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PANEL DISCUSSION

RELATIONSHIP BETWEEN ACTUARIES AND CERTIFIED PUBLIC ACCOUNTANTS

Panel Members:

ROBERT G. ESPIE, *Moderator*
WILLIAM A. DREHER
ALFRED N. GUERTIN
B. RUSSELL THOMAS

ROBERT G. ESPIE:

Our panel discussion today deals with the relationship between actuaries and certified public accountants. It is our intention in the course of this discussion to bring to light some of the areas in which these two professional bodies have collided or are in danger of colliding.

Broadly speaking, the areas of difficulty are of two kinds. The first deals with the problem of certification by certified public accountants of the annual statements of insurance companies, whether for reports to stockholders or policyholders or to government regulatory bodies.

The second principal area is in the pension field. It deals with the problem of determining the proper charge against income for the current costs of pensions—a problem which involves the question of the measurement of that cost and the measurement of the related liabilities.

Our panel includes three gentlemen who have special qualifications in these fields.

Mr. William A. Dreher, a Fellow of our Society, is located in New York as a principal in the actuarial division of the national public accounting firm of Lybrand, Ross Bros. & Montgomery. In this capacity he is responsible for actuarial aspects of life insurance company audits, and he participates in the research leading to the Lybrand firm's positions on matters of insurance company accounting. Mr. Dreher has been close to the development of Lybrand's research on pension accounting and is in close association with Frederick P. Sloat, a Fellow of the Society, who has also been working with the American Institute of Certified Public Accountants in pension accounting research. Another qualification of Mr. Dreher is his current assignment with the Education and Examination

Committee of the Society in the co-ordination of a joint effort between the Society and Lybrand for the production of a textbook on insurance company accounting.

Mr. Alfred N. Guertin has been actuary of the American Life Convention since 1945, previous to which he served for thirteen years as actuary of the New Jersey Department of Banking and Insurance. In his work with the New Jersey Department he acquired a very considerable experience in the matter of examination of insurance companies and pension funds and in his current position with the American Life Convention has been very active in the work of the Blanks Committee and related fields dealing with insurance company annual statements. He has taken a very active role in recent discussions between insurance industry representatives and CPA's, of which you will hear more later. The "Report of the Actuary of the American Life Convention," an annual contribution by Mr. Guertin to our knowledge of the state of affairs within the industry, has in each of the last two years signaled the concern which he has felt over our problems in the accounting field.

The third member of our panel is Mr. B. Russell Thomas, a Fellow of the Society and vice-president and actuary of The Wyatt Company. Mr. Thomas has had a varied background with state insurance departments, consulting work, and a large company in the East before joining The Wyatt Company in 1955 in Chicago, where he is now also a member of the company's Board of Directors. Mr. Thomas brings to this discussion his experience during the past four years as a member of a project advisory committee of the American Institute of Certified Public Accountants, studying accounting for the cost of pension plans.

ALFRED N. GUERTIN:

I have a question for our Moderator, Robert G. Espie, but before I put it to him I would like to point out that he too has had a very broad experience in this field. He is the chief accounting officer of the Aetna companies; he has had experience in the life insurance field and in the property insurance field as well. He has also been a stalwart on the Blanks Committee of the American Life Convention and the Life Insurance Association of America, and he has served on the Blanks Committees of the property insurance organizations. In addition to that, he has also been one of the representatives of whom I will speak later in connection with the discussions with the American Institute of Certified Public Accountants, which we will be designating as AICPA.

And now, Mr. Espie, might it not be well for you as Moderator to give us the background of the current situation on certification of insurance company annual statements.

ROBERT G. ESPIE:

It started at least as far back as 1957. In that year AICPA formed an Insurance Accounting Committee for the purpose of exploring the areas where the services of CPA's might be jointly availed of to mutual advantage by insurance companies and the governmental regulatory bodies having jurisdiction over them.

This committee was comprised entirely of members of AICPA, including accountants who had had considerable experience in insurance accounting areas. Although the committee initially included two CPA's who were in the employ of insurance companies, no specific contact was made with the insurance industry as such, with the actuarial profession, or with any of the insurance accounting organizations.

This committee deliberated at some length, concentrating in the fire and casualty field, and published in November, 1960, an exposure draft of an "Audit Guide for Fire and Casualty Companies." This audit guide was sent around for review to a substantial number of fire and casualty companies and their associated accounting organizations. The reaction was prompt. The principal organizations of the fire and casualty companies and the industry accounting groups condemned the audit guide on several counts. A second draft containing the bulk of the objectionable items was later circulated. The audit guide has not yet been officially published.

The next major move occurred in the fall of 1962, when the Accounting Principles Board announced to the membership of AICPA that henceforth industries subject to governmental regulatory authorities, including banks, railroads, insurance companies, and the like, would nevertheless have to prepare their financial statements in accordance with generally accepted accounting principles and that CPA's would not be allowed to certify to them without taking exception for deviations from these generally accepted accounting principles. In practice this meant that insurance companies could no longer get the form of audit certificate which had been customary, which used language such as "a fair presentation in accordance with insurance accounting practices as prescribed or permitted by state insurance authorities." This pronouncement was, to the best of my knowledge, not discussed with any representation from the insurance business, and for many insurance companies the first inkling of its existence was when CPA's presented their certificates in connection with 1962 annual reports. Again, the insurance companies objected, since they felt that they were doing nothing differently from what they had done in the past, their statements met the requirements of the laws under which they operated, and they had not been consulted as to the validity or relevancy of the so-called generally accepted accounting principles.

