In Interpretive Bulletin ERISA IB RD 75-1 published November 20, 1975 (CCH Pension Plan Guide ¶14,370) (now IB RD 75-9) the Labor Department provides examples of situations in which "an accountant will not be considered independent" for purposes of §103(a)(3)(A) of ERISA. Independence will be lacking if (1) the accountant or his or her firm or a member thereof had a direct financial interest or a material indirect financial interest in the pension plan or the plan's sponsor, or if (2) the accountant, his or her firm, or a member thereof was connected as a promoter, underwriter, investment adviser, voting trustee, director, officer, or employee of the plan or the plan sponsor, or if (3) the accountant or a member of the firm maintains financial records for the plan. The
first two restrictions are limited in time to the period of the engagement and the date of the opinion.5/

The Interpretive Bulletin continues:

"However, an independent qualified public accountant may permissibly [sic] engage in or have members of his or her firm engage in certain activities which will not have the effect of removing recognition of his or her independence. For example . . . the rendering of services by an actuary associated with an accountant or accounting firm shall not impair the accountant's or accounting firm's independence."

It is not apparent whether the Labor Department intended only to say that some actuarial services could be rendered by an accountant to an audit client without impairing its independence or whether it sets forth the remarkable conclusion that under no circumstances will the provision of actuarial services affect an accountant's independence. We note that this interpretation was not intended to have the force of a substantive regulation, since it was not promulgated under the notice and comment provisions of the Administrative Procedure Act (5 U.S.C. §553). Accordingly, the Department never had the benefit of any public comment.

Perhaps more significantly, this interpretation was issued in the context of a statutory scheme that carefully

5/ Originally the rule included the period covered by the financial statements, but there has appeared a bulletin stating that the Labor Department intends to issue a modification to the effect that the accountant can have had an interest during the period covered by the financial statements, but not during the period of the accounting engagement or on the date of the opinion. CCH Pension Plan Guide ¶23,625.
allocates responsibility for reporting between accountants and actuaries. Section 103(a)(3)(A) requires the financial statements included as part of an employee benefit plan's annual report to be the subject of an opinion by an independent and qualified public accountant. Section 103(d) requires the annual report to include in addition an actuarial statement, the preparation of which, pursuant to §103(a)(4)(A), must be the responsibility of an enrolled actuary. The accountant is expressly authorized, by §103(a)(3)(B) to "rely on the correctness of any actuarial matter certified to by an enrolled actuary, if he so states his reliance." Correspondingly, the actuary is allowed, by §103(a)(4)(D) to "rely on the correctness of any accounting matter . . . as to which any qualified public accountant has expressed an opinion . . . ." Thus it was contemplated that no review by the accountant of the matters certified to by the enrolled actuary would be necessary, but rather that the actuary and the accountant, if necessary in performing their statutory functions, would each follow the course of relying upon the opinion of the other, with appropriate disclosure of such reliance.

We would like to point out that the present AICPA audit guidelines applicable to the use of experts in rendering opinions on financial statements (S.A.S. 11) seem to preclude the use of the reliance procedure provided for in the statute since, as we interpret S.A.S. 11, it would result in a "qualified opinion". Accordingly, if the financial statement included any
actuarial values, (e.g., as proposed by the FASB in its 1977 exposure draft on defined benefit plans), the auditor would seem to be required by AICPA guidelines to review the values in order to provide an unqualified opinion. This would then create, in the case of the auditor employed by a firm which has affiliated actuaries, a situation where the auditor would be engaged in self-review. We doubt whether the Labor Department employees responsible for the publication of the interpretation gave consideration to the potential self-review that might result from inconsistencies between the "reliance provisions" of ERISA and the audit guidelines of the AICPA.

In any event, given all the circumstances, we believe that little weight can be given to this interpretation until it is ascertained just what it means and until it appears that the Department has given consideration to the matters set forth in this comment.

C. An Alternative Solution.

We believe the correct course for the Commission to take would be to reject explicitly, as it did the AICPA's bookkeeping interpretation, the interpretation set forth at item 54 of AICPA ET Section 191. We are not taking the position that accountants should be barred from rendering actuarial services to their audit clients. We do assert that if they do render such services they ought not, at the very least, to be permitted to audit financial statements that incorporate the results of those
services. This would be the most straightforward and easily administered rule to adopt.

