

Session 047 PD - Pension Actuaries and Auditors' Expectations

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2017 SOA Annual Meeting & Exhibit

PANEL DISCUSSION:

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Monday, October 16, 2017, 1:45 pm- 3:00 pm



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Session 47 Panel Discussion: Pension Actuaries and Auditors' Expectations

- Credits: 1.50 CPD; 1.50 Noncore EA
- Session Sponsor(s): Pension Section
- Competency: Technical Skills & Analytical Problem Solving
- Moderator(s): Lisa A. Schilling, FSA, EA, FCA, MAAA
- Presenter(s): Karla Brocker, ASA, EA, FCA, MAAA; Lisa G. Ullman, FSA, EA, FCA, MAAA
- Pension actuaries assist employers/plan sponsors in preparing the pension liabilities for the employer's/plan's financial statements and footnotes. The employer's/plan's auditor generally relies on the actuary as a specialist as part of the audit. Join this panel of pension actuaries who assist auditors by assessing the information provided by employers'/plan sponsors' actuaries for their perspectives. Instead of concentrating on the nuts and bolts of the accounting standards, we will discuss the intersection of the AICPA (American Institute of Certified Public Accountants) and PCAOB (Public Company Accounting Oversight Board) auditing standards and actuaries' Professional Code of Conduct and Actuarial Standards of Practice. Issues can arise about the acceptability of methods and the reasonability of assumptions.
- Country Relevance: U.S.
- Experience Level: All
- Session Coordinator(s): Andre Claude Menard, FSA, EA

Agenda

	Estimated Time
Introduction	5
Use of a third party specialist by management	18
What is the auditor looking for?	18
Materiality	18
Reasonability of assumptions	18

Overview

- We will
 - Look at auditing standards to get a flavor of the auditor's perspective
 - Define terms which may have different meanings to auditors and actuaries
 - Discuss auditor's professional skepticism
 - Discuss actuary's professionalism when working with auditors
 - Discuss how employers'/plans' actuaries can make the audit confirmation process more productive

Objectives

- At the conclusion of the session, attendees should be able to:
 - Identify the similarities and differences between the auditing standards (AICPA and PCAOB) and actuaries' Professional Code of Conduct and Standards of practices (ASOP);
 - Demonstrate a better understanding of the auditing standards and the auditor's professional "skepticism" role; and
 - Develop ways to better work with their auditors to make the audits more productive.

Audit Evidence¹

“all the information, whether obtained from audit procedures or other sources, that is used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence consists of both information that supports and corroborates management's assertions regarding the financial statements or internal control over financial reporting and information that contradicts such assertions.”

¹ PCAOB Standards, General Concepts AS 1105.01

Use of a Third Party Specialist by Management



Use of a Third Party Specialist

- Parties involved
 - Management
 - Human Resources at the employer
 - Finance Department at the employer
 - **Management's Specialist (Actuary)**
 - Auditor
 - Audit Engagement Team
 - Auditor's Specialist

What Standards Apply to the U.S. Actuary

- Code of Conduct
- Qualification Standards
- Actuarial Standards of Practice
- Practice Notes
- Continuing Education

Standards the U.S. auditors look to

- Different, but parallel, rules for publicly traded (PCAOB) and other entities (AICPA)
 - PCAOB – “Public Company Accounting Oversight Board”
 - AICPA – “American Institute of Certified Public Accountants”

Side note on nomenclature

- In the US, there are two sets of Professional Standards:
 - “AS” - [PCAOB Standards and Related Rules](#) - applicable to audits of issuers (as defined by the Sarbanes-Oxley Act of 2002)
 - PCAOB's reorganized auditing standards – a new numbering system established December 2015
 - “AU-C” - [AICPA Professional Standards \(clarified\)](#), which are applicable to audits of nonissuers.
 - AICPA's clarified auditing standards – a new numbering system established October 2011