The objections were so great at this time—and since there were also rumors of revival and distribution of the so-called audit guide for fire and casualty companies—that senior officers in the insurance industry organizations arranged to get together with senior officials of AICPA to explore the problem. Mr. Guertin was one of the senior and knowledgeable industry officials who were drawn into this discussion.

However, before asking Mr. Guertin to tell us about subsequent action in the field of certification and the audit guide, I would like to ask Mr. Dreher to tell us about the American Institute of Certified Public Accountants. How large is the AICPA and what are the membership requirements? What are its objectives and how does its code of ethics operate?

WILLIAM A. DREHER:

The AICPA now has about 50,000 members. This is about five-eighths of all the CPA's in the country. Of that 50,000, about 35,000 are in public practice.

To become a member of the AICPA, one must first be accepted by one of the fifty states or the District of Columbia as a certified public accountant and, in addition, must have at least two years of practical experience in public accounting. The requirements of the several states are not identical but are increasingly becoming uniform. They are of three types: examination, education, and experience.

The examination requirement is already uniform. The examination, which is set and graded by the AICPA, is given semiannually. It includes four separate examinations lasting a total of approximately twenty hours: accounting theory, auditing, commercial law, and accounting problems.

The experience requirements relate to experience in public accounting under the supervision of a CPA, and in the large majority of states are one to three years. In all circumstances there must be two years of public accounting experience to join the national body.

The education requirements vary widely. A majority of states require a college degree, including several courses in accounting. About one-third of the states will accept a high-school diploma. Of the other two-thirds, many will accept the high-school diploma in lieu of the college degree if the candidate has a longer experience in public accounting.

The AICPA has two principal objectives which closely parallel those of our profession. Their intent is to unite the accounting profession and to promote and maintain high professional and moral standards. These objectives are accomplished through two means. The first is the guidance provided by the standing committees of the AICPA, of which the most important are the Accounting Principles Board and the Committee on Auditing Procedure.

The other means of the Institute in accomplishing its objectives is through its Code of Professional Ethics, which is quite similar to the Guides to Professional Conduct of our Society, but is more strict in two areas—independence and advertising. In order to be independent of one's client, one can neither be an officer nor a director, nor may one own stock in the company, either directly or indirectly. As to advertising, I think one can sum it up by saying that much greater modesty about areas of special competence or one's availability to the public is required of the accountant.

One of the primary objectives of the organization is to define what are known as "generally accepted accounting principles" for the guidance of its members. It may be of value to explain how they are developed, how one may determine what these principles are, and how they work.

A generally accepted accounting principle is often a broad guide to the solution of a particular accounting problem. Frequently there is not a unique and direct solution; any of several alternatives may be satisfactory in a particular set of circumstances. Principally, the accountant regards as a generally accepted accounting principle an opinion given by the Accounting Principles Board or a bulletin released by its predecessor committee, the Committee on Accounting Procedure. There are, however, other sources of what is "generally accepted" to which the accountant may look. One does, after all, look to the objectives of a professional body and to the purposes it is trying to accomplish. I should describe the way in which the Accounting Principles Board of the American Institute works, because the individual practitioners are constantly looking to the main national body for guidance.

The Accounting Principles Board, which is composed of leaders in the accounting profession, prominent businessmen, and educators, has a full-time research department to which it assigns the investigation of particular problems. The research staff, often augmented by a project advisory committee consisting of accountants and others who are particularly conversant in a particular field, analyzes the problem and prepares a study which is distributed in preliminary form to certain accountants and to companies which may be affected by its conclusions. After receiving their comments, the report and its conclusions may be modified before publication on the authority of the Director of Research of the AICPA. The published study is available to all who wish to obtain it, and readers are invited to express their views in writing on its conclusions and recommendations. After publication, the Accounting Principles Board considers the study, together with the comments thereon, as a basis for a decision to either issue an "Opinion" or to refrain from doing so. Incidentally, any opinion issued by the Board need not necessarily agree with the conclusions in the related study. If the APB elects to issue an "Opinion" on the subject, it must obtain the affirmative vote of two-thirds of the members of the Board. Members of the Board may give a written statement of their dissent, which is published as part of the "Opinion." The broadly based membership of the Accounting Principles Board and the extent of its research activities indicate the seriousness with which the accounting profession views the problems of determining and communicating generally accepted accounting principles.

In October, 1964, the Council of the AICPA, which is comparable to our Board of Governors, gave further weight to the decisions of the Accounting Principles Board by declaring that members of the AICPA must, in reporting on financial statements for fiscal years beginning after December 31, 1965, disclose departures from accounting principles as defined by the APB or its predecessor committee, even though the member believes that the principles used in the preparation of the financial statements have other substantial authoritative support.

It has been said by some that accountants have endeavored to determine generally accepted accounting principles applicable to insurance companies without consideration of the views of the insurance business. However, as I understand the history of the "Statement on Auditing Procedure Number 32," the accountants were attempting to develop a general guide for use by their members and applicable to all the statements upon which an accountant might be asked to give an opinion, irrespective of the particular kind of business. Only one or two paragraphs of that statement specifically relate to regulated industries as a whole. No specific statement was made about the insurance industry in particular. In my opinion, Statement 32 was intended to consolidate the thinking of the profession on a major aspect of its professional responsibility, but, in the effort for completeness, a very important special industry situation did not get sufficient treatment.