A possible alternative might be to follow the lead set forth in Section 103 of ERISA and permit an accountant to conduct an audit of the financial condition of a client to which actuarial services have been rendered with the proviso that an unaffiliated actuary be retained to make the necessary review and perform whatever tests may be required and to require, as part of the accountant's opinion, identification of the actuary and the extent to which the opinion relies upon the findings of the actuary. This would require a slight departure from the anonymity requirements of paragraph 11 of AICPA S.A.S. No. 11, which could be modified as necessary. Whether this would be a feasible arrangement, as a practical matter, would have to be determined by experience, but we see no major obstacle to such a procedure. In any such consideration, it should be kept in mind that this is apparently a unique situation; to our knowledge the language in §103(a)(3)(B) of ERISA is the only instance where a federal statute has specifically permitted an auditor to express reliance on another expert without rendering a qualified opinion.
II. SUMMARY RESPONSE TO THE COMMISSION'S QUESTIONS

We set forth, in this section, the responses to the Commission's specific questions which follow from the foregoing discussion.

Question 1: "A description of each specific kind of service provided by public accounting firms."

Several large accountant auditor firms provide actuarial services to audit clients. The actuarial services involve complex and extensive professional work and materially affect the financial position of both the clients and their retirement plans.

Question 2: "Information indicating the extent of each such service."

The majority of accountant auditors do not provide such dual services. We believe, though, that at least two of the "big-eight" accounting firms offer actuarial services directly and another provides such services indirectly through a joint venture with an actuarial consulting firm.

Question 3: "Information as to the reasons any previously provided service has been discontinued, any new service has been initiated, or any service that has been considered is not provided."

We have not responded to this question.

Questions 4: "Should auditors be prohibited from providing their audit clients any non-audit services? If not, which particular services should be permitted? Should any permitted services
be limited to a percentage of the audit fee? What is an appropriate limitation?"

In no case should an accountant-auditor audit the results of actuarial work of a person affiliated with the auditor.

Question 5: "What attributes should be used to evaluate the effect on independence and the desirability of the service being offered by auditors?"

At the risk of repetition we point out that insufficient attention has been given to the question of whether there will be a review, as part of the audit process, of the other services performed by the auditor. If, for example, a firm providing tax advisory services actively participates in a decision to take a questionable foreign tax credit on the federal income tax return, the auditing function is obviously compromised. Similarly, since actuarial determinations may have a direct impact upon balance sheet and operating statement items, we cannot see how self-review can be permitted. We do note that the increasing significance of actuarial determinations makes it useful for accounting firms to develop actuarial capabilities of their own. But this capability should be used in the audit only of determinations made by unrelated actuaries.

Question 6: "What services are desirable for auditors to continue in order to maintain employees with specialized skills to contribute to improvements in auditing methods and procedures?"
The actuarial profession involves knowledge, experience, and skills that are distinct from those of the accounting profession. Actuaries are readily and competitively available for employment within, or retention by, accounting firms. The rendering of actuarial services to audit clients, however, does not contribute in any way to improvements in auditing procedures. With respect to possible cost savings to clients, we see no economies that an accountant-auditor could realize and pass on to a client through self-review without breaching independence (as, for example, in simply relying on the previous work done by the actuary or having the same actuary perform the review as performed the original determination).

Question 7: "Should auditors be permitted to appear before regulatory bodies as experts on matters which affect their clients?"

We have not responded to this question.

6/ Some indication of the nature of the expertise which an actuary must acquire is provided by the syllabus of the examinations which a life or pension actuary must pass to qualify as a Fellow of the Society of Actuaries and a Member of the Academy. They are attached as Appendix A.
III. CONCLUSION

We do not think that accounting firms can render actuarial services and then make an "independent" audit of financial statements which depend upon those services. We would acknowledge that there is much on the subject of accountants' independence with which we are unfamiliar and which may be relevant to this issue. We do believe that this issue is one that falls squarely within the jurisdiction of the Commission, that it is important, that it involves significant and continuing relationships between the accounting and actuarial professions with respect to matters that are of increasing importance and that prompt action by the Commission is appropriate.

We suggest that it would be desirable to have an open meeting conducted by the Chief Accountant to which representatives of the AICPA and of the Academy would be invited. This should enable the staff to recommend the publication of a Commission interpretation that would resolve this important issue.

