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Executive Office
Suite 515
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Administrative Office
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CONTENTS

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JOURNAL

ANNUAL MEETING
October 8, 1979
Seattle, Washington

MR. DALE R. GUSTAFSON (President): First, a quick review of our agenda. I'm going to make a very few brief orientation and introductory remarks. Kevin Ryan will give a Treasurer's report. We'll have a brief report from our Executive Director and the report of the Nominating Committee. After the election of Directors, Ron Bornhuetter and I will chat back and forth a little bit.

Right now I want to remind you of some of our history. The Academy was formed in 1965, jointly sponsored by four Actuarial bodies. A procedure was set up then that has been followed ever since - that the Academy's Annual Meeting would take place in rotation in connection with the Annual Meetings of each of the sponsoring bodies. And this year we are pleased to be with the Conference. The purpose of the rotation has been twofold. One purpose has been to give the Academy hierarchy, particularly the Board, Executive Committee, and Committee Chairmen, real live experience with each of the co-sponsoring groups. That way we life insurance actuaries can find out what the Conference is about and so on. This year it is your turn and you have a chance to share the other part of the purpose, which is that each of the constituent bodies gets an exposure to what the Academy is and what it is about. And, over the years, these purposes have been served very well.

So that is why we're here and that is why we're going to go through this business meeting, which will be as brief as we can make it . . . but I think you will find it of interest. And Kevin, now tell us the bad news.

BUSINESS SESSION
REPORT OF THE TREASURER
KEVIN M. RYAN

The Bylaws of the American Academy specify that the duties of the Treasurer include the maintenance of a register of members, the publication and preparation of the yearbook, and the general supervision of the funds, including collection of dues and payment of bills of the American Academy. I would like to report to you briefly on those functions for 1979.

The Academy membership has increased from 4,137 at the end of December, 1976 to an estimated 5,000 as of December 30, 1979. It is anticipated that a year from now this number will climb to 5,700. These large increases are due to the change in the membership requirements.

Associated with this increase in membership is the anticipated increase in income, to be realized in 1980. The processing of new applications for membership has been a difficult task due to the slow response of the potential members, the number of applicants, and the diligence with which the Membership Committee reviews the prospective members. As a result, an anticipated increase in revenues for 1979 over 1978 has not been realized. The actual increase in income is now anticipated to be approximately $26,000.

Expenses have exceeded income for the first nine months by $25,000. The remaining three months of 1979 should show a deficit amount of approximately $85,000. As a result, the fund balance of the Academy will stand at approximately $63,000 at the end of 1979. The balance was $173,000 at the close of 1978.

Heightened communications, a major goal of the Academy's Board in 1979, resulted in these anticipated cost increases. The increased publications directed to the members, as well as increased statments to the public, have fulfilled the goals established by the Board. On the other hand, it is anticipated that costs will be curtailed in several areas in 1980, primarily because of two items. One, the employment of in-house counsel will lessen the need for external legal assistance, and, two, 1979 was a catch-up year as far as publications were concerned. With the normal publication schedule, costs for printing should be less than in 1979.

Detailed financial reports of the Academy are reviewed regularly by the Board in a certified audit conducted annually at the close of the fiscal year.

Earlier this year an Investment Committee was formed to establish a policy for investing the funds of the American Academy. That committee has recommended to, and received approval from, the Board for a new system which involves the closing of several savings accounts and placing the Academy funds in money market securities. As a result of this action, we expect the Academy to realize a greater investment income.

MR. GUSTAFSON: Thank you, Kevin. Now I'll call on Steve with a few remarks from his point of view.

BUSINESS SESSION
REPORT OF THE EXECUTIVE DIRECTOR
STEPHEN G. KELLISON

Thank you, Gus. This report is designed to provide a brief summary of developments in the Academy offices and of other Academy activities not covered elsewhere in this program since the 1978 annual meeting. The scope and volume of Academy activities has grown substantially during the past year, both internally within the actuarial profession and externally with the Academy's public interface activities.

The Academy maintains offices in both Washington, D.C., and Chicago. Routine membership services are provided by the administrative office in Chicago, jointly for the Academy, the Conference of Actuaries in Public Practice, and the Society of Actuaries. The Washington office serves as a focal point for other Academy Activities.

The past year has witnessed a number of important developments in both offices. In the Chicago office a number of administrative changes have occurred as a result of a conversion from a manual records system to a computerized system. The new system shows promise of strengthening and improving administrative services being provided in Chicago, once the conversion is completed. Most of you are also aware of the appointment of John O'Connor as the head of the Chicago office during the past year. John has had extensive experience as an association administrator and has a number of ideas on the drawing boards for administrative changes in Chicago.

The year in the Washington office was highlighted with the addition of William D. Hager as General Counsel for the Academy on September 1. Bill has an ideal background for the Academy, having both federal and state governmental experience. The former was as a chief staff aide for an Iowa Congressman, while the latter was as First Deputy Commissioner for the Iowa Insurance Department. The creation of the new position of General Counsel will provide an important new resource for a number of Academy committees and will strengthen the Academy's government relations program. The addition of a General Counsel brings the staff size in the Washington office to six.

Another development in the Washington office is the design and implementation of a reference center for the Academy. The first phase of this reference center is a legislative monitoring system which has become operational during the past year. The system is designed to track more efficiently a number of legislative issues in which actuaries are interested and should be a valuable resource to Academy committees and others working with these issues for the profession. We are hopeful of adding other phases to the Reference Center during the next year.

The Washington office also provides staff support for certain activities within the profession which are not confined to the Academy. Among these are staff support for the Council of Presidents, for the Annual Meeting for Enrolled Actuaries in Washington, D.C., which is cosponsored by the Academy and the Conference, and for the governmental contract which the Actuarial Education and Research fund has undertaken for the Department of Health, Education and Welfare concerning universal coverage under Social Security. You will be hearing more about the universal coverage project later this morning.

The past year has witnessed an extensive overhaul of the Academy committee structure. Since the listing in your 1979 Year Book , six new committees were formed, one was disbanded, and four were substantially restructured.

The one committee disbanded is the Committee on Federal Relations and Accreditation. This committee has been replaced by three new committees, the Committee on Life Insurance, the Committee on Health Insurance, and the Committee on Property and Liability Insurance. This change was made to reflect the fact that the Committee on Federal Relations and Accreditation had become obsolete. The scope of federal issues in which the actuarial profession is interested is far too broad to be effectively handled by one committee. It also became apparent that the greatest weakness in the former structure was in the insurance area, since active committees were already in existence for pensions and social insurance. The three new insurance committees should provide a greatly expanded capacity to deal with issues confronting life, health, and casualty actuaries, respectively. These new committees will monitor NAIC activities, as well as those at the federal level.

Another new committee is the Committee on Life Qualifications which will develop proposed standards of qualification to be applicable to those actuaries signing statements of opinion on the annual statement. This committee parallels an existing Committee on Property and Liability Qualifications. As mentioned in the Treasurer's Report, the Investment Committee has been appointed to develop and monitor an investment program to improve the yield on invested funds. The final new committee is the Committee on Long Range Planning, and you will hear more about this committee later in the program.

Two committees were restructured by the creation of permanent subcommittees and task forces to more effectively deal with a growing multiplicity of issues. These committees are the Pension Committee and the Committee on Risk Classification. The Committee on Guides to Professional Conduct has been reorganized to reflect the greater degree of cooperation and coordination among the various actuarial organizations that has developed in this most important area. The former structure, in which each organization maintained a separate committee, has been replaced with one committee for all, which should significantly reduce the duplication of effort and confusion created by multiple committees. It is important to note that the governing board of each organization retains the right to accept or reject any proposed new or modified Guide or Opinion, but hopefully the number of discrepancies among the Guides and Opinions of the various organizations will be minimized. The final committee to be restructured is the Committee on State Relations and Accreditation. A special ad hoc task force is now developing a proposed restructuring of this committee, so that the Academy can more effectively deal with state-by-state issues.

A number of strides have been made in connection with Academy publications during the past year. The most significant of these has been the incorporation of Academy statements into the Journal . By now you should have received two new hard-bound Journals , a retroactive issue for 1977 and a regular issue for 1978. It is intended to continue to publish the new, expanded Journal on a annual basis. Although many of these Academy statements have been the subject of Newsletter articles and all of them are listed in the Newsletter , we believe that the inclusion of the statements in the Journal is necessary to keep the membership more fully informed about Academy activity in filing statements and position papers to external audiences and is also important in building a permanent historical record of this important activity.

We have also tried to improve the Newsletter as a vehicle to keep membership better informed about Academy activities. In addition to the obvious aesthetic changes you may have noticed, a number of new features have been added. Among these are the table of contents, periodic reports of the President, Editor and Executive Director, checklists of statements, interviews with leading public figures, and special subject supplements on topics of particular interest in greater depth.

One final item to note in connection with Academy publications is that the popular List of Members by Business Connection , which has not been produced since July 1, 1977, will again be available with a new edition in early 1980. Consideration is also being given to the possibility of including a geographical breakdown along with the breakdown by business connection.

In summary, it has been an exciting and busy year for the Academy. On behalf of myself and the staff, I would like to express our gratitude to the officers and directors of the Academy, to the committees and task forces, and to the general membership for the outstanding support which we have been afforded during the past year. The staff always welcomes your comments and thoughts as to how we can better serve the needs of the membership in the years ahead.

MR. GUSTAFSON: Thank you, Steve. Before proceeding to the next report, I want to thank the Conference for allowing the Academy to be a part of this meeting, and especially to thank the Conference Board for the very fine joint social meeting of the two Boards last evening. A special thanks to Larry Mitchell as the formal host of that affair and to Jim Curtis as the one who actually did the work in setting it up. It was a fine occasion and enabled the Members of these two Boards to engage in informal dialogue and get to know each other better. These affairs do help to build a repoire, to enable us to deal better with the inter-relationships between the organizations.

The next item on the program is going to be the Academy's Nominating Committee report. Your function in this formal meeting is to deal with the election of new Directors. Let me take this occasion, just before I introduce Ed Boynton to conduct that part of the meeting, to thank the Officers and members of the Board for their help and support during this past year. And a special thanks to the six Members of the Board who are retiring. I also want to thank Staff, especially Steve...he works hard. Fred Hunt and Cindy in the Washington office have also been a great help, and Madeline Madden, who is the Academy's full-time employee in Chicago, carries quite a burden for us. She does a fine job for us. Now Ed Boynton will take over for the Nominating Committee's report.

BUSINESS SESSION
NOMINATION AND ELECTION OF DIRECTORS

MR EDWIN F. BOYNTON: Thank you, Gus. The structure of the Academy election process... as Gus indicated... is that the membership elects the Board of Directors, in groups of six at each Annual Meeting, for three-year terms. The Board, immediately following this Meeting, will meet and will elect the officers for the coming year. The Nominating Committee's function is to first make up a slate of nominees for the Board and then to make up a slate of nominees for the officers who will be elected by the Board. The committee includes the two immediate past presidents... Bob Winters is chairman, I am vice-chairman, and because Bob isn't here, I'm standing in for him. There are fifteen other members, selected with great care to represent every cross current that might exist within the Academy by occupation, by employer, by geography, by area specialty. Similarly, we try to achieve that same kind of breadth on the Board. Generally, I think we've done a very adequate job.

With that background, let me present to you the slate of six Directors selected by the Nominating Committee to be considered by you for election to three-year terms.

Raymond A. Bierschbach, Fellow of the Society of Actuaries.

Charles Greeley, Fellow of the Society of Actuaries.

David G. Hartman, Fellow of the Casualty Actuarial Society.

Robert Pollack, Fellow of the Casualty Actuarial Society.

Elizabeth C. Poston, Fellow of the Conference of Actuaries in Public Practice.

David M. Reade, Fellow of the Conference of Actuaries and Fellow of the Society of Actuaries.

Are there any nominations from the floor? Hearing none, I call for a motion that nominations be closed. (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.)

Next, I'll read to you the recommendations that the Nominating Committee will make to the Board immediately following this meeting.

As Treasurer, Kevin M. Ryan.

As Secretary, Charles B.H. Watson.

As Vice President, for one-year term, Mary H. Adams.

As Vice Presidents for two-year terms, Robertson S. Richards and P. Adger Williams.

As President-Elect, Walter L. Grace.

MR. GUSTAFSON: Thank you, Ed.

REPORT OF THE SECRETARY
DWIGHT K. BARTLETT, III

NOTE: The Annual Report of the Secretary was not presented at the Annual Meeting, but is included in the Journal to complete the record.

Since the annual meeting last year the Board of Directors has held three full-day sessions. Following are items of nonroutine business considered and/or acted upon at these sessions.

1. It was voted to discharge the Joint Committee on Review of Education and Examinations, contingent upon the taking of similar action by the other sponsors of the Joint Committee, and further to authorize the President to appoint a liaison representative to the Education Policy Committee of other actuarial organizations when requested.

2. It was voted to authorize the creation of a joint committee to coordinate meeting dates, the locations, etc. and to encourage co-sponsorship of meetings contingent upon the taking of similar action by other sponsoring actuarial organizations.

3. It was voted to discharge the Joint Committee on Professional Conduct, contingent upon the taking of similar action by the other sponsoring actuarial organizations.

4. It was voted to adopt a resolution stating that the Board of Directors of the American Academy of Actuaries believes that for the property and casualty annual statement, instructions should be adopted that are essentially the same as the current instructions adopted by the NAIC Blanks Subcommittee for the Life, Accident and Health annual statement.

5. It was voted to endorse the following statements on casualty loss reserves.

   a. Summary and complete statements to the NAIC (A-5) Subcommittee, dated November 10, 1978
   b. Statement of Stephen G. Kellison at the NAIC Semi-Annual Meeting, December 6, 1978.
   c. Position paper of the Academy to be presented to the NAIC Blanks (A-1) Subcommittee, March 1979.

6. It was voted to create a full-time position on the Academy staff for an attorney.

7. It was voted to discharge the Academy's Coordinating Committee for Pensions and to authorize the President to appoint representatives to a Joint Coordinating Committee on Pensions with a similar charge, contingent upon the taking of similar action by other sponsoring actuarial organizations. It was also voted to create an Academy Committee on Pensions to develop technical material needed for public statements, testimony, or other needs.

8. It was voted to authorize the President to appoint a joint committee in conjunction with the Conference of Actuaries in Public Practice to handle the annual enrolled actuaries meeting.

9. It was voted to conduct a study on behalf of the Academy to find out what persons with what type of professional qualifications were determining the loss reserves of the larger casualty insurance companies.

10. It was voted to instruct the Executive Committee to consider in conjunction with the Casualty Actuarial Society what steps the Academy or others should take in developing and implementing a program to educate and certify those persons setting loss reserves who are not members of the American Academy of Actuaries.

11. It was voted to discharge the Committee on Federal Relations and Accreditation. It was voted to authorize the President to appoint three committees to monitor governmental regulatory and legislative activities in the fields of life insurance, health insurance and casualty insurance respectively.

12. It was voted to authorize the President to appoint a committee to study the long-range goals, directions, and operations of the Academy.

13. It was voted to authorize the Committee on Risk Classification to respond to a draft statement of the principles of risk classification to the membership.

14. It was voted to adopt the following three resolutions:

    a. That the Board of Directors receives the report of the Specialty Designations Committee and endorses the concept of indentifying publicly, as an aid to regulatory authorities, those members who have demonstrated their qualifications to
       (1) Sign the actuarial opinion of the statutory "life and accident and health insurance" annual statement, or
       (2) Sign any required opinion on loss reserves in the statutory "fire and casualty insurance" annual statement.

    b. That the President be authorized to appoint a Committee on Life and Health Qualifications.

    c. That the Committees on Property and Liability Qualifications and Life and Health Qualifications be directed to recommend to the Board standards of qualification in their respective domains. These recommendations should be prepared in time for the Spring 1980 meeting of the Board.

15. It was voted to adopt a section d concerning advertising as an addition to Opinion A-1 on professional conduct as recommended by the Committee on Guides to Professional Conduct.

In accordance with the recommendations of the Board of Directors, the membership adopted two changes in the bylaws, the first eliminating the separate affiliate membership status previously provided for under Article I, Section 2: and the second, providing for certain changes in administrative procedures with respect to the discipline of members provided for under Article VII, Section 2.

BUSINESS SESSION
DIALOGUE BETWEEN THE PRESIDENT AND THE PRESIDENT-ELECT
DALE R. GUSTAFSON AND RONALD L. BORNHUETTER

MR. GUSTAFSON: Several years ago we introduced a change from the usual format at Annual Meetings of the President's address by substituting a dialogue between the President and the President-Elect. My term of office as president will end at the brief Academy Board Meeting that will take place at lunch today. The new President will be my partner here, Ron Bornhuetter. However, at this moment I am still the President and he is still the President-Elect.

I want to start off with a few words of very high praise for the Academy's Committee on Admissions. As you know, just about a year ago, the Academy membership requirements were changed to admit enrolled actuaries to full membership rather than affiliate status, and to change the education requirements otherwise to associateship in the Society of Actuaries and the Casualty Actuarial Society. There is also now a three-year experience requirement. As a result of this change in membership requirements, we have received something considerably in excess of 1,000 new applications . The process of considering applications is not just mere routine, but requires a considerable amount of work on the part of the members of the Admissions Committee, as well as the Academy staff, especially the Chicago office, and even some regular detailed involvement on the part of each member of the Executive Committee. However, the chief burden falls directly on the Admissions Committee, and especially its chairman. In the spring of this year just as the deluge of applications was getting really underway, the chairman of our Admissions Committee, Mr. Thomas Chamberlain, suffered a heart attack. Tom is well-known, to most of you, as he is a long-time member of the Conference. For those of you who don't already know, he is recovering very nicely and is now back at work almost fulltime. However, it was immediately seen last spring that the Admissions Committee burden simply had to be taken off of Tom's back. Mr. Earl Petz, a member of the Committee, was asked to step in and take over for Tom and deal with the massive number of applications pouring in. He accepted the challenge, and he and his staff have done a marvelous job of dealing with this very large number of applications. Of course, he had considerable help, from the other members of the committee, the Academy's Chicago office staff and especially Tom Chamberlain's secretary. The other members of the Committee who have helped deal with this crisis are Dan Macken and Robert G. Bolton. I wanted you to know about this for two reasons. It should be of interest to you to be aware of the very strong response that has come from those eligible for membership in the Academy with the change in Bylaws about a year ago. The other reason was to publicly recognize and thank the four members of the Admissions Committee whom I have named and, of course, the various staff people who have helped them through this very important piece of work for the Academy.

The word that identifies the next area that I am going to remark briefly about is Independence. Actually, it involves a great deal more than simply the concept of Independence, but that is the word we generally use to identify the area. It has to do, to a large extent, with interrelationships between the actuarial profession and the accounting profession. The roots go back to the beginning development of the Audit Guide for Stock Life Insurance Companies, now about 12 years ago. A critically important part of that interrelationship is the relationship between actuaries and accountants in the preparation of audits of life insurance company financial statements. A most sensitive part of that relationship is the fact that certain public accounting firms have consulting actuarial arms and audit the financial statements of life insurance companies which utilize the actuarial services of the auditing firm.

Another area, somewhat more recent in development, but also quite complex, is the relationship between the actuary, especially the enrolled actuary, who is engaged by a pension plan and/or its sponsor, and, again, the accounting firm which audits either the financial statement of the plan or the financial statement of the employer, or both.

The American Institute of Certified Public Accountants, itself, a year or so ago appointed a high level body called the Public Oversight Board to examine some very broad areas of management advisory services, including actuarial services, provided by public accounting firms.

The Financial Accounting Standards Board, established as an independently financed, free-standing body charged with the responsibility for developing accounting principles, is also involved with the relations between actuaries and accountants. Finally, the Securities and Exchange Commission is also involved and quite concerned about certain aspects of the providing of management advisory services by public accounting firms.

Our time is much too brief on this occasion to even try to paint in general terms the nature of the issues and current state of their progress. Suffice it for the moment to say that the Academy has been actively involved with all of the bodies named. For seven years now, we have had a committee meeting jointly with a counterpart committee of the American Institute of Certified Public Accountants at least four times a year to deal with interprofessional issues. We have made written statements and presented oral testimony before the Public Oversight Board, the Financial Accounting Standards Board, the SEC, and certain pertinent committees of Congress.

It may be something of an oversimplication, but what we are involved in is working out definitions of turf between the accountants and the actuaries so that we both may responsibly and effectively go about doing our work. Even from my rather vague and general remarks, it is quite clear that this area is one of significant interest to consulting actuaries. It must be added, however, that actuaries employed by companies are also concerned. I will simply conclude my remarks on this subject by assuring you that all that can be reasonably done in this area is being done and to say that in no significant way is there any significant conflict between various groups of actuaries.

I have spoken for a few minutes on the general subject of Independence without mentioning casualty loss reserves, even though the relationship between the actuarial profession and the accounting profession is also a significant part of this area. The reason is simply that Ron Bornhuetter is going to spend a few moments bringing you up to date on the current status of the loss reserve situation.

MR. BORNHUETTER: So much of the past activities of the Academy have concentrated on pensions and pension related areas that I am pleased to discuss another area where the Academy was able to respond effectively. That is: the rendering of an opinion on property/liability loss reserves--commonly referred to as "certification". The work in this arena is far from over. In fact, the ultimate battle lies in the future...just two short months ahead in Los Angeles.

For those of you who have not followed the events over the past two years, I will briefly summarize this activity.

It all started when Fletcher Bell, Insurance Commissioner for the State of Kansas and Chairman of the NAIC (A5) Subcommittee, decided to advocate a required certification program for property and liability statements. The near collapse of GEICO and the demise of other property/liability companies was the impetus behind his effort.

The first draft was not very good, and included all members of the AICPA on an equal footing with Academy members as "qualified loss reserve specialists." After a public hearing, matters got worse. The second draft also required independence and still left in all 10,000 members of the AICPA. This draft was approved by the NAIC (A5) Subcommittee last December, and sent to the Blanks Committee for implementation. At this nadir, matters finally turned for the better. The Academy discussed its position with each and every member of the Blanks Committee and last April this Committee approved the program, but asked the (A5) Subcommitttee to reconsider its original approach. Politics was at its thickest. By a split vote, the (A5) Subcommittee last June agreed to ask its own task force to reconsider the approved program. An integral part of the pause was a joint agreement reached between the Academy and the AICPA. This was summarized in a letter from Larry Jones, Chairman of the American Insurance Association. Two programs were advocated...one, an "in-house" actuarial certification similar to the current life program, and second, a mandatory audit requirement, thus hopefully separating the two issues that kept becoming intermingled.

To shorten the story, the (A5) task force has now provided a new draft which, first, does not require independence and, second, does not specifically mention the AICPA. It also relies heavily on the Casualty Actuarial Society and the Academy for administration, both among actuaries as well as other "qualified loss reserve specialists." In addition, a parallel proposal concerning audits is also moving forward.

At this moment, there appears to be two alternatives--adopt the revised version, which is quite satisfactory to the Academy, or, do nothing. There is strong pressure in the NAIC to do nothing. Right now, it is a toss up, and the issue well probably be settled on the floor of the NAIC plenary session this December.

Whatever the outcome, both answers are far more satisfactory than what we had one year ago. You can be proud of your Academy. Everyone pitched in and worked hard. Without the help of the "life" side, we would not be where we are today. Watch for the outcome of the December NAIC meeting...it will be interesting.

This program has aspects that cover all disciplines. Another "hot" topic affecting us all is risk classification and Dale will discuss this activity.

MR. GUSTAFSON: It is my personal opinion that the current controversy surrounding the general subject of risk classification, which seems to be impinging with equal force on all branches of the actuarial profession, is the most serious matter before the profession at this time. One of the most difficult, and yet most important, aspects of risk classification is sorting out what is social policy, what are actuarial principles, and what is political preference.

The American Academy of Actuaries is charged with dealing with public interfaces for the actuarial profession. We must be extremely careful that we don't unknowingly take positions that are not essentially actuarial in their nature. Because I have only a very few minutes, I will try to make this point by an analogy. Several hundred years ago, a legislature in a European country passed a law that proclaimed that the mathematical constant pi would henceforth be 3. The aim, of course, was to make mathematical calculations simpler. (That could be identified as accomplishing a broad social purpose.) Proper actuarial testimony at the time would have forcefully and clearly pointed out that such legislation would not and could not change the actual circumference and area of a circle.

The Academy Committee on Risk Classification and a number of task forces or subcommittees are very hard at work trying to deal effectively with those who would have pi equal 3. A statement of general principles is in process of preparation, and in fact may be already on its way to the members. Needed testimony is being prepared in a number of areas, and in general a rather high level of activity is going on in the area of risk classification.

There are several quite important lawsuits underway. The Academy may well seek to enter certain of these cases as amicus curiae. It is a matter of policy that we will not do so at any level lower than the Federal appellate court.

I have tried to give you a hint of an extremely complex subject in a few minutes. Next, Ron will try to cover an even more complex area in an even shorter period of time, that is, the general area of pensions.

MR. BORNHUETTER: Pensions are even more complex when a casualty actuary starts talking about this subject to an audience of mainly pension experts. In the vernacular, its called suicide.

Pensions and related activities continue to be a major activity for the Academy, and I will just mention a few.

I will start with a related area...The SAS #11 Task Force. It is an area where we have not done well, but we are still trying. It goes to the heart of the "reliance" issue. Our Task Force, formed about a year ago, had been meeting with a comparable group from the AICPA as the latter group appeared to be reexamining the entire issue. Without warning, the AICPA "closed the door" without a full hearing from our side of the table. This turn of events is very discouraging. However, we have just requested, through this Auditing Standards Board, that the AICPA reopen the issue. We are not too hopeful, but will keep trying.

The second area of interest is the effort expended on the FASB exposure draft on defined benefit pension plans, which is probably the most significant pension item we have going. As you all know, the April 1979 exposure draft had many unacceptable areas, and the Academy commented extensively both orally and with written statements. The July 1979 exposure draft was vastly improved. In fact, the FASB explicitly recognized the Academy's views in explaining the changes between the two drafts. This was a major accomplishment of many hardworking Academy members, many of whom are in this room today.

The second draft still has some problems from our point of view, and we have recently filed another major statement with the FASB...just two weeks ago.

Other pension activities this past year included a complete restructuring of the Pension Committee in order to minimize the duplication of effort and, hopefully, to expedite important projects. Another is the most successful Enrolled Actuaries meeting, a joint Conference and Academy project, certainly the largest and most successful meeting yet held.

Lastly, a related pension item is the Universal Coverage project sponsored by AERF. The Academy has expended a considerable amount of effort in order to make it happen.

While I have the floor, I would also like to comment briefly on the overall topic of our relations with the AICPA...one of our most crucial assignments. As you know, we have a joint committee with the AICPA which, I must admit, has performed admirably.

I would like to read you one of the agendas some time, but time will not permit. Let me just relate a project just completed which could not have happened without the help of the AICPA members of the joint committee. In mid-September we had the opportunity to make a presentation to the full FASB Board about the actuarial profession. This lasted over three hours and we also had lunch and dinner with the Board...in all, over ten hours. Considering the demands of their time, this was no mean accomplishment on our part.

Enough said in this area. Let me turn you back to Dale to talk a bit more about the future.

MR. GUSTAFSON: My final part of this dialogue will be quite brief, although the subject is also of considerable importance. The Academy's Board, officers and staff have on numerous occasions discussed the Academy's purpose and how it was going about meeting its purpose. Our conception of purpose has changed gradually but rather dramatically as the years have gone by and we have learned. At its June meeting, the Board of the Academy authorized the appointment of a high level, Long-Range Planning Committee. The purpose of this Committee will be to take a very hard look at where the Academy has come from, where it is, and where it ought to be headed. The chairman of that Committee is Mr. Thomas P. Bowles. The membership of the Committee will be listed in the 1980 Year Book of the Academy. At the same time that the Board authorized the appointment of the Long-Range Planning Committee, it also asked staff to begin looking at how the Academy's statment of purpose might be revised and what the technical problems were in revising it. The technical problems arise because it is part of the Academy's Articles of Incorporation. The purpose was to enable staff to get a head start on what is expected to be one of the important areas to be considered by the Long-Range Planning Committee. I am perhaps biased because of the intimate involvement I have had with Academy affairs for these past several years, but I do not look for any dramatic changes in our current activities to come from this Long-Range Planning Committee. I believe it is an extremely important activity, but not because I fear that we have gone off in the wrong direction. Rather, it is very important that we chart carefully our course for the future from where we are now.

I will now turn to Ron for his final section in these remarks. He has the clean-up spot to cover any other important subjects that we think should be brought to your attention.

MR. BORNHUETTER: Gus has just begun a commentary about the Academy's future. Let me briefly comment on a few issues the Academy will face in the next twelve months (in no particular order):

First--Independence--something will happen.

Second--Qualification Standards--a perplexing problem for the minorities.

Third--Rendering an Opinion on Property and Liability Reserves--if it goes, do we bring in all non-actuary "loss reserve specialists" under the Academy umbrella--as members?

Fourth--Reorganization--what happens with the Society of Actuaries turn down of the Fraternal consolidation?

Fifth--Risk Classification--a very "volatile" issue.

Sixth--Ten issues I haven't thought of.

Finally, my part in the program would be remiss without acknowledging to each of you the major contribution to our profession of Dale Gustafson. His leadership has been outstanding, and we are all the benefactors of his efforts. The Academy has flourished under his guidance, and really is a tough act to follow.

MR. GUSTAFSON: Thank you very much. The Meeting is adjourned.

CONCURRENT SESSION
SPECIALTY DESIGNATIONS

Moderator: FREDERICK W. KILBOURNE. Panelists: DAVID R. CARPENTER, GEORGE D. MORISON

MR. FREDERICK W. KILBOURNE: This is the Specialty Designations panel, which will conclude at 12:15 p.m. I am Fred Kilbourne, moderator of the panel and chairman of the Specialty Designations Committee. The panelist on my right is George Morison. George is a Fellow and Past President of the Casualty Actuarial Society, and is a member of the Academy Specialty Designations Committee as well as the Chairman of the Academy Committee on Property-Liability Qualifications. The panelist on my left is Dave Carpenter. Dave is a member of the Conference, a Fellow and Board member of the Society of Actuaries, and is a member of the Society's Committee on Reorganization.

We plan to use a slightly different format for this panel. Most actuarial panels assail the listener with several long, boring speeches. We plan to break our presentation up into more, but shorter, boring speeches. Short, specific topics will be discussed in about a minute each. When we're through talking we'll convert to a workshop format, with questions and answers from the audience encouraged.

It's worth noting that the description of this panel is taken almost verbatim from the Academy statement of purpose for the Specialty Designation Committee. This will be a review of issues relating to specialized areas of practice. What are suitable standards for qualification to practice in a specialized area? Under what circumstances, if any, should public acknowledgement of such qualification be made?

I think a good starting point would be a brief description of what our Committee has done. Would you like to take your minute on that, George?

MR. GEORGE D. MORISON: What would you do if I said no?

MR. KILBOURNE: I'd probably do it myself.

MR. MORISON: Oh, in that case I'd be glad to. (Laughter.) The Committee met twice and developed two quite different plans. The second one was presented to the Academy Board last week. What it boils down to is a recommendation that we concern ourselves with only three areas of practice at this time, while recognizing the possibility that others may emerge as time goes by. The first area, pension plan liabilities, is easy because the Government has identified qualified actuaries for us. The second area, casualty insurance claim reserves, is the subject of activity as was reported earlier today. The third area, life insurance policy reserves, already has requirements at the state level.

MR. KILBOURNE: Good. One important thing about this Committee is its makeup in terms of cross-sections of Academy membership. Dale Gustafson and others made every effort to construct a Committee that would be representative of every faction, every member. I'm sure that wasn't perfectly realized, but it certainly is a representative Committee. The Committee was established less than a year ago, and last month submitted its final report, as George mentioned and as we will discuss further. But first, Dave, perhaps you could comment on Society of Actuaries activities in this area or reorganization or something else pertinent to this panel.

MR. DAVID R. CARPENTER: Well, I got out all my old notes on reorganization. I've been involved in Society efforts on the subject for nearly three years (I see Anna Rappaport in the audience; she certainly has been similarly involved) and I'm particularly interested in whether Fred's Committee report conforms to or conflicts with early reorganization discussions, particularly as they relate to professional designations and specialties. There can easily be confusion between this Committee report, with its emphasis on the needs of the public, and the reorganization discussions over the past two years, which basically are more directed at the egos and needs of actuaries themselves. For instance, what if (remember, I said "what if") the Academy were to become the main United States actuarial organization, with the Conference and the other bodies brought in on some basis under the Academy umbrella. This would never fly without specialty sections which would retain a high degree of automony, and perhaps even senatorial representation on the Academy Board. What would the professional designations of actuaries be under this circumstance? It seems it would be best to have us all be identified as Member, American Academy of Actuaries without further qualification at that point (such as "L" for life insurance). There would be lists prepared of actuaries presumptively qualified to practice in a given area, but this would not be confused with the Membership designation itself. The lists might be in the yearbook, of course, to serve as a research tool. I hope I haven't confused anyone, but we can respond to questions when the time comes.

MR. KILBOURNE: Let me comment about our Committee, which is, I guess, inextricably interwoven with the subject of this panel. It is the wrong Committee, this is the wrong topic, and all of you are at the wrong meeting. The issue is not specialty designations; it is qualification standards, and the name of the Committee has been changed, by Board action last month, to the Qualification Standards Committee. Our large and broadly-representative Committee has never wanted to designate everyone as a specialist in one or two particular areas of practice. Rather, we see the need to establish minimum qualification when - and only when - there is a compelling public need for such professional standards to be established. Would you agree, George?

MR. MORISON: Yes. Where there is a need to identify qualified actuaries in a specialty, we feel the Academy should step forward with the identification. The new Committee on Property-Liability Qualifications, of which I am chairman, is charged with identifying the requirements of those wishing to be deemed presumptively qualified to sign the property-liability statement. Fred and I will have to talk later as to how our respective Committees should dovetail, if at all.

MR. KILBOURNE: In a way, I expect our Committee to fall into a stupor for a while. We're being continued, and we've been renamed, but I can't see that the Qualification Standards Committee should be active until someone can assume the burden of proof that we should go beyond the three areas already identified. I'll comment in a minute on this concept of presumptive evidence and burden of proof, because this has been a tool that we've used throughout our Committee work. The list that would be prepared as a result of the charge to George's committee would be a list of people who have, in the opinion of the Academy, presumptively met standards to render expert opinions for the casualty blank, period. This is clearly quite narrow, going back to what I was saying about the limited focus of this Committee. Our Committee early took the stand that no one has the right to limit any actuary in his practice unless he can assume the burden of proof that the public interest requires that there be minimum standards for this particular area. Looking at the Academy as a whole, I think that's what we have said to the public with regard to what it means to be an actuary. To be a member of the American Academy of Actuaries is, we've claimed, presumptive evidence of at least meeting minimum standards to call yourself an actuary. What we would like, and what has happened in many areas, is for the regulatory authorities and legislators to accept Academy membership as presumptive evidence of qualification to be an actuary. That is not to say that someone else does not qualify, but merely shifts the burden of proof onto the person claiming to be qualified. Our Committee said we do not want to establish any internal limits at all unless a burden of proof can be satisfied that the public interest requires it. We concluded that this burden has been met in three areas and three areas only: the particular statements that require actuarial opinions in the pension, life and casualty areas.

MR. CARPENTER: Does this mean, Fred, that if a Member of the Academy undertakes one of these three specific functions without being on the list, then the burden of proof is on him to prove that he is innocent?

MR. KILBOURNE: In answer to your question, as I understand the Committee's intent as reflected in its report (which was received by the Board and which will be published in the next issue of the Newsletter), why, yes, the intention is to have the casualty and life committees come up with lists of people who are presumptively (not conclusively) qualified to sign the particular statement with the burden of proof of qualification falling on an unlisted member who signs the statement. We can get into how the list should be prepared, but once you're on the list you are deemed to have met the presumptive (not conclusive) standards of qualification. If you're not on the list, the burden of proof shifts to you - but it is an assumable burden, if you're qualified. If you can bring forth sufficient evidence that you are qualified, so be it, that's fine. That's the underlying theory; the doors are left open, or at least ajar.

MR. CARPENTER: You know, I imagine that the public will demand something from us as to which actuaries are or are not qualified to practice in certain areas, and I'd like to get some reaction from the people here as to how they see it.

MR. KILBOURNE: The concept of lists is one, of course, that could take many different forms. It could be special identification in the yearbook, it could be an actual list, it could be by some other means. The concept of tattoo was discussed and we came out strongly in favor, but it hasn't been adopted as Academy policy yet. (Laughter.) I do want to comment that the public interest question is one that is significant, and maybe even to the point of reading a paragraph out of the report: "The Committee avers that public interest alone should be the criterion for identification of a specialty area and for the establishment of minimum standards to qualify for inclusion on the corresponding list. Only the public interest should justify limitation of an actuary in his practice, but that interest demands strict enforcement of reasonable minimum standards of qualification." This is one paragraph out of our Committee report which will be available, as I mentioned, when the next Newsletter comes out. Let's see, did we miss anything as to Academy Board or officer action at the meeting last month?

MR. CARPENTER: I was there and I applauded Fred's efforts. He kept an active discussion going for at least two hours at the Board meeting. No one else could have possibly come close to that. But in general I think the Academy Board reaction to the report was favorable. The report was received rather than accepted by the Board, but I think that was cautious wording more than anything else. There was a lot of discussion because it is a serious topic and even those on the Board who were supportive of the Committee report just wanted to have time to discuss it thoroughly to make sure they understood it. I don't think there was any strong dissent.

MR. MORISON: I'm not sure that there is unanimous opinion that this Committee should continue to limit its attention to those three areas where there is now strong public demand. I think there are some on the Board and certainly in the Academy who would like to see this concept expanded, but among the members of the Committee most wanted to take this rather modest step only, for now.

MR. CARPENTER: You know, Fred, I was wondering if you'd comment on how your Committee report lines up with opinion A5 with regard to professional conduct. Do you believe it fits in pretty well?

MR. KILBOURNE: Well, I do. Members of the Academy will soon receive a letter sent by Dale Gustafson with an article, on the back, on the subject of opinion A5. It says that there will be a life qualification committee established. It says that it is the opinion of two Academy committees that the only set of examinations which presumptively demonstrates the required study and training for life policy reserves is the set of examinations required for Fellowship in the Society of Actuaries. It then goes on to say that Members who are not Fellows of the Society of Actuaries but who nonetheless have been appropriately signing life blanks in the past should feel free to continue to do so. The article on the back of Dale's letter is one that I generally agree with but I do have a problem with opinion 5 as it varies among the professional bodies. One way in which opinion 5 varies is that the casualty opinion says "the actuary should decline any assignment for which his qualifications are insufficient". The Academy opinion no longer says that, and I feel the change was ill-advised. The article goes on to say that many people felt that the "insufficient qualifications" limitation was too restrictive and that an actuary was thereby not free to venture into a new and unexplored field. Opinion A5 goes on to say that the actuary should accept an assignment only after disclosure to his client of limitations in his education or experience, and undertaking, in the course of the assignment, research and professional consultation sufficient to overcome these limitations. I feel and have seen that the end result of this is often tokenism, so I feel there's a problem with that. The Society of Actuaries has a set of examinations which is extensive as far as qualifying people to know about life insurance policy reserves, and Academy members should recognize that fact. The same is true of the casualty exams. I think maybe to wrap up what I have on my notes, the recommendations that were made in the committee report had several purposes. The main committee recommendation was that there be lists established of Academy members who presumptively have met minimum qualifications to practice in a particular area. We felt that the value of the recommendation was that this would be an aid to regulators and legislators as to which Academy members are qualified in a particular area. Further, the lists and also the process by which the lists would be developed would be an aid to Members, who might wonder whether their qualifications were sufficient, as to how they might bolster their qualifications in order to meet the minimum standards for a particular area. Finally, the recommendations were intended as an aid to discipline committees which in the past have worked hard and for reasons beyond their control have not been very effective. The problem has been the fact that the burden has always been on the discipline committee to establish that a particular actuary was working outside of his area of qualification. All that the list concept would do is to aid the discipline committee by shifting that burden, and it should be a reasonable burden, to the actuary who is not on the list but who nonetheless operates in a particular area. I'm talking here, of course, only of professional sanctions. We're hopeful that the regulators and legislators will adopt this concept as far as admitting people to practice before them or sign statements before them within these particular limited and narrow areas. George or Dave, is there something else that we should say before we are drowned out by the din from the people before us?

MR. MORISON: I don't know of anything further that I need to say now.

MR. CARPENTER: Why don't we leave then. (Laughter.)

MR. KILBOURNE: Okay. Why don't we move on to an open discussion.

MEMBER OF THE AUDIENCE: I'm not so sure I'm understanding what you're saying. You have three areas where the burden is on the actuary to prove that he is qualified. Take medical malpractice, something else like that, is the burden then on other actuaries to prove that this person isn't qualified? Is that the way the burden goes?

MR. KILBOURNE: The Committee did not change anything, of course, and did not intend to have the Board change anything with regard to practice other than signing these three particular statements. In other words, we were not intending to liberalize nor tighten any of the existing constraints as expressed in the professional guides. These contraints do now permit the actuary to practice outside his competency and then the burden is on a discipline committee or some other actuary to prove that he wasn't qualified. What do you think, Dave?

MR. CARPENTER: Well, I was just looking at opinion A5 and it seems to me that for any area outside those three, the following short paragraph is appropriate: "The actuary, bearing in mind the responsibility to his clients, his profession and the public, will have to judge whether or not his training and experience qualify him to give advice on a particular assignment. He must also be prepared to accept the opinion of his peers on the validity of that judgement." That doesn't completely answer the burden of proof thing but it almost certainly shows it's up for grabs. I mean, he could be questioned and legitimately so. Do you agree with that?

MR. KILBOURNE: Yes, I do. I think what's being proposed does not change the existing situation except with regard to the three identified statements that are to be signed. The burden of proof identified continues to be on the discipline committee with regard to everything else. I wonder if Lou Garfin might comment.

MR. LOU GARFIN: I think the basic responsibility is on the individual actuary himself to make that determination. If another actuary believes he's not qualified, then it becomes a matter for the committee on discipline to handle.

MR. CARPENTER: At that point, isn't it really a matter , Lou, of peer review rather than of proving guilt?

MR. KILBOURNE: The practical effect has been to have the burden fall more on the accuser than on the accused. This sounds appropriate at first, but suppose actuaries in general agree that actuary B is not qualified in a particular area, and actuary B says that he is. Why I think that the practical effect is to limit the discipline committee greatly by imposing an almost impossible burden of proof.

MR. LARRY MITCHELL: Now I don't have to prove that I'm qualified because there's a list which says I'm presumptively qualified. And now the burden changes slightly. Now when I think you're doing a lousy job, I can refer to the list...

MR. KILBOURNE: Remember presumption is only that.

MR. MITCHELL: I agree that presumption is only that, but I'm not quite sure who the public is. There are times when I think the public is being defined as different groups. The actuarial groups, for example, rather than the public of John Jones, XYZ Corporation, or somebody such as that.

MR. KILBOURNE: When I use public, I mean only the total public.

MR. MITCHELL: Well, only the total public doesn't care, I think. You have a designation of simple clearly defined areas. Pension plan liabilities, casualty claim reserves, life insurance policy reserves. I assume the pension statement referred to is schedule B. A lot of people who do pension work are not involved in this schedule and don't claim to be enrolled actuaries. You have life insurance actuaries who have to sign the casualty statement because his company is doing medical and disability insurance as a casualty insurer. Or you have, say, medical insurance which is obviously a life insurance line. Unless it happens to be for animals, in which case it goes into casualty miscellaneous, because that's the only place the insurance departments have for it. They couldn't put it in life miscellaneous, since life doesn't have a miscellaneous line. So you may have a life actuary who's better qualified to handle medical than a casualty actuary and you have, suddenly, gradations of definition, and I'm not quite sure why. I'm not quite sure why there's this reluctance to accept opinion A5. If you do not accept A5, then you find yourself in the position of saying you cannot do anything for the first time, which is ridiculous, but it's what it says. Because if you're not qualified to do it, you can't do it. And if you haven't previously demonstrated that you're qualified to do it, then you're never qualified to do it. I wonder if this is what the public really wants.

MR. KILBOURNE: The Committee report, as I understand the deliberations that went into it, speaks in a contrary way to some of that. It says that there is a public interest even though there is not, at least as far as I know, a mob armed with bricks and bats outside this door. We find that there is a public interest in these particular areas. We find further that it is possible to become qualified to act in a particular area, even a new area. Inclusion on the list means only that your peers within the Academy believe that you are qualified to some minimum extent. We're not saying that you're not qualified if you're not on the list, but just would expect you then to be able to establish that you are qualified.

MEMBER OF THE AUDIENCE: One Society committee did something that's unusual. It polled the membership and said, "What do you want us to do?" We got back an enormously high percentage of the membership responding. There were over 500 people who gave comments. And we discovered a lot of things that those of us on the Committee did not really know beforehand. And one of the things we discovered was a tremendous fear that the Society would become factionalized into specialties, that people could not move from life to pension to health, etc. This was an enormous fear, especially among the younger members of the Society who felt that they wanted to have their options open to them. They did not want to be designated or classified. This report is being presented to the Society Board later this month and I think that the work that your Committee is doing should have some input from the people you are attempting to designate or classify to find out exactly how they want to be designated or classified. I think, for example, the areas that you have mentioned, signing statements for reserves, exclude what is perhaps the greatest area of public interest, and that is monopolistic ratemaking. Rates are being made by actuaries to be used in workers' compensation or automobile insurance.

MR. KILBOURNE: I'd like to defer to George Morison, currently President of the Workers' Compensation Rating and Inspection Bureau and the Automobile Rating and Accident Prevention Bureau of the State of Massachusetts.

MR. MORISON: Sure, there's a great deal of public interest in rates and the way they deal with that in a place like Massachusetts is to conduct a public hearing. The current one has already lasted two weeks and will go for another two weeks starting tomorrow. That's an isolated instance of course. I'm not sure the members of Fred's Committee feel very strongly that we ought to identify people who are especially qualified to take part in rate setting. Some people think it would help, but it is seen to be too restrictive. They feel a concern that we not unnecessarily deprive anyone of his or her means of livelihood. It might be that only a small number of actuaries is qualified to put together a rate filing, but this would be considered by many people unduly restrictive.

MR. KILBOURNE: I am aware of public statements that have been made by actuaries who present themselves as experts expressing opinions as to workers' compensation and/or automobile insurance ratemaking who have no training whatsoever in the lines of insurance that are involved. They may have had generalized actuarial training in ratemaking, they may have had specific actuarial training in life insurance and health insurance premium rates, but they are speaking from considerable ignorance when it comes to workers' compensation or automobile insurance ratemaking and they are nonetheless presenting themselves as experts for this purpose. I think that is a matter of concern to our profession and to the public. A question in the back...

MEMBER OF THE AUDIENCE: The question is this. If this is in the public interest, I assume that list will include enrolled actuaries who are not in the Academy.

MR. KILBOURNE: The Academy list I would expect would include only Academy members.

MEMBER OF THE AUDIENCE: Well then how can this be something you're justifying as being in the public interest?

MR. KILBOURNE: I would consider it to be in the public interest to show members of the Academy who are enrolled actuaries to someone who may wish to come to the Academy to find out who the enrolled actuaries in our membership are. But, I have no problem with the Academy's list going beyond and including enrolled actuaries who are not members. I don't see any problem with that. Anna?

MS. ANNA RAPPAPORT: I'm deeply troubled by what I see as a basic conflict in the roles, in the multiple roles, of the Academy and I think that this discussion this morning and the questions in a way really brings it to light very well. Your Committee has basically, then, acted "to protect the public interest", but there's also a need to protect the interest of the Academy's members. Really maybe the Academy is here to protect the interest of the Academy's members. I don't think the Academy can effectively serve as a lobbying organization to protect the interests of actuaries with other professions and Government and then turn around and say, "Hey public, we're here to protect you!" In terms of the purposes of this list, as an aid to legislators and regulators, I think really what we're trying to do is to protect the interests of our members again. And that's very consistent with the lobbying role. In terms of, for example, the aid to the discipline committee, I think that's very dangerous from a legal point of view. I feel what we're doing by going around and telling the public we're trying to protect the public interest and at the same time lobbying is destroying our credibility on both sides. That's why I'm so concerned about it. We're coercing a lot of people into paying Academy dues, which is fine if we're acting in the public interest, but then if we are lobbying, we've taken away from people the option of being able to disagree with us effectively. So I see very fundamental problems with what your Committee is trying to do as it relates to what other activities of the Academy are trying to do and as it relates to the Academy as something that has viable public credibility.

MR. KILBOURNE: If the Academy is taking positions that are designed to further the interests of the profession, or the interests of the Academy, and those positions are contrary to the public interest, then we should stop. The positions of the Academy should be indeed to further the public interest and perhaps, secondarily, the interests of the Academy or the actuarial profession, but only if it is clear that this is not contrary to the public interest. I personally don't see any conflict between the recommendations of this Committee and the actions of the Academy.

MR. CARPENTER: I'm not so sure the primary interest of your report is to protect the public interest. I see it more as responding to the public interest. I think there's a big difference.

MR. MORISON: We anticipate that the NAIC will ask the Academy for a list of its members who are qualified to sign a casualty reserve opinion. We're anticipating a public need.

MEMBER OF THE AUDIENCE: I'd be very interested to hear a response from the panel on one of the issues that Larry raised. Question: In the area of casualty loss reserves, with respect to a life actuary who is qualified to do reserves for those lines which a casualty company can write and for which a life actuary is trained, will he be (A) not presumptively qualified; (B) presumptively qualified for casualty loss reserves in general, or (C) presumptively qualified for a subset of casualty reserves?

MR. MORISON: I think not (C) unless we are really nailed to the wall. We would like to keep this as simple as possible. I can't really answer your question because our Committee hasn't given an awful lot of thought yet to its assignment; however, I'll go ahead anyway. The Academy has gone on record, I think about two years ago, by a letter from Bob Winters saying hey, folks, this thing is off in the distance and it may happen one of these days and you might think about taking some examinations of the Casualty Actuarial Society if you want to sign those statements. I think at the time he suggested parts five, six and seven of our exams. So that's on the record already. We don't know yet what the qualification standards are going to be but the exams are there and that's certainly one way to go.

MEMBER OF THE AUDIENCE: May I just go on the record along with what Larry said. I feel personally that I'm well qualified to sign statments regarding the reserves for disability income insurance and medical insurance regardless of whether it is written by a casualty company or not and I know damn well I'm not qualified to sign anything with regard to automobile insurance or other personal lines. I would resent very strongly, oppose very strongly, any position of the Academy that said that if I were to work for a life insurance company that had a casualty insurance subsidiary in the medical area that I could not be on that list for the company unless I sat down and took a casualty exam.

MR. KILBOURNE: If I could respond to that, I certainly understand your point and I think you have a valid point and that the committee that George heads will need to address that. That will be important. I think the decision on qualification is going to be made ultimately outside our profession and it will be made by the insurance commissioner of State X. And the insurance commissioner of that state may well want to make provision for you as a Fellow of the Society of Actuaries who has had adequate training and experience in disability income reserving and who is clearly well qualified in that line. As to whether he wants to make provision in his acceptance of qualified loss reserve specialists for the distinction between different types of casualty lines, I suspect that it may well prove impracticable considering the thirty or so different lines of casualty insurance but rather just say that this person is or is not qualified to sign the yellow blank, period. But it may well be, especially given a shortage of qualified loss reserve specialists, that the NAIC might want to make that kind of distinction.

MR. CARPENTER: I'm not sure I follow Larry. I envision that certain insurance departments would think it a legitimate question to point to the Academy and say, we went along with qualifying MAAA's to sign the life blank. What's going on? Which of these MAAA's are qualified to sign the life blank anymore? I mean, they're the ones looking at these reserve statements that we're signing. And I think we owe that public, in this case the insurance commissioner, an answer to that question.

MR. MITCHELL: I disagree. Maybe we could list instead the specialty groups to which each actuary belongs. And maybe that's a much more reasonable approach, rather than to be a licensing body.

MR. KILBOURNE: This isn't a licensing body. The conclusion of the Committee was that we should indeed establish minimum standards of qualification for just these three statements, and that the Academy should be ready to provide lists of members who have met these presumptive qualifications. We have to conclude this. It's 12:15 and George has a plane to catch. Thank you very much.

(Applause.)

CONCURRENT SESSION
RISK CLASSIFICATION

Moderator: ROY R. ANDERSON. Panelists: LAWRENCE J. LATTO, BARTLEY L. MUNSON, MAVIS A. WALTERS*

MR. ROY R. ANDERSON: During the business session earlier this morning, retiring President Dale Gustafson described the issue of risk classification as the most serious matter before the actuarial profession at this time. I don't quite share that opinion. Risk classification is vitally important, but in my judgement, there is an even more important challenge that confronts our profession: That is, the need to recognize -- and to understand the implications of -- some of the deep and fundamental developments that are occurring in our society.

I'll mention two such developments -- first, economic inflation and, second, changes in societal values. I chose these two because it is they -- operating in combination -- that have precipitated the risk classification issue itself.

Let's consider first economic inflation. I doubt that our practices of risk classification would have become a major issue had it not been for inflation. For example, ten years ago, there were relatively few objections to the system of auto classification. Young men were being charged much higher rates -- but everyone know that young men caused more than their fair share of accidents. The same was true with premiums in the cities. But as inflation made its effects felt, the premiums for the high risk classes and the central cities became excessive. As a result, some insurance commissioners -- especially in some states with the highest premium levels -- came to the conclusion that some kind of action had to be taken. In this context, it was inflation that precipitated the risk classification issue.

Let's now consider changes in societal values. From another perspective, it could be claimed that the issue of risk classification emerged primarily because of the substantial changes that have been occurring in societal values.

What do I mean by societal values? These include a great range of diverse concepts. For example: they include the value that society places on the rights of individuals, such as the right to personal security and the right to privacy. They include the attitude the public has about institutions -- such as business, or the professions, or government. They include the value society places on a clean environment -- or the need to conserve natural resources for benefit of future generations. One of the most fundamental values that is now in a state of flux is society's attitude toward sex, toward the respective rights of men and women and toward the role of the nuclear family.

*Mr. Latto, not a member of the Academy, is an attorney with the firm of Shea & Gardner, Washington, D. C. Because Mr. Latto participated in the Concurrent Session on Independence of the Actuary, his paper on Risk Classification was presented by Steve Kellison.

This changing attitude with respect to the classification of risk by sex has impacted virtually all lines of insurance: auto insurance, health insurance, life insurance, the pension business -- and the underwriting of property insurance.

I have touched briefly on these two major societal developments -- economic inflation and changing values -- to underscore the point that the roots of the issue of risk classification go deep. It's only academic as to which of these forces precipitated the issue. But it is clear that there will be no quick and easy solutions to the problems of risk classification as the forces continue to impact the various lines of insurance -- because neither the forces of inflation nor changing societal values have run their course. And these forces themselves are a part of an even broader development: our society itself is in the process of an historicl transformation -- a period during which we are developing new beliefs, new values and new institutions.

Now to return to the risk classification issue itself. One lesson our committee on Risk Classification has learned during its first year-and-a-half of operation is that this issue is highly ecumenical in nature -- in several ways. First, it is impacting all of the various systems of insurance, from Governmental or Social Systems -- to Group or mass merchandising systems -- to the individual lines of Life and Health and Property and Casualty. Second, within each system of insurance, it is ecumenical in that it impacts all functions -- from marketing and product development, to underwriting and actuarial, to claim handling and general administration. You cannot study the workings of risk classification for any one of these functions without considering its impact on the others.

Lastly, and perhaps most importantly, risk classification is ecumenical in that it affects many different disciplines: the insurance professions, such as actuaries, underwriters and salesman; economists; academicians; consumerists; legislators and regulators; lawyers -- including the members of the judiciary.

I close on this note -- that the risk classification issue has become of increasing interest to other professions -- to underscore the fact that risk classification is no longer an arcane function that is the peculiar interest and province of the actuary. We must be prepared to listen to and to understand the viewpoints of those from other disciplines. And, hopefully, they will listen to us.

MS. MAVIS A. WALTERS: From the perspective of auto insurance, some of you may or may not know that this discussion centers primarily around the use of the rating variables of age, sex, marital status of drivers and to some extent, the use of geographical territories, that is, the place where the auto is garaged. These are the rating variables which are under attack. We've tried to take a look at the controversy from two perspectives; the first being that of consumers or the public, if you will. I'm not really sure that any of us know what the consumers or the general public thinks about this issue because I don't think that they totally understand it. We have, however, heard from those we might term the consumerist regulators. Their objections to the use of the traditional rating variables seem to be based on two concerns: first, the idea of using social stereotypes; that is, these folks seem to believe that insurers and actuaries have some preconceived notions of behavorial patterns and inherent traits that belong to groups of people and that we've never verified these notions, but simply continue to adhere to them.

The second objection seems to be that somehow it is inherently unfair to the individual in this day and age of civil rights and equal rights opportunities to apply averages to individuals and to consider individuals as members of a group rather than as unique persons. On the other hand, to insurers and to actuaries who perform a rate-making function for insurers, we see this issue as quite a serious challenge to the basic, fundamental principle upon which our pricing system is founded; namely, that price should be determined as a function of cost; a very basic, very elementary, fundamental economic principle as well as the foundation of actuarial pricing practices. A fair price in an actuarial and economic sense, in my opinion, is simply a price that is equal to the individual's expected costs plus a provision for expenses profit and contingencies. It follows from this that individuals with the same expected costs should pay the same premium. All individuals with different expected costs should pay different prices. In remarks which you will be hearing a little later, from Larry Latto, he makes the same point -- that we should, we need to, look at groups; but bear in mind the individuals. A key element in this concept that I just described of equals being treated equally and unequals, unequally, we call homogeneity, but an awfully important component is that you do have a homogeneous group, unless there is a clearly identifiable subset with different expected costs. I think too many of us too often lose sight of that element and it may come up later in the discussion.

So, let's take a closer look at the popular misconception of social stereotypes. Is it or is it not true that our auto classifications systems are, in fact, based on these social stereotypes? Quite simply, it is not true. The current variables that we use -- age, sex, and marital status -- are supported by extensive statistical studies, investigations and a wealth of data, both internal and external to the insurance industry. Those data are very well presented, in fact, in a rather extensive report of the advisory committee to the NAIC D(3) Subcommittee which was dated May 1978. The facts are, as presented in the report, that young drivers cost more to insure than older drivers. Young male drivers cost more to insure than young female drivers. And young single drivers cost more to insure than young married drivers. And, by the way, in that report, we also thoroughly analyzed the most commonly suggested alternatives to age, sex, and marital status; and we were able to demonstrate, I believe rather conclusively, that these substitutes were not as effective, not as predictive, as the ones that are currently being used. They simply will not work as substitutes. Specifically, I'm talking about the use of variables such as mileage, years licensed, and driving record. They simply do not explain as much variance as does the total system of risk classification which includes the use to some degree of some of these other variables.

There are some today, we might call them our critics, who will maintain that even though these rating variables are statistically supportable, they should still be rejected because they are neither causal nor controllable. Those of you who are familiar with the auto scene will pick up those words immediately. These seem to be the new catch words: causality and controllability. Those notions, which at first blush are noble sounding and rather simple, I believe are based on a fundamental misunderstanding of the purpose of risk classification as well as being without actuarial, economic, or logical foundation. The purpose of risk classification, in my opinion (and by the way, this discussion took place within the Committee, and I'm not sure that our Committee fully agreed with me, but as I see it), the fundamental purpose is to assist in the estimation of the individual's expected losses. That quantity is not directly knowable or measurable. I don't believe that there are many people who would question, at least from an actuarial sense, that a fair premium is equal to the individual's expected loss, plus a provision for expenses, profit, and contingency. However, again I emphasize the individual's expected loss is not, nor can it ever be, precisely know. It must be inferred from available information.

Some people believe that we can use an individual driver's past driving record alone for premium determination, but they incorrectly equate an individual's past losses with expected losses. That is, of course, fundamentally unsound. Further discussion will show the basic problems with this concept of causality. Consider first, having had a number of auto accidents in the past one, two, three, five years, what have you, doesn't cause a driver to have an accident in the current period. Auto accidents may be caused by any number of factors: bad weather, poorly maintained roadways, careless driving, defective autos, excessive drinking, bad luck, or any combination of these and other factors. In fact, the U.S. Department of Transporation in their study Causation, Culpability and Deterrence in Highway Crashes states, "driver responsibility for crashes is rarely unilateral and is often impossible to isolate from the multiplicity of cause involved in almost any crash." Obviously then, past losses and past claims experience alone are not and can never be a precise measure of an individual's true expected losses.

Secondly, in trying to determine the individual's expected losses, remember that any individual, over a period of time, may have and, in fact, probably does have, a changing distribution of expected losses so that even observing one individual over a significantly long period of time, if that were possible (let's say ten or fifteen years), would still not be a valid means of estimating that individual's expected losses. Since, however, a single individual's expected loss cannot be directly known, some people suggest that insurers ignore all other evidence and charge all drivers equally. I don't know how popular that would be in the real world, but I believe that the fundamental principles of insurance equity which are consistent with the regulatory requirements that rates not be unfairly discriminatory require that we not ignore the strong evidence which demonstrates that some drivers are more likely to have accidents than others.

I believe it is through the use of classifications which estimate the individual's expected loss by the observation of similar individuals over a reasonably short period of time that we do the best possible job for the individuals. Placing like drivers into risk classes on the basis of their common characteristics is clearly more equitable than totally ignoring all individual differences and charging all insureds the same amount. The current risk classification process in auto insurance uses variables which statistically correlate with future accident involvement. I believe this is far more objective, more scientific than simple trying to determine causality.