It has been said that not only did the accountants not take the insurance people into the discussion but they did not take in any of the other industries either. However, I do not believe that would be a fair conclusion. You must remember that nearly all other industries have financial statements routinely audited by CPA's. Not only is the accountant more familiar with the accounting practices of those industries, but there are channels of communication between the industry and the accounting profession. In my view, the accounting profession made two errors in its approach to reporting requirements applicable to the insurance industry. They failed to recognize that another profession, namely, ours, had longstanding functions and interests in the insurance industry. And, in the second place, they did not give proper recognition to the fact that their position within the insurance industry was nominal by comparison to that in other industries.

These are some of the difficulties which have been in the background of the discussions with the AICPA. We spoke about the "Statement on Auditing Procedure Number 32" issued by the Committee on Audit Procedure of the AICPA. I wonder, Mr. Guertin, if, in accordance with Mr. Espie's earlier question, you would describe the events since that time insofar as they involve the life insurance companies and that organization.

ALFRED N. GUERTIN:

Statement 32 affected both property insurance companies and life insurance companies. The latter had not had any discussions with the accountants but were drawn into them when it became apparent that for 1962 and 1963 certifications of annual reports by certified public accountants would not be satisfactory to the life insurance companies. It will be recalled that this rule says in effect that in the audit of regulated organizations, departures from "generally accepted accounting principles" must be noted in the certifications. The effect of this is that a corporation in a regulated industry must publish statements in a form and according to standards prescribed by the regulatory agency and bear a penalty imposed by the accounting profession merely for complying with legal requirements imposed upon it. This seemed a little rough on the life insurance business.

Early in the year 1963, an *ad hoc* committee representing the various branches of the insurance business conferred several times to find ways of meeting this difficulty. The life insurance representatives were all members of the Society. They included, at the last writing, Robert Espie, who chairs this panel; Bruce Shepherd, president of the Life Insurance Association of America; Gathings Stewart, vice-president and actuary of the Lincoln National and Treasurer of the Society; and myself.

The first concrete result of our discussions was a meeting with representatives of the AICPA, which considered a draft of a paper by Richard C. Lytle, C.P.A., director of the Technical Services Division, AICPA, under the title "Audit Reports on Insurance Companies." This paper, which was published in the *Journal of Accountancy* for January, 1964, developed formula language for certifications of both property and life insurance company financial statements. There is no doubt that the form of certification was improved as a result of the conferences held, but, nevertheless, it still fell short of what would be acceptable to the life insurance business. The proposed language, which was intended to implement Statement 32, clearly reflected upon the accounting methods of life insurance companies. While the certifications might contain language stating that the accounts were maintained in accordance with state insurance department requirements, it was indicated that the certification must also state that the accounts were not in accordance with "generally accepted accounting principles" and indicated that the certification must list the departures from such principles.

We understand that within the accounting profession there was far from complete agreement that the Lytle suggestions represented an adequate solution to the problem. Naturally, those of us who are not accountants and were not privy to these discussions within the organization itself concluded that, coming in this way, in a regular article in a regular column which is published in the *Journal*, it was an authoritative statement.

This conclusion was understandable. However, as has been pointed out by William Dreher, the opinions of individual CPA's differ considerably on the application of generally accepted accounting principles to the insurance industry and about the form and content of the CPA's opinion on financial statements prepared by the industry.

The particular issues to which the accountants took exception, so far as life insurance accounting methods were concerned, included: (1) the valuation of bonds on other than current market; (2) the treatment of acquisition costs and other initial expenses as expenses of the current year rather than allocated to the year of benefit (in other words, there was no capitalization of initial expenses); (3) the failure to establish a liability for capital gains taxes against unrealized capital gains; (4) the charging-off of such items as agents' debit balances, furniture and fixtures, and other nonadmitted assets; and (5) the failure to set up a liability for deferred Phase

Three federal income taxes. In addition to the above, it was generally the position of some of the accounting people that policy reserves, deferred premiums, and other items involving the use of mortality tables and interest rates were determined on unrealistic bases, that is, on bases which were ultraconservative and hence resulted in unwarranted charges against current earnings. Another item that could lead to discussions is the current proposal of the NAIC to modify security valuation requirements for annual statement purposes insofar as it involves further departures from market valuations.

Property insurance companies also had their problems. The issues involved such items as an assumed redundance in unearned gross premium reserves, the use of formula bases in the calculation of loss reserves, and the practice of charging off agents' balances ninety days overdue. In the cases of both classes of companies, the accountants took exception to the practice of eliminating any credit for nonadmitted reinsurance. Perhaps, Mr. Dreher, you can tell us whether, in practical application, these exceptions are taken absolutely uniformly by all accounting firms.

WILLIAM A. DREHER:

No. There was and still is a wide variation in the reporting by CPA's on the financial statements for both fire and casualty and life companies. This variation is another illustration of a key problem that threads its way throughout the history that we have been covering, namely, a failure of communication within each of the professions, between the actuarial and accounting professions, and between the professions and the clients they serve.

ROBERT G. ESPIE:

There has been a real lack of communication. We were under the impression that these announcements which came out in the *Journal* of AICPA had been graven on stone. But we did go back and work with the Committee.

Mr. Guertin, would you like to pick up again as to the work of these two committees and the progress that they made?

ALFRED N. GUERTIN:

Yes, in May a conference was held between a technical subcommittee representing the *ad hoc* committee to which I made reference and a subcommittee of the AICPA to explore the basic nature of these items and determine if a common approach might be developed. It is my belief that these discussions were helpful to both sides. It was apparent, however, that a complete meeting of the minds was not possible. Obviously, there were certain fundamental differences in concept that would make agreement difficult. However, there certainly will be further conferences, out of which, we hope, constructive action on both sides may be possible.

