A PUBLIC POLICY PRACTICE NOTE

Working with Pension Plan Auditors

May 2011

American Academy of Actuaries
Pension Accounting Committee

AMERICAN ACADEMY *of* ACTUARIES

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Developed by the Pension Accounting Committee
of the American Academy of Actuaries

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This practice note is not a promulgation of the Actuarial Standards Board, is not an Actuarial Standard of Practice, is not binding upon any actuary, and is not a statement as to what constitutes generally accepted practice in the area under discussion. Events occurring subsequent to the publication of this practice note may make the practices described in the practice note no longer relevant or otherwise obsolete.

This practice note was prepared by the Pension Accounting Committee of the American Academy of Actuaries to offer information to actuaries on current practices relevant to the audit of pension plan financial information that is subject to US generally accepted accounting principles (US GAAP). The note is intended to assist Responding Actuaries (and Reviewing Actuaries) in working effectively with Auditors throughout the course of an audit by providing a better understanding of:

- The information that is expected to complete the review of the year-end measurements for clients;
- Why Auditors ask the questions they do; and
- How Responding Actuaries, Reviewing Actuaries, Auditors and Companies can work together to help the process go smoothly.

The note offers issues for consideration and is not intended to define practice, set standards, or be audit guidance. The note includes some commonly observed questions and answers. While this note does reflect experiences of both Responding and Reviewing Actuaries, it is not intended to provide definitive guidance or set practice. Rather, it is intended to help a Responding Actuary better appreciate the thought process and context in which a Reviewing Actuary approaches a year-end audit with an emphasis on general principles and not specific guidance. To the extent of any conflict with the statements contained herein with applicable laws, rules, or regulations, the relevant laws, rules, or regulations should be followed.

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BACKGROUND

This practice note is written from the perspective of actuaries working with auditors under US GAAP. The broad issues and thought processes illustrated may be useful for actuaries and auditors working under other accounting and auditing standards, although the standards will differ in their particular requirements, the specifics of which are beyond the scope of this practice note.

Roles and Responsibilities

Company – the entity whose financial statements are being reviewed in the audit or examination. For purposes of this note, "Company" includes publicly traded companies, not-for-profit organizations, or any other entity that is subject to US GAAP accounting standards. The Company is responsible for the accuracy and appropriateness of all of the information contained in its financial statements. As such, all of the assumptions and methods of calculation become the responsibility of the Company. In addition to auditing the information in the financial statements, Auditors will also gain an understanding of the Company's internal controls – the collective processes that a Company uses to assure the reliability of financial reporting and the preparation of financial statements for external reporting purposes.[1]

Responding Actuary – as defined in ASOP 21, a Responding Actuary is an "actuary expressly designated by an entity to respond to the Auditor or examiner with respect to specified elements of the entity's financial statement that are based on actuarial considerations. An entity may expressly designate one or more actuaries as responding actuaries for a particular audit or examination." Thus, typically a Responding Actuary will ultimately prepare the financial measurements necessary for the financial statements. In the course of that process, the Company will often consult the Responding Actuary regarding the assumptions to use in the calculations; although the Responding Actuary provides this input in the assumption setting process, the ultimate responsibility for the assumption selection lies with the Company.

Auditor – as defined in ASOP 21, an Auditor is "The firm or professional engaged to conduct an examination in accordance with generally accepted auditing standards for the purpose of issuing an opinion on a financial statement."

Reviewing Actuary – as defined in ASOP 21, a Reviewing Actuary is "An actuary expressly designated by the Auditor or examiner to assist with the audit or examination of a financial statement with respect to specified elements of the financial statement that are based on actuarial considerations." Reviewing actuaries are often, but not always, employees of audit firms.

[1] PCAOB Auditing Standard No. 5, paragraph 2.
http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx#introduction

Specialist – As defined by the auditing standards[2], a specialist is a person or firm who possesses specialized skill or knowledge in a field other than accounting or auditing. When examining the financial statements of a client, the Auditor may lack the expertise needed to evaluate the relevant documentation in a particular area. The Specialist is able to analyze the information and provide the necessary reviews to support the audit opinion. An actuary is one type of Specialist.

It should be noted that "Specialists" are not necessarily "Experts," which the SEC describes as being completely independent from the reporting company and solely responsible for the selection of the underlying methods and assumptions. ("Experts" are commonly encountered in SEC filings when the situation requires a "fairness" opinion, such as