There's one other example that is given by Dr. Plotkin which also speaks to the causality argument and I think it's a very good one. Take a look at smoking and the relationship between smoking and a variety of illnesses. It is certainly true, as spokesmen and P.R. people for the tobacco industry point out, that the precise physiological mechanisms linking smoking to death and illnesses are not fully known, yet no scientist, physician, or responsible person can or should ignore the overwhelming statistical evidence in providing personal or professional advice or in making personal decisions. Again, if you think of the objection to applying averages to individuals, think of the smoking analogy: not every smoker will die prematurely, or develop some serious illness; but remember that the statistical evidence remains overwhelming for the group of smokers versus non-smokers. I don't believe that one can or should ignore that evidence.

I have the same difficulty with the concept of controllability. It sounds so simple: do not charge me more because of a factor that I cannot control. Well, I will simply point out that that standard is a very difficult one, and we use the example of age in life insurance. Obviously, it's essential, yet it's not controllable.

So, where are we? I believe that the current private passenger auto classification variables are valid from an actuarial and economic perspective. Classifying drivers on the basis of age, sex, marital status, and place of garaging an auto is a good means statistically of separating those drivers into homogeneous risk classes so that we can predict, with some confidence, the likely losses for those groups. This then means that we can price those risks fairly in an economic and actuarial sense so that the higher risk drivers pay more than those of lower risk.

Where are we going? I don't know for sure, but I believe strongly before any changes are made in the name of public policy or for social considerations, that it is extremely important that the economic consequences be understood before public policy is made and that those consequences be accepted. Two important points need to be understood: eliminating some or all of the current variables which seem to give people some problems, with or without substitutes, will not lower the overall cost -- the overall need for premiums to cover the expected losses in auto insurance or all drivers in a state. It simply redistributes that premium, and many critics seem to forget that. Also, substitute variables will not solve the problem of high rates for some drivers. In fact, to the extent that substitute variables are effective in identifying the high risk drivers, the price disparities are going to continue to exist, so that problem won't be solved. And finally, if the current predicted variables are eliminated before other substitutes can be found which measure the differences among these drivers (the high risk versus the low risk) as well or better than the current ones, then significant governmental intervention will be necessary to alleviate the inevitable market consequences.

MR. LAWRENCE J. LATTO: When I agreed to participate in this panel discussion I had the metaphorical "little learning" about the subject, but I was not really aware of the dangerous thing I had done to accept. What I had in mind at the time was an elaboration of the thesis that actuaries had not wholly succeeded in persuading the public, legislators and regulators of the soundness of their views about the role of risk classification in various contexts, in part because, although the subject called primarily for the expertise of actuaries, it also required the expertise of lawyers and economists. Of course, all three professions have participated actively in the debate. Too often, however, this has been done without the prior consultations and exchange of views that is essential to the most effective presentation. And on more than one occasion I have seen papers written by actuaries in which, consciously or unconsciously, the author has turned to the practice of law. While I would never contend that lawyers are the only ones that have insight into difficult legal issues, they have long dealt with concepts of "fairness," "equity," and "discrimination," and I am sure that a happy combination of the expertise of the actuary and the lawyer would provide a more persuasive cause than the skills of either.

I have now read extensively in this area over the past months and learned enough to be aware that there has been a tremendous amount of thoughtful, careful, scholarly consideration of the issues and that much of the foolishness and inconsistencies that have occasionally characterized the debate over the use of sex in connection with the classification of risks has been on the part of non-actuaries who have not even tried to understand the arguments that have been advanced. This does not mean, however, that actuaries -- or, at least, some actuaries -- are without blemish. Assuming, therefore, that one of the objects of this discussion is to explore the ways in which the profession can make an even better case, I have decided that, instead of attempting any analysis or synthesis, from a lawyer's point of view, of the current issues in this area, I would offer a number of essentially unrelated examples of instances in which I believe actuaries -- or, at least, some actuaries -- have fallen into error. To save time, I propose to be blunt and undiplomatic, and in order to make a point, I may occasionally be guilty of overstatement. My object is not to persuade but to stimulate discussion.

A. Has the Profession Shown the Impartiality and Objectivity It Professes?

In the August 1977 report of the Academy Task Force on Risk Classification, a key recommendation was that a Task Force be established which "without assuming an adversary or an advocacy position," would "determine the best way to communicate to legislatures, lawyers, jurists and the public at large, the consequences of any effort to limit or prohibit the classification process." Of course, there is a certain inconsistency in this statement; it was surely not envisioned that the Academy should not oppose inappropriate restrictions upon the risk classification processes. A major recommendation of the report, however, seemed to be that when responsible questions were raised about aspects of the risk classification process, they should be responded to with patience and understanding and, above all, with the recognition that many advances, in scientific and other scholarly pursuits, have often been made or stimulated by "laymen", by persons who did not have the requisite professional qualifications. Nevertheless, throughout the Task Force report itself, and in many papers I have seen which seek to establish the validity of gender as a classification, there is an unfortunate lack of patience, a sense of annoyance and irritation, over what the writer perceives as a stubborn refusal on the part of the uninformed to accept the evident correctness and necessity of employing this factor in classifying risks. The promise held out in the Task Force report is not, I fear, being adequately met. And this is unfortunate because it not only deprives the public of the education that the actuarial profession can offer, but it also weakens the case presented on behalf of the profession.

All of us, I believe, men and women alike, must admit that, as our consciousnesses have been raised, we have gained helpful insights into the errors of our former behavior. We have unthinkingly and unfairly attributed to individuals, characteristics that may have been accurate of a substantial majority of the group to which those individuals belonged. We now perceive --as many of us did not ten years ago--that it is unfair to deny a woman, who has all the qualifications, the opportunity to compete for a job, or for a place on a team, not only when women, generally, are as well qualified as men, generally, but also when it is true that only 1 out of 10 women do have the necessary qualifications. We have a deeper understanding of the dignity and uniqueness of the individual , of the desirability of treating people, so far as possible, on the basis only of characteristics relevant to them individually, rather than on the basis of characteristics that many or even most of them may share with a readily identifiable group.

It is hardly surprising that persons who have in other contexts successfully established the error of treating women as members of a class rather than as individuals should insist that there must be something wrong in treating them as a class for risk classification purposes. And, I suppose, it is not surprising to find that actuaries, who have spent much of their professional lives in identifying valid classifications in order to treat persons as members of a class rather than as individuals for the very same objective of treating persons as fairly as possible, should resent the assertion that they are guilty of invidious discrimination. This is particularly so when the assertions are based upon principles which, if applied generally, amount to attacks not only on the validity of a particular classification but upon the risk classification process itself.

Having said this, I think it is incumbent upon the actuarial profession, made up as it is of the more mature, more intelligent and better informed of the persons involved in the debate, to consider sympathetically the arguments that have been advanced to recognize that they are not wholly without merit. I think that the profession must avoid extravagant rhetoric -- and I have encountered predictions of chaos and devastation and of an end to the system of free enterprise that have been far from adequately supported -- in favor of a reasoned explanation of why and how valid risk classification serves the objective of being fair to individuals as well as to classes of individuals.

This point deserves to be emphasized. I believe that many defenders of the present system of risk classification have limited themselves to arguing that the focus <u>must</u> be upon classes rather than individuals, and this has led them into overstatement that is not wholly accurate and also unnecessary to a convincing defense of the need generally for risk classification and for the validity in particular of classification on the basis of sex. Which leads me to my next topic.

B. <u>"Actuarial Equity"</u>

I am glad to start with the axiom -- to use , from among several equally acceptable phrasings, one in the 1977 Task Force Report -- that "a particular group should be subdivided by class for determining the amount of price of benefit so that the expected experience for each person in a class is close to the expected averages for the class as a whole." I am not so sure I can agree with the very next sentence. "Hence equitable benefits are paid within each class while different but equitable benefits are paid to other classes."

I do not believe that this conclusion is sufficiently self-evident to make unnecessary a deeper explanation, in arithmetical terms if at all possible, of why <u>all</u> the members of a specific class, particularly one that intuitively does <u>not</u> appear to be subject to a higher risk than the complementary class, should appropriately be asked to contribute a commensurately higher portion of the total cost. One stumbling point may be the unfortunate adoption of the term "actuarial equity." Everyone in this room is fully aware of the fact that every class that can be feasibly employed in the real world must necessarily include some persons who are not subject to the higher risk that is characteristic of a majority of the other persons in the class. It is troublesome to say to those "low-risk" persons, in the light of our new, enhanced concern for the Individual, that it is "equitable" for them to pay a higher premium. My four grandparents lived a total of 380 years. My parents are still alive and well and have now lived 172 years. I think it is grossly inequitable for me to pay the same amount for life insurance as my healthy neighbor whose ancestors were short-lived. I would be less offended if I were told that it was "actuarially sound" rather than "actuarially equitable" for me to pay the same premium and, more important, if it were carefully explained to me why the objective of being fair to each and every person was beyond our reach.

The advantage that I see in this kind of explanation is that it shows a willingness to look at the individual within a group as well as at the group. While I suggest below that the Manhart case had absolutely nothing to do with risk classification, it is important to recognize that at the center of the Supreme Court's decision in that case was a strong preference to treat persons as individuals rather than as part of a class whose characteristics, while generally applicable to most members of the class, are not in fact applicable to all members. The actuarial profession should not underestimate the attractiveness of this argument to those who have not thought carefully about its consequences. In the extreme, it would permit risk classification only if perfect risk categories could be developed, which we know to be an impossible task.

I think accordingly, more should be done to provide simple and easily understood charts and tables comparing the results -- under a hypothetical or actual set of facts -- of using a particular classification with the results of not using it. This would provide a more comprehensible showing of the nature and extent of the disadvantage imposed upon the low-risk individuals who must, unfortunately, be placed in a high-risk class, so that it can be compared with the somewhat smaller disadvantage that would be imposed upon a much larger number of individuals if use of the class is proscribed. This would enable policy makers to make more rational decisions about whether other non-actuarial considerations that make the use of the class socially or politically undesirable are sufficiently weighty to carry the day. To illustrate what I mean, I have attached to this paper a chart, which is based upon one found at page 226 of the May 1979 report of the NAIC D(3) Advisory Committee, that tries to make such an explanation. I submit that this kind of thing needs to be done more often and with more helpful narrative explanation than is found in the Advisory Committee report. In any classification that the actuarial profession could adopt, some disadvantage is going to be imposed upon the low risk individuals who must, unfortunately, be placed in a high-risk class. But at the same time this process does provide substantial benefits to the vast majority of those persons obtaining insurance coverage. The problem is that the non-actuarial participants in the dialogue on risk classification do not seem to understand fully the nature and extent of this trade-off.

C. Establishing the Validity of a Particular Classification

While actuaries know that the validity of particular classifications requires that certain standards be met -- homogeneity, practicality, absence of ambiguity, to name a few -- much of what I have seen written for popular consumption, or even for policy makers, has neglected to disclose candidly that we are working in an area where there is no escape from the fact that it is never possible to accumulate all the relevant data and that it is better to employ the reliable data that is available rather than reject it because it is not wholly complete. The case would be stronger, I believe, if the inherent deficiencies and inexactitudes of the process were fully exposed and an explanation given of why the use of available classifications is nonetheless sound, rather than leaving the reader with a nagging discomfort that she is not being told the whole story.

In many of the papers and comments I have seen, the assertion appears to be made that if empirical studies show that a readily identifiable class will receive a larger share of the total benefits than the complementary class, then if "actuarial equity" is to be achieved, it is always appropriate to require the first class to pay a larger premium. Sometimes. there are qualifying phrases added but so briefly as not to impress their significance upon the lay reader. Moreover, some of those papers, or at least it seems that way to me, resist the suggestion that if several classifications satisfy this test, some may be preferred over the others, and more important, that more intensive analysis and the accumulation of more data may show that it is actually unsound to use a classification as a rating factor even though it meets this test.

The problem raised by this attitude on the part of some actuaries is shown again in the Supreme Court's opinion in the Manhart case. There the majority opinion notes that "(s)eparate mortality tables are easily interpreted as reflecting innate differences between the sexes; but a significant part of the longevity differential may be explained by the social fact that men are heavier smokers than women." What this suggests is a belief by the Court that gender is merely a surrogate for other factors which, if they could feasibly be employed, would make unnecessary, and even improper, classification on the basis of sex.

Now there may be a number of you who at this very moment are running quickly in your mind through a long list of arguments that explain why this belief is erroneous. But the point is that judges and other social groups do not fully understand these arguments and can legitimately ask the question why the actuarial profession cannot identify the factors for which gender is a surrogate and use those factors in the risk classification process. The brief which the Academy and the Society filed in the Manhart case, despite the deficiencies noted below, was an initial effort to educate a broader public in these issues. More needs to be done. And these efforts must include some real consideration and soul-searching by the actuarial profession to insure that in fact some of the alternative approaches that are now being suggested might not be superior even from an actuarial standpoint.

Let me illustrate by describing a hypothetical example of the kind that I think the actuarial profession should be providing to the public. I am aware that the assumptions employed below are contrary to fact, but they serve to pose the question, in terms of the principle involved, of whether a classification that correlates with incidence of loss may still be invalid.

Suppose first that the only data available with respect to 20,000 policyholders are those shown in Table 1.

Table 1

Class	Expected Aggregate Claims
10,000 Men	$1,250,000
10,000 Women	$ 750,000

At this point all should agree that it is actuarially sound for men to pay a pure premium of $125 and women a pure premium of $75.

Suppose the additional information shown in Table 2 becomes available.

Table 2

Class	Expected Aggregate Claims
Persons who drive more than 10,000 miles/year (8000 men, 2000 women)	$1,350,000
Persons who drive less than 10,000 miles/year (2000 men, 8000 women)	$650,000

If these data are all that are available, the appropriate pure premiums would be as follows:

Men who drive more than 10,000 miles	Mm	$138.30
Men who drive less than 10,000 miles	Ml	$ 71.80
Women who drive more than 10,000 miles	Wm	$121.80
Women who drive less than 10,000 miles	Wl	$ 63.30

Suppose, however, that instead of the data shown in Table 2 the following data is obtained:

Table 3

Class	Expected Aggregate Loss
Persons who drive more than 10,000 miles/year (8,000 men, 2000 women)	$1,415,000
Persons who drive less than 10,000 miles/year (2,000 men, 8,000 women)	$ 585,000

Now, if apparently bizarre results are to be avoided, the Appropriate pure premiums should be:

Mm	$141.5625
Ml	$ 58.75
Wm	$141.25
Wl	$ 58.4375

At this point, many persons would say, intuitively, that a complete explanation for the data in Table 1 has been found. Since experience and common sense tell us that persons who drive more miles have a greater potential to be involved in accidents, it can now be said, on the basis of the data we have in hand, that it would be grossly unfair and inequitable to the 2000 men who drive less than 10,000 miles per year to use sex as a rating factor to any extent whatever. Perhaps this would not be sound, and the additional data establish only that the classifications of men and women are not homogeneous; that there is a subset of each with significantly different expected losses than the rest of the class. It may be that we have not estblished that classification on the basis of sex is necessarily unsound; that more data relating to other factors, such as age or marital status, might once again make it appropriate to classify on the basis of sex. But upon the assumption that our knowledge is limited to the data in Tables 1 and 3, it seems plainly unsound to continue to use sex as a rating factor even though the data in Table I remain wholly accurate.

There is nothing in this simple demonstration that is novel or instructive to actuaries. In submissions directed to non-actuaries, however, the argument too often includes an assertion that a rating variable is always appropriate unless it can be demonstrated that it does not differentiate among classes based upon expected costs. It would be more persuasive, I submit, if the explanation went a little deeper and included a candid admission that it was possible that such a variable <u>could</u> be inappropriate but that efforts had been made to identify more satisfactory variables and that those efforts had been unsucessful. The explanation, to be complete, would then have to continue in the manner similar to that shown in Appendix A, so that it would not only be shown that prohibiting a valid rating variable in favor of one that is less satisfactory introduces a disparity between the cost and prices applicable to the prohibited class, but also <u>how</u> the prohibition affects both the persons who are properly classified <u>and</u> those who, while falling within the class, actually exhibit different risks than the majority.

The Report of the D(3) Advisory Committee of May 1979 comes closest to the kind of analysis I suggest is desirable, but even that report frequently is written in conclusory terms that may leave its message not fully comprehensible even to the more knowledgeable audience to which it is addressed.

D. <u>The Need for More Detailed Submissions</u>

I am aware that the constraints of inadequate time and resources, applicable particularly to actuaries who prepare papers on behalf of professional associations in their limited spare time, are severe. This results in shorter, more tightly written and hence less understandable papers. But if the effort to persuade is to be made at all, a way must be found to do it with the depth and length necessary to carry the message adequately to the reader.

I believe that three recent submissions, one of which I feel free to criticize since I participated actively in its preparation, would have been more effective if they had been less conclusory. They are (i) the Statement of the Risk Classification Committee of the Academy on the Labor Department's proposed amendment to its Interpretive Bulletin abandoning its equal benefits or equal contribution rule in favor of an equal benefits requirement; (ii) the Committee's Statement to the NAIC (D3) Subcommittee on June 4, 1979; and (iii) the brief <u>amicus</u> filed in the <u>Manhart</u> case by the Academy and the Society of Actuaries. In each case preparation of the comment or the brief was undertaken too close to the date, but that is one of the failures that can be easily remedied in the future. It is an unfortunate fact of life that legislators, regulators and particularly judges are often intimidated by anything that looks like mathematics. They must be taken tenderly by the hand and led patiently into a full understanding of the applicable concepts. The Manhart amicus brief, for example, asserted that prohibiting differences in pension benefits on the basis of sex under trusteed plans would not cause overwhelming difficulties but that "monumental" and almost insuperable problems would be created for insured plans. Since the necessary details of what these problems were and how they would be created were not adequately furnished (a deficiency for which I must assume major responsibility), the assertion could not have been very persuasive to judges unfamiliar with the subject. Similarly, the two comments by the Academy's Risk Classification Committee would, I believe, have been far more persuasive if they had been expanded to explain why the conclusions expressed were sound. The Department of Labor's statement of the reasons supporting its proposed changes was distressingly superficial, and a detailed rebuttal, which evidently was needed, was not offered by the persons who were best qualified to do so.

E. Pensions, Title VII and Equal Pay

Let me close with some observations in this area. First, I wonder whether the risk classification process is involved at all. The questions, rather, involve the appropriate design of retirement programs, the application of actuarial expertise in that design and in the operation of the plans, and the essentially legal questions of what is meant by "equal pay" and "discrimination in compensation on the basis of sex" in this context. These are legal questions, because they are going to be answered by judges, employing the tools of their trade -- determining the "intent" of Congress by resorting to legislative history, interpreting language in the light of legislative purpose and reliance upon precedent and analogy. Analytically, the principles of risk classification and the reasons why the process is an integral part of the business of insurance are wholly irrelevant to these issues. To be sure, if it is suggested that insurers should employ, or be required to employ, unisex tables, then the validity of risk classification becomes highly relevant. But it is wholly appropriate to insist that Title VII and the Equal Pay Act must be interpreted, at least in 1979 and 1980, upon the assumption, which can be accepted without having to defend its validity, that insurance companies may lawfully charge and do charge different Annuity rates for men and women. Employers do not classify risks. They decide how to fund their plans and try to comply with the law. That does not mean, however, that actuaries cannot be enormously helpful in helping judges to understand the concepts that are critically relevant to the issue of what is meant by "discrimination in compensation" in this context. And, as an aside, it might be noted that however these questions are decided, the maintenance and operation of pension plans will not be possible without actuaries.

In this area also I find that the help contributed by actuaries is often incomplete and for the reason inadequate. I have seen vigorous explanation of why it is "unfair" and "inequitable" to ask employers who have adopted defined contribution plans to increase their contributions so as to equalize benefits for men and women. But the actuarial profession has been notabley reluctant about making what seems to me an equally and perhaps more persuasive argument, namely that the defined benefit plans of thousands of significant corporations are, if Manhart principles are rigidly applied, in violation of Title VII because employers contribute more for women employees than for similarly situated men. Indeed, I believe a strong case can be made that, even if the Manhart approach of focussing on the individual rather than on the group is followed, there is an apparent invidious discrimination against men employees.

The argument would run that any individual employee's compensation is made up of the take-home pay, amounts withheld and the promise that if certain contigencies are met a pension will be paid in the future. The latter element of the compensation has a definite ascertainable present market value. It is capable of being assigned. It is often valued for tax and other purposes. The amount is greater for a woman than it is for a similarly situated male. This looks like unequal "compensation" to me, without getting into the group versus individual debate. Yet I wonder whether judges would be willng to find that Congress intended to declare that these popular, widely adopted defined benefit plans were all in violation of law. If I am right, then, in principle, the Manhart and the recent Sprit cases are wrongly decided.

Still, a reconciliation may be possible. Lawyers are fond of quoting Justice Holmes' famous remark: "The life of the law has not been logic but experience." The answer may lie in an interpretation of the Act that adopts a more refined version of the Department of Labor's "Equal contribution or equal benefits" rule. Since the focus and structure of defined-benefit plans make benefits the significant aspect of such plans, they should be held valid whenever the benefits are equal for men and women. Defined contribution plans, for similar reasons, should be held valid only when employer contributions do not depend upon the sex of the employees. How elections to obtain different forms of benefits under both types of plans should be treated under Title VII will require further analysis and consideration, and the answers may be different for defined benefit and defined contribution plans. This will also be necessary for plans funded partially with life insurance policies and for certain types of "cafeteria" plans. Medical plans would be treated in the same way as defined benefit plans. It seems to me most unlikely that any court would uphold, as consistent with Title VII, a medical that excluded coverage only for uterine cancer, or that set maximum benefits for women at eleven percent less than the maximum for men, for the expressed purpose of making the aggregate cost of the benefits for women equal to that for men -- or, arguabley, to make the value of the medical coverage provided to any given woman employee equal to that provided for a similarly situated man.

My point here is that determining whether there is discrimination in compensation, in the case of both defined benefit and defined contribution plans, by ascertaining, in every case, whether the present value of all the compensation received by a male employee and a similarly situated woman employee is substantially the same would lead to a major upheaval in the manner in which pensions are provided in this country. The same result would follow from a requirement that all plans must provide equal monthly benefits under all circumstances. The sensible solution can be found only by abandoning the effort to find a principle that can be uniformly applied and recognizing that Congress probably did not intend to make a revolutionary change in the manner in which private pensions have been provided in this country but may well have intended to make unlawful differences in treatment that were highly visible, where the impact was direct and immediate, and which were not central to the retirement plan. On this analysis Manhart was correctly decided, even though it would not have been under the old DOL "equal-or" rule. A non-contributory defined benefit plan that provided identical pensions is valid. So, too, would be a contributory plan providing for equal employee contributions. In that case a plan calling for unequal employee contributions is not lawful. If logic is not to be abandoned entirely, only bent a little, it is necessary to invalidate defined benefit plans that ask women to contribute more than men.

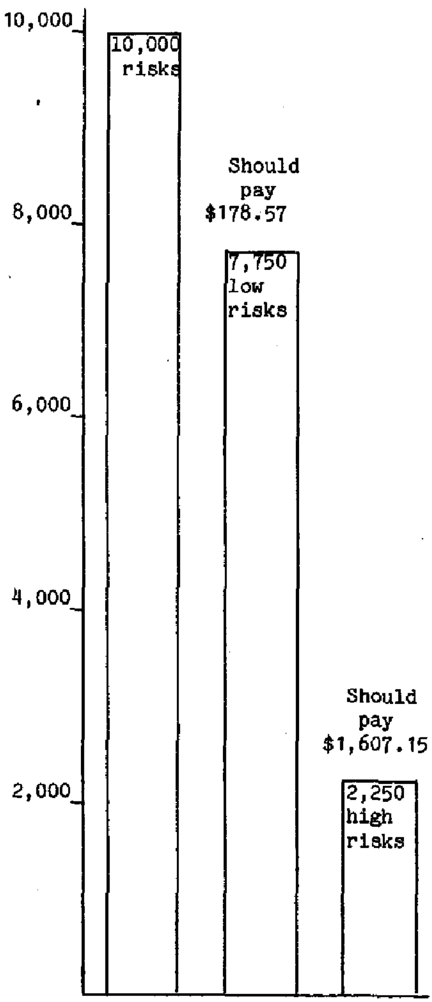
This, of course, is only the beginning of a comprehensive analysis, but I think it is worth exploring. I recommend that those of you who have the time consider it further and determine whether it will withstand closer analysis. If it does, it may not be too late to inject a proposal of this kind into the continuing public debate.

Appendix A

Assumptions

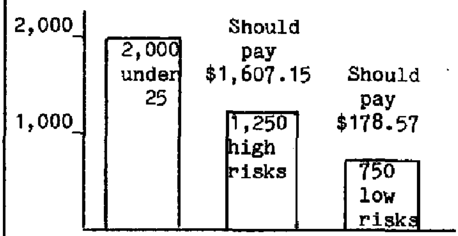
1) 10,000 insureds; total cost $5 million.
2) 2,000 are men under 25 years of age; made up of 1,250 high-risk drivers and 750 low-risk drivers, but we cannot identify which persons fall into each category.
3) The remaining 8,000 include 7,000 low-risk and 1,000 high-risk drivers.
4) The men under 25, as a group, produce three times the cost per capita as the "all others" group. Thus, total cost for men under 25 is $2,142,860.

1. One Combined Class



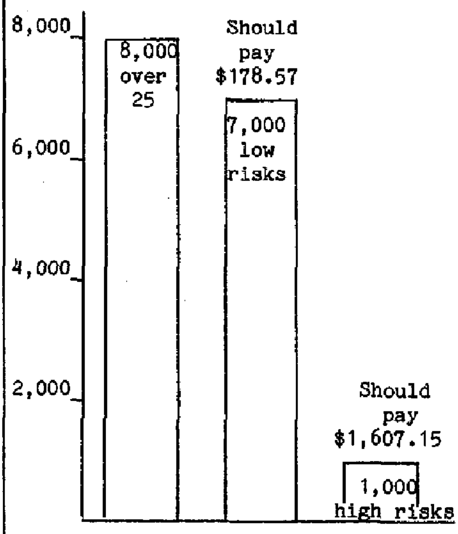
Class Average Rate $500.00/yr.

2. High-rated class - men under 25



Class Average Rate $1071.43/yr.

3. Low-Rated Class - All Others



Class Average Rate $357.14/yr.

MR. BARTLEY MUNSON: I would like to quickly cover four topics with you. One is the Committee of the Academy that's functioning with this subject. Secondly, two hot items that you've heard of, just to share a few insights on those with you. Thirdly, to talk briefly about our Statement of Principles. And then, fourth, some concluding comments.

The Committee has been functioning for something over a year with Roy as Chairman. We have five subcommittees, along product lines: one for auto, which is chaired by Mavis; one for health; one for life; one for pensions; and one for property insurance. There are a total of thirty-four actuaries in this structure, twelve on the parent Committee and twenty-two additional members of the subcommittees. It is an ecumenical effort, as Roy indicated; we represent all six actuarial bodies. All of us, of course, are members of the Academy. We, as an interesting footnote maybe, represent fifty-five memberships in the six various actuarial organizations. One thing we have in common, I think, from what I've seen in my brief service, is the desire to work. We are meeting monthly. A couple of items I'll talk about in a second are consuming a great deal of effort. We've had a great deal of support from Steve, as Roy indicated, and I would also want to identify the great amount of help we're receiving from the Academy's General Counsel, Bill Hager. Bill was only recently hired by the Academy and, particularly on a task such as ours, is already proving a valuable addition to staff.

I'd like now to speak of the two particularly hot items before us. One is the bundle of three alleged sex discrimmination cases that are in the federal courts. You've heard the names, but I think I should mention a couple of things about them.

You recognize the names of Spirt vs TIAA/CREF/Long Island University. A second case is EEOC vs TIAA/CREF/Colby College. And the third would be Peters vs TIAA/CREF/Wayne State. These are all quite similar, at least for discussion this morning, in that they are charges against TIAA/CREF and the respective university for providing equal contributions but different periodic pension benefits to males and females, and this is alleged to be improper under Title VII of the 1964 Civil Rights Act.

In Spirt vs Long Island, the judge ruled on August 9th in favor of the plaintiffs, stating that CREF can no longer use sex-based mortality tables and that Long Island University can no longer require its employees to contribute to any pension plan which uses sex-based tables. Anybody retiring after May 1st cannot retire with benefits based on that type of table. The defendents will definitely be appealing to the Federal Appellate Court.

The second case, Colby College, was begun in 1975 when EEOC filed their complaint. The district court found for the defendent Colby College. The First Circuit Court of Appeals, however, at the time when the Supreme Court decision on Manhart came down, remanded the Colby Collge case to the district court, saying we think you ought to take another look at this. It is scheduled for a two week trial starting tomorrow, October 9th.

In the third case, Peters vs Wayne State, the Federal District Court of Michigan, Southern division, has heard the case some time ago and we are awaiting the ruling.

We might note in passing that members of the American Academy of Actuaries appeared as expert witnesses in the Wayne State case. It's interesting to keep in mind that two members of the Academy appeared for the plaintiff and one member of the Academy appeared as an expert witness for the defense. The point for us to remember is that in anything we do, as a committee or as a profession, we must recognize the fact that we have people in our profession who are testiffying as experts on both sides of this issue.

In summary, we have one case being appealed to the Appellate level, one going to trial tomorrow and one awaiting the judge's decision. The committee has decided to file an amicus brief, either at the Appellate Court level or the Supreme Court level. It is quite likely that one of these cases will ultimately get to the Supreme Court. Our purpose simply is (and I say "simply" in quotes) to educate the court on the principles of risk classification and on the implications of the judge's possible decision. We need to be ready by early next year; we don't know the dates of that yet. The Committee and Bill Hager in our Washington office are hard at work trying to develop our amicus brief. We just decided at our meeting a week ago to file this brief, so we don't have anything to share with you on that yet.

The second hot item is the HR 1100 Dingell Bill. It was introduced January 15th in the Congress by Representative Dingell from Michigan. It was covered in the special Academy Newsletter Supplement last July. It was reintroduced August 1st with 61 additional sponsors, so there are 62 people in the House who are willing to put their name on this bill. It's been referred to the Committee on Interstate and Foreign Commerce and specifically its Subcommittee on Consumer Protection, headed by Representative Scheuer of New York, who is one of the co-sponsors of the bill. There is no bill yet on the Senate side.

The bill would prohibit discrimination in insurance on the basis of race, color, religion, national origin or sex, the latter being a significant addition to what already exist as prohibitions in many states. And secondly, very disturbingly, it would prohibit any insurance from using those factors to discriminate on premiums of benefits for any insurance already in force; that is, it has a retrospective reach to it, which is an interesting development.

The Subcommittee intends to have hearings this year. Our Committee decided that we will prepare testimony and testify at those hearings. The member of the committee who has been assigned and willing to take that initial stab at the draft is Charlie Hewitt, sitting here in the front of the room and still smiling in spite of the big challenge that represents. We have indications from Representative Scheuer's staff that they strongly desire factual input from the actuarial profession.

We recognize in both these issues, the pension court cases and the Dingell Bill, that there are difficulties and dangers and it's a careful road we must walk. But the Committee believes, and the Board agreed at its most recent Board meeting, that if our profession has a purpose and if our Committee has a purpose -- and we think we do, of course -- this is the place we must stand up and say something in a careful, constructive, and properly structured way. We should not sit silently on the sidelines.

The third item I want to touch on is the Statement of Principles. You will have it very soon. It is in the Academy office, being printed right now, and with some luck it will be mailed to you in a week or two. We had hoped that it would be to you prior to this meeting, but it hasn't been an easy process, as Roy indicated. It's gone through seven or eight drafts. We hope you will chew on it very actively. It's an exposure draft for the members of the Academy, and each page is labeled in exactly that fashion. We truly want the input of all the actuarial profession. Some have warned me that we'll be sorry we asked for that because we'll have more than we can handle. That would be a very pleasant problem and we invite that very sincerely.

My concluding remarks have two parts. One is the very brief but sincere tip of the hat to Roy; I'm saying it now because I'm not sure he'll give me the floor later. He has been serving as Chairman since the creation of this Committee and understandably sought a Vice Chairman with the understanding that his role might cease as of the Board meeting today.

My belief, and certainly those of the Committee members who have served in this a lot longer than I, is that we owe him a sincere vote of thanks. He's an FSA who, interestingly, has devoted half of his career to property and liability actuarial work. We'll miss his foresight and his feelng for the environment in which we're functioning. Actuaries would make a grave mistake if we think we have all the answers and if we make the mistake of talking only to ourselves, in our own language; and I think Roy has brought that warning to us very thoroughly. We'll miss his direct involvement, but I'm glad to say that he's promised to read our minutes and our Committee mailings and he'll feel free to comment on those to the Committee as time permits.

My second final comment is merely to indicate that the Board, as you heard this morning, gives our effort visibility, much support and a label of importance. I view that as good news and bad news. The good news, of course, is that we appreciate the Academy Board support and we need it; we appreciate that very sincerely. The bad news, I think, is that we may fail to satisfy the Board or others who would expect us to have a nice, tidy, definitive piece of work done at some point in time. I personally suspect that won't be possible. That doesn't mean that we won't continue to try with your help to get there, and we'll need all the help you can give us.

STATEMENTS OF THE ACADEMY RELEASED IN 1979

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., 1979-1 was the first statement released during 1979. 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 1979 STATEMENTS

Index Code: 1979-1

To: Advisory Council on Social Security

Date: January 5, 1979

Length: 37 pages beginning on page 56

Concerning: Social Security

Background: This statement was presented at a public hearing of the Advisory Council on Social Security. The statement specifically addressed 11 questions on which the Advisory Council was soliciting comments.

Drafters: The Committee on Social Insurance, chaired by Robert F. Link.

Index Code: 1979-2

To: Financial Accounting Standards Board

Date: January 9, 1979

Length: 2 pages beginning on page 93

Concerning: Establishment of accounting standards

Background: This statement was submitted to the FASB in response to a "Request for Written Comments on an FASB Proposal for Dealing with Industry Accounting Matters and Accounting Questions of Limited Application" dated November 7, 1978. This proposal would transfer from the AICPA to the FASB authority for standard setting on industry accounting matters and accounting questions of limited application. The FASB has possessed general standard-setting authority since its inception in 1973, but the AICPA did retain limited standard-setting authority in the areas mentioned above. This proposal would also transfer these to the FASB.

Drafters: The Committee on Financial Reporting Principles, chaired by Richard S. Robertson.

Index Code: 1979-3

To: American Institute of Certified Public Accountants

Date: January 16, 1979

Length: 24 pages beginning on page 95

Concerning: Using the work of a specialist

Background: This statement was presented to the AICPA Task Force on Using the Work of Specialists in connection with the AICPA Statement on Auditing Standards No. 11 (SAS No. 11) entitled "Using the Work of a Specialist." The AICPA Task Force was reexamining SAS No. 11 for possible revision and had invited comment from the Academy.

Drafters: A special task force, chaired by Robert H. McMillen.

Index Code: 1979-4

To: Senate Committee on Labor and Human Resources

Date: February 8, 1979

Length: 25 pages beginning on page 119

1979-4 (Cont.)

Concerning: Pension legislation (S.209)

Background: This statement was presented at a legislative hearing on S.209, the ERISA Improvements Act of 1979, jointly sponsored by Senator Harrison A. Williams and Senator Jacob K. Javits. This bill is an omnibus ERISA-revision bill which is an outgrowth of S.3017 introduced in 1978. The Academy also testified on this earlier bill (see statement 1978-18).

Drafters: This statement was the joint work product of Donald S. Grubbs, Jr., Chairman of the ERISA Revisions Subcommittee of the Pension Committee, Edwin F. Boynton, Immediate Past President, and Stephen G. Kellison, Executive Director. It was largely based on the earlier submission on S.3017.

Index Code: 1979-5

To: Senate Committee on Agriculture, Nutrition and Forestry

Date: March 20, 1979

Length: 3 pages beginning on page 144

Concerning: Crop insurance

Background: This statement was presented at a public hearing held by the Subcommittee on Agricultural Production, Marketing, and Stabilization of Prices of the Senate Committee on Agriculture, Nutrition, and Forestry. The hearing addressed various proposals to amend the Federal Crop Insurance Act. This statement derives from previous statements on crop insurance in 1977 (see statements 1977-4, 1977-17, and 1977-20).

Drafters: Executive Director Stephen G. Kellison

Index Code: 1979-6

To: NAIC Blanks (A1) Subcommittee

Date: March 21, 1979

Length: 7 pages beginning on page 147

Concerning: Statements of opinion on casualty loss reserves

Background: This position paper was submitted to the NAIC (A1) Subcommittee in connection with proposals to require statements of opinion on casualty loss reserves on the Fire and Casualty Blank and to reconsider the current statement of opinion on the Life and

1979-6 (Cont.)

Accident and Health Blank. The Academy has made numerous statements on this matter previously (see statements 1978-9, 1978-10, 1978-25, 1978-31, and 1978-35).

Drafters: The position paper was written by Executive Director Stephen G. Kellison with the assistance of selected members of the Academy Board of Directors. The statement was ultimately endorsed by the Board as a statement of the Board (statements 1978-31 and 1978-35 were similarly endorsed).

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Index Code: 1979-7

To: President's Commission on Pension Policy

Date: March 23, 1979

Length: 4 pages beginning on page 154

Concerning: Actuarial involvement with Commission

Background: This statement was submitted to the President's Commission on Pension Policy at its initial public hearing. This statement was accompanied with the roster of the actuarial advisory group appointed by the Academy to work with the Commission.

Drafters: Executive Director Stephen G. Kellison.

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Index Code: 1979-8

To: Financial Accounting Standards Board

Date: March 27, 1979

Length: 12 pages beginning on page 158

Concerning: Accounting and reporting by defined benefit pension plans

Background: These comments were submitted to the FASB in response to the February 14, 1979 draft released by the FASB in connection with the continuing FASB project on accounting and reporting by defined benefit pension plans. The Academy had filed three previous statements with the FASB (see statements 1977-6, 1978-1, and 1978-26).

Drafters: These comments were jointly developed by the Committee on Pension Actuarial Principles and Practices, chaired by Douglas C. Borton, and the Subcommittee on Pension Accounting Matters of the Pension Committee, chaired by Edwin F. Boynton.

Index Code: 1979-9

To: Financial Accounting Standards Board

Date: March 29, 1979

Length: 4 pages beginning on page 170

Concerning: FASB study on accounting for interest costs

Background: This statement was submitted in response to the FASB Exposure Draft on Capitalization of Interest Costs dated December 15, 1978. The Academy had previously submitted a statement on a previous Discussion Memorandum on Accounting for Interest Costs dated December 16, 1977 (see statement 1978-4).

Drafters: The Committee on Life Insurance Financial Reporting Principles, chaired by Jack E. Wood.

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Index Code: 1979-10

To: Financial Accounting Standards Board

Date: May 1, 1979

Length: 4 pages beginning on page 174

Concerning: Financial reporting and changing prices

Background: This statement was submitted in response to the FASB Exposure Draft on Financial Reporting and Changing Prices dated December 28, 1978 and a supplementary Exposure Draft on Constant Dollar Accounting dated March 2, 1979.

Drafters: The Committee on Life Insurance Financial Reporting Principles, chaired by Jack E. Wood.

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Index Code: 1979-11

To: Senate Committee on Finance

Date: May 17, 1979

Length: 2 pages beginning on page 178

Concerning: National health insurance

Background: This letter was sent to the staff of the Senate Committee on Finance in connection with S.760, a bill on catastrophic health insurance introduced by Senator Long. The letter was confined to comments on the definition of qualifications for actuaries to

1979-11 (Cont.)

serve on the Actuarial Committee which would be created by the bill.

Drafters: This letter was prepared by Donald S. Grubbs, Jr., Chairman of the Committee on Federal Relations and Accreditation.

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Index Code: 1979-12

To: Securities and Exchange Commission

Date: May 22, 1979

Length: 16 pages beginning on page 180

Concerning: Independence/self-review

Background: This statement was submitted to the Securities and Exchange Commission in reaction to the Public Oversight Board Report on Scope of Services by CPA Firms released on March 9, 1979. The Academy had previously submitted a major statement to the Public Oversight Board at their public hearing on August 17, 1978 (see statement 1978-19). The Academy has also filed several other statements on independence/self-review (see statements 1977-12, 1977-23, 1978-2, and 1978-7).

Drafters: The statement was developed by the law firm of Shea and Gardner and reviewed by certain members of the Academy Executive Committee:

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Index Code: 1979-13

To: NAIC Accounting Practices and Procedures (A6) Subcommittee

Date: May 25, 1979

Length: 3 pages beginning on page 196

Concerning: Statutory accounting practices for insurance companies

Background: This letter was sent to the NAIC (A6) Subcommittee in response to a revised Exposure Draft of the Life and Accident and Health Accounting Practices and Procedures Manual being developed by the Subcommittee. The Academy had also commented on the previous Exposure Draft (see statement 1978-32).

Drafters: The letter was drafted by Jack E. Wood, Chairman of the Committee on Life Insurance Financial Reporting Principles.

Index Code: 1979-14

To: NAIC Life Insurance (C3) Subcommittee

Date: May 29, 1979

Length: 2 pages beginning on page 199

Concerning: Dividend principles and practices

Background: This letter was sent to the Life Insurance Cost Disclosure Task Force of the NAIC Life Insurance (C3) Subcommittee concerning the activities of the Committee on Dividend Principles and Practices.

Drafters: The letter was drafted by John H. Harding, Chairman of the Committee on Dividend Principles and Practices.

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Index Code: 1979-15

To: NAIC Automobile Insurance (D3) Subcommittee

Date: June 4, 1979

Length: 4 pages beginning on page 201

Concerning: Risk classification in automobile insurance

Background: This statement was presented at a public meeting of the NAIC (D3) Subcommittee. The Subcommittee was considering the recommendation of one of its Task Forces to eliminate sex and marital status as classification criteria in automobile insurance rating.

Drafters: The statement was developed by the Automobile Insurance Task Force under the auspices of the Committee on Risk Classification. The chairman of the Task Force was Mavis A. Walters and the chairman of the Committee was Roy R. Anderson.

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Index Code: 1979-16

To: Advisory Council on Social Security

Date: July 13, 1979

Length: 4 pages beginning on page 205

Concerning: Social Security

Background: This statement was submitted to the Advisory Council on Social Security to provide supplementary information to that contained in the previous submission of January 5, 1979 (see statement

1979-16 (Cont.)

1979-1). The statement addresses ways to reduce or eliminate the inequities created by the lack of universal coverage under Social Security

Drafters: The Committee on Social Insurance, chaired by Robert F. Link.

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Index Code: 1979-17

To: Department of the Treasury

Date: July 18, 1979

Length: 3 pages beginning on page 209

Concerning: Establishment of pension actuarial principles and practices

Background: This letter was sent to the Department of the Treasury in connection with potential regulations on actuarial cost methods under pension plans. The letter is concerned with the establishment of pension actuarial principles and practices in the private vs. public sector.

Drafters: The letter was prepared by the Committee on Pension Actuarial Principles and Practices, chaired by Douglas C. Borton, and was sent over the signature of President Dale R. Gustafson.

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Index Code: 1979-18

To: Advisory Council on Social Security

Date: July 27, 1979

Length 5 pages beginning on page 212

Concerning: Social Security

Background: This statement was submitted to the Advisiory Council on Social Security to provide supplementary information to that contained in the previous submission of January 5, 1979 (see statement 1979-1). The statement addresses ways to redesign the earnings test under Social Security to make it more palatable to its critics.

Drafters: The Committee on Social Insurance, chaired by Robert F. Link.

Index Code: 1979-19

To: Senate Committee on Governmental Affairs

Date: August 1, 1979

Length: 25 pages beginning on page 217

Concerning: Independence/self-review

Background: This statement was presented at a public hearing of the Subcommittee on Governmental Efficiency and the District of Columbia of the Senate Committee on Governmental Affairs. The subject of the hearing was oversight of the accounting profession with particular emphasis on the independence issue. The Academy has also filed numerous other statements on independence/self-review (see statements 1977-12, 1977-23, 1978-2, 1978-7, 1978-19, and 1979-12).

Drafters: The statement was developed by the law firm of Shea and Gardner and presented by President Dale R. Gustafson.

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Index Code: 1979-20

To: NAIC Financial Condition Examination (A5) Subcommittee

Date: August 13, 1979

Length: 12 pages beginning on page 242

Concerning: Statements of opinion on casualty loss reserves

Background: This statement was presented at a public meeting of a special task force of the NAIC (A5) Subcommittee considering revisions to the proposal previously adopted to require statements of opinion on casualty loss reserves. Also presented at the meeting were the results of a survey of the larger property-liability insurance companies that had been commissioned by the Board of Directors.

Drafters: The survey was conducted by the staff of the Washington office of the Academy and the statement was presented by Executive Director Stephen G. Kellison.

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Index Code: 1979-21

To: Financial Accounting Standards Board

Date: August 17, 1979

Length: 2 pages beginning on page 254

1979-21 (Cont.)

Concerning: Financial reporting and changing prices

Background: This statement contains comments on the Interim Report of the Insurance Task Group in response to the two FASB Exposure Drafts on Financial Reporting and Changing Prices and on Constant Dollar Accounting. The Insurance Task Group was on of six Task Groups appointed by the FASB to respond to the FASB proposals as they would impact six special industries. The Academy had previously submitted comments directly in response to the Exposure Drafts themselves (see statement 1979-10).

Drafters: The Committee on Life Insurance Financial Reporting Principles, chaired by Jack E. Wood.

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Index Code: 1979-22

To: Internal Revenue Service

Date: August 20, 1979

Length: 2 pages beginning on page 256

Concerning: Regulations on annual reports under ERISA

Background: This letter was submitted to the Internal Revenue Service in connection with proposed regulations on annual reports under ERISA that appeared in the June 26, 1979 issue of the Federal Register.

Drafters: The letter was prepared by the Task Force on ERISA Regulations of the Subcommittee on ERISA of the Pension Committee. The respective chairmen of the above groups are Gerald Richmond, Donald S. Grubbs, Jr., and Preston C. Bassett. The letter was sent over the signature of Executive Director Stephen G. Kellison.

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Index Code: 1979-23

To: Financial Accounting Standards Board

Date: September 21, 1979

Length: 17 pages beginning on page 258

Concerning: Accounting and reporting by defined benefit pension plans

Background: This statement was submitted to the FASB in response to three documents released by the FASB. The first was entitled "An Overview of Proposed Accounting and Reporting Standards for Defined Benefit Pension Plans" dated July 9, 1979; the second was an Exposure Draft on "Accounting and Reporting by Defined Benefit

1979-23 (Cont.)

Pension Plans" dated July 9, 1979; while the third was an Exposure Draft on "Disclosure of Pension and Other Post-Retirement Benefit Information" (an amendment of APB Opinion No. 8) dated July 12, 1979. The Academy had filed several previous statements with the FASB on this subject (see statements 1977-6, 1978-1, 1978-26, and 1979-8).

Drafters: This statement was developed by a special task force composed of members from the Committee on Pension Actuarial Principles and Practices, chaired by Douglas C. Borton, and the Subcommittee on Pension Accounting Matters of the Pension Committee, chaired by Edwin F. Boynton.

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Index Code: 1979-24

To: Pension Benefit Guaranty Corporation

Date: September 24, 1979

Length: 2 pages beginning on page 275

Concerning: Contingent employer liability insurance

Background: This statement was submitted to the Pension Benefit Guaranty Corporation in response to their report entitled "Contingent Employer Liability Insurance: Status Report to the Congress" dated July 1, 1978.

Drafters: This statement was prepared by the Task Force on CELI of the Subcommittee on PBGC of the Pension Committee. The respective chairmen of the above groups are Bruce D. Moore, Martin J. Frank, and Preston C. Bassett.

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Index Code: 1979-25

To: Securities and Exchange Commission

Date: November 7, 1979

Length: 46 pages beginning on page 277

Concerning: Independence/self-review

Background: This request for ruling was submitted to the Securities and Exchange Commission. The Academy has also filed several other statements on independence/self-review (see statements 1977-12, 1977-23, 1978-2, 1978-7, 1978-19, 1979-12, and 1979-19).

Drafters: The statement was developed by the law firm of Shea and Gardner and was approved by the Academy Executive Committee.

Index Code: 1979-26

To: Senate Committee on Finance
Senate Committee on Labor and Human Resources
House Committee on Education and Labor
House Committee on Ways and Means

Date: November 7, 1979

Length: 6 pages beginning on page 323

Concerning: Pension Legislation (HR 3094 and S1076)

Background: This statement was distributed to the members and staffs of the four above-named committees in connection with HR3094 and S1076, which is proposed legislation on the multiemployer termination insurance program.

Drafters: This statement was prepared by the Task Force on Multiemployer Plans of the Subcommittee on PBGC of the Pension Committee. The respective chairmen of the above groups are Fenton R. Isaacson, Martin J. Frank, and Mary H. Adams.

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Index Code: 1979-27

To: President of the NAIC

Date: November 27, 1979

Length: 1 page on page 329

Concerning: State regulation of insurance

Background: This letter was sent to the Honorable Wesley J. Kinder, Commissioner of Insurance of the State of California and President of the NAIC, in reaction to the report of the General Accounting Office entitled "Issues and Needed Improvements in State Regulation of the Insurance Business" dated October 9, 1979. This report contains several references to actuaries and the regulation of the insurance business which prompted the letter.

Drafters: President Ronald L. Bornhuetter.

Index Code: 1979-28

To: Internal Revenue Service

Date: December 3, 1979

Length: 7 pages beginning on page 330

Concerning: Regulations on reasonable funding methods under ERISA

Background: This statement was submitted to the Internal Revenue Service in connection with proposed regulations on reasonable funding methods under ERISA that appeared in the October 5, 1979 issue of the Federal Register.

Drafters: This statement was prepared by the Task Force on ERISA Regulations of the Subcommittee on ERISA of the Pension Committee with input from the Committee on Pension Actuarial Principles and Practices. The respective chairmen of the above groups are Gerald Richmond, Donald S. Grubbs, Jr., Mary H. Adams, and Leonard Mactos. The letter was sent over the signature of Executive Director Stephen G. Kellison.

STATEMENT TO THE 1978 ADVISORY COUNCIL ON SOCIAL SECURITY ON BEHALF OF THE AMERICAN ACADEMY OF ACTUARIES

Robert F. Link

Washington, D. C., January 5, 1979

Introduction

My name is Robert F. Link. I am a Member of the American Academy of Actuaries and Chairman of its Committee on Social Insurance. The Academy is a professional organization of actuaries. It was formed in 1965 by the four actuarial organizations in the United States to foster the accreditation and public recognition of actuaries with various areas of specialization. At the end of 1977 there were 4,418 members in a variety of types of employment including insurance companies, consulting organizations, government, and academia. Membership can be attained only by satisfying demanding examination and experience requirements. Members are subject to rigorous guides to professional conduct.

The Academy welcomes this opportunity to present views concerning the many important questions that the Advisory Council is called upon to consider. We are not here to advocate courses of action with respect to particular issues. Instead, we wish to offer what we hope will be helpful comments based on our expertise, as actuaries, with respect to financial enterprises involving life, death, disability and on other contingencies and our broad acquaintance with benefit plans. In particular, these comments do not represent an official view of the Academy but are the views of its Committee on Social Insurance.

Background - the Present Situation

It has been said that the Social Security system is in serious financial trouble. This is not a simple issue. Congress has always had the resolution in the past to take the necessary actions to match revenues and costs. This, rather than some technical concept of "actuarial soundness" is the financial backbone of the system. We believe that Congress expects to continue as it has in the past in this respect. We note, however, that the present scheduled tax rates will be inadequate according to current projections, starting sometime after the year 2000. Congress will find it a challenge to close this gap.

In any event, there are other serious problems with the system. Some of these problems, which I will now enumerate, form the broad backdrop for our comments on specific issues.

The public's view of the system. The public probably unduly analogizes Social Security to other systems with somewhat similar purposes, such as private insurance or pensions. There is a supposition, somewhat natural in the light of the structure of the system and much of the writing about it, that an individual's contributions to the system are being accumulated in an account somewhere to fund that individual's benefits. This perception, to the extent that it exists, is clearly at variance with the true situation. We join with those who believe that there is a major need to improve public understanding of the true nature of Social Security.

"Fairness" and "money's-worth". In terms of value, the relation of benefits to contributions varies widely, reflecting different family compositions, pay levels, etc.. As nearly as a comparison can be made, Social Security is likely to be a favorable deal for some and an unfavorable deal for others, if measured against any criterion of "money's worth." This would be true whether or not employer taxes are included in the comparison. These variations, which reflect an orientation toward social objectives, are inherent in the design of our Social Security system. Getting one's money's worth is not a valid design criterion of such a system. This is fundamental: the public must be helped to understand that individual "money's worth" is not a relevant issue for Social Security.

In any event, concerns about fairness and "money's worth" currently exist, and they are exacerbated by some other aspects of the system. The retirement test is a perennial and painful example. Also, population dynamics mean that the system will produce cost differences for different generations of workers that do not correspond to differences in expected benefits.

Tax levels. Since the 1977 Act was passed, there have been cries of serious dissatisfaction with the level of Social Security taxes. We should note that it's not entirely clear who is dissatisfied. A recent CBS - New York Times survey failed to find major dissatisfaction among individual taxpayers. And a recent survey of employers by the consulting firm of William M. Mercer, Inc. indicates that employers generally oppose innovative changes in the financing system but do favor cutting benefits and thereby lowering future costs. In any event, Congress has been considering various ways of redistributing the tax burden so as to make it more palatable. However, there has been little consideration of ways of reducing the total tax burden, which in the end may mean reducing benefits.

This situation is really a scramble over the goods-and-services pie. To the extent that the expectations of the respective groups - beneficiaries and producers - exceed the total pie, there is a problem, identified as insufficient benefits or excessive taxes. Any such problem can be solved only by reducing benefits, by increasing taxes, or by increasing the size of the pie. The last is an important aspect of the continuing debate over the relative role of public programs and private programs. Private programs, by accumulating capital, both defer consumption to a later time (improving fairness among generations) and also increase the size of the pie through capital formation.

With this background, I will now comment on the various topics that you have suggested. These comments will relate in general to OASDI and will not specifically address Medicare issues.

Comments on the Advisory Council's Specific Questions

1. How should the responsibility for supporting retirement incomes be divided among the Social Security program, programs of income assistance, (mainly the Supplemental Security Income program) and private retirement income support programs? Should Social Security bear more or less of the responsibility for supporting the retirement incomes of higher income households or lower income households?

The issues raised by this question are primarily political or philsophical. While individual actuaries may have strong feelings on them, there can be no authoritative actuarial viewpoint. To the extent that there is concern with issues of fairness or money's worth, particularly as between succeeding generations of workers, these problems will be larger if the role of Social Security is larger and smaller if the role of Social Security is smaller. Stresses that would be tolerable in a true floor-of-protection system may not be tolerable in a system that meets a higher proportion of the income replacement needs of the American public. Attachment A presents some data to illustrate what has been happening in this respect.

2. The Social Security program has always been structured to serve the social objective of assuring lower wage workers a more adequate retirement income than would be produced if all benefits were strictly proportional to preretirement earnings. Should this policy be

continued? Under this policy, are higher wage workers getting a fair return on their Social Security contributions?

The "tilt" of benefits in favor of lower wage workers is a social issue, rather than an actuarial one. There is no persuasive actuarial reason to eliminate the tilt. However, we note that there are responsible proposals for fundamental change in the system (e.g., ideas recently put forward by Haeworth Robertson) that would effectively convert the system into a dual system consisting of a basic flat benefit (the maximum tilt) and a benefit based directly on contributions (no tilt). Such a change would narrow the area in which the issue of tilt arises. We encourage serious study of such proposals.

There is very good reason to suppose that higher wage earners are getting a lesser return on their contributions than others. However, I emphasize again that the issue of fairness or "money's worth" is largely irrelevant to a social security system.

3. Should the present Social Security earnings test be modified or abolished? Should beneficiaries who are over age 65 be treated differently than beneficiaries under age 65?

4. Should the normal retirement age in Social Security, now set at age 65, be changed?

5. At what age should Social Security benefits first be made available? Should early retirement benefits be reduced by the full actuarial amount? Should the size of the credit given people who delay their retirement beyond age 65 be changed?

The questions under items 3, 4, and 5 deal with different facets of the definition of Social Security old age benefits. I'll deal with them as a unit.

The arguments for and against an earnings test are familiar. Those who favor the test point out that it reduces the cost of the system. They also believe that such a test is appropriate in an income replacement system. On the other side, many observers see the test as grossly inequitable. Some observers say it involves serious work disincentives. These issues are political rather than actuarial. However, it is clear that elimination of the earnings test would lead to higher costs and a consequent exacerbation of the general stresses that the system is now subject to.

Regardless of the merits of these arguments, it may be that adverse reactions to the present retirement test will ultimately override all other considerations. If the test is to be preserved, some redesign or repackaging may be needed to overcome these reactions. If the Advisory Council wishes; the Academy's Committee on Social Insurance would be happy to develop some suggestions along these lines for your consideration.

In view of the striking changes in the age distribution and life expectancies in the United States during the last forty years, as well as the significant financial stresses that will impact the system as these changes continue, it makes sense to consider an increase in the normal retirement age under Social Security. Such a change could ease the financial pressures on the system caused by falling fertility rates and the retirement of the post-World War II "baby boom" generation.

While conceptually simple, an increase in the Social Security retirement age might present difficulties of implementation. Some of the issues and problems in this connection have been noted in a brief paper by George E. Bell III, a Member of the Academy (Attachment B). The Advisory Council could make an immense contribution by developing a practical mechanism to increase the normal retirement age so as to capture for the system the long term savings that should result.

One tactical point in this connection. We should all be particularly wary of proposals for further liberalization of the retirement test at this time, whatever their general merits. One reason is that liberalizing the retirement test might confer benefits that would need to be withdrawn again if the retirement age is raised. Better not to create the problem in the first place.

A second reason relates to the recent elimination of mandatory retirement at age 65 in business generally and private pensions in particular. To the extent that more individuals than formerly continue in full employment beyond age 65, they would draw full Social Security benefits if the retirement test were eliminated. This seems a questionable use of the financially tight resources of the system.

We have no specific proposals for change with regard to benefit adjustment factors that apply to early or late retirement. However, we are struck by the relationship of this question to other issues, particularly the retirement test and the normal retirement age. For example, if an increased retirement age were seen as desirable, it would seem incongruous to encourage early retirements by limiting reduction of early retirement benefits or by making benefits available at a still earlier age. Similarly, it would seem inconsistent to "undo" the cost savings of an increase in the retirement age by increasing the benefit credit for delayed retirement.

We urge that the Advisory Council explore all the interrelationships of these issues before settling on specific recommendations with respect to any one of them; and we urge consistency of objectives and recommendations, whatever the final decisions of the Council.

6. Does the present system treat fairly both the partners of a marriage when both are working? When one works for pay and the other remains in the home to care for children? When a marriage is dissolved through divorce?

Our Committee has never actively addressed the specific issues relating to marital status that are raised by this question. However, we would like to comment on the relation of benefits to family composition in general. These thoughts are grounded in our belief that fairness is an unproductive issue in a social security system.

There are two seeming objectives that are relevant to the issue of benefits and family composition. These are (i) to prevent a descent into poverty at the time of entitlement and (ii) beyond this, to preserve some portion of pre-entitlement purchasing power. Variations of benefits by family composition are consistent with the first; they are largely inconsistent with the second. In the latter connection, I attach a copy of a paper by Harrison Givens, Jr. and Morton D. Miller that was presented in 1976 at the meeting of the International Congress of Actuaries in Tokyo (Attachment C). A key finding of the paper is that the preservation of purchasing power after a change in status such as retirement calls for a replacement income that is largely independent of family composition.

Again, some of the proposals for fundamental restructuring of the system would do away with the kinds of issues that are raised in this question.

7. How important is exclusive reliance on the payroll tax as the method of financing retirement and survivor benefits or disability insurance benefits? Should general revenues be used to finance all or a portion of the benefits paid under these two programs?

Actuaries have ample opportunity to observe the financing of benefit plans, including benefit plans in the public sector. Everybody wants higher benefits. Costs are a deterrent. There is a natural human tendency to want to minimize the impact of costs, either by exercising options to have lower rather than higher cost figures, or by adopting financing approaches that make the costs less visible. The virtue of the payroll tax is that it does keep the costs visible. Putting some of the costs in general revenues would make them less visible. Also, it's worth noting what general revenue financing really means. The money has to come from somewhere: (i) higher taxes - most likely higher Federal income taxes, or (ii) reduced spending on other government programs, or (iii) a matching increase in the national debt. Attached is an article by Haeworth Robertson, commenting on general revenue financing proposals (Attachment D).

The visibility issue relates to some of the other financing approaches. Raising the tax on employers is a device to get additional funds without much voter impact. Likewise raising the maximum taxable earnings base, because it affects only those above the old maximum. (Also, raising the maximum raises benefits and is thus partially self-defeating.) A "value added" tax has low visibility. These devices effectively insulate most voters from what is really happening to benefit costs and how they are being paid for.

8. Should the general revenues be used to finance a greater portion of the hospital insurance program or should it continue to be financed virtually entirely from the payroll tax?

We have no special comments on the financing of the hospital insurance program as such. However, our earlier comments on the visibility of costs apply here also.

9. Should those employees of Federal, state and local government and of private nonprofit firms who are not now covered by the Social Security program be brought into the program?