It is obvious to any actuary, of course, that it is impossible to compute the earnings of a life insurance company without the making of certain assumptions as to future experience under the existing policies. Under our present system of accounting, as laid down for us by the state governments, these assumptions must be on "conservative" bases. A security analyst, representing stockholder interest, however, is faced with exactly the same problem except that he is interested in "most probable" assumptions rather than "conservative" assumptions as to future experience. The accountant finds himself attempting to rationalize these two requirements with the needs of sound accounting and "generally accepted accounting principles." The supervisory authority is interested in solvency and the basic soundness of the enterprise. The analyst is interested in the value of the company to its stockholders and the level of annual earnings. The accountant, in seeking to serve both, finds himself in a dilemma.

Mr. Dreher, do you think that there is any way of reconciling these two basic points of view from an accounting standpoint? What can be done with respect to the several items which I have mentioned as causing trouble for us?

WILLIAM A. DREHER:

I think we first have to get a better understanding of the function the accountant is attempting to perform. As you have indicated, Mr. Guertin, it is directly and closely related to the interest of shareholders in the company upon whose financial statements he is giving an opinion.

I think we can identify a significant difference between the viewpoint of the actuary and the viewpoint of the accountant by emphasizing that the actuary traditionally looks to the balance sheet to measure the financial position of a company, whereas the accountant gives much less importance to the balance sheet but rather stresses the income statement.

ROBERT G. ESPIE:

This is, of course, one of the fundamental problems we have, as you know, because the NAIC statement aims at solvency. Earnings are an incidental thing by which you get from solvency at one end of the year to another. The accountants look at this from quite the other point of view. Their emphasis is on earnings.

Mr. Dreher, tell us what progress can be made in this reconciliation. Take the case of the use of the amortized value of bonds. What has happened there since they came out with the "Statement on Auditing Procedure Number 32"?

WILLIAM A. DREHER:

There is some evidence of a better meeting of minds. Even at the time Statement 32 was issued, there was some feeling within the profession that it was quite proper to use amortized cost of bonds. I would say that, since that time, it has become generally recognized among accountants that amortized cost is the proper method of valuing those investments.

Acquisition costs constitute a much tougher problem. Here, I think, we have a good example of the way in which effective communication between the two professions can be achieved. There are some accountants who still feel that the amounts by which first-year costs exceed renewal levels represent a prepaid expense that should be set up on the books of the company and spread over future years. But a very different approach which has received considerable recognition among other firms and by the Committee on Insurance Accounting and Auditing Procedure of the AICPA is the view that one must consider all the costs of an insurance policy and must examine those costs over the policy's lifetime. It is not sufficient merely for one to look at expenses such as commissions, which may be considerably higher in the first year than in renewal years; one has to look at all the cost elements which are not evenly distributed over the first year and the renewal years. Specifically, one has to consider the reserve valuation method also. An item of particular importance to the small company is the treatment of reinsurance premiums.

The consequence of this analysis is that it is not necessary for a well-established life insurance company to set up as an asset any amounts by which the combined effect of first-year costs may exceed renewal levels because the effect on the income statement may be nominal. This does not prevent the booking of acquisition costs which might exceed renewal levels, but some feel that it is an oversimplification to look merely at the excess of first-year over renewal commissions. Such an approach would require a gross premium valuation that considered all the future expectations under the policy and considered possibilities for excess mortality, the effect of renewal expenses, and reserve methods, among others.

This view about the proper accounting procedure for small insurance companies is an indication that the accountant, like the actuary, also has an interest in conservatism. The conservative accountant views it as actively dangerous for a new and rapidly growing company to consider booking initial costs which may exceed renewal levels, and he would not consider it sound accounting procedure to do so. It may, however, be proper to disclose the amount of such additional first-year costs in a footnote to the statements.

Reserves and their bases are another area of discussion. I believe that the accountant has an obligation to form his opinion on the financial statements as a whole—and this includes the reserves—but I believe that he must rely on another expert, the actuary, for an appraisal of their proper amount. I can attest from my own experience that the accountant accepts the actuary as an expert in the insurance field and is prepared to rely upon the judgment of an independent actuary in evaluating the reserves and other actuarial items in financial statements.

Mr. Guertin, possibly you would comment on the impact of some of these CPA requirements on state insurance departments and on other regulatory reporting.

ALFRED N. GUERTIN:

The time may not be far distant when we must recognize that annual statements to the state insurance departments are not the only reports we must file with governmental bodies. And it could be that some of them might be in conflict with those of the states. In addition to the annual statements filed with state insurance departments, we have (1) registration statements filed with SEC, differing from annual statements with respect to companies seeking capital publicly; (2) annual reports to the SEC by some companies; (3) special reports to be filed with the Department of Defense by companies seeking to do business on military reservations and in which capitalization of acquisition costs is recognized in calculating earnings; (4) provision for data relating to employee benefit plans to be provided by insurance companies to be filed by employers with the Department of Labor; and (5) developments in governmental studies in the pension area which suggest the possibility of valuations and certifications as to the adequacy of funding of pension plans.

The advent of the Securities and Exchange Commission into the picture cannot be ignored. Recent legislation limits accounting requirements to those falling within the annual statement. There is nothing to prevent the SEC from asking the NAIC to add material to the annual statement blank. And a request from this source could be almost a demand, so we should not be surprised to see substantial changes in our statement forms in the next few years. While aimed at stockholder interest, it is always possible for the quest for uniformity to cause a spillover into mutual operations.

