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Section 404 Is Not Only About Deductibility Anymore

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"Internal Controls" and the Actuary

When Enron collapsed and the public was besieged with numerous allegations of accounting scandals, Congress responded by passing the Sarbanes-Oxley Act of 2002 (S-O Act). The S-O Act placed new controls on the development and auditing of corporate financial statements as a means to assure the investing public that the information contained within accurately reflects the economic viability of publicly traded companies and thereby strengthens the nation's domestic financial market.

The S-O Act emphasizes the need for the auditing firm to be independent from the corporations it audits by further restricting the manner in which it may interact with its audit clients. It also added personal responsibility for the accuracy of the information contained in audited financial statements by requiring attestations to that effect by certain corporate executives, including the fact that proper controls are in place for data derived from sources outside the control of the auditor.

This information is not new to many readers, yet many actuaries who provide employee benefit plan services have been surprised when contacted by their clients attempting to identify the controls in place for work performed and included in audited financial statements.

Implications for Pension and OPEB Actuaries

For companies registered with the Securities and Exchange Commission (SEC), Section 404 of the S-O Act essentially requires that: 1) corporate management establish a structure to control the information provided in its financial statements; 2) corporate management assess the effectiveness of its internal control structure; and 3) an SEC-registered public accounting firm evaluate and attest to the effectiveness of the internal control structure surrounding the development of information included in the corporation's financial statement. For many registrants, the requirements are effective for the fiscal year that ends after Nov. 15, 2004. For smaller companies and those with only registered debt, the requirements become effective as of the fiscal year ending after July 15, 2005.

Of particular interest to actuaries who perform employee benefit valuations for SEC-registered clients is the requirement for corporate management to take responsibility for the controls on the information contained within the financial statements' pension and other postemployment benefit (OPEB) footnotes. For corporate management to be able to make a formal attestation, the appropriate executives must understand and be able to document the process of how the pension and OPEB results are developed. Consequently, actuaries may be contacted by their clients to gain a better understanding of the controls that are in place for performing actuarial valuations, including the annual setting of assumptions.

Typical questions that arise for pension and OPEB actuaries during these assessments include:

- *Has your firm received a "SAS 70" letter for your valuation process?*
  Statement of Auditing Standards No. 70 ("SAS 70") identifies the factors that an auditing firm should consider when a corporation uses a third-party service organization to process certain transactions. When appropriate, an auditing firm can audit the risk controls surrounding a process performed by the service organization and provide such organization a letter that can in turn be furnished to the auditors of the corporations for whom it processes transactions. This allows the process of the service organization to be audited once, with the resulting letter usable by all of the service organization's clients. An SAS 70 report is not essential and is only provided in situations where there is a single process applied to a large group of clients; for example, defined contribution recordkeeping. Given the nature of the processes in an actuarial valuation of pension and OPEB plans, it may be difficult to obtain an applicable SAS 70 report.

- *What is the process of developing and selecting actuarial assumptions?*
  Corporate management is required to identify and document the controls around the selection of the assumptions used for footnote disclosures. Although Actuarial Standards of Practice (ASOP) Nos. 27 and 35 indicate that the assumptions used in the footnote disclosure are prescribed assumptions, the employer will be interested in documenting the process and the controls around the actuary's work to the extent an actuary helps the client develop those assumptions.

- *What tests, crosschecks and edits does the actuary perform on the census data?*
  This question may receive a broad spectrum of responses. The process of gathering the census data begins with the client. Thus, any response here will likely be considered in connection with other checks performed by another party.

- *What are your quality review or quality assurance processes?*
  In order for corporate management to attest that the controls surrounding the development of the numbers are sufficient, they will want to understand the manner in which information has been checked and reviewed. They will likely want to have a brief description of all of the quality assurance steps that are undertaken.

- *What role does the actuary play in developing information for the financial statements?*
  There are different services an actuary may provide for a particular client. For example, an actuary might be responsible for tracking information that helps determine whether a special event, such as a settlement or curtailment, has occurred during the year; or he or she might have a role in designing procedures to ensure that the valuation is based on the most recent plan document.

What Should Pension and OPEB Actuaries Do?

When actuaries are questioned along these stated lines, they should keep in mind that corporate management is seeking answers to be able to attest that the controls surrounding the development of financial statement data are sufficient. From this perspective, the cooperation of the actuary is essential to resolving any issues quickly. An actuarial client's corporate management will certainly appreciate the actuary who can help to resolve this small part of a much greater process.

The requirements under Section 404 of the S-O Act are new to everyone involved. Over the course of the coming year or two, chief executive and financial officers, auditors, specialists such as actuaries, and other professionals who will be involved in the implementation of the law's requirements have to work through the details of the proper documentation for compliance. Along the way, various professional organizations (e.g., American Institute of Certified Public Accountants) and/or the SEC may provide new guidance and clarifications to help all parties comply. In the meantime, every actuary should do the best professional job possible in completing this documentation and responding to information requests in a timely manner. ◆

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Several SOA staff memebers and session speakers get together to chat at the Spring Meeting in Anaheim. (Left to right): Emily Kessler and Lois Chinnock, SOA Staff; Ian Genno, session speaker and Pension Section Council co-chair; Patrick Landry, meeting participant; Dan Cassidy and Jeremy Gold, session speakers.