Respectfully submitted,

Edwin F. Boynton

Of Counsel:

Lawrence J. Latto
John Parsons Wheeler III

SHEA & GARDNER
734 Fifteenth Street, N.W.
Washington, D.C. 20005

cc: Mr. A. Clarence Sampson
Chief Accountant
Securities and Exchange Commission
File No. S7-721
Submission of the
American Academy of Actuaries

APPENDIX A

Syllabus of Examinations Which a Life or Pension Actuary Must Pass To Qualify as a Fellow of the Society of Actuaries and a Member of the Academy of Actuaries
ASSOCIATESHIP EXAMINATIONS

<table>
<thead>
<tr>
<th>Part</th>
<th>Time Allowed and 1977 Date</th>
<th>Subjects</th>
</tr>
</thead>
<tbody>
<tr>
<td>1...</td>
<td>Three hours</td>
<td>General mathematics</td>
</tr>
<tr>
<td></td>
<td>Thursday, May 12,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>and Thursday,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>November 3</td>
<td></td>
</tr>
<tr>
<td>2...</td>
<td>Three hours</td>
<td>Probability and statistics</td>
</tr>
<tr>
<td></td>
<td>Thursday, May 12,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>and Thursday,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>November 3</td>
<td></td>
</tr>
<tr>
<td>3...</td>
<td>Three hours</td>
<td>a) Numerical analysis</td>
</tr>
<tr>
<td></td>
<td>Friday, May 13,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>and Friday,</td>
<td>b) Theory of interest</td>
</tr>
<tr>
<td></td>
<td>November 4</td>
<td></td>
</tr>
<tr>
<td>4...</td>
<td>Five hours</td>
<td>Life contingencies</td>
</tr>
<tr>
<td></td>
<td>Tuesday, May 10,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>and Wednesday,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>November 9</td>
<td></td>
</tr>
<tr>
<td>5...</td>
<td>Five hours</td>
<td>a) Demography</td>
</tr>
<tr>
<td></td>
<td>Friday, May 6</td>
<td>b) Principles underlying the construction of mortality and other tables</td>
</tr>
<tr>
<td></td>
<td></td>
<td>c) Elements of graduation of mortality tables and other series</td>
</tr>
<tr>
<td></td>
<td></td>
<td>d) The sources and characteristics of the principal mortality and disability tables (including the methods used in their construction and graduation) and of the principal mortality and morbidity investigations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>e) Risk theory</td>
</tr>
</tbody>
</table>
FELLOWSHIP EXAMINATIONS

<table>
<thead>
<tr>
<th>Part</th>
<th>Time Allowed and 1977 Date</th>
<th>Subjects</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.....</td>
<td>Six hours</td>
<td>a) Life, Health, and Pension Coverages (Basic)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b) Life, Health, and Pension Coverages (Advanced)</td>
</tr>
<tr>
<td></td>
<td>Wednesday, November 2</td>
<td>c) Marketing of Insurance Products</td>
</tr>
<tr>
<td></td>
<td></td>
<td>d) Selection of Risks</td>
</tr>
<tr>
<td></td>
<td></td>
<td>e) Life, Health, and Pension Coverages (Advanced)*</td>
</tr>
</tbody>
</table>

| 7.....| Six hours                 | a) Investment of Life Insurance and Pension Funds and Valuation of Assets (Basic) |
|       | Wednesday, May 11         | b) Valuation of Liabilities (Basic) |
|       |                           | c) Investment of Life Insurance and Pension Funds and Valuation of Assets (Advanced) |
|       |                           | d) Valuation of Liabilities (Advanced) |

| 8.....| Six hours                 | a) Gross Premiums, Distribution of Surplus, and Pension Funding (Basic) |
|       | Monday, November 7        | b) Contract Values and Changes (Basic) |
|       |                           | c) Expense Analysis |
|       |                           | d) Gross Premiums, Distribution of Surplus, and Pension Funding (Advanced) |
|       |                           | e) Contract Values and Changes (Advanced)† |

| 9.....| Six hours                 | a) Social Insurance (Basic) |
|       | Monday, May 9             | b) Life and Health Insurance Accounting |
|       |                           | c) Life Insurance Law |
|       |                           | d) Life Insurance Taxation |
|       |                           | e) Social Insurance (Advanced) |

During the transition period (the examinations given from May, 1976, through November, 1978), Parts 6–9 are divided into fractional parts as shown below, to give candidates who already have credit for a fractional part of an examination an opportunity to pass the remaining fractional parts.

| 6A.....| Three hours               | a) Life, Health, and Pension Coverages (Basic) |
|       | Wednesday, November 2     | b) Life, Health, and Pension Coverages (Advanced) |

