RECORD OF SOCIETY OF ACTUARIES
1977 VOL. 3 NO. 3

THE GROWING MAGNITUDE AND SCOPE OF PENSION SERVICES TO CLIENTS

Moderator: WALTER P. HENRY. Panelists: JOHN H. GRADY, HERBERT I. KOSLOFF, DENIS J. SULLIVAN

1. Work involving investments, including asset valuation methods, investment strategy and analysis.

2. Special actuarial calculations including minimum funding determinations, gain and loss review, selection of appropriate assumptions, and cash flow and benefit projections.

3. Services in non-actuarial areas, such as preparation of employee booklets, drafting of documents, completion of governmental forms, and development of administrative manuals.

4. Ways in which consulting firms and insurance companies are meeting the heavy volume of ERISA-related work.

5. Audits of actuarial calculations.

6. A look at new services which may be provided in the future.

MR. WALTER HENRY: It appears that the day of the cheap pension plan, if there ever was such a thing, is over. This is due both to substantial increases in benefit levels over the past few years, and to the increase in administrative expenses--primarily those due to the implementation of ERISA. Recently, I saw an estimate that the average cost of administering a pension plan had increased nearly 400% since ERISA.

This increase is not in the cost of the benefits, but in the administrative cost--legal, actuarial, communications, and so forth.

In view of this, it is appropriate to examine the scope of the services which are, and in many cases must be, provided to pension clients. Some of these may be required either implicitly or explicitly by ERISA. Some may be optional to clients. Some others may be triggered by FASB or other accounting requirements.

We're fortunate to have on our panel an actuary from an insurance company, Herb Kosloff from Equitable, as well as two consulting actuaries--Denis Sullivan of Milliman and Robertson and John Grady of Coopers Lybrand. We hope to provide an overview of the types of services which are being provided or contemplated for pension clients.

MR. HERBERT KOSLOFF: I would like to describe the types of services being provided to group pension clients by a large, eastern mutual insurance company.

The first area that I would like to address is that of services relating to investments.

A full range of investment vehicles is provided for long term fixed income, equity and short term investments. The long term fixed income vehicles consist of the insurance company's general account and various separate accounts for publicly traded bonds and for direct placement bonds which operate on an open end and closed end basis. The equity vehicles provide for common stock and real estate investments. The separate accounts are run primarily on a pooled basis.

In addition to providing investment vehicles, assistance is provided to the client by investment professionals in establishing investment objectives. These objectives are uniquely determined for each plan and depend on the expected level of benefit payments and contributions and the nature and financial condition of the business. Most importantly, they depend on the client's expectation as to yield, risk and liquidity.

Once having assisted the client in establishing investment objectives, an investment program is next developed. This would entail determining which of the investment vehicles are appropriate and what proportion of fund assets should be allocated to each vehicle. Varying degrees of discretion are delegated to the insurance company with respect to the timing and proportionate allocation of assets among the various investment vehicles.

The client receives regular reports on his progress toward his overall investment objectives. Investment performance analysis is provided on a regular basis with respect to standard indexes such as S & P 500, Dow - 30 or Salamon Bros. High Grade Corporate Bond Index. For this purpose, comparative yields are calculated on a dollar weighted basis for key historical periods.

The client is also informed on a frequent and regular basis as to the insurance company's overall economic and investment outlook as well as investment commentary for each of the separate account investment vehicles.

I would now like to discuss the actuarial services provided to pension clients.

A full range of actuarial consulting services is provided to clients who wish to avail themselves of these services. These services entail the engagement of enrolled actuaries to perform the annual valuations, minimum funding standard account determinations and Schedule B certifications, plan design, benefit evaluations and cost studies.

The impact of ERISA on the delivery of actuarial consulting services has been significant. Considerable assistance has been given in the last two years to clients to enable them to conform their plans to ERISA standards.

The valuation process has also undergone the same type of change that is typical elsewhere in the industry. Valuation assumptions have been modified to become more realistic and, in our situation, less conservative. Guidelines for Actuarial Valuation Methods and Assumptions were developed for use by the professional staff. These guidelines specify acceptable valuation methods, ranges of acceptable assumptions and inter-relationships among these assumptions. Situations which might fall outside the guidelines must be brought before a professional practices committee for approval.

In the area of asset valuation techniques, our guidelines require recognition of market value with the exception of insurance company general account funds which are valued, typically, at the contractual or book value. We have established an 80% to 120% corridor around market value and specify acceptable techniques such as moving averages of market to book, the spreading of capital gains/losses equally over say, a five year period, or a weighting of book and market value.

Gain and Loss analysis has been introduced in an increasing number of situations as an aid in verifying the valuation results and in tracking the continued appropriateness of the various valuation assumptions. Cash flow projections are becoming an increasingly frequent by-product of the valuation and are used in establishing the client's investment objectives. Another by-product of the valuation process, the preparation of individual participant accrued and projected benefits, is also being requested with increasing frequency.

In an attempt to reduce expense charges for smaller clients, triennial valuations with reduced scope, interim valuations in the intervening years have been actively encouraged.

The entire area of educating our clients about ERISA and enabling our clients to understand the requirements being placed upon them and their options for conforming to ERISA, has entailed a major effort. We have had a well organized program for this purpose, which by necessity, has placed a heavy strain on our resources. This program has been made available in part to all clients and in its totality to those clients for whom we provide actuarial services. The major elements of this "ERISA program" have been the following:

(1) Ongoing communication, in lay terms, describing the various ERISA requirements and regulations as they were released. These communications were in no way designed to replace the client's counsel, but rather to present a lay understanding of the requirements imposed by ERISA.