Actuaries are acutely aware of the many problems which arise in connection with (i) employee groups that are excluded from coverage and (ii) groups where coverage is optional and opting out is a possibility. These problems would be eliminated if the excluded groups were instead brought into the system. We see no reason why these groups should not be brought in, other than the admitted formidable political and transitional problems of bringing this about.

One aspect of the universal coverage issue is the windfall benefits obtained by members of excluded groups, such as government employees, who get short periods of coverage under Social Security. The system treats them as low-wage workers and gives them benefits that are disproportionately high in relation to their contributions. If universal coverage is not enacted, this anomaly should be fixed. We'd be glad to offer suggestions in this connection if desired.

10. Is the present definition of disability too restrictive? Are disability benefits too high, too low, or at roughly appropriate levels? Is sufficient effort made to rehabilitate disabled beneficiaries?

We suggest several areas for study by the Advisory Council. First would be steps to achieve greater uniformity of treatment among different geographical areas. The present treatment is significantly variable. Second would be to improve the incentives for disabled workers to rehabilitate themselves and reenter the labor force. These two topics are amplified in the attached brief paper by James L. Cowen, a Member of the Academy (Attachment E).

Third is the issue of overinsurance -- benefits that are so large as to encourage claims and discourage recovery. One authority has estimated that at least 44% of covered workers are currently overinsured for disability. (John H. Miller: Disability Insurance, an Assessment of its Social Value, CLU Journal, Vol. XXXII, No. 3, July 1978, page 12). In private insurance, avoidance of overinsurance is considered essential to the sound financial operation of disability coverage.

11. Are there significant areas (e.g., types of benefits or types of events) in which Social Security could and should offer wage replacement protection not now offered? Are there parts of the current package which are no longer necessary given their cost and the alternative sources of income support currently available?

We have no specific comments in this area, though some comment is implied in the answers to the preceding questions.

Actuarial Services for Social Security

Over the more than four decades of operation of the Social Security program, the Social Security Administration and the Department of Health, Education, and Welfare have recognized the necessity of having the highest quality actuarial services available. This has been accomplished by the establishment of a separate Office of the Actuary, with the Chief Actuary reporting directly to the Commissioner of Social Security.

Recently, the responsibilities for the Medicare program were transferred away from the SSA to the Health Care Financing Administration (another component of DHEW). We note, with serious concern, that the actuarial functions in HCFA are to be substantially downgraded by being assigned to the Office of Financial and Actuarial Analysis. This Office is a division of HCFA's Office of Policy, Planning, and Research, and it is headed by a non-actuary. We believe that, at such a low organizational level, it will not be possible to recruit and maintain the top-flight actuarial staff that is essential to carry out the actuarial responsibilities for a program as important to the national economy as is Medicare.

This change also reduces the scope and influence of the job of Chief Actuary in the Social Security Administration. We think that there should be one actuary with the duty to pull together the financial picture of the inevitably interrelated OASDI and HI systems. Lack of coordination here just doesn't make sense.

Summary

OASDI has significant problems arising from the discontinuity between the actual system and the public's perception of it and from increasing awareness of the system's high cost and many elements of inequity as among groups in varying circumstances. The pressures of the situation make the time ripe for a fundamental re-examination of purposes and scope.

ATTACHMENT A

THE INCOME REPLACEMENT ROLE OF SOCIAL SECURITY

The following tables were prepared to illustrate (i) trends in the income replacement role of Social Security and (ii) the degree to which the Social Security system as amended in 1977 meets the real income replacement needs of individuals in varying circumstances. They are based on work done at The Equitable Life Assurance Society during 1978.

Table I illustrates trends in replacement ratios. The replacement ratio is (i) the total benefit income in the first full year of entitlement (assuming entitlement on January 1), divided by (ii) covered income in the year preceeding the year of entitlement. The calculation methods used are consistent with those used in the Office of the Actuary in the Social Security Administration.

Three income levels are used. They are average (covered pay in each calendar year assumed to be the national average for covered pay in the year); 85th percentile (covered pay assumed to be 167.5% of average); and 95th percentile (covered pay assumed to be 239.0% of average).

Table II relates future (1990) income benefits to need. Need, or "target income" is defined as the level of tax-free income needed to maintain net family purchasing power after allowing for elimination of Federal income and F.I.C.A. taxes, work-related expenses, and the need to save (but not recognizing the effect of state and local taxes). Target income is taken as 80%, 70%, and 60% of pre-entitlement income for the average, 85th percentile, and 95th percentile cases respectively. This represents an update of the calculations in the Givens-Miller paper referred to in the accompanying statement.

Table I

Selected Replacement Ratios For Average, 85th Percentile, and 95th Percentile Wage Earners

	Retirement At Age 65[1]			Death or Disability at Age 45					
				Maximum Benefit[2]			Low Benefit[3]		
Year	Aver.	85th	95th	Aver.	85th	95th	Aver.	85th	95th
1955	47	30	21	68	44	31	no applicable case		
1965	43	28	19	70	45	32	31	20	14
1970	47	31	22	61	42	30	34	23	16
1975	61	43	30	81	54	38	43	30	21
1978	64	48	33	86	61	43	47	35	25
1979	64	48	34	78	56	39	43	32	22
1990	57	44	33	79	61	47	43	35	27
2000	57	45	35	79	61	50	43	35	29
2020	57	46	38	79	61	50	43	35	29

[1] Assumes spouse three years younger, calling for a benefit of 137.5% of the Primary Insurance Amount.

[2] Assumes family maximum benefit (typical for a family with children).

[3] Assumes only Primary Insurance Amount (e.g., disability, no children).

Table II

Social Security Income as a Percent of "Target" Income[1]
at Various Ages and Income Levels
(Entitlement in 1990)

Case	Benefit	Percent of Target Income		
		Average	85th Pctl.	95th Pctl.
Retirement at 65	1.375 PIA[2]	71	63	55
Disability/Death				
at 25	FMB[3]	100	89	85
at 35	FMB	99	87	83
at 45	FMB	99	87	78
at 55	FMB	99	83	72

[1]Target income taken as 80% of pre-entitlement income for average, 70% for 85th, and 60% for 95th percentile cases.

[2]Assumes spouse aged 62.

[3]Assumes family becomes entitled to a family maximum benefit at the worker's indicated age.

ATTACHMENT B

THE NEWSLETTER (a periodic publication of the American Academy of Actuaries), September, 1978.

REVISING THE SOCIAL SECURITY RETIREMENT AGE

by George E. Bell, III

I. Introduction

If there are any actuarial certainties that apply to Social Security, there are at least these two:

(1) Even with passage of the 1977 Amendments, the Social Security System's long range funding problems have not been solved.

(2) Nearly every observer has one — or more — proposals to solve the problems that still exist.

One proposal that has received wide publicity is to raise the Social Security retirement age; or, more precisely, to raise the age of initial eligibility for unreduced Social Security old age benefits. A number of arguments are generally offered in support of this view:

(1) Demographics - the ratio of covered employees to all Social Security beneficiaries is declining steadily as the population ages, and is expected to reach a low of about 2:1 in the 21st century. Raising the retirement age, some say, would alleviate this problem and the funding difficulties it introduces—and, further, would ease the labor shortages foreseen when the "baby boom" generation retires.

(2) Longevity - at inception of Social Security, age 65 was chosen, fairly arbitrarily, as the retirement age; since then, life expectancy at age 65 has increased significantly, and it is argued that "old age," for purposes of old age social insurance benefits, ought to be redefined.

(3) Consistency - with passage of the new mandatory retirement amendments to the Age Discrimination in Employment Act (ADEA)—which, in general, raise the minimum compulsory retirement age for those in private employment to age 70—it is argued that it would be inconsistent to continue to use age 65 as the retirement age for Social Security. More important—especially in light of pressure for removal of the earnings test—the inconsistency would allow "double dipping by everyone."

There are other cogent arguments as well; but it is not the purpose of this paper to argue for revisions in the retirement age. Rather, it is to examine how feasible those revisions might be—or, more pointedly, to cite some examples of the implementation problems they might face—and to prompt thought and comment on the issue within the profession.

II. Stumbling Blocks

A. *Social/Political*—Probably the most important consideration to be kept in mind in examining any deliberalizing "reform" of Social Security is that such changes are made, *not in an actuarial environment, but in a political one.* And the most important political problem facing any such "reform"—be it increasing the retirement age, tightening the earnings test, or whatever—is the public perception of Social Security as an earned retirement annuity due an individual by virtue of his contributions, and due at the stated retirement age regardless of marital status, other earnings, or the System's financial troubles.

To be sure, that is a misperception—the benefits, at least originally, were designed as payments to meet the social insurance risk of old age destitution, and many have found that marital status and other earnings do affect benefit levels—but the misperceptions will take much undoing, and will probably *require* undoing before a change in retirement age can be made.

Adding to the problem is another misperception—the popular misreading of current life expectancy at birth as average age at death for those now at retirement age: try convincing a 65 year old, if male life expectancy is 72, that he won't be "robbed" of 3/7ths of his benefit if retirement age is raised to 68.

Another social/political difficulty is the imponderable future trend in work force retirement age, and the problems that would result if it did not parallel changes in the Social Security retirement age. Sample questions: will the trend to early retirement continue; or will the ADEA amendments, coupled with a lesser number of future young entrants to the work force, combine to move the average retirement age higher? If early retirements continue, but Social Security retirement age is increased, will an undue burden be placed on private pension plans to provide larger Social Security supplements for longer periods of time?

Finally, the current environment suggests another problem: unemployment, particularly among the young. How, it would be argued, could it be rational to "force" later retirement and thereby only intensify the unemployment problem? (Some of this same sentiment was expressed in opposition to the ADEA amendments.)

Naturally, there are other social/political problems — the

REVISING THE SOCIAL SECURITY RETIREMENT AGE

foregoing is not meant to be an exhaustive list. For the moment, however, let us assume that the political problems can be dealt with—more on that at the conclusion of this paper—and address the technical problems we actuaries are probably more suited to solve.

B. Technical—Technical difficulties in revising the retirement age would arise in four general areas:
   (1) Establishment of an appropriate revised retirement age, and creation of a transition arrangement—for "equity" purposes—to prevent "loss" to retirees at or just after revision.
   (2) Interplay with other potential revisions—a retirement age revision probably wouldn't prove satisfactory if made in a vacuum; the interplay with other possible revisions would have to be considered. For example, the cost reductions of raising the retirement age might well disappear if the earnings test were abolished or the delayed retirement credit increased.
   (3) Interplay with other Social Security benefits—many other benefits provided by the System—for example, dependent spouse and widows' benefits, and Medicare benefits—are tied at least in part to the current retirement age. How, if at all, should these benefits be affected by a revision in retirement age?
   (4) Interplay with the private sector - the possibility of an additional burden on private pensions, in the form of increased Social Security supplements payable for a longer period of time, has already been mentioned. Another potential problem could be the gaps in health insurance coverage that would result if the age for Medicare eligibility were raised while most private coverage, as at present, ceased at age 65.

III. Possible Revision Approaches

A challenge that comes immediately to mind in reviewing these problems is the design of an appropriate revision "formula." For purposes of stimulating creative impulses within the profession, let us talk of a number of possible approaches—and, to demonstrate that nothing is as simple as it seems, find some difficulties with each one.

A few possible approaches, and their more obvious pitfalls, are as follows:

(1) One time increase in retirement age - simple, but the "equity" or "transition" problems are probably insurmountable.
(2) Index retirement age to current age 65 life expectancy - this is attractive actuarially, but whose life expectancy do we use (white males is asking for trouble), how do we keep it adequately updated, and, possibly most important, how do we deal with the discontinuity if, say, a cure for cancer is suddenly found?
(3) Phase in by gradual increases in retirement age - an approach that would, say, start in 1990 by increasing retirement age to 65-¼ and add ¼ year to retirement age each year thereafter until, say, age 68 were reached in 2001. This has a certain appeal, but would probably create administrative problems, as people would seek counseling on the exact timing of retirement, and pension actuaries and plan administrators would wrestle with integration and supplement problems.
(4) Phase in by temporary suspension of indexing - this approach would introduce the actuarial reduction in benefits, for retirements before the new revised retirement age, through a temporary suspension of the automatic CPI/benefit increases in the current law. Problems: an administrative nightmare, coupled with the difficulty in introducing a "takeaway" feature.

IV. Conclusion

So much for easy solutions. If this issues paper has proved anything, it is that increasing the Social Security retirement age is not—cannot—be the "quick fix" many seem to have implied. So the question becomes: "where do we go from here?"—and it applies to many issues, including retirement age, the earnings test, mandatory universal coverage, and the like.

The path which the Social Insurance Committee can foresee has three basic steps:

(1) First, present this series of issues papers to the profession to help provoke the thought, comment and creativity we know exists.
(2) Recognize, as a profession, that these deliberalizing "reforms" many advocate are fraught with political problems, most of them stemming from the widespread lack of public understanding of Social Security—and then help to promote a better understanding.
(3) Bring to bear the actuarial expertise to deal with all the issues in an integrated manner, and to solve the myriad technical problems that arise with each "simple reform."

Enough, for now, of calls to action. This paper has been, we hope, the first part of the first step. We on the Committee welcome your comments.

ATTACHMENT C

Determination of adequate income benefit levels in the United States of America

by

Harrison Givens, Jr. and Morton D. Miller
U.S.A.

prepared for

The 20th International Congress of Actuaries

October 25 - November 1, 1976

Tokyo, Japan

ADVISORY COUNCIL: Note particularly
Tables V, VI, and VII.

This paper deals with income maintenance: for employees and their families after retirement or disability, and for survivors after death of the employee. The paper offers a standard for judging the adequacy of income benefits in each of these three circumstances, and thus for designing rational benefit objectives for each of the three principal sources.

Illustrations are then given on how such a standard may be usefully applied in the design and evaluation of employee benefit plans.

Résumé

L'assistance financière dont bénéficient aux Etats-Unis les individus et les familles en cas d'invalidité, de décès et de retraite provient de leurs programmes individuels d'assurance, des programmes d'assurance collective offerts par leurs employeurs et du Programme Fédéral de Sécurité Sociale.

Cette communication traite de la garantie des revenus: pour les employés et leur famille après la retraite ou en cas d'invalidité et, pour les survivants, en cas de décès de l'employé. La communication propose une norme pour établir dans quelle mesure les prestations de revenu dans chacune de ces trois circonstances sont satisfaisantes et ainsi pour établir des objectifs rationnels de prestations pour chacune des trois sources principales.

Des exemples sont alors donnés pour illustrer comment ces données peuvent être utilement appliquées à la mise en œuvre et à l'évaluation de régimes de prestations des employés.

Zusammenfassung

In den Vereinigten Staaten von Amerika besteht im Falle von Invalidität, Tod und Pensionierung die finanzielle Basis für Einzelpersonen und Familien aus Vorsorgemaßnahmen der Einzelpersonen selbst, aus Maßnahmen auf Grund von Unternehmern geschaffenen Plänen für Gruppen von Angestellten und aus Leistungen auf Grund des Bundessozialversicherungsprogramms.

Die Studie hier behandelt die Frage der Aufrechterhaltung des Einkommens für Angestellte und deren Familien nach der Pensionierung und im Falle der Invalidität, und für die Hinterbliebenen nach dem Tod des Angestellten. Sie schlägt einen Maßtab für die Beurteilung der Angemessenheit der in diesen drei Fällen zu erbringenden Leistungen vor und damit auch für die Festsetzung von vernünftigen Leistungszielen für jede dieser drei hauptsächlichen Basen.

An Beispielen wird gezeigt, wie diese Daten in geeigneter Weise bei dem Entwurf und der Beurteilung von Plänen, die von Unternehmern fär Angestellte geschaffen werden sollen, verwendet werden können.

Determination of adequate income benefit levels in the United States of America

by

Harrison Givens, Jr. and Morton D. Miller

U.S.A.

Introduction

In the United States of America, financial support for individuals and families in the event of disability, death and retirement comes from the measures taken by the individuals themselves on their own behalf, by employer-sponsored benefit plans for groups of employees, and by the federal government's Social Security program. This tripartite approach may be described in the following way.

Each of these measures—individual, group and government—has a special and necessary function of its own, which need not, and should not, compete with or overlap the others. Each should derive mutual support from the others and perform its role better because of their existence. When properly coordinated, they may be pictured as a three-legged stool affording firm and well rounded support for the citizens. A major strength of this triple support is its wide scope and diversity.

Benefit programs of all varieties have expanded tremendously in recent years and have become vastly more complex. Coordination of benefits from these three major sources is thus more difficult, but highly desirable in order to avoid overlap and to see that the huge amounts spent in aggregate are most effectively and economically applied to achieve their common purpose.

This paper deals with income maintenance: for employees and their families after retirement or disability, and for survivors after death of the employee. The paper offers a standard for judging the adequacy of income benefits in each of these three circumstances, and thus for designing rational benefit objectives for each of the three principal sources.

Benefit Sources

The pluralistic society of the United States of America gives rise to a wide variety of income security provisions. In addition to conventional savings and investments, home purchases and the like, individuals may contract with insurance companies for:

(1) life insurance—either *industrial* (smaller amounts, weekly or monthly premium collection at home), or *ordinary*, and *credit* (for installment loans);

(2) individual annuities—including, under 1974 legislation, retirement plans with tax advantages; and
(3) disability income insurance.

In addition, individual life insurance is available from fraternal associations, from savings banks in several states, and to veterans from the federal government.

Employment-related plans are primarily:

(1) group life insurance—normally a single-sum payment, but income plans have recently become popular;
(2) disability income insurance for non-occupational disability, and mandatory Workmen's Compensation benefits in case of job-related death or disability; and
(3) pension plans—the bulk of the funds traditionally with banks, but with larger life insurance companies increasingly competitive.

The federal Social Security system provides income benefits in the event of death, disability, and retirement for nearly all employed persons, including the self-employed, and their families. The system is financed on a pay-as-you-go basis; that is, revenues are approximately equal to aggregate benefits year by year. Special taxes are levied as a percentage of covered earnings, shared by employees and employers equally and somewhat less than one and one-half times the employee rate for the self-employed. Benefits are based on average covered earnings over the career of the individual, adjusted for changes in the Consumer Price Index. The benefit formula is weighted significantly in favor of those with lower earnings. Eligible beneficiaries, besides the covered employee, are primarily the spouse and minor children.

The level of payments to finance these security provisions gives an overall measure of their value, using the premiums for insurance plans, the current contributions for uninsured plans, and the total taxes for Social Security cash benefits, exclusive of the taxes for the Hospital Insurance portion of Medicare (see Table I).

Table I
Aggregate expenditures
(in billions)

	1963		1968		1973		1973 As Percentage of 1968	1973 As Percentage of 1963
Individual Plans	$13.5	28.5%	$17.4	23.4%	$23.5	18.3%	135%	174%
Group Plans	18.1	38.4	29.8	40.2	53.2	41.3	179	294
Social Security	15.6	33.1	27.0	36.4	51.9	40.4	192	333
Total	$47.2	100.0%	$74.2	100.0%	$128.6	100.0%	173%	272%

The aggregate of $128.6 billion for 1973 is 272% of that for 1963 or, on a constant purchasing power basis, about 187%.

From the point of view of the three-legged security stool, expenditures in 1963 were fairly evenly distributed. Since then, our stool has become somewhat lopsided, with individual plans growing least rapidly, employer group plans somewhat faster than the aggregate, and Social Security most of all. Individual plans would, of course, be more equal if savings in the form of home ownership, securities, etc., were taken into account, but they would still decline in relative importance.

Benefit payments (Table II) provide another comparative measure.

Table II
Aggregate benefits
(in billions)

	1963		1968		1973		1973 As Percentage of 1968	1973 As Percentage of 1963
Individual Plans	$ 9.1	26.4%	$12.3	22.0%	$17.9	17.4%	146%	197%
Group Plans	9.9	28.8	18.7	33.5	33.5	32.6	179	338
Social Security	15.4	44.8	24.9	44.5	51.5	50.0	207	334
Total	$34.4	100.0%	$55.9	100.0%	$102.9	100.0%	184%	299%

Benefits tripled from 1963 to 1973 in terms of dollars, but were only double in constant purchasing power. Social Security is more dominant by this measure than by current contributions because it is financed on a pay-as-you-go basis, whereas much of the private expenditures for individual and group programs is reserved for future benefits.

Standard of Adequacy

How much income maintenance should there be? There is a legislatively pre-determined *lower bound*: the adoption of the Social Security program over 40 years ago marked the establishment in the United States of America of the basic philosophical principle that the federal government should provide a level of income maintenance at least sufficient to keep the wage earner and family from becoming a public charge. This concept of "social adequacy," which continues to the present day, leaves the provision of additional benefits to the individual, alone or through group action. The principle justifies the more generous treatment of lower income wage earners and their families under the Social Security benefit formula.

The precise level of Social Security benefits is a function of the political process. The aggregate amount of earnings recognized for tax and benefit purposes was roughly 80% of total earnings in covered employment during the period from 1951 through 1972 but is about 86% currently. The worker's own benefit for retirement at age 65 has averaged roughly 35% of his covered earnings near retirement, and this benefit is increased by 50% if there is a spouse age 65 or over. Table III relates this benefit level to those of certain other countries.

A natural *upper bound* for the aggregate income needed from all sources is the level of spendable income received by the employee in a representative period shortly before his death, disability, or retirement. This leaves to the combination of employer and employee actions the provision of income to meet some, or all, of the margin by which this upper bound exceeds Social Security.

Table III[a)]

Replacement rate of old-age pension for a male worker with average earnings in manufacturing,[1] retiring at the end of 1972, and pension formula, selected countries

Country	Years worked	Pension as percent of earnings in year before retirement		Pension formula		
		Single worker	Couple[2]	Type of formula	Retirement age for full pension	Computation provisions
Austria[3]	40	61	61	Percent of average earnings in last 5 years (or age 45-50), time-related, indexed.	65..............	30 percent of "basis of assessment" (average covered earnings of last 5 years) plus 0.6 percent per year for 1-10 years, 0.9 percent for 11-20 years, 1.2 percent for 21-30 years, and 1.5 percent per year for 31 years and over.
Belgium	45	33	41	60 percent (single) or 75 percent (couple) of lifetime average covered earnings, indexed.	65..............	....
Canada[3]	[4]40	33	51	Universal pensions plus 25 percent of average covered earnings, highest 10 years, indexed.	65..............	Earnings-related Canada Pension Plan began with 2.5 percent for retirement in 1967, increasing 2.5 percentage points per year to 25 percent in 1976.
Denmark	[4]40	31	44	Universal old-age pension plus time-related supplementary pension.	67..............	Supplementary pension, 100 kroner a year times years of coverage.
France[3,5]	34	47	62	22.6 percent of average credited earnings of highest 10 years, indexed.	65[5]	4.5-percent increment per year of deferral after age 60.
Germany, Federal Republic of	35 40	44 50	44 50	Percent of average lifetime earnings.	65..............	1.5 percent of "assessed wages" times years of coverage. "Assessed wages" is the ratio of the individual's earnings to the national average earnings, multiplied by the national average during the 3 years preceding the year before retirement.
Italy[3]	40	68	68	74 percent of average earnings of last 3 years.	60..............	....
Netherlands	[4]50	34	48	Flat-rate.	65..............	....

Norway	[4]40	39	53	Universal pension, plus supplement related to average earnings of highest 20 years.	67...............	45 percent of a base amount tied to both price and wage indexes, times number of average annual pension points. Pension points are derived by dividing annual earnings (between the base amount and the ceiling) by the base amount. Base amount is roughly one-third of the national average wage.
Sweden	[5]30	49	62	Universal pension, plus supplement related to average earnings of highest 15 years.	67...............	60 percent of a base amount tied to a price index, times number of average annual pension points. Pension points are derived by dividing annual earnings (between the base amount and the ceiling) by the base amount. Base amount is roughly one-third of the national average wage.
Switzerland[3]	Years since 1948.	19	28	Percent of average earnings since 1948, indexed.	65...............	125 francs a month plus 1.25 percent per month of average earnings.
United Kingdom ...	([6,7])	29	40	Flat-rate plus graduated pension based on percent of contribution.	65...............	Graduated pension related to total contribution paid.
United States[3]	([8])	38	57	Weighted formula based on average earnings after 1950, with lowest 5 years omitted.	65...............	108.01 percent of first $110 plus 39.29 percent of next $290 plus 36.71 percent of next $150 plus 43.15 percent of next $100 plus 24.00 percent of next $100 plus 20 percent of next $250.

[1] Based on earnings data from International Labor Organization, *Yearbook of Labor Statistics, 1973.*

[2] Includes supplement for spouse in countries with such a provision.

[3] Data relate to all adult workers; comparable data for male worker not available.

[4] "Number of years worked" is smallest number required to receive full pension when system is mature, but because the system is somewhat new the earnings-related component is still relatively small and covers few years.

[5] Statutory retirement at age 60 (30 years of work required), with 22.6-percent replacement rate; under the law retirees with 35 or 40 years of work would also have a 22.6-percent replacement rate at age 60. Age shown in "retirement age" column is "normal" retirement age, and computations here are for that age.

[6] With contributions each year from ages 16 to 64 inclusive; 2-percent decrement for each unexcused year of noncontribution, but system is in effect virtually universal

[7] For universal part of program, contributions in all years since attainment of age 18; for wage-related part, contributions in all years after 1962.

[8] With 1 calendar quarter of coverage for each year after 1950 and up to year worker reached age 65.

[a] Social Security Bulletin, December 1974, page 45.

The gross income received by the employee is, of course, not his spendable income. Deductions must be made to recognize federal income taxes, Social Security taxes, and often state and local income taxes. Also, there is no need to replace the component of income spent before death, disability or retirement on work-related expenses, e.g., the costs of commuting to work. Finally, the share of earned income allocated to savings, e.g., to build up funds for future income maintenance, is no longer required. The portion of gross income remaining after these adjustments represents the income actually consumed by the individual or family; it is this net income that supports and measures their standard of living.

Standard-of-Living Measure

Table IV shows how these considerations may be quantified in the case of employees from age 55 to 65. This age range, close to retirement, is also where the deaths and disabilities of the working span are concentrated.

Table IV[a]
Spending patterns while working
for ages 55 to 65 as of July 1, 1974

(1)	(2a)		(2b)		(3)		(4)		(5)	
Gross Annual Earnings	Federal Income Taxes	% of (1)	Social Security Taxes	% of (1)	Work-Related Expenses	% of (1)	Personal Savings	% of (1)	Standard-of-Living Measure	% of (1)
					Single					
$ 5,000	$ 490	9.8%	$290	5.8%	$ 260	5.2%	$ 0	.0%	$ 3,960	79.2%
7,500	1,000	13.3	440	5.8	400	5.3	100	1.3	5,560	74.1
10,000	1,530	15.3	580	5.8	560	5.6	400	4.0	6,930	69.3
15,000	2,630	17.5	770	5.1	930	6.2	1,500	10.0	9,170	61.1
25,000	5,420	21.7	770	3.1	1,480	5.9	4,250	17.0	13,080	52.3
50,000	15,350	30.7	770	1.5	2,280	4.6	8,850	17.7	22,750	45.5
	Married, husband and wife of equal age with no other dependents									
$ 5,000	$ 330	6.6%	$290	5.8%	$ 260	5.2%	$ 0	.0%	$ 4,120	82.4
7,500	760	10.1	440	5.8	400	5.3	100	1.3	5,800	77.3
10,000	1,190	11.9	580	5.8	560	5.6	400	4.0	7,270	72.7
15,000	2,100	14.0	770	5.1	930	6.2	1,500	10.0	9,700	64.7
25,000	4,310	17.2	770	3.1	1,480	5.9	4,250	17.0	14,190	56.8
50,000	12,620	25.2	770	1.5	2,280	4.6	8,850	17.7	25,480	51.0

[a] See Notes on Page 120

The calculations are as of mid-1974. Much of the raw material for this type of analysis is available from government sources. While judgmental modifications are necessary in adapting the data, the reliability of the results is not impaired as long as they are taken, as intended, to measure relative magnitudes rather than the precise circumstances of particular individuals. For example, Table IV says that, on the average, a married employee with annual earnings of $15,000 pays $2,100 in federal income taxes, and $770 in Social Security taxes, has $930 of work-related expenses, and saves $1,500, leaving $9,700 for current consumption, which we are designating as the *standard-of-living measure*.

Retirement

This leads us to the question of how much gross income is necessary at age 65 to maintain pre-retirement living standards. As mentioned earlier, work-related expenses have ceased and savings need no longer be added to. Also, substantial Social Security payments are received, which are not subject to income taxes, and larger exemptions are available for federal income tax purposes.

After allowing for all these factors, the question becomes how much pre-tax income will provide a total after-tax income, along with Social Security, equal to the standard-of-living measure before retirement? Table V provides this analysis.

Table V[a]

Spending patterns after retirement

(1) Pre-Retirement Earnings	(2) Social Security	(3) Taxable Income Supplement[b]	(4) Federal Income Taxes	(5) Standard-of-Living Measure[c]
		Single		
$ 5,000	$2,540	$ 1,420	$ 0	$ 3,960
7,500	3,300	2,260	0	5,560
10,000	3,660	3,350	80	6,930
15,000	3,720	5,980	530	9,170
25,000	3,840	10,740	1,500	13,080
50,000	3,840	23,630	4,720	22,750
	Married, husband and wife of equal age with no other dependents			
$ 5,000	$3,810	$ 310	$ 0	$ 4,120
7,500	4,950	850	0	5,800
10,000	5,490	1,780	0	7,270
15,000	5,580	4,120	0	9,700
25,000	5,760	9,210	780	14,190
50,000	5,760	23,180	3,460	25,480

[a] See Notes on Page 120

[b] Column (5) minus Column (2) plus Column (4)

[c] From Table IV

The taxable income supplement is the balancing item, solved for as the amount that, after reduction for federal income taxes, will equal the standard-of-living measure when added to Social Security. At the $50,000 earnings level, for instance, the standard-of-living measure for a couple is $25,480. Since Social Security provides $5,760 tax free, a taxable income supplement is needed which will provide $19,720 after taxes. At that level of income, on average, $23,180 of taxable income will be reduced by $3,460 in federal income taxes, leaving $19,720 of after-tax income.

Disability

Now consider the case of an employee who becomes disabled in his 50's or early 60's for an extended period or permanently. What income should be continued if he and his family are to maintain their pre-disability standard of living? Their need for continued

Table VI[a]
Spending patterns after disability

(1) Pre-Disability Earnings	(2) Social Security	(3) Taxable Income Supplement[b]	(4) Federal Income Taxes	(5) Standard-of-Living Measure[c]
		Single		
$ 5,000	$2,540	$ 1,420	$ 0	$ 3,960
7,500	3,300	2,260	0	5,560
10,000	3,660	3,270	0	6,930
15,000	3,720	5,450	0	9,170
25,000	3,840	9,620	380	13,080
50,000	3,840	21,980	3,070	22,750
		Married, husband and wife with no other dependents		
$ 5,000	$2,540	$ 1,580	$ 0	$ 4,120
7,500	3,300	2,500	0	5,800
10,000	3,660	3,610	0	7,270
15,000	3,720	5,980	0	9,700
25,000	3,840	10,760	410	14,190
50,000	3,840	24,660	3,020	25,480
		Married, husband and wife with one dependent child, age 18 to 21 and in school		
$ 5,000	$3,810	$ 430	$ 0	$ 4,240
7,500	4,950	1,000	0	5,950
10,000	5,490	1,960	0	7,450
15,000	5,580	4,440	0	10,020
25,000	5,760	9,610	120	15,250
50,000	5,760	24,690	2,840	27,610

[a] See Notes on Page 120
[b] Column (5) minus Column (2) plus Column (4)
[c] From Table IV, with adjustment in the third tier for lesser federal income taxes and savings

support is analyzed in Table VI. The calculation of the taxable income supplement proceeds in the manner described for Table V, recognizing that the first $100 per week of employer-financed disability income is not taxable.

Two special and opposing considerations apply to disability income benefits. Underwriting caution would set the maximum income during disability somewhat below that required to maintain pre-disability living standards in order to leave a financial incentive for the wage earner to seek to return to work. On the other hand, extended disability sometimes results in continuing, substantial medical expenses, creating an income need not recognized by the standard-of-living measure.

Death

Similarly, Table VII brings out the income maintenance required to preserve the living standard of the family of a wage earner who dies before retirement.

Social Security benefits are available to a surviving spouse without dependent children only after age 65 (or age 60 in a reduced amount). If there are dependent children, the age

Table VII[a]
Spending patterns after death

(1) Pre-Death Earnings	(2) Social Security	(3) Taxable Income Supplement[b]	(4) Federal Income Taxes	(5) Standard-of-Living Measure[c]
		Widow, under 65, with no dependent children		
$ 5,000	$ 0	$ 3,520	$ 220	$ 3,300
7,500	0	4,810	460	4,350
10,000	0	5,720	630	5,090
15,000	0	7,240	940	6,300
25,000	0	10,060	1,540	8,520
50,000	0	18,930	3,630	15,300
		Widow, with two dependent children		
$ 5,000	$4,150	$ 200	$ 0	$ 4,350
7,500	6,160	10	0	6,170
10,000	6,690	190	0	6,880
15,000	6,790	2,000	0	8,790
25,000	6,960	5,570	300	12,230
50,000	6,960	18,080	2,740	22,300

[a] See Notes on Page 120
[b] Column (5) minus Column (2) plus Column (4)
[c] From Table IV, adjusted to remove employee expenses, lower federal income taxes, and eliminate savings

of the widow is not a factor, and the amount of the benefit depends on whether there is one child, or two or more. The table does not show two intermediate situations: (i) the surviving spouse without dependent children becomes eligible at age 65 for about four-sevenths the Social Security benefits shown for the two-dependent-children case, and (ii) the surviving spouse with one dependent child is eligible for about six-sevenths of that shown.

Benefit Plan Design

These analyses of spending patterns of wage earners and their families are useful as quantitative tools in designing new income benefit plans and evaluating the effectiveness of existing plans.

Using the simpler retirement situation for illustration, let us look first at Social Security. What proportion of the standard-of-living measure does Social Security provide? This is shown in Table VIII.

The benefits are seen to be weighted strongly in favor of those at lower income levels. At $5,000 of earnings, which is at the lowest end of wage levels now, the Social Security percentage is 64% for a retired individual and 92% for the more typical case of a retired couple. Broadly speaking, the System appears to be working well at the lower income levels in assuring the maintenance of living standards. Furthermore, with rising earnings, the benefits as a percentage of standard-of-living requirements diminish progressively

Table VIII
Social security related to standard of living

(1) Pre-Retirement Earnings	(2) Social Security[a]	(3) Standard-of-Living Measure[b]	(4) % of Standard-of-Living Measure[c]
		Single	
$ 5,000	$2,540	$ 3,960	64%
7,500	3,300	5,560	59
10,000	3,660	6,930	53
15,000	3,720	9,170	41
25,000	3,840	13,080	29
50,000	3,840	22,750	17
Married, husband and wife of equal age with no other dependents			
$ 5,000	$3,810	$ 4,120	92%
7,500	4,950	5,800	85
10,000	5,490	7,270	76
15,000	5,580	9,700	58
25,000	5,760	14,190	41
50,000	5,760	25,480	23

[a] Column (2) of Table V
[b] Column (5) of Table IV
[c] Column (2) divided by Column (3)

to 17% for an individual and 23% for a couple when pre-retirement earnings become $50,000. This is consistent with the philosophy of providing only a floor of protection.

An employer seeking to evaluate his own retirement plan starts with the almost universal Social Security program as a given. In general, these plans are paid for wholly by the employer, and so their benefits are fully taxable to the employees.

Table V sets forth the amount of taxable income supplement required in addition to Social Security for the employees' standard of living to be maintained into retirement. The adequacy of the employer's plan can therefore be measured by expressing the benefit, i.e., the company plan supplement, as a percentage of this taxable income supplement.

How well the standard-of-living measure, itself, is met can be judged by expressing the sum of Social Security and the company supplement as a percentage of the sum of Social Security and the taxable income supplement. (Strictly speaking, the federal income taxes should be calculated for the employee's benefit so that after-tax comparisons can be made, but these calculations are tedious and the results would not be materially different for most plans.)

As a useful example, consider a plan providing for the career employee an income equal to 50% of his average earnings near retirement, reduced by 83 1/3% of the primary (single employee) Social Security retirement benefit, with benefits proportionately lower for shorter service employees.

The use of final average earnings and a direct offset of the Social Security benefit is representative of modern benefit design in the United States of America. The level of offset allowed must comply with complex rules of the Treasury Department if the plan is to qualify for favorable tax status. The reduction of five-sixths of the primary benefit is the largest permitted and somewhat higher than usual practice.

The evaluation of this company plan appears in Table IX. For each of the comparisons, the plan does less well for the single employee than for the married employee. The reason is that in the United States of America single individuals are taxed more heavily than married persons. Consequently, for single individuals the amount of the taxable income supplement is significantly more. The company income supplement, therefore, becomes proportionately less, and to a greater degree at the lower income levels, and the percentage of the standard-of-living measure suffers as well.

The plan does a good job for married employees, the situation of most employees at retirement and, therefore, normally the one given the most weight. The company plan supplement is somewhat larger than the taxable income supplement except for the highest earnings and, correspondingly, the plan provides for a little more than the maintenance of living standards. The excess could be reduced if an increase in the offset of Social Security were allowable under Treasury rules, or if the 50% of earnings in the benefit formula were reduced by 1%, or so, but either of these would worsen the plan for single employees. Benefits under private plans are not customarily varied by marital status.

Table IX
Company plan evaluation

(1) Pre-Retirement Earnings	(2) Social Security	(3) Company Plan Supplement	(4) Taxable Income Supplement[a]	(5) % of Taxable Income Supplement[b]	(6) % of Standard-of-Living Measure[c]
		Single			
$ 5,000	$2,540	$ 383	$ 1,420	27%	74%
7,500	3,300	1,000	2,260	44	77
10,000	3,660	1,950	3,350	58	80
15,000	3,720	4,400	5,980	74	84
25,000	3,840	9,300	10,740	87	90
50,000	3,840	21,800	23,630	92	93
	Married, husband and wife of equal age with no other dependents				
$ 5,000	$3,810	$ 383	$ 310	124%	102%
7,500	4,950	1,000	850	118	103
10,000	5,490	1,950	1,780	110	102
15,000	5,580	4,400	4,120	107	103
25,000	5,760	9,300	9,210	101	101
50,000	5,760	21,800	23,180	94	95

a) From Table V
b) Column (3) divided by Column (4)
c) [Column (2) plus Column (3)] divided by [Column (2) plus Column (4)]

By contrast, we may consider a plan that does not offset Social Security. Under the present plan for public employees in a prominent industrial state, career employees are entitled to 60% of final pay up to $12,000, and 50% of final pay in excess thereof in addition to Social Security. The results are shown in Table X.

In this instance, the state plan supplement provides much more than the amount of the taxable income supplement, and the combination of Social Security and the state plan supplement provides income far in excess of that needed to maintain pre-retirement living

Table X
Public employee plan evaluation

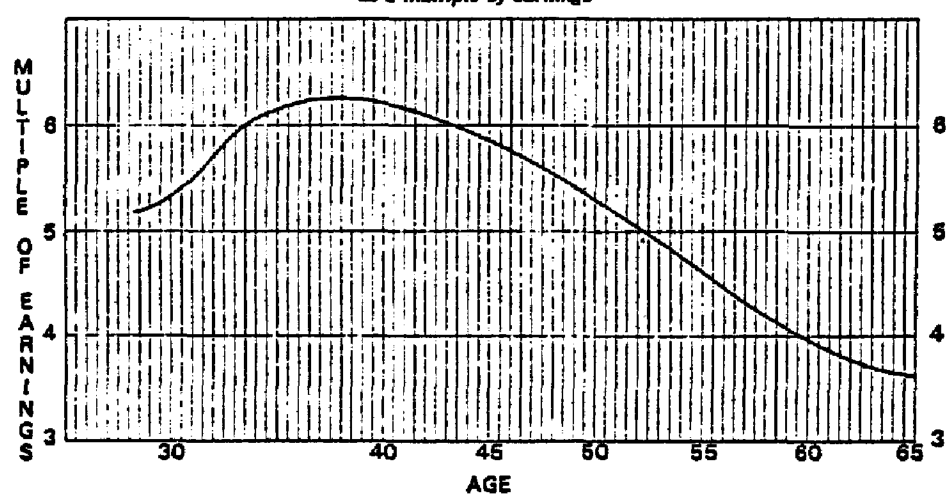
(1) Pre-Retirement Earnings	(2) Social Security	(3) State Plan Supplement	(4) Taxable Income Supplement[a]	(5) % of Taxable Income Supplement[b]	(6) % of Standard-of-Living Measure[c]
		Single			
$ 5,000	$2,540	$ 3,000	$ 1,420	211%	140%
7,500	3,300	4,500	2,260	199	140
10,000	3,660	6,000	3,350	179	138
15,000	3,720	8,700	5,980	145	128
25,000	3,840	13,700	10,740	128	120
50,000	3,840	26,200	23,630	111	109
		Married, husband and wife with no other dependents			
$ 5,000	$3,810	$ 3,000	$ 310	968%	165%
7,500	4,950	4,500	850	529	163
10,000	5,490	6,000	1,780	337	158
15,000	5,580	8,700	4,120	211	147
25,000	5,760	13,700	9,210	149	130
50,000	5,760	26,200	23,180	113	110

[a] From Table V
[b] Column (3) divided by Column (4)
[c] [Column (2) plus Column (3)] divided by [Column (2) plus Column (4)]

standards. It would appear that this kind of analysis played little part in the pragmatic political process which shaped the state plan's benefit formula.

Retirement plans different from those illustrated can be tested in a similar way. Disability plans can be designed or evaluated similarly, using the data in Table VI. Disability

Chart 1
Present value of needed survivor income as a multiple of earnings



plans are free to take full account of Social Security benefits, and frequently do by defining benefits as a percentage of earnings reduced by whatever Social Security benefit may become payable regardless of family status.

Death benefit plans can be analyzed with the data in Table VII. The typical death benefit plan presents a complication because, unlike Social Security benefits and private disability benefits, the predominant form of individual and group life insurance provides a single-sum payment at death. This makes comparison and evaluation somewhat more difficult, not because income must be converted to its single-sum equivalent but because employer plans customarily vary benefits only with earnings rather than with the age of the wage earner and his family situation. Hence, the usual single-sum plan is relatively least adequate at the younger ages and most adequate at the older ages because the insurance need is largest at the younger ages and then gradually diminishes as the family grows older.

Chart 1 illustrates the pattern of variation with age in the single-sum equivalent of survivor income maintenance requirements for a typical family. Expressed as a multiple of earnings, the example shows that the need starts at about five times earnings when the employee gets married, rises above six times and then begins to diminish at about age 40.

Maintenance of Purchasing Power

The standard-of-living measure was derived in terms of the economic circumstances of the individual shortly before cessation of earnings because of retirement, disability, or death. How long into the income period will these measures remain valid? The recent sharp rises in the rate of inflation have made this a major concern.

Social Security was amended in 1972 to adjust benefits annually in proportion to changes in the Consumer Price Index and to adjust covered earnings in proportion to an index of wages in covered employment. Periodic but sporadic updating of benefits for existing retired employees has become far more common and a few plans, including those for retired military personnel and federal civil service employees as well as some in industry, have introduced a regular plan mechanism for periodic adjustment. In a major development in private union-negotiated benefits, the aluminum, can and steel industries introduced a limited experimental indexing in 1974 which will be watched closely by students of private benefit design.

Conclusion

Some employers find this quantitative approach to income benefits immediately appealing, both in evaluating present plans and in designing new ones. This is true mainly in connection with plans for salaried employees where there are no union employees, or where negotiated and salaried benefit programs are designed independently.

Other employers feel constrained to keep in line with the benefit patterns of employers in their locality or industry. Still others must bargain benefit costs directly, e.g., on a cents-per-hour basis; often the translation of costs into specified benefits is done by others on an industry-wide basis or in a negotiating atmosphere that subordinates such plan design considerations to more pressing objectives. Even so, employers and unions in the private sector have responded to this type of quantitative examination when benefits were shown to be reaching excessive levels. A significant recent example is the reintroduction into the negotiated pension plans of the aluminum, can and steel industries of "cap" provisions that limit the sum of the primary Social Security benefit and the company plan supplement to a specified percentage of earnings near retirement.

The authors hope that the analyses presented here will be useful to others involved with pension and welfare plans. They are offered only as guides to overall patterns and average situations, and leave ample room for the exercise of individual judgment. Nevertheless, the concept of a quantitative approach to the design and evaluation of income benefits should lead to a more useful and realistic allocation of benefit plan resources.

Notes to Tables IV, V, VI, and VII

[1] Federal income taxes are based on the 1974 income tax schedules with personal and dependent exemptions of $750 each. For annual incomes under $10,000, the low income allowance was taken into account. For annual incomes of $10,000 or more, deductions totaling 15% of income were assumed.

[2] Social Security taxes equal 5.85% of taxable wages, with a maximum taxable earnings base of $13,200. Social Security benefits are those that would have commenced July 1, 1974, assuming that prior earnings had increased at the rate of 5% each year and do not reflect changes in benefit levels since that time.

[3] Work-related expenses are based on the 1960–61 Consumer Expenditures and Income Survey, adjusted to reflect the rise in such expenses through early 1974.

[4] Personal savings estimates are derived from the Survey of Changes in Family Finances.

[5] The estimated standard-of-living incomes in the case of survivor spending patterns in Table VII have been modified from those presented in Tables V and VI to reflect reduced consumption following the death of the wage earner. The reduction factors are consistent with the findings presented in The Widows Study: Adjustment to Widowhood.

References

1. Life Insurance Fact Book—Institute of Life Insurance, published annually.

2. Source Book of Health Insurance—Health Insurance Institute, published annually

3. Social Security Bulletin—Social Security Administration, December 1974

4. With An Eye To Tomorrow—Report on the Future Outlook Study—Institute of Life Insurance—Appendix IV

5. 1960–61 Consumer Expenditures and Income Survey—Department of Labor

6. Survey of Changes in Family Finances—Dorothy S. Projector, Board of Governors of the Federal Reserve System, November 1968

7. The Widows Study: Adjustment to Widowhood—Life Insurance Agency Management Association, Vol. 2, 1971

Summary

In the United States of America, financial support for individuals and families in the event of disability, death, and retirement comes from the measures taken by the individuals themselves on their own behalf, by employer-sponsored benefit plans for groups of employees, and by the federal Social Security program.

ATTACHMENT D

LETTERS

Social Security

Sir:

Mr. Bayo's article in the June issue summarizes the 1978 reports on the Social Security Trust Funds. I would like to emphasize the importance of these reports which does not terminate with their publication. These reports on the program's financial condition were released by Social Security's Board of Trustees with as little fanfare as possible. To do otherwise would have been to risk publicizing that, despite recent assurances to the public that the 1977 Amendments placed the Social Security program in sound financial condition for the next 50 years, the facts (according to projections prepared by the Social Security Administration actuaries) are as follows:

- The Hospital Insurance program will begin operating at a deficit in 1985 and the Hospital Insurance trust fund will be exhausted in about 1990—just 12 years from now.
- To finance the benefits provided under the present Social Security program (Old-Age, Survivors, Disability and Hospital Insurance combined) will require current tax rate of 6.05 percent to be increased steadily to approximately 8 percent by the year 2000 and 12 percent by the year 2025. In other words, the tax rate will have to increase, on the average, by 0.13 percent *each year* for the next 46 years at which time it will be some 12 percent of taxable earnings. (Current law provides for the tax rate to increase to 7.65 percent by the year 1990 and to remain level thereafter.)

Publicity of this type could have been considered to be inappropriate at a time when the public was balking at a scheduled tax rate increase in 1979 of a mere 0.08 percent (from 6.05 percent to 6.13 percent) and when the Congress was considering "rolling back" the tax rate to 5.85 percent and "using general revenue" to meet the deficits thus created. For those not familiar with government jargon, it may be useful to point out that to "use general revenue" can mean any one of these three things:

(1) Reduce government spending so that a portion of the general taxes already being collected will be available to pay Social Security benefits.

(2) Increase the general taxes so that additional funds will be available to pay Social Security benefits.

(3) Do neither (1) nor (2), but increase the national debt by the amount needed to pay the portion of the Social Security benefits which cannot be financed by Social Security payroll taxes, i.e., engage in deficit spending.

Proposals the past few months to use general revenue to finance Social Security benefits have contemplated definition (3) so as "to minimize the impact on the economy." This is specious reasoning to say the least. Such action would be tantamount to continuing benefit payments at ever-increasing levels but refusing to collect the taxes necessary to pay for such benefits. This first small dose of deficit spending "to pay for" Social Security would undoubtedly result in continuing and larger doses until the public eventually became hopelessly addicted to the illusion of getting something for nothing. Congress has an awesome responsibility in deciding whether to be the pusher for euphoric deficit spending for Social Security.

In addition to this responsibility, Congress has a golden opportunity to regain some of the public confidence it has lost in recent years. Just because the Trustees issued their financial reports to the Congress without fanfare, that doesn't mean the Congress has to keep quiet. Congress should communicate the results of these financial reports to the public so they will have a full understanding of the probable cost of Social Security, now and in the future. Attempts to conceal the cost, or minimize the significance of the cost, or apologize for the cost will not change the cost in any way. Furthermore, Congress should explain to the public the rationale of the Social Security program so that people will know what role they should expect Social Security to play in meeting their income maintenance needs.

Once the public knows what Social Security is and what it costs, they will be in a position to reaffirm the program or effect a revision which strikes an acceptable compromise between what the public wants and what it is willing to pay for. In either event, everyone will be the winner. If the public is not given more information, everyone will be the loser.

A. Haeworth Robertson

THE ACTUARY (a periodic news publication of the Society of Actuaries), September, 1978.

ATTACHMENT E

THE SOCIAL SECURITY DEFINITION OF DISABILITY

For purposes of disabled worker's benefits under the Social Security Act, disability is defined as the inability to engage in any substantial gainful activity because of a medically determinable physical or mental disorder which is expected to result in death or last for at least 12 consecutive months. Not only must the worker be unable to perform his regular job but he must be unable to perform any kind of substantial work that exists in the national economy.

The disability determinations are made by appropriate state agencies according to standards set by the Social Security Administration and a selected sample is reviewed by the Social Security Administration. However, in spite of this attempt to assure uniformity, a study made several years ago indicated that there are significant differences between the states in the application of the standards.

If the agency making the determination feels that the worker might be rehabilitated, the worker may be referred to a state vocational rehabilitation agency and the costs of these services may be paid from the Social Security trust funds. However, there are weaknesses in this which will be explained later when substantial gainful activity is discussed.

The key items in the definition of disability are (a) medically determinable mental or physical disorder and (b) substantial gainful activity available in the national economy. Each of these is discussed below.

Medically Determinable Mental or Physical Disorder - This is interpreted to mean that the disability must be able to be shown by medically acceptable clinical and diagnostic techniques. Thus, the statement of a doctor that a worker is disabled is not sufficient to demonstrate that a worker is disabled and this is necessary to avoid vast differences in the application of the standards especially since few doctors know what the Social Security standards are. However, non-medical factors such as age, education and past work experience are also taken into account in determining if an employee could perform any work that exists in the national economy as defined below.

Substantial Gainful Activity Available in the National Economy

Under this criteria all that is necessary is to show that there are a significant number of jobs in existence somewhere in the nation that the disabled workers could perform. It is not necessary to show that the employee would be hired if he applied for them or that there are vacancies for these jobs. To do otherwise would make the application of the standards susceptible to changes in the economy and other non-medical factors. However, the courts have been taking the position that the employee need only prove he cannot perform his regular job and that after he has done that the burden of proof shifts to the Social Security Administration to show what other jobs exist that the worker could perform. The services of vocational consultants are used for this purpose but here again there is a lack of uniformity especially if the medical evidence might be conflicting since the consultant makes an evaluation of the medical evidence on his own.

Another major problem is in defining what constitutes substantial gainful activity. This is not defined in the Act but in regulations put out by the Social Security Administration. If an employee earns more than the exempt amount applicable to non-disabled beneficiaries for purposes of the earnings test (in 1977 this amount was $3,000), he is deemed able to perform substantial gainful activity.

The above definition of substantial gainful activity is also used to terminate benefits after a trial work period. Since the earnings are taxable and frequently less than the non-taxable Social Security benefit which the worker stands to lose by engaging in employment, this definition acts as a deterrent to an employee trying to rehabilitate himself. It is possible that if employees were encouraged to try to work and make substantial earnings without risking the complete loss of benefits worth more than the earnings, the costs of the program might be reduced. No doubt many disabled workers intentionally limit their earnings so that they do not exceed the exempt amount in order to avoid losing their Social Security benefits completely. Because of the above, the conscientious individual who tries to help himself is frequently put at a disadvantage. Furthermore, the disabled employee is in an all or nothing position as far as his benefit is concerned but the non-disabled retired worker can retain part of his benefit if he works and earns above the exempt amount because of the way the earnings test works. There is a question as to why the restrictions on the disabled worker whose medical impairment is continuing should be more severe than on the non-disabled beneficiary under the age of 72.

The standards above apply to disabled workers and disabled children beneficiaries. A different standard applies to disabled widows primarily because of the difficulties involved in showing the ability to work for a woman who may have been out of the labor force for many years before she became a widow.

Based on the above, any changes contemplated in the definition of disability should take into account two areas (a) more uniformity and (b) an incentive to disabled workers to rehabilitate themselves and to reenter the labor force.

AMERICAN ACADEMY OF ACTUARIES
208 South La Salle Street • Chicago, Illinois 60604
312/782-1204

January 9, 1979

Director of Research and Technical Activities
Financial Accounting Standards Board
File Reference No. 1056
High Ridge Park
Stamford, Connecticut 06905

Dear Sir:

The American Academy of Actuaries Committee on Financial Reporting Principles welcomes and supports your "Proposal for Dealing with Industry Accounting Matters and Accounting Questions of Limited Application". We share the concerns expressed by others over the difficulties which are certain to arise when more than one organization is determining accounting standards. For the reasons listed in your letter, we agree that it is reasonable that the FASB should have exclusive responsibility for determining accounting standards.

Two aspects of the proposal concern us.

In the past, the FASB has recognized the difficulties in applying accounting principles to employee benefit plans, insurance companies, and other entities for which actuaries are especially concerned. The FASB also recognized the necessity of taking actuarial principles into consideration in developing accounting standards. As more specific accounting principles are developed, it becomes even more important that the FASB solicit and seek to understand the contribution which actuaries can make. We ask that you continue this effort and, to the extent possible, increase it. We also recommend that the FASB strengthen its staff to include individuals with specialized knowledge and experience in accounting for employee benefit plans and insurance companies including, if possible, one or more actuaries.

More generally, there are certain activities which are so dependent on actuarial considerations that an understanding of those actuarial considerations is necessary in order to develop proper accounting standards. Such activities include complex discounting functions of all kinds and activities dependent upon the occurrence (or lack

Director of Research and Technical Activities
January 9, 1979
Page Two

thereof) of future events (such as insurance or annuity functions). When an issue involving actuarial considerations is under study, we very strongly urge that the actuarial profession be directly involved in the developmental stages of the work. In particular, FASB committees or task forces for such issues should include appropriate actuarial representation.

Our second concern is with the proposed "technical bulletins". We are concerned that many of the issues of special importance to actuaries may be the subjects of these technical bulletins. In some cases, the concern of actuaries may not even be apparent to the FASB staff. In the past, we have observed that some FASB positions have been issued without fully recognizing informed opinion--for example, Interpretation 15 to Statement 8. We believe that the process for issuing technical bulletins will need to include greater opportunity for public participation than is contemplated. One specific suggestion we have is that the FASB regularly publish lists of issues on which technical bulletins are being developed. Interested parties would then be able to alert the FASB of possible pitfalls or interrelated special concerns and, where appropriate, could offer to provide knowledgeable assistance or advice.

Finally, we wish to assure you that the Academy of Actuaries is always available to provide assistance in matters involving actuarial concerns.

Sincerely,

Richard S. Robertson

Richard S. Robertson, Chairman
American Academy of Actuaries Committee
on Financial Reporting Principles

RSR:co

MATERIALS RE SAS 11
INSURANCE

CONTENTS

PRELIMINARY COMMENT

1. This material was prepared as if there would be a separate SAS to cover only life and health insurance (which will not cover casualty insurance, nor pensions, nor other industries). The reason for selecting this format was simply to make it easier to put something together. The selection of this format does not imply that it is the format which should be used. Eventually, hopefully, the SAS from life and health insurance would be expanded to include casualty insurance to make one SAS for all insurance and also further expanded to include pensions to make one SAS for actuarial work. Such expansion would take into account specific needs in the other areas such as the ERISA requirements that the Enrolled Actuary be retained on behalf of plan participants and that he render an opinion regarding the actuarial assumptions and methods. Having made the simplifying assumption that the material covered only life and health insurance, it was natural to label it SAS #11, Section 336, as if the present SAS did not exist.

2. The final product will read much easier if some thinking now going forward about the definition of types of actuarial communications reaches fruition. Specifically, we are distinguishing between two distinct types of communications. In an "actuarial opinion" an actuary states an opinion on a matter with respect to which he had the responsibility for the work. In an "actuarial review" an actuary states an opinion based on a review of actuarial work he did not himself do. An actuarial review could be rendered only by an actuary who was not involved in the original work and was not involved organizationally or financially with any person or firm who did the work.

3. In the material as drafted, there are certain implicit and/or explicit perceptions concerning the roles unique to the auditor and the actuarial specialist which we trust will be clear to the informed reader.

4. This material is simply a starting draft for discussion. We hope that it will be a useful vehicle enabling use to progress toward a meaningful product.

5. The Recommendation 2 draft, especially, needs more work on clarity, syntax and organization.

Pertinent Portions of AICPA

Professional Standards

AU ¶#	Issue Date	SAS#	
336	12/75	11	Using the Work of a Specialist
337	1/76	12	Inquiry of a Client's Lawyer
333	9/77	19	Client Representations
509	10/74	2	Reports on Audited Financial Statements
322	12/75	9	Internal Control
543	11/72	1	Part of Examination Made by Other Auditors

Also:

1. Interpretations of Above.
2. Industry Audit Guide: Audits of Stock Life Insurance Companies

AU Section 336

USING THE WORK OF AN ACTUARY - LIFE AND ACCIDENT AND HEALTH INSURANCE

.01 The purpose of this section is to provide guidance to the auditor with respect to his using the work of an actuary in performing an examination of financial statements of a life and accident and health insurance company in accordance with generally accepted auditing standards.

DECISION TO USE THE WORK OF AN ACTUARY -

.02 The auditor's education and experience enable him to be knowledgeable about business matters in general, but he is not expected to have the expertise of a person trained for and qualified to engage in the practice of the actuarial profession.

.03 The life and accident and health insurance business is characterized by long term obligations and is based upon probabilities, risks, and the time value of money. Hence, financial statements are based on probabilistic evaluations of future events with appropriate recognition of the time value of money. In general, actuarial liabilities reflecting these considerations amount to 70-90% of total liabilities, and assets reflecting these considerations amount to 10-40% of total assets. The provision for future policy benefits, unamortized acquisition costs, and related items are examples of such liabilities and assets. The necessary preparation to practice in the actuarial profession involves extensive training and experience in the determination of such items. Their determination requires professional actuarial judgment. These items are extremely material to the financial statements, usually being the dominant element.

.04 Hence, an auditor should, unless his judgment dictates otherwise due to exceptional and unusual circumstances, make use of an actuary as a specialist during his examination. Such actuary is referred to hereafter in this section as the "specialist".

QUALIFICATIONS OF THE ACTUARY -

.05 The auditor should satisfy himself as to the professional qualificiations and reputation of the specialist by inquiry or other procedures as appropriate. The auditor should consider the following:

(a) The professional designation of the specialist. Membership in the American Academy of Actuaries (the Canadian Institute of Actuaries with respect to Canada) is generally considered evidence of qualification to practice in the actuarial profession.

(b) The professional reputation and standing of the specialist in view of his peers, especially other actuaries and CPA's. The auditor should make inquiries in this regard of other practitioners (actuaries and CPA's), responsible sources in the insurance industry, and other appropriate sources.

(c) The professional standards enunciated by the American Academy of Actuaries govern the types of assignments an actuary should accept.(1)

.06 The auditor must also consider the relationship of the specialist to the parties and to the preparation of items for the financial statements.

(a) The auditor may use the services of a specialist who is an employee of the client, including a specialist who prepared items for the financial statements.

(b) The auditor may use the services of a specialist who is independent (financially and organizationally) of the client and of the auditor whether or not the specialist or a member of his firm has supplied advice or has otherwise been involved regarding elements of the financial statements.

(c) The auditor may use the services of a specialist who is not independent (financially and organizationally) of the auditor but neither the specialist, nor a member of his firm, has supplied advice or otherwise been involved regarding elements of the financial statements. (Use of the services of a specialist who is not independent [financially and organizationally] of the auditor where the specialist or a member of his firm has supplied advice or has otherwise been involved regarding elements of the financial statements is not appropriate. This is because of the independence and objectivity required to apply audit considerations and procedures to the qualifications of, and use of the findings of, the specialist.)

In all cases, it is good practice to learn in advance of such relationships.

(1) For example, the AAA Opinion A-5 as to professional conduct revised 1978 states "... A special responsibility rests on every actuary to undertake only those assignments which he is qualified to do...There may be some situations where,... an actuary is invited to give adivce in a field where he has had inadequate training or experience. The actuary should accept an assignment for which his qualifications are so limited only after he has disclosed the limitations to his client, and should undertake in the course of the assignment research and professional consultation sufficient to overcome these limitations."