* On Group portion of Part 6 only.
† On Individual portion of Part 8 only.
<table>
<thead>
<tr>
<th>Part</th>
<th>Time Allowed and 1977 Date</th>
<th>Subjects</th>
</tr>
</thead>
</table>
| 6B   | One and one-half hours    | a) Life, Health, and Pension Coverages (Advanced)  
|      | Wednesday, November 2     | b) Marketing of Insurance Products  
|      |                           | c) Selection of Risks  
|      |                           | d) Life, Health, and Pension Coverages (Advanced)  
| 6C   | One and one-half hours    | e) Investment of Life Insurance and Pension Funds (Basic)  
|      | Wednesday, November 2     | f) Valuation of Liabilities (Basic)  
| 7A   | Four and one-half hours   | g) Investment of Life Insurance and Pension Funds (Advanced)  
|      | Wednesday, May 11         | h) Valuation of Liabilities (Advanced)  
| 7B   | One and one-half hours    | i) Investment of Life Insurance and Pension Funds (Advanced)  
|      | Wednesday, May 11         | j) Valuation of Liabilities (Advanced)  
| 8A   | Three hours               | k) Gross Premiums, Distribution of Surplus and Pension Funding (Basic)  
|      | Monday, November 7        | l) Contract Values and Changes (Basic)  
|      |                           | m) Expense Analysis  
| 8B   | Three hours               | n) Gross Premiums, Distribution of Surplus and Pension Funding (Advanced)  
|      | Monday, November 7        | o) Contract Values and Changes (Advanced)  
| 9A   | One and one-half hours    | p) Social Insurance (Basic)  
|      | Monday, May 9             | q) Life and Health Insurance Accounting  
| 9B   | One and one-half hours    | r) Life Insurance Law  
|      | Monday, May 9             | s) Life Insurance Taxation  
|      |                           | t) Social Insurance (Advanced)  
| 9C   | Three hours               | u) Social Insurance (Advanced)  
|      | Monday, May 9             | v) Social Insurance (Advanced)  

* On Group portion of Part 6C only.  
† On Individual portion of Part 8B only.
The Committee on Property and Liability Insurance Companies Financial Reporting Principles of the American Academy of Actuaries is pleased at the opportunity to comment on the proposed statement of position dated October 31, 1977. It is hoped that the observations contained herein will be helpful to the Insurance Companies Committee in formulating its position on a number of extremely difficult issues.

The Committee recognizes the interest of accountants in these matters, but feels it is also important to emphasize the direct interest in and the responsibility of the actuarial profession for those principles which involve the application of actuarial judgment and actuarial methods. The concerns of actuaries in financial reporting for property and liability insurance companies were ably described by the Academy's General Committee on Financial Reporting Principles in a letter to the AICPA dated March 15, 1976, and are repeated here for emphasis.

1. To determine the probable amounts of future payments expected to result from the assumption of risk, taking into account both monetary inflation and the aggregation of societal forces which are comprehended by the term "social inflation";

2. To determine the probable incidence of payout of such amounts, as well as of any related receipts; and
3. To give effect to the time value of money in valuing such future payments and receipts, and to present the results in a way which does not jeopardize the effectiveness of reserve testing procedures and the development of credible financial data for use in rate-making.

".... Items (1) and (2) require skill and judgment believed to be uniquely covered in the professional education and experience of the actuary. Item (3) is a fundamental actuarial principle, as expressed in the comments of the P/L Committee."

Some additional general observations may also be useful in interpreting the specific comments offered on topics covered in the proposed statement of position.

First, the Committee has attempted to restrict its comments to the topics that affect well-recognized actuarial principles; the Committee takes no position on matters of accounting presentation that do not have actuarial implications.

Second, the Committee has attempted to adhere to actuarial principles in its recommendations, even where this leads to conclusions that may be incompatible with prevailing practices in the insurance industry. This is intended not as an exercise in theory divorced from reality, but rather as an attempt to identify the principles that must be considered in any effort to reconcile such conflicts.
Recommendations on such topics as Premium Deficiencies, Losses, and Loss Adjustment Expenses are consistently based on the principle that all relevant items arising out of any policy transaction should be carried at present value in the statement. This provides for consistent treatment of these topics, but leaves open the problems raised by other situations in which the principle is currently violated or ignored.