Management's Use of a Specialist

- Some rules apply to the auditor's own specialists
 - We aren't discussing those today
- Some rules apply to management's third party specialists such as an actuary
 - [PCAOB AS 2501](#) and [AICPA AU-C 540](#), *Auditing Accounting Estimates*
 - [PCAOB AS 1210](#) and [AICPA AU-C 500](#), *Using the Work of a Specialist*

Using the Work of Management's Actuary

- An auditor can generally rely on an actuary's work, but has to consider:
 - Reliability of the actuary;
 - Nature and scope of the actuary's work;
 - Relationships of the actuary with the entity being audited;
 - Methods and assumptions used are acceptable and reasonable;
 - Data provided to the actuary is complete and accurate; and
 - Amounts in the audited entity's financial statements are supported by the actuary's work.

Auditor Assesses Reliability of the Actuary

- Competence - relevant qualifications and experience
- Capability - ability to exercise that competence in the circumstances
- Objectivity - possible effects that bias, conflict of interest, or the influence of others may have on the professional or business judgment of the actuary
- Controls - processes within the entity

Examples of Possible Issues

- No actuarial certification with the exhibits
- No statement of objectivity
- Actuary's credentials are not in the actuarial directory or the actuary is not up to date with compliance for continuing education
- Actuary's qualifications not consistent with type actuarial determination

Questions and Discussion

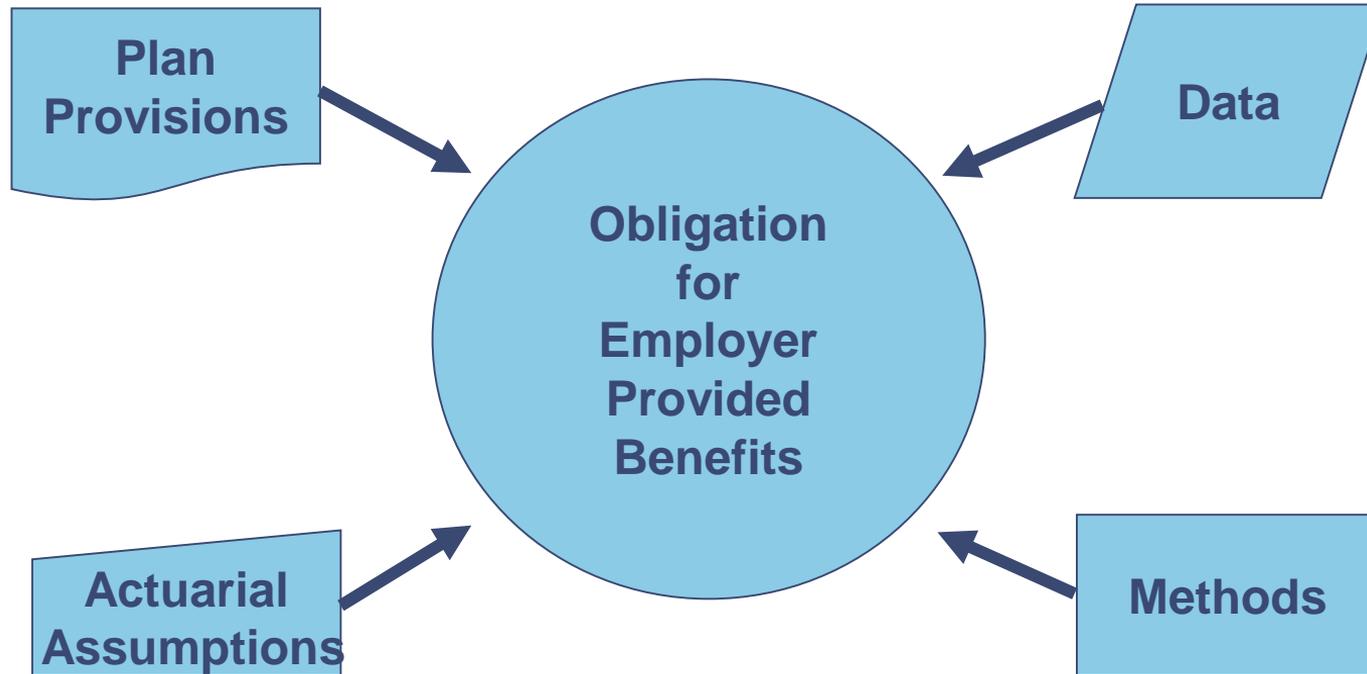
What is the auditor looking for?