AUDITING CONSIDERATIONS AND PROCEDURES - QUALIFICATIONS OF THE ACTUARY

.07 In addition to the considerations and procedures mentioned above, the auditor should satisfy himself that: 1)the specialist has sufficient understanding of the requirements of generally accepted accounting principles as they apply to life insurance company financial reporting and the roles of the actuary and the auditor, and 2)the specialist is thoroughly familiar with professional standards of the actuarial profession, especially as regards the engagement.(2) The importance of this procedure cannot be overemphasized. The auditor should take special pains to assure that there is good communication between the specialist and himself with regard to such matters as "matching" revenue and expense, "consistency", and "materiality". These concepts are of fundamental importance to the auditor and have specific meanings to him. The auditor's procedure of satisfying himself concerning qualifications of the actuary - whose professional judgment will lead to results the auditor plans to use - should be performed and the results of the procedure documented in the auditor's files before the work has commenced, and not when the time to use the findings of this specialist has arrived.

.08 Planning:

(a) The auditor and the specialist should determine in advance: 1)the items, if any, with respect to which the auditor will exoress reliance on the actuary in his report, 2)the items with respect to which the specialist will render an opinion and, 3) the items with respect to which the specialist will provide assistance to the auditor.

(b) The auditor and specialist should determine the extent to which the auditor is assuming responsibility for audit forspecific items which will be used by the specialist in his work.

(c) The auditor should assure himself that the specialist has a clear understanding as to the use to which the specialist's findings will be put.

(d) The results of the planning procedures should be put in writing.

AUDITING CONSIDERATIONS AND PROCEDURES - USE OF THE FINDINGS OF THE ACTUARY

.09 All cases:

(a) The auditor is entitled to rely on the professional judgment of the specialist. The auditor is entitled to use the work of the specialist unless

(2) The American Academy of Actuaries Committee on Life Insurance Company Financial Reporting Principles has approved "Recommendation 2: Relations With the Auditor" and "Recommendation 3: Actuarial Report and Statement of Actuarial Opinion". These Recommendations are reprinted as Exhibit II (Section 336A) for the convenience of readers, but are not an integral part of this statement.

the findings are unreasonable in the circumstances. The statement of opinion of a specialist (selected according to the above considerations and procedures) is sufficient, competent, evidential matter with respect to the items on which the opinion is rendered unless the findings appear unreasonable. The standard "unless the findings appear unreasonable" is quite different than "if the findings appear reasonable". Inquiry concerning the actuarial items need be made only if the items in question appear unreasonable on their surface compared to the statement taken as a whole.

(b) Although it is not intended to expand this standard, the auditor should be aware that other significant sources of information are available to him from the specialist and/or his own tests of the financial statements taken as a whole. The first such source of information is the report of the specialist. It should be of such form and content that it can be followed by another actuary. The auditor should carefully read this report to determine whether the areas addressed by the specialist are in accordance with the plan for the engagement and whether its content satisfies the auditor's needs. He should inquire of the specialist concerning any apparent inconsistencies in the report. Second, the auditor will generally have available the results of the application of quantitative analyses to the financial statements as a whole. These are analyses which show the relationship between numerous items in the financial statements (as opposed to analyses of the component parts of each item). Such analyses are frequently prepared by actuaries and it is entirely appropriate for the auditor to discuss with the specialist the results of his review of them; any indication of inconsistency between the items supplied by the actuarial specialist and the other items in the financial statements should lead to inquiry of the specialist. The disciplining of actuarial assumptions is the responsibility of the actuary and the auditor should not substitute his judgment for the professional judgment of the specialist. However, the auditor's review of these sources of information is important to his understanding of common practices regarding actuarial assumptions in GAAP financial statements, and he should inquire of the specialist about any apparent inconsistencies.

(c) If the findings of the specialist appear unreasonable to the auditor he should not substitute his judgment for that of the specialist. He should discuss the results with the specialist, and if necessary, obtain the advice of a second actuary specialist. Inquiry of the specialist should be most productive of explanations for the apparent unreasonableness since the specialist is more familiar with the circumstances. Hence, such inquiry will usually resolve any questions. However, if the results of this discussion are not completely satisfactory, the auditor should seriously consider obtaining the opinion of a second actuary specialist who should be independent with respect to both the first specialist and the client. In the unlikely case of a conflicting professional specialists' opinions the ultimate decision must be made by the auditor as to which values, derived from apparently conflicting sets of competent evidenital matter are to be utilized in the financial statements. If the auditor cannot make such judgment, he must consider rendering a qualified opinion.

(d) The auditor will find the professional standards of the American Academy of Actuaries helpful in determining whether or not all items which should be addressed in the actuarial report have been addressed. The auditor should determine whether or not the actuarial report has considered all items of the statement which are interrelated. Where the actuarial report has not considered all interrelated items, he will take special care to assure that all such items which are not contained in the actuarial report are treated in a manner consistent with the treatment such items which are contained in the actuarial report. The auditor will usually find his purposes are best served if he makes available to the specialist, on a basis which gives due regard to matters concerning confidentiality,a copy of his consolidating work papers so that the specialist will have an opportunity to judge whether his findings appear reasonable to him in light of the financial statements taken as a whole.

(e) Additional considerations and procedures apply if: 1)the specialist is an employee of the client (see paragraph .10), or 2)the specialist is independent of the client and of the auditor and has contributed elements to the financial statements or lacks independence with respect to a person who has contributed elements to the financial statements (paragraph .11).

.10 Specialist is an employee of the client: The auditor should consider additional factors and perform additional procedures as follows:

(a) The professional requirements and standards of the actuarial profession are the same whether the actuary is employed by the client or is independent of the client, except with regard to the format of the reports the actuary renders. The auditor must satisfy himself as to the objectivity of the specialist. The auditor should take into account the organization level to which the specialist reports. This frequently is an indication of the extent of his ability to act objectively and knowledgeably. Another method for determining objectivity of the employed specialist is to review the recommendations made in his reports.

(b) With respect to elements of actuarial judgment reflected in the specialist's report, the auditor (as in the case of the independent specialist) should not substitute his judgment for the professional judgment of the specialist. If the results produced by the specialist appear unreasonable, the auditor should discuss the results with the specialist, and if necessary, obtain the opinion of a second actuary specialist. Again, inquiry of the specialist should be most productive. A part of the actuary's exercise of professional judgment is the selection of methods of approximation in performing calculations.

(c) The calculations and working papers which carry out the specialist's judgments are often prepared by other employees of the client other than the specialist. In such cases the auditor should consider the need for planning with the specialist procedures including: 1)reviewing the work papers: i)to determine their scope, ii)to compare for consistency on a test basis the results shown on the work papers with the results indicated in the specialist's actuarial report and, iii) to verify on a test basis that the work papers support the information presented in the report and, 2)verifying on a test basis some of the calculations exhibited in the work papers. Where the auditor has established that the work has been done under appropriate supervision by the specialist and the auditor's preliminary review indicates a high degree of control over the work product, the review and tests just mentioned may be limited in nature and extent. The same is true where the work product has been assembled by people not closely supervised by the specialist, but where either the specialist or people directly supervised by him have reviewed and tested the work product and where objective evidence of these measures is available to the auditor.

.11 Specialist is independent of the client and of the auditor, and has contributed elements to the financial statements or lacks independence with respect to a person who has contributed elements to the financial statements:

(a) The auditor should consider the circumstances of the case and apply his judgment to determine the advisability of using some or all of the auditing considerations and procedures in paragraphs .10(a) and (b).

(b) Also, if significant elements of the actuarial work were contributed by employees of the client other than the specialist or if the auditor feels the specialist is acting in the role of a member of management or as an employee of the client, then the auditor should consider the circumstances of the case and apply his judgment to determine the advisability of using some or all of the auditing considerations and procedures of paragraph .10(c).

EFFECT ON AUDITOR'S REPORT -

.12 The auditor may express reliance on the specialist with the consent of the specialist if: 1)the specialist is independent (organizationally and financially) of the client and of the auditor or, 2)the specialist is not independent of the auditor (organizationally and financially) but neither he nor any member of his firm has supplied advice or has otherwise been involved regarding elements of the financial statements. The auditor should appreciate that the specialist can only consent to such public expression of reliance on his opinion in accordance with his own professional standards.

.13 An example of appropriate reporting by the auditor indicating the division of responsibility when he makes reference to the work of the specialist follows:

We have examined the consolidated balance sheet of X Company and subsidiaries as of December 31, 19.., and the related consolidated statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the provision for future policy benefits or unamortized acquisition costs which represent 80% of the total liabilities and 30% of the total assets, respectively. These items were examined by John Doe, M.A.A.A. (insert employment affiliations), whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to such amounts is based solely upon the report of John Doe, M.A.A.A.

In our opinion, based upon our examination and the opinion of John Doe, M.A.A.A., the accompanying consolidated balance sheet and consolidated statements of income and retained earnings and changes in financial position present fairly...

.14 An actuarial opinion on which reliance is expressed should appear with the financial statements, immediately following the auditor's report; the client should be encouraged to follow this practice in publication of the statements.

An actuarial opinion on which reliance is not expressed should accompany the auditor's report; and the client should be encouraged to include such opinion in publication of the statements. The form and customary wording of the actuarial opinion reflects whether the specialist performed the work himself or reviewed the work of another actuary. Where, in addition to the specialist's opinion on which the auditor expresses reliance a statement of actuarial opinion is provided by an actuary employed by the client, it is recommended that the latter opinion be published as well.

.15 If the actuarial opinion is not included in the published statements, the footnotes to the financial statements should indicate that the auditor obtained the findings of an actuary specialist, should identify the actuary and his employment affiliation, and should indicated the items with respect to which the actuary expressed an opinion.

.16 If the opinion of the specialist is qualified, the auditor should decide whether the subject of the qualification is of such nature and significance - in relation to the financial statements on which the auditor is reporting - that it would require qualification of his own report. If the subject of the qualification is not material in relation to such financial statements, and the specialist's opinion is not presented, the auditor need not make reference in his report to the qualification; if the specialist's opinion is presented, the auditor may wish to make reference to such qualification and its disposition.

.17 The footnotes to the financial statement should in any event provide data concerning actuarial assumptions and matters pertinent to the financial statement.

e fourth standard of reporting is as follows:

› report shall either contain an expression of opinion regarding ıancial statements, taken as a whole, or an assertion to the effect n opinion cannot be expressed. When an overall opinion cannot pressed, the reasons should be stated. In all cases wherein an ›r's name is associated with financial statements, the report l contain a clear-cut indication of the character of the auditor's nation, if any, and the degree of responsibility he is taking.

e objective of the fourth standard is to prevent misinterpre- f the degree of responsibility the auditor is assuming when e is associated with financial statements. Reference in the eporting standard to the financial statements "taken as a ıpplies equally to a complete set of financial statements and lividual financial statement, for example, to a balance sheet. iitor may express an unqualified opinion on one of the finan- ›ments and express a qualified or adverse opinion or disclaim on on another if the circumstances call for this treatment.

r's Standard Report

› auditor's report customarily is used in connection with the ancial statements — balance sheet, statement of income, state- retained earnings and statement of changes in financial posi- these financial statements are accompanied by a separate it of changes in stockholders' equity accounts, it should be l in the scope paragraph of the report but need not be re- n separately in the opinion paragraph since such changes are , in the presentation of results of operations and changes in position.

› auditor's standard report consists of a statement describing e of the examination, usually in an opening or "scope" para- ıd an expression of the auditor's opinion, usually in a closing ›n" paragraph. The form of the standard report is as follows:

(Scope paragraph)

have examined the balance sheet of X Company as of [at] ber 31, 19XX, and the related statements of income, retained ;s and changes in financial position for the year then ended. amination was made in accordance with generally accepted g standards and, accordingly, included such tests of the ac-

counting records and such other auditing procedures as we considered necessary in the circumstances.

(Opinion paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of X Company as of [at] December 31, 19XX, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

.08 The report may be addressed to the company whose financial statements are being examined or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to examine the financial statements of a company that is not his client; in such a case, the report customarily is addressed to the client and not to the directors or stockholders of the company whose financial statements are being examined.

section 336 of any actuary specialist)

Circumstances Resulting in Departure From Auditor's Standard Report

.09 The circumstances that result in a departure from the auditor's standard report[1] are as follows:

a. The scope of the auditor's examination is affected by conditions that preclude the application of one or more auditing procedures he considers necessary in the circumstances.

b. The auditor's opinion is based in part on the report of another auditor. or opinion (in accord with

c. The financial statements are affected by a departure from a generally accepted accounting principle.

d. The financial statements are affected by a departure from an accounting principle promulgated by the body designated by the AICPA Council to establish such principles.

e. Accounting principles have not been applied consistently.

[1] As to circumstances in which the auditor is not independent, see section 517.

l statements are affected by uncertainties concern-
vents, the outcome of which is not susceptible of
stimation at the date of the auditor's report.

wishes to emphasize a matter regarding the financial

r can determine that he is able to express an unquali-
· if his examination has been conducted in accord-
lly accepted auditing standards and if he therefore
apply all the procedures he considers necessary in
s. Restrictions on the scope of his examination,
ly the client or by circumstances such as the timing
· inability to obtain sufficient competent evidential
lequacy in the accounting records, may require him
inion or to disclaim an opinion. In such instances,
e auditor's qualification of opinion or disclaimer of
e described in his report.

r's decision to qualify his opinion or disclaim an
of a scope limitation depends on his assessment of
f the omitted procedure(s) to his ability to form an
nancial statements examined. This assessment will
e nature and magnitude of the potential effects of
stion and by their significance to the financial state-
ntial effects relate to many financial statement items,
s likely to be greater than if only a limited number
d.

estrictions on the scope of the auditor's examination
lying to the observation of physical inventories and
f accounts receivable by direct communication with
rictions may concern other phases of the audit (for
tion 542.06). Restrictions on the application of
udit procedures to important elements of the

' as the timing of his work may make it impracticable or
uditor to accomplish these procedures. In such case, if he is
lf as to inventories or accounts receivable by applying alter-
here is no significant limitation on the scope of his work, and
include reference to the omission of the procedures or to the
ocedures.

(See section 543) or opinion of an actuary specialist (see section 336)

financial statements require the auditor to decide whether he has examined sufficient competent evidential matter to permit him to express an unqualified or qualified opinion, or whether he should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements.

.13 The auditor may be asked to report on one basic financial statement and not on the others. For example, he may be asked to report on the balance sheet and not on the statements of income, retained earnings or changes in financial position. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if he applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

Opinion Based in Part on Report of Another Auditor

.14 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his opinion, he should disclose this fact in stating the scope of his examination and should refer to the report of the other auditor in expressing his opinion. These references indicate division of responsibility for performance of the examination. Although they are departures from the standard report language, they do not constitute a qualification of the auditor's opinion. (See section 543.)

Departure From a Generally Accepted Accounting Principle

.15 *General.* When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has examined the statements in accordance with generally accepted auditing standards, he should express a qualified or an adverse opinion (see paragraphs 29 and 41). The basis for such opinion should be stated in his report.

.16 In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or an adverse opinion, one factor to be considered is the dollar magnitude of the effects. However, materiality *does not* depend entirely on relative size: the concept involves qualitative as

RECOMMENDATION 2: RELATIONS WITH THE AUDITOR

(Published May, 1979 by the Committee on Life Insurance Company Financial Reporting Principles)

1. This Recommendation supplements Opinion A-6 in giving advice concerning the actuary's relations with the auditor in connection with the preparation and review of financial statements of a stock life insurance company to be presented as having been prepared in accordance with "generally accepted accounting principles" as that term is understood in the United States.

2. The actuary will appreciate that if the results of the information furnished by the actuary appear unreasonable to the auditor, the auditor will make further inquiry. In these cases the auditor may review the actuary's findings with the actuary and/or submit the actuary's findings to another qualified actuary for review. In such case the actuary should make his material available to the other actuary and should himself be available for supplemental advice and explanation.

3. When a CPA audits financial statements of a company which are intended for publication or for filing with a regulator authority such as the Securities and Exchange Commission, the auditor is required by the tenents of his profession to form and express an opinion as to whether or not the statements fairly reflect the operations and the conditions of the company in accordance with generally accepted accounting principles.

INTERPRETATION 2-A: RELATIONS WITH THE AUDITOR

(Published May, 1979 by the Committee on Life Insurance Company Financial Reporting Principles)

1. The meaning of generally accepted accounting princples as applied to the financial reporting of a stock life insurance company is described in "Audits of Stock Life Insurance Companies", published by the AICPA.

2. Generally accepted accounting principles differ in certain material respects from accounting principles prescribed by state regulatory authorities and from those prescribed for life insurance companies by

federal tax law. The Audit Guide's definitions of generally accepted accounting principles do not apply to financial statements prepared for such purposes, and an auditor who audits financial statements which are based on such other accounting requirements will be required to qualify his opinion appropriately.

3. Pages 63 and 64 of the Audit Guide comment on background material which is of concern to both actuaries and auditors. Pages 97 to 99 of the Audit Guide contain advice to the auditor on utilization of actuaries.

4. In particular, the actuary should appreciate that concepts such as "consistency" and "materiality" are uniquely important to generally accepted accounting principles and have greater importance and different meaning than they have traditionally had in life insurance accounting. The words "consistent", "consistently", and "generally accepted accounting principles" all appear in the standard wording of the opinion which the actuary renders.

5. The actuary should appreciate that the auditor in fulfilling his responsibility will use the work of an actuary specialist. The designation "specialist" has a specific meaning as regards audit work performed by a CPA in accordance with AICPA auditing standards for the purpose of the CPA expressing his opinion.(1) The actuary should understand that care, including rigorous inquiries, in the selection of a specialist is a very significant part of the auditor's procedures.

6. An actuary who is engaged by an auditor as a specialist should plan with the auditor the items and areas on which he will express an opinion as an actuarial specialist, any other items and areas to be addressed in his report as well as other matters on which he will advise the CPA. The planning process should culminate in preparation of a written plan of coordination clearly setting forth the nature and scope of the actuary's work with respect to the audit.

(1) The auditing Standards Executive Committee has published Statement of Auditing Standards 11 concerning the use by the CPA of the work of an actuary specialist. The actuary serving as specialist will find this document helpful in giving the needed understanding of the auditor's needs. Copies thereof can be obtained from the AICPA and the AAA.

7. Advice concerning the form and content of the actuarial report and actuarial opinion are set forth elsewhere in professional literature. The actuary should clearly identify in writing to the auditor the basic records upon which he has relied in the course of his work. He should also describe any interpretations relied upon (e.g. "valuation amount" for a decreasing term plan is the initial amount, "age" for a renewable term plan is the original age, etc.). The actuary should clearly document his work. He should either reconcile his figures with those appearing in published financial statements or submit a letter to the auditor setting forth details of the figures he has reviewed and ask the auditor for a copy of his reconciliation with published financial statements. The actuary's purpose will be well served if he makes available to the auditor on a confidential basis preliminary drafts of his report and of his opinion which the auditor can consider in light of the auditor's other findings. The actuary's purpose will also be well served if he makes available to the auditor on a basis which gives due regard to matters concerning confidentiality any analyses he prepares of the relationship of the items on which he is expressing his opinion to the financial statements as a whole and other pertinent analyses. Discussion with the auditor by the actuary of his findings from such analyses is encouraged.

8. Although the disciplining of actuarial assumptions is the responsibility of the actuary, and the auditor does not substitute his judgment for the professional judgment of the actuary specialist, the auditor does have the responsiblity of further review and inquiry if the findings of the actuary appear to him to be unreasonable. In such event the acutary may receive inquiries from the auditor as to why the assumptions and/or findings of the actuary have values which appear to the auditor to be unreasonable. The actuary should respond fully and in a professional manner and understand that such inquiries are in the interest of achieving a mutual objective. They may provide the actuary with the only reivew he can obtain based on mutual interest. The actuary should understand that the auditor may seek the advice of another actuary specialist.

9. The auditor may choose to express reliance upon the findings of the actuary specialist, if the actuary consents to such expression, when: 1)the actuary is independent (organizationally and financially) of the client and of the auditor or, 2)the actuary is not independent (organizationally and finan-

cially) of the auditor but neither he nor a member of his firm has given advice or contributed elements to the financial statements. It is considered good actuarial practice for the actuary to consent to such expression provided that he feels such expression is justified (if he felt otherwise there is serious question as to whether or not the actuary's report and/or opinion should be submitted to the auditor as it stands). Expression of reliance on the actuary's findings in the published financial statements represents a sharing of responsibility for the review of such financial statements between the auditor and the actuary. In this event, the actuary should understand that his assumption of full personal responsibility for the findings is clearly evident to the public (indeed the willingness to assume such responsibility is a creiteria on that the actuary may well use in deciding whether or not to render a given report and/or opinion regardless of its intended distribution).

10. The actuary would not consent to such public expression of reliance if he: 1)were not independent (organizationally and financially) of the client or, 2)were not independent (organizationally and financially) of the auditor and also, either he or a member of his firm rendered advice or contributed elements to the financial statements. Further advice for the actuary is contained elsewhere in the professional literature.

11. The actuary's opinion will generally be contained immediately after the auditor's report in the published financial statements.

12. If the actuary specialist is not independent of the client, then the auditor is under obligation to considering performing additional auditing procedures. Such additional procedures do not involve substitution of the auditor's judgment for the actuary specialist's professional judgment, but they do include procedures to provide further assurance to the audtior with respect to the application of professional judgment to the determination of the financial statement items. These procedures involve, generally speaking, either working with the actuary or arranging for certain reviews and/or tests of the work product and the work papers. Also, if the actuary is independent of the client but contributed elements to the financial statements,.then the auditor may, depending on his judgment, perform additional procedures depending on the circumstances of the case.

INTERPRETATION 2-B: DOCUMENTATION

No change.

RECOMMENDATION 2: RELATIONS WITH THE AUDITOR

(Published April, 1974 by the Committee on Life Insurance Company Financial Reporting Principles)

1. This Recommendation supplements Opinion A-6 in giving important advice concerning the actuary's relations with the auditor in connection with review of financial statements of a stock life insurance company to be presented as having been prepared in accordance with "generally accepted accounting principles" as that term is understood in the United States.
2. The actuary will appreciate that if the auditor is unable to form an opinion on the basis of information furnished by the actuary the auditor may submit the actuary's findings to another qualified actuary for review, and in such case the actuary should make his material available to the other actuary and should himself be available for supplemental advice and explanation.
3. A consulting actuary who is engaged with an auditor in the same audit should prepare a written plan of coordination clearly setting forth the nature and scope of the actuary's responsibilities with respect to the audit. The actuary should clearly identify in writing to the auditor the basic records he has relied upon in the course of his work and should describe any interpretations relied upon (e.g., "valuation amounts" for decreasing term plans is initial amount, "age" for renewable term plans is original age, etc.) The actuary should clearly document his work and should either reconcile his figures with those appearing in published financial statements or should submit a letter to the auditor setting forth details of the figures he has reviewed and ask the auditor for a copy of his reconciliation to published financial statements.

INTERPRETATION 2-A: RELATIONS WITH THE AUDITOR

(Published April, 1974 by the Committee on Life Insurance Company Financial Reporting Principles)

1. When a public accountant audits financial statements of a life insurance company which are intended for publication or for filing with a regulatory authority such as the Securities and Exchange Commission, the auditor is required by the tenets of his profession to form and express an opinion as to whether the statements fairly reflect the operations and the condition of the company in accordance with generally accepted accounting principles. The meaning of "generally accepted accounting principles" as applied to the financial reporting of a stock life insurance company is described in "Audits of Stock Life Insurance Companies," published by the AICPA.
2. Generally accepted accounting principles differ in certain material respects from accounting principles prescribed by state regulatory authorities and from those prescribed for life insurance companies by federal tax law. The Audit Guide's definitions of generally accepted accounting principles do not apply to financial statements prepared for such purposes, and an auditor who audits financial statements which are based on such other accounting requirements will be required to qualify his opinion appropriately.
3. Pages 63 and 64 of the Audit Guide comment on background material which is of concern to both actuaries and auditors. Pages 97 to 99 of the Audit Guide contain advice to the auditor on utilization of actuaries.

INTERPRETATION 2-B: DOCUMENTATION

(Published October, 1975 by the Committee on Life Insurance Company Financial Reporting Principles)

1. A consulting actuary engaged with an auditor to audit or review a financial statement of a stock life insurance company, or specified elements thereof, shall clearly document his work (Recommendation 2). It is prudent and reasonable to prepare documentation which both aids the actuary in his work and provides support for the actuarial report or opinion rendered pursuant to his audit or review.

2. Documentation should include an adequate and complete description of the nature and scope of the actuary's engagement and should be so clearly and systematically prepared that it will be possible at any time to determine from such documentation the procedures followed, the tests performed, the evidential matter collected, the conditions found, and the conclusions reached. Accordingly, documentation may include work programs, analyses, memoranda, letters of confirmation and representation, complete copies of or excerpts from company documents, and schedules or commentaries prepared or obtained by the actuary.

3. Documentation should fit the circumstances and the actuary's needs on the engagement to which it applies. The factors affecting the actuary's judgment as to quantity, type, and content of the documentation desirable for a particular engagement include (*a*) the nature and scope of the work undertaken and the report or opinion required pursuant thereto, (*b*) the nature and condition of the actuary's and/or company's records he reviews, and (*c*) the needs in the particular circumstance for supervision and review of the work performed by any assistants.

4. Although the quantity, type and content will vary with the circumstances, documentation should generally include or show:

   a) Information sufficient to demonstrate that the items audited or reviewed were in agreement with (or reconciled with) the company's records.

   b) That the actuary's activities had been planned and coordinated with auditor engaged in the audit or review.

   c) The procedures followed, tests performed, and documentary evidence collected to support findings and conclusions.

   d) The resolution of exceptional or unusual matters.

5. Such documentation shall be the property of the actuary. He should adopt reasonable procedures for its safe custody with particular regard for the provisions of item 2(*b*) of the Academy's Guide to Professional Conduct. The actuary should retain his documentation for a period of time sufficient to meet the needs of his work and to satisfy any pertinent legal requirements for record retention. While such documentation shall be the property of the actuary, he is, of course, subject to all applicable legal requirements. The enumeration of these is beyond the scope of this Interpretation.

RECOMMENDATION 3: ACTUARIAL REPORT AND STATEMENT OF ACTUARIAL OPINION

(Published April, 1972 by the Committee on Life Insurance Company Financial Reporting Principles)

1. This Recommendation applies to the work of an actuary who acts for a stock life insurance company in the preparation of its financial statements, who contributes elements for inclusion in any such financial statement, or who audits or reviews elements of such a financial statement, when such financial statement is to be presented as having been prepared in accordance with "generally accepted accounting principles" as that term is understood in the United States.

2. As used in This Recommendation and related Interpretations, "Actuarial Report" means the actuary's report to management and auditor referred to in Number 4 of Opinion A-6 on the Academy's Guide to Professional Conduct, and "Statement of Actuarial Opinion" means a statement of the acuary's opinion prepared for publication with financial statements, referred to in Numbers 2 and 5 of Opinion A-6. A written plan of coordination or other working communication of a consulting actuary to an auditor as referred to in paragraph 3 of Recommendation 2 is not an "Actuarial Report" or a "Statement of Actuarial Opinion" within the meaning of this Recommendation.

3. Any judgment as to the appropriateness of the actuarial assumptions used in preparing data for financial statements must be formed in the light of the purpose for which the statements are being prepared. Financial statements which are primarily intended to reflect a matching of revenues and costs in accordance with generally accepted accounting principles may require the use of actuarial assumptions which differ from those which would be used in, for example, financial statements which give primary emphasis to solvency for the protection of policyholders, as is the case with statements based on standards prescribed by state regulatory authorities.

4. Guide 4(*d*) provides, in part, that "When a member characterizes reserves as adequate, he shall either (i) assure himself that they meet any applicable statutory or regulatory standards or (ii) clearly qualify his characterization in this respect, including an explicit statement as to whether the reserves meet such statutory or regulatory standards."

Actuarial Report

5. Opinion A-6 provides (No. 4), "When an actuary's work relates to financial statements prepared in accordance with generally accepted accounting principles, it is the opinion of the (Professional Conduct) Committee that Guide 2(*c*) requires as a minimum that an actuarial report should be furnished to the company and to the company's independent auditor, if any," and (No. 6), "It is the opinion of the (Professional Conduct) Committee that Guide 4(*a*) as applied to the actuary's work in connection with financial statements prepared in accordance with generally accepted accounting principles requires that the actuary disclose to the auditor the actuarial assumptions and methods, including, where appropriate, an appraisal of their suitability for the purposes at hand and reference to factors which have not been considered."

6. An Actuarial Report should contain descriptions of the scope of the actuary's work and of the actuarial assumptions and methods used.

7. An Actuarial Report should contain expressions of the actuary's opinion as to whether the reserves and other actuarial items in the statements are based on assumptions which are appropriate to the purpose for which the statements were prepared, whether the methods employed are consistent with sound actuarial principles, and whether provision has been made for all actuarial reserves and related statement items which ought to be established. An Actuarial Report should also include a statement of the actuary's opinion as to whether any amount carried in the balance sheet on account of unamortized acquisition expenses and the amount of liabilities carried on account of other future policy obligations and expenses are fairly stated (i.e., neither materially understated nor materially overstated) in accordance with sound actuarial principles (c.f., Recommendation 1).

8. If the actuary is unable to form an opinion in any respect defined in paragraph 7, or if his opinion in any such report is adverse or qualified, the Actuarial Report should specifically state the reason.

4. The scope paragraph should also contain a sentence such as the following:

"I have examined the Actuarial assumptions and actuarial methods used in determining future policy obligations and expenses, deferred acquisition expenses, and related actuarial items (list other material items) in the financial statements of the Company, as prepared by the Company to accord to generally accepted accounting principles, as of December 31, 19__, and December 31, 19__, and for the years then ended."

5. If the actuary has examined the underlying records the scope paragraph of a Statement of Actuarial Opinion might include a sentence such as the following:

"My examination included such review of the actuarial assumptions and actuarial methods and of the underlying basic records and such tests of the actuarial calculations as I considered necessary."

If the actuary has relied upon an independent auditor's review of basic in-force records the foregoing sentence might be preceded by a sentence such as the following:

"I relied upon the auditor's verification of basic in-force records."

In such case the sentence as first suggested above might commence:

"In other respects my examination (etc.)."

6. The expressions of opinion described in paragraph 7 of Recommendation 3 might be expressed as follows:

"In my opinion the amounts carried in the balance sheet on account of unamortized acquisition expenses and on account of other future policy obligations and expenses are computed by sound actuarial methods consistently applied and are fairly stated in accordance with sound actuarial principles, and are based on actuarial assumptions which are appropriate to financial statements of the Company prepared in accordance with generally accepted accounting principles and which are consistent with the assumptions previously employed; and provision has been made for all actuarial reserves and related statement items which ought to be established."

If there has been any change in the actuarial assumptions or methods from those previously employed, that change should be described in a footnote to the financial statements or in a previous paragraph of the Statement of Actuarial Opinion, and the reference above to consistency should be modified by inserting a phrase such as:

"... with the exception of the change described in the preceding paragraph (or in footnote__) ..."

7. The comparison of net liabilities referred to in paragraph 10 of Recommendation 3 might be stated as in one of the following examples, or in such other way as meets the circumstances of a particular case:

a) The amount of net liability for future policy obligations and expenses, less the amount of unamortized acquisition expenses is, \$_____ less than the amount of net liability for future policy obligations reported in financial statements filed with the Insurance Commissioner of the State of__________.

b) The amount of net liability for future policy obligations and expenses, less the amount of unamortized acquisition expenses, plus an amount of \$_____ provided for in restricted surplus, is at least equal to the amount of net liability for future policy obligations reported in financial statements filed with the Insurance Commissioner of the State of__________.

c) The amount of net liability for future policy obligations and expenses, less the amount of unamortized acquisition expenses, is at least equal to the amount of net liability for future policy obligations reported in financial statements filed with the Insurance Commissioner of the State of__________

8. The text of an Actuarial Report is likely to be much more detailed and more extensive than the text of a Statement of Actuarial Opinion, and the form is likely to be controlled by the nature and extent of the information to be recorded.

9. Material changes in actuarial assumptions from those previously used should be disclosed in an Actuarial Report and their effects noted. Such disclosures should not be limited to factors explicitly assumed but should include reference to the handling, or absence of handling, of such other factors as the actuary in his judgment deems to have pertinence. The adoption for new issues of an actuarial assumption which differs from a corresponding assumption used for any prior issues is not a change in actuarial assumptions within the meaning of this paragraph.

10. The report should also compare (*a*) the amount of net liability for future policy obligations and expenses, less any amount of unamortized acquisition expenses, with (*b*) the amount of net liability for future policy obligations reported in financial statements filed with state regulatory authorities; and if (*a*) is less than (*b*) the report should state the amount of the difference. The "net liability" referred to in (*a*) and (*b*) above should reflect adjustments for deferred premiums and other related items.

Statement of Actuarial Opinion

11. Opinion A-6 states (No. 4) that the objective of Guide 2(*c*) will be more fully satisfied if the auditor's opinion identifies the actuary or if published financial statements include a formal Statement of Actuarial Opinion.

12. A written Statement of Actuarial Opinion prepared for publication with financial statements of a life insurance company will normally include statements as to the scope of the actuary's participation in the preparation and the appraisal of the financial statements, his professional opinion as to the actuarial elements in the statements, and a statement of his relationship to the company. Such Statement of Actuarial Opinion should cover the subjects referred to in paragraphs 6, 7, 8, 9, and 10. above, although normally without the supporting detail which would be appropriate in an Actuarial Report.

Other Actuarial Statements

13. In preparing any statement or report relating to a life insurance company, other than an Actuarial Report or Statement of Actuarial Opinion described in this Recommendation, the actuary should be aware of the Guides to Professional Conduct as interpreted by Opinions of the Professional Conduct Committee.

INTERPRETATION 3-A: ILLUSTRATIVE STATEMENTS OF ACTUARIAL OPINION

(Published April, 1974 by the Committee on Life Insurance Company Financial Reporting Principles)

1. A Statement of Actuarial Opinion will normally consist of a scope paragraph, describing the scope of the actuary's work and his relationship with the company, and an opinion paragraph identifying the subjects on which an opinion is to be expressed, and expressing such opinion. One or more additional paragraphs may be needed in individual cases if the actuary considers it necessary to state a qualification of his opinion or to explain some aspect of the financial statements which is not already sufficiently explained in a footnote.

2. The following are examples, for illustrative purposes, of language which in typical circumstances might be included in a Statement of Actuarial Opinion in connection with financial statements of a stock life insurance company prepared in accordance with generally accepted accounting principles as that term is understood in the United States. The illustrative language should be modified as needed to meet the circumstances of a particular case, and the actuary should in any case use language which clearly expresses his professional judgment.

3. The scope paragraph of a Statement of Actuarial Opinion should contain a sentence which describes the facts of the actual situation, such as one of the following:

   a) "I am the Vice President of the X Life Insurance Company and am a Member of the American Academy of Actuaries."

   b) "I am associated with the firm of A & B, Consulting Actuaries, and am a Member of the American Academy of Actuaries. I have (have not) been involved in the preparation of the financial statements of the X Life Insurance Company."

SOURCES OF INFORMATION REGARDING ACTUARIAL MATTERS

1. Survey of Actuarial Assumptions - American Academy of Actuaries.

2. Auditors own files.

3. Inquiry of other auditors, actuaries.

STATEMENT OF THE AMERICAN ACADEMY OF ACTUARIES

HEARINGS ON ERISA IMPROVEMENTS ACT OF 1979 (S. 209)

SENATE COMMITTEE ON HUMAN RESOURCES

February 8, 1979

Stephen G. Kellison, Executive Director
Donald S. Grubbs, Chairman of ERISA Revisions Subcommittee
Edwin F. Boynton, Immediate Past President

I. INTRODUCTION

The American Academy of Actuaries ("Academy") appreciates the opportunity to present this statement on the ERISA Improvements Act of 1979 (S. 209). The Academy is a professional organization of actuaries whose members are deeply involved with the implementation of ERISA and the private pension system in general. Appendix A provides some background information on the Academy.

The membership of the Academy includes actuaries with a wide range of views on the many issues being discussed today in the private pension field. Certain of the more controversial of these issues are not primarily actuarial in nature. Accordingly, this Academy statement is limited to commentary on items which have actuarial implications. The views expressed in this statement are those of the task force that prepared it, and are not necessarily the views of all the members of the Academy.

Although the Academy statement will not specifically address itself to several of the proposals involved in this bill, we are supportive of the general thrust of most of them. ERISA was a most complex piece of legislation which has produced implementation problems. The Academy applauds the general intent to resolve such problems as multiple-agency administration and the complex reporting and disclosure requirements of ERISA. A worthwhile objective of this bill is to extend the benefits of the private pension system to a larger group of Americans, both by reducing the number of plan terminations and increasing the number of new plan formations. The disappointing statistics involving both plan terminations and new plan formations since the passage of ERISA indicate that Congressional attention to these problems is warranted. The intention of this bill is compatible with these goals.

The Academy is particularly pleased to see the declaration of policy contained in Section 101 of S. 209 which would add the following to Section 2 of ERISA:

> "It is hereby further declared to be the policy of this Act to foster the establishment and maintenance of employee benefit plans sponsored by employers, employee organizations, or both."

This statement of public policy is vital, and is a most important addition to ERISA.

One of the lessons ERISA has taught us is that efforts to close loopholes and prevent abuses also create complexity and extra costs. At some point such efforts, worthy as they may be, become counterproductive if they result in increased plan terminations and decreased new plan formation. Thus, certain complex requirements which do not have major significance for most plans may create more negative than positive results, even though conceptually the requirements appear desirable. In considering simplifications to ERISA Congress should thus evaluate proposals with the balance between benefits and costs clearly in focus.

This Academy statement is directed toward the actuarial aspects of S. 209. In view of the short advance notice for the hearing, we have not attempted to develop a list of other suggested amendments to ERISA not contained in S. 209. A number of suggestions of this type from individual actuaries were presented to the Committee in connection with our previous submission on S. 3017 on August 17, 1978. In Section III we do propose some minor changes in the statute in connection with ambiguities that have arisen with respect to "enrolled actuaries" and the Joint Board for the Enrollment of Actuaries ("Joint Board").

II. COMMENTARY ON S. 209

At the ERISA hearings on August 17, 1978 the Academy commented on seven areas contained in S. 3017, the predecessor bill to S. 209. Three of these areas do not require any additional comment at this time; namely, (1) disclosure of accrued benefits, (2) pre-emption of securities laws, and (3) deduction for employee contributions. We would like to comment on the following four areas of S. 209 at this time:

A. Opinions of Actuaries and Accountants

B. Survivor Annuities

C. Funding Standard Account

D. Impact of Inflation on Retirement Benefits

A. Opinions of Actuaries and Accountants

Section 115 of S. 209 would make some fundamental changes in the relative roles of actuaries and accountants in connection with annual reports for plans and the Academy strongly endorses this Section of the bill. ERISA currently provides that the accountant may (emphasis added) rely on the work of the actuary, and conversely. S. 209 would change "may" to "shall," which would provide for compulsory reliance (in both directions, i.e. reliance on actuaries by accountants, and conversely).

Section 103 of ERISA appears to create a division of responsibility between actuaries and accountants. The actuarial statement required by Section 103(d) is concerned with such items as the determination of plan liabilities for future benefit payments and the various computations required to determine whether the plan complies with minimum funding requirements. The financial statement prepared by the accountant pursuant to Section 103(b) is concerned with a proper presentation of the financial status of the pension fund itself.

Despite this apparently clear division of responsibility contemplated by ERISA, some differences of opinion have arisen between actuaries and accountants concerning their relative roles under the Act. It now appears quite likely that actuarial liabilities will appear in the financial statement of the plan, as well as in the actuarial statement, although nothing in ERISA indicates that such dual reporting on two different bases was intended by the Act. Extensive discussions involving the Financial Accounting Standards Board, the U. S. Department of Labor, the American Academy of Actuaries, and other interested parties have been held over the past 21 months concerning the proper actuarial liability to report in the plan's financial statement. Considerable progress has been made in arriving at a mutually agreeable result.

A problem that remains will arise if the actuarial liabilities are included within the scope of the auditor's opinion. This creates a potential for friction between the auditor and the enrolled actuary. If the auditor chooses to challenge the work of the enrolled actuary, an impasse may result. The enrolled actuary cannot change his/her results, since he/she has already certified them to the Federal government as his/her "best estimate of anticipated experience under the plan." Such an impasse, if it developed, would be most unfortunate for plan sponsors, plan participants, and all others concerned.

The provisions of S. 209 to require reliance by each profession on the work of the other in their respective defined areas of practice would be quite beneficial in resolving such potential difficulties.

As indicated at the outset the Academy strongly endorses Section 115 of S. 209. We also feel that some additional amendments could be made to further clarify the relative roles of the two professions. These amendments are consistent with the division of responsibility between the two professions which we believe was contemplated by ERISA. These amendments are submitted for the consideration of the Committee in Appendix B. These amendments, coupled with Section 115 of S. 209, should resolve the differences which have arisen in this area.

The proposed amendments in Appendix B have been exposed to a large number of actuaries representing a good cross-section of the membership. A nearly unanimous consensus emerged supporting them. These amendments have also been submitted to the U. S. Department of Labor Advisory Council on Employee Welfare and Pension Benefit Plans.

B. Survivor Annuities

Section 205 of ERISA now makes survivor annuity protection available for married participants who die while eligible for early retirement. Section 127 of S. 209 would extend the availability of such protection to married participants with 10 or more years of service, regardless of whether they are eligible for early retirement benefits. This would increase the number of instances in which survivor benefits are paid to widows and widowers of deceased participants.

The cost of pre-retirement survivor annuity benefits may be met in one of two methods. One method, used by many plans, is to have the participants who elect to be covered by the protection pay the cost through decreases in the pensions paid to them upon retirement. In such plans, extending the survivor annuity protection for a longer period would result in reducing the retirement incomes of those participants who elect to receive the protection for a longer period of years. The amount of reduction in pensions would depend upon factors applicable to the plan and by the number of years the protection is provided.

The other method of meeting the cost of pre-retirement survivor annuity protection, also used by many plans, is to have the cost paid by the plan sponsor. For plans using this method, the pre-retirement survivor annuity protection is provided automatically for all eligible participants, with no reduction in their ultimate retirement benefits. In plans other than Taft-Hartley plans, the cost to employers would be increased, the increase in cost varying from plan to plan. One actuary has estimated the range of increase in cost for most plans would be from 1% to 4% of present plan costs. Correspondingly, the total value of benefits provided by the plans would increase by roughly the same proportion.

However, in many instances of such mandated changes, the additional costs generated may defer or eliminate consideration of other plan changes which might otherwise have been made, so that the total value of benefits and plan costs may remain about the same.

For multiemployer plans and other Taft-Hartley plans, employer contributions are fixed by the collective bargaining agreement. In such plans, if the cost of the pre-retirement survivor annuity is borne by the plan as a whole, rather than assessed against those participants who elect the coverage, the plan assets available to provide retirement benefits would be reduced by the amount of survivor benefits paid. In the long run the total benefits provided by such plans would be the same, the increase in survivor benefits being offset by decreases in retirement benefits.

Employee death benefits are often provided under group insurance programs, as well as under pension plans. Many plan sponsors take a comprehensive view of all employee fringe benefit programs taken together and attempt to coordinate the benefits provided by the various components in the total package. It is likely that some plan sponsors would offset any increases in survivor annuity benefits under the pension plan be decreases in death benefits under group insurance. To the extent that survivor income benefit increases under the pension plan are offset by decreases in group insurance, the net effect would be to increase neither death benefits nor employer costs.

C. Funding Standard Account

Section 131 of S. 209 would add a new provision to Section 302(c)(1) of ERISA concerning computations in the funding standard account. Specifically, it would require the actuary to:

> " . . . take account . . . of all provisions of the plan, including provisions which have not yet affected any participant as to entitlement to, or accrual of, benefits."

Section 131 is intended to apply to a rather common situation in negotiated plans; for example, a 3-year negotiated contract in which the benefit formula was, say, \$8 per month per year of service for participants retiring in the first year of the contract, \$9 for the second, and \$10 for the third.

Section 131 would require immediate recognition of the cost of the \$10 benefit, the ultimate amount payable for the third and later years. In this event, the operation of the funding standard account would involve a level-dollar funding of these benefits over the 3-year period. If the plan sponsor wished to use a step-rate contribution schedule (a common practice in multiemployer and other collectively bargained plans), there would be a risk of an accumulated funding deficiency at the end of the first and/or second years.

Section 131 would overturn IRS Rev. Rul. 77-2. This Revenue Ruling requires that only the initial benefit level (\$8.00 in the example) be considered in determining the minimum required contribution and the maximum deductible limit for the first year. A copy of Rev. Rul. 77-2 is attached as Appendix C (see particularly Sec. 4, Ex. 1).

ERISA requires the actuary to base the actuarial computations upon his "best estimate of the anticipated experience under the plan." If a plan has already adopted an amendment requiring that all benefits to those retiring after three years be $10.00 per year of service, the actuary's best estimate would ordinarily be that such benefits will be paid. Ignoring the $10.00 benefit level called for by the plan document is contrary to the best estimate requirement of ERISA. By requiring that plans not recognize the plan's provisions, Rev. Rul. 77-2 forces the plan's actuary to ignore the law. The Academy supports the intent of Section 131 to allow the actuary to recognize plan provisions relating to future benefit provisions.

However, we believe that Section 131 goes too far in requiring that the ultimate benefit level always be recognized. Although there is good theoretical justification for that position, it ignores the very practical considerations which led the Internal Revenue Service to not require recognition of the ultimate benefit level. No law should be passed which contains a gaping loophole for its evasion. If the law required recognition of the ultimate benefit level, it could easily be evaded by the plan sponsor by passing a series of plan amendments rather than a single amendment. Rather than a single amendment increasing benefits to $8.00 this year, $9.00 next year and $10.00 the third year, plan sponsors could agree to accomplish the same thing by making three amendments in three successive years. The step-up of benefit rates over the period of a collective bargaining agreement became more popular several years ago in a period of wage-price controls. Since the wage increase limitations had to meet annual tests, it was logical to have benefit improvements phase in over the period of the contract to spread out the cost effect. In the current environment of wage-price guidelines, this would seem to be a valid reason not to overturn Rev. Rul. 77-2.

Therefore, the practical approach for the law to take is to allow plans to recognize the ultimate rate of benefit, but not to require it. Thus, we recommend deletion of the words, ", and for any plan year beginning after December 31, 1980, shall take account."

Section 131 should also be clarified to indicate that costs for the year may be based upon the plan in effect as of the date of the actuarial valuation, as allowed currently by the Internal Revenue Service. Some multiemployer plans have many benefit levels, with hundreds of employers agreeing to change from one benefit level to another at many different dates during the year. The actuarial valuation to determine costs is ordinarily made as of the beginning of the plan year, and it may not be feasible to do otherwise.

Finally, we are also puzzled by the last sentence of Section 131:

> "A provision adopted but contingent on a future event shall be deemed not to be in effect as a provision of the plan prior to the occurence of that event."

This provision is quite perplexing and seems to be at odds with the rest of the Section.

Consider, for example, a plan with an automatic cost-of-living feature. This is a benefit "contingent on a future event;" namely, the rate of inflation in years hence. Does this sentence prohibit the actuary from assuming a cost-of-living increase in future benefit projections? If it could be interpreted in that manner, the results would be most unfortunate. The possibility of massive under-funding for such a plan would be great. Also, it would essentially force an actuary to violate Section 103(a)(4)(B)(ii) requiring him to make his ". . . best estimate of anticipated experience under the plan."

In general, the Academy believes considerable clarification of Section 131 is needed. The last sentence is particularly disturbing.

D. Impact of Inflation on Retirement Benefits

Section 152 of S. 209 provides that the Secretary of Labor ". . . conduct a study of the feasibility of requiring employee pension benefit plans to provide cost-of-living adjustments to benefits payable under such plans." This study would be conducted during the 24-month period following the enactment of the bill.

Inflation greatly decreases the purchasing power of pensions, reducing many retired workers to poverty. Adding a cost-of-living adjustment provision to the typical defined benefit pension plan as a additional benefit solves the problem for retirees, but results in a dramatic increase in benefit costs. Even if limitations are placed on the amount of increases (e.g. an annual limitation, a cumulative lid on total increases, etc.), substantial assistance can be provided to retirees but the cost impact can still be large.

Mandating cost-of-living benefits involves profound philosophical, economic, and actuarial considerations. Proper recognition of future rates of inflation is one of the most difficult, but important, challenges facing the pension actuary today. Obviously, cost-of-living benefits are extremely sensitive to future rates of inflation.

The Academy believes that a cost-of-living requirement would involve major actuarial considerations. Accordingly, if the study contemplated by S. 209 is conducted by the Department of Labor, the actuarial profession should be deeply involved in the study.

III. PROPOSALS INVOLVING "ENROLLED ACTUARIES"

Sections 3041 and 3042 of ERISA created the Joint Board for the Enrollment of Actuaries to enroll actuaries to perform services required of actuaries under the Act. We would like to comment on two unintended developments which have occurred involving "enrolled actuaries" since the passage of ERISA.

The first is the very name "enrolled actuary" itself. Enrollment under ERISA involves rather narrow credentials to perform certain specific functions, such as providing the actuarial statement required by Section 103(d) of ERISA (contained in IRS/DOL Form 5500 Schedule B). The regulations promulgated by the Joint Board to implement Sections 3041 and 3042 have required satisfaction of certain examination and experience standards involving basic actuarial mathematics and pension actuarial topics related to ERISA. However, the Joint Board has not required evidence of education and/or experience in a variety of other areas of actuarial practice not directly related to ERISA.

Unfortunately, since enrollment essentially involves licensing of actuaries by the Federal government (albeit licensing in a narrow area to perform only a small number of well-defined functions) "enrolled actuary" status has understandably been interpreted by many non-actuaries as evidence of broad qualifications as an actuary more generally. This is not to say that many enrolled actuaries do not possess broader credentials as an actuary, since most do. However, nothing involved in becoming an enrolled actuary is evidence of such broader training and experience per se.

Accordingly, the Academy proposes that the term "enrolled actuary" be changed to "enrolled pension actuary" throughout ERISA. This revised term is much more descriptive of the training and experience inherent in the enrollment process and should lessen the confusion and ambiguity which has occurred.

The second involves the performance of actuarial services for welfare plans (see Section 3(1) of ERISA for a definition of "welfare plan"). Although ERISA affects both welfare plans and pension plans (the latter to a much greater extent), no actuarial statements or reports for welfare plans are required by the Act or subsequent regulations.

The Joint Board requires evidence of both education and experience in pension actuarial matters in order to meet the standards for enrollment. The Joint Board does not require any evidence of either education or experience on welfare plans in order to meet these standards. The Joint Board does not require such evidence in its enrollment regulations, understandably because nothing is required by the government of an actuary on a welfare plan.

This situation involves potential problems of both inclusion and exclusion. On the one hand, the designation "enrolled actuary" does not provide any assurance that the individual in question has competence to perform actuarial services on welfare plans. On the other hand, a number of actuaries that are not enrolled because of lack of education or experience in pension matters may be highly qualified to perform services on welfare plans. Certain problems may arise from this anomaly, since the users of actuarial services are often not aware of these subtleties. For example, cases have been called to the attention of the Academy in which auditors do not rely on the work of an actuary on a welfare plan unless the actuary is enrolled.

The confusion in this area has arisen from the language in Section 3042(a):

> "The Joint Board shall, by regulations, establish reasonable standards and qualifications for persons performing actuarial services <u>with respect to plans to which this Act applies</u> . . ."
>
> (emphasis added)

The Academy proposes an amendment to clarify that enrollment involves only pension plans and not welfare plans. This proposal is quite compatible with the first proposal to change the term "enrolled actuary" to "enrolled pension actuary."

Appendix D contains proposed amendments to implement these two clarifications.

IV. SUMMARY AND CONCLUSIONS

In summary, the Academy commends the intention of S. 209 to resolve the difficulties created by ERISA. Many of the proposals in this bill are highly constructive in this regard. The comments presented in the Academy statement are being offered in the same constructive spirit.

The Academy appreciates the opportunity to appear at these hearings. Actuaries have a vital interest in the development of amendments to ERISA and the Academy has a continued interest in this area. Representatives of the Academy are available to meet with the Committee or staff at your convenience to discuss these, or other, proposals in more detail.

INDEX TO APPENDICES

APPENDIX A

BACKGROUND INFORMATION ON THE *AMERICAN ACADEMY OF ACTUARIES*

The American Academy of Actuaries is a professional organization of actuaries which was formed in 1965 to bring together into one organization all actuaries in the United States and to seek accreditation and greater public recognition for the profession. It includes members of four founding 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 founding organizations and their predecessors have represented the actuarial profession in the United States for about 90 years.

The Academy is unique as the national accrediting actuarial organization for actuaries in all areas of specialization. Requirements to become a member of the Academy can be summarized under two broad headings: (1) education and (2) experience; an individual must satisfy both in order to be admitted. At the present time, the education requirements for membership can be satisfied by passing certain professional examinations given either by the Casualty Actuarial Society or the Society of Actuaries or by becoming an "enrolled actuary" under the Employee Retirement Income Security Act of 1974 (ERISA). The experience requirement consists of three years of responsible actuarial work.

As of December 31, 1978, Academy membership stood at 4,702. These actuaries have a variety of types of employment, including insurance organizations, consulting firms, academic institutions, and government. 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.

APPENDIX B

PROPOSED AMENDMENT ON OPINIONS OF ACTUARIES AND ACCOUNTANTS

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, [except to the extent required by subparagraph (B),] 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.

Sec. 103(a)(3)(B) In offering his opinion under this section the accountant [~~may~~ shall] rely on the correctness of any actuarial matter certified to by an enrolled actuary [~~, if he so states his reliance~~]. 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(a)(4)(D) In making a certification under this section the enrolled actuary [~~may~~ shall] rely on the correctness of any accounting matter under section 103(b) as to which any qualified public accountant has expressed an opinion [~~, if he so states his reliance~~].

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~~ funds, the statement required under paragraph (1) or (2) shall have attached the following information in separate schedules:

(A) a statement of the assets and non-actuarial liabilities of the ~~plan~~ fund aggregated by categories and valued at their current value, and the same data displayed in comparative form for the end of the previous fiscal year of the plan; ----

NOTE: Amendments contained in brackets are those contained in S. 3017. All other amendments are proposed by the American Academy of Actuaries.

APPENDIX C

Rev. Rul. 77-2: I. R. B. 1977-1, 9.

Charges and credits to funding standard account for changes in benefits effective after valuation date.—A change in the benefit structure of a qualified pension plan that becomes effective in a plan year subsequent to the plan year for which charges and credits to the funding standard account are being computed shall not be considered in the computation.

SECTION 1. PURPOSE.

The purpose of this Revenue Ruling is to provide guidelines for determining the charges and credits to be made to the funding standard account to reflect changes in benefits that become effective after the valuation date.

SEC. 2. GENERAL RULE.

.01 In the case of a change in the benefit structure that becomes effective during a plan year subsequent to a given plan year for which the charges and credits to the funding standard account are being computed, such change in benefit shall not be considered in determining the charges or credits to the funding standard account for such given plan year.

.02 In the case of a change in the benefit structure that becomes effective as of a date during a plan year (but subsequent to the first day in such plan year), the charges and credits to the funding standard account (1) shall not reflect the change in such benefit structure for the portion of such plan year *prior to the effective date of such change*, and (2) shall reflect the change in such benefit structure for the portion of the plan year subsequent to the effective date of the change.

.03 For purposes of this section, the effective date of the change in benefit structure shall not be later than (1) in the case of a *collectively-bargained plan described* in section 413(a) of the Internal Revenue Code of 1954, and which includes more than one collectively-bargained unit, the date such change with respect to benefits of participants included within any unit becomes effective with respect to any individual who is or could be both a participant in the plan and in such bargaining unit, and (2) in the case of any other plan, the date such change becomes effective with respect to any individual who is or could be a participant in the plan.

SEC. 3. CHANGES NOT ADOPTED AS OF THE VALUATION DATE.

In the case of a change in benefit structure that becomes effective in a plan year and that is not adopted on or before the valuation date in such plan year, in lieu of using the rule described in section 2.02 such change in benefit structure may not be considered in determining the charges and the credits to the funding standard account for such plan year. Whichever method is adopted may not be changed for such year once the annual return described in section 6058 of the Code is filed.

SEC. 4. EXAMPLES.

The guidelines provided in this revenue ruling may be illustrated by the following examples:

Example 1. An employer adopts an amendment on the first day of year 1 that provides benefit structures b_1, b_2, and b_3 which becomes effective on the first day of years 1, 2, and 3, respectively. In computing the charges and the credits to the funding standard account for years 1, 2, and 3, benefit structures b_1, b_2, and b_3 would be reflected in the respective plan years during which they become effective.

Example 2. A collectively-bargained plan provides for a single benefit structure for years 1, 2, and 3 under an arrangement in which the employer contributions to fund such structure are increased in each of three years. *The charges and the credits to the* funding standard account must be computed on the basis of such single benefit structure using a funding method not designed to reflect such negotiated phase-in of contribution increases. If the contributions in year 1 (determined without regard to the contributions negotiated for years 2 and 3) are insufficient to prevent an accumulated funding deficiency, the minimum funding requirements are not satisfied.

APPENDIX D

PROPOSED AMENDMENT INVOLVING "ENROLLED ACTUARIES"

Sec. 3042(a) The Joint Board shall, by regulations, establish reasonable standards and qualifications for persons performing actuarial services with respect to pension plans to which this Act applies and, upon application by any individual, shall enroll such individual if the Joint Board finds that such individual satisfies such standards and qualifications. The term "enrolled pension actuary" means an actuary thus enrolled. With respect to individuals applying for enrollment before January 1, 1976, such standards and qualifications shall include a requirement for an appropriate period of responsible actuarial experience relating to pension plans. With respect to individuals applying for enrollment on or after January 1, 1976, such standards and qualifications shall include --

(1) education and training in actuarial mathematics and methodology, as evidenced by --

(A) a degree in actuarial mathematics or its equivalent from an accredited college or university,

(B) successful completion of an examination in actuarial mathematics and methodology to be given by the Joint Board, or

(C) successful completion of other actuarial examinations deemed adequate by the Joint Board, and

(2) an appropriate period of responsible actuarial experience.

Notwithstanding the preceding provisions of this subsection, the Joint Board may provide for the temporary enrollment for the period ending on January 1, 1976, of actuaries under such interim standards as it deems adequate.

Sec. 3042(b) The Joint Board may, after notice and an opportunity for a hearing, suspend or terminate the enrollment of an individual under this section if the Joint Board finds that such individual --

(1) has failed to discharge his duties under this Act, or

(2) does not satisfy the requirements for enrollment as in effect at the time of his enrollment.

The Joint Board may also, after notice and opportunity for hearing, suspend or terminate the temporary enrollment of an individual who fails to discharge his duties under this Act or who does not satisfy the interim enrollment standards.

Conforming Amendments

All references to "enrolled actuary" in ERISA are changed to "enrolled pension actuary".

STATEMENT OF STEPHEN G. KELLISON

EXECUTIVE DIRECTOR, AMERICAN ACADEMY OF ACTUARIES

TO THE

SUBCOMMITTEE ON AGRICULTURAL PRODUCTION, MARKETING AND

STABILIZATION OF PRICES

OF THE

SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

March 20, 1979

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 appreciates the invitation to present testimony at this hearing.

During the last session of the Congress, the Academy presented testimony to both houses of the Congress in connection with hearings on crop insurance programs. Attached to this statement is a copy of our previous statement to this Committee dated November 15, 1977. We would request that both be entered in the record of this hearing.

The interests of the Academy as a professional association of actuaries in connection with crop insurance legislation have not changed materially, since our prior statement. Our primary interests are to ensure:

1. That actuarial activity is identified as such.
2. That actuarial techniques are being properly applied where appropriate.
3. That actuarial work is being performed by qualified actuaries.

The Academy has consistently not taken a position on how the costs of various crop insurance proposals should be borne by various individuals and groups in the private or public sectors. However, we do urge that these programs be funded according to sound 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 by professional actuaries.

During the deliberations involving crop insurance proposals in the last session of the Congress many references to the desirability of an "actuarially sound" crop insurance program were made by Secretary Bergland, Mr. Deal, various members of the Congress, and others interested in crop insurance legislation. We are gratified at these expressed intentions to establish an "actuarially sound" program and hope that these intentions will continue in this Congress.

We are aware that an Ad Hoc Crop Insurance Actuarial Committee of leading actuaries in the crop insurance area was formed in 1978 to review the cost estimates of the Farm Production Protection Act being considered in the last Congress. This Committee met last September with officials of the Federal Crop Insurance Corporation concerning the cost estimates on last year's bill.

We are encouraged by these developments since our last statement. We feel that there is increased awareness of the need for proper actuarial estimates of the cost of these programs and are pleased that increased attention to these actuarial estimates is being given.

Since the Academy received the invitation to appear here today only a few days ago, we have not had time to develop any more detailed analyses of the proposals before you today. However, we do appreciate the opportunity to enter these brief preliminary remarks into the record and we do intend to enter more extensive comments at a later date if the opportunity becomes available.

The Academy stands ready to be of service to the Congress and the Administration on matters of actuarial concern. If we can be of further assistance to you, please do not hesitate to call upon us.