Third, the Committee has assumed that all recommendations made under this general principle will be subject to appropriate considerations of materiality and feasibility, and we have not made reference to these considerations in our specific recommendations. We have also assumed that appropriate statistical or aggregate methods may be employed in any valuation process, and especially in any process of estimation or projection. Where reference is made to individual transactions or to specific contractual provisions it is for the sake of identifying their character and the applicable principles, and not to suggest that they require detailed calculation at the level of the individual transaction or policy.

Finally, it should be noted that the purpose of this letter is to communicate to you the opinions of the Committee for your information and guidance in reaching your conclusions on these topics. This communication does not have the status of a formal Recommendation or Interpretation of the Academy of Actuaries.
Premium Revenue Recognition

The Committee endorses the Division's basic position. We suggest, however, that the phrase "revenues should be recognized" at the third line be replaced by "premiums should be taken into net income" to avoid the implication that only earned premiums (as opposed to written) should be shown in the revenue section of the income statement. Many believe that written premiums constitute a more satisfactory proxy for sales volume, and accordingly should be displayed separately in the income statement, with the change in unearned included with charges against income. This would have the additional advantage of consistency with the audit guide for stock life insurance companies, where premiums paid at the beginning of a one-year term life insurance policy would be recorded in revenues, with the (unearned premium) reserve change recorded as benefits.

The Committee suggests that the phrase "The incidence of losses is not relevant ..." on the fourth line be changed to read: "Although the incidence of losses is not relevant, the exposure to loss is relevant to the recognition of revenue." The balance of the sentence beginning with "... But is relevant to the recognition of costs, which ...", in the Committee's opinion is gratuitous, and could be omitted in a reference to premium revenue recognition.

The Committee suggests an addition to the wording on page 8, second column, in the paragraph which discusses exceptions to the rule that "... premiums should be recognized as being earned evenly over the term of the insurance contract ...". We recommend an additional sentence be added to the paragraph as follows:
"There are also lines in which the exposure to loss varies significantly over the term of the insurance contract, and recognition of income should reflect the exposure variations."

The Committee calls attention to uneven exposure to loss as represented by surety, growing crops and mortgage guarantee coverages, for example. Unless premium is recognized as exposure to loss, financial reports would recognize premium revenue in a different period than costs.

As reference to the Division's position on retrospectively rated and reporting policies, the Committee wishes to emphasize that all premiums should be accounted for on an accrual basis. There are other types of premium adjustments in addition to "retrospective" adjustments and adjustments on reporting form policies which should be treated on an accrual basis. The Committee recommends that the wording "... on retrospectively rated and reporting-form policies ..." be deleted.

The Committee is of the opinion that the word "rare" in the final sentence of the Division's position on Premium Revenue Recognition is gratuitous, and should be removed.

The Committee also suggests that only true dividends, declared with respect to a proper dividend class of policies, should be treated as charges to income, and that any items that have the character of adjustments of policy premiums should be accounted for as premiums even though they may be called dividends.
Deferred Acquisition Costs

The Committee endorses the Division's basic position. We strongly recommend, however, that alternative methods for the deferral and amortization of acquisition costs be permitted, particularly in instances where acquisition costs are incurred for the purpose of producing premiums in the future. An example would be the case of policies that are renewable at expected or estimable rates of persistence by the payment of successive periodic premiums; in such a case, acquisition costs should be amortized over the expected life of the policy rather than related to the initial premium payment.

The Committee also endorses the "lock-in" principle, but takes exception to the writedown of previously capitalized costs in the event of premium deficiencies. The Committee feels that premium deficiencies should be accounted for by a separate charge against income, because in most instances the loss rates give rise to the deficiency and this clearly has no relationship to deferred acquisition costs.

The Committee also notes that several such presentation questions could be avoided by adoption of the "unitary" reserve concept. It seems to make more sense to establish a net reserve liability for future outgo that reflects the present value of all anticipated transactions related to the policy than to establish one piece (deferred acquisition costs) as an asset which is inextricably related to the basic policy premium.
Premium Deficiencies

The Committee does not endorse the Division's position. Premium deficiencies should be determined in the aggregate for the entire enterprise and should be presented in such a way as to avoid the distortion of current operating results. Groupings of business as defined in the exposure draft are rarely arbitrary conventions adopted for purposes of providing some perspective on current and historical results, and presumably may be changed at will. Accordingly, it makes little sense to apply loss recognition tests to such arbitrary classes of business. The forces of competition and regulation and the imperfect (at least for short periods) nature of the pricing process are such that some classes of business will be profitable in some periods and unprofitable in others. The insurance enterprise is primarily concerned with the viability of its entire risk portfolio. Therefore it follows that the determination of possible deficiencies should only be made in the aggregate.