(2) Plan conformance to ERISA, i.e., direct contact by the field account individual to assist the client in conforming his plan to ERISA in such areas as: designating named fiduciaries, participation, vesting, Qualified Joint-and-Survivor Annuity (QJSA), service definitions, maximum benefits and so forth. This effort has entailed the drafting of plan specific documents where required and actuarial cost studies.

(3) Assistance in completing Form 5500 when required.

(4) As an insurer, the ERISA requirement for the release of the material required for Schedule A was naturally satisfied. This entailed the development of a reporting system which accessed information available on a number of data bases.

(5) Summary Plan Descriptions - case specific drafting assistance is being made available in addition to the release of a description of final regulations and "model" summary plan descriptions.

(6) Various administrative kits or manuals designed to assist the plan administrator. Among the subjects addressed by these administrative kits are ones which cover determination of Social Security offsets and optional form and QJSA factors.

ERISA has obviously created a tremendous volume of additional work which I will, for convenience, group into four broad classifications: actuarial service related, plan administration related, insurance company reporting and a fourth category that I will call "heightened awareness".

The increase in actuarial service related work occurs in an area that for us was not easily expanded and created serious backlogs and increases in throughput times. Fortunately, we have passed the peak on those demands and the backlogs and throughput times are returning to normalcy.

To meet the increase in plan administration related work, resources were drawn from other priorities and allocated to meet these demands. We're hopeful that the future level of work will be reduced over the demands of the last two years; however, we do not expect to completely return to pre-ERISA levels of activity.

The demands on insurance company reporting were, in a way, easiest to meet because they lend themselves to standardized EDP based responses rather than individualized, and therefore people-dependent, responses. Accompanying the increased reporting to contractholders has been a very substantial increase in the level of inquiries coming from client's auditors, frequently coming at the "eleventh hour" before the client's reporting deadlines. Not only has it been necessary to respond to these inquiries, e.g., for direct release of data or confirmation of previously released data, audit trail information and the "ERISA' questions re: reportable transactions, or "leases-in-default", but there has been a demanding need to educate the auditors on the "what" and "how" of the insurance company product.

The demands of the "heightened awareness" created by ERISA has placed a pervasive strain on all the available resources. It has taken the form of greater interest on the part of clients in the operation of their plan, their insurance contracts, and their investment objectives and results. It has created for us the need to satisfy this interest by education and explanation.

We have not experienced any full scale audits of the actuarial calculations we have performed. We have, however, encountered a number of situations where the auditing firm has audited the data used in the actuarial calculations.

With respect to new services, we do have some new investment vehicles under study, but little else at this time.

MR. KEN SHAPIRO: In preparing individual illustrations of accrued benefits, do you actually keep a salary history? What do you do about decrease in accrued benefits?

MR. KOSLOFF: In some situations we have salary history, in others we qualify the basis of calculation. I think you'd have to prepare an explanation for the benefit formula to show why a decrease occurred. We've had no particular problem that I know as yet.

MR. DONALD GRUBBS: There is one provision in ERISA that says accrued benefits shouldn't be reduced, but that one has been ignored as it's impractical for enforcement. There is a provision saying that you can't pay less than the early retirement benefit at normal retirement. That one is an extremely difficult one to administer, and one that found most people not set up to check back to see whether the benefit is less than it might have been if someone retired early last year--particularly under Social Security offset plans. But it's an old problem when benefits go down as Social Security increases under offset plans, not a new problem.

I have another question for Mr. Kosloff. The fiduciary requirements say a fiduciary can divorce himself of some of his liability by naming an investment manager, giving that investment manager discretion. The major insurance companies have differed as to whether they're willing to be insurance investment managers. What are the pros and cons of that and where do you stand?

MR. KOSLOFF: We'll accept fiduciary responsibility with respect to the separate accounts where we're given investment discretion. We'll work out a fairly detailed understanding with the client, hopefully in writing, as to what his objectives are. We'll make sure that he understands the pros and cons of the various investment vehicles and we will assume full discretion as to the allocation of assets among the separate accounts. This involves dollar amounts and timing and assumption of fiduciary responsibility for this.

MR. HARRY PURNELL: I would like to know more about the assumptions that you are using currently. You mentioned that there was a tendency to give up some of the conservatism that perhaps was there previously. Could you expand on that please?

MR. KOSLOFF: I think the pattern we've observed is a gradual evolution through the years toward realistic assumptions. But I think the ERISA pronouncement accelerated that trend fairly dramatically. In many situations it caused the assumptions to become more realistic, particularly interest rates and salary scales.

For some plans that were heavily funded, and hence had a leverage effect, there were substantial decreases in the required annual contributions.

MR. PURNELL: Are you thinking of assumptions on the level of 7½% interest as realistic?

MR. KOSLOFF: I think our typical interest assumption range is between 5% and 7%. We'd go beyond 7% in certain situations, but in those situations I think we'd want to test the current earnings potential of the fund.

MR. HENRY: I've observed that perhaps more realistic assumptions for plans which were well funded under 4½% or lower interest assumption, even with a salary scale, result in a decrease in employer contribution. Our company made a study of its Fortune 500 clients. The rates of return which we were using for almost exactly 1/3 were at the 6% level and none were higher than 7%. The rest were clustered around, I think, 5½%.

MR. DALE LAMPS: You mentioned that on smaller clients you're using a reduced scope valuation in interim years. I was wondering if you could go into greater detail in what constitutes a reduced scope valuation?

MR. KOSLOFF: What we would do in such situations is still to request the data and verify if there had been any changes in plan. If there had not been changes in plan or significant changes in employee turnover or salary history between the two years, we would not go through the whole process of calculating the results, but would use the prior year normal cost percentage applied to current year's salaries and reduce the scope of the report itself.

We've encountered many situations where at the small end of our business the client realistically cannot afford to have a full scale valuation, and we've seen, as possibly you've heard or experienced, a high level of plan termination at the low size end.