POSITION PAPER

OF THE

AMERICAN ACADEMY OF ACTUARIES

CONCERNING PROPOSALS

(1) TO REQUIRE STATEMENTS OF OPINION ON CASUALTY LOSS RESERVES ON THE FIRE AND CASUALTY BLANK

AND

(2) TO RECONSIDER THE CURRENT STATEMENT OF OPINION ON THE LIFE AND ACCIDENT AND HEALTH BLANK

BY

NAIC BLANKS (A1) SUBCOMMITTEE

March 21, 1979

Introduction

The agenda for the April, 1979 meeting of the NAIC Blanks (A1) Subcommittee includes three separate proposals involving statements of opinion on casualty loss and loss expense reserves on the Fire and Casualty Blank. These three proposals have been sponsored by the NAIC Financial Condition Examination (A5) Subcommittee, the American Insurance Association, and the National Association of Independent Insurers. Although there are some similarities among these proposals, major differences among them exist. It is assumed in this position paper that the details of these three proposals are known to the reader.

Also, on the agenda is the suggestion that the statement of opinion required on the Life and Accident and Health Blank be reconsidered to possibly include a requirement that the actuary rendering the opinion be independent of the insurer. The current provision, which has been in effect since 1975, does not include an independence requirement.

Endorsement

The Academy endorses the general concept of requiring a statement of opinion on casualty loss reserves. The existing requirement on the Life and Accident and Health Blank has worked well and has produced meaningful assurances on that blank. Recent experience indicates that a similar program for the Fire and Casualty Blank is appropriate and desirable.

Nature of Actuarial Work

The determination of reserves for all lines of insurance involves the evaluation of current financial values for future contingent events. The cornerstone of the discipline of actuarial science involves placing financial values on future uncertainty. The training and experience patterns for actuaries make them uniquely qualified to perform such determinations. Other, more extensive, submissions on this subject by the Academy have fully documented the training received by actuaries.

Nature of Statement Being Sought by NAIC

Confusion currently exists about the nature of the statement being sought by the NAIC on the Fire and Casualty Blank. There are fundamental differences between a statement of professional opinion rendered in connection with the original determination of the reserves and an opinion by an independent auditor.

The former involves a statement by a qualified professional who is generally the preparer of the reserves concerning the adequacy of those reserves and the professional standards used. In other words, the reserve preparer is asked to "stand up and be counted" as to the quality of his or her original work and to assume personal and professional responsibility for it. On the other hand, a "review" or "audit" function involves an appraisal by an independent auditor as to the reasonableness of the firm's financial statements, i.e. that certain accounting standards were followed.

The threshold question that must be decided is which of these very different kinds of opinion is more appropriate for the Fire and Casualty Blank.

We believe that the NAIC should require a statement of professional opinion, rather than an audit on casualty loss reserves for the following reasons:

- The history of the statement required on the Life and Accident and Health Blank clearly shows that the intention was to have a qualified professional who is generally the preparer of the reserves sign off on his or her original work. We believe that the rationale on the Fire and Casualty Blank is no different.

- Such a statement provides new and different assurances to state regulatory officials. If the opinion involved is to be an audit, then it overlaps much of the work already done by state examiners and CPA audits (where in existence).

- The fact that an opinion is being sought concerning one particular statement item of critical importance indicates that a special opinion is intended. If an audit were intended, it would be logical to apply it to cover the entire financial statement.

Independence

Once the basic decision above is reached, the debate over independence resolves itself. If a statement of professional opinion on the original determination of the reserves is intended, then independence is not necessary. If an audit is intended, then independence is generally acknowledged to be a requirement.

It should also be noted that independence is not a requirement imposed in other areas of actuarial practice. The statement of opinion on the Life and Accident and Health Blank has already been cited. A second example is the statement required of an enrolled actuary on a private pension plan under the Employee Retirement Income Security Act of 1974 (ERISA). The required actuarial statement must include an opinion by an actuary, who may be an employee of the plan sponsors or an outside consultant, but in neither event is it required that he/she be independent. In both of these cases, the lack of an independence requirement has not resulted in any lessening of the objectivity and professionalism of the actuarial statements provided.

Recognition of Accountants

If the NAIC decision is to have a statement of professional opinion on casualty loss reserves, then direct recognition of the AICPA (as contained in the (A5) proposal) is inappropriate. The training necessary to become a CPA is not, in and of itself, sufficient to qualify an individual to determine insurance reserves.

If the NAIC decision is to require an independent audit, then, of course, the AICPA should be recognized. It should be noted that, in auditing procedures, the AICPA itself recognizes that certain highly technical and specialized financial values require special expertise (see AICPA Statement on Auditing Standards No. 11 - "Using the Work of a Specialist").

It should also be noted that a growing number of states are requiring CPA audits of statutory statements. If the NAIC also requires an audit on casualty loss reserves, the net effect in many cases would be to have two audits and no statement of professional opinion, a result which is quite illogical.

Supply of Specialists

Concern has been expressed over the supply of qualified specialists for casualty loss reserves. We believe that the existing number of Members of the American Academy of Actuaries, together with others deemed qualified by the insurance commissioners, will be sufficient to meet the needs of any of the proposals. It should be noted that the large majority (conceivably all) individuals who currently determine casualty loss reserves (including CPA's with experience in this area) will be able to render opinions since provision is made for qualification of any person who has demonstrated actuarial competence to the satisfaction of the insurance commissioners. Over time, the insurance commissioners may choose to tighten requirements for those eligible to become specialists in the future as the supply of more highly qualified individuals increases.

Conclusions - Fire and Casualty Blank

AIA Proposal

Of the three proposals before the Subcommittee, this proposal appears to be the best for the reasons cited above. The Academy recommends its adoption.

(A5) Proposal

This proposal appears to confuse a statement of professional opinion and an audit. The recognition of the AICPA and the independence requirement are inappropriate for a statement of professional opinion. The independence requirement will involve an additional cost impact on companies.

NAII Proposal

We have no objection to this proposal, if the NAIC wants a much more limited program than the others.

Conclusions - Life and Accident and Health Blank

The current program for the Life and Accident and Health Blank is working well and no need for change has been demonstrated. The addition of an independence requirement would be inappropriate for the reasons cited above. The fact that the program has worked well for health insurance, as well as life insurance, indicates that the AIA proposal is likely to succeed for other casualty lines as well.

STATEMENT OF STEPHEN G. KELLISON

EXECUTIVE DIRECTOR, AMERICAN ACADEMY OF ACTUARIES

TO THE

PRESIDENT'S COMMISSION ON PENSION POLICY

March 23, 1979

Mr. Chairman, members of the Commission, my name is Stephen G. Kellison and I am the Executive Director of the American Academy of Actuaries. The Academy appreciates the opportunity to appear at this initial meeting of the Commission.

By way of background, the American Academy of Actuaries is a professional organization of actuaries which was formed in 1965 to bring together into one organization all actuaries in the United States and to seek accreditation and greater public recognition for the profession. It includes members of four founding organizations, so that despite the relatively short duration of its formal existence, the Academy, its founding organizations and their predecessors have represented the actuarial profession in the United States for about 90 years.

The Academy is unique as the national accrediting actuarial organization for actuaries in all areas of specialization. These actuaries have a variety of types of employment, including insurance organizations, consulting firms, academic institutions, and government. As of December 31, 1978, the Academy membership stood at 4702, which was over 90% of those who have satisfied the education and experience requirements necessary to join the Academy. The entire Academy membership is subject to rigorous guides to professional conduct and standards of practice.

The discipline of actuarial science involves placing financial values on future uncertainty. The cornerstone of actuarial science involves the estimation 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 role of the actuary in connection with retirement systems has long been recognized for both public-sector and private-sector plans. Major Federal programs such as Social Security and the Civil Service Retirement System have had extensive involvement of actuaries for many years.

The same is true for many state and local plans. In recent years there has been a marked increase in the recognition of and concern about financial problems of certain state and local plans. As a result, a growing number of state legislatures and other governing bodies are requiring actuarial analyses and, in some cases, more substantial funding programs for plans within their jurisdictions.

The role of the actuary was considerably heightened for private-sector plans with the passage of the Employee Retirement Income Security Act of 1974, commonly referred to as "ERISA." This Act created a class of actuaries known as "enrolled actuaries" and charged them with specific and stringent responsibilities. As a result of this legislation, it was made specific that the enrolled actuary is engaged "on behalf of plan participants" and a detailed statement as to the funding status of the plan is required each year by the Department of Labor and the Internal Revenue Service. In providing this actuarial statement the enrolled actuary is required to certify that the results are his/her "best estimate of anticipated experience under the plan." It now appears likely, based on recent releases of the Financial Accounting Standards Board, that the enrolled actuary will also provide actuarial liabilities for the financial statements of the plan.

Each year the Academy and the Conference of Actuaries in Public Practice jointly sponsor a meeting in Washington, D.C. for enrolled actuaries to assist them in professionally discharging their responsibilities under the Act. At this time I would like to publicly express our appreciation to your Executive Director, Thomas Woodruff, for his talk at our most recent meeting on January 25, 1979 about the important work of this Commission. Mr. Woodruff's remarks were quite enlightening and stimulated considerable interest among actuaries in the anticipated activities of the Commission.

Subsequent to the announcement of the appointment of the Commission on February 14, 1979 the Academy has appointed an Actuarial Advisory Group with the specific charge of working with the Commission. This Advisory Group is available to work with the Commission as your deliberations proceed.

The Actuarial Advisory Group is composed of ten senior actuaries with a wide variety of backgrounds, representing expertise in large and small corporate pension plans, insured and uninsured plans, social insurance programs, state and local pension plans, Taft-Hartley multiemployer plans, and demography. The Chairman of the Advisory Group is Edwin F. Boynton, who is a leading consulting actuary with over twenty years experience in the field. He is also the Chairman of the Board of Actuaries of the Civil Service Retirement System and the Immediate Past President of the Academy. Other members of the Advisory Group include consultants, insurance company employees, academicians, two former Chief Actuaries of the Social Security System and a former demographer for the Census Bureau. Many of the members have been extensive contributors to the actuarial literature.

One of the areas to be investigated by the Commission, that was listed in Executive Order 12071 creating the Commission, was "the financial ability of present private, Federal, State and local retirement, survivor, and disability systems to meet their future obligations" (#1-203(b)). We believe that the Advisory Group can make major contributions in this area, since the financial health of a retirement system in many respects is an actuarial measurement. The Advisory Group also hopes to make contributions in other areas as well, such as the impact of demographic trends.

In summary, we extend our best wishes to the Commission as it commences its monumental assignment. The development of a national retirement policy is a most important goal which could have major social and economic ramifications. The actuarial profession is vitally interested in your deliberations. As mentioned above, the Academy stands ready to provide actuarial assistance to the Commission. Please let us know how we can help.

Thank you.

March 27, 1979

Mr. Jules M. Cassel
Project Director
Research and Technical Activities
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Cassel:

As indicated in our letter of March 6, 1979, representatives of the American Academy of Actuaries have reviewed the 2/14/79 draft of the FASB staff on accounting and reporting standards for defined benefit pension plans. A copy of that letter and the attached comments, which are mainly of a technical nature, is enclosed with this letter as Exhibit A.

The Academy representatives were pleased to find that most of the objections to the April 1977 Exposure Draft have been resolved in a manner which is acceptable to the Academy. However, as discussed at the meeting on March 9 of Mrs. Kahn, Mr. West and you with Mr. Boynton, Mr. Biggs and me, there still appears to be one important area of disagreement, namely the instructions for setting appropriate actuarial assumptions, particularly with respect to the rate of investment return, to calculate the present values of vested and non-vested accrued benefits.

Paragraphs 22 and 23 of the draft would require the use of an interest rate which reflects the currently available rate of return on the market value of the assets over the expected payout period for the accrued benefits. Moreover, a separate interest rate determination would have to be made for non-guaranteed benefits which are expected to be paid from an insurance company contract which would be related to its "contract value."

We have the following problems with this approach:

(1) Varying the assumed interest rate to reflect market yields on new money can produce wide fluctuations in the present value of accrued benefits. This is illustrated by the hypothetical example in the attached Exhibit B, which shows the sensitivity of the market value of the assets and the actuarial value of accrued benefits to the rate of investment return on new money. For simplicity, the example assumes all of the assets are invested in bonds. Since most pension fund portfolios include a substantial amount of equity investments, the comparison would be distorted even further by short term fluctuations in common stock values. Although the example is simplified for illustrative purposes, we believe it is representative of the types of swings which could occur.

Mr. Jules M. Cassel
March 27, 1979
Page 2

(2) The sensitivity of actuarial values to changes in the assumed yields becomes even more dramatic when one looks at two consecutive valuations following the FASB recommendation to "fine tune" the assumed yield each year. Exhibit C develops a simplified example of the swings that can occur in the unfunded liability. The example is simple but not exaggerated; in many situations the changes in unfunded liability would be even larger. A brief summary of the pertinent results from Exhibit C follows below.

If we follow the "actuarial" approach of keeping the assumed investment yield relatively stable (changing it only when it appears long range yields have changed), then the following illustrates the potential unfunded liabilities in the second year of the analysis, depending on what the market yield is:

Market Yield	Market Value	Investment Gain (Loss)	Unfunded Liability	Actuarial Gain (Loss)
7%	$6,850M	$ 0M	$4,920M	$ 0M
6%	7,370	520	4,400	520
8%	6,390	(460)	5,380	(460)

Thus, ignoring gains and losses from other sources, the investment gain or loss flows directly through to the change in the unfunded liability of the plan, and is explainable to the participants in logical fashion.

On the other hand, adopting the FASB approach of adjusting the assumed actuarial rate of return to reflect current market yields, the following develops:

Market Yield	Market Value	Investment Gain (Loss)	Unfunded Liability	Actuarial Gain (Loss)
7%	$6,850M	$ 0M	$4,920M	$ 0M
6%	7,370	520	7,080	(2,160)
8%	6,390	(460)	3,240	1,680

This approach produces the anomalous result that a $520,000 gain in the assets results in a net actuarial loss in the unfunded liability of about four times such gain. Similarly, a $460,000 loss in the assets becomes a $1,680,000 gain in the unfunded liability of the Plan. We doubt that anyone could convince plan participants that such year-to-year variations make any sense. It is also doubtful that any qualified actuary would want to be associated with the development of such figures.

(3) The proposed instructions ignore the fact that the value of the future benefits will depend largely on the rates at which the income on the present investments, proceeds from the maturity or sale of these investments and future contributions can be reinvested. As an illustration, the actual rate of return on an investment in a newly issued 30-year 9% bond whose income is reinvested at 6% and which is held to maturity is only about 7.2%. If the effect of future contributions invested at 6% also were taken into account the actual rate of return would be less than 7.2%.

Mr. Jules M. Cassel
March 27, 1979
Page 3

(4) It is important to recognize that it usually is not appropriate to compare present value amounts which are based on investment prospects over a long time span with the market value of assets which reflects investment conditions on a single day. Therefore, the present value of vested and nonvested accrued benefits should also be compared with the actuarial value of assets, which may differ significantly from the market value since the actuarial value usually is determined in a manner which is intended to smooth out the effects of short term fluctuations. Paragraph 32 of Opinion No. 8 of the AICPA states "The Board believes unrealized appreciation and depreciation should be recognized in the determination of the provision for pension cost on a rational and systematic basis that avoids giving undue weight to short-term market fluctuations." ERISA also provides that all unrealized appreciation and depreciation need not be taken into account for minimum funding standards calculations. Therefore, we believe that the actuarial value of assets, as well as the method of calculating this value, should be reported and that the actuarial value of accrued benefits should be compared to the actuarial value of assets.

(5) It usually is not possible to differentiate between the portion of the accrued benefits which will be paid by the trust fund and the insurance company under a plan which uses both funding vehicles. Therefore, actuaries almost universally treat an insurance contract as an investment of the plan such as a stock or bond since it is impossible in most cases to relate the value of any guarantees to a particular block of benefits.

(6) The alternative in paragraph 23 would not be suitable for an ongoing plan, except possibly in the case where future benefit accruals have been suspended and the accrued benefits are fully vested. It is not possible to obtain insurance company guarantees with respect to such factors as rates of separation or retirement which are an integral part of the present value calculations under a continuing plan. Moreover, the level of insurance company guarantees varies considerably among companies depending in large part on the desire of the company to underwrite this type of business. Since these types of contracts result in a drain on the insurance company's surplus, this decision usually depends on the company's surplus position. Even for a single company, the guarantees tend to be extremely volatile and subject to change over a very short period with most proposals being offered for a period of 90 days or less. We believe this alternative is suitable only for a terminated plan and conflicts with the objective of reporting financial information on an ongoing plan basis.

(7) The proposed instructions are not consistent with the requirements of the Department of Labor with respect to the entries on Schedule B of Form 5500, which require the use of assumptions representing the actuary's best estimate of future experience on an ongoing plan basis with respect to the total benefits of all participants. There can be no question but that the interests of participants and other interested parties would be ill-served if different present value amounts were reported on Schedule B and financial statements. In addition, the preparation of the additional calculations would expose the plan sponsor to unnecessary actuarial fees.

Mr. Jules M. Cassel
March 27, 1979
Page 4

(8) The proposed instructions are not consistent with the concept of an ongoing plan, perhaps best illustrated by Exhibit C. In selecting an appropriate interest rate for the valuation of future obligations, the actuary takes into account not only the rate of return which is available currently on new investments but also the rate which may reasonably be expected over a longer period of time than the period over which the accrued benefits will be paid, including a margin for the risk of unfavorable variations which may be expected over the future. In setting an interest rate the actuary will be guided by the past performance and the overall investment policy of the plan as well as the present asset mix. Obviously this process requires a considerable degree of professional judgment on the part of the actuary.

In view of these concerns, we suggest that the draft be modified to specify that the actuary should follow the Guidelines and Interpretations of the American Academy of Actuaries in selecting the actuarial assumptions to be used in determining the present value of vested and nonvested accrued benefits. If the Board feels it would not be acceptable to refer directly to these Guidelines and Interpretations, we would be pleased to work with you and your staff in developing instructions which are consistent with them. Any other approach might place an actuary in the position of having to violate his professional guidelines in order to provide information for plan financial statements.

If the Board agrees with our position that actuarial assumptions should be selected by the actuary based on his professional experience and knowledge, we do not believe it would be necessary to release another Exposure Draft. However, if the Board feels that the approach proposed in the 2/14/79 draft should be followed, we feel strongly that an Exposure Draft should be issued so as to give individual members of the Academy an opportunity to present their views.

Mr. Boynton, Mr. Biggs and I appreciate the opportunity to have met with you and your associates and to present these comments, which are intended to be constructive.

Please get in touch with us if we can be of further assistance in this difficult area. Should it be appropriate, we will be pleased to meet with the Board to present the Academy's views personally.

Very truly yours,

Douglas C. Borton

Douglas C. Borton
Chairman
Committee on Pension Actuarial Principles and Practices
American Academy of Actuaries

DCB:EC
Enc
cc Mr. Dale R. Gustafson
Mr. Stephen G. Kellison
Mr. Edwin F. Boynton
Mr. James F. Biggs
Mr. E. F. Friend
Mr. P. A. Gerwitz
Mr. A. F. Rohlfs
Committee Members

EXHIBIT A

March 6, 1979

Mr. Jules M. Cassel
Project Director
Research and Technical Activities
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Jules:

As we discussed, I am sending you my informal notes on the staff's draft of 2-14-79 of the statement on accounting and reporting by defined benefit pension plans, which reflect the discussion at a meeting of my Committee and other Academy representatives last Wednesday. These notes, which have not been edited, can form the basis for discussion on Friday. The Academy will then submit formal comments later.

Although we have commented on a number of topics, I believe you will agree that they reflect mainly suggestions to achieve greater clarity for both accountants and actuaries, rather than basic differences in philosophy. Perhaps explicit references to the Academy guidelines could eliminate some confusion in the technical actuarial areas.

Best regards.

Sincerely,

Douglas C. Borton
Chairman
Committee on Pension Actuarial Principles and Practices
American Academy of Actuaries

DCB:EC
Enc

cc Mr. Dale R. Gustafson
Mr. Stephen G. Kellison
Mr. Edwin F. Boynton
Mr. James F. Biggs
Mr. E. F. Friend
Mr. P. A. Gewirtz
Mr. A. F. Rohlfs
Committee Members

NOTES ON 2-14-79 DRAFT OF FASB STATEMENT
OF FINANCIAL ACCOUNTING STANDARDS ON
ACCOUNTING AND REPORTING BY DEFINED
BENEFIT PENSION PLANS

STATEMENT

Page	Item	Notes
S1	3	In reference to "a trade or other employee association" what is intended? Are unfunded plans audited?
S3	8c	It is not clear that the plan sponsor (in consultation with the actuary) selects the benefit valuation date. If actuarial valuations are not prepared annually as permitted by ERISA, can the present values be reported as of the last valuation date?
S6	14	It would be preferable to refer to "Form 5500 and interpretive regulations."
S6	Note 6	"Contract value" is not a commonly used term.
S8	19	At the start of the 10th line it would be clearer to insert the words "form of" before the word "benefit" and to make a similar change later in the sentence. Also in the 10th line, the words "post retirement" should be inserted before the words "death benefit."
S9	20e	It would be better to replace "shall" by "need."
S9	20f	It would be better to track Interpretation 2 more closely. In two places "should" would be better than "shall."
S9	21	The wording should be clarified, possibly by tracking Interpretation 2.
S10	22	The lead in doesn't specify that the actuary picks the assumptions. A general reference to the ERISA language could replace all of item 22.
S10	22a	This is in conflict with the acceptable approach for Schedule B as described in the Federal Register and could necessitate multiple calculations for a plan. Also it ignores the long range nature of the investments and a possible need for conservatism. Interpretation 2 language would be better.
S10	22b	It would be preferable to refer to "assumed rates of investment return" rather than interest rates. The combination of explicit interest rate assumptions and the use of market value would lead to the use of different rates each year and would not produce year to year consistency. Moreover, this approach is not appropriate for a continuing plan. In a plan with trust and insurance company non-allocated assets, it is not possible to determine which benefits will be paid by the trust and the insurer. In particular, the first sentence implies the use of graded interest rates. The second sentence ignores rollover of

		investments and new contributions. The third sentence is not consistent with "contract value."
S10	22c	This is redundant as it is covered by a.
S10	22d	This overemphasizes one minor assumption. In most cases these expenses are paid outside of the plan. A separate allowance for investment expenses is usually not explicitly stated in describing the interest rate.
S11	23	It is not possible to purchase an insurance contract which will guarantee rates of retirement or turnover. Therefore, this approach is not feasible for a continuing plan. It may have limited application where benefits have been frozen and fully vested under a continuing plan.
S11	25	The second sentence could refer to the ERISA rules.
S12	26	The last two sentences are redundant.
S12	28	It is not clear that the plan sponsor (in consultation with the actuary) decides on whether or not to report a reconciliation.
S13	29b	The reference to "inflation rates" should be deleted since it is not a separate assumption but is a basis for the actuarial assumptions. "for example" might better be "including."
S14	30b	If 20e is changed, this will have to be modified. This seems to conflict with the second sentence of i.
S14	30c	This should be very general, because of the complexity of the PBGC guarantees (which are incorrectly described in the sample notes).
S14	Note 18	It should be made clear that reference to the SPD is the preferred approach.
S14	Note 19	It would be better to replace "extent to which" by the "nature of."
S14	30d	The employee contribution rates belong in a.
S15	30i	Concerning the last sentence, the effects may not be quantified simply because there has not been sufficient time to do the calculations. Perhaps the next to last sentence should be limited to events which occurred before the "as of" date of the accounting statement.
S16	31	It may be necessary to use projections to get beginning-of-plan-year benefit information if actuarial valuations are not prepared annually.

GLOSSARY

Page	Definition	Notes
C2	Benefits	Insert "or beneficiaries" after participants.
C2	Defined benefit plan	It would be better to replace "there is a promise to participants of a determinable pension benefit" with "benefits are based on a formula which is."
C3	Funding policy	The words "employees, and any other sources (for example, state subsidies or Federal grants)" should be deleted. It would be clearer to refer to contribution policy, since funding policy is defined differently in ERISA.
C3	Non contributory plan	The words "made only by the employer(s)" should be replaced by "not made by employees."
C3	Normal retirement benefits	It is suggested that the end of the sentence be changed to "upon retirement at or after normal retirement age."

ILLUSTRATION OF FINANCIAL STATEMENTS

Page	Item	Notes
D6	A	It might be better to show an example where the approach is to use the SPD by reference.
D6	A2	The description does not indicate how early retirement benefits are determined. The word "forfeit" in the 4th sentence is unfortunate.
D7	-	The rates of employee contribution should be included in the plan summary.
D7	A4	The description of what happens upon plan termination is much longer and detailed than what happens if the plan is continued, which seems to be misplaced emphasis.
D12	B2	The method of determining the actuarial value of assets and the amount of this value are not stated. The language appears to assume that the same assumptions would be used for funding purposes as for determining the present value of vested and nonvested accrued benefits, which frequently may not be the case. As previously noted, a separate interest rate assumption would not be used for the insurance company contract. Also most actuaries would not believe it appropriate to use an 8% interest rate, when according to E a lower rate may apply to deposits made after 1982.

Page	Item	Notes
D13	C	The actuarial cost method is not specified. The status of the funding standard account at the beginning and end of the plan year would seem to be significant.
D15	D	It is not clear how the increase or decrease in fair value for securities purchased or sold during the year is handled.
D16	E	There ordinarily would be no individual annuity contracts under a group annuity contract. The $5,000 dividend does not seem to appear on the financial statements.

EXHIBIT B

New Money Interest Rate	Maturity Value of Assets	Market Value of Assets (a)	Actuarial Value of Accrued Benefits (b)	(a) - (b)
7%	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 0
6	1,000,000	1,097,000	1,228,000	-131,000
8	1,000,000	914,000	818,000	96,000

Assumptions:

(1) All assets are invested in 7% bonds which will mature in 15 years.

(2) The accrued benefits, which are valued at the new money interest rate, will become payable in 15 years and will be paid for 15 years certain.

EXHIBIT C

Determination of Actuarial Value of Accrued Benefits

Illustration of Effect of Varying Actuarial Investment Return Assumption Directly with Changes in Market Yields

The purpose of this is to demonstrate the effects of changing the assumed rate of investment return to reflect year-to-year variations in the market yield of the invested assets, as proposed by the FASB draft. From the actuary's viewpoint, the actuarial value of accrued benefits does not change every time the market yield of the investments held by the plan changes. Rather, the actuary assumes a long term yield based on past experience and projected future experience and only makes changes in this when it appears to him that the long term yields have truly changed. Thus, the actuarial values of accrued benefits should be a much more stable value and not reflect every up and down variation in the market value of the assets.

The example given below is oversimplified to illustrate the effect of adjusting the actuarial value of accrued benefits to reflect market yields on a given valuation date. It is based on the same assumptions used to develop Exhibit B and shows the effect of a 1% change in the market yield between plan anniversaries for a plan that is 50% funded (ratio of market value to present value of accrued benefits) at the beginning of the period.

The pertinent values as of 1/1/79 are as follows:

A. Valuation as of 1/1/79:

1.	Valution rate of interest:	7%
2.	Present Value of Accrued Benefits	$10,000,000
3.	Market Value of Assets	5,000,000
4.	Unfunded Value of Accrued Benefits	5,000,000
5.	Value of benefits Accruing in 1979 (as of 1/1/79)	1,000,000
6.	1979 Contribution to Plan (as of 12/31/79)	1,500,000

B. Valuation as of 1/1/80 Assuming Market Yield of Fund = 7% as of 1/1/80

1.	Present Value of Accrued Benefits (7%)	$11,770,000
2.	Market Value of Assets	6,850,000
3.	Unfunded Value of Accrued Benefits (7%) (B.1. - B.2.)	4,920,000

C. Valuation as of 1/1/80 Assuming Market Yield of Fund = 6% as of 1/1/80 and Actuarial Value of Accrued Benefits based on 6% Interest

1.	Present Value of Accrued Benefits (6%)	$14,450,000
2.	Market Value of Assets	7,370,000
3.	Unfunded Value of Accrued Benefits (6%) (C.1. - C.2.)	7,080,000
4.	Unfunded Value of Benefits if Valuation Rate Remains 7% (B.1. - C.2)	4,400,000

D. Valuation as of 1/1/80 Assuming Market Yield of Fund = 8% and Actuarial Value of Accrued Benefits based on 8% Interest

1.	Present Value of Accrued Benefits (8%)	$ 9,630,000
2.	Market Value of Assets	6,390,000
3.	Unfunded Value of Accrued Benefits (8%)	3,240,000
4.	Unfunded Value of Accrued Benefits if Valuation Rate Remains 7% (B.1 - D.2.)	5,380,000

E. Summary of Unfunded Liabilities Based on Actuary's Approach (AAA) and FASB Recommendation (FASB) (000 omitted)

Market Yield	Market Value of Assets	Unfunded Liability AAA	Unfunded Liability FASB
7%	$6,850M	$4,920M	$4,920M
6%	7,370	4,400	7,080
8%	6,390	5,380	3,240

Conclusions

1. When the market yield remains unchanged, the AAA and FASB approaches will produce the same result.

2. When there is unrealized appreciation in the fund (due to a reduction in market yield from 7% to 6%), the AAA approach shows this as an actuarial gain resulting in a reduction in the unfunded liability of the plan by a like amount. However, following the FASB approach, a "gain" in the market value of $520,000 ($7,370,000 minus $6,850,000) results in a $2,160,000 ($7,080,000 minus $4,920,000) increase in the unfunded liability. How is a $2,160,000 loss in the unfunded liability due to a $520,000 gain in the assets explained to plan participants?

3. Conversely, when there is an unrealized capital loss in the assets (due to an increase in the market yield from 7% to 8%), this results in a comparable increase in the unfunded liability of the plan under the AAA approach. Under the FASB approach, a $460,000 loss ($6,850,000 minus $6,390,000) in the market value of assets results in a gain (reduction) in the unfunded liability of $1,680,000 ($4,920,000 minus $3,240,000). Again, this is an anomalous result to explain to plan participants.

4. Although the example is oversimplified to make the point, the type of swings illustrated above would be common. Since most plans have a significant portion of their assets in equities, the swings could be even wider in many plans because of the higher volatility of common stock values. Similarly, for plans that are thinly funded (such as new plans), there is a high degree of leverage involved so that the effect of relatively small dollar changes in unrealized gains and losses of a fund would be magnified many times - and in the opposite direction.

5. Much attention has been focused on unfunded corporate pension liabilities, and unusual changes therein, by the press and legislators in recent years. The wide fluctuations created by the FASB proposal would undoubtedly cause even more adverse and unwarranted publicity.

comments on

FASB EXPOSURE DRAFT on CAPITALIZATION OF INTEREST COST

from Jack E. Wood, Chairman, American
Academy of Actuaries Committee on Life
Insurance Financial Reporting Principles

As stated in our response to the FASB Discussion Memorandum on Accounting For Interest Costs, actuaries are accustomed to thinking of interest as a cost which accrues as a result of holding an asset, regardless of the source of the funds used to acquire the asset, and regardless of whether the asset has been put into productive use.

For that reason, we view with regret the positions taken in the exposure draft, that interest may be capitalized only on certain limited categories of assets, and then only during certain limited periods of time, and that (paragraph 10a) the amount of interest cost allocated during a time period may not exceed the interest cost incurred by the enterprise during that period. It is our feeling that such limitations result in inconsistencies and are not in accord with economic reality.

For example, it seems to us clearly inconsistent that an asset should have one historical cost if acquired over a period of time with borrowed funds, and a different historical cost if acquired over the same period of time with internally generated funds. (Also, we question the relevance of interest rates applicable to older borrowings as a measure of the value of the funds employed in the current production of an asset.)

We feel that, if a new qualifying asset is acquired without concurrent borrowing, such new qualifying asset is acquired from current equity funds, and that there is neither less nor more reason to capitalize interest in such instance (regardless of the existence of any old borrowings) than in the case where there has been concurrent borrowing.

As other respondents have no doubt noted, an enterprise with no debt or with only debt incurred in prior years at lower rates can presently incur interest costs at high rates by the simple expedient of borrowing sufficient money and reinvesting the proceeds in short-term securities covering the period during which interest is permitted to be capitalized on a qualifying asset. At the end of the period during which capitalization of interest cost is permitted, the securities could be sold and the debt repaid.

This would produce the sort of result recommended by actuaries, namely, the capitalization of interest at current rates, regardless of the source of the funds. But we feel it would be much more desirable to make this (to us) eminently proper result directly obtainable, by revising the proposed statement to provide that interest cost be included in any case, so that the value of an asset is independent of the source of funds used to acquire that asset.

Paragraphs 35-37 state very ably the case for recognizing that the time value of money (resulting in the charging of interest costs for its use) is of significance in defining the acquisition cost of an asset. And paragraph 41 states that a majority of the Board recognizes the validity of the conceptual argument which would, for this purpose, recognize both interest paid on borrowed funds and interest imputed on equity capital. However, the concept is rejected because it does not conform to the present accounting model. We respectfully suggest that the problem area is the model, not the concept.

Paragraphs 43-45 begin "Given the interest-on-borrowings limitation," and then go on to explore various methods for determining the amount of interest to be capitalized. As has been said earlier in other words, we feel that no method subject to that limitation can be appropriate.

Although in theory we feel that the category should be defined far more broadly, we have no strong objection to the definition of a qualifying asset (although many actuaries feel that expensive computer software which is developed over an extended period of time should be specifically designated as a qualifying asset). We have no strong objection to the capitalization period, although there is a belief among actuaries that a longer period would be appropriate. We concur with the view that the accounting disposition of capitalized interest should be the same as for other components of cost.

We anticipate that other respondents will comment on the inconsistencies that result when the financial figures for several companies, some with debt and some without, are consolidated in a parent company financial statement. Also, we note that the exposure draft does not deal with the treatment to be accorded capitalized interest of an unconsolidated subsidiary which is accounted for by the equity method.

Actuaries have long felt that failure to recognize the time value of money constitutes a very substantial weakness in existing accounting principles. It may be that the conceptual framework project is a better arena for dealing with the implications of this basic concept. In any case, we respectfully recommend either that the interest-on-borrowings limitation be removed or that this exposure draft be withdrawn and reissued after the conceptual framework project is completed. We would hope that a method for capitalization of interest can then be developed which will conform more closely to economic reality as we perceive it.

RESPONSE

by

AMERICAN ACADEMY OF ACTUARIES COMMITTEE ON

LIFE INSURANCE FINANCIAL REPORTING PRINCIPLES

to

PRELIMINARY REPORT OF THE INSURANCE TASK GROUP

ON THE FASB EXPOSURE DRAFTS,

"FINANCIAL REPORTING AND CHANGING PRICES"

and "CONSTANT DOLLAR ACCOUNTING"

1. The Academy's Committee on Life Insurance Financial Reporting Principles agrees that current value accounting is not appropriate for current consideration for the life insurance industry for the reasons stated in the Tentative Conclusion section of the Task Group's Preliminary Report.

   The Committee also agrees that there is not sufficient time to develop the techniques necessary to derive discounted cash flow (DCF) data within the time frame specified by the FASB. The Committee has not yet reached a consensus as to whether such accounting information, which generally implies market valuation of assets and gross premium valuation of reserves, would be of more value to users than the other alternatives. We believe that the concept of DCF has sufficient merit to warrant further study and that this concept could be developed for the life insurance industry, since life insurance company statements are already based upon many items that represent present values of future cash flows.

2. The Committee has no comment on the form of presentation of supplemental information at this time.

3. The Committee is in general agreement with the Task Group's conclusions on the classification as monetary or nonmonetary of life insurance industry balance sheet accounts and with the arguments presented in support of those conclusions.

We offer comments on the following specific items:

a. <u>Reserves for Future Policy Obligations.</u>

This is by far the most significant item on most life insurance companies' balance sheets. When these obligations become due, they will be payable in fixed dollars regardless of changes in prices. This item should clearly be treated as monetary.

b. <u>Deferred Acquisition Costs.</u>

This item differs from prepaid expenses in that it is not a claim to future services but, rather, it represents past services paid for in the expectation of receiving future fixed-dollar premium income. The item is reduced as the related premiums are received, and those premiums are measured in terms of fixed dollars unaffected by price level changes.

Further, most actuaries consider the deferred acquisition cost as part of the reserve for policy obligations. A typical life insurance contract is looked on as a program under which a company collects premiums uniformly over time and makes cash outlays which are not level with time, with sales and administrative expenses tending to concentrate at time of issue and claim payments increasing for the life of the contract. The reserve for policy obligations and the deferred acquisition cost are constructed to apportion these outlays to the accounting periods in which the related premiums are taken into income. The same assumptions and techniques which are used to calculate the reserve for policy obligations are used to determine the deferred acquisition cost. Since the policyholder benefit reserve is to be considered a monetary item, any other treatment of the deferred acquisition cost would render the resulting financial statement inconsistent.

c. Deferred Premium Asset.

We assume that the deferred premium asset would not appear in a stock life insurance statement prepared in accordance with Generally Accepted Accounting Principles, since that form of presentation does not conform to Rule 7A-03-04 of SEC Regulation S-X, as revised February 14, 1974.

d. Deferred Income Taxes.

The March 2, 1979 Exposure Draft of the FASB on Constant Dollar Accounting treats this item as monetary, but only as a practical solution, stating that nonmonetary treatment would be technically preferable. The Committee believes that monetary treatment of most life insurance company deferred taxes is theoretically as well as practically correct. Most deferred taxes in life insurance company statements result from timing differences between changes in statement policy reserves and changes in policy reserves required or allowed for income tax reporting. Since these reserves are to be treated as monetary items, the related deferred income taxes should be treated consistently.

e. <u>Health Insurance Loss Reserves.</u>

The Committee agrees that reserves for health insurance policies where the benefits provided are fixed in dollars, such as reserves for long term disability benefits, are similar to life insurance reserves and should be considered monetary.

The Committee believes, however, that claim reserves for disability policies and other health insurance reserves for benefits which are not expressed in fixed dollars are nonmonetary. But, because these reserves are established as a conservatively realistic estimate of amounts which will be paid, incorporating assumptions for future inflation where appropriate, treatment different from that for other nonmonetary items is required. The Committee believes that under constant dollar accounting these items should carry the same values as though they were monetary, since the impact of future inflation has already been reflected in their calculations.

f. <u>Property and Casualty Deferred Policy Acquisition Costs, Unearned Premiums, and Loss and Loss Adjustment Reserves.</u>

We believe that these property-casualty balance sheet accounts should be treated as monetary.

May 17, 1979

Mr. Jay Constantine
Senate Finance Committee
2227 Dirkson Senate Office Building
Washington, D.C. 20510

RE: S.760

Dear Mr. Constantine:

John Kern suggested that I put in writing the concerns of the American Academy of Actuaries concerning the proposed addition of section 2105 to the Social Security Act, contained in section 101 of S.760.

Section 2105 would create an Actuarial Committee. It states qualifications for the members of that Committee. It would require a member of the Committee to be enrolled as an enrolled actuary by the Joint Board for the Enrollment of Actuaries.

The Actuarial Committee would deal with health insurance and similar benefits provided by insurance companies, Blue Cross-Blue Shield, HMOs, etc. The Committee should consist of actuaries who are experts in these areas.

Enrollment by the Joint Board for the Enrollment of Actuaries shows qualification as an actuary dealing with pensions. I was the first Chariman of the Joint Board for the Enrollment of Actuaries. The large majority of enrolled actuaries are not experts in health insurance. Most of the best health insurance actuaries are not enrolled actuaries, because they do not work with pensions. Thus, the requirement for enrolled actuaries is inappropriate, and would exclude most of the best qualified actuaries in the field of health insurance.

The American Academy of Actuaries has no present position on what the best alternative requirement would be.

The large majority of the best qualified actuaries in this field are either Fellows of the Society of Actuaries or Fellows of the Casualty Actuarial Society. Either status shows that this individual has passed rigorous examinations in the actuarial aspects of health insurance as well as other actuarial subjects. If it were not advisable to specify these particular statuses in the bill, it might be better to state general criteria such as, "has a broad knowledge of actuarial science in the area of health benefits." It would also be possible to include Associates of the Society of Actuaries and Associates of the Casualty Actuarial Society; Associates have completed part of the examinations required to be a Fellow. Most qualified actuaries, in addition to their affiliation with the Society of Actuaries or Casualty Actuarial

Mr. Jay Constantine
May 17, 1979

Society, are Members of the American Academy of Actuaries. Many of these are also affiliated with the Conference of Actuaries in Public Practice or the Fraternal Actuarial Society. Reference to these three latter organizations might also be considered. A close relation exists between the five organizations.

I enclose "The Actuarial Profession", which gives a very brief summary of the profession and of the professional organizations which serve it.

We believe it may be useful for a few actuaries to meet with you or other appropriate persons working with the Finance Committee. If you concur, we shall be pleased to make appropriate arrangements for a meeting at your convenience.

Yours sincerely,

Donald S. Grubbs, Jr.
Chairman, Committee on Federal Relations
and Accrediatation American Academy of Actuaries

DSG/mep

Enclosure

cc: Stephen G. Kellison

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

May 22, 1979

Mr. A. Clarence Sampson
Chief Accountant
Securities and Exchange Commission
500 No. Capitol Street
Washington, D.C. 20549

Dear Mr. Sampson:

As you may know, the American Academy of Actuaries, of which I am President, has been following very closely the discussion in various forums concerning the scope of services offered by C.P.A. firms, particularly as regards the furnishing of actuarial services. We have previously submitted comments to the Commission with respect to this issue, initially on December 16, 1977, in response to the invitation for comments made in Release No. 33-5869, and then on April 11, 1978, following the submission of comments by others that we believed warranted a rejoinder.

We have been advised by the Academy's legal counsel that in discussions last week with Ms. Gretta Powers, Chief Counsel to your office, Ms. Powers indicated that you would welcome a statement of our views concerning the recently issued recommendations of the Public Oversight Board regarding this issue. We anticipate that the Academy will soon be filing a formal request for an interpretation by your office of the statutory and regulatory requirements relating to the independence of an auditing firm in certain designated situations. In the interim, however, the enclosed analysis of the Public Oversight Board's discussion of the provision of actuarial services by C.P.A. firms to their audit clients should be helpful to you. While this analysis was prepared largely by the Academy's legal counsel, it has been reviewed by certain of the Academy's officers and generally reflects the views of the Academy on this important issue.

The Academy hopes to submit its request for a formal interpretation from your office in the near future. In the interim, if the Academy can be of assistance to you, please do not hesitate to call upon us.

Sincerely yours,

Dale R. Gustafson
President

DRG:les

Enclosure

SHEA & GARDNER

The Public Oversight Board Report on the Scope of Services by C.P.A. Firms

The Public Oversight Board of the American Institute of Certified Public Accountants has recently issued its report on the scope of services offered by C.P.A. firms. Despite the extensive submission of the American Academy of Actuaries to the Board, the Board's report, particularly as it relates to the furnishing of actuarial services by C.P.A. firms to their audit clients, fails to properly analyze and resolve the important issues.

The Academy expects that it will soon file with the Chief Accountant of the Securities and Exchange Commission a formal request for an interpretation of the statutory and regulatory requirements that relate to the independence of an auditing firm when it offers actuarial services. To assist in the preparation of this request, we have in this memorandum sought to analyze the Public Oversight Board's treatment of this issue. While we have restricted the discussion in this memorandum to the Public Oversight Board report, much of the fuller treatment of this issue contained in the Academy's December 16, 1977 response to SEC Release No. 33-5869 is of continued relevance. We note in particular the discussion on p. 9-18 expressing skepticism about managements' ability to make the kind of informed judgments on actuarial matters that the AICPA argues would permit an accounting firm to audit companies to whom it had provided actuarial services.

I. The Board's Treatment of the Furnishing of Actuarial Services by C.P.A. Firms

While the Board's discussion of the considerations that affect the furnishing of management advisory services generally is applicable to the provision of actuarial services, the discussion of this specific area is found primarily at pp. 48-53 of the Board's report. There, the Board first identified three situations in which a problem of independence might arise:

(1) An accounting firm audits the financial statements of an insurance company for which it has furnished actuarial services;

(2) An accounting firm audits the financial statements of a client for which it acted as the enrolled actuary of the client's employee

benefit plan; and

(3) An accounting firm audits the financial statements of an employee benefit plan for which it also acted as the enrolled actuary.

We believe that the description of the first and third of these problem situations is accurate. The second situation, we think, could be rephrased so as to frame more precisely the issue that is posed when an audit is made of the financial statements of a corporation that has a retirement plan. The financial statements of such an employer will include items, often of considerable significance to the financial condition of the company, concerning liabilities arising in connection with the funding of the employee benefit plans which rest upon actuarial determinations. Those items, and the actuarial determinations upon which they are based, will most often have been prepared by the persons who prepared related items included in the reports of the employee benefit plans themselves, but the actuary who made the determinations will have done so not in his function as enrolled actuary for the plan but as consulting actuary to the employer. The issue is whether a C.P.A. firm can audit the financial statements of the employer where these items were prepared by or with the significant participation by an actuary employed by the accounting firm. We believe that the Public Oversight Board's discussion is inadequate because it fails to address this issue.

After identifying these three situations, the Board goes on to explain that there are two separate but related arguments advanced to support the assertion that an accounting firm would not be independent if it performed both the actuarial and auditing functions in those situations. These arguments are (1) that the dual services will result in "self-review" to a degree that might impair the necessary objectivity with which the audit should be performed; and (2) that the actuary will be unable to limit his role to providing advice and technical assistance but will in fact bear greater responsibility than is appropriate for the relevant items in the financial statements. At an earlier point in its report, the Board concludes that an accounting firm could not properly audit financial statements where its role with respect to the preparation of the significant items in the financial statements was not limited to advice and technical assistance. Failure to observe this role limitation would give rise at the very least to an appearance of the C.P.A. firm being a "part of the management's team," which forecloses acting as auditor for the company.

Although the Board carefully identified these three situations and two arguments, its discussion of whether self-review to an unacceptable degree might result was not directed explicitly to each of the three identified situations. Instead, the Board undertook to establish that an accounting firm which undertakes to employ the procedures recommended in the Statement of Auditing Standards No. 11 ("SAS 11") would not be engaged in an unacceptable self-review. We believe that the Board proceeded upon a fundamental misconception of SAS 11 that vitiates the conclusions it reached.

With respect to whether as a practical matter it is possible for actuarial services to be provided by an accounting firm without breaching the requirement that it limit its role to advice and assistance, the Board reached what we believe to be inconsistent and conflicting conclusions. It concluded that when an accounting firm audits the financial statements of an insurance company it should not furnish actuarial services unless they are "supplemental to primary actuarial advice furnished by another actuary not associated with the accounting firm." The Board believed that an accounting firm in this context would not adhere to the previously described role limitation requirement that was considered to be essential. The Board concluded, however, that this requirement would not be violated if an auditor, either of an employee benefit plan or of the sponsoring employer, also served as the enrolled actuary of the plan.

We believe that a more systematic analysis can be made of the three areas identified by the Board and of the applicability to each of those areas of the two circumstances that may result in a lack of independence. In the remainder of this letter, we attempt such an analysis.

II. Audits of Financial Statements of Insurance Companies to Which the Accountant Has Furnished Actuarial Services.

The Public Oversight Board concluded that accounting firms should not be the primary source of actuarial services to those insurance companies whose financial statements they audit. It took this position even though it concluded that the furnishing of such services would not violate the principle of "self-review," the first element of the independence requirement. The Board was of the view that an accounting firm could not generally provide actuarial advice to insurance company audit clients and still be deemed to be acting only in an advisory or "technical assistance" role rather than as a participant in management decisions. As a consequence, the accounting firm would violate the "role limitation" that is a second and independent element in the independence requirement.

The reasoning of the Board with respect to the role limitation requirement is significant.

> "Actuarial considerations for an insurance company are integrally related to the role and responsibility of management. Thus, if an accounting firm furnishes actuarial services to management of an insurance company audit client, care must be taken to satisfy the role requirements contained in the AICPA's MAS Professional Standards. This means generally that the actuary must only furnish advice to management and render assistance and that management must make the final decision. To do this, the accountant must be satisfied that the client has the expertise to understand the significance of his recommendations so that 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 Board does not believe that this standard can reasonably be met if an auditing firm is doing more than rendering supplementary actuarial advice." POB Report, p. 53.

The conclusion of the Board was that an accounting firm could furnish actuarial services to insurance company audit clients only if such services were supplemental to primary actuarial advice furnished by another actuary.

Basically, the Board found actuarial determinations to be so central to the business of an insurance company that an accounting firm could not participate in those determinations and still retain its independence. Determining potential future liabilities and the adequacy of current reserves, while preeminently an actuarial matter, are also central concerns of top management of any insurance company. Participation in these determinations inevitably makes the accounting firm part of the "management team" and compromises the appearance if not the substance of independence.1/ That it is this consideration which motivated the Board is suggested by the Board's comment that "[a]ctuarial considerations for an insurance company are integrally related to the role and responsibility of management." POB Report, p. 53.

What the Board appears to have perceived but did not fully articulate is that an auditing firm must limit its role when providing non-audit services to audit clients in more than one way if it is to remain independent. If it does not limit itself to advice and technical support, it begins to make management decisions and becomes a part of management, a "member of the team." Even if it does limit itself to giving advice and technical support, it can still lose the required independence in two situations. First, if the advice is given pervasively, on a continuing or on-going basis, the audit firm will again have made itself part of management. Secondly, if the advice relates to matters that are the essential and critical aspects of the client's business, independence will also have been compromised. It is for this latter reason that the rendering of actuarial services to an audit client is inappropriate.2/

1/ "Another purpose for a role limitation is to avoid appearing essentially as part of management's team" POB Report, p. 49.

2/ It is this same principle that bars an accounting firm that has performed legal or brokerage services for a client from also auditing its financial statements. These services are regarded as so intertwined with management functions as to impair the independence of the accountant, even where the work does not relate to representations in the financial statements. The furnishing of actuarial services to an insurance company involves an even greater involvement in management functions.

The Board concluded, however, that the rendering of "supplemental" rather than "primary" actuarial services would be acceptable. We do not believe this to be a workable rule but will defer our suggestions until we have discussed the other reason why, in our view, an accounting firm should not be permitted to provide actuarial services to insurance company audit clients.

While the Board recognized in its analysis of the role limitation issue the central role of actuarial determinations in the management of an insurance company, it ignored that role when discussing the relationship between self-review and the provision of actuarial services to insurance company audit clients. The Board's discussion of self-review was cast in general terms, unrelated to the particular functions or procedures performed by accountants when auditing the statements of insurance companies.

A central feature of the "independence" of an audit is that the audit be "objective" and that there be a "lack of bias and resistance to any conscious or subconscious influence toward action, inaction, conclusions or statements that are based on anything other than an impartial evaluation of the best available evidence." POB Report, p. 26. The "role limitation" proposed by the Board reflects the need to eliminate "bias" introduced by an auditor whose ties to the reviewed entity are too close, who has too great a stake in the management decisions reflected in the financial statements, or who has otherwise become part of the "management team." But objectivity is also threatened where "self-review" is countenanced. "Resistance" to an "impartial evaluation" must be expected where the very person who has been involved in the initial preparation of analysis reflected in certain entries on the financial statement is conducting the audit review. If, in the case of actuarial analysis, the methods or assumptions employed were, in part, unreasonable, one would expect questions to be raised by the auditor. But it is unlikely that this would occur in a review conducted by the very persons who prepared the initial analysis. More broadly, where, as in the case of actuarial services provided by accounting firms, the reviewer is professionally associated with the preparer of the original analysis, the reviewer will be unavoidably reluctant to identify discrepancies in this analysis and subject his associates (and their common business entity) to the professional embarrassment of having to disclose mistakes and discrepancies to the client.

The Board sidesteps these objections by arguing that the principle of "self-review" is not violated because, in the case of actuarial services provided by an accounting firm, no meaningful "review" is being conducted in the first place. While admitting the presence of at least a theoretical self-review, the Board asserts:

> "This does not mean, however, that the limited self-review involved impairs the auditor's independence or otherwise is harmful to the public or investors. First of all, it must be remembered that the review is quite limited and is not duplicative of the work performed by an actuary." POB Report, pp. 50-51.

The Board comes to this conclusion by what we believe is a misinterpretation of Statement of Auditing Standards No. 11 ("SAS 11"), one of a series of interpretations of generally accepted auditing standards issued by the American Institute of Certified Public Accountants (AICPA). This standard provides guidance to an auditor who must audit financial statements that contain representations the review of which requires knowledge or expertise that the auditor does not himself possess and that, in the auditor's judgment, requires the use of a specialist. SAS 11 is explicitly made inapplicable to using the work of a specialist who is a member of the auditor's staff. An accounting firm that has actuaries on its own staff already has the expertise necessary to perform whatever procedures are appropriate with respect to the representations or items in question, and accordingly the guidance offered by the statement simply is inapplicable.3/

The POB report suggests that self-review is not a serious problem in the case of an insurance company because the review of actuarial work is a limited one which "is not duplicative of the work performed" by the originating actuary. SAS 11 plainly contemplates that the auditor who does not have actuarial expertise will retain the services of a consulting actuary to review and test the original actuarial work just as thoroughly as the accountant reviews non-actuarial items on the insurance company's financial statement (i.e., not a limited, circumscribed review). The auditor must first satisfy himself concerning the professional qualifications and reputation of the specialist. An understanding must be developed among the auditor, the client, and the specialist as to the nature of the work to be performed by the sepcialist. The auditor must make appropriate tests of the accounting data provided by the client to the specialist. Finally, while the appropriateness and reasonableness of the methods and assumptions used and their application are still the responsibility of the specialist, the auditor is required to obtain an understanding of those methods and assumptions so as to enable him to determine whether the specialists' findings corroborate and support the related representations in the financial statement.

SAS 11 goes on, moreover, to say that in unusual cases the auditor may use the services of a specialist employed by the client. Significantly, the statement does not speak to whether or not this specialist can be the same person responsible for the original determination and representations. We think

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3/ This exclusion is contained in the first footnote in SAS 11. The Board apparently failed to make note of this exclusion, for on page 50 of its report it explicitly applies the guidelines set out in SAS 11 to the case where an auditor's "specialist" is an actuary employed by the auditing firm. What is more significant, the footnote merely confirms what is implicit in the entire statement, namely that it applies only when an "outside" specialist must be used. This is one, but not the only, respect in which the Board failed to consider adequately the meaning and function of SAS 11.

the specialist cannot be the originator of the actuarial work and that if he were, the auditor would not be using a "specialist" at all within the meaning of SAS 11 but would in fact be making his own judgments based directly on the original work.

SAS 11 does, however, unarguably contemplate the use of a specialist employed by the client who is not the author of the original analysis. In this event, the auditor's responsibilities under SAS 11 are increased. He must consider performing additional procedures with respect to some or all of the assumptions, methods, or findings to determine that the findings are not unreasonable (or to engage an outside specialist for this purpose).

The Board misconceived, in important respects, the applicability of SAS 11 and what it says about the obligations of an auditor when items requiring specialized knowledge are being reviewed. This mistaken analysis caused the Board to come to the wrong conclusion regarding the "self-review" issue.

The Board begins its analysis by assuming that where the audit of a financial statement entails the review of representations based on analysis prepared by an actuary, the guidelines contained in SAS 11 are to be applied by the auditor in reviewing that actuarial analysis. First, the Board asserts that the actuary who prepared the analysis is to be treated as a "specialist" for purposes of SAS 11. Second, while the Board admits that self-review is involved in the audit of a financial statement which reflects in part analytical work provided by actuaries employed by the auditor, it says that the auditor's independence is not impaired because the review itself is so limited as to be considered trivial. Even where the initial preparer of the actuarial analysis is an employee of the insurance company, and so subject to the higher standard of review required by SAS 11 where a specialist is "related" to the client, the review is still said to be limited because the auditor "would not be required to duplicate the actuarial work performed." POB Report, p. 51.

In this situation, the Board contends, "[p]erhaps more important from the public's standpoint is not the potential for self-review but the objectivity of the person performing actuarial services in the first place." POB Report, p. 51. This leads the Board to argue that, on balance, it is less objectionable to have an auditor reviewing financial statements reflecting actuarial work performed by an actuary employed by the auditor than it is where the work has been performed by an actuary who is an employee of the client -- a practice which the Board correctly notes is very common in the insurance industry.

The Board's analysis is inaccurate at each crucial juncture precisely because of the Board's misconceptions concerning SAS 11. The Board's analysis applies the SAS 11 guidelines to an auditor's review of original actuarial work by viewing the initial preparer of the analysis as a "specialist" within the meaning of SAS 11. But the "specialist" envisioned by the drafters of SAS 11 is an expert (in this case an actuary) brought in by the auditor to take a "second look" at the actuarial analysis underlying the specific entries of the financial statement. Thus the Standard envisions two experts, the actuary who initially prepared the analysis underlying certain financial statement representations, and the expert called in to review this analysis. Only the latter expert is a "specialist" within the intent of SAS 11, and its provisions provide guidance to the auditor only in reviewing the work of this second expert.

Should the auditor seek to examine the original actuarial work directly, the situation is analogous not to the use of a "specialist" under SAS 11 but to an auditor who has decided that he is able to conduct an adequate review without the assistance of any outside actuarial expert. SAS 11 provides no guidance in this situation. In that case the auditor must conduct his review of the relevant representations in the same manner as he would the evidentiary matter underlying any other representation contained in the financial statement. The auditor should satisfy himself as to the reasonableness of the assumptions and methods used, and the findings reached, in the actuarial work underlying representations in the financial statement. This will be particularly important to the auditor because several of the most important entries on insurance company financial statements are heavily dependent upon actuarial analysis.

While the Board thus relied upon SAS 11 in a situation to which it is not applicable, even its reading of the statement is in our view mistaken. The review required by SAS 11 of the work of a specialist is in fact much more extensive and significant than the Board suggests. In the accounting industry's own audit guide entitled Audits of Stock Life Insurance Companies, prepared by a committee of the AICPA, the review required by the auditor is clearly a significant one even where an actuarial specialist is an "outside expert" presumably unrelated to either the client or the auditing firm.

> "Actuaries are not practicing auditors; they are not specifically trained in auditing procedures, nor are they governed by generally accepted auditing standards. Therefore, there is no justification for the auditor to omit all audit procedures or to perform only token procedures as to the reserves reviewed by the consulting agency unless the terms of the engagement contemplate a qualification or denial of opinion by the auditor." Audits of Stock Life Insurance Companies, at p. 99.

Where the specialist is related to the client, SAS 11 provides, as noted above, that the auditor should consider performing additional procedures "to determine that the [specialist's] findings are not unreasonable." Finally, the industry audit guide quoted above provides that the auditor must satisfy himself as to the "propriety of the actuarial factors" used in computing the insurance company's reserves and in making similar determinations.

The Board supports its case for the "limited" nature of the review required by SAS 11 by noting that the auditor is not required "to duplicate the actuarial work performed." But such duplication is not required of the auditor in reviewing any representation contained in the financial statement. All that is required of the auditor is that he satisfy himself that the representations are reasonable and fairly presented in accordance with generally accepted accounting principles.

Finally, the Board contends that the admitted "self-review" necessarily entailed in the audit of work performed by an actuary who is an employee of the auditor should be of less concern to the public than allowing the initial determinations to be made by an employee of the company. The various government authorities having jurisdiction over these relationships, however, have taken a different view. The state commissioners who regulate the insurance industry have declined to require that the actuary relied upon by an insurance company be unrelated to and independent from the company. On the other hand, the Congress and the SEC have required that where an audit is conducted pursuant to statutory requirement, the auditor must be independent of the insurance company whose financial statements it audits. The very presence of an audit requirement assumes that the initial work, whether involving supporting actuarial analysis or the preparation of the financial statement itself, will be performed by someone who is not independent of the entity being audited. What the Board is reduced to contending is that an independence requirement imposed on the preparer of the financial statement would be more effective than the requirement of an independent audit. Congress, however, has already resolved this issue in a different fashion.

The Board did, of course, conclude that accounting firms should not as a general matter furnish actuarial services to insurance companies whose financial statements they audit. The Board found that the provision of these services causes the accounting firm to step outside its limited advisory role and become part of the management team -- raising the potential for the kind of bias that is inconsistent with the objectivity required of an independent auditor. What the Board failed to recognize is that the provision of these services to audit clients introduces an element of "self-review" which also threatens the kind of impartial evaluation required of the independent auditor.

The Board does permit an exception to its ban on the provision of actuarial services to insurance company audit clients in those instances where such services are "supplemental to primary actuarial advice furnished by another actuary not associated with the accounting firm." POB Report, p. 53. This rule suffers from considerable vagueness. When are actuarial services merely "supplemental?" Is it determined by timing considerations (i.e., after other actuarial services have been provided) or by the relative magnitude of the services (i.e., when compared to the total volume of actuarial services consumed by the audit client)? Greater precision is needed to provide guidance not only to accounting firms but also to the actuaries they employ, many of whom are members of the American Academy of Actuaries.

More importantly, however, the rule would not be sufficient to prevent "self-review." The actuarial services provided by the auditor might clearly be supplemental in character yet still find their way onto the financial statement of the insurance company, presenting a self-review problem. A better approach would be to ban actuaries employed by an accounting firm from any work for an insurance company audit client where the work might involve participating in any way in the valuation of reserves or in the determination of any other representation as regards assets and liabilities on the financial statement. It will be difficult to know in advance, however, what the results and the use made of the actuarial work will be. Actuarial analysis is so central to the operation of an insurance company that there is always the likelihood that it will in some way be reflected in the representations on the financial statement. For this reason, accounting firms should establish a prophylactic rule barring the provision by its actuaries of any actuarial services to insurance company audit clients.