The determination of any future loss should be on the basis of all the premium loss and expense items involved, appropriately discounted to present value. The use of present values therefore obviates the necessity for explicit separate treatment of investment income.

As noted earlier, the employment of a unitary policy reserve eliminates the need to decide how to classify a provision for premium deficiency. The decision to first write off any unamortized costs simply fails to recognize the realities of the business where frequently it is not possible to allocate the cause of the deficiency between the expense and loss provisions in premium rates. Further-
more, acquisition expense is not an asset of the sort usually subjected to impairment tests, but is rather an accounting artificiality which is employed solely to expedite the matching of revenue and outgo for discrete accounting periods.

Finally, if present value accounting is not adopted, the Division's own illustrations (see especially the table on page 15) make crystal clear the need to consider investment income in the determination of premium deficiencies. Indeed, if the matching concept is pervasive it is equally clear that it should be done on the basis whereby investment income is amortized over the entire period.

**Losses**

All losses should be accrued on the basis of the present value of the payments that will ultimately be made. The estimation of the ultimate cost of settlement should take into account all potential payments and recoveries, including salvage and subrogation. The Committee sees no basis for distinguishing in principle between periodic fixed loss payments and other payments to be made at some future date. The actuarial methods customarily employed for the estimation of the claim liability involve estimates of the patterns of future payments and provide an appropriate basis for discounting to present value.

**Loss Adjustment Expenses**

All costs involved in the future settlement of incurred losses should be handled under the same principles that govern the valuation of the loss payments themselves. Accordingly, all loss adjustment expenses should be accrued, and future expenses for the settlement of losses already incurred should be carried at their present value.
Reinsurance

The Committee does not agree with the Division's position. It has already been noted that losses should be provided for on a basis which takes account of all potential payments and recoveries. Amounts receivable from reinsurers related to losses which have been paid should be recorded as an asset. However, to reflect amounts recoverable from reinsurers on unpaid losses as an asset in the financial statements reflects the form but not the substance of the reinsurance transaction. As long as the reinsurance transaction results in a real transfer of risk, and the reinsurer is solvent and expected to honor his obligations, liabilities should be presented net of reinsurance. To reflect such amounts on a gross basis inflates both assets and liabilities, is inconsistent with the position that such amounts should be netted in the income statement, and does not reflect the realities of the reinsurance mechanism.

Other Topics

The remaining topics in the exposure draft appear to be governed by considerations that are not essentially actuarial in nature. Nevertheless, the Committee feels constrained to observe that the proposed adoption of certain departures from current accounting practices in the areas of reinsurance, real estate and capital gains, ostensibly for the purpose of conformity with other commercial enterprises, raises questions as to whether the Division fully appreciates the unique characteristics of insurance companies as financial intermediaries and risk-takers, and whether slavish adherence to ordinary commercial accounting conventions will really promote a better understanding of those unique characteristics by users of insurance company financial statements.
Related Considerations

The Committee recognizes that the adoption of its recommendation that loss reserves and related items be carried at present values would invalidate many of the customary guidelines, standards and rules-of-thumb that have prevailed in the industry. Any extension of this principle to regulatory accounting would require a wholly new perspective on the quantification of such concepts as reasonableness of rates, underwriting capacity, experience reporting and experience rating, regulation for solvency, reserve adequacy, and other vital matters; it could have significant tax consequences, conceivably requiring revision of the tax laws. Leaders of the industry, possibly including many actuaries in their roles as company officers, may consider the resulting practical problems so grave as to outweigh any considerations of actuarial or accounting principle, and we therefore expect vigorous dissent from our views. It is not clear that these problems will prove insuperable, but it does seem likely that their weight will prevent immediate acceptance of our recommendations. Nevertheless, we considered it our responsibility to submit our recommendations on the basis of actuarial principles rather than to offer pragmatic solutions in the guise of professional recommendations. However these issues may be decided, it will be essential that the true basis for the decision be recognized.

In conclusion, we would like to express our appreciation of this opportunity to participate in your consideration of these important topics. We are prepared to submit additional commentary, clarification, or argument in support of our recommendations, which we have attempted to keep relatively brief in this presentation, and we would be happy to cooperate in the course of your further consideration in any way you feel would be appropriate.