MR. HENRY: I'm not sure a small case of 100 lives is really a very valid definition. I, myself, would put that several times higher to designate what a small case is.

What has been the reaction of the agents and general agents of your sales force? Are they still pushing pension plans or do they feel it's too much trouble now?

MR. KOSLOFF: We've recently introduced a new small product geared towards agent sales that's very different from my group area that has been successful. There has been a tendency toward defined contribution rather than defined benefit plans. Most of our sales activity is really not geared toward a new pension plan. It's really geared toward investment services.

MR. GARY HERTEL: What about auditor requests? How are you handling these? We seem to be getting quite a few that stretch the gamut from very little data to four or five page sets of questions asking for complete data on the case. Some of the larger size cases seem to get a little out of hand.

MR. KOSLOFF: In general, we take a reasonable man's view of it. Data that's readily available from our records, if the request is reasonable, we'll send directly. If the request is completely off-the-wall, we'll go back to our client, not the auditors, and let them know there's going to be a cost involved. If they want to pay the expense then we complete the requested material. We've developed standardized responses. We found that many of the questions coming in, though phrased quite differently, even from the same auditor's office, tend to fall into various sets of patterns. In a production area you can respond to that.

MR. DENIS J. SULLIVAN: In presenting the topic from the viewpoint of the midwest consultant, I hope that I'm not unduly influenced by the fact that I've led a sheltered actuarial life among pension plans such that I am thoroughly convinced, were these the only plans in the United States, there would not have been any ERISA.

ERISA brought investments further into focus with codification of "prudent man" rule and the requirement to reflect market value when valuing assets for valuation purposes. However, market conditions had really put the matter of investments in the limelight before ERISA, so for us the law has really been more of an extension of what was already taking place.

Years ago it did not seem unusual to see assets valued at cost or market but as interest rates climbed and the market had its ups and downs, the method of valuing assets became a definite issue. The asset valuation methods we are now seeing most frequently are:

a) The average of cost and market.
b) A moving (usually 5 years) cost and market average.
c) Fixed income assets at amortized value, equities at an average (or moving average) of cost and market.

Our needs are for straightforward methods because of understandability and acceptance by the client and because of the expense to the client. More elaborate methods do not appear justified in the small and even medium size cases when the final results depend on a variety of assumptions.

We have not experienced any trends regarding client desire to influence the choice of the asset valuation method, but there is definite interest in having market values reflected and in understanding the method.

The codification of the "prudent man" rule has no doubt resulted in some rethinking of investment strategy. However, the banks and investment advisors we have been exposed to have, in my opinion, adhered to the "prudent man" rule in the past; and the economic climate had started a trend in a revision of the investment strategy before ERISA.

The strategy revision has been to reduce equity holdings and move to more fixed income type investments, although the extent of the change of investment blends has not been as great as the apparent interest first indicated it would be. Our experience has been that the blend has not, in the majority of cases, gone below 50% in equities. A recent article in a banking industry magazine stated that their survey showed investors felt equities would increase about 12.3% (the median percentage) a year in years to come, and the recent market experiences would not be repeated.

Our involvement has been primarily limited to general discussions with clients and communication of what others are doing in the area. We do not advise clients on what the proper investment blend should be, nor do we enter into the aspects of investment quality.

Although not producing extended services on our part, there has been a trend toward putting the investment advisor on the carpet more and wanting more explanations and communications regarding investment strategy and results.

Special actuarial calculations have certainly increased. The most obvious one is probably the calculations with respect to minimum funding standards and the preparation of Schedule B of Form 5500.

Those methods recognizing gains and losses involve even more work in the renewal years because of the possibility of funding excesses or deficiencies.

Where appropriate, gains or losses have been analyzed in the past, so there has been no significant increase in activities in this area. The size of the pension case has an influence here because of the lack of statistical reliability in the smaller cases. Also, in the plans with quite small memberships, interest may be the only pre-retirement assumption.

Selecting appropriate assumptions has always been a fact of life, but the certification called for in Schedule B has generated a new wave of assumption reviews. In years past assumptions may have been conservative, but one had to guard against a selection influenced by the desire to "help" those paying for the actuarial services. Now, since we are all working for the plan participants, one must guard against a selection influenced by a desire to "help" those participants. The certification requirement to use the best estimate of future experience seems to dictate the use of assumptions which are not only reasonable in the aggregate but which are "neutral".

Our general experience has been that the cash flow in pension plans has not been a problem since very few of our plans have lump sum settlements for retirement or death. Thus, cash flow projections have been minimal. Benefit projections are something else. Many administrators of plans of all sizes are asking for benefit projections for all participants. These are the projected plan benefits at age 65 and the projected Social Security at age 65. Providing accrued benefits has been mainly left to an "on request" basis for final average type plans.

We have heard attorneys advise against the mass production of accrued benefits because of the potential problems of being stuck with a stated accrued benefit that is subject to error from employment data and from salary data. They feel a projected benefit at age 65 is generally accepted to be an estimate whereas the accrued benefit is thought of as being exact. Doing accrued benefits upon request provides the opportunity to work with the individual files. The volume of requests for accrued benefit determinations may be the key to the workability of this approach. For small and medium sized plan memberships, the expense of mass producing accrued benefits under final average plan is a factor, since the appropriate wage and employment history is needed.