In addition to this, we cannot ignore the needs of the security analyst who represents the stockholder and the interest of the investing public in the hundreds of new life insurance companies that have been and are being organized. All the groups I have mentioned have a legitimate interest in our accounting practices. Somehow, we must find ways of satisfying it.

B. RUSSELL THOMAS:

Many smaller companies, especially those stock companies whose stock has been publicly offered, are required to file statements with the SEC and, for that reason, have audits made by certified public accountants. There are also some larger companies, including mutuals, which have audits made by CPA's, even though they are not required to do so for filing with the SEC. There is no single procedure followed by certified public accountants in auditing life insurance companies, regardless of the size and circumstances surrounding the audit. There are at least five variations in procedure.

1. A few certified public accounting firms have actuaries on their own staff and may have a verification of the reserves made by staff actuaries. The audit report may or may not indicate that the reserves were verified by the accounting firms' staff actuaries.

2. Some certified public accounting firms have a working relationship with one or more consulting actuarial firms under which the insurance company's reserves are verified by the consulting actuary and are accepted by the public accounting firm.

3. A few public accounting firms make their own check of reserves, even though they do not have actuaries on their own staff and do not utilize the services of a consulting actuary in such verification. They use test-check procedures similar to those used on other liability and asset items and discuss problems and questions which they may have concerning the valuation procedures and factors with the company's actuary, who may be either a staff actuary or a consultant.

4. The certified public accountant may accept policy reserves as certified by the state insurance department.

5. The certified public accountant may accept the reserves as com-

puted by the company's staff actuary or consultant, which is the usual practice in Canada.

WILLIAM A. DREHER:

As an actuary working with accountants on behalf of clients in the life insurance industry, I am often asked what the actuary does in connection with an audit by a certified public accountant. I am also quizzed as to his independence with respect to the accountant and with respect to the client.

I think it would be helpful, first, to give a brief description of what the certified public accountant is attempting to accomplish and then to draw an analogy to the role that the actuarial division of the public accounting firm would play in participating in such an audit.

There are three cardinal rules, in my view, that govern the CPA's conduct of his engagement. He is trying to get a proper matching of revenues and costs, and he wants assurance that there will be consistency in the application of generally accepted accounting principles from year to year. But, in judging the results that are achieved in applying these standards, he applies a test of materiality. In other words, he makes no attempt to arrive at an answer which uniquely and exclusively represents the results of operations or the financial position of a company at a given time. The CPA's concern is to have a fair presentation of operating results; he applies standards of a knowledgeable and reasonable man. In executing his engagement, he is not trying to reproduce all the books of account or to follow every transaction through the company's records. He wants to be satisfied that the company has established acceptable accounting procedures and to verify by testing that specific items have been properly recorded.

Similarly, as an actuary reviewing the actuarial items of a balance sheet or operating statement, I would be concerned that they were determined in accordance with the valuation bases or estimation techniques that have been established by the company and that the end results fairly present the application of those actuarial bases and methods to the insurance in force.

ROBERT G. ESPIE:

Now, Mr. Thomas, let us turn to the problems of the actuary in the pension field. How do the responsibilities of the actuary in the pension field differ from those of a company? Are his responsibilities to his client quite different from those of a company actuary to his company?

B. RUSSELL THOMAS:

In the field of corporate pension plans, there are several points which involve both the actuary and the certified public accountant. These include the following:

1. Determination of the accounting charge of pension costs for the year. The actuary makes the basic cost calculations and may recommend the amount to be contributed. The accountant may also make a recommendation as to the amount to be contributed to the pension fund or accrued on the company's books.

2. The SEC requires disclosure of (*a*) changes in the pension plan, (*b*) changes in the cost method or assumptions, (*c*) the amount charged as pension expense, and (*d*) the amount of unfunded prior-service cost. The actuary furnishes the accountant this information to be filed with the SEC.

3. Many companies include in their reports to stockholders the same information which is required to be filed with the SEC. As in the case of the SEC filing, the actuary furnishes the information which is reviewed by the accountant for inclusion in these reports.

4. Financial reports of certain welfare and pension trust funds are required to be filed under federal and state disclosure laws. Under certain circumstances, these reports are required to be signed by a certified public accountant. Many of these reports are required to include a statement of the actuarial cost method, actuarial assumptions, and costs. This information must be supplied by the actuary, but no signed statement is required.

In connection with pension costs, we find that many certified public accountants recognize that the actuary has special skills which enable him to make calculations involving life contingencies, but in many cases the accountant insists that determining the proper accounting charge is the responsibility of the accountant rather than the actuary. The accountant concedes that an engineer may be able to make a better estimate of the life of an asset than an accountant, but the accountant rather than the engineer is responsible for determining the proper depreciation charge for the asset. A similar position is taken concerning the actuary and pension costs.

For many years the AICPA has had guidelines for the handling of pension costs in the financial statements of employers. The rules now in effect are set forth in "Accounting Research Bulletin Number 47," published in 1956. In my opinion, the most important provisions of this bulletin are as follows:

1. Pension costs should generally be treated as business expenses incurred in contemplation of present and future benefits. The cost of past-service benefits should, therefore, not be charged to earned surplus when the plan is adopted.

2. The cost of past-service benefits should be charged to operating expenses over a period of time, such as twenty or thirty years.

3. As a minimum, the accounts and financial statements should reflect accruals which equal the present value of vested pension benefits reduced by any accumulated trusteed funds or annuity benefit purchases. This rule concerning the value of vested benefits has created more confusion than any of the others, because in most plans vesting is contingent upon the adequacy of the pension fund. There is also a question as to whether a company is required to set up a liability on its books if it is making regular contributions toward the past-service liability.