Accounting firms would, of course, be free to provide actuarial services to non-audit clients without restriction or to use their own actuaries in auditing statements reflecting actuarial work done by others. This should meet the Board's concern that the actuarial services provided by accounting firms not be so restricted as to render the firms unable to attract qualified actuarial personnel. In any event, actuarial activity within accounting firms cannot be bought at the price of the independence and absence of self-review required of the auditor.

III. The Furnishing of Actuarial Services to Employee Benefit Plans and to Their Sponsoring Employers by Accounting Firms Which also Act as Auditors

As indicated at the outset of this letter, it is helpful to distinguish carefully between the work performed by actuaries and auditors for employee benefit plans and the work done by them for employers who have established such plans. Its failure to do so, we believe, was an important contributing cause to the erroneous analysis made by the Public Oversight Board.

Section 103(a)(1)(A) of the Employee Retirement Income Security Act of 1974 ("ERISA") requires an annual report to be published with respect to every employee benefit plan to which the Act applies. That report is the responsibility of the "Plan Administrator," who will usually be an officer of the employer, a committee of such officers or the employer itself. The report must include a financial statement and an opinion by an independent qualified public accountant that the statements are presented fairly, in conformity with generally accepted accounting principles. The report must also include an actuarial statement, the preparation of which, pursuant to Section 103(a)(4)(A), is the responsibility of a qualified enrolled actuary engaged by the plan administrator. The actuarial statement must include an opinion by the actuary that the contents of the actuarial statement "are in the aggregate reasonably related to the experience of the plan and to reasonable expectations" and "represent his best estimate of anticipated experience under the plan." The actuary must also state that to the best of his knowledge the report is complete and accurate and that the requirements of Section 302(c)(3) (relating to reasonable actuarial assumptions and methods) have been complied with. Included among the items that make up the actuarial statement required by ERISA, which is reported on Schedule B of Form 5500, are: the current value and actuarial value of the assets, the present value of benefits for retired employees, the present value of vested benefits, the present value of non-vested accrued benefits, the accrued liabilities and normal cost used to determine the minimum contribution, the determination of the minimum contribution requirement, and the funding standard account balance (including the alternative minimum funding standard account entries if applicable), and a description of the funding method and principal actuarial assumptions.

Section 103(a)(3)(B) provides that the independent accountant, in offering the opinion concerning the plan's financial statements required by the Act, "may rely on the correctness of any actuarial matter certified to by an enrolled actuary, if he so states his reliance." In practice, most of the accounting firms have been unwilling to accept the option provided by this section. They have taken the position that their responsibilities extend to all the representations in the financial statements, including those that depend upon the estimates and calculations made by the actuary, and they have therefore undertaken to employ whatever audit procedures are considered necessary and appropriate with respect to these matters in connection with their report on the plan's financial statements.

While the liabilities of a retirement plan that are based upon actuarial determinations constitute the principal items of the statement, this is not the case, except for insurance companies, with respect to the financial statements of the sponsoring employer. While the items are material and important, there are usually only two which are based upon actuarial determinations. The determination of the amounts of these items, in virtually every instance with which we are familiar, will be made by the same actuary who is the enrolled actuary for the plan, but in making these determinations he will be acting as a consulting actuary to the employer rather than as the enrolled actuary to the plan.

The first item is found in the income statement that is part of the financial statements of the employer. A significant deduction from gross income is the amount of the accrued pension cost of the plan for the year. In many instances this may not be separately stated as a line item on the income statement, but a footnote will usually describe the basis used in arriving at the amount. It should be noted that this amount will often be different from the minimum contribution requirement which is one of the items included in the actuarial statement of the plan, and it will sometimes be different from the annual contribution actually made for the year which will also be shown in the actuarial statement. The actuarial statement, however, will not show the accrued pension cost for the year.

The second item is the amount of the unfunded, vested liability of the plan. This also appears in a footnote, but to the statement of assets and liabilities rather than to the income statement. While not a part of the balance sheet proper, it is an item whose significance to the financial condition of a company is increasingly being recognized in the financial community. In most cases this amount can be calculated readily from the actuarial statement by taking the value of the accumulated benefits, stated separately for retired employees, active employees whose benefits are vested, and active employees whose benefits are not yet vested, as well as the current value of the plan assets.

As stated above, the issue of whether an accounting firm can provide an independent audit of the financial statements of a plan for which the firm also serves as enrolled actuary must be examined separately from the issue of whether an accounting firm can provide an independent audit of a corporation's financial statements where an actuary employed by the accounting firm has made determinations concerning the corporation's pension plan upon which representations in the financial statements are based.

A. Auditing the Financial Statements of a Pension Plan

With this background we can now turn to an examination of the validity of the Board's conclusion that an accountant may properly audit the financial statement of a pension plan where the firm or a subsidiary of the firm or an actuary employed by the firm serves as enrolled actuary to the plan.

First we note that, if the auditor elects to exercise the option provided by Section 103(a)(1)(B) of ERISA and relies explicitly upon the correctness of the matters certified to by the enrolled actuary, then no issue of self-review will arise. If the auditor is not required to evaluate the actuary's assumptions and methods, then no question is raised for this reason concerning a possible lack of objectivity. In that event the actual audit work performed by the accounting firm will relate entirely to matters that were the initial responsibility of persons not related to the accounting firm. On the other hand, if the accounting firm prefers not to rely on the actuary's statement or feels that it cannot so rely and still adequately meet its obligations in connection with its report upon the plan's financial statements, then the self-review issue is squarely presented.

As we have already shown in our discussion of the auditing of insurance company financial statements, when an auditor must review representations in a financial statement that rest upon the work of an actuary, the accountant must do more than simply verify the professional qualifications and status of the actuary. Even under SAS 11, the auditor as an absolute minimum must satisfy himself that the financial statement representations are supported by the findings of the actuary. In fact, in almost every case the auditor will satisfy himself that the findings themselves are not unreasonable. This means that there _is_ a meaningful review of the work of the actuary, and we can only repeat the point that we have made so often that a review of one's own work, whatever the competency and integrity of the individual may be, and however reliable the report may be in the great majority of instances, is not what the public and the Commission understand to be an independent audit. An audit is grounded in the concept of a second look, and if an audit is a statutory requirement, it can be satisfied only if the review is made by a second person, not by the person or entity who did the original work.

Even if an accounting firm were to elect to rely upon the correctness of the matters certified to by the enrolled actuary, so that no self-review would be involved, there is still grave doubt whether an accounting firm that served directly or indirectly as the enrolled actuary for the plan could satisfy the role limitation requirement that the Public Oversight Board regards as an independent and necessary element of independence. The matters certified to by the enrolled actuary are no less "integrally related" to the operation and financial soundness of the pension plan than the issues of potential liability and reserve adequacy are to the operation of an insurance company. In each case the actuary is providing actuarial services which, even if characterized as only advice and technical support, relate to matters so essential and critical to the management of the entity involved as to make the actuary providing the "advice" part of the management team, thereby compromising his independence. Indeed, an even stronger case can be made as to pension plans, where liabilities are equal to many times the value of assets.

For this reason, it would seem that the Board's own analysis would have obliged it to apply at least the rule it adopted with respect to insurance companies to the audit of employee benefit plans, thereby barring the provision of actuarial services by the auditor unless "supplemental to primary actuarial advice furnished by another actuary" to the plan. But the Board did not go even this far and instead found no objection to an accounting firm serving as both enrolled actuary and auditor to an employee benefit plan.

The Board readily acknowledged that the person who serves as an enrolled actuary to a pension plan and files the actuarial statement described in Section 103(a)(4)(B) is doing more than simply giving advice. But the Board concluded that this did not violate the role limitation requirement.

> "On the other hand, it is equally difficult to conclude that the actuary has usurped management's role and is making management decisions. Rather, it appears to the Board that, in the context of an employee benefit plan, the enrolled actuary is simply performing an independent professional service outside of management's traditional area of operation and expertise. It is not, therefore, making management decisions and should not be viewed as being part of management's team."

This analysis suffers from a failure to identify the persons responsible for the conduct of the operations of a retirement plan. In the case of a corporation, the "management" is plainly the directors and officers. In the case of an ERISA plan, the "management" is the plan administrator. While the plan administrator may be an officer of the sponsoring corporation, he relies heavily on two other persons who exercise specific management functions with respect to the plan. Custody of assets and selection of investments are performed by a trustee or an insurance company. Preparation of the actuarial statement is the responsibility of the enrolled actuary. Just as the management of an industrial corporation is responsible for the corporation's financial statements -- which are then subject to audit by an independent public accountant -- so, too, the plan administrator is responsible for the financial statements of the plan, including the representations that are based upon actuarial determinations -- which must similarly be examined and reported upon by an independent accountant.

The Board's statement about "the enrolled actuary . . . simply performing an independent service outside of management's traditional area of operation and expertise" is, simply, wholly erroneous. The enrolled actuary is, in fact, performing a significant management function on behalf of the plan. If the Board's conclusion is sound that participating in management functions and decisions is inconsistent with independence, then an accounting firm cannot audit the financial statements of a plan for which it or an actuary employed by it acts as the enrolled actuary.

We note that the Department of Labor may have taken a different view in Interpretive Bulletin ERISA IB RD 75-1 (now IB RD 75-9) published November 20, 1975 (29 CFR § 2509-75-9), which provides examples of situations in which an accountant will not be considered independent for purposes of the audit requirement of ERISA. After listing three such examples,4/ the Interpretive Bulletin provides:

> "However, an independent qualified public accountant may permissably [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 was suggesting that under no circumstances would the provision of actuarial services affect an accountant's independence. It does not state, one way or another, whether an actuary employed by the auditor may be the enrolled actuary for the plan. This interpretation was not promulgated under the notice and comment provisions of the Administrative Procedure Act (5 U.S.C. § 533) and, accordingly, the Department never had the benefit of any public comment. We think that the Bulletin does not reflect an adequate understanding or analysis of the issue. We intend to seek clarification. In our view, even where the accounting firm has elected to rely on the correctness of the matters certified to by the enrolled actuary so as to avoid the self-review problem, it cannot act as both auditor and enrolled actuary for the pension plan and still comply with the role limitation requirement of independence.

B. Auditing the Financial Statements of the Corporation Sponsoring the Plan

As noted earlier, the financial statement of an employer that has adopted a pension plan will include at least two items -- the pension cost accrual and the unfunded actuarially computed value of vested benefits. A self-review problem will thus be presented if actuaries employed by the accounting firm are responsible for the computation of these items and then the same accounting firm is asked to audit the sponsoring employer's financial statement. In the Academy's comment in response to Release No. 33-5869, dated December 16, 1977, we pointed out why the principle behind the Commission's

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4/ The bulletin provides that independence will be deemed 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.

ruling on "EDP and Bookkeeping Services" was fully applicable here, and there is no reason to repeat that discussion here. These important financial statement representations cannot properly be audited by a firm that has made the initial determinations. The AICPA position that "all of the significant matters of judgment involved" can satisfactorily be "determined or approved by the client" is simply not credible. If there is anything that would create an appearance of lack of independence this would be it. Indeed, more than an appearance is involved. The performance of both functions creates exactly the kind of impediment to the achievement of objectivity that the independence requirement was designed to prevent.

Since the disability arising from self-review seems to us so clear, there is no need to consider whether participation in the determination of these items violates the role limitation that the Board regarded as essential. The issue is not comparable to that of an insurance company or pension plan where actuarial considerations are central to the operation of these entities. Whether significant involvement in one out of a great many significant management decisions that affect the financial statements creates a lack of independence for reasons unrelated to self-review is a matter that is within the special province of the Commission, as to which we therefore express no view.

Respectfully submitted,

SHEA & GARDNER

Lawrence J. Latto
Stephen J. Hadley

May 25, 1979

Mr. James M. Hanson, Supervisor, Financial Analysis
State of Illinois, Department of Insurance
320 West Washington Street
Springfield, Illinois 62767

Dear Mr. Hanson:

NAIC Life and Health Accounting Manual

Thank you for sending me the copy of the current draft of the manual and the related materials.

In view of the imminence of the (A6) subcommittee meeting, I have not attempted to distribute copies of the material to the other members of the American Academy of Actuaries Committee on Life Insurance Financial Reporting Principles and solicit their reactions.

However, I have read it through, and I commend those people who have been working on it. In my opinion, as respects those chapters which touch on actuarial concerns, the current draft is a decided improvement over its predecessor.

I know that the other members of the committee will be as pleased as I was to learn that a large percentage of the recommendations and suggestions in our memo of November 10 have been incorporated in the current draft.

You and I have already discussed several typographical errors and other minor items which I had noted. However, as I told you, there are a few things on which I wanted to comment in greater detail. These comments are strictly my own, and do not represent the views of the Committee.

One topic is page 40, which is for the most part made up of material extracted from chapter 11 of the earlier draft. I have several comments about it.

For one, the text just prior to the three numbered sections reads "Examples of these benefits include," but section one begins "The most common additional death benefit is . . ." Simply as a matter of style, it would be better if the opening words were "Accidental death benefits," as in the earlier draft. This would be consistent with the opening of sections two and three.

However, the sections are described as being examples of benefits, but section two is disability--active lives and section three is disability--disabled lives. These are not really two separate benefits, they are two types of reserves related to the same benefit. So I would suggest either (a) sections 2 and 3 be combined, or (b) the introductory wording be changed to "Examples of these reserves include."

Language stating that the cost of the supplemental benefit may be quoted as a separate premium or may be incorporated in the basic premium appears both in the introductory paragraph and in the first paragraph of section two. The latter could be deleted, since the statement is true of both benefits.

In the second paragraph of section 3, the last two sentences seem to be to be ambiguous and could therefore be quite misleading. A possible alternative wording, which says what I think was intended, would be "The same reserve method may be employed for group certificates as for ordinary policies. However, in the case of group term, the more common procedure is to combine the active life unearned premium reserve (if any) for the disability benefit with that for the underlying life coverage. A disabled life reserve (if the liability exists) is carried separately.

The final sentence on the page says "Disabled life reserves must include a provision for incurred but not reported disability benefits." The statement is certainly correct. I simply raise the question as to whether it might be appropriate in this context to address the issue of when a disability claim is incurred and should be recognized for this purpose. One view is that the claim is incurred (and the reserve should be established) if the insured is disabled on the valuation date. Another view (to which I happen to subscribe) is that the claim is not incurred until the disability has persisted through the waiting period, since not until then have all of the events taken place to fix the liability.

On another subject, one of the comments in our Committee's November 10 memo had to do with the reference, in the sixth paragraph on page 47, to disabled life reserves for waiver of premium benefits provided with loss-of-time policies. Our points were that (1) waiver of premium benefits are sometimes sold with other health coverages, and thus these reserves may be needed for them also, (2) active life reserves for the waiver benefit may be indicated, and (3) if the reference on page 47 is to be retained, parallel references to these other needs should also be included, somewhere in the chapter, for consistency. So far as I could determine, that suggestion was not heeded. I continue to believe that it is desirable.

Mr. James M. Hanson May 25, 1979

One other comment (which was also in our earlier memo) has to do with the sections, on pages 61 and 62, on Premiums Received in Advance and on Premium and Other Deposit Funds. It seems to me that the distinction between these two items, which is not made clear by the text, is that, if the sum involved was credited to Premium Income when it was received, it should be included in Premiums Received in Advance, and not otherwise. I would hope that the language will be expanded to make that clear.

Thank you very much for the opportunity to review and comment on this draft.

Sincerely,

Jack E. Wood

Chairman,
Committee on Life Insurance
Financial Reporting Principles
American Academy of Actuaries

JEW:ma

May 29, 1979

TO: Erma Edwards, Chairman, Life Insurance (C3) Cost Disclosure Task Force

FROM: John H. Harding, Chairman, American Academy of Actuaries Committee on Dividend Principles and Practices

SUBJECT: Update on Committee Activity

This Committee met in Kansas City on May 23 and 24, to explore in detail the nature of the problem we are trying to solve and to agree on a course of action.

The problem can be stated as follows:

The scope of practices with regard to dividend allocation and illustration has been expanding significantly in the past decade. This expansion has occurred as a result of two primary factors. First, consumer and regulatory interest in cost disclosure has made companies more concerned with the illustration of low-cost products. Second, advances in computer technology have made it possible for companies of all sizes to adopt far more elaborate methods to allocate and illustrate dividends.

The Society of Actuaries Committee on Dividend Philosophy is defining appropriate standards of practice for dividend allocation and defining the relationship between dividend allocation and dividend illustration. These standards of practice will necessarily and properly give the actuaries and companies broad scope in the allocation process, but at the same time, they will force consistency between allocation and illustration.

While these standards of practice will limit the range of permissible dividend illustrations, there will still exist dividend illustrations which are not truly comparable. The pattern of the solution to this problem is expected to be the following nature:

This Academy Committee will use the work of the Society Committee as the basis for establishment of a proper framework to:

A. Provide full disclosure to company management with regard to the method of dividend allocation and its consistency with actuarial standards of practice and the relationship between allocation and illustration; and

B. Inform and disclose to the insurance commissioners and the informed public that the standards for allocation and illustration have been met, with full disclosure of any exceptions. This will include a certification by the responsible actuary in the annual statement. It may also include a revision of Schedule M to provide more information relevant to the company's practices of allocation and illustration; and

C. Inform the prospective buyer of the nature of the dividend illustration presented and its impact upon cost comparisons.

Drafts of items B and C are being prepared and distributed within the Committee. It is expected that substantial progress can be made with these drafts through the use of telephone and mail. The date of the next meeting will depend upon the rate of this progress.

JHH:mw

American Academy of Actuaries
Committee on Risk Classification

Statement to the

NAIC (D3) Subcommittee

June 4, 1979
Chicago, Illinois

The Committee on Risk Classification of the American Academy of Actuaries believes that it is important to make a public statement on risk classification since actuaries have been engaged in the study, development and evaluation of this subject beginning with the assessment of life insurance risks in the early 1700's.

In the development of private passenger automobile classification plans, actuaries have a consistent standard against which their final product will be measured, i.e., that classifications should be based on differences in losses or expenses. This standard, that differences in prices should reflect differences in costs, is fundamental to pricing in all economic activity and is embodied in the NAIC model rate regulatory bills, in language such as ... "Such standards may measure any differences among risks that can be demonstrated to have a probable effect upon losses or expenses."

We believe that the benefits to society in a private competitive market are compelling reasons to endorse a system in which prices are based on costs. The benefits are:

(1) Overall costs to society are reduced because uneconomic activities are discouraged by associating the costs of such activities with the decision to engage in such activities. It is well recognized that the insurance mechanism does not create high risk drivers but does serve to identify, through higher premiums, those who have the greater expectation of loss. The decision to participate in that activity, i.e., driving a car, can be made with the full knowledge of the cost of

that activity. If the costs of driving are not associated with the decision to drive, and how much to drive and what kind of vehicle to drive, etc., overall costs to society will increase because the subsidy to high risk activities will encourage an increase in utilization of high risk activities.

(2) If one departs from objective standards not all parties are equally protected and equity cannot be assured. Those who render the subjective judgments will likely be guided by the more vocal group of drivers with little protection afforded to the silent ones. The result is that costs are unfairly shifted from one group to another. Equity can only be achieved by the consistent application of an objective cost-based standard.

(3) Cost effectiveness is maximized. With insurance, unlike most other products, ultimate costs are unknown at the time the product is sold. The incentives of the competitive environment act to produce the most cost effective system -- balancing the costs of obtaining information about a risk's cost potential against the value of that information. The results may not be perfect.

> Although competition, like democracy, is also imperfect, our society continues to support it because it is better than its alternatives for the reasons summarized above. In addition, independent studies such as those conducted by the Stanford Research Institute have indicated that any departure from objective, cost-based pricing systems is likely to be more costly and involve greater governmental intervention.

The American Academy of Actuaries Committee on Risk Classification recognizes that the sex and marital status of drivers do correlate with automobile accident involvement. Unless other variables, not yet identified, can be found which measure these differences as well or better, sex and marital status should continue as valid classification considerations.

We believe that a competitive system offers positive economic rewards to improve the risk classification process and provides no incentive to misclassify.

In conclusion we would urge caution in rejecting any effective rating variables unless it can be demonstrated that they do not differentiate among classes based on expected costs. The absence of a demonstrated cause and effect relationship is not sufficient to reject a rating variable which has a significant correlation with automobile accident involvement.

Finally, the Academy Committee on Risk Classification is also concerned with the deliberations on this subject at other forums -- such as the Accident and Health (C1) Subcommittee and with the many discussions affecting employee benefit programs such as pensions. Our Committee urges the NAIC not to adopt a course of action in one area, for one line of insurance, without careful consideration of the impact of such a decision in other insurance areas.

July 13th, 1979

Mr. Lawrence Thompson
Executive Director
Advisory Council, Social Security
Room 530, Altmeyer Building
6401 Security Blvd.
Baltimore, Maryland 21235

Dear Mr. Thompson:

This letter is in reference to the statement that I presented to the Advisory Council on January 5, representing the American Academy of Actuaries.

In commentary on the Advisory Council's Question 9 dealing with possible Social Security coverage for public employees, the statement alluded to the disproportionate benefits that public employees get when they have some covered employment in addition to their non-covered government employment. We said, "If universal coverage is not enacted, this anomaly should be fixed. We'd be glad to offer suggestions in this connection if desired." Such suggestions are provided in the material accompanying this letter.

As you know, this is one of the issues being considered by the HEW Universal Coverage Study Group. It appears that this group will develop specific suggestions in this area. Perhaps the Advisory Council would therefore want to direct its main attention to the policy question raised in the enclosed submission rather than the details of particular solutions.

We hope that the Advisory Council will find this submission useful.

Sincerely,

RFL:jb
enclosure
cc: Messrs. J. L. Cowen
H. J. Levin
R. J. Myers

WAYS TO AVOID EXCESSIVE TOTAL RETIREMENT BENEFITS FOR PERSONS WITH BOTH SOCIAL SECURITY COVERED EMPLOYMENT AND NON-COVERED GOVERNMENT EMPLOYMENT

An individual can earn a full pension in government employment that is not covered by Social Security. He or she can then obtain Social Security benefits (in many cases either by moonlighting or by a period of covered employment after retirement from non-covered employment).

Whereas such marginal employment for a person in the private sector would yield only marginal additional Social Security benefits, the same amount of marginal covered employment for a formerly non-covered government employee yields very generous benefits. Many observers consider this to be a serious inequity.

One oversimplified case can illustrate the inequity. Suppose an individual worked in covered employment long enough to attain the amount of service necessary for a maximum benefit at his or her rate of pay. Assume that the monthly rate of pay is $1,200 in all years, that the service all occurs after 1979, and that there is no increase in average rates of pay in nationwide employment after 1979. (The last assumption is of course totally unrealistic, but the unrealism fortunately does not affect the relative magnitudes of the numbers.) The Primary Insurance Amount for such an individual is $469. If on the other hand, the individual had covered employment for three-quarters of the time necessary to attain the full Social Security benefit based on the $1,200 rate of monthly pay, the Primary Insurance Amount would be $392. Adding that last 25% of covered employment gets the person the difference between the two amounts, only an incremental $77.

Now, consider a comparable individual who attains pension coverage from a career in non-covered employment with the government, and who then retires and works one-quarter of the years necessary to get a full Social

Security benefit. The covered service will bring a PIA of $200, over 2½ times the $77 that the first employee gets. This large difference exists because the first individual's additional benefit is figured at marginal (low-percentage) rates, whereas the second individual's benefit is figured at bottom-dollar (high-percentage) rates.

This difference is widely recognized as a serious inequity as between non-covered public employees and employees in the private sector. Some suggestions of possible solutions have been set down by Robert J. Myers, former Chief Actuary of the Social Security Administration, in a paper that is soon to be published in the Transactions of the Society of Actuaries. A preliminary copy of Mr. Myers' paper is attached. The paper presents two approaches to correction: (i) "an alternative approach" (referred to herein as Approach A), and (ii) "a simplified alternative approach" (Approach B). Extensive illustrations of both approaches are given.

Approach A treats covered Social Security employment as marginal, so that, in the example given above, such employment would produce a benefit of only $77, as the same employment would for a private sector employee. Approach B provides a Social Security benefit in the proportion that the covered employment bears to all employment, producing in our example a Social Security benefit of $117 (one-quarter of the full term benefit of $469).

What are the arguments as between these two general approaches? For Approach A, it is argued that the government employee should not be put in any favored position relative to employees in the private sector. The opportunity to earn even a proportional benefit for incremental additional service constitutes a favored position, and such discrimination should be eliminated. For Approach B, it is argued that, while the government employee should not get favored treatment under Social Security, his Social Security benefit should be equitable in comparison with the treatment of other persons under Social Security, without regard to his non-covered employment and any benefits gained therefrom. In other words, Approach A aims for equity in the combination of Social Security and employer pensions (public and private). Approach B aims for a more limited equity within the Social Security system itself. In addition to the foregoing, Mr. Myers' paper brings out the point that, under certain conditions, Approach A can produce benefits so small that FICA tax refunds might be called for.

The corrective methods set forth in Mr. Myers' paper require recognition of earnings in non-covered employment as one factor in the determination of the benefit from covered employment. We are not aware of any disabling administrative problem in this connection. However, we did spend some time looking at an Approach C, intended to produce results analogous to Mr. Myers' Approach B, that could be administered on the basis of Social Security records only. Approach C had possible promise, but we have not ironed out the bugs and are not certain that they could be ironed out. If there is concern with the need to use a record of non-covered employment to get a Social Security benefit, we would give further thought to Approach C.

The design of such approaches can be perfected by technicians if we reach that point. The key policy question is, do we want to eliminate the favored treatment of government employees under Social Security, and if so is something like Approach A (marginal) or Approach B (proportional) to be preferred?

In conclusion, we emphasize our belief that, if universal coverage is not enacted, something should definitely be done to eliminate the inequitable favored treatment of government employees who are not under Social Security.

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

July 18, 1979

Mr. Donald C. Lubick, Esq.
Assistant Secretary (Tax Policy)
Department of the Treasury
Fifteenth and Pennsylvania Avenue N.W., Room 3112
Washington, D.C. 20220

Dear Mr. Lubick:

The Internal Revenue Service intends to publish proposed regulations under ERISA which are of concern to the American Academy of Actuaries, which includes in its membership more than 80% of the Enrolled Actuaries under ERISA, and the actuarial profession generally. This concern arises because the regulations would put the Department of the Treasury and the Internal Revenue Service in the position of imposing rules upon all pension plans and their Enrolled Actuaries which in some cases are in direct conflict with the collective actuarial judgment of the actuarial profession, as represented by the published Opinions, Interpretations and Recommendations of the Academy.

The point at issue here is not a question of the proper interpretation of a law but, rather, the question of whether or not a government agency should overrule a standard established by a profession in the absence of a need to do so because of Congressional intent or national concern. In this instance, we do not believe that justification exists.

We are directing this matter to your attention in advance of the publication of the proposed regulations because we consider the mere publication, even on a proposed basis, as implied recognition of the Internal Revenue Service's right to establish professional guidelines for actuaries beyond the justifiable requirements of ERISA.

The fact that the government has the authority to establish the proposed regulations is not questioned. It concerns the expanded definition of "acceptable actuarial cost methods" for the purposes of the minimum funding requirements of defined benefit (pension) plans, as established by ERISA under section 412 of the Internal Revenue Code. Section 3(31) of Title I of ERISA defines "actuarial cost method" and the last sentence thereof reads: "The Secretary of the Treasury shall issue regulations to further define acceptable actuarial cost methods."

Under ERISA, Congress imposed the responsibility for the determination and certification of a plan's minimum funding requirement upon the plan's Enrolled Actuary; and created a governmentally administered procedure to identify those persons qualified to act as an Enrolled Actuary. In section 412 of the Code, Congress also specified in substantial detail, certain rules for the determination of a plan's minimum funding requirement.

Mr. Donald C. Lubick, Esq.

Page 2

But, because pension plan costs also involve judgments regarding long-term future events and circumstances for which there is no certainty, we believe that Congress rightfully intended that a plan's minimum funding requirement be determined by the plan's Enrolled Actuary, acting in accordance with his personal judgment within the guidelines established by his profession. Such intent is clearly expressed in section 412(c)(3) of the Code, which reads: "For the purposes of this section, all costs, liabilities, rates of interest and other factors under the plan shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan."

We believe that professional guidelines as to what is and is not reasonable should be established collectively by a profession and not by a government agency which administers a law affecting the profession, so long as the profession's guidelines are not in conflict with Congressional intent nor national concern.

As previously noted, a large percentage of Enrolled Actuaries are members of the American Academy of Actuaries. Guidelines for the Academy's members regarding the determination of pension plan costs have been established in the form of Recommendations and Interpretations from the Academy's Committee on Pension Actuarial Principles and Practices. The Committee is broadly representative of actuarial practitioners generally; and the Committee's Recommendations and Interpretations are issued only after long periods of analysis and discussion, including the evaluation of comments received from other Academy Members through the wide circulation of draft copies. Accordingly, the Academy's guidelines represent a consensus of opinion within the actuarial profession.

A specific conflict in the proposed regulations concerns the use of the actuarial cost method identified as the "accrued benefit cost method (unit credit method)" in section 3(31) of Title I of ERISA, as such method is applied to certain types of pension plans, primarily final average pay plans. Under such a plan and method, the actuary determines a participant's projected benefit at retirement and then allocates a portion of the benefit to each year of the participant's entire employment career (past and future) in order to compute the plan's cost in respect of that particular year of employment.

Under one application of the method, the same dollar portion of the benefit is allocated to each year of employment; and such application is sometimes referred to as "proration by service." Under another application of the method, the portion of the benefit allocated to each year of employment is in proportion to the participant's compensation for that year relative to compensation for all years; and it is sometimes referred to as "proration by pay."

We do not think that a lengthy analysis of the pros and cons of the two types of application would be appropriate in this letter. Some actuaries have a strong preference for one or the other; and other actuaries use both, depending upon the particular plan and its circumstances.

Mr. Donald C. Lubick, Esq.

Page 3

The main issue is that the actuarial profession, as represented through the Academy's published guidelines, has concluded that both types of application are acceptable. In contrast, the Internal Revenue Service appears to have concluded that only the "proration by service" application is acceptable and that the "proration by pay" application is not acceptable.

We urge the Department of the Treasury not to publish this proposal, which we sincerely believe represents an unjustifiable usurpation of the right of the actuarial profession to establish its own standards. If the Internal Revenue Service feels that the Opinions, Interpretations or Recommendations of the Academy conflict with the requirements of ERISA, or are incomplete, we would be pleased to discuss this subject with representatives of the Department and the Service.

Very truly yours,

Dale R. Gustafson
gs

Dale R. Gustafson
President

DRG:cal

cc: Jerome Kurtz, Commissioner, Internal Revenue Service
Daniel I. Halperin, Deputy Assistant Secretary (Tax Legislation)

July 27th, 1979

Mr. Lawrence Thompson
Executive Director
Advisory Council on Social Security
Room 530, Altmeyer Building
6401 Security Blvd.
Baltimore, Maryland 21235

Dear Mr. Thompson:

On July 13 of this year I wrote you a letter in reference to the statement that I presented to the Advisory Council on January 5, representing the American Academy of Actuaries. This present letter also refers to that statement.

In commentary on the Advisory Council's *Question 3* dealing with the Social Security earnings test, the statement alluded to the widespread adverse reactions to the present test. We said, "If the test is to be preserved, some redesign or repackaging may be needed to overcome these reactions. If the Advisory Council wishes, the Academy's Committee on Social Insurance would be happy to develop some suggestions along these lines for your consideration." Such suggestions are provided in the memorandum accompanying this letter.

In this connection, we wish to underline several points. First, no endorsement is implied by the submission of these suggestions. They represent a collection of ideas for consideration, but neither the American Academy of Actuaries nor its Committee on Social Insurance takes any position at this time for or against any of them. Second, the suggestions are ideas for exploration, rather than fully developed proposals that could be implemented. If there is interest in any of them, significant developmental work would be required before any proposal to implement. Third, most of the suggestions have cost implications, in some cases significant. We have not explored these but would consider it essential to do so as a part of any further study.

We hope that the Advisory Council will find this submission useful.

RFL:jb
attachment
bcc: Messrs. J. L. Cowen
R. J. Myers
C. J. Nesbitt
A. E. Robertson

Memorandum to the Advisory Council on Social Security
from
The American Academy of Actuaries Committee on Social Insurance
Suggestions for Possible Modifications of the Social Security Earnings Test

Introduction

The Committee on Social Security Insurance is pleased to offer suggestions to the Advisory Council for possible modification of the Social Security earnings test. In this memorandum, two basic approaches to modification or redesign are outlined: the first deals with various means of restructuring the test, while the second notes ways of modifying the overall context within which the test is applied. Both approaches offer "solutions" that may be controversial; therefore, because of the political context of the issue, the Committee offers the following qualitative observations:

- First, to the extent that a suggestion may have "advantages" and "disadvantages" of a social or political nature, the Committee has no special expertise to offer, and does not take an advocacy position. However, since the Advisory Council has accepted the Committee's offer of suggestions with regard to making the test "more palatable" to those affected while still retaining it in some form, the suggestions do not include the option of outright elimination of the test.

- Second, it should be noted that several of the suggestions have the primary thrust of liberalizing the test. These suggestions are noted in the interest of completeness, since they clearly might make the test more palatable by reducing its impact on those affected. However, the Committee is concerned about the added financial strain on the system that such liberalizing steps would cause, and believes that the Council should consider the need for thorough actuarial analysis in weighing the overall merit of any particular suggestion -- liberalizing or otherwise.

Restructuring the Earnings Test

The first approach to redesign of the earnings test would involve restructuring its provisions or its application. Several palliative changes that might fall under this heading are as follows:

(i) Apply a set of "bands" over the exempt amount so that a series of progressive reductions would apply; that is, a $1 reduction for each $5 of initial non-exempt earnings, followed by a $1 for $4 band, a $1 for $3 band, and finally, a $1 for $2 band. This measure would ease into the reductions less abruptly than at present.

(ii) Apply a more strict earnings test only to the one-half of the Social Security benefit than can be construed to be provided by employer taxes. The "employee-paid" portion of benefits would then be exempt from the earnings test. (Another approach, involving packaging rather than redesign, would say that the test applies first to employer-paid benefits and only thereafter to employee-paid benefits, with no necessary change in the substance of the results.)

(iii) Restructure the test to compare earnings after retirement with earnings before retirement, rather than -- as is now the case -- offsetting or comparing earnings after retirement with benefits after retirement. The test might apply in practice as follows: For each year of benefit, an eligibility fraction, $0 < f < 1$, would be determined by the relation

$$f = 1 - \frac{\text{Excess earnings}}{\text{Base earnings}}, \quad \text{but not less than } 0.$$

Excess earnings would be those in excess of some exempt amount (to be indexed forward from year to year). Base earnings might be the AIME at time of claim, and would also be indexed forward. For example, if base earnings were $12,000, actual earnings for a year were $9,000, and the exempt amount were $4,000, then

$$f = 1 - \frac{5,000}{12,000} = \frac{7}{12},$$

and the beneficiary would be eligible for $\frac{7}{12}$ of the Social Security benefit. For the first and last years of claim, earnings would be relative to the fractional year of entitlement. The system would have to be applied on a current basis, and might require the beneficiary to submit earnings estimates twice a years, say, in March and September. Some adjustment process would be needed to take account of the effect of any difference between actual and estimated earnings.

(iv) Restructure the test so that it becomes more severe rather than less severe with advancing age. At present, the retirement test is most severe for entitled persons who are below age sixty-five, somewhat less severe after age sixty-five, and inapplicable after age seventy-two (age seventy starting in 1982). The implied objective of this design would appear to be to push people out of the labor force and then cut back over time the impediments to their returning to it. The suggested redesign would aim to increase, rather than decrease the pressure for entitled persons to leave the labor force as age advances.

Modifying the Context of the Earnings Test

In this section we identify changes that would make the earnings test more palatable by modifying its overall context, or changing its surrounding circumstances. Some changes that fall in this category include:

(i) Eliminate employeee-paid FICA contributions on wages paid to any person entitled to Social Security benefits. It is irritating to entitled persons that, in addition to income reduction due to the retirement test itself, the FICA taxes on earned income further reduce its value. The elimination of FICA taxes could be accomplished directly through each employer's payroll and reporting system, or indirectly, by claiming FICA withholding as a tax credit or refund on an individual's tax return. The latter approach would be analogous to the tax credit currently available for excess FICA withholding by two or more employers.

(ii) Make Social Security benefits subject to income tax. Similarly to the above, those whose marginal amounts of earned income are partially offset by the retirement test (and the FICA taxes) are further distressed because their earned income is subject to income tax at their marginal income tax rate, whereas the replaced Social Security benefit is not. We doubt that many people would suggest that Social Security benefits should be made taxable for the sole purpose of making the earnings test more palatable. However, the suggestion has been made for other reasons - basically that the suggesters believe the present exemption of Social Security benefits from income tax is not appropriate. If Social Security benefits became taxable, fully or in part, the perceptions of inequity on the part of those affected by the retirement test might be reduced.

(iii) Increase the age at which full retirement benefits first become available under Social Security. Under this approach, it would not be unnatural for the earlier age at which benefits first become available also to be increased. This would lead to the elimination of some years of age during which the retirement test might otherwise have operated, deferring the application of the test to higher ages at which significant earned income is less prevalent. (As part of a "solution" of the retirement test "problem," this suggestion suffers from the usual accompanying thought that any increase in the retirement age under Social Security should be put in gradually, starting a good number of years hence.)

(iv) Incorporate the intent of the test in a fundamental change of the Social Security system itself. This final suggestion stems from ideas recently raised by several observors, including A. Haeworth Robertson, former Chief Actuary of the Social Security Administration. These proposals envision the modification of Social Security benefits to have a flat (non-earnings-related) benefit coupled with a variable (contribution-dependent) benefit. If this restructured approach were adopted, the new "retirement test" might be applied only to the flat benefit portion. The individual worker's earnings-related benefit could be exempted from the retirement test adjustment -- presumably with greater public acceptance of the test that remained.

(One member of our Committee would modify the foregoing. He suggests instead that the flat benefit portion should be exempted from the earnings test, while the earnings related portion should continue to be subject to the test, since it is an earnings test.)

It should be noted, of course, that this or any other such approach to modifying the earnings test should be consistent with changes to other provisions of the law that would occur in such far-reaching restructuring. In this instance, redesign of the earnings test would not be accomplished uniquely; rather, it would be part of the overall redesign of the benefit system.

STATEMENT

OF

MR. DALE R. GUSTAFSON

PRESIDENT OF THE AMERICAN ACADEMY OF ACTUARIES

TO THE

SUBCOMMITTEE ON GOVERNMENTAL EFFICIENCY

AND THE DISTRICT OF COLUMBIA

OF THE

SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

August 1, 1979

The American Academy of Actuaries is pleased to submit this written statement in support of the oral testimony given by Dale R. Gustafson, President of the American Academy of Actuaries, on August 1, 1979, to the Subcommittee on Governmental Efficiency and the District of Columbia.

I. Introduction

We understand the purpose of these two days of hearings to be to review the self-regulatory activity of the accounting profession and its implementation of the independence requirement. It has been, after all, nearly two years since the Subcommittee on Reports, Accounting and Management concluded its inquiry into this area, and several events of considerable significance have occurred in the interim.

Since that time, both the accounting profession and the Securities and Exchange Commission have taken actions of significance to one particular issue raised in this earlier inquiry, namely, the provision of Management Advisory Services (MAS) by accounting firms to their audit clients. It is on this issue that the Academy would like to focus its comments today, and particularly upon the provision of actuarial services by accounting firms to their audit clients.

II. The Interest of the Academy

The American Academy of Actuaries was formed as an umbrella organization for the four existing national actuarial organizations -- the Society of Actuaries, the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, and the Fraternal Actuarial Association. As such, the Academy and its sponsoring organizations function as a professional association for over 7,000 actuaries. While most of these professionals are employed by insurance companies, independent consulting actuarial organizations, government departments and agencies, or in institutions of higher learning, a significant number are employed by accounting firms (and a smaller number by management consulting firms or industrial corporations).

The Academy's interest in the provision of actuarial services by accounting firms is not simply that actuaries are involved *per se*. It was the intention of the four existing national actuarial organizations when they formed the Academy that one of its major responsibilities would be to "establish, promote, and maintain high standards of conduct and competence within the actuarial profession."_/ What has caused the Academy to become concerned with the provision of actuarial services by accounting firms to their audit clients is that all too frequently this practice has placed actuaries in a difficult professional position, caught between the competing demands of their employer and the professional standards of their profession.

_/ Articles of Incorporation of the American Academy of Actuaries.

III. The Requirement of an Independent Audit and the Avoidance of "Self-Review"

The Securities and Exchange Commission has employed the authority granted to it by statute to require that the significant financial reports submitted to it be certified by an independent accountant. Through a series of releases the Commission has been gradually defining for the public what it means by an "independent" accountant. Much of the Commission's emphasis has been upon prohibiting certain financial or organizational relationships between the auditor and the entities whose statements are being audited, in order to avoid any possible introduction of bias or partiality on the part of the auditor. The Commission has sought to avoid not only the actual lack of independence but also the appearance of non-independence. The critical need for public confidence in the reports of accountants upon financial statements has led the Commission to conclude that, even where it is plain that the requisite objectivity exists, certain relationships should nonetheless be barred simply because they suggest a lack of independence. In effect the Commission has been leaning over a little backward in this area in order to ensure that it will never be less than upright.

Another crucial element of independence has been that the accountant not participate in "self-review," or be placed in the position of reviewing his own work. This is not because accountants cannot be relied upon to carry out professional assignments with conscientiousness and integrity. Quite the contrary. What the Commission had in mind, however, when it mandated an "independent audit" was quite literally an objective "second look" at a financial statement by someone who had not been involved in any way in its preparation.

Perhaps the best example of this concern was the Commission's decision on bookkeeping or accounting services. There the Commission concluded that an accounting firm could not be deemed "independent" in auditing the financial statements of a client if it had participated in the maintenance of the client's basic accounting records or in the preparation of its financial statements. The Commission concluded:

> "A major value of an audit of financial statements by an independent accountant is derived from the fact that the accounting records and financial statements of management are reviewed and examined from an independent or outside viewpoint by knowledgeable professional accountants who are not connected with management. The application of an independent viewpoint is particularly important with respect to judgments exercised in the determination of appropriate principles and methods applicable to the recording, classification and presentation of financial data. By their nature such judgments cannot subsequently be evaluated on an impartial and objective basis by the same accountant who made them."__/

Even if the preparer of the accounting records and the auditor of the financial statements are two different persons, "self-review" is not avoided (and the "independence" requirement is not satisfied) if those persons are members of the same accounting firm. For it can be expected that the auditor will be sorely tempted to rely heavily upon his professional associate, a person with whom he has worked and in whom he undoubtedly

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__/ SEC Release No. AS-234 (December 13, 1977), 6 Fed. Sec. L. Rep. (CCH) ¶ 72,256 at p. 62,650. See also SEC Release No. AS-126 (July 5, 1972), 6 Fed. Sec. L. Rep. (CCH) ¶ 72,148 at 62,307:

> "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."

has a high degree of confidence. The mere fact of a common employer could create the kind of appearance of conflict of interest that the independence requirement seeks to avoid. The Commission has clearly indicated that review by an auditor that has a professional or organizational relationship with the preparer of the financial statements would not constitute the kind of impartial and objective "second look" that is at the basis of the requirement for an independent audit.__/

IV. The "Self-Review" Problem Where Actuarial Services are Involved

The provision of actuarial services by an accounting firm to its audit clients poses a problem very analogous to the situation where the auditing firm has rendered accounting or bookkeeping services to an audit client (or participated directly in the preparation of the financial statements themselves). The problem posed by these two kinds of services distinguishes them from most of the services that generally fall under the label of Management Advisory Services. The accounting profession has, for example, included such services as executive recruitment, marketing analysis, data processing, plant layout and product design.

A. Actuarial Services Are Distinguishable from Most Other MAS

While these other services do, in some sense, affect the financial statements by influencing, for example, costs incurred or annual expenses, they do not result in representations about expenses or liabilities

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__/ The Commission found that independence would be adversely affected where an accounting firm proposes, by use of its computer, to perform certain data processing activities in connection with the client's stockholder ledger notwithstanding that programming, keypunching, and computer processing would be performed by personnel of the data processing department who were separate from the audit staff. SEC Release No. AS-126 (July 5, 1972), 6 Fed. Sec. L. Rep. (CCH) ¶ 72,148 at 62,308.

that will have to be reviewed in the course of an audit. The issue of "self-review" simply does not arise with respect to these non-actuarial MAS services.

By contrast, in the case of or actuarial services, the service that is provided will as a general rule involve either the computation of the very figures and representations that appear on the financial statements or the preparation of analysis and data from which those representations are directly derived. In auditing the financial statements, the accounting firm will be reviewing its own work in a literal sense, namely, the work of its own actuaries. The "self-review" is direct and immediate.

In the area of actuarial services, the potential for "self-review" arises with respect to the financial statements of three kinds of entities:

(1) Insurance companies. Actuarial analysis is significant with respect to many of the entries on insurance company financial statements. For example, the two most important entries on the liability side of the company's balance sheet are the "aggregate reserve" representing the provision for future claims and the "policy and contract claims" that are accrued but unpaid (including both reported and unreported claims). Both are heavily dependent upon actuarial analysis.

(2) Employee benefit plans. In similar fashion, the most significant entries on the liability side of the balance sheet of an employee benefit plan are dependent upon actuarial calculations. Actuarial calculations are so important in these determinations that the annual financial statement required by Section 103(a)(1)(A) of the Employee Retirement Income Security Act of 1974 ("ERISA") must be accompanied by an actuarial statement prepared by a qualified enrolled actuary.

(3) Corporate sponsors of employee benefit plans. The financial statement of a corporation that sponsors an employee benefit plan will usually have two items that are based upon actuarial determinations, the deduction from gross income for the amount of the accrued pension cost and the unfunded vested liability of the plan. The unfunded vested liability figure can reflect a substantial portion of the total liabilities of the corporation, and the annual pension cost typically represents a significant factor in relation to the net income of the company.

An audit of any of these financial statements by anyone organizationally affiliated with an actuary who prepared actuarial determinations that underlie these specific representations would involve the audit in "self-review" inconsistent with independence.

B. The Academy Has Sought To Deal with the "Self-Review" Problem.

In response to some of the same considerations that motivated the Commission to require that the statutory audit be "independent," the Academy and its sponsoring organizations established some years ago a Joint Committee on Independence of the Actuary. The Joint Committee published two exposure drafts, which received extensive comment throughout the profession, and in November, 1976, submitted its final report. One of the central conclusions of the Joint Committee, which has been adopted by the Academy Board of Directors and is in the process of being incorporated into the Academy's Guides to Professional Conduct, is that:

> "If an actuary makes an actuarial review of an actuarial determination, and such review is intended for public use, then under no circumstances should he have any organizational or material financial relationship with the preparer of the actuarial determination or with the entity to which the determination relates."

While this "independence" requirement would seem to closely parallel the requirement imposed upon the accounting profession, it presents a difficult problem for an Academy member employed by an accounting firm. The problem is presented most acutely when an accountant is auditing a financial statement containing representations that are based on or directly derived from actuarial analysis. In order to assist him in forming his own opinion as to whether these particular representations are fairly stated in accordance with generally accepted accounting principles, the individual auditor may ask another actuary employed by his accounting firm to make an "actuarial review" of the original actuarial work. If the original actuarial work (the "actuarial determination") has been prepared by an actuary already employed by or affiliated with the accounting firm, the reviewing actuary will have an "organizational relationship" with the preparer of the actuarial determination (being members of the same or related organizations) in violation of the principle of independence adopted by the Academy.

C. Actuaries Employed by Accounting Firms Face a Dilemma as to "Self-Review"

It is the Academy's view that for an actuary employed by an accounting firm to participate in the audit review in these circumstances would violate not only the Academy's "independence" requirement, imposed upon him by virtue of his status as a member of the actuarial profession, but would also presumably violate the "independence" requirement to which his accounting firm employer is subject. The accounting profession, however, has not adopted this view. Nor has it shown any willingness to accommodate the actuarial profession either by eschewing as a general matter the provision of actuarial services to audit clients or by making clear to its actuary employees that they need not participate in any audit involving the review of actuarial determinations prepared by an actuary employed by or affiliated with the accounting firm.

In this situation, the actuary is left with the choice of either violating the standards of his profession or disobeying the instructions of his employer. The Academy has sought for some time to bring to the attention of the Commission and the accounting profession the dilemma facing actuaries employed by accounting firms. We have hoped that both could be convinced that it would violate the independence requirement imposed upon the accounting profession for an accounting firm to provide SEC reporting companies with actuarial services that become reflected in representations on financial statements and then to audit those statements. Adoption of this view by the accounting profession or the Commission would remove from actuaries employed by accounting firms the dilemma that is posed in really two ways: first, how to respond if asked to conduct an actuarial review when the underlying actuarial work was prepared by an actuary employed by the same firm, and, second, what is his responsibility if he becomes aware that his own work is being audited by a member of the same accounting firm.

V. The Accounting Profession's Response

The first consideration by the accounting profession of the dilemma posed for actuaries employed by accounting firms that engage in "self-review" is reflected in an interpretation of the Executive Committee of the Ethics Division of the AICPA:

> "Member Providing Actuarial Services
>
> 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?

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." __/

A. "Adoption" by the Client Does Not Solve the "Self-Review" Problem

From the beginning, the Academy has argued that this approach is inconsistent with accepted principles of independence. Under a literal reading of this Ethics Division interpretation, once the determination of the reserve liabilities of an insurance company or the actuarial valuation of a pension plan had been completed by an actuary employed by the accounting firm, and the results "adopted" by the client relying on its own "informed judgment," the auditor could bring back that same actuary to "audit" the accuracy and reasonableness of his own work. But even if the Ethics Division interpretation be "clarified" to require that a different actuary participate in the audit, this would not eliminate the unacceptable self-review.

The AICPA's argument as applied to actuarial services has already been rejected by the Commission with respect to the provision of bookkeeping or accounting services. __/ The reason, of course, is that the AICPA's "adoption" argument could be made with respect to an entire financial statement and permit an accounting firm to prepare the statement, obtain

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__/ AICPA Professional Standards, v. 2, ET Section 191.107-08.

__/ This approach is contained in Rule 101-3 of the Rules of Conduct of the AICPA, which may be found in AICPA Professional Standards, v. 2, ET Section 101.04. The AICPA acknowledges the Commission's rejection of this approach by including a statement that "[w]hen 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."

the client's "approval" by the exercise of its "informed judgment," and then audit the statement. This approach would read the "avoidance of self-review" element of "independence" right out of existence.

Further, as a practical matter, it is fairly unlikely that client management will have sufficient expertise to make an "informed judgment" on the actuary's work and be able to accept responsibility for the results. While corporate officers often have acquired a reasonably satisfactory knowledge and understanding of accounting practices and principles, it is extremely unlikely that they will have acquired commensurate knowledge of the more specialized actuarial services. Even in the case of actuarial work performed for insurance companies, where the business is highly dependent upon actuarial theory, many of the top industry executives have a legal or marketing rather than an actuarial background. Especially if the client does not have an in-house actuarial staff, it will of necessity have to rely almost totally on the work of the accounting firm's actuary. The case of a pension or other employee benefit plan is even more difficult, since many corporate officers without any background in actuarial science or any in-house actuarial staff have found themselves named administrators of corporate-sponsored plans.

B. Since the Auditor's Role With Respect to Actuarial Work is Significant, the "Self-Review" Problem is Significant

More recently, the accounting profession has adopted a somewhat different response to the Academy's concern. The Public Oversight Board of the SEC Practice Section for CPA firms issued a report on the Scope of Services by CPA Firms on March 9, 1979. In its section on actuarial services, the Board's report acknowledged that the provision to audit clients of actuarial services (where those services are reflected in representations on financial statements) presents at least a theoretical problem of "self-review." But the Board asserted:

> "This does not mean, however, that the limited self-review involved impairs the auditor's independence or otherwise is harmful to the public or investors. First of all, it must be remembered that the review is quite limited and is not duplicative of the work performed by an actuary." POB Report, p. 50-51.

The Board argues that actuarial analysis is the work of a "specialist" and as such is subjected to only "limited" review by the auditor. But by the standards of the profession itself, the auditor is to avoid express reliance on the work of a specialist in issuing an unqualified opinion. As a consequence, he remains responsible for the work performed by the actuary on some very important items of the financial statements. As an example, the accounting industry's own audit guide entitled Audits of Stock Life Insurance Companies, prepared by a committee of the AICPA, provides that in auditing the "aggregate reserve" the auditor is required, in order to satisfy himself that the reserve is fairly presented, to examine "the propriety of the actuarial factors used in computing the reserves." While the guide notes that the auditor will need to utilize the services of a qualified actuary for certain of the audit procedures, the guidelines suggest an active auditor role.

> "Although an actuary has been involved in these determinations, perhaps even to the extent of testing clerical accuracy, it is incumbent upon the auditor to be satisfied that reserves are fairly stated on a consistent basis.
>
> * * *
>
> Actuaries are not practicing auditors; they are not specifically trained in auditing procedures, nor are they governed by generally accepted auditing standards. Therefore, there is no justification

> for the auditor to omit all audit procedures or to perform only token procedures as to the reserves reviewed by the consulting actuary unless the terms of the engagement contemplate a qualification or denial of opinion by the auditor." Audit Guide, p. 98-99.

Further, the industry's guide on the use of a specialist, Statement of Auditing Standards No. 11 (SAS 11), one of a series of interpretations of generally accepted auditing standards issued by the AICPA, provides that "[a]lthough the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings are suitable for corroborating the representations in the financial statements." Where the auditor uses a specialist related to the client, the auditor's responsibilities under SAS 11 are increased. He should consider performing additional procedures with respect to some or all of the assumptions, methods, or findings of the specialist to determine that the findings are not unreasonable. (Alternatively, he may engage an outside specialist for this purpose.)

These materials seem to suggest that the auditor remains responsible for the substantive work performed by the actuary and that the review conducted by the auditor of that work is not the trivial one suggested by the Public Oversight Board. Admittedly, the audit is not "duplicative" of the work of the actuary, but duplication is not required of the auditor with respect to the representations contained in the financial statements. All that is required is that the auditor satisfy himself that the representations are fairly presented in accordance with generally accepted accounting principles.

VII. The Commission's Response

The Securities and Exchange Commission has recently issued another release on the independence of accountants, Accounting Series

Release No. 264, dated June 14, 1979. That release identifies four basic elements that accountants must consider when deciding whether acceptance of a particular engagement to provide management advisory services will impair their independence:

-- Dependence on MAS (the relationship between the audit fee and the MAS fee, both for a particular client and for aggregate revenues generally).

-- Avoidance of supplanting management's role (requiring the accountant in providing MAS to limit himself strictly to an advisory capacity).

-- Avoidance of self-review (insuring a dispassionate "second look" by an outside auditor).

-- Impact on audit quality (whether enhanced audit quality will result from the performance of the nonaudit service involved).

A. The Commission's Test for Impairment of Independence.

The Commission has combined these four factors into a test which accounting firms should apply when considering whether to undertake a nonaudit engagement for a public audit client:

> "[T]est the services in question against each of these factors and proceed when satisfied that the total balance of considerations favors proceeding with the engagement and that none of the factors tilts strongly against performance of the nonaudit work involved." (Emphasis added.)

The Academy is of the view that this general test is sound and that the four factors denominated by the Commission as elements of independence are appropriate. We agree especially that any significant impairment of any one of these four factors is sufficient to violate the independence requirement. However, the Academy is concerned with what appears to be the

Commission's adoption of a case by case approach to the independence issue. The Commission expressly avoided any proscriptive rules in Release No. 264 and instead encouraged accountants to "exercise self-restraint and judgment in determining which nonaudit services are appropriate in specific cases." The Commission pledged that its staff would "continue to examine particular cases in which questions arise concerning the independence of accountants."

B. The Commission Has Not Adequately Applied Its Test.

Under the Commission's own test, there are at least two categories of services which we believe are inappropriate for treatment on a case by case basis. In the case of these two kinds of services, namely, accounting or bookkeeping services and actuarial services, the provision by an accounting firm of such services to its audit clients would in almost every case have to be judged inconsistent with the requirement of independence under the Commission's own test. As a consequence, a broader proscription of these kinds of services is clearly warranted. The Commission has recognized this fact with respect to accounting or bookkeeping services. The Academy has urged that a similar position should be adopted with respect to actuarial services.

C. The Academy's Proposal for the Treatment of Actuarial Services.

The approach which the Academy would recommend is somewhat different depending upon whether actuarial services are being provided to an insurance company, an employee benefit plan, or a corporate sponsor of such a plan, and as a consequence we will discuss each of these separately.

1. Insurance company financial statements. As we have noted earlier, several key representations on the financial statements of an insurance company directly reflect actuarial work. For an accounting firm to involve its employees in the preparation of these representations or of analysis and data from which

these representations are directly derived must be deemed to render that firm ineligible to conduct an "independent" audit of the resulting financial statements. This conclusion would seem to follow directly from the Commission's own test, which would require that "<u>none</u> of the factors [dependence on MAS, avoidance of supplanting management's role, avoidance of self-review, and impact on audit quality] tilts strongly against performance of the nonaudit work involved." (Emphasis added.)

Where direct "self-review" is involved, as would be the case with actuarial services directly reflected on the balance sheet, it is hard to conceive of a situation where the fact of "self-review" could tilt more strongly against the performance of the non-audit work involved. If that portion of the Commission's test (suggesting that seriously offending any one of the four criteria will defeat independence) is to mean anything, it must mean that the independence requirement cannot be satisfied where such direct "self-review" is involved. For one could not conceive of a situation where <u>that</u> criteria could be more seriously offended, particularly since the representations reflecting actuarial work are such important elements of the balance sheet of an insurance company.

The same argument can be made with respect to a second of the four elements of independence outlined by the Commission, namely, avoidance of supplanting management's role. Even the Public Oversight Board found that an accounting firm could not generally provide actuarial services to an insurance company audit client and still be deemed to be "independent." A limitation on the provision of actuarial services to insurance company audit clients was required, the Board concluded, in order to avoid stepping out from a strictly advisory role and becoming viewed as a part of management._/

Basically, the Board found actuarial determinations to be so central to the business of an insurance company that an accounting firm could not participate in those determinations and still retain its independence. Determining potential future liabilities and the adequacy of current reserves, while preeminently actuarial matters, are also central concerns of top management of any insurance company. Participation in these determinations inevitably makes the accounting firm part of the "management team" and compromises both the substance and the appearance of independence._/

The Public Oversight Board concluded that because of the danger of being perceived as part of management, an accounting firm could not be the primary source of actuarial services to an insurance company audit client. However, the Board concluded that the firm could still provide such services to the client so long as they were supplemental to primary actuarial advice

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_/ "Actuarial considerations for an insurance company are integrally related to the role and responsibility of management. Thus, if an accounting firm furnishes actuarial services to management of an insurance company audit client, care must be taken to satisfy the role requirements contained in the AICPA's MAS Professional Standards. This means generally that the actuary must only furnish advice to management and render assistance and that management must make the final decision. To do this, the accountant must be satisfied that the client has the expertise to understand the significance of his recommendations so that 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 Board does not believe that this standard can reasonably be met if an auditing firm is doing more than rendering supplementary actuarial advice." POB Report, p. 53.

_/ It is this same principle that bars an accounting firm that has performed legal or brokerage services for a client from also auditing its financial statements. These services are regarded as so intertwined with management functions as to impair the independence of the accountant, even where the work does not relate to representations in the financial statements. The furnishing of actuarial services to an insurance company involves an even greater involvement in management functions.

furnished by another actuary. The Commission generally adopts this position in Accounting Series Release No. 264.

What this position fails to recognize, however, is that provision of actuarial services to insurance company audit clients poses a problem not only because the accounting firm is participating in a management function but also because a problem of direct "self-review" is involved. The actuarial services provided by an accounting firm might clearly be supplemnetal in character and still find their way onto the financial statement of an insurance company, resulting in direct "self-review."

The approach which the Academy would recommend would be to rule that it is inconsistent with the independence requirement for an accounting firm to provide actuarial services to an insurance company audit client where that work might involve the accounting firm's actuaries in any way in the valuation of reserves or in the determination of any other representation on the financial statements. However, it will often be difficult to know in advance what use will be made of actuarial work. Actuarial analysis is so central to the operation of an insurance company that there is always the likelihood that it will in some way be reflected in the representations on the financial statements. As a consequence, accounting firms might will be advised as a general matter to avoid altogether the provision of actuarial services to insurance company audit clients.

2. Employee benefit plans. We have already seen that important entries and representations on the financial statements of an employee benefit plan directly reflect actuarial computations and analysis. As a consequence, it is the Academy's view that the case of an accounting firm providing both actuarial and audit services to an employee benefit plan

presents the same self-review problem as where an insurance company's financial statements are involved. Hence the rule suggested with respect to insurance company financial statements should apply here too.

Additionally, it must be noted that Section 103(a)(3)(B) of ERISA provides that the independent accountant, in offering an opinion concerning the plan's financial statements, "may rely on the correctness of any actuarial matter certified to by an enrolled actuary, if he so states his reliance." Where the auditor elects to exercise this option, then no "self-review" issue arises. In practice, however, most accounting firms have been unwilling to accept the option provided by this section. They have taken the position that their responsibilities extend to all the representations in the financial statements.