Other areas of increased actuarial activity are as follows:

a) The actuarially equivalent joint and survivor, or contingent annuitant, benefit. Some plans did not provide these options.

b) Providing joint and survivor information to those reaching early retirement age, as required by regulation.

c) Providing information for electing out of surviving spouse pre-retirement death benefits, if the cost of such benefits is to be passed on to the plan participants. Our experience has been that most plans are underwriting death benefits, or had adopted and paid for death benefits before ERISA.

d) Calculating the vested benefits of terminating employees, since more liberal vesting has simply increased the number of vested terminations.

e) In contributory plans, calculating the part of the benefit attributable to the employee's money so the employee will have all the facts if a refund of employee contributions is desired.

f) Calculating the full funding limitation, or having sufficient flexibility to determine that limitation if the need arises.

g) Appropriate adjustments of valuation figures when the plan year and fiscal year differ. We have noticed a trend to get these years to coincide.

h) PBGC related calculations -- premium payments and plan termination calculations.

i) Increased regular valuation calculations because of adding or liberalizing vesting provisions and death benefit provisions.

j) Calculations pertaining to ERISA distribution and allocation provisions in the event of plan terminations. Fortunately, we are experiencing very few plan terminations.

In the past we have provided sample language for, or made reviews of, employee communications, plan drafts and funding agency instruments. ERISA has, of course, caused a surge in this activity in order to get plans into compliance. The drafting of plan booklets was always demanding, but the requirements of the law and regulations has added to the difficulty.

Activity in completing governmental forms has increased. We seem to have about the same number of clients having us assist in completing forms -- and those who did their own or had other professional people do them have tended to go the same way -- but the number of forms has increased.

The interest in administrative manuals, or at least in formalizing procedures so that a manual evolves, has gone up. Pension plan committees are now taking their duties more seriously and are conducting those duties in a direct and documented way. Larger plans were likely to be this way before ERISA, but the small and medium sized plans are getting into line.

Probably the most significant increase in non-actuarial work for us has been in the area of communications with other professional advisors to plans, with plan committees and administrators, with plan trustees and with plan participants and retirees. Attorneys have seemed more desirous of having plans reviewed to see that the actuarial aspects and benefit provisions are properly constructed. Accountants are wanting more things. Plan committees and plan administrators are having more meetings and want the actuary present more often. Plan trustees want to be sure that they are properly informed on plan benefits to be paid, and that they are aware of investment goals. Meetings with participants and retirees are more frequent, and the actuary is being invited.

One of the most favorable aspects of ERISA, in my opinion, has been the trend toward an employer having a full-time manager of employee benefits. Before ERISA the task of operating the pension plan, and other fringe benefit plans, fell to a person who had other full-time duties, so the plan operation was just a sideline. The move to the use of someone who had no other duties than those related to fringe benefits has actually increased our volume of work. These people tend to be better informed on the matters at hand, but this often leads to their asking more questions and seeking help because they recognize when help is needed.

One obvious way for handling the heavy volume of ERISA-related work has been to add to the working staff.

Another way has been to put in more time, since much of the work has been on a non-repeated basis, such as putting plans into compliance with ERISA.

Another way has been to help the plan administrator, the plan committee and the employee benefits manager help themselves. For example, these people can do much of the work connected with the filing of forms and in determining plan benefits. In other words, they can be trained and educated to take over some of the things they didn't do before.

The audit of actuarial calculations has taken on new dimensions. APB Opinion No. 8 was pre-ERISA, but the accountants for many smaller employers seemed to ignore it. Now, the accountants for plans of all sizes are interested in pension matters. Thus, the time spent communicating with accountants has increased quite dramatically.

Besides the need to know the value of vested benefits and unfunded accrued liability, there is the desire to understand what these figures really stand for and what accounts for changes in these figures.

There are now audits of the data furnished to the actuary and audits of the determination of benefit calculations.

With respect to plan costs, the accountants we deal with are now going into more depth in order to understand what affects the level of costs and what accounts for year to year variations.

Future services -- on a small scale -- will involve death benefits, since the exposure to the prospects of these benefits being paid has increased significantly. On a larger scale, serving government agencies may be an area of need. Some governmental agencies have already faced staffing problems and have turned to outside sources for help. If governmental involvement increases, their need for staffing or outside assistance will grow.

An ERISA for public plans is very likely, which would result in new and expanded services for those groups.

Even without a law for the public plans, we have found that governmental agencies, particularly those involved with utilities, are investigating compliance with ERISA. This would enable them to be competitive, from the pension plan point of view, in the labor market; and there is a public relations element of complying with ERISA without being compelled to do so.

MR. HENRY: Thank you, Denis. Are there questions now?

MR. JOHN H. GRADY: I have a question on changing the plan year. Let's say a company has a calendar year tax year. The plan was effective 12-1-75. In 1975 you take a deduction for the plan year running from 12-1-75 to 11-30-76. In 1976 you change the plan year to the calendar year. Now in 1976 can you take a deduction for a full plan year so that you're overlapping 11 months or do you have to take a deduction for just the one month in 1976 that you haven't previously taken a deduction for?

MR. SULLIVAN: Our approach, at least now, is that it would involve a short year situation. Deductions would be taken on that basis.

MR. GRADY: Take a deduction for one month, calendar year 1976?

MR. SULLIVAN: I would actually report in effect on that short plan year and go with that for both deductions and minimum funding purposes.

MR. GRADY: Anyone in the audience, is there any authority that you're aware of requiring you to do one or the other? I haven't had much luck in finding an authority for this.

MEMBER OF AUDIENCE: Yes, there is a requirement that you get approval for that short plan year. There's a form for that. The description given by Denis is essentially the manner in which we would handle this case.

MR. HENRY: The form that he speaks of, I think, is Form 1128. I know of situations also where plans have been put in effect at the end of an employer's fiscal year. This is going back into the 1950's. A plan was put into effect on December 30, and the employer contributed the entire amount in that calendar year (I think put in an entire normal cost). The IRS disallowed all except two days of this contribution for that particular plan year. I think this was rather an extreme case.

MR. GRUBBS: When you're changing plan year and not tax year, then there is one year's cost in your tax year. Minimum funding is on a plan year basis, so you only have a pro rata portion of cost for your short plan year. The maximum deductible limit for a tax year is the one-year normal cost and the 10-year funding of your initial past service base.