4. Pay-as-you-go method of accounting is permissible where there is an informal arrangement for voluntary payments.

"Accounting Research Bulletin Number 47" was published, as I said, in 1956. There have been some developments since that time.

About four years ago the AICPA began work on a research project on accounting for the cost of pension plans. It was intended that this project would ultimately lead to the adoption of a new accounting research bulletin on pensions which would be more satisfactory to the accountants than the present Bulletin No. 47.

As Mr. Dreher explained, the Accounting Principles Board determines which research projects are to be undertaken and makes the final decision concerning generally accepted accounting principles. When a research project is undertaken, the Director of Accounting Research, with the approval of the Chairman of the Accounting Principles Board, appoints a Project Advisory Committee which suggests sources of information, reviews conclusions of research staff members and ultimately reviews the draft of the report, and determines whether it is suitable for publication. The individual who has direct responsibility for conducting the research may be (*a*) a member of the research staff of the Institute, (*b*) an accountant in an academic position who is given a single assignment, or (*c*) a research accountant with a major accounting firm.

When originally instituted in the fall of 1960, the project "Accounting for the Cost of Pension Plans" was assigned to one of the members of the research staff of the AICPA. The Project Advisory Committee originally consisted of four representatives of accounting firms which are in the "Big Eight," two financial executives of giant corporations, an attorney, and a Fellow of the Society of Actuaries. I was the sole representative of the actuarial profession on the committee during its first three years of existence. About a year ago, after some other changes had been made in membership of the committee, Sylvester Huse, an Associate of the Society, and another industry representative, who has an actuarial background but is not a member of the Society, were appointed to the Committee.

In the fall of 1960, the Society and the Conference of Actuaries in Public Practice each appointed a Committee on Accounting for the Cost of Pension Plans. These committees expected to work with the accountants' research staff and also to do some independent research of their own. The Society committee, under the chairmanship of Frank Griffin, had several meetings and explored a number of possible methods of determining the "standard cost" of a pension plan. I understand that the attempts of the committee to meet with and to influence the research staff as it existed during the first three years of this project of the AICPA were not very successful but that the circumstances since that time have improved considerably.

During the first three years the accounting project was under way, the Director of Accounting Research presented two drafts of a report. Both presented a highly theoretical approach to the problem, and neither was considered acceptable by the members of the Project Advisory Committee. In 1963, after summaries of the proposed recommendations of the accountants were submitted to two hundred corporations for comments, Frank Griffin's Society committee distributed its "suggested guidelines" to the major accounting firms. His committee's recommendations are essentially those which appear under "Practical Considerations" in Preston Bassett's paper, which will be discussed today. Mr. Bassett's paper appears to be very timely, and there have been developments since the guidelines were distributed.

In the summer of 1963, a new Director of Accounting Research was appointed, and the project was reassigned—this time to a research accountant with one of the major firms. The June, 1964, draft of the report prepared by this accountant has been accepted by a majority of the members of the Project Advisory Committee as being appropriate for publication, although individual members may dissent on specific points. After publication of the report, the Accounting Principles Board will consider it and determine whether to accept it as the generally acceptable basis for accounting for the cost of pension plans.

The June, 1964, draft of the report recommends that (1) the accrual basis of accounting be used for pension costs; (2) provision be made annually for the normal cost of the pension plan; (3) past-service cost be taken into expense in substantially equal annual amounts over a period of ten to forty years; (4) actuarial cost methods now in use, except terminal funding and pay-as-you-go, be accepted for use in accrual accounting, but preference for the entry-age-normal method is indicated; (5) actuarial gains and losses be spread over the current year and future years; (6) appreciation or depreciation of common stocks whether realized or not be recognized in estimating pension costs; and (7) if the recommendations concerning costs are adopted, special pension disclosures would ordinarily not be required in the company's financial statement.

The purpose of all but the last of these recommendations is to produce a greater uniformity of pension costs in the income statement than might be produced under "Accounting Research Bulletin Number 47" and the practices of many companies. The entry-age-normal cost method is preferred because it is the method of the going concern, which tends to produce greater consistency of costs from year to year. The recommendation that actuarial gains and losses be handled on a spread basis would also have the effect of producing more consistent costs from year to year than would the present Internal Revenue Service rules, under which experience gains are frequently offset against the following year's contributions. The recognition of appreciation and depreciation in the value of common stocks is also intended to produce greater consistency of costs from year to year. The recommendation concerning disclosure was made because it was recognized by the accountants involved in this research project that the past-service liability in a pension plan merely constitutes an item which the actuary uses in arriving at the contribution or cost accrual for an accounting period and that the amount of such liability depends on the cost method used rather than on the status or soundness of the pension plan.

There has been some improvement in the relationship between the AICPA and the actuaries. It is my understanding that no actuaries were consulted by the accountants in the development of "Accounting Research Bulletin Number 47" in 1956. As a result, many questions were raised after release of this bulletin. The appointment of an actuary to the Project Advisory Committee in 1960 indicated *some* degree of recognition of the actuarial profession. A more co-operative spirit was displayed after the appointment of a new Director of Accounting Research in 1963. This was evidenced not only by the appointment of additional actuaries to the committee but also by the many discussions between the accountant in charge of the research project and certain members of the Society's committee and other actuaries.