Auditing Accounting Estimates

- An auditor wants to make sure the assertions made by management are fairly stated and reflect:
 - Methods – acceptable in the circumstances
 - Data – accurate, complete and relevant
 - Other inputs – source, relevance and reliability
 - Assumptions – reasonable and consistent
 - Application – correct based on all of the above

Information for an Actuarial Determination



Actuary's Professional Responsibility

- ASOP 21, *Responding to or Assisting Auditors or Examiners in Connection with Financial Audits, Financial Reviews, and Financial Examinations*
 - Latest update for fiscal periods beginning on or after December 15, 2016
- Actuary and auditor should:
 - Establish the scope of the review of the actuarial work – nature, format and timing required
 - Communicate in a responsive professional way and cooperate in compiling information

Be Prepared to Discuss:

- Data – sources, assumptions, problems
- Methods and assumptions – judgments applied and rationale
- Source of methods and assumptions not set by the you
- Models used –
- Controls around the process, procedures, and models
- Significant risks to the entity considered by the responding actuary
- Reasoning to support results and conclusions
- Impact of changing conditions

Changing Conditions

- May significantly impact the determinations and include:
 - Changes in operating environment
 - Trends in experience
 - Changes in the plan or demographics
 - Changes in the entity's policies or procedures
 - Compliance with new or revised rules

What the Auditor Needs from the Actuary

- Actuarial report(s) containing all the information required by ASOP 41, *Actuarial Communications* and other applicable ASOPs
- Actual data used
- Backup required to assess assumptions and their rationale
 - Details of models used
 - Cash flows
 - Experience studies

Basic requirements of ASOP 41

- The responsible actuary and intended user(s)
- Scope and intended purpose of the engagement or assignment
- Acknowledgement of qualification as specified in the *Qualification Standards*
- Any cautions about uncertainty or risk
- Limitations of use
- Disclosure of apparent conflicts of interest

Basic requirements of ASOP 41

- Reliance on other sources for data and other information
- Who is responsible for assumptions and methods
- Information date of report
- Subsequent events, if applicable
- Explanation of material differences from previous communications
- Deviations, if any, from any applicable ASOPs

Communication Requirements of Other ASOPs

- ASOP 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*,
- ASOP 6, *Measuring Retiree Group Benefits Obligations and Determining Retiree Group Benefits Program Periodic Costs or Actuarially Determined Contributions*
- ASOPs 5, 12, 25, 27, 35, 44 see the *applicability standards* for guidelines

Examples of Possible Issues

- There is a large unexplained gain or loss in the obligation as of the beginning of the year from what was disclosed as the end of the prior year
- The data used does not match the data the auditor sees at the entity
- There is a large change in the population
- No identification of what changed from the prior year and the impact of each change
- Report does not have all the information required by the ASOPs, e.g. summary of participant data is missing

Questions and Discussion

Materiality



What is Auditor's Definition of Materiality?

- Performance Materiality or Tolerable Misstatement – Information is considered material if omitting it or misstating it could reasonably be expected to influence the economic decisions of users
- Clearly Trivial (or *de minimis*) Threshold (CTT) – items over the CTT are accumulated to see if they are material in the aggregate

What is Actuary's Definition of Materiality?