MR. GRADY: It seems to me there might be the problem of taking a deduction for the same eleven months twice.

MR. HENRY: I think you'd have to really look at the plan years and the taxable years to make sure you didn't deduct, as Don said, in the taxable year more than the one-year normal cost within that particular taxable year. You can't get a double deduction merely by changing your plan year.

For accrued benefit calculations, what percentage of your clients do you think are doing their own and what percentage are asking you to certify or write letters or such thing?

MR. SULLIVAN: So far none of our clients is doing their own. They either are not providing the accrued benefits or are asking us to determine them.

MR. ETHAN STROH: Have you given any thought to the new FASB requirements as they apply to calculating the accrued benefit?

MR. HENRY: We're going to cover the FASB opinion. I don't want to devote an undue amount of time to this, although I do think it is an extremely important topic. John Grady is a consultant with an organization which is primarily an accounting firm. So, maybe he can tell us about some of his consulting work and also perhaps touch on the exposure draft.

MR. GRADY: For the first part of my remarks I'll make some brief comments about some trends in pension services. Secondly, I'll discuss FASB exposure draft and the impact it might have on the services of actuaries.

The first trend I'll comment on is use of cash flow projections. I think there's an increase in the number of these that we see. I think partly this is because a number of actuarial organizations are getting the computer ability for producing these, so we are all more alert to areas where they might be helpful.

Here are three or four examples where I've seen them proved to be useful. Directly related to ERISA is a request by plan trustees for a projection of benefit disbursements for the purpose of recognizing liquidity needs in their investment policies. This is not really frequent, because in most cases yearly contributions exceed yearly benefit disbursements.

A second application is the public plan where a portion of the benefit structure may be funded on a pay as you go basis and part on an advance money basis. Where you have funding on a pay as you go basis, in order to demonstrate the future trend in costs, you need a projection of benefit disbursements.

Yet another situation is the multi-employer plan that's declining. The number of retired lives relative to active lives is going up. There are few new entrants. Perhaps the financing is sound on the assumption that the population is stable. But it may be enlightening to observe what can happen to the fund if the present level of contributions stays constant but you experience declining active membership.

Still another area of application is for a municipal plan when, after a given date, all the new municipal employees are entering a statewide plan. The existing municipal plan continues to exist for current retireds and also for a closed group of actives (some of which perhaps elected not to enter the statewide plan when they had the opportunity). In this situation, the sponsor may be interested in comparing future benefit disbursements from the fund against the maturities of his investments, the cash flow resulting from his assets. He may want to know at what point he's going to need additional resources to continue paying benefits.

A second trend I want to comment on is the area of actuarial reviews. By this I mean reviews by one actuary of another actuary's work. The scope of such reviews may be limited to just looking at an actuarial report and giving some reaction to the reasonableness of the assumptions and methods used. It might extend to actually reviewing the actuary's work and discussing the assumptions and so forth with the plan actuary. In the extreme it might involve setting your own independent assumptions and performing independent valuations. In the public plan sector I think we're seeing more of this sort of thing because of the passage of ERISA, the activities surrounding the development of ERISA-type public plan law, and all the publicity that is given to problems in public plans and certain situations that we've all seen.

These things have caused the level of concern of public plan administrators and in some cases legislators to increase . . . their concern, for example, about their potential fiduciary liability and about proper funding. One thing they ask is what impact an ERISA-type law would have on their own particular system. In some cases they don't fully understand the actuarial status of their own system, and that's a source of concern for them.

The result of this increase of concern has been, as I mentioned, to increase the number of actuarial reviews by an independent or a second actuary. I think it's caused a trend maybe to more frequent valuations in public plan sector. Certainly, it's caused more attention to communication, not only with regard to results of actuarial studies but communication relating to actuarial concepts -- just the education process of people who are responsible for these public plans.

Also, audits of pension plans have increased. Obviously, audits of plans have increased in the corporate sector because of ERISA. In the public plan sector there's legislation that requires audits by independent CPA firms in some cases. Even where legislation doesn't require it, you will still see these aduits in some cases because of concern on the part of people in authority.

This last trend I want to comment on will lead me into the second part of my talk -- dealing with the FASB exposure draft and the impact it might have on the services of actuaries. To discuss this in the proper context, I think it's important to first cover the present situation with regard to audits and the present situation with regard to the role of actuaries and accountants.

The attitude of accountants with regard to the scope of audits of defined benefit plans can be characterized as inconsistent, presently. There is much variation among accountants as to what they deem to be the proper scope of audits.

One group of accountants, probably small, feels that the actuarial process is entirely outside the scope of the audit, so they wouldn't be concerned with it at all if they had their way.

Another group, and probably a large group, thinks the scope of the audit does include the actuarial process, but then there is the question as to the extent to which the auditor is responsible for verifying the actuarial numbers and so forth. A rather typical approach I believe is to say at least three steps are required on the part of the auditor. One is to verify the census data and perhaps the asset data sent to the actuary. A second step is to verify that the results of actuarial valuations are applied appropriately in determining the employer contribution rates. A third step would be to verify the professional qualifications of the actuary and also to verify the independence of the actuary from the plan sponsor.

Another group of auditors would go beyond this and say you should also include additional steps, such as verifying that the appropriate and correct plan provisions are reflected in the actuary's work. Another step that more possibly leads to some conflict between actuaries and auditors occurs when the auditor feels he must satisfy himself as to the assumptions and methods used by the actuary being "not unreasonable". Another group will even go beyond that and say the auditor is responsible to determine that assumptions and methods are reasonable, which is quite different from "not unreasonable". Maybe a small group would actually say that an auditor has to satisfy himself as to the reasonableness and accuracy of the determinations themselves.