It is my personal opinion that a great deal of progress has been made in establishing a co-operative spirit between certain accountants and certain actuaries as a result of this project of the AICPA. Actuaries have come to recognize the viewpoint of the accountant and to appreciate the problems encountered by the accountant in attempting to produce accurate and consistent statements of income from year to year. An appreciation of this problem may result in actuaries changing their recommendations concerning contributions to a pension fund so that (*a*) there will be less friction between the two professions; (*b*) there will be less need for the accountants to insist upon accrual of pension costs on the books in a different amount than is contributed to the pension fund; and (*c*) there will be less need for footnotes explaining year-to-year changes in the company's practices.

ALFRED N. GUERTIN:

We have discussed two issues here at some length, and I would like to bring up a third issue. We have not discussed the company federal income-tax situation, but I think that this is one where some co-operation is needed. First, the accountant and his knowledge of the application of tax law to business and industry generally is of great value to the life insurance business because of the vast body of experience that has been built up. Second, the actuary, with his expert knowledge of the operations of the life insurance company, is in a position to project the impact of taxes on developments in his own company and, in addition, is able to interpret the impact of regulations and of the law with respect to the companies themselves. Both the accountant and the actuary should always work in close contact with a tax lawyer, and we have here a team of three different professions, each of which makes its own unique contribution to the solution of problems which are very important to our companies and in which each performs a distinct function.

ROBERT G. ESPIE:

Let me introduce another thought here, and that is that through most of the comments made by Mr. Dreher and Mr. Thomas we continually run into the problem of the independence of the certified public accountant and the independence of the actuary. How can an actuary claim to be completely independent when the firm for which he is working is actually a part of another company such as a public accounting firm? Is he really independent of his employer? Is he any more independent of his employer than a staff actuary is?

WILLIAM A. DREHER:

Before merging our practice with Lybrand's, we had clearly in mind our professional responsibilities under the Guides to Professional Conduct. The introduction to the Guides points out that the Society's constitution does not define exclusively what represents proper professional conduct, but it does clearly imply that the actuary has professional responsibilities to his professional associates. It is our view—and I speak for all the actuaries who are the principals of the firm—that an actuary cannot associate properly and effectively with a certified public accountant unless there is full professional parity within the business relationship. Let me describe briefly the organization of our firm and how we feel that we have met our responsibilities under the Guides.

We have an actuarial division operating directly with our clients within the sphere of our professional competence in the same manner as partners operate in the accounting practice. The division is headed by a Fellow of the Society of Actuaries, and others of us who are principals of the firm manage and direct the affairs of our clients with respect to actuarial matters. I should mention that we are principals; we are not partners, because it is not legally possible to practice as a certified public accounting firm unless all partners are CPA's. But it is our firm's standard that anyone who is admitted as a principal must possess all the personal qualifications, including specialized education, training, and experience in his particular field of competence, which would be required for admission as a partner, except that he is not eligible to qualify for the CPA certificate.

We also recognize that, while it is necessary to have the proper organizational and interprofessional relationship, we must make the proper representation of that fact to the public. In this connection, No. 11 of the Guides influences us in our preparation of reports to our clients. It states: "The member will recognize his ethical responsibilities to the person or organization whose actions may be influenced by his professional opinions or findings. When it is not feasible for the member to render his opinions or findings direct to such person or organization, he will act in such manner as to leave no doubt that the member is the source of the opinions or findings and to indicate clearly the personal availability of the member to provide supplemental advice and explanation."

Let me illustrate how we apply that Guide in our work for life insurance companies. The accountant's opinion, which is signed by Lybrand, has within it a phrase that says: "Our examination included an examination of policy reserves and other actuarial items by Fellows of the Society of Actuaries." Other firms do not do this. A typical statement used by some other accounting firms is to say: "We have made such tests of the accounting and actuarial records as we deemed necessary in the circumstances."

Supplementing this reference to our professional competence, we deliver a report to the board of directors of our client which elaborates on the actuarial items. This report is presented in the name of Lybrand, Ross Bros. & Montgomery, but is signed by one of us who is a Fellow of the Society of Actuaries and a principal in the firm.

ROBERT G. ESPIE:

But does this protect the client, particularly a company like ours that writes group annuities and group insurance, if you audit its books and also serve as consulting actuary to an organization that may be thinking of a group annuity plan? I think you could use privileged information developed from the audit to take unfair advantage of us in competition with other insurers or with trusteed plans for which your firm would do all the actuarial work.

WILLIAM A. DREHER:

You have the assurance provided by our Society's Guides to Professional Conduct—to which we are both subject. There is an additional assurance in dealing with an organization such as ours in that we have to comply with the more severe of the standards set by the accountants and those set by the actuaries. Number 4 of the Guides indicates: "The member will act in professional matters for each client or employer with scrupulous attention to the trust and confidence that the relationship implies and will have due regard for the confidential nature of his work."

As employee benefit consultants, we successfully work with many clients in the same industry without revealing the confidential nature of information we receive from one which may have some interest to the other. Similarly, in dealings with insurance companies, we stand comfortably before them and are satisfied that we are not impairing the interests of one through information we have from another.

Coming to the nub of your question, Mr. Espie, namely, the interplay between the actuary who renders professional assistance in the audit of an insurance company and at another time serves as consulting actuary for an industrial company which is investigating the choice of an insurance company to underwrite a group annuity, as you already know we routinely ask the insurance companies for detailed information about premium rates, dividend formula practices, and the entire operation of a proposed contract. We already feel we have sufficient and reliable information in order to advise our clients. I might add here that one of the reasons why our firm tries whenever possible to deal directly with the actuaries of an insurance company is that we know that actuaries are obligated by the Guides to furnish full and complete information in response to our questions.

In summary, I believe that insofar as our profession is worthy of its name and we, as individual members, are abiding by proper professional standards, your fears are groundless.