- Materiality—“Materiality” is a consideration in many aspects of the actuary's work. An item or a combination of related items is material if its omission or misstatement could influence a decision of an intended user. When evaluating materiality, the actuary should consider the purposes of the actuary's work and how the actuary anticipates it will be used by intended users. The actuary should evaluate materiality of the various aspects of the task using professional judgment and any applicable law (statutes, regulations, and other legally binding authority), standard, or guideline. In some circumstances, materiality will be determined by an external user, such as an auditor, based on information not known to the actuary. The guidance in ASOPs need not be applied to immaterial items.
 - * Per ASOP 1, *Introductory Actuarial Standard of Practice*, paragraph 2.6

How do Auditors set materiality levels?

- Understand the users of the financial statements and their focus
- Identify the benchmarks of most importance to the users (e.g. net profit, revenue, total assets, etc.)
- Determine appropriate percentage to apply to benchmark
- Determine final materiality, performance materiality, component materiality, clearly trivial threshold

What is an Entity?

- Corporate Audits
- Plan Audits – Defined Benefit Plans, Health and Welfare Plans
- Materiality will be much smaller for a Plan Audit

Let's define some terms – in our words, not “official”

- Acceptable – in accordance with accounting standards, auditing standards and actuarial standards
- Significant – subject to professional judgement unless specifically defined in an accounting standard
- Material – a numeric threshold for each audited entity which incorporates the risk of not stating the financial statements fairly
- Reasonable – would/could another professional get a similar answer given the same circumstances and a robust rationale
- Exception – an auditor disagrees with the acceptability of a method or reasonability of the assumption

How Auditor's Deal with Exceptions

- If clearly trivial (*de minimis*), usually ignore, except if there are so many trivialities is leads to questions about accuracy or controls
- If not large enough to make a difference by itself, but not trivial, then keep track of all of the separate differences and if they accumulate to something large, there may be a material misstatement – this is also reported to the Audit Committee
- Large enough the “shit hits the fan”

Assessing Pension/OPEB risks

- Pension/OPEB determination are often
 - Complex
 - Large amounts relative to the other financial measurements
 - There aren't many alternative sources
 - Many not be well understood by the auditor of the entity's management
- Actuaries as specialists
 - The actuary may be influenced by management
 - Management should have controls around the work from the actuary
 - The actuary is bound by professional standard

Reliability of Other Clients' Experiences

Just because another client has not had negative feedback about an approach or result does not mean it is acceptable for all situations

- Materiality, as judged by the auditors, may mean that entity's financial condition will still be fairly stated regardless of that approach or result
 - Consolidated statements may not be impacted, but subsidiary's may
 - A plan may be larger or smaller compared to an entity's financial statements
 - The financial position of an entity changes year to year
- Entity's structure and accounting policy
 - If there are similar plans within another part of the entity, each may need to be treated consistently
- Plan structure, asset allocations, or other facts and circumstances may be significantly different from one entity to another

Examples of Possible Issues

- Plan audit materiality is usually much smaller than for a corporate audit – what might not be significant in a corporate audit, might be for a plan audit
- There may be several issues that are each small, but in aggregate could lead to intolerable misstatement

Questions and Discussion

Reasonability of Assumptions



What is Management's Responsibility?

- The Entity is ultimately responsible for the assumptions underlying measurements reported in its financial statements; therefore management should:
 - Assess the relevancy and reasonableness of each significant assumption on an ongoing basis
 - Consider preparing a memo supporting the basis for each important assumption and how management determined which assumptions were important (this is a leading practice)

What is the Actuary's Responsibility?

- As a professional:
 - Assist management in understanding each assumption in context
 - Make appropriate disclosures about assumptions, rationales and changes
 - The auditor may ask for an affirmative statement taking responsibility for all assumptions used
- Comply with ASC 715-30-35-42:
 - Requires an explicit approach to assumptions.

What is the Auditor's Responsibility?