The purpose of these remarks is to demonstrate the variations that exist and the inconsistency that exists. The same thing is true among accountants with regard to the proper format of financial statements. This is closely related to their views on the scope of an audit. Some think that actuarial values should not be reflected in the financial statements at all, or if at all, maybe in the disclosure in the footnotes of the excess of vested liabilities over assets.

Another group of auditors would feel that a financial statement should reflect some measure of liability for plan benefits. Then the question arises as to what measure to use. Some would prefer the termination-of-plan or accrued benefit approach. Others would prefer the accrued actuarial liability under the cost method that is performed for funding purposes. Some accountants think that the actuarial liability should actually be an item on a balance sheet. Others think they don't belong on a balance sheet but they should be disclosed in a footnote.

This inconsistency or variation on the part of auditors certainly has an impact on the role of actuaries related to plan audit. First, we'll comment on the role of the plan actuary.

Currently, the plan actuary may be completely unaffected by an audit of his plan. Perhaps the auditors got a copy of the actuarial report from the sponsor and the actuary might not even be informed. In another case, the actuary may simply be requested to provide a copy of the actuary's report for the auditor. In still another case, the actuary may receive a phone call from the auditor to discuss the actuarial assumptions, or the methods, or the census data, or the plan provisions, or whatever, to increase the accountant's understanding.

In still another situation, an actuary may receive a request to produce data that he hadn't produced already. For example, he may be asked for a projection of plan liabilities from a plan year end to a fiscal year end, where the two are not the same.

In addition to being the plan actuary, there's another capacity for actuaries in regard to plan audit. This gets back to my comments on actuarial reviews of an actuary's work. There are at least two situations I think that would give rise to an actuary functioning in this other capacity of reviewing the plan actuary's work.

One such situation is where the sponsor specifications for the job are broader than just an accounting audit. In some cases they actually emcompass both an accounting audit and actuarial review. In this case, in order even to bid on such a job, an accounting organization must form an affiliation with an actuarial organization, and they could conduct the job jointly.

A second situation that could lead to an actuary functioning in this second capacity with respect to a plan audit would be for this actuary to be retained by an accounting firm. As I mentioned, some auditors feel that they need to satisfy themselves as to the reasonableness of assumptions and, in some cases, the final result. If they feel that it's a gray area in a particular plan, that they are not able to say it's okay, or it's not okay, they may feel the need for advice from an outside expert. Accountants in their literature have guidelines for using outside experts in areas such as actuarial work or engineering, or independent appraising so an actuary could be retained by an accounting firm to assist them in reaching their position on the acceptability of the actuarial process.

In summary of the present situation, I think there's a lot of variation that can be characterized in this way. The position of the accountants is widely varied. As a result, the role of the actuaries in regard to various audits is widely varied from one case to another.

Let us now turn to the future situation and what impact the FASB exposure draft might have. By way of introduction, the Financial Accounting Standards Board issued, on April 14th of this year, an exposure draft titled, "Accounting and Reporting by Defined Benefit Pension Plan". I should say that in my comments on this and the comments I've already made, I'm speaking only of my own opinions and perceptions, not in any way taking a position for my firm or any of the other actuaries in my firm. The actuaries in my firm vary on this topic, I'm sure, as much as the actuaries in this audience.

This document if adopted will constitute generally accepted accounting principles, so that in the future, the wide variation that I talked about on the part of accountants would be narrowed. Regardless of their previous position, they'd be compelled to follow the accounting principles outlined here. The approach I'd like to take on this is to first give a few of the highlights of the draft as I see them and then get into some discussion on certain other points.

The exposure draft calls for four financial statements: a statement of net assets available for benefits, a statement of changes of net assets available for benefits, a statement of accumulated benefits, and a statement of changes of accumulated benefits. It gives rules to be used in preparing these statements. For example, in the statement of net assets available for benefits, it specifies that this is to be presented using current market values.

The statements that will be of most concern to actuaries, of course, are the second two -- the statement of accumulated benefits and of changes in same. The draft specifies that accumulated benefits are to be determined on an accrued benefit basis -- a termination of plan basis, I would say. It specifies that certain provisions such as a cost-of-living provision are not to be reflected because these provisions will be given effect after the date of the financial statement. The present valuing process of these accumulated is to be done on PBGC rates using interest and mortality only. The exposure draft calls for disclosures in the footnotes to financial statements regarding such items as plan provisions. It calls for disclosure of the assumptions and methods underlying the present value of accumulated benefit. It calls for disclosure of the funding policy. It also calls for disclosure of the tax status -- whether or not there's an approval letter on the plan.

The body of the exposure draft is just a few pages, but there's an appendix to this that goes into much detail concerning the rationale of the FASB in reaching its position. They go into detailed alternatives considered that were rejected and the reasons.

One point that they discuss is the question of what is the proper reporting entity, the fund versus the plan. They also state two basic premises that are quite important. They come to the conclusion that the primary users of financial statements of plans are plan members, and that the primary objective of financial statements should be to enable plan members to assess the security that the fund offers with regard to the receipt of their benefits. Those two premises are quite important. They underlie the positions taken by the Board in this draft. I, of course, am not going into too much detail because I think the primary concern that all of us here have will be about the appropriateness of the general approach. There certainly may be problems in some of the details, but in my remarks I'll stay more on the general level.

First, I want to comment on the question of the plan versus the fund being the proper reporting entity. Over the past two or three years, as I've been involved in a few situations relating to plan audits and the interaction of actuaries and accountants, I've wanted to take the position that the fund is the proper entity. That's a very attractive position because it neatly delineates the scope of the accountant's job in regard to an audit and it very neatly eliminates much of the possible conflict between the actuaries and the accountants, but I've really not been successful in rationalizing this in my own mind. I feel it just doesn't make too much sense. The main problem I have with it is that the financial statements just wouldn't have much purpose or much value if they only related to the fund. I think the position of the FASB as to the proper or primary objective of statements is reasonable, namely to enable participants to assess the position of the fund and their own benefit security.