The financial statement required by ERISA specifically does not include any actuarial values. In determining generally accepted accounting principles for pension plan financial statements, however, the Financial Accounting Standards Board, with the support of the AICPA, has taken the position that such financial statements are to include certain actuarial liabilities. Thus the accounting profession has decided, first, to include actuarial values in pension plan financial statements even though not required by ERISA, and, second, to reject the permission provided by ERISA to express reliance on the actuary. They have therefore undertaken to employ whatever audit procedures are considered necessary and appropriate with respect to these matters in connection with their report on the plan's financial statements. In most cases, therefore, the issue of self-review is squarely presented.

Even if an accounting firm were to elect to rely upon the correctness of the matters certified to by the enrolled actuary, so that no self-review would be involved, there is still grave doubt whether an accounting firm that served as the enrolled actuary for a plan could satisfy the requirements of independence. The matters certified to by the enrolled actuary are no less integrally related to the operation and financial soundness of the pension plan than the issues of potential liability and reserve adequacy are to the operation of an insurance company. In each case the actuary is providing actuarial services which, even if characterized as only advice and technical support, relate to matters so essential and critical to the management of the entity involved as to make the actuary providing the "advice" part of the management team, thereby compromising his independence. Indeed, the significance of the liabilities of a pension plan and the need for an understanding of how they are arrived at may be even greater than is the case with insurance company liabilities, since a pension plan's actuarial liabilities will often be many times the value of the plan's assets (without suggesting in any way that the plan is inadequately funded).

The Public Oversight Board rejected this argument, and the Commission seems to agree in Release No. 264. The Board concluded that:

> "[T]he enrolled actuary is simply performing an independent professional service outside of management's traditional area of operation and expertise. It is not, therefore, making management decisions and should not be viewed as being part of management's team."

The Academy respectfully disagrees with this analysis and contends that it suffers from a failure to appreciate the nature of the relationships involved and what the work of the actuary entails. First, the Board's approach seems to assume that the "management" of the plan is identical with the "management" of the sponsoring employer, namely its Board of Directors. That is not the case. The management of the plan is the plan administrator. To be sure the administrator may be, and often is, an officer of the sponsoring corporation, but he acts in a different and independent capacity when he acts as plan administrator. His duties and obligations run to the beneficiaries, not to the Board of Directors or stockholders of the sponsoring corporation.

Second, as the accounting profession has repeatedly made clear, the responsibility for the plan's financial statements is that of the "management" and not that of the auditor or of any consultant that prepares the representations on the financial statements. Thus when a plan administrator uses an enrolled actuary -- as the law requires him to do -- to arrive at amounts that appear on the liability side of the balance sheet, the plan administrator must assume responsibility for those items. The Public Oversight Board's statement that an enrolled actuary is "simply performing an independent professional service" and is "not, therefore, making management decisions and should not be viewed as being part of management's team" can as easily be said of a consulting actuary hired by an insurance company to determine its aggregate reserves, yet the Public Oversight Board concluded that such an actuary would be so involved with management functions as to disqualify any accountants associated with him from auditing the insurance company's financial statements. Delegating management functions does not convert them into non-management functions. What it does do is to make the person who actually does the work part of the management team. In the case of an employee benefit plan, the enrolled actuary is in fact performing a significant management function on behalf of the plan. If the Board's conclusion is sound that participating in management functions and decisions is inconsistent with independence, then an accounting firm cannot, consistent with the independence requirement, audit the financial statements of a plan for which it or an actuary employed by it acts as the enrolled actuary.__/

3. Corporate sponsors of employee benefit plans. The financial statement of an employer that has adopted, for example, a pension plan, will include at least two items -- the pension cost accrual and the unfunded actuarially-computed value of vested benefits -- dependent upon actuarial analysis. A self-review problem will be presented if actuaries employed by the accounting firm are responsible for the computation of these items and then the same accounting firm is asked to audit the sponsoring employer's financial statements. It should also be noted that Section 103(a)(3)(B) permitting the auditor to rely on an actuary's determinations does not appear to apply where the audit is of the financial statement not of the employee benefit plan but its corporate sponsor.

__/ We must note that the Department of Labor may have taken a different view in Interpretive Bulletin ERISA IB RD 75-1 (now IB RD 75-9) published November 20, 1975 (29 CFR § 2509-75-9) which provides that:

> "However, an independent qualified public accountant may permissably [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 was suggesting that actuarial services that appeared on the financial statement would not affect an accountant's independence. This interpretation was not promulgated under the notice and comment provisions of the Administrative Procedure Act (5 U.S.C. § 533) and, accordingly, the Department never had the benefit of any public comment. We think that the Bulletin does not reflect an adequate understanding or analysis of the issue.

Thus there is not, as in the case of an employee benefit plan financial statement, an avenue for avoiding the self-review problem.

The problem of identification with management appears to be, admittedly, less severe with respect to financial statements of corporate sponsors than it is with respect to employee benefit plans or insurance companies, in part because of the relative significance of the amounts involved. In contrast to insurance companies and employee benefit plans, where actuarially-related issues form the core of the matters to which management must give its attention, the administration of the corporate pension plan is only one of many important issues facing corporate management. But its importance must not be underestimated. There is indeed increasing recognition of the significance of the two pension plan-related items reflected in the financial statements -- and the fact that unfunded vested liability is often a substantial percentage of net worth and that pension expense often reflects a similarly large portion of total pre-tax earnings. For example, a sampling of data for twelve large U.S. corporations reveals that in 1978 pension expense typically ran between 20 and 25 percent of pre-tax earnings, while unfunded vested liability ran in some instances as high as 30 percent of net worth.

For reasons of avoiding both self-review and supplanting management's role, the Commission should rule that it is inconsistent with the independence requirement for an accounting firm to provide both audit and actuarial services to a corporate sponsor of an employee benefit plan where the results of the actuarial services will be reflected in the financial statements of the corporate sponsor.

VIII. The Need for Further Commission Action

The Academy's concern is that the Commission has not gone far enough in applying the test enunciated in its most recent release and that its case by case approach will prove inadequate to protect some members of the actuarial profession from the competing demands of the accounting firms for which they work and the profession to which they belong. Instead the Commission should recognize that where actuarial services are involved, as in the case of accounting or bookkeeping services, the case by case approach should be abandoned in favor of a ruling of general applicability.

Where actuarial services are involved, an accounting firm should be deemed to be acting inconsistent with the independence requirement if it provides an audit client, through its own or affiliated actuaries, with actuarial services that directly result in representations on a financial statement. In the case of insurance companies and employee benefit plans, such a rule ought generally to result in accounting firms refusing to provide actuarial services to insurance company or employee benefit plan audit clients.

The Academy intends to request a formal ruling from the Commission in the near term. The Academy would request that this subcommittee, in the exercise of its oversight role, encourage the Commission to apply the sound principles it has announced and enunciate rules of more general applicability where, as with actuarial services, the case by case approach is not required. This would provide the guidance that is needed now rather than several years from now.

The result which the Academy seeks is fully consistent with the position taken with respect to actuarial services by the Subcommittee on Reports, Accounting and Management in its November, 1977, report on Improving the Accountability of Publicly Owned Corporations and their Auditors. That report in fact went considerably further than the course of action suggested here. The subcommittee there concluded that:

> "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. Nonaccounting 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. Management services related to accounting are confined to the limited area of providing certain computer and systems analyses that are necessary for improving internal control procedures of comporations." (Emphasis added). __/

The Academy is not seeking the broad proscription called for in the subcommittee report. The Academy has not objected to an accounting firm using actuaries in the audit process, so long as the original actuarial work has not itself been performed by the accounting firm, or to the furnishing of actuarial services to nonaudit clients. Our concern is limited to the provision of both audit and actuarial services where the actuarial work will be reflected in financial statements and involve the accounting firm and its actuary employees in self-review.

We would hope for this subcommittee's support in our efforts.

__/ Improving the Accountability of Publicly Owned Corporations and their Auditors, p. 17

COMMENTS OF STEPHEN G. KELLISON, EXECUTIVE DIRECTOR
AMERICAN ACADEMY OF ACTUARIES
NAIC (A5) TASK FORCE ON LOSS RESERVES
SALT LAKE CITY, UTAH
AUGUST 13, 1979

The American Academy of Actuaries appreciates this opportunity to comment on the recent proposal concerning statements of opinion on casualty loss and loss expense reserves contained in Mr. Schacht's letter of July 26, 1979. The Academy has a great interest in the proposals which have emerged to date and wishes to reiterate our pledge to work with the NAIC as the development of a loss reserve program proceed

By way of background, the Board of Directors of the Academy on March 12, 1979 endorsed the general concept of statements of opinion on casualty loss reserves. The Board action recommended that instructions be adopted for the Fire and Casualty annual statement that would essentially be the same as the current instructions for the Life and Accident and Health annual statement. The Life and Accident and Health program has worked well and produced meaningful assurances on that blank.

Subsequently, on May 22, 1979, the American Insurance Association recommended adoption of such a statement of opinion for casualty loss reserves and a uniform procedure for CPA audits. Both the Academy and the AICPA endorsed the AIA recommendations.

The Academy believes that the loss reserve proposal on your agenda today is a great improvement over previous proposals and is compatible with these past recommendations of our Board of Directors. Thus, if the NAIC decides to adopt a program of loss reserve statements of opinion, we support adoption of the proposal before you.

However, we would urge one significant modification. The proposal before you requires everyone rendering a statement of opinion after January 1, 1982, who is not a Member of the Academy, to pass Part 7 of the Casualty Actuarial Society examinations. Although the Part 7 requirement may be appropriate for new individuals qualifying to sign after January 1, 1982, we feel it is too harsh for individuals who are currently responsible for loss reserve determinations and have been for many years. It is a great imposition to require loss reserve specialists with substantial experience, who have done this work successfully for many years, to face the rigors, anxieties, and uncertainties of an examination. Many such specialists may not have written examinations since their college days or shortly thereafter. For such specialists we would recommend permanent grandfathering.

This modification would have significant advantages as follows:

1. It would create no problems of supply, since existing loss reserve specialists would remain qualified indefinitely, assuming their future performance is competent.
2. It would lead to higher standards of education and experience for loss reserve specialists in the future.
3. It nevertheless would avoid the problem of regulatory officials taking a position in advance on the competency of specific individuals to sign.

Mr. Snader of the Casualty Actuarial Society is here today and is available to discuss the Casualty Actuarial Society examination program in more detail.

In order to shed more light on the effect various proposals might have, the Board of Directors of the Academy at its meeting on June 14, 1979 directed the staff to conduct a survey of the larger property-liability insurers. We have just completed tabulating the results of this survey in order to have it available at this meeting. Attached are the results of the survey for your review.

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR

August 13, 1979

MEMORANDUM

TO: Interested Parties on Casualty Loss Reserve Survey

In order to shed more light on the effect various proposals involving statements of opinion on loss and loss expense reserves of property-liability insurance companies might have, the American Academy of Actuaries has conducted a survey of all property-liability insurers with $50 million or more of premium volume. There are 154 such companies, of which 123 responded to the survey.

Attached are seven pages containing the results of the survey:

p. 1 - Tabulation for all respondents

p. 2 - Tabulation for all companies with $250 million or more of premium volume

p. 3 - The survey form

pp. 4,5,6 - The list of 123 respondents

p. 7 - The list of 31 non-respondents

In interpreting these results please note the following:

1. Each multiple-company structure (group, fleet, holding company, etc.) was tabulated as only one response in the survey.

2. The attached p. 2 is a tabulation for companies with $250 million or more of premium volume. There are 48 such companies, or 39% of the respondents. However, these companies have 86.1% of the total premium volume.

3. In comparing the answers to the first part of question 4 with question 6, it is apparent that some companies have actuaries on staff that do not currently assume responsibility for the determination of loss reserves. However, in a number of these situations the actuaries in these companies are directly involved in the process of reserve development.

4. The answers to question 4 are based on in-house company employees. A number of companies use outside consulting actuaries for reserve work, but this is not reflected in the survey results.

SGK:cal

Enclosures

TABULATION FOR ALL RESPONDENTS
(123 Companies)

Question 4. Please provide the following information about the individual who assumes responsibility for the determination (not the audit) of loss and loss expense reserves:

Is this individual a Member of the American Academy of Actuaries?

Yes	50
No	73

Is this individual a certified public accountant?

Yes	22
No	101

Question 5. Would the individual in #4 above sign the professional statement of opinion concerning the adequacy of loss and loss expense reserves, if the NAIC adopts such a requirement?

Yes	67
No	18
Unsure	38

Question 6. Does your company have a member of the American Academy of Actuaries on its staff?

Yes	72
No	51

Question 7. Does your company have an annual CPA audit of its financial statements?

Yes	118
No	5

TABULATION FOR ALL COMPANIES
WITH $250 MILLION OR MORE OF PREMIUM VOLUME
(48 Companies --- 39% of respondents)

Question 4. Please provide the following information about the individual who assumes responsibility for the determination (not the audit) of loss and loss expense reserves:

Is this individual a Member of the American Academy of Actuaries?

Yes	27
No	21

Is this individual a certified public accountant?

Yes	6
No	42

Question 5. Would the individual in #4 above sign the professional statement of opinion concerning the adequacy of loss and loss expense reserves, if the NAIC adopts such a requirement?

Yes	30
No	2
Unsure	16

Question 6. Does your company have a member of the American Academy of Actuaries on its staff?

Yes	39
No	9

Question 7. Does your company have an annual CPA audit of its financial statements?

Yes	46
No	2

Note: Premium volume all 123 companies ------- $56,079 million

Premium volume of 48 largest companies -- $48,284 million

(86.1% of total)

SURVEY ON CASUALTY LOSS RESERVES

1. Name of company ______________________________

2. Premium volume (line 31, col. 4, part 2c, p.8 of 12/31/78 annual statement)

   ____

3. Amount of loss and loss expense reserves (lines 1 & 2, p.3 of 12/31/78 statement)

   ____

4. Please provide the following information about the individual who assumes responsibility for the determination (not the audit) of loss and loss expense reserves:

   Title ______________________

   Years of experience with the determination of loss reserves ______________

   Is this individual a Member of the American Academy of Actuaries?

   ________Yes ________No

   Is this individual a certified public accountant?

   ________Yes ________No

5. Would the individual in #4 above sign the professional statement of opinion concerning the adequacy of loss and loss expense reserves, if the NAIC adopts such a requirement?

   ________Yes ________No ________Unsure

6. Does your company have a member of the American Academy of Actuaries on its staff?

   ________Yes ________No

7. Does your company have an annual CPA audit of its financial statements?

   ________Yes ________No

8. Additional comments ______________________________

____

____

PLEASE MAIL NO LATER THAN JULY 31 TO:

Casualty Loss Reserves Survey
c/o American Academy of Actuaries
1835 K Street, N.W., Suite 515
Washington, D.C. 20006
(202) 223-8196

RESPONDENTS TO CASUALTY LOSS RESERVES SURVEY

1. Aetna Life & Casualty
2. Aid Insurance Co.
3. Alabama Farm Bureau Ins. Cos.
4. American Agricultural Ins. Co.
5. American Bankers Ins. Co. of Fla.
6. American Family Mutual Ins. Co.
7. American Hardware Mutual Ins. Co.
8. American Indemnity Group
9. American International Group
10. American Mutual
11. American Re-Insurance
12. American Security Group
13. American States Ins. Cos.
14. American Universal Ins. Group
15. Andover Cos. (Merrimack Mutual)
16. Argonaut Ins. Co.
17. Arkwright-Boston Ins. Group
18. Auto-Owners Insurance Croup
19. Balboa Ins. Co.
20. Bituminous Ins. Co.
21. California State Automobile Association
22. Calvert Fire Ins. Co.
23. Celina Insurance Group
24. Central Mutual of Ohio Group
25. Central National Ins. Co. of Omaha
26. Colonial Penn Life Ins. Co.
27. Commercial Union Ins. Co.
28. Continental Casualty Co.
29. Continental Ins. Co. & Affiliates
30. Cotton States Mutual Group
31. Country Companies Group
32. Crum and Forster Group
33. John Deere Ins. Co. (Rock River)
34. Detroit Automobile Inter-Insurance Exchange
35. Dodson Ins. Group (Casualty Recip. Group)
36. Empire Mutual Ins. Group
37. Employee Benefits Ins. Co.
38. Employers Insurance of Texas
39. Employers Ins. of Wausau (Wausau Ins. Cos.)
40. Employers Mutual of Iowa Group
41. Employers Reinsurance Corp.
42. Erie Ins. Exchange and Erie Ins. Co.
43. Equitable General Ins. Group
44. Farm Bureau Ins. Group of Michigan
45. Farm Bureau Mutual Ins. Co., Inc. - Manhattan, Kansas
46. Federal Ins. Co. Group
47. Federated Mutual Ins. Co.
48. Fireman's Fund
49. Foremost Ins. Co.
50. Fremont Indemnity Co.

RESPONDENTS TO CASUALTY LOSS RESERVES SURVEY

51. General Accident Group
52. General Reinsurance Corp.
53. Government Employees Ins. Co.
54. Grain Dealers Mutual Ins.
55. Great American Ins. Cos.
56. Hanover Ins. Cos.
57. Hartford Ins. Group
58. Hawkeye-Security/United Security Ins. Cos.
59. Highlands Ins. Co.
60. Home Group
61. Indiana Ins. Co.
62. Insurance Company of North America
63. Interinsurance Exchange of the Automobile Club of Southern California
64. Iowa National Mutual Ins. Co.
65. Kemper Ins. Group
66. Kentucky Farm Bureau Mutual Ins. Co.
67. Keystone Insurance Co.
68. Liberty Mutual Ins. Cos.
69. Lumbermens Mutual Ins. Co.
70. Lumbermen's Underwriting Alliance
71. Medical Protective Co.
72. Merchants Ins. Group
73. Mercury Casualty Co.
74. Meridian Ins. Group
75. Metropolitan Property & Liability Ins. Co.
76. Michigan Millers Mutual Ins. Co.
77. Michigan Mutual Ins. Group
78. Michigan State Accident Fund
79. Midland Ins. Group
80. Milbank Mutual Ins. Co.
81. Mortgage Guaranty Group
82. Motors Ins. Corp.
83. Munich American Reinsurance Co.
84. Mutual Service Casualty Ins. Co.
85. National American Ins. Group
86. National Farmers Union Property & Casualty
87. Nationwide Insurance
88. North American Reinsurance Corp.
89. North Carolina Farm Bureau Mutual Ins. Co.
90. Northwestern National Ins. Group
91. Ohio Casualty Group
92. Old Republic Ins. Co.
93. Peerless Ins. Group
94. Pekin Ins. Group (Farmers Auto Grp.)
95. Progressive
96. Providence Washington Ins. Group
97. Prudential Property & Casualty
98. Ranger Ins. Co. Group
99. Reliance Ins. Co.
100. Royal-Globe

RESPONDENTS TO CASUALTY LOSS RESERVES SURVEY

101. Safeco Ins. Cos.
102. St. Paul Fire and Marine Ins. Co.
103. Security Ins. Group
104. Sentry Ins.
105. State Compensation Ins. Fund of California
106. The Statesman Group
107. South Carolina Ins. Co. Group
108. Southern Farm Bureau Casualty Ins. Co.
109. Transamerica Ins. Co.
110. Transport Indemnity Co.
111. Travelers Ins. Cos.
112. Unigard Ins. Group
113. United States Fidelity and Guaranty Group
114. Universal Underwriters Ins. Co.
115. USAA Consolidated Group
116. Utica Mutual Ins. Co.
117. The Western Casualty and Surety Co.
118. U.S. Branch of "Winterthur" Swiss Ins. Co.
119. Zenith Ins. Co.
120. Zurich-American Group

121. California Casualty Group
122. Mutual Medical Ins., Inc.
123. Public Service Mutual Ins. Co.

NON-RESPONDENTS TO CASUALTY LOSS RESERVES SURVEY

1. Allendale Mutual Group
2. Allstate Ins. Co. Group
3. American General Group
4. Atlantic Mutual Group
5. Bellefonte Ins. Group
6. Cincinnati Ins. Group
7. Constellation Reinsurance Co.
8. Dailey Underwriters of America
9. Electric Mutual of Mass. Group
10. Farmers Ins. Group
11. Greater New York Group
12. Hartford Steam Boilers Group
13. Medical Liability Mutual
14. MFA Mutual Ins. Group
15. Milwaukee Mutual Group
16. Mission Ins. Co. Group
17. Mutual Hospital Ins. Inc.
18. National Grange Group
19. National Ind. Ins. Group
20. Ohio Farmers Ins. Group
21. Oklahoma Property & Casualty Ins. Co.
22. Peninsular Fire Group Co. of America
23. Protection Mutual Ins. Co.
24. Public Employers Mutual Ins. Group
25. Republic Vanguard Group
26. Selected Risks Group
27. Skandia American Reinsurance Group
28. State Auto Mutual Group
29. State Farm Mutual Group
30. State Workmens Ins. Fund
31. W.R. Berkley Corp. Group

AMERICAN ACADEMY OF ACTUARIES
208 South La Salle Street • Chicago, Illinois 60604
312/782-4204

August 17, 1979

Director of Research and Technical Activities
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Sir:

The enclosed comments on the Interim Report of the Insurance Task Group on the FASB Exposure Drafts "Financial Reporting and Changing Prices" and Constant Dollar Accounting" have been prepared by the American Academy of Actuaries Committee on Life Insurance Financial Reporting Principles.

We hope that these comments will be helpful.

Sincerely,

Jack E. Wood

Jack E. Wood, Chairman

American Academy of Actuaries
Committee on Life Insurance
Financial Reporting Principles.

COMMENTS

of

AMERICAN ACADEMY OF ACTUARIES COMMITTEE ON

LIFE INSURANCE FINANCIAL REPORTING PRINCIPLES

on

INTERIM REPORT OF THE INSURANCE TASK GROUP

ON THE FASB EXPOSURE DRAFTS

"FINANCIAL REPORTING AND CHANGING PRICES"

and "CONSTANT DOLLAR ACCOUNTING"

The Academy's Committee on Life Insurance Financial Reporting Principles supports the specific recommendations of the Insurance Task Group as stated in the "Summary" of the May 31, 1979 Interim Report of that Task Group.

The Committee also supports the approach described in the "Basis For Recommendations" section of the Interim Report which entails the use of a single index (the Consumer Price Index--Urban) for converting key financial data to a constant dollar result.

We concur with the use of the assumption that all insurance company assets and liabilities are monetary.

We recommend that the Task Group's approach be prescribed until further research and study produces a more informative means of disclosing the effects of changing prices in the insurance industry.

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR

August 20, 1979

Chairman, Tax Forms Coordinating
Committee
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 5577
Washington, D.C. 20224

Attention: ERISA Annual Reporting Revisions

Dear Sir:

This letter presents comments of the ERISA Subcommittee of the American Academy of Actuaries concerning the proposed revision of forms appearing in the June 26, 1979 Federal Register. The Academy is aware that a number of actuaries and actuarial firms have extensive comments on these proposed forms which will be communicated to you. Accordingly, we will restrict our comments in this letter to strictly actuarial matters; namely, item 6(d) of proposed Form 5500-R.

Item 6(d) asks the plan administrator of a defined benefit plan to state whether the plan has experienced a funding deficiency. The plan administrator is not independently qualified to answer the question, and would be able to answer it only if the enrolled actuary has determined the information. Thus, question 6(d), without Schedule B, raises the possibility of erroneous answers and of inadequately funded plans.

The enrolled actuary can make the determination only by doing the underlying work to complete Schedule B. If the actuary has done this underlying work, there is very little additional work needed to complete Schedule B itself, so that the elimination of Schedule B makes no substantial reduction in the work required to complete the annual report form. Submission of Schedule B, signed by an enrolled actuary, would assure that the funding requirements are satisfied.

TO: Chairman, Tax Forms Coordinating Committee

August 20, 1979

Therefore, we recommend that Schedule B be required to be attached for defined benefit plans. One appropriate way to accomplish this would be to use item 20 from the 1978 Form 5500-C in place of item 6(d).

Respectfully submitted,

Stephen G. Kellison

Stephen G. Kellison

SGK:cs

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

September 21, 1979

Director of Research and Technical Activities
File Reference 1025-019
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Sir:

I am pleased to enclose a copy of the comments of a Task Force of the American Academy of Actuaries appointed to review the Revised Exposure Draft on "Accounting and Reporting By Defined Benefit Pension Plans" issued by the Board on July 9, 1979.

Representatives of the Academy have worked closely with the Board and staff over the past few years to render assistance in the development of this statement. The Academy appreciates the cooperative effort of the Board and its staff and the attention given to our comments as reflected in the Revised Draft. In general, the Task Force believes the Revised Exposure Draft to be a significant improvement over the original draft issued in April, 1977. However, there still remain a few issues which will be troublesome for actuaries in attempting to carry out their professional responsibilities, and these are discussed at some length in the enclosed report of the Task Force.

The Task Force, as well as other resources of the Academy, stand ready to assist the Board in any way it can to resolve the remaining issues so as to produce a statement of accounting principles which will be consistent with the professional responsibilities of both the accounting and actuarial professions.

Sincerely,

Dale R. Gustafson

Dale R. Gustafson
President

DRG:cal

Enclosure

AMERICAN ACADEMY OF ACTUARIES

Task Force on Review of Revised FASB Exposure Draft
on Accounting and Reporting by Defined Benefit Pension Plans

Comments and Recommendations on Exposure Draft

The American Academy of Actuaries appointed a Task Force to review the Revised Exposure Draft relating to pension plans issued by the Financial Accounting Standards Board on July 9, 1979, and our comments thereon follow. We appreciate the consideration given by the Board to the extensive comments and suggestions made by the Academy on the original Exposure Draft, as well as subsequent suggestions made on other proposed changes, many of which are recognized by changes made in the Revised Exposure Draft.

The Revised Exposure Draft represents a substantial improvement over the original draft. In particular, we are pleased that beginning-of-year present values will now be acceptable and that a full reconciliation of these values will not be required generally. We are also pleased that the determination of the amount of the accrued benefit will follow the Academy's Interpretation 2. We recognize the difficulty which the Board faced in dealing with the complex questions regarding the use of salary projection factors in such determinations, and endorse the Board's, decision, consistent with Interpretation 2, that for this purpose the use of salary projection factors is not appropriate.

However, there remain three significant issues which pose particular problems for actuaries. These are: (1) the implication that the investment yield which the actuary uses to calculate the present value of accrued (accumulated) benefits may have to be adjusted from year to year to reflect short term fluctuations in the market value of the assets, at least to the extent that such fluctuations are deemed to affect longer term yields, (2) the lack of a stipulated format which permits identification of, and submission of additional pertinent information by, the actuary who carries out the actuarial valuation of the accrued plan benefits, and (3) the absence of a stable basis to use in comparing plan assets and actuarial present values from year to year. There are a number of other technical comments and specific suggestions of less significance which are summarized in Exhibit A attached hereto. The remainder of this commentary will focus on the two major issues mentioned above.

Selection of Yields to Determine Actuarial Present Value of Accrued Plan Benefits

This problem was addressed at some length in our letter to the Board of March 27, 1979. For completeness of response to the Exposure Draft, however, our position will be restated here, since we feel it is an extremely important issue.

Paragraph 20a. requires the use of an assumed rate of return on investments based on the "fair value" of plan assets and Paragraph 24 mentions that such assumed rate may change "periodically" due to changes in the expected yields on (the fair value of) plan investments. Paragraph 186 states that "changes in rates of return on existing assets as a result of changes in fair value will affect the interest rates at which benefits are discounted." It further states that the Board has rejected the view that assumed rates of return should be changed only when it is apparent that "long term" interest rates have changed (i.e., which seems to say that the Board believes that the assumed rates of return should reflect short term fluctuations in asset values). There also is the example used in the illustrative "Notes to Financial Statements" wherein interest rates of 6.75%, 6.25% and 7% are used in three consecutive years (page 123). The illustrative change of 0.75% in the assumed rate of return in just one year is further evidence of the Board's apparent desire to reflect rather directly short term fluctuations in the yield on market values.

All of these would seem to imply that the assumed rate of return should be (1) based essentially on current yield projections related to market value, and (2) adjusted to some extent at each valuation date to reflect short term fluctuations in the market value of assets. Although discussions with the Board staff indicate that it was not intended to imply that changes would be required each year to reflect short term fluctuations in market value yields on the assets, the above citations from the Exposure Draft could lead one to conclude that annual revisions in the assumed yield were contemplated. If this was not intended, the final statement should be clarified in this regard, bearing in mind that this document will be the principal source of authority in this area for thousands of practitioners in the accounting and actuarial professions.

The actuary for a pension plan must select the assumed rate of investment for the valuation of the plan bearing in mind the very long nature of pension promises. Benefits accruing for the youngest employees in the plan may be deferred 60, 70 or even 80 years from the valuation date, and even for the average employee, benefits may be deferred for 40 or 50 years. Current yields on even long term fixed income securities cover only a small fraction of this period, and the actuary must recognize that the rates at which the income from current investments is reinvested and that future contributions are invested may be lower than current market yield.

For example, just considering the reinvestment of future income on current investments, the actual rate of return on a newly issued 30-year 9% bond whose income is reinvested at 6% and which is held to maturity is only about 7.2%. Accordingly, in selecting the assumed rate of return to determine actuarial present values, the actuary must look to the long term and not overly react to periodic fluctuations in the market value.

The footnote example on page 123 suggests that significant fluctuations (i.e., decreasing by 0.50% one year and increasing by 0.75% the next year) from year to year in the assumed rate of return might be expected. In order to demonstrate the sensitivity of actuarial present values to changes in the assumed rate of return, we have prepared the attached Exhibit B which develops a simplified example of the type of swings that could occur in the unfunded present value. The example is simple but not exaggerated; in many situations the relative changes in unfunded present value would be even larger. A brief summary of the pertinent results from Exhibit B follows below.

If the "actuarial" approach of keeping the assumed investment yield relatively stable is followed (changing it only when it appears long range yields have changed), then the following illustrates the potential unfunded present value in the second year of the analysis, depending on the market yield (dollar figures in thousands):

Market Yield	Fund Market Value	Investment Gain (Loss)	Unfunded Present Value	Actuarial Gain (Loss)
7%	$6,850	$ 0	$4,920	$ 0
6%	7,370	520	4,400	520
8%	6,390	(460)	5,380	(460)

Thus, ignoring gains and losses from other sources, the investment gain or loss flows directly through to a change in the unfunded liability of the plan.

On the other hand, if the assumed actuarial rate of return is adjusted each year as implied, the following develops:

Market Yield	Market Value	Investment Gain (Loss)	Unfunded Present Value	Actuarial Gain (Loss)
7%	$6,850	$ 0	$4,920	$ 0
6%	7,370	520	7,080	(2,160)
8%	6,390	(460)	3,240	1,680

This approach produces the anomalous result that a $520,000 gain in the assets results in a net actuarial loss in the unfunded present value of about four times such gain. Similarly, a $460,000 loss in the assets becomes a $1,680,000 gain in the unfunded present value of the plan, a somewhat illogical result.

Additionally, the proposed instructions are not consistent with the requirements of the Department of Labor with respect to the entries on Schedule B of Form 5500, which require the use of assumptions representing the actuary's best estimate of future experience on an ongoing plan basis. Participants and other interested parties would be confused if different present value amounts were reported on Schedule B and in the financial statements. In addition, the preparation of the additional calculations, which we believe are unnecessary and misleading, would expose the plan sponsor to additional actuarial fees. Considering the estimates involved in appraising these long range pension obligations, the confusion created by having different amounts to represent the same values and the additional expense incurred by duplicate valuations, it would be unfortunate if the final statement of GAAP for pension plan financial statements established criteria for the selection of the assumed rate of investment return which often resulted in different actuarial present values appearing in the financial statement presentation and in Schedule B.

In short, the nature of these actuarial present values is such that they do not change with short term fluctuations in the market value of assets, but rather should be viewed as long term values, the actuarial basis of which should not change to reflect short term trends in yields on market values. If the objective, as expressed by the Exposure Draft, is to present the actuarial present values on a "going plan" basis, it is inappropriate to require that such present values be determined on a basis that would result in wide fluctuations over short time periods.

It has been pointed out that paragraph 8.4 of Recommendation A issued by the Academy Committee on Pension Actuarial Principles and Practices provides that: "If the actuarial present value is to be compared with the market value of the plan's current assets, and the plan's actuarial basis uses another method of measure of such assets for actuarial purposes, the actuary should either: (a)....., or (b) redetermine the present value using an investment return assumption consistent with the market value of the assets."

While some might interpret that this statement offers support for the Exposure Draft, it only becomes applicable in the situation where the market value of assets is relevant to the actuarial determination involved, such as a plan termination. It was not intended that this statement be made applicable to the determination of plan present values on a "going plan" basis, such that the valuation rate of interest would be adjusted to reflect every short term fluctuation in the market value of assets.

The FASB proposals relative to the selection of the appropriate assumed rate of investment return pose a serious problem for an Enrolled Actuary who is a Member of the Academy in order to adhere to legal and professional responsibilities. ERISA clearly assigns the responsibility for the determination of actuarial values to the Enrolled Actuary for the plan, and the calculation and reporting of these values must be in accordance with the appropriate guidelines to professional conduct of the actuarial profession. We appreciate the fact that the Revised Exposure Draft is consistent with the Academy's guidelines in most respects. However, we would like to point out that the Academy does require its members to meet certain conditions in connection with pension plan computations. These include identification of the actuary responsible for the calculations and a requirement that the actuary have an opportunity to ensure that the information he prepares is presented in a manner which is complete, including any limitations on the applicability of information.

In order to comply with the guidelines of the Exposure Draft, the actuary might be required, at certain times, to prepare actuarial values and information for inclusion in the financial statement of the plan which, (1) do not represent his best estimate of the future experience, etc. under the plan, as required by ERISA, (2) in his opinion, are prepared or presented in a manner inconsistent with the guides and opinions to conduct of his profession, and/or (3) are inconsistent with the Schedule B prepared by the actuary for the actuarial statement filed for the plan.

If faced with this problem of supplying information that he believes is inappropriate, Enrolled Actuaries and/or Members of the Academy preparing such information would seem to have two choices:

(1) Refuse to prepare the actuarial information on the basis requested, or

(2) supply the requested information on the basis requested, but with an accompanying statement which states that the values are inappropriate for the purpose.

Obviously neither of these alternatives is satisfactory.

What is the professional responsibility of the actuary, if requested to provide actuarial values for a pension plan financial statement which he believes are inappropriate? The Academy has not yet had to address specifically this issue, but some action by the Academy would seem to be required if the FASB present proposal is adopted. While we recognize that the FASB has the responsibility for establishing GAAP for pension plan financial statements (most of which are prepared under ERISA requirements), it should be recognized that: (1) the inclusion of actuarial present values in the financial statement is completely a voluntary action on the part of the FASB, not required or even implied by ERISA, and (2), for ERISA plans at least, the selection of actuarial assumptions is clearly the responsibility of the actuary, not the accountant preparing the financial statement.

Form of Presentation of Actuarial Present Value of Accumulated Plan Benefits

The Exposure Draft (paragraph 8) allows flexibility in the manner of presentation of the actuarial present value of accumulated plan benefits and the year-to-year changes therein. It suggests that such information may be presented either directly in the financial statements or in notes thereto. While we generally applaud the concept of flexibility in this regard, it may create a problem for the actuary supplying the requested information if the actuarial values are blended into the financial statement directly.

The Guides to Professional Conduct of the Academy state that "When it is not feasible for the actuary to render his opinions or findings directly to the person or organization (i.e. one influenced by his actuarial opinions or findings), he will act in such a manner as to leave no doubt that he is the sources of the opinions of findings...". Additionally, if the actuary has qualifications regarding the actuarial values prepared for the financial statement, he should be able to assure himself that such qualifications and comments will be presented to the users of the information.

This problem could be resolved if the Board established a method of presentation utilizing a separate statement by the actuary to be included as part of the financial statement which would provide the information for which the actuary is responsible by law, including any explanatory material which the actuary feels to be important. This would, for example, permit the actuary to include the actuarial value of assets within his statement (see discussion below). To avoid additional expense, Schedule B or information extracted therefrom could be utilized for ERISA plans, while a similar statement could be used for other plans. For ERISA plans this approach would have the further advantage of insuring consistency in reporting for statutory and accounting purposes and would eliminate unnecessary duplication of work.

We recognize that this problem may raise certain problems in connection with the normal audit procedures and principles established by the accounting profession, but it would seem likely that a procedure could be established which would allow actuaries to fulfill their professional responsibilities without violating the audit responsibilities of the accounting profession.

Comparison of Actuarial Present Values and Assets

As to the nature of information prepared by the actuary and presented in the financial statement, we believe that participants and other users of the financial statement will be better informed about the funded position of accrued plan benefits by observing the year-to-year relationships between the present value of accrued benefits and the assets rather than from the relationship which exists at a single point in time. We also believe that the information will be more meaningful if the actuarial present value amounts and the assets with which they are being compared are both determined on a stable and consistent basis which minimizes short term fluctuations. For this purpose, the actuarial value of assets affords a more appropriate and more stable basis for comparison with the present value of accumulated benefits than does the market value of assets. Although actuaries use various formulas to determine actuarial asset values, the purpose of these formulas is to avoid giving undue recognition to short term market fluctuations. Thus we recommend that, where appropriate, the actuarial value of assets be included as part of the statement which presents the actuarial present value of accrued benefits.

* * * * * * * * * * *

The Task Force will be pleased to provide any further information needed by the Board or its staff to clarify these comments. It may be that some of the problems we have raised have resulted from misinterpreting the Board's intention, in which case we would be pleased to offer suggestions for language that would clear up these possible misconceptions.

Despite these extensive comments, we would like to emphasize again our appreciation of the efforts of the Board to reflect the viewpoints of the Academy in the Revised Exposure Draft.

Respectively Submitted,

Task Force on Review of Revised FASB Exposure Draft on Accounting and Reporting by Defined Benefit Pension Plans

Douglas C. Borton, Co-Chairman
Edwin F. Boynton, Co-Chairman
James F. A. Biggs
Paul A. Gewirtz
Harry M. Leister, Jr.
Leonard Mactas
Barry L. Shemin

EXHIBIT A

TECHNICAL COMMENTS ON
REVISED EXPOSURE DRAFT

Paragraph	Comments
2	We would expect plans covering employees of the Federal government also to be included.
6c	We do not believe that an acceptable benefit valuation date should be restricted to the beginning or end of the plan year. The use of any date within the year should be permissable, provided that the same day is used consistently from year-to-year. Adjusting present value amounts to either the beginning or end of the plan year would be of no additional value to participants and hence the additional expense would not be warranted.
18c	We believe it is intended that the words "benefit valuation date" should be "participant's retirement."
18e	We understand that benefits which are scheduled to take effect after the calculation date do not have to be taken into account in the calculation of the present value of accrued benefits, but that the existence of these benefits must be disclosed, if significant.
20c	This item, relating to administrative expenses paid by the plan, emphasizes an assumption which usually is not significant in relation to the other assumptions. The last sentence implies a precision in the selection of an interest rate which is impossible to achieve. Therefore, we recommend it be deleted.
21	We feel that this paragraph should be deleted. Since the exposure draft proposes criteria for selecting the assumed rate of return based on current investments of the plan and the plan's stated investment policy for the future,

Exhibit A
Page 2

use of insurance company actuarial assumptions for this purpose would be inconsistent with such criteria unless the plan's investments and policy matched those of the insurance company, an unlikely event. Further since the assumptions underlying the insurance company rates, not the rates themselves, would be used, there would be no significant cost savings from using this alternative. In addition, we understand that many insurance companies would consider these assumptions to be proprietary information which they would be unwilling to disclose.

24 We suggest that this paragraph be deleted, since it is concerned with only one aspect of selecting an appropriate interest rate.

26 Footnote 11 differentiates between situations where insurance company values are used and where they are not. We do not see the rationale behind this distinction.

28 We suggest replacing the last two sentences with one sentence reading "If the effects of such events on transactions have been determined, they should be disclosed."

30 We do not believe that the expense of restating financial statements for prior years, including the computation of the present value of accumulated benefits, can be justified in terms of the value of this additional data.

Exhibit A
Page 3

Appendix C. Glossary

"Accumulated Plan Benefits" We strongly urge that this be redefined as "Accrued Plan Benefits" or just simply "Accrued Benefits". While recognizing that the word "accrued" has certain accounting/legal connotations when used in other contexts, the term "accrued benefit" under a pension plan has been so precisely defined by ERISA and implementing regulations and so widely accepted by all other interested parties involved in pensions, that we believe the accounting profession should accept it also. "Accrued benefit" is defined (or clearly implied by the plan's provisions) in at least every pension plan covered by ERISA, (as well as in most others). For the accounting profession to ignore the facts as they exist in the pension world would simply add more inconsistency to the already confusing pension terminology. The term "accrued benefit" is at least one term that is relatively well understood in the language of pensions, and the invention of a new term to mean the same thing scarcely contributes to an understanding of pensions by participants and others

"Benefit Information" is defined as "the actuarial present value of accumulated plan benefits," which itself is a defined term. We see nothing to be gained by using two different terms to mean precisely the same thing, particularly when one of them (Benefit Information) generally carries a much broader connotation in the absence of a definition. We suggest "Benefit Information," as well as "Nonvested Benefit Information" and "Vested Benefit Information" which also are defined as other defined terms, be deleted.

General

Since the Department of Labor does not require a calculation of the present value of accrued benefits for plans covering less than 100 participants, it would seem appropriate for the FASB to adopt the same rule. It should be noted that the bulk of the total present value amount for a small plan frequently would be concentrated on one or two individuals. Since, the use of actuarial assumptions, which rely on the law of large numbers, is of limited value in these situations, the expense of developing these amounts generally could not be justified.

EXHIBIT B

Determination of Actuarial Value of Accrued Benefits

Illustration of Effect of Varying Actuarial Investment Return Assumption Directly with Changes in Market Yields

The purpose of this is to demonstrate the effects of changing the assumed rate of investment return to reflect year-to-year variations in the market yield of the invested assets, as proposed by the FASB draft. From the actuary's view point, the actuarial value of accrued benefits of an ongoing plan does not automatically change every time the market yield of the investments held by the plan changes. Rather, the actuary assumes a long term yield based on past experience and projected future experience and only makes changes in this when it appears to him that the long term yields have truly changed. Thus, the actuarial values of accrued benefits should be a much more stable value and not reflect every up and down variation in the market value of the assets.

The example given below is oversimplified to illustrate the effect of adjusting the actuarial value of accrued benefits to reflect market yields on a given valuation date. It shows the effect of a 1% change in the market yield between plan anniversaries for a plan that is 50% funded (ratio of market value to present value of accrued benefits) at the beginning of the period.

The pertinent values as of 1/1/79 are as follows:

A. Valuation as of 1/1/79:

1.	Valuation rate of interest:	7%
2.	Present Value of Accrued Benefits	$10,000,000
3.	Market Value of Assets	5,000,000
4.	Unfunded Value of Accrued Benefits	5,000,000
5.	Value of benefits Accruing in 1979 (as of 1/1/79)	1,000,000
6.	1979 Contribution to Plan (as of 12/31/79)	1,500,000

B. Valuation as of 1/1/80 Assuming Market Yield of Fund = 7% as of 1/1/80

1.	Present Value of Accrued Benefits (7%)	$11,770,000
2.	Market Value of Assets	6,850,000
3.	Unfunded Value of Accrued Benefits (7%) (B.1. - B.2.)	4,920,000

C. Valuation as of 1/1/80 Assuming Market Yield of Fund = 6% as of 1/1/80 and Actuarial Value of Accrued Benefits based on 6% Interest

1.	Present Value of Accrued Benefits (6%)	$14,450,000
2.	Market Value of Assets	7,370,000
3.	Unfunded Value of Accrued Benefits (6%) (C.1. - C.2.)	7,080,000
4.	Unfunded Value of Accrued Benefits if Valuation Rate Remains 7% (B.1. C.2.)	4,400,000

D. Valuation as of 1/1/80 Assuming Market Yield of Fund = 8% and Actuarial Value of Accrued Benefits based on 8% Interest

1.	Present Value of Accrued Benefits (8%)	$ 9,630,000
2.	Market Value of Assets	6,390,000
3.	Unfunded Value of Accrued Benefits (8%)	3,240,000
4.	Unfunded Value of Accrued Benefits if valuation Rate Remains 7% (B.1. - D.2.)	5,380,000

E. Summary of Unfunded Present Values Based on Actuary's Approach (AAA) and FASB Recommendation (FASB) (000 omitted)

Market Yield	Market Value of Assets	Unfunded Present Value AAA	FASB
7%	$6,850M	$4,920M	$4,920M
6%	7,370	4,400	7,080
8%	6,390	5,380	3,240

Conclusions

1. When the market yield remains unchanged, the AAA and FASB approaches will produce the same result.

2. When there is unrealized appreciation in the fund (due to a reduction in market yield from 7% to 6%), the AAA approach shows this as an actuarial gain resulting in a reduction in the unfunded liability of the plan by a like amount. However, following the FASB approach, a "gain" in the market value of $520,000 ($7,370,000 minus $6,850,000) results in a $2,160,000 ($7,080,000 minus $4,920,000) increase in the unfunded liability.

3. Conversely, when there is an unrealized capital loss in the assets (due to an increase in the market yield from 7% to 8%), this results in a comparable increase in the unfunded liability of the plan under the AAA approach. Under the FASB approach, a $460,000 loss ($6,850,000 minus $6,390,000) in the market value of assets results in a gain (reduction) in the unfunded liability of $1,680,000 ($4,920,000 minus $3,240,000).

4. Although the example is oversimplified to make the point, the type of swings illustrated above would be common. Since most plans have a significant portion of their assets in equities, the swings could be even wider in many plans because of the higher volatility of common stock values. Similarly, for plans that are thinly funded (such as new plans), there is a high degree of leverage involved so that the effect of relatively small dollar changes in unrealized gains and losses of a fund would be even larger than indicated above.

5. Much attention has been focused on unfunded corporate pension liabilties, and unusual changes therein, by the press and legislators in recent years. The wide fluctuations created by the FASB proposal would undoubtedly cause even more adverse unwarranted publicity.

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

September 24, 1979

Pension Benefit Guaranty Corporation
2020 K Street, N.W.
Washington, D.C. 20006

Gentlemen:

This letter presents our comments on the PBGC draft report on single-employer pension plan Contingent Employer Liability Insurance issued in early 1978. In general, our reaction to the PBGC report was favorable. We do wish to make the following specific comments:

1. The CELI risk is not insurable, and development of a CELI program is impractical. The PBGC program (Alternative C) is actuarially sound.
2. Allocation of plan assets at termination under Section 4044 is indeed burdensome and expensive. We agree that it is desirable to avoid this expense in cases where it may not be completely necessary. Furthermore, the PBGC should consider simplifying Section 4044 and making it internally consistent.
3. It is desirable to have the sponsoring employer continue to absorb experience gains and losses arising from experience after the plan is terminated but before it has fully funded benefits.

4. The provision for spreading the funding of terminated plans over a 10-year period is preferable to a single-sum payment at the time of termination.
5. While not directly addressed in the PBGC report, some comments on possible changes in accounting rules for pension plans that might result from the PBGC proposal are in order. It would not be desirable to have employers carry the unfunded present value of vested benefits as a liability. Under the PBGC proposal, the employer's legal responsibilities for funding would continue to be determined by the minimum funding standard after termination, so continuation of current accounting principles for these plans would appear to be appropriate.
6. The present value of unfunded vested benefits should be reflected in the rating structure for PBGC premiums.

Respectfully submitted

CELI Task Force
American Academy of Actuaries
Bruce D. Moore, Chairman
Preston C. Bassett
Lynd Blatchford
Harrison Givens, Jr.

AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

RONALD L. BORNHUETTER, M.A.A.A., President
c/o GENERAL REINSURANCE CORP.
600 STEAMBOAT RD.
GREENWICH, CT 06830
203/622-4000

November 7, 1979

Mr. A. Clarence Sampson
Chief Accountant
Securities and Exchange Commission
500 No. Capitol Street
Washington, D.C. 20549

Dear Mr. Sampson:

Enclosed with this letter is a formal request for a ruling by your office as to whether an accounting firm is independent if it provides actuarial services to an audit client in three specific situations.

The request is being submitted by the American Academy of Actuaries, which as you know has been an active participant in the continuing debate on the scope of services provided by C.P.A. firms. The Academy has previously submitted comments on this issue to the Commission, first on December 16, 1977, in response to the invitation for comments made in Release No. 33-5869, and then on April 11, 1978, responding to comments by other parties on our December 16 submission. Our current submission also reflects a more considered view of the report of the AICPA's Public Oversight Board, which the Academy commented upon in a May 22, 1979, letter to you.

The enclosed submission sets out the Academy's position on the provision of actuarial services by C.P.A. firms to their audit clients, and formally requests a ruling that we hope will resolve this issue. The analysis was prepared by the Academy's legal counsel, with active participation from knowledgeable members of the Academy, and has been approved by the Academy's Executive Committee.

If the Academy can be of any assistance in your consideration of this request, please do not hesitate to call upon us.

Sincerely yours,

Ronald L. Bornhuetter
President

Enclosure

REQUEST FOR RULINGS WITH RESPECT TO WHETHER
AN ACCOUNTING FIRM IS INDEPENDENT IF IT
PROVIDES CERTAIN KINDS OF ACTUARIAL SERVICES TO AN AUDIT CLIENT

The American Academy of Actuaries hereby requests the Chief Accountant to pass upon the specific question of whether an accounting firm is acting in a manner inconsistent with the statutory and regulatory requirement of independence if, in the circumstances described below, it audits the financial statements of a client to which it has previously provided actuarial services, where the results of that actuarial work are reflected in representations on the client's financial statements.

I. Background

The Commission has been concerned for some time with the problems presented when accounting firms furnish nonaudit services to publicly-held corporations. These so-called "management advisory services" or "MAS" include such things as executive recruitment, marketing analysis, data processing, plant layout, and profit planning. Over the last several years accounting firms have also begun to provide actuarial services to their audit clients.

The problem for the Commission has been to determine the impact of the provision of these nonaudit services on the ability of an accounting firm to carry out what from the Commission's standpoint is the firm's primary responsibility—auditing the financial statements that are a part of the registration statements and periodic reports that are filed with the Commission by publicly-held corporations. The Commission requires that the accountant who audits these financial statements and issues an opinion on them be "independent" of the entity being audited. The issue for the Commission has been whether an accounting firm can provide both audit and management advisory services to a client and still be deemed to satisfy this "independence" requirement.

Rule 2-01 of Regulation S-X sets forth in broad terms what kinds of financial and organizational relationships will cause an accountant to be deemed not independent of his audit client. Until recently, further clarification has come largely on a case by case basis, with the Commission responding to individual requests for guidance in particular fact situations and, periodically, summarizing and publishing these responses in an accounting series release.

The Commission's latest release on this subject, Accounting Series Release No. 264, dated June 14, 1979, begins by adopting a somewhat broader approach. It identifies four factors which accountants, audit committees, boards of directors, and management are advised to take into account when considering the provision by an accounting firm of a nonaudit service to one of its public audit clients, and provides specifically that such an engagement should be undertaken only if "none of the [four] factors tilts strongly against performance of the nonaudit work involved." The Commission has for many years consistently taken the position that the provision of one kind of nonaudit service to audit clients--bookkeeping and accounting services--is inconsistent with independence (see pp. 6-7 below). The Commission has also ruled that legal services and brokerage services could not be provided by accounting firms to audit clients. It seemed logical that the Commission might follow these examples in ASR 264 and apply its four criteria to proscribe specific categories of nonaudit services. The Commission did not follow this approach, however, and instead indicated that it would consider the appropriateness of the provision of nonaudit services on a case by case basis.

It may be that as a general matter it is wholly appropriate for the Commission to adopt a case by case approach. However, it is the Academy's view that actuarial services are distinguishable from most other types of nonaudit services and lend themselves to the same kind of ruling of general applicability that the Commission has adopted with respect to bookkeeping and accounting services. The Academy believes that an accounting firm is acting in a manner inconsistent with the independence requirement if it audits the financial statements of a client to which it has previously provided actuarial services (whether by means of its own actuary employees or actuaries otherwise affiliated with the accounting firm) where the results of that actuarial work are reflected in representations on the client's financial statements.

II. The Interest of the Academy

The American Academy of Actuaries was formed as an umbrella organization for the four existing national actuarial organizations—the Casualty Actuarial Society, the Conference of Actuaries in Public Practice, the Fraternal Actuarial Association, and the Society of Actuaries. As such, the Academy and its sponsoring organizations function as a professional association for 7,000 actuaries. While most of these professionals are employed by insurance companies, independent actuarial consulting organizations, government departments and agencies, or institutions of higher learning, a significant number are employed by accounting firms (and a smaller number by management consulting firms or industrial corporations).

As we have earlier advised the Commission, the Academy does not object to the provision of actuarial services by accounting firms. The Academy regards as a desirable development the addition of persons qualified as actuaries to the staffs of accounting firms particularly to assist in the audit of actuarial items on financial statements. The Academy recognizes that while actuarial expertise can be obtained through the use of consulting actuaries, many firms will prefer to acquire this expertise directly by employing actuaries as part of their professional staffs.

Notwithstanding, the practice does present certain difficulties for the actuarial profession in a fairly narrow but nonetheless important area. As a general matter, no problem is presented when an accounting firm uses actuaries to assist in auditing financial statements. Nor does the provision of actuarial services by an accounting firm to a client for whom the accounting firm does not act as auditor (nonaudit clients) pose any problem. Some actuarial services may also be furnished to audit clients. But a problem does arise when an accounting firm performs actuarial work for a client and then audits its financial statements where entries on those financial statements reflect the earlier actuarial work.

The accounting profession has taken the view that it is not inconsistent with independence for the accounting firm to audit the financial statements in this situation, so long as all significant matters of judgment can be and in fact are determined or approved by the client. The actuarial profession views such a practice as inconsistent with broadly accepted concepts of independence. Thus the two professions disagree on what independence requires. This issue is of relevance to actuaries because the profession has adopted its own independence requirement. Moreover, even where the independence requirement is one applicable to the accounting profession, by virtue of Commission regulation, actuaries may be involved in the audit process and can legitimately be concerned that an appropriate interpretation is given to the concept of independence.

The American Academy of Actuaries takes an interest in this issue because it was founded in part to "establish, promote and maintain high standards of conduct and competence within the actuarial profession."1/ At the same time it is with some reluctance that the Academy has decided to seek Commission intervention. The Academy strongly agrees with the general approach of the Commission in supporting and encouraging the efforts of the accounting profession to regulate itself. We feel that industry self-regulation continues to be altogether appropriate and in the best interest of both the accounting profession and the public. However, on this particular issue, we feel that the accounting profession has failed to adopt the kind of minimal standard of conduct that is really a prerequisite to a successfully functioning self-regulatory system. Guidance from the Commission could correct this lapse and effectively restore a healthy self-regulatory regime.

III. The Independent Auditor Must Avoid "Self-Review"

The guidance provided by the Commission on the meaning of independence has focused primarily on the relationship between the auditor and the entity whose financial statements are being audited. The Commission has sought to identify certain financial or organizational relationships between the two that might possibly result in bias or partiality on the part of the auditor.

The Commission has sought not only to promote independence, but also to avoid the appearance of non-independence. The critical need for public confidence in the reports of accountants upon financial statements has led the

1/ Articles of Incorporation of the American Academy of Actuaries.

Commission to conclude that, even where it is likely that the requisite objectivity can be achieved, certain relationships should nonetheless be barred simply because they give the appearance of a lack of independence.

In addition to its examination of the relationship between the auditor and the entity whose financial statements are being reviewed, the Commission has also focused on the relationship between the auditor and those persons who have participated in some way in the preparation of the entity's financial statements. The Commission has been concerned that the accounting firm conducting the audit not participate in "self-review"--that it refrain from putting itself in the position of reviewing its own work. This is not because the accounting firm could not as a general rule be expected to carry out such an audit with conscientiousness and integrity, despite its earlier involvement in the preparation of the financial statements. And it is not because of a desire to eliminate pressures that might exist, consciously or unconsciously, from the existence of financial or organizational relationships that carry the potential for impairing objectivity. It is rather because what the Congress and the Commission had in mind when they mandated an "independent audit" was quite literally a "second look" at the financial statements by someone who had not been involved in any way in their preparation.

Perhaps the best example of this concern is the Commission's decision on bookkeeping or accounting services. There the Commission concluded that an accounting firm could not be deemed independent in auditing a financial statement if it had participated in the maintenance of the basic accounting books and records underlying that statement, or had otherwise participated in its preparation. The Commission concluded:

> "A major value of an audit of financial statements by an independent accountant is derived from the fact that the accounting records and financial statements of management are reviewed and examined from an independent or outside viewpoint by knowledgeable professional accountants who are not connected with management. The application of an independent viewpoint is particularly important with respect to judgments exercised in the determination of appropriate principles and methods applicable to the recording, classification and presentation of financial data. By their nature such judgments cannot subsequently be evaluated on an impartial and objective basis by the same accountant who made them."2/

As the Commission said in Interstate Hosiery Mills, Inc., 4 SEC 706, 717 (1939):

> "[I]f an accountant is permitted to do original work, the whole purpose of the audit is lost."

Even if the preparer of the accounting records and the auditor of the financial statements are two different persons, "self-review" is not avoided (and the "independence" requirement is not satisfied) if those persons are members of the same accounting firm. For it can be expected that the auditor will have difficulty maintaining a completely critical and detached view of the work of his associate, a person with whom he has worked, in whom he undoubtedly has a high degree of confidence, and who participates with him in a common business venture. Moreover, the mere fact of their affiliation in

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2/ SEC Release No. AS-234 (December 13, 1977), 6 Fed. Sec. L. Rep. (CCH) ¶ 72,256 at p. 62,650. See also SEC Release No. AS-126 (July 5, 1972), 5 Fed. Sec. L. Rep. (CCH) ¶ 72,148 at 62,307:

> "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 same accounting firm could create the kind of appearance of a conflict of interest that the independence requirement seeks to avoid. The Commission has clearly indicated that review by an auditor who has a financial or organizational relationship with the preparer of a financial statement would not constitute the kind of impartial and objective "second look" that is at the basis of the requirement for an independent audit.[3/] Where a close question arises as to whether a significant item in a financial statement is based upon an appropriate and generally accepted accounting principle, the likelihood that the auditor will conclude that the principle employed was inappropriate is necessarily far lower than it would otherwise be if the firm has participated actively in the original determination of which of two alternative principles should be applied.

IV. The "Self-Review" Problem Where Actuarial Services are Involved

The provision of actuarial services by an accounting firm to its audit clients presents a "self-review" problem closely analogous to that presented where the auditing firm has rendered accounting or bookkeeping services to an audit client. The problem posed in these two situations is wholly distinguishable from the "self-review" problem presented with respect to the other nonaudit services that are offered by accounting firms.

3/ The Commission found that independence would be adversely affected where an accounting firm proposes, by use of its computer, to perform certain data processing activities in connection with the client's stockholder ledger notwithstanding that programming, keypunching, and computer processing would be performed by personnel of the data processing department who were separate from the audit staff. SEC Release No. AS-126 (July 5, 1972), 5 Fed. Sec. L. Rep. (CCH) ¶ 72,148 at 62,308.

A. Actuarial Services are Distinguishable from Other Nonaudit Services

These other services include such things as executive recruitment, marketing analysis, plant layout, and profit planning. They may, in one sense, affect the representations on financial statements by influencing, for example, the magnitude of costs incurred or of annual expenses. However, none of the nonaudit services referred to above involves a determination of what amounts may properly--or, more accurately, what amounts may in accordance with generally accepted accounting principles--be accrued as an expense for the fiscal year, or be included as an asset or as a liability on the balance sheet. These other nonaudit services do not involve derivation of the representations themselves or call for the accounting judgments that must be made in determining what amounts should be set forth in the financial statements. It is these judgments that will be reviewed in the course of an audit. Thus, the issue of "self-review" with respect to these non-actuarial services simply is not as a general matter a serious problem.

By contrast, where actuarial services are involved, the actuary is retained in many although not in all situations to develop the very representations that appear on the financial statements or to prepare those analyses which when applied to the appropriate data directly yield those representations. Assumptions will be made and accounting principles will be applied (e.g., APB 8, in the case of expenses related to the maintenance of pension plans) which the accounting firm, in auditing the financial statements, will in some instances have to find to be reasonable or at least not unreasonable, and in other instances will have to find to be generally accepted and correctly applied. If the actuary who did this work is an employee of the accounting firm, then it is the "firm" that has done and assumed the responsibility for the work, and in a literal sense the firm, as auditor, will be reviewing its own work.[4/] The "self-review" will be direct and immediate.

This fact becomes clearer, in the case of actuarial services, after a brief review of certain of the items that appear on the financial statements of those SEC reporting entities which are the most common consumers of actuarial services. These entities are of three kinds.

(1) Insurance companies. Actuarial analysis is significant with respect to many of the entries on insurance company financial statements.

In the life area, for example, two of the most important entries on the liability side of a life insurance company's balance sheet involve the policy reserve (the amount that is represented to be necessary to provide for the future payment of benefits that are guaranteed under existing policies and contracts) and the entry for policy and contract claims that are accrued but unpaid as of the date of the balance sheet (including both reported and unreported claims). On the asset side of the balance sheet, actuarial considerations are involved particularly in computing the amount of deferred and uncollected premiums and the deferred acquisition expense. Sophisticated mathematical techniques which are uniquely within the province of the actuary are so important in the computation of these items that the various state insurance commissioners have established a common requirement that the annual statement filed by insurance companies in the life, accident, and health areas

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4/ The AICPA's response to this assertion is discussed at pages 16-19 below.

must include a statement signed by a qualified actuary. In that statement, the actuary expresses his opinion as to whether the actuarial items on the financial statement (including but not limited to the aggregate reserve, the net deferred and uncollected premiums, and the policy and contract claims entries) are, among other things, "fairly stated" and "computed in accordance with commonly accepted actuarial standards consistently applied," and make "good and sufficient provision for all unmatured obligations of the company guaranteed under the terms of its policies."