The problem is not one of competition between those of us in private practice and those of you who are officers of insurance companies but rather the competitive posture of one insurance company compared with another.

ROBERT G. ESPIE:

We have discussed two areas in which there appears to be a current conflict or a danger of conflict between certified public accountants and actuaries. We have raised a lot of questions to which we do not profess to have answers. I do want to say, however, as a sort of conclusion to this discussion, that we have one very valuable theme running through both of these areas of difficulty. Namely, in the matter of pension valuation and accompanying financial presentation the actuaries and the certified public accountants have worked out quite early in their discussions a common meeting ground, so that information and points of view can be exchanged. The result has been the avoidance of many pitfalls and the achievement of substantial progress toward a satisfactory working relationship. In the field of certification of insurance company statements we have only recently devised a basis for contact between the two professions. However, that contact has been established, and we hope by means of it to bring together the areas where the one profession impinges on the other and through mutual exchange of information and points of view achieve a more harmonious relationship.

Opinions differ as to how optimistically we should view the outcome of joint discussions between actuaries and accountants. Some feel that the prospects are very good for an extremely useful meeting of minds. There are others who feel that the hurdles to be overcome are so great that it will be a very long and hard road indeed. Personally, I recognize the hurdles, but I would like to be classed among those who are optimistic that between us we can iron out any differences.

A very appropriate comment in this respect was made at the recent meeting of the International Congress of Actuaries by Mr. J. A. T. M. Brans, a consulting actuary from The Netherlands. In effect, he said that the management of an insurance company or a private pension plan may ask a statement of a public accountant who is not an expert in actuarial work and a statement of an actuary who is not an expert in accountancy but only a common signature of a public accountant and an actuary together can provide a satisfactory objective statement about the position and continuity of the insuring institution. An accountant who is a sensible layman in the actuarial field and an actuary who is a sensible layman in the accounting area can, between them, by collaboration, arrive at a right solution, and that is what we are striving for.

An informal discussion period followed the presentation by the panel members, during which the Moderator invited comments and questions from the floor. The principal discussion, reported below, concerned the possible conflict of interest facing the consulting actuary associated with an accounting firm.

MR. BLACKBURN H. HAZLEHURST: Mr. Bassett in his paper presented this morning on the subject "Accounting for Pension Plan Costs" says that "the independent public accountant is responsible for his opinion on . . . all the figures in the statements, including the amount recorded for the cost of a pension plan. However . . . it will probably fall upon the actuary to advise the accountant and make the necessary computations . . . of this cost." He concludes by saying: "The corporation and the auditor should accept the certification in the form outlined above, from a qualified actuary, as evidence of the proper determination of the amount of the charge to operations."

While the actuary is best qualified to inventory and evaluate the pension costs involved, there would seem to be no reason why the actuary's work should not be open to audit to see if the results are consistent with the methods, and the methods are consistent with statements made with respect to them. It would seem unusual for the firm preparing an inventory or evaluation to also be the one to audit this. In other words, certification may be in order by the actuary, but this work should still be open to audit.

The corollary is just as true. No auditor should have any conflict of interest with respect to the figures he is auditing. Accordingly, no auditing firm should supply pension-cost calculations for the same firm for which it acts as auditor. In view of recent activities by accounting firms, it would seem that this position should be reviewed carefully and, if agreed to, should be strongly taken by the actuaries.

Conceivably there may also be room for a firm of consulting actuaries which does not accept direct assignments but which confines its activities to advice and assistance to accounting firms, other actuarial firms, etc.

MR. FREDERICK P. SLOAT: Mr. Hazlehurst's question relates primarily to the independence of an accountant rather than an actuary. An actuary may give advice to a client regarding pension funding, but he remains independent of the client so long as he does not make management decisions for the client. The same criterion determines the independence of an accountant who expresses an opinion, for the use of third parties, on the financial statements of a client. Considerable research has been done on this subject, and the accounting profession has expressed its conclusions on a similar question related to additional services provided by an accounting firm. This is summarized by the following paragraph from Opinion No. 12, on "Independence," of the Committee on Professional Ethics of the AICPA:

> In summary, it is the opinion of the committee that there is no ethical reason why a member or associate may not properly perform professional services for clients in the areas of tax practice or management advisory services, and at the same time serve the same client as independent auditor, so long as he does not make management decisions or take positions which might impair that objectivity.

Accordingly, professional independence of an accountant in joint professional practice with an actuary is assured if the actuary provides advice only regarding pension funding and does not make management decisions.

MR. DONALD R. ANDERSON: While Mr. Hazlehurst has raised an interesting point, I hope that actuaries and accountants will fulfill their responsibilities toward their respective professions with integrity and thoroughness, regardless of whether they happen to be working for the same or different firms. The actuary should not employ unreasonable assumptions which would be unacceptable to an auditor working for a different firm, nor should an auditor attempt to bring undue pressure to bear upon the actuary to use unreasonable assumptions on the basis of the actuary being employed in the same firm.

I feel that it is not a correct analogy to compare this to the question of the validity of an internal audit versus an external audit of a calculation made by an engineer in the employ of an industrial company. Obviously, the external audit has greater validity from the point of view of stockholders and other outsiders, but it is equally valid whether the calculation which is being audited is originally the work of an employee of the client, an employee of an outside consultant to the client, or an employee of the auditor's own firm. In each case, the auditor must satisfy himself as to the financial statement before he signs the certificate.

To imply that there is any lack of validity in pension calculations when actuary and auditor are working for the same firm is to imply a lack of ethics in both professions.