If you accept FASB conclusions as to the reporting entity and the proper purpose of these financial statements, then obviously you have to have some major benefit liability in there. The question then is how to do this. On this question, I personally have tended over past years to favor the actuarial cost method accrued liability, although I recognize some problems with this. I guess this stems from my own view that the real comparison should be between the actuarially required contribution rates versus the financing policy of the sponsor. So, to really assess benefit security in a system, it boils down to the ability and willingness of the sponsor to meet the required contribution rates. I don't think the focus should be on the liabilities at all. If you are going to make a comparison of required contribution rates and financing policy, I feel it makes little sense to introduce still a different calculation which does not tie in to the basis of determining the contribution requirements. If you are going to show something, you should show the actuarial accrued liability on the same cost basis or method as used for determining the contribution rate.

However, the big problem I see now with that is you're looking at a balance sheet with current assets on one side and a measure of liabilities on the other side. The magnitude of that accrued liability on an actuarial cost method basis can vary considerably. You can have two funds, for example, with one taking an implicit approach to assumptions, the other taking an explicit approach to assumptions. Assume the benefit structure to be the same and the required level of contributions should be the same from the two sets. Yet, the accrued liability for the implicit assumptions is likely to be higher than for the explicit assumptions even though the required contributions resulting from the valuations are very similar. A user of the financial statements would look at one and say this fund is in a lot worse trouble than the other when the circumstances could be practically identical. There's no good basis for comparison between plans in this situation. Comparing current assets against entry age normal accrued liability, for example, doesn't make too much sense.

What about the termination of plan approach? What's the problem with that? The problem I have with that one is that it doesn't achieve very well what the primary objective of the FASB is. That is, to allow users of the statements to assess the benefit security. If you have a plan with assets equal to accrued liabilities, the plan is a final average plan, and it has cost-of-living provisions and high expected future salary increases, the fact that your assets are equal to the termination of plan liability doesn't really indicate that the benefits are secure because the benefit expectations are based on total projected benefits. Participants are expecting to get what they're promised at retirement which reflects future salary increases. If there's a cost-of-living provision in there, it's going to reflect that, so equality between assets and benefit liabilities on this basis of calculation doesn't really mean that your benefits are 100% secure in my view. That's the weakness I see in that approach.

I'll comment on using the PBGC rates for this purpose. My first reaction to this was that actuaries should retain their prerogatives in setting assumptions and so forth. However, an actuary just yesterday was pointing out to me that, for this purpose, you're comparing current value of assets against something comparable to that, namely benefits accrued to a given date, on a shutdown basis. So, what's the proper measure? What can you go out and buy those benefits for?

I was informed that the PBGC keeps their rates very current. Every two or three months, I understand, they survey the insurance companies to see what their competitive annuity rates are for this purpose, and make some sort of average of these. It seems to me that perhaps the PBGC is the appropriate measure now for this purpose.

Some disadvantages, or at least potential disadvantages, of the FASB position include the inconsistency that would exist between the numbers in the actuarial report and the numbers in the financial statements. Of course, you won't see the PBGC liability in the actuary's report in most cases, and you're not going to see the actuarial liabilities in the financial statement. There will be no relation between the two sets of numbers. I personally don't see this as a major disadvantage like the one I mentioned previously about whether or not you have an appropriate measure of benefit security. The reason I don't see it as too big a problem is because I think the purpose of the financial statement number is very simple to explain. The concept is simple. The difference between the two calculations can be explained very easily.

The second potential disadvantage is the additional expense that will result from this calculation. It's a determination we're not usually making now as actuaries. The plan sponsor is going to have to bear the burden of this, but this is not a major problem to me because I think pension actuaries will simply gear up to get these numbers as a by-product of the regular valuation. Once we have a subroutine in our valuation package to throw these out, the additional cost is going to be negligible.

There will also be problems with timing, being required to have these numbers by seven months after the end of the plan year and such, and these are additional disadvantages. I think maybe such things should be able to be worked out within the basic framework that the FASB has taken.

There are some advantages that could result from adoption of the FASB approach. One advantage, I think, is that it will narrow the confusion and the inconsistency that exists now among accountants and actuaries. Of course, any resolution of the situation would have this advantage, whether it was to use the actuarial cost method approach or to exclude the actuarial process entirely.

Another advantage, however, is that this would, for once, permit comparability of accrued liability between plans. We're all aware of the absurdity of some of the surveys that we read in some of the magazines and newspapers where accrued liability of one system is compared to accrued liability of another system and you don't know what the assumptions were, or, in some cases, what the actuarial cost method was. It's just ridiculous to say that these numbers have any value in the absence of knowing the other things. Under this proposed FASB approach, however, for once we would have a basis for comparing a measure of benefit liability from one system to another. I personally think that would be significant.

A third thing I see is that the basic approach the FASB has taken has the advantage of being very simple, and very easy to explain. You're talking about what benefits have accrued to date and what it would cost to go out and buy those. You're comparing that against current assets on hand at that time. That's a simple concept to explain. Plan members as well as plan sponsors in a lot of cases don't really understand too well actuarial concepts. One reason I think the simplicity is significant is because I have the impression that there are problems with every approach that can be taken to this, so that the degree of success that can be achieved in financial accounting is limited. If we are going to have to settle for limited ability to assess benefit security, or to assess the financial condition of the system, and if the best we can do is limited anyway, at least it should be simple. There shouldn't be hard-to-understand, complicated solutions.