- The auditors will assess the reasonableness of the assumptions. They do not “approve” the assumptions.
 - Consider the methodologies used to set assumptions
 - Consider the consistency of the approach year over year
 - Consider the credibility of the population and assumptions used by comparable populations
 - Watch for patterns in demographic gains and losses and expected vs. actual benefit payments

Information an Actuary Should Provide about Each Significant Assumption

- Consistent with
 - ASOP 27, *Selection of Economic Assumptions for Measuring Pension Obligations*, and
 - ASOP 35, *Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations*
- Include rationale
- Disclose changes in assumptions

Assessing Economic Assumptions

- Assumptions are part of an estimate determined using an accounting principle
 - A change in estimate is treated as an actuarial gain/loss
 - A change in accounting principle requires evaluation of preferability and must be applied retroactively - material retroactive application leads to restatement of previously issued financial statements
- Assumptions should be management's best estimate
- Each individual assumption should be reasonable
- Economic assumptions should have consistent building blocks – can vary by purpose and duration
- Management's overall accounting policy should be consistent for similar plans
- The plan is the unit of accounting and each plan will have its specific circumstances

Considerations Regarding Discount Rates

- High quality bonds: which match cash flows
 - SEC: AA or better considered “high quality”
 - Reinvestment: cash-flow matching should be close and shouldn’t be skewed by unreasonable reinvestment assumptions
- Cash flows: consider interest-sensitive features (not specifically addressed in accounting literature) –two approaches often seen:
 - Settlement approach: similar to how a financial analyst would assess the “fair value” of an economic instrument with embedded options - implemented as “annuity substitution” or by using implied forward rates
 - Deterministic: incorporate best estimates based on long-term economic assumptions when determining cash flows

Considerations Regarding the Expected long-term Return On plan Assets

- **Long-term:** base on current* assets allocation and time horizon of obligations
- **Forward-looking:** expected returns by asset class based solely on historical rates are generally not appropriate
- **Inflation:** should be consistent with other long-term economic assumptions
- **Impact of active management:** only if there is demonstrated additional return (sometimes referred to as alpha)
- **Best estimate:** in most cases, using high or low end of a range may not be supportable as a best estimate
- **Net return:** expected investment-related fees and taxes should be considered, as well as administrative fees (unless these are explicitly included elsewhere)

* It can be acceptable to consider probable changes in the portfolio mix if these changes will occur in a reasonable period with appropriate management approval

Considerations Regarding Health Care Trend Rates

- **Cost-sharing:** trends may be higher if increases in out-of-pocket costs are not permitted; however may reflect net increase when
 - A pattern of managing trend through incremental benefit reductions
 - Those changes considered actuarial gains, not plan amendments
- **Initial trend:** generally in the mid to upper single digits
- **Period to ultimate:** generally over several years rates should decline otherwise increases would not be possible on a macroeconomic level; generally not reset each year
- **Ultimate:** generally higher than inflation consistent with presumed economic growth
- Many possible components: e.g. medical, prescription drugs, administrative expenses, vision, dental, pre-65 vs. post-65

Assessing Demographic Assumptions

- Demographic assumptions should reflect the characteristics of the population covered
 - Consider industry
 - Consider experience, if credible
 - May differ based on work classification, location, division, or other factors

Considerations Regarding Mortality

- Should be based on the latest available information about conditions as of the date of measurement
 - May need to reflect updates after the initial valuation if new information is available before the financial statements are available
- Need to have a robust rationale – static tables that are not approximations of fully generational tables may not be appropriate
 - Consider both the base rates and the projection scales
 - Any study of plan experience should meet credibility standards

Examples of Possible Issues

- LTRR falls in the 25th to 75th percentile range using a stochastic model (best estimate?). LTRR uses an “alpha” which is not supported
- Management does not consider the most recent mortality studies in setting the mortality assumption
- Lump sum mortality table doesn't take into consideration future improvements
- Discount rate not determined as of measurement date and/or based on plan population and benefit provisions

Questions and Discussion

Other Resources

- [Working with Pension Plan Auditors - A Public Policy Practice Note, May 2011, American Academy of Actuaries, Pension Accounting Committee](#)
- [AICPA Employee Benefit Plan Audit Quality - Understanding Auditor Communications](#)



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