In the property/casualty area, of central importance to the financial statements are the determination of the reserves for accrued but unpaid losses (including both reported and unreported claims) and for the adjustment expenses likely to be incurred in settling those losses. Again, actuarial analysis is so important in the computation of these figures that the National Association of Insurance Commissioners (NAIC) is now considering whether to add to the annual statement filed by fire and casualty companies a requirement for a separate actuarial statement similar to that already required in the life, accident, and health areas. Specifically, a loss reserve specialist (who in most instances would be a qualified actuary) would have to express an opinion on the actuarial items in the statement, including the "reserve for unpaid losses" and the "reserve for unpaid loss adjustment expenses." The specialist would verify that the amounts carried in the balance sheet on account of these actuarial items are, among other things, fairly stated and make good and sufficient provision for all unpaid loss and loss expense obligations of the company.

(2) Employee benefit plans. Actuarial calculations are so important in the determination of the liability side of the balance sheet of

an employee benefit plan that the annual financial statement required by Section 103(a)(1)(A) of the Employee Retirement Income Security Act of 1974 ("ERISA") must be accompanied by an actuarial statement prepared by a qualified enrolled actuary. This statement must include an opinion by the actuary that the contents of the actuarial statement are in the aggregate reasonably related to the experience of the plan, represent his best estimate of anticipated experience under the plan, and reflect reasonable actuarial assumptions and methods.[5/] The principal balance sheet liability item for the plan, the "actuarial present value of accrued plan benefits," is prepared using the information contained in the actuarial statement.

(3) Corporate sponsors of employee benefit plans. The financial statements of a corporation that sponsors an employee benefit plan will usually have two items that are based upon actuarial determinations. In the case of a corporate sponsor of a pension plan, the first item will be the amount of the accrued pension cost for the plan for the year. In most instances this item will not appear separately as a line item on the income statement but rather in a footnote that breaks out this amount and describes the basis used in computing it. The second item is the unfunded vested

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5/ Included among the items that make up the actuarial statement required by ERISA (as reported on Schedule B of Form 5500) are: the current value and actuarial value of the assets, the present value of benefits for retired employees, the present value of vested benefits, the present value of nonvested accrued benefits, the accrued liabilities and normal cost used to determine the minimum contribution, the determination of the minimum contribution requirement, and the funding standard account balance (including the alternative minimum funding standard account entries if applicable), and a description of the funding method and principal actuarial assumptions.

liability of the plan, appearing in a footnote to the balance sheet.6/ In both cases, these amounts, if not appearing directly on the actuarial statement for the plan, are usually derived from the same actuarial valuation as, and consistent with the actuarial calculations contained in, the actuarial statement required for the plan by ERISA. In both cases the items are significant with respect to the sponsoring corporation's financial statements. The annual pension cost is typically a sizeable expense item for the corporation, and the unfunded vested liability can reflect a substantial portion of its net worth. (See Appendix A.)

Thus with respect to each of these three consumers of actuarial services, the actuarial work will almost certainly be the basis for highly significant representations appearing on the financial statements of the client. If these financial statements are then audited by the same accounting firm that provided the actuarial services, the accounting firm will be engaging in "self-review" inconsistent with the independence requirement.

B. The Academy's Position on "Self-Review"

The Academy and its sponsoring organizations established some years ago a Joint Committee on the Independence of the Actuary. The Joint Committee published two exposure drafts, which received extensive comment throughout the

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6/ The Financial Accounting Standards Board has issued an exposure draft of a proposed statement on Disclosure of Pension and Other Post-Retirement Benefit Information. The proposed draft would require a corporate sponsor of a defined benefit plan to disclose the actuarial present value of accumulated plan benefits, the actuarial present value of vested plan benefits, the plan's net assets available for benefits, and a description of significant actuarial assumptions and asset valuation methods employed.

profession, and in November, 1976, submitted its final report. One of the central conclusions of the Joint Committee report, which has been adopted by the Academy Board of Directors and is in the process of being incorporated into the Academy's Guides to Professional Conduct, is that:

> "If an actuary makes an actuarial review of an actuarial determination, and such review is intended for public use, then under no circumstances should he have any organizational or material financial relationship with the preparer of the actuarial determination or with the entity to which the determination relates." (Emphasis added.)

This provision means that if an actuary is asked to review certain actuarial determinations to ascertain whether they were arrived at in accordance with reasonable actuarial assumptions and methods, and his opinion is intended for public use and reliance, then the actuary must have no organizational or material financial relationship with, among other persons, the preparer of the original actuarial work.

It is the Academy's view that the foregoing represents a sound concept of independence that reflects appropriate concern for avoiding "self-review." If this concept were adopted by the accounting profession in interpreting its own independence requirement, it would be clear that an accounting firm could not audit financial statements that included representations reflecting actuarial work performed by actuaries employed by or affiliated with the accounting firm (since, being members of the same or an affiliated organization, the parties would have an "organizational relationship" to each other).

The Academy believes that the Commission has already adopted this concept of independence in its ruling on the provision of bookkeeping and accounting services to audit clients and that the accounting profession has simply failed to acknowledge the clear applicability of this concept in the area of actuarial services. Our concern with this situation is heightened by the fact that members of the Academy are being asked to participate in procedures that the Academy regards as improper.

The Academy has sought for some time to bring this problem to the attention of the Commission and the accounting profession.[7/] We believe that this is an area--like that of bookkeeping and accounting services--which can be identified as one where, in all cases, the existence of self-review "tilts strongly against" the provision of these services. A statement to this effect by the Commission is necessary because, as we show below, the accounting profession has persisted in advancing and relying upon an unsound

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7/ To this end the Academy testified before and submitted written comments to the Commission on Auditors' Responsibilities (the "Cohen Commission"), an independent commission formed by the American Institute of Certified Public Accountants (AICPA) in 1974 to study several aspects of the accounting profession including MAS. The Academy responded with written comments to the Commission's issuance of Securities Act Release No. 5869, which requested information concerning the nonaudit services being offered by accounting firms and sought advice as to which, if any, were inappropriate. The Academy's initial comment was dated December 16, 1977, and was followed by a supplementary comment on April 11, 1978. The Academy pursued the independence issue with the Public Oversight Board (POB) of the SEC Practice Section of the AICPA after the SEC suspended its activities pending issuance of the POB report on the scope of services being provided by CPA firms. An extensive comment was filed with the POB on August 11, 1978, and the Academy later commented on that portion of the final POB report dealing with the provision of actuarial services in a letter to the Chief Accountant of the Commission dated May 22, 1979.

The Academy has also pursued this issue in the Congress, making a submission on February 18, 1978, to the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce (the Moss Subcommittee). Most recently, the Academy testified on August 1, 1979, before the Subcommittee on Governmental Efficiency and the District of Columbia of the Senate Committee on Governmental Affairs.

justification for continuing to provide actuarial services to audit clients. This justification was not directly addressed in ASR-264, nor, so far as we can determine, in any other Commission pronouncement.

V. The Accounting Profession's Position

The accounting profession formally considered the "self-review" problem presented when actuarial services are provided to audit clients in an interpretation of the Executive Committee of the Ethics Division of the AICPA:

> "Member Providing Actuarial Services
>
> 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?
>
> 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."8/

A. "Adoption" by the Client Does Not Solve the "Self-Review" Problem

From the beginning, the Academy has argued that this approach is inconsistent with any reasonable interpretation of accepted concepts of independence. Under a literal reading of the Ethics Divison interpretation, once the determination of the reserve liabilities of a life insurance company or the actuarial valuation of the annual pension cost and accrued unfunded liability of the sponsor of a pension plan had been completed by an actuary employed by an accounting firm, and the results "adopted" by the client

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8/ AICPA Professional Standards, v. 2, ET Section 191.107-08.

relying on its own "informed judgment," the firm could bring back that very same actuary to assist in the "audit" of the accuracy and reasonableness of his own work. But even if the Ethics Division interpretation is clarified to require that a different actuary participate in the audit, this would not, as we have seen, eliminate the unacceptable "self-review" so long as the two actuaries involved are employed by the same accounting firm.

The AICPA's argument with respect to actuarial services has already been rejected by the Commission in ruling on the provision of bookkeeping or accounting services.[9/] The reason, of course, is that the AICPA's "adoption" argument could be made with respect to the entire financial statement and would permit an accounting firm to prepare the statement, obtain the client's "approval" by the exercise of its "informed judgment," and then audit the statement. This approach would read the element of independence requiring the avoidance of "self-review," an element which the Commission has just reaffirmed, right out of existence.

Even assuming, for the moment, that corporate executives for the most part do have the requisite ability to understand broadly the actuarial and accounting principles that are applied in reaching financial statement representations, and do adopt and assume responsibility for them, there will still be no acceptable audit of these representations. In the ordinary course

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9/ The AICPA's approach to accounting services is contained in Rule 101-3 of the Rules of Conduct of the AICPA, which may be found in AICPA Professional Standards, v. 2, ET Section 101.04. The AICPA acknowledges the Commission's rejection of its approach by including the statement that "[w]hen 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."

the actuary will make a report to the client, which will include his recommendations. Where there are reasonable options open as to the methods and assumptions adopted—as there often are—they will be discussed with the client and, on the basis of those discussions, sometimes will be modified. The point is that, even where the end result is adopted by the client, the actuary will have been satisfied that the methods and assumptions used and the principles followed were sound and appropriate. It might well be concluded that a formal opinion from the actuary would provide adequate assurance of the acceptability of these determinations and dispense with the need for an audit of these items. But so long as there is a requirement that there be an audit, the "second look" that an audit contemplates will not be provided if the preparer of the actuarially-based representations then audits the financial statement. The auditor will necessarily be predisposed to conclude that the representations adopted by the client were properly arrived at by the application of generally accepted accounting principles.

However, even if one were to set aside this conclusion for purposes of analyzing the "informed judgment rule," it is evident that in the great run of cases, it is most unlikely that clients will have sufficient expertise to make an "informed judgment" about the actuary's work. It is not enough under the AICPA's argument for the client merely to accept actuarial determinations in reliance on the actuary's judgment. The client must rather be in a position to form a judgment of its own on the actuarial work. While corporate officers often have acquired a reasonably satisfactory knowledge and understanding of accounting practices and principles, it is extremely unlikely that they will have acquired commensurate knowledge of the more specialized actuarial principles. As a consequence, in the case of corporate sponsors of employee benefit plans, the responsible corporate officials are unlikely to be able to form their own judgment about the acceptability of the amount accrued for pension cost or the accuracy of their pension plan's unfunded vested liability. Even in the case of actuarial work performed for insurance companies, while many industry executives have actuarial backgrounds, by far the largest number have legal or marketing rather than actuarial experience. Especially if the client does not have an in-house actuarial staff, it will of necessity have to rely almost totally on the work of the accounting firm's actuary. The problem in the case of a pension or other employee benefit plan may be even worse since many corporate officers without any background in actuarial science or any in-house actuarial staff have been named the administrators of a corporate-sponsored plan, and in that capacity have become responsible for the plan's financial statements. Only in the exceptional case where a very large corporation is involved would the corporation have someone on its staff with an actuarial background.[10/]

In any event, the argument as to whether or not certain individuals can make an informed judgment on the results of actuarial determinations is really irrelevant because of the fact that one cannot engage in a review of his own work (or that of an associate) and claim it to be an "independent" review even if the client is in a position to adopt the results.

B. Since the Auditor's Role With Respect to Actuarial Work Is <u>Significant, the "Self-Review" Problem is Significant.</u>

More recently, a very different response has been made to the problem of "self-review" inherent in an audit of original actuarial work done

10/ It is even more unusual for a multiemployer plan to have an actuary on its staff or a plan administrator with even a financial background, much less actuarial experience.

by the auditing firm. The report of the Public Oversight Board of the AICPA's SEC Practice Section on the Scope of Services by CPA Firms, dated March 9, 1979, acknowledged that the provision to audit clients of actuarial services (where those services are directly reflected in representations on financial statements) presents at least a theoretical problem of "self-review." But the Board asserted:

> "This does not mean, however, that the limited self-review involved impairs the auditor's independence or otherwise is harmful to the public or investors. First of all, it must be remembered that the review is quite limited and is not duplicative of the work performed by an actuary."11/

The Board argues that actuarial analysis is the work of a "specialist" and as such is subjected to only "limited" review by the auditor. The standards of the profession require the auditor to avoid express reliance on the work of the actuary and to issue a letter expressing the auditor's own opinion on the entire financial statement. As a consequence, he remains responsible for expressing his opinion on the work performed by the actuary. Nonetheless, if the Board is right and the audit review is only a limited one, then it might be argued that the third of the Commission's four elements of independence (avoidance of "self-review") does not "tilt strongly against performance of the [actuarial] work involved" and that the provision of actuarial services to audit clients is not improper. But while this is a very ambiguous area, the Academy believes that the Board is wrong. The auditor's review of actuarial work is not a "limited" one.

Taking the audit of a life insurance company's financial statements as an example, the accounting industry's own audit guide entitled Audits of

11/ Report of the Public Oversight Board on the Scope of Services of CPA Firms, pp. 50-51.

Stock Life Insurance Companies, prepared by a committee of the AICPA, provides that in order for an auditor to satisfy himself that the reserves are fairly presented:

> "The reasonableness of assumptions and propriety of the actuarial factors used in reserve calculations should be reviewed and tested."12/

Specific guidelines are provided to assist the auditor in his review of the "reasonableness" of the assumptions as to interest rate, mortality, expenses, and withdrawals—assumptions that are fundamental to the calculation of the reserve factors.

As to interest rate, for example, the guide provides that for an established company the auditor should conduct tests using such things as the company's current and historical portfolio yield, trends in such yield, new money rates, the experience on long-term U.S. government bonds or similar high-yield investments, and cash flow projections.

> "While it is not possible to establish a precise limitation or a guideline that will apply in all circumstances, the auditor should be satisfied that the rate used is reasonable and conservative."13/

As to the reasonableness of withdrawal assumptions, the auditor is instructed to review both "historical lapse rates" and recent data on the company's "termination rate experience," and to ascertain whether there have been significant changes in underwriting practices that might affect the validity of these data. Also,

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12/ Audits of Stock Life Insurance Companies, p. 96. While compliance is not mandatory, AICPA members are served notice in the audit guide that they may be called upon to justify departures from its recommendations.

13/ Id. at 99-100.

"[C]onsideration should be given to the mix of business and the mode of premium payments in determining the reasonableness of withdrawal assumptions. In all cases, the auditor should request adequate documentation to support conclusions on the part of a company."14/

The guide does note that the auditor will need to utilize the services of a qualified actuary (or "specialist") for certain of the audit procedures. Nonetheless, it insists upon an active auditor role since it is the auditor who must take responsibility for the fairness with which the overall financial position and operating results of the company are presented.

"Although an actuary has been involved in these determinations, perhaps even to the extent of testing clerical accuracy, it is incumbent upon the auditor to be satisfied that reserves are fairly stated on a consistent basis.

* * *

Actuaries are not practicing auditors; they are not specifically trained in auditing procedures, nor are they governed by generally accepted auditing standards. Therefore, there is no justification for the auditor to omit all audit procedures or to perform only token procedures as to the reserves reviewed by the consulting actuary unless the terms of the engagement contemplate a qualification or denial of opinion by the auditor."15/

14/ Id. at 101.

15/ Id. at 98-99. This responsibility expressly reaches the assumptions used by the actuary in making his calculations.
"The choice of actuarial assumptions and the disciplining of that choice are primary responsibilities of the actuarial profession. The related responsibility of the auditor is to form a judgment as to whether the actuary has been guided in his work by considerations which are consistent with generally accepted accounting principles.

* * *

However, the actuary's choice of assumptions to be used in connection with general purpose financial statements is disciplined by the principles of his profession. His responsibility to use assumptions which are 'adequate and appropriate' is consistent with the concept,

F'nt Cont.

The AICPA subsequently issued a separate guide on the use of a "specialist" (in this case, an actuary) designated Statement of Auditing Standards No. 11 (SAS 11), one of a series of interpretations of generally accepted auditing standards. In using a "specialist," SAS 11 instructs the auditor to satisfy himself concerning the professional qualifications and reputation of the specialist. But the auditor's responsibilities do not stop here. The Statement goes on to provide that:

> "Although the appropriateness and reasonableness of methods or assumptions used and their application are the responsibility of the specialist, the auditor should obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings are suitable for corroborating the representations in the financial statements. * * * Ordinarily, the auditor would use the work of the specialist unless his procedures lead him to believe that the findings are unreasonable in the circumstances."

When the auditor uses a specialist related to the client, the auditor's responsibilities under SAS 11 are increased. He must consider performing additional procedures with respect to some or all of the assumptions, methods, or findings of the specialist to determine that the findings are not unreasonable. It is even suggested that he might engage an outside specialist to perform these additional procedures.

The foregoing materials, all issued by the accounting profession itself, make it clear that the auditor remains responsible for expressing an

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<u>under generally accepted accounting principles, that actuarial assumptions be characterized by conservatism which is 'reasonable and realistic.' The auditor should expect the actuary to be able to demonstrate that assumptions used in determining actuarial items in a general purpose financial statement meet such standards."</u> <u>Id</u>. at 64 (emphasis added).

opinion on the substantive work performed by the actuary and that the review conducted by the auditor of that work is not the trivial one suggested by the Public Oversight Board.16/ Admittedly, the audit is not "duplicative" of the work of the actuary, but duplication is not what is required of the auditor with respect to any of the representations contained on the financial statements. What is required is that the auditor satisfy himself that the representatives are fairly presented in accordance with generally accepted accounting principles.

VI. The Commission's Response

The Commission's most recent release on the independence of accountants, Accounting Series Release No. 264, dated June 14, 1979, identifies four factors which bear on whether the provision of nonaudit services to public audit clients impairs independence:

— Dependence on MAS (the relationship between the audit fee and the MAS fee, both for a particular client and for aggregate revenues).

— Avoidance of supplanting management's role (requiring the accountant to limit himself in providing MAS to strictly an advisory capacity).

— Avoidance of self-review (insuring that the auditor's review is a dispassionate "second look" at the client's financial statements.)

16/ The Public Oversight Board's conclusion that an auditor's review of representations that are based upon actuarial determinations is a limited one rests heavily upon its reading of SAS 11. The Academy finds considerable ambiguity in the text of SAS 11, first with respect to its applicability and particularly whether it applies at all where the actuarial expert is employed by the auditor (see SAS 11, fn. 1), and, second, with respect to precisely what it requires of the auditing accountant.

— Impact on audit quality (whether enhanced audit quality will result from the performance of the nonaudit service involved).

The Commission has combined these four factors into a test which accounting firms are instructed to apply when considering whether to undertake a nonaudit engagement for a public audit client:

> "[T]est the services in question against each of these factors and proceed when satisfied that the total balance of considerations favors proceeding with the engagement and that none of the factors tilts strongly against performance of the nonaudit work involved." (Emphasis added.)17/

A. The Commission Should Apply Its own Test Where Actuarial Services Are Being Provided to Public Audit Clients.

Under the Commission's own test, there are at least two categories of services which we believe are inappropriate for treatment on a case by case basis and where a broader proscription is required. For these two kinds of services, namely, accounting or bookkeeping services and actuarial services that are reflected in the client's financial statements, the provision by an accounting firm of such services to its public audit clients would in almost every case have to be judged under the Commission's own test to be inconsistent with the requirement of independence. As a consequence, accounting firms should generally be barred from providing these services to audit clients. The Commission has recognized this fact with respect to accounting or bookkeeping services. The Academy urges that a similar position

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17/ The release is set out in 6 Fed. Sec. L. Rep. (CCH) ¶ 72,286 at pp. 62,749-60 through 62,749-68. The material quoted above appears at 62,749-66.

be adopted with respect to actuarial services that are reflected in the client's financial statements.18/

B. The Academy's Proposal for the Treatment of Actuarial Services.

The approach which the Academy would recommend is best explained by treating separately the provision of actuarial services to insurance companies, employee benefit plans, and corporate sponsors of such plans.

1. Insurance company financial statements. As we have noted earlier, pp. 10-11, key representations on the financial statements of an insurance company directly reflect actuarial work. It is the Academy's contention that for an accounting firm to involve its employees or affiliated actuaries in the preparation of these representations or of the analysis from which they are derived renders that firm unable to conduct an "independent" audit of the resulting financial statements. This conclusion would seem to follow directly from the Commission's own test, which would require that "none of the factors [dependence on MAS, avoidance of supplanting management's role, avoidance of "self-review," and impact on audit quality] tilts strongly against performance of the nonaudit work involved." (Emphasis added.)

Where "self-review" is involved, as would be the case, for example, with actuarial services reflected in the policy reserve entry on the balance sheet, it is hard to conceive of a situation where the fact of "self-review" could tilt more "strongly against the performance of the nonaudit work involved." If that portion of the Commission's test (suggesting that

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18/ While refusing to impose an outright ban on any MAS activities, the Commission has listed certain MAS services that "may, in many cases, prove difficult to justify on the basis of the tests set forth above." Actuarial services and employee compensation and benefit consulting were included on this list. Id. at 62, 749-66, n. 29.

seriously offending any one of the four criteria will defeat independence) is to mean anything, it must mean that the independence requirement cannot be satisfied where such "self-review" is involved. For one could not conceive of a situation where <u>that</u> criteria could be more seriously offended, particularly since the representations that reflect actuarial work are perhaps the most important entries on the financial statements of an insurance company. For example, the AICPA has indicated that for the reserve item alone, if the auditor is unable to satisfy himself as to the fairness of that item, then "because of the materiality of reserves, the auditor should disclaim any opinion as to the fairness of the financial statements taken as a whole.[19/]

A similar argument can be made with respect to the second of the four elements of independence outlined by the Commission, namely, "avoidance of supplanting management's role." The Public Oversight Board found that an accounting firm could not provide primary actuarial services to an insurance company audit client and still be deemed to be independent. A limitation was

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19/ Audit of Stock Life Insurance Companies, p. 122.

required, the Board concluded, in order to avoid stepping out from a strictly advisory role and being viewed as a part of management.[20/]

Basically, the Board found actuarial determinations to be so central to the business of an insurance company that an accounting firm could not participate in those determinations and still retain its independence. Determining potential future liabilities and the adequacy of current reserves, while preeminently actuarial matters, are also central concerns of the management of any insurance company. Participation in these determinations inevitably makes the accounting firm part of the "management team" and compromises both the substance and the appearance of independence.[21/]

20/ "Actuarial considerations for an insurance company are integrally related to the role and responsibility of management. Thus, if an accounting firm furnishes actuarial services to management of an insurance company audit client, care must be taken to satisfy the role requirements contained in the AICPA's MAS Professional Standards. This means generally that the actuary must only furnish advice to management and render assistance and that management must make the final decision. To do this, the accountant must be satisfied that the client has the expertise to understand the significance of his recommendations so that 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 Board does not believe that this standard can reasonably be met if an auditing firm is doing more than rendering supplementary actuarial advice." Report of the Public Oversight Board on the Scope of Services by CPA Firms, p. 53.

21/ It is this same principle that bars an accounting firm that has performed legal or brokerage services for a client from also auditing its financial statements. These services are regarded as so intertwined with management functions as to impair the independence of the accountant, even where the work does not relate to representations on the financial statements. The furnishing of actuarial services to an insurance company involves an even greater involvement in management functions.

The Public Oversight Board concluded that because of the danger of being perceived as part of management, an accounting firm could not be the primary source of actuarial services to an insurance company audit client. However, the Board concluded that the firm could still provide actuarial services to its audit client so long as they were supplemental to primary actuarial advice furnished by another actuary. The Commission generally adopted this position in Accounting Series Release No. 264.22/

The Academy does not disagree with the Board's conclusion that the furnishing of primary actuarial services by an accounting firm to an insurance company audit client is inconsistent with independence. But this restriction fails to go far enough.

The most obvious problem with this standard is its vagueness. When are actuarial services merely "supplemental"? Is it determined by timing considerations (i.e., supplemental services are those furnished after other actuarial services have been provided) or by the relative magnitude of the services (i.e., services are supplemental when constituting only a small portion of the total volume of actuarial services consumed by the audit client)? Or did the Board view "supplemental" actuarial services as being those actuarial services unrelated to financial statement items?

But there is a more fundamental problem with this approach: it fails to recognize that provision of actuarial services by an accounting firm to insurance company audit clients poses a problem not only because the firm would be participating in a management function but also because "self-review"

22/ 6 Fed. Sec. L. Rep. (CCH) ¶ 72,286 at p. 62,749-64, n. 20.

is involved. The actuarial services provided by an accounting firm might be considered "supplemental" under the Board's test and still find their way onto the financial statements of the insurance company, resulting, should the firm then audit those statements, in "self-review."

The Academy believes that the SEC should rule that it is inconsistent with the independence requirement for an accounting firm to audit the financial statements of an insurance company where actuaries employed by or affiliated with that accounting firm have participated in the valuation of reserves or in any other actuarial determination that is reflected in the representations on those financial statements.

Admittedly, there may be actuarial services provided to an insurance company which will not be reflected in its financial statements. However, it will often be difficult to know in advance what use will be made of actuarial work. Actuarial analysis is so central to the operation of an insurance company that there is always the likelihood that it will end up being reflected in some way in the representations on its financial statements.

For example, pricing of insurance coverage is a major actuarial activity that may not appear to impact directly upon financial statements. However, if it is subsequently discovered in reviewing existing premium levels that these levels are insufficient to meet expected future policy obligations, the value of the deficiency would have to be immediately reflected on the financial statements of the insurance company. This should disqualify any accountant affiliated with the actuary who assisted in the original pricing from conducting an audit of those statements since such an audit would have to determine whether the additional reserve is adequate. The natural inclination of the originating actuary to defend the original pricing decision would not be helpful in this situation and could not be squared with the independence requirement.

Thus while it might appear initially that actuarial work for an insurance company would not be reflected in its financial statements, there is often a significant likelihood that it will end up appearing on those statements and disqualifying the accounting firm from auditing them. As a consequence, while the Commission may not want to require it, accounting firms might well be advised as a general matter to avoid altogether the provision of actuarial services to insurance company audit clients.

2. Employee benefit plans. As with insurance companies, important entries and representations on the financial statements of employee benefit plans will reflect actuarial computations and analysis. As a consequence, it is the Academy's view that an accounting firm providing both actuarial and audit services to an employee benefit plan will face a "self-review" problem. Hence the rule suggested with respect to insurance companies should apply here too.23/

Although setting forth extremely detailed requirements for the statement of fund balances and cash receipts and disbursements, the financial statements as required by ERISA specifically do not include any actuarial values. Rather, ERISA requires a separate statement of actuarial liabilities. However, in its initial attempt to set out generally accepted

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23/ The independence issue with respect to employee benefit plans is also within the jurisdiction of the Department of Labor. The action which the Department has already taken in this area is discussed later. The application of the independence requirement to employee benefit plans should not be without some interest to the Commission, however, since in some instances these plans are required to file a financial statement with the Commission. Further, the Commission's long experience with the independence requirement would be a useful guide to the Department in the benefit plan area.

accounting principles for pension plan financial statements, the Financial Accounting Standards Board (FASB), with the support of the AICPA, has taken the position that these financial statements should include certain actuarial liabilities, notwithstanding that this information already appears on the actuarial statement required by ERISA. Even if the FASB finally concludes that actuarial liabilities should be included in these financial statements, accountants could, if they chose, avoid reviewing these actuarial liabilities. Section 103(a)(3)(B) of ERISA provides that the independent accountant may, in offering an opinion concerning the plan's financial statement, "rely on the correctness of any actuarial matter certified to by an enrolled actuary, if he so states his reliance." If the auditor were to elect to exercise this option, then no "self-review" problem would arise.

In practice, however, most accounting firms, in the absence of a specific audit guide, have been unwilling to accept the option provided by the statute. They have taken the position that their responsibilities extend to all the representations on the financial statements. Thus the accounting profession has decided, first, to include actuarial values in pension plan financial statements even though not required by ERISA, and, second, to reject the permission provided by ERISA to express reliance on the actuary. They have therefore placed upon themselves the burden of performing whatever audit procedures are considered necessary and appropriate with respect to these matters in preparing their opinion on financial statements. This means that, in most cases, the issue of "self-review" is squarely presented if the accounting firm seeks to audit the financial statement of a plan to which it has provided actuarial services.

While no audit guide has been issued with respect to employee benefit plans, the Financial Accounting Standards Board has recently issued a revised exposure draft of a proposed statement on Accounting and Reporting by Defined Benefit Pension Plans ("FASB" draft). The FASB draft sets out what will constitute generally accepted accounting principles with respect to such plans. It includes a rather detailed discussion of the variety of assumptions that go into the determination of the actuarial present value of "accumulated" plan benefits (the principal liability item on a pension plan's financial statement as defined by the FASB draft). For example, the FASB draft discusses the propriety of making an assumption as to future salary increases, of recognizing automatic cost-of-living adjustments, and of providing for the future withdrawal of persons currently in the plan. The draft requires that for financial statement purposes every assumption is to "reflect the best estimate of the plan's future experience."

> "Assumed rates of return shall reflect the expected rates of return on plan investments during the periods for which payment of benefits is deferred and shall be consistent with the returns realistically achievable on the types of assets held by the plan and the plan's investment policy." (Emphasis added).24/

Inflation rates assumed in estimating automatic cost-of-living adjustments are to be consistent with this assumed rate of investment return, and guidelines are provided with respect to the administrative expenses expected to be incurred by the plan.

A review of the FASB draft makes clear that as in the case of insurance company financial statements, key items on the financial statement of an employee pension plan will reflect actuarial work and the accounting

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24/ Proposed Statement of Financial Accounting Standards on Accounting and Reporting by Defined Benefit Pension Plans, ¶ 20 (Revised Exposure Draft dated July 9, 1979).

firm that is auditing the statement will be reviewing that work in expressing its opinion on the financial statement as a whole. If the FASB proposal is ultimately accepted, there will be constraints on the assumptions underlying the actuarial present value of accumulated plan benefits as it appears on the financial statement and these constraints will have to be respected if a plan financial statement is to be deemed to be in accordance with generally accepted accounting principles. Since an auditor must satisfy himself that the statement is fairly presented in accordance with these principles, he will have to satisfy himself that the enrolled actuary's assumptions are reasonable and appropriate--that, for example, the rates of return assumed by the actuary are "realistically achievable" and that remaining assumptions are acceptable "best estimates" of future experience. Indeed, we can envision a situation arising under the FASB draft where the auditor may want to insist upon using in financial statements different actuarial assumptions than those used by the enrolled actuary in determining comparable items on the actuarial statement of the plan.[25/] The responsibility of the auditor can hardly be deemed to be a

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25/ For example, ¶ 20(a) of the FASB draft, quoted in part in the text, provides that:

> "Assumed rates of return shall reflect the expected rates of return on plan investments during the periods for which payment of benefits is deferred and shall be consistent with the returns realistically achievable on the types of assets held by the plan and the plan's investment policy. To the extent the assumed rates of return are based on the values of existing plan assets, the values used in determining assumed rates of return shall be the values presented in the plan's financial statements pursuant to the requirements of this Statement."

This could be interpreted (see also ¶ 186) to provide that the assumed rate of return is to fluctuate directly in response to the market value of assets. The yield used by the enrolled actuary, on the other hand, would generally reflect long term expected rates of return and not fluctuate over the short term due to changes in market conditions.

trivial one. As in the case of insurance company financial statements, a significant "self-review" will be involved if an accounting firm serves as both enrolled actuary and auditor to an employee benefit plan.

Even if an accounting firm, in its role as auditor, were to elect to rely upon the correctness of the matters certified to in its role as enrolled actuary, so that no "self-review" would be involved, there is still grave doubt whether the accounting firm could be deemed independent for purposes of conducting an audit of the plan. The matters it would certify to as enrolled actuary are no less integrally related to the operation and financial soundness of the plan than the issues of potential liability and reserve adequacy are to the operation of an insurance company. In both cases, the actuary is providing actuarial services which, even if characterized as only advice and technical support, relate to matters so essential and critical to the management of the entity involved as to make the actuary part of the management team, thereby compromising his independence. Indeed, the significance of the liabilities of a pension plan and the need for an understanding of how they are arrived at may be even greater than is the case with insurance company liabilities, since a pension plan's actuarial liabilities will often be many times the value of the plan's assets (without suggesting in any way that the plan is inadequately funded).

The Public Oversight Board rejected this argument, however.

> "[The] enrolled actuary * * * is simply performing an independent professional service outside of management's traditional area of operation and expertise. It is not, therefore, making management decisions and should not be viewed as being part of management's team."26/

26/ Accounting Series Release No. 264, *supra*, at 62,749-64. n. 20.

The Academy respectfully disagrees with this analysis. As the accounting profession has repeatedly made clear, the responsibility for the plan's financial statements is that of plan "management" and not that of the auditor or of any consultant that prepares representations on the financial statements. Thus when a plan administrator uses an enrolled actuary--as the law requires him to do--to arrive at amounts that appear on the liability side of the balance sheet, the plan administrator must assume responsibility for those items, for their preparation is a management function. Delegating management functions does not convert them into non-management functions. What it does do is to make the person who actually does the work part of the management team. In the case of an employee benefit plan, the enrolled actuary is in fact performing a signficant management function on behalf of the plan.

Further, the Public Oversight Board's statement that an enrolled actuary is "simply performing an independent professional service" and is "not, therefore, making management decisions and should not be viewed as being part of management's team" is a non-sequitur. There is no dichotomy between "independent professional services" on the one hand and "management decisions" on the other. In this case the independent professional service happens to relate to the most significant management decisions of the plan.27/ The statement of the Public Oversight Board quoted above could just as easily have

27/ It might be noted that the "plan" is an entity separate and distinct from the employer that sponsors the plan. Management of the plan is not the Board of Directors of the corporate sponsor but the plan administrator (who, of course, will have been designated by the sponsor). Thus while the work performed by the enrolled actuary may not involve a significant part of the corporate sponsor's business, it relates to the principal "business" of the plan--the entity for which the audit is being performed.

been said of a consulting actuary hired by an insurance company to determine its policy reserve. Yet the Public Oversight Board concluded that such an actuary would be so involved with management functions as to disqualify any accountants associated with him from auditing the insurance company's financial statements. If the Board's conclusion is sound with respect to insurance company financial statements, as the Commission thinks it is, then by parity of reasoning an accounting firm cannot, consistent with the independence requirement, audit the financial statements of an employee benefit plan for which it acts as the enrolled actuary.[28/]

3. Corporate sponsors of employee benefit plans. The financial statements of an employer that has sponsored an employee benefit plan will include at least two items that are dependent upon actuarial analysis. In the case of a pension plan, these items are the pension cost accrual and the

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28/ The Department of Labor may have taken a different view in Interpretive Bulletin ERISA IB RD 75-1 (now IB RD 75-9), published November 20, 1975 (29 CFR § 2509-75-9), which provides that:

> "However, an independent qualified public accountant may permissably [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 was suggesting the more extreme view that providing actuarial services that are later reflected in financial statements would not affect an accountant's independence. This interpretation was not promulgated under the notice and comment provisions of the Administrative Procedure Act (5 U.S.C. § 553) and, accordingly, the Department never had the benefit of any public comment. We think that the Bulletin does not reflect an adequate understanding or analysis of the issue.

unfunded actuarially-computed value of vested benefits.[29/] A "self-review" problem will be presented if actuaries employed by an accounting firm are responsible for the computation of these two items and the same accounting firm is then asked to audit the sponsoring employer's financial statements. It should also be noted that the authority provided by Section 103(a)(3)(B) whereby the auditor can rely on an actuary's determinations is limited to the financial statement of the employee benefit plan and does not extend to the statement of its corporate sponsor. Thus there is not, as in the case of employee benefit plan financial statements, an avenue for avoiding the "self-review" problem without modification of the current AICPA rules with respect to expression of reliance.

The problem of identification with management appears, at first glance, to be less severe with respect to the corporate sponsor than it is with respect to the employee pension plan itself or an insurance company. In contrast to insurance companies and employee benefit plans, where actuarially-related issues form the core of the matters to which management must give its attention, the maintenance of its retirement programs is only one of many important issues facing the management of the sponsoring corporation. But its importance must not be underestimated. There is indeed increasing recognition of the significance of the two pension plan-related items reflected on the sponsor's financial statements--that unfunded vested liability is often a substantial percentage of net worth and that pension expense often reflects a

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29/ The proposed statement of the Financial Accounting Standards Board on Disclosure of Pension and Other Post-Retirement Benefit Information would alter and expand this disclosure somewhat. The argument as presented here would thus apply, *a fortiori*.

similarly large portion of total pre-tax earnings. For example, a recent article in Business Week reveals that fifteen major U.S. corporations incurred pension expense in fiscal 1978 or 1979 that ran between 21.7 and 165.3 percent of pre-tax profits while unfunded vested liability ran between 20.1 and 157.0 percent of net worth. See Appendix A.

The Commission should rule that it is inconsistent with the independence requirement for an accounting firm to provide both audit and actuarial services to a corporate sponsor of an employee benefit plan where results of the actuarial work will be reflected in the financial statements of the corporate sponsor.[30/] We recognize that some actuarial services provided to the corporate sponsor will in most instances not be reflected on financial statements. These might include, for example, actuarial work in connection with changes in the benefit formula or other provisions of the plan, or where the employer uses actuarial services in connection with its collective bargaining effort so as to estimate the cost of changes in the level of benefits. As to these services, we recommend only that the principles of ASR 264 should apply. Where, however, the work of the actuary ends up being reflected on financial statements, no "second look" is present and the independence requirement is violated.

VII. The Need for Further Commission Action

The Academy's concern is that the Commission has failed to provide the necessary and appropriate guidance in a significant area where that

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30/ In fact, because the same actuary will generally provide actuarial services to both the plan and its corporate sponsor, precluding the provision of both audit and actuarial services to the plan may well generally eliminate the independence problem with respect to the corporate sponsor.

guidance is needed. The case by case approach enunciated in its most recent release is inadequate where actuarial services are involved. The Commission should recognize that in this narrowly defined area a ruling of general applicability is both feasible and appropriate.

An accounting firm should be deemed to be acting in a manner inconsistent with the independence requirement if it provides an audit client, through its own or affiliated actuaries, with actuarial services that are reflected in representations on the client's financial statements. In the case of insurance companies and employee benefit plans, such a rule will probably cause accounting firms to cease providing any actuarial services to insurance company or employee benefit plan audit clients, since it will be difficult to insure in advance that those services will not become reflected in the client's financial statements. In the case of a corporate sponsor of an employee benefit plan, an accounting firm should simply avoid serving as an enrolled actuary for an employee benefit plan where it already serves as auditor for the plan's corporate sponsor.

The Academy recognizes the considerable amount of time and effort that went into the preparation and issuance of Accounting Series Release No. 264 and it is not asking the Commission to reconsider that release. On the contrary, we think that it puts the independence requirement for the first time on a firm conceptual basis. We are asking only that the Commission apply the principles enunciated in that release to a fairly narrow area where both the actuarial and accounting professions are in need of guidance.

Nothing in the AICPA's response to ASR 264 dated July 26, 1979, changes in any way the Academy's positive assessment of that release or our conviction that further guidance is needed in the area of actuarial services. Quite the contrary. While we have some reservations about other sections of the AICPA response, the discussion of "self-review" on pages 7 and 8 is particularly troublesome. With all due respect to the seriousness with which the accounting profession has treated the independence issue, we think that those pages miss the point so far as "self-review" is concerned. We agree that an "essential element of an audit is that the auditor be outside the control of management." But an even more "essential element" is that the audit be an audit—a "second look" at the representations on the financial statements. Where the auditor has assisted in preparing those representations, this function is lost.

The "self-review" element of independence is not simply an extension of the element calling for the "avoidance of supplanting management's role." It is a separate element of independence to insure that the audit is truly a "second look." The AICPA response does not deal with this fact. It avoids it by assuming that the Commission is concerned only with the auditor avoiding a management role and that the avoidance of "self-review" is only an aspect of that concern. But ASR 264 makes it clear that the Commission regards the avoidance of "self-review" as a wholly separate requirement.

We should also note that our argument is unchanged by the disclosure requirements of Accounting Series Release No. 250. Disclosure may be an adequate remedy where the threat is to the appearance of independence and is a function of degree—an MAS fee, for example, which at some point will become too large in relation to the audit fee and begin to impair at least the appearance of independence. But with the provision of actuarial services to audit clients, the problem is not, as we have seen, one of degree—the "self-review" is of the most obvious and direct sort. To argue that disclosure would provide an adequate remedy is really to argue that no proscriptions whatsoever are needed to insure accountant independence. The Commission has not adopted this view. In the same way that the Commission found maintenance of basic accounting records and preparation of financial statements for an audit client to be inconsistent with independence, it should find that the provision of actuarial services which become reflected in the financial statements of audit clients is inconsistent with independence.

The Academy recognizes that the Commission has not adopted this position with respect to tax advisory services. We think the case of tax services is distinguishable, as the Commission must itself have found in issuing its opinion on bookkeeping or accounting services. The difference is not that no "self-review" is involved, for tax advice can readily be reflected in representations on financial statements and present a clear case of "self-review" where the same firm provides both tax and audit services. It is rather that the Commission has chosen to tolerate this "self-review" rather than disrupt a long and well-established pattern, particularly among smaller companies, of looking to accounting firms for tax advice and for assistance in preparing tax returns. It is highly significant, also, that the rendering of tax advice results in the sharpening of audit skills and thus the Commission's fourth element of independence tilts strongly in favor of permitting this long-standing practice to continue.

By contrast, the furnishing of actuarial services by accounting firms is a relatively limited phenomenon, with only two major firms engaging extensively in the development of original actuarial determinations. That an arguably questionable practice that cannot easily be changed because of historical precedent has developed in one area is no reason to extend it into another. This is particularly true since although the skills of the accountant properly prepare him to provide tax advisory services, actuarial analysis requires a range of skills that are outside the training or experience of most accountants. Moreover, in the tax area, the prospect of an IRS audit provides an external incentive for the accounting firm to be fair and accurate in its audit of any tax work reflected in the financial statements. Where accounting or actuarial services are involved, it is the audit by the "independent" accountant which is itself the vehicle for insuring that the financial statements are fairly stated.

The ruling sought by the Academy is a narrow one, to clarify for the two professions a closely defined area of disagreement in what has otherwise been a rather effective pattern of self-regulation and mutual cooperation by the two professions.[31/]

The Academy requests, accordingly, that the Chief Accountant respond to the following questions:

1. If an actuary employed by or affiliated with an accounting firm has performed services for an insurance company that involved participation in actuarial determinations that are reflected in the financial statements of

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31/ The Academy has not, for example, called for the broad prohibition of nonaccounting management services to audit clients that was recommended by the Senate Subcommittee on Reports, Accounting and Management in its 1977 report on Improving the Accountability of Publicly Owned Corporations and their Auditors. The subcommittee there concluded that:

> "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. Nonaccounting 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. Management services related to accounting are confined to the limited area of providing certain computer and systems analyses that are necessary for improving internal control procedures of corporations." Id. at 16-17.

that company, will the accounting firm be considered to be independent within the meaning of Rule 201(b) of Regulation S-X, 17 CFR § 210.2-01(b), for the purpose of auditing and reporting upon the financial statements of the company?

2. If an actuary employed by or affiliated with an accounting firm has performed services for a corporate sponsor of an employee benefit plan that included participation in determining the amount accrued for pension cost, the amount reported as the aggregate unfunded vested liability of the plan, or other actuarial items appearing in the sponsor's financial statement, will the accounting firm be considered to be independent within the meaning of Rule 201(b) of Regulation S-X, 17 CFR § 210.2-01(b), for the purpose of auditing and reporting upon the financial statements of the company?

3. If an actuary employed by or affiliated with an accounting firm acts as the enrolled actuary of an employee benefit plan pursuant to Section 103(a)(4)(A) of the Employee Retirement Income Security Act of 1974 (ERISA), will the accounting firm be considered to be independent within the meaning of Rule 201(b) of Regulation S-X, 17 CFR § 210.2-01(b), for the purpose of auditing and reporting upon the financial statements of the plan?

If the staff considers it to be desirable, representatives of the Academy will be glad to furnish any further information or to meet with the staff for the purpose of clarifying any of the matters set forth in this memorandum.

Lawrence J. Latto
Stephen J. Hadley

Of Counsel:
Shea & Gardner
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036

Of 100 Major U.S. Corporations in a *Business Week* Survey: The Top 15 as to Unfunded Vested Benefits as a Percent of Net Worth

	Unfunded Prior Service Costs		Unfunded Vested Benefits		FY 78 or 79 Pension and Retirement Expense	
	$ Million	% of 3-yr. Avg. Pre-Tax Profit	$ Million	% of Net Worth	$ Million	% of 3-yr. Avg. Pre-Tax Profit
Lockheed	869.0	839.9	440.0	157.0	116.0	112.1
LTV	860.0	NM	557.0	100.7	101.0	NR
Trans World	314.1	396.8	308.0	57.1	61.9	78.2
Bethlehem Steel	1101.0	NEG	1247.0	52.8	273.9	NA
National Steel	NR	NR	596.0	44.4	90.2	NA
Republic Steel	895.0	1119.8	565.0	40.1	96.9	121.3
Chrysler	1810.0	1140.8	1100.0	37.6	262.3	165.3
Bendix	570.3	263.0	346.2	37.2	80.5	37.1
Westinghouse	770.0	183.8	740.0	30.3	136.3	32.5
Eaton	369.0	165.4	229.0	27.6	55.0	24.7
Alcoa	847.0	250.8	536.0	25.4	135.3	40.1
Reynolds Metals	620.0	408.2	273.0	25.3	64.9	42.7
Rockwell Intl.	483.7	157.4	320.0	23.6	199.7	65.0
General Motors	8000.0	130.9	3900.0	22.2	1326.7	21.7
Goodyear	703.6	199.5	423.0	20.1	127.3	36.1

Source: "Unfunded Pension Liabilities: A Rein on Their Growth -- For Now" appearing in *Business Week*, August 13, 1979 (pages 84-85). [Data in columns 1 through 5 is contained in the *Business Week* article. Data in column 6 is derived therefrom.]

Legend:

NA - Not Available
NM - Not Meaningful
NR - Not Reported
NEG - Earnings Deficit

AMERICAN ACADEMY OF ACTUARIES
1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

ACTUARIAL ISSUES IN PROPOSED FEDERAL LEGISLATION ON THE MULTIEMPLOYER TERMINATION INSURANCE PROGRAM

H.R. 3094 & S. 1076

PREPARED BY:

THE AMERICAN ACADEMY OF ACTUARIES

TASK FORCE ON MULTIEMPLOYER PLANS

NOVEMBER 7, 1979

FOREWORD

The Task Force was originally formed in 1978 in response to a letter of request from the Pension Benefit Guaranty Corporation to the Academy for input and recommendations from the actuarial profession to assist the PBGC in narrowing the range of alternatives presented to Congress in its Multiemployer Study dated July 1, 1978. To fulfill that request, the Task Force met several times and formulated two reports (dated October 2, 1978 and October 20, 1978) on the PBGC Multiemployer Study to Congress.

This report from the Task Force focuses specifically on actuarial issues in proposed legislation (H.R. 3094 and S. 1076) designed to amend the Multiemployer Termination Insurance Program.

The Task Force sincerely hopes that this report will be of value to the Congress in designing ERISA amendments that will result in more efficient and effective provisions pertaining to Multiemployer Plans.

Respectfully submitted,

Academy Task Force Members

Lawrence N. Bader, M.A.A.A.
Thomas G. Bierley, M.A.A.A.
Charles E. Farr, M.A.A.A.
Joseph A. Lo Cicero, M.A.A.A.
Claude Poulin, M.A.A.A.
Mary Brauer, Attorney (Ex Officio)
Fenton R. Isaacson, M.A.A.A. Chairman

Comments On Actuarial Issues In Proposed Federal Legislation On The Multiemployer Termination Insurance Program

1. Definition of Multiemployer Plan

As stated in our earlier report, we agreed with the proposed change.

2. Mergers

Our earlier report endorsed PBGC's proposed replacement of the ERISA requirements with a plan continuation test and business purpose test. The proposed legislation would instead permit a merger only if the merged plan's reorganization index is not greater than the index of either separate plan. Assuming that benefit/contribution structures are not changed as part of the merger, this would permit mergers if the merged plan is not in reorganization and prohibit them otherwise. For example, a merger of two plans in reorganization would produce a plan with reorganization index equal to the total of the indexes of the two separate plans; this merger would be prohibited, although under some circumstances, the merged plan might have a better chance of survival than the two separate plans. For example, a plan with sound long-term prospects but current cash flow problems might profitably merge with a smaller plan with substantial assets but poor long-term prospects.

We agree that mergers should be permitted if they satisfy the proposed legislative test. Other mergers, however, should not be prohibited automatically but should be subject to advance approval by PBGC, based on whether they help the participants without increasing risks to the PBGC.

3. Premiums

We agree with the continuation of a flat per capita premium, as suggested in our earlier report for premium levels not significantly greater than the single employer premium. We are not able to comment on the adequacy of the proposed premium.

4. Minimum Funding Standards

As in our earlier report, we strongly endorse the strengthening of multiemployer funding standards to the level of single employer standards, with the transition allowed in the bill. We also agree with the minimum contribution requirement. We repeat our suggestion of tightening the shortfall rules, currently set by regulation rather than statute.

5. Plan Reorganization

The bill introduces the concept of the "vested liabilities charge" as a funding requirement and reorganization threshold test. We ask that the bill be clarified to avoid disturbing the agreements on actuarial methodology being developed among the Department of Labor, Financial Accounting Standards Board, and the actuarial profession. The bill uses such terms as vested obligations, vested liabilities, and value of assets without adequate definition, or with definition left to regulation. To preserve uniformity, we ask that the bill define vested liabilities for retirees and other participants to be the numbers reported on Schedule B (Form 5500) Line 6(d). The value of assets used in determining the vested liabilities charge should be the value used by the actuary in maintaining the funding standard account. This is not necessarily the fair market value, but it must take fair market value into account, under IRS regulations.

This basis is more appropriate than other possibilities such as PBGC assumptions and market value of assets, since the vested liabilities charge is a supplementary funding test and should be consistent with the funding standard account. On the other hand, the cash-flow amount in Section 4243(b)(2) must be based on the immediate liquidation value of plan assets, since the cash-flow amount relates to the plan's ability to pay the current year's benefits.

6. Withdrawal Liability

We asked that this section be clarified to provide that the total unfunded vested liability of the plan be based on PBGC assumptions for valuing all vested benefits and on the market value of assets.

While we are reluctant to deviate from the Schedule B numbers, we have concluded that they are inappropriate for determining withdrawal liability. Use of a PBGC assumption has several advantages.

- The assumptions used for funding may include margins for conservatism, future benefit increases, or anticipated changes in plan experience. This makes them inappropriate for a withdrawal, which is akin to partial plan termination. The relationship of withdrawal to termination is reflected in the current statute, which determines liability under PBGC assumptions.

- The PBGC assumptions give the same results as permitting the withdrawing employer to partition and terminate his share of the plan (with responsibility for vested rather than guaranteed benefits).

- The timing and effect of assumption changes for funding purposes will not have unintended effects on withdrawing employers.

- The PBGC assumptions preserve better equity between withdrawing and remaining employers, if the plan terminates soon after withdrawal.

The manner of allocating the total unfunded vested liability to individual employers is not strictly an actuarial matter except in the details of calculation. Some members of the Task Force have worked as individuals with the drafters of the legislation, but the Task Force has developed no view favoring a specific method. We do feel that the law should permit a plan to select a method which avoids assigning to any new employers a share of the liability which predates their participation in the plan - an objective not met by the method in the bill.

The bill charges "prevailing market rates" of interest on installment payments of withdrawal liability. Apart from a risk charge to cover default possibilities, it is incorrect to use rates other than those used in calculating the unfunded vested liability. For a payment period of 15 years, the average of the PBGC's K_1 and K_2 rates would be reasonable.

AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

ONALD L. BORNHUETTER, M.A.A.A., President
c/o GENERAL REINSURANCE CORP.
600 STEAMBOAT RD.
GREENWICH, CT 06830
203/622-4000

November 27, 1979

Honorable Wesley J. Kinder
Commissioner of Insurance
State of California
600 S. Commonwealth 14th Floor
Los Angeles, California 90005

Dear Wes:

I am certain that you are keenly aware of the major report of the General Accounting Office (GAO) concerning state regulation of the insurance industry dated October 9, 1979. There are a number of items discussed in the report which, I am sure, are of great interest to the NAIC and to state regulators in general.

One matter dealt with at some length in Chapter 3 of the report is the role of actuaries in the state regulatory mechanism. The report indicates that "actuarial science is perhaps the most relevant professional background for an insurance department" but goes on to discuss a shortage of professionals with specialized training relevant to the insurance business and notes that "in particular, there are few certified actuaries".

As President of the American Academy of Actuaries, I have a professional interest in these GAO conclusions. The American Academy of Actuaries is committed to the fostering of a strong, objective and high quality actuarial role in the regulation of insurance.

The Academy is concerned about the references in the GAO report and is interested in doing what it can as a professional actuarial organization to strengthen the actuarial role in insurance regulation. We would be happy to offer our services to the NAIC to explore various avenues of addressing the points raised in the GAO report. I would welcome your thoughts about this portion of the GAO report.

Academy representatives will be present at the upcoming meeting of the NAIC next week and would be available to discuss the matter with you at your convenience. Thank you for your consideration.

Yours truly,

Ronald L. Bornhuetter

Ronald L. Bornhuetter
President

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1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

STEPHEN G. KELLISON, M.A.A.A.
EXECUTIVE DIRECTOR

December 3, 1979

Commissioner of Internal Revenue
Attention CC: LR: T
Washington, D.C. 20224

Attention: Proposed IRS Regulations on Reasonable Funding Methods under ERISA

Dear Sir:

This presents comments prepared by a task force of the American Academy of Actuaries concerning the proposed regulations on reasonable funding methods under ERISA which appeared in the Federal Register on October 5, 1979.

We believe that, consistent with his responsibility for overseeing sound funding on behalf of plan participants, the enrolled actuary should be permitted maximum discretion in selecting appropriate funding methods and assumptions to assure the sound funding of pension benefits. We also recognize the need to minimize the cost of actuarial services, particularly for small plans, without sacrificing sound funding. Flexibility in regulation, particularly to avoid costly submissio for requests of a change in funding method, further this goal.

We enclose comments on specific paragraphs in the proposed regulations. If a public hearing on the proposed regulations is held, we request the opportunity to appear.

Respectfully submitted,

Stephen G. Kellison

Stephen G. Kellison
Executive Director

SGK:cal

Enclosure

Paragraph of Section 1.412(c)(3)-1	Comment
(a)(2)	"The funding method includes...also each specific method of computation used in applying the overall method."

This statement on the funding method of a plan is so broad that it could be interpreted by IRS personnel to allow them to check funding calculations down to the last detail and last decimal point. This would introduce unnecessary complexity and detail into regulatory functions. ERISA makes clear that the six methods listed in section 3(31) are each funding methods, and that it is changes from one to another which require IRS approval under IRC section 412(c)(5), not merely a change in some detail of computation.

In addition it should be clarified that funding method does not include the actuarial method of valuation of assets, since the legislative intent is clear on this matter.

A de minimis exception should grant automatic approval without submission to IRS if the total net charges to the funding standard account are changed by less than 10%. This would reduce the costs of actuarial work involved with submissions that are not really needed. The use of the "de minimis" rule could be disclosed by the enrolled actuary as an attachment to Schedule B.

(b)(1)(i) The basic funding formula should be clarified to cover a contributory pension plan by rewording (i) as follows:

"(i) The present value of employer normal costs over the future working lifetime of participants, plus the present value of future employee contributions (if applicable)."

Paragraph of Section 1.412(c)(3)-1	Comment
(c)(1)(i)	Other reasonable bases are in use. Add, ", or a multiple of employee contributions, or any other reasonable basis approved by the Commissioner."
(c)(1)(ii)	Add, ", reduced by the present value of any employee contributions payable for such year, and expressed as a flat dollar amount, a percentage of pay, multiple of employee contributions or any other reasonable basis approved by the Commissioner."
(c)(3)(i)	This section deals with actuarial assumptions and is not appropriate to a regulation on funding <u>methods</u>. This section (c)(3)(i) should be deleted in its entirety.
(c)(4)	It should be made clear that the actuary is not prohibited from using the traditional accrued benefit cost method for a plan with benefits unrelated to pay (flat dollar unit benefits) based upon the plan's accrued benefit rather than proration. After "career average pay plan" add, "or a plan with benefits not related to pay."
	This paragraph requires the proration to past years in proportion to credited years ("credited" not defined) of service at <u>normal retirement age</u>. Many actuaries assume rates of retirement or an assumed retirement age before the normal retirement age as well as assuming rates of death, disablement and termination to value ancillary benefits. In such cases the proration may be made to each age the event could occur rather than to normal retirement age. These methods should be permitted. After "normal retirement age" add, "or other age of benefit entitlement.
	Finally, this section provides that an allocation (to past years) based on compensation is not permitted. We would

Paragraph of Section 1.412(c)(3)-1	Comment
	like to point out that actuarial opinion as to the acceptability of this practice is divided. It is to be noted that, in Paragraph 4.4 of the Academy's Pension Plan Recommendation A, it is stated the method may be used "if appropriate", without specific reference to situations which may be appropriate (public employees systems, corporate planning, basic funding, etc.). The Academy's Board of Directors has directed the Committee on Pension Actuarial Principles and Practices to prepare an Interpretation as to the circumstances under which this method is appropriate, and pending that Committee's report we feel the method should not be condemned on a blanket basis.
	As an overall comment, we believe that no actuarial cost method recognized by the profession (e.g. use of allocations based on compensation, as described above, or use of an open group method) should be excluded, if it can be demonstrated that for funding standard account purposes the resulting contributions exceed those which would be obtained under a method generally accepted under the regulations. If the method used does not meet this criterion, it should be examined on a case by case basis to determine its propriety in each particular instance. (A comparable test under a generally accepted method would appear appropriate with respect to maximum deductible contributions.)
(d)(1)	Sound funding ordinarily requires the actuary to anticipate changes in plan benefits which are scheduled to become effective in the future. Section 412(c)(3) requires the actuary to use methods which offer his "best estimate of anticipated experience". An actuary who knows that the plan is required to pay higher

Paragraph of Section 1.412(c)(3)-1	Comment
	benefits next year and who ignores the fact would appear to be in violation of the statute. The purpose of the minimum funding requirements is to assure sound funding; the proposed regulation would tend to defeat this purpose.
	On the other hand, to require the actuary to recognize future increases, while theoretically sound, would not be practical. Such a requirement could be avoided by deferring the adoption of benefit increases until their effective date.
	Therefore the regulation should allow, but not require, anticipation of changes in plan benefits based upon plan provisions or amendments which have already been adopted.
	Regardless of the above, it should be clarified that "changes in plan benefits" does not refer to post-retirement increases under plans which provide such increases automatically, based on a consumer price index, a wage index, or a constant percent of increase. Failure to recognize such post-retirement increases would be contrary to standard actuarial practice and would result in serious underfunding for such plans.
(d)(2)(i)	Actuaries often appropriately include in the valuation current employees who may be expected to become participants upon completion of the age and service requirements. Opinion 8 of the Accounting Principles Board states, "all employees who may reasonably be expected to receive benefits under a pension plan should be included in the cost calculations, giving appropriate recognition to anticipated turnover." Opinion 8 allows the exclusion of such employees only if the effect is not materia

Paragraph of Section 1.412(c)(3)-1	Comment
	It is common practice, but not universal practice, to exclude employees who are not yet participants, since the cost is usually not material in light of the high turnover of such short service employees. Therefore the regulations, which do not appear to have any authority from ERISA, should allow both alternatives, rather than force plans to adopt a weaker funding approach.
	This paragraph should also be clarified not to exclude beneficiaries with a contingent right to future benefits, e.g. the spouse of an active participant who may eventually become entitled to a pre-retirement survivor annuity. Perhaps, wording such as "and all other individuals currently or <u>contingently</u> entitled to benefits under the plan" would be appropriate.
(f)(2)	This exception should be clarified for the use of whole life policies (or similar policies) plus a side fund in funding pension benefits as opposed to term insurance for a death benefit. Expand the exception as follows "......, the cost of a pre-retirement ancillary benefit may equal the term insurance premium paid for that benefit under a term insurance contract or reflect the costs implicit in the premiums paid for whole life or similar policies."
(f)(4)	It should be clarified whether the 5% safe harbor applies to <u>all</u> or <u>each</u> ancillary benefit funded. A somewhat higher percentage might be appropriate, particularly if it applies to all. Also the regulations should make clear that the total plan costs should be on a "no assets" basis. There could be excessive computational expense to determine safe harbor limits if it is not clarified that approximations are suitable for testing purposes.

Paragraph of Section 1.412(c)(3)-1	Comment
(g)(2)	Changes in method made in order to first comply with the regulation should not require advance approval by IRS. Applicability of final regulations should be related to plan years rather than to when a valuation is performed.
General Comments	It is suggested that the regulations contain a transition rule covering plan sponsors who may suffer hardship in switching from a no longer approved method to an approved method. A transition period of, say, five years may be suitable with the graduation up to the approved method on a straight line basis with respect to normal costs, past service contributions, or both.