As to my own suggestions for changes to the FASB position, one is the cost-of-living subject. I strongly feel that if we're going to compare current assets against accrued benefits at that time, we should be using total benefits expectations accrued today. Obviously, if the plan includes a provision for post-retirement cost-of-living adjustments, that's part of benefit expectations accrued to that point. I don't see any reason for excluding this. The rationale of the FASB in excluding it is that this part of the liability will arise in periods subsequent to the date of the financial statement, but this doesn't seem to be an overriding concern to me. Even with constant retirement benefits, you have to survive to retirement to collect these benefits -- a future contingency.

I think that the cost-of-living liability should be added to the major benefit liability.

Secondly, I think an improvement would be to expand disclosure in the footnotes in two different ways.

One is with regard to the limitation that's inherent in the accrued benefit comparison. I think that should be specified, especially in the case of a final average plan. In a career pay plan maybe the comparison is pretty meaningful. In the final pay plan it definitely, in my opinion, is less meaningful. It reminds me of the Surgeon General's statement on cigarette packages, that this may be hazardous to your health. I think there should be a message in the financial statement to say, "caution, this whole approach has limited value in assessing benefit security", especially in final pay plans.

Another disclosure I think essential is a statement of the actuary's findings. Again, in view of the objective being to assess benefit security, I think it's appropriate to include a comment, perhaps in the footnote on funding policy, that gives the recommended contribution rates of the actuary, and says that it's the policy of the sponsor to make the recommended contributions if that's the case.

In another situation, perhaps in a public plan, it may be the actuary's report is qualified. Maybe the actuary is using assumptions that he doesn't think are reasonable, but statutes limit him in this. If his actuarial report is qualified, I think it's essential that in the financial statements this be disclosed.

In conclusion, I'll make one additional comment. There's a phrase in the exposure draft that appears more than once. That phrase is, "within the limits of financial accounting". As I read that, I thought that that was significant. It seems to recognize that the accounting profession realizes that there are limits as to what can be achieved in the context of financial statements. They seem to realize that any approach has limitations. This doesn't mean that the approaches are worthless, it just means that they're not perfect. I think that the objective should be to find not the perfect solution, but to find a solution that has the most advantages while at the same time is the least objectionable.

MR. HENRY: Thank you, John. I have some comments. I think our company sent off to the FASB a rather lengthy list of reasons why we disagreed with the majority of the opinions and conclusions in the exposure draft. I find it hard myself to put a great deal of emphasis on termination liabilities for plans of financially sound and healthy employers, especially when these liabilities, as you pointed out, are changing monthly or quarterly or how ever many times the PBGC may change them to reflect the current marketplace. You made the comment that this would facilitate comparison of liabilities between plans. Since this business is geared to informing the individual participants of their benefit security under the plan, I'm a little bit at a loss as to what information he can get which will be useful to him. If he's under Company A's plan, why would he really be comparing it with Company B's plan or Company C's plan? What use is this? Maybe I missed your point. You said it was to facilitate comparison. It seems to me that's been the goal of the securities analysts in the past in facilitating comparison between companies and looking at the company's liabilities. I'm not sure that's a valid point of disclosure to plan participants.

MR. GRADY: Yes, I think your point is probably valid. Participants in one plan perhaps aren't interested in the situation of another plan. However, I certainly am interested and other people in the industry are interested. I can think of one situation in a state where there's a plan for teachers and a plan for public employees. There may be a great deal of comparison between those. In some cases, a person could go from one plan to another. Non-certified employees of a school system could switch, i.e., their plans could change so that they're covered by the public employees' plan rather than the teachers' plan.

MR. REUBEN RIGEL: It seems to me that increased cost is, in a way, the crux of all this.

MR. GRADY: I didn't mean that the increased costs wouldn't be a problem, I'm saying that I don't think there would be much increase in cost.

MR. PRESTON BASSETT: Some of you probably already know my position on this but, John, I agree with much of what you say, what the auditors have said, and what the FASB has said. Unfortunately, they start from the wrong premise, and this has led to the wrong conclusion. This premise is that it's the auditors who should be reviewing the actuarial work. My premise is that it's none of their business, that the actuaries should be doing the review of an actuary's work. Information to be provided to plan participants is not an exclusive right of the auditors. It is also the right of the actuary as well. Thus, the auditor should stay to the asset side and the actuary should be responsible for providing the plan participants what they should know about the liability side in the comparison.

It's unfortunate that the FASB where I first served on their task force didn't listen to me there, nor did they listen to the testimony by the American Academy of Actuaries later in review. To me they've come out with a good answer but the wrong people are doing it.

MR. DANIEL M. ARNOLD: What about the inconsistency between the annual report to stockholders versus the annual report to participants? Why is one on an ongoing, the other to be on a termination basis? Isn't use of the "going concern" basis a major position of the accounting profession?

MR. GRADY: I'd have to have an accountant to respond to these things because I don't pretend to be knowledgeable in this. My feeling about that question is that the purposes of the two statements are completely different. Statements for the corporation are on an ongoing concern basis. You're concerned with the accruing cost of the plan, but the purpose of the financial statement on the plan itself is entirely separate. They're trying to have some measure of current assets against some measure of benefits accrued to date.

MR. BASSETT: May I respond to that John? From FASB, the project that you have an exposure draft for is strictly audit of a pension plan independent of the corporation. This is an audit of the pension plan itself, the liabilities and assets. It has nothing to do with what appeared on the corporate financial statement. That is the second project, and that project is underway. The FASB now is reviewing what should be provided on the corporate financial statement, or, to put it another way, they're reviewing a revision of Opinion 8.

MR. HENRY: I think maybe his comment was directed to the thought that it might be inconsistent to look at the overall accounting of a corporation on a going concern basis, then, when you turn your attention to a pension plan, you look at it on a termination basis. If you audit a company on a termination basis, you might find the value of the company to be considerably different than when audited as a going concern.

I'd like to thank you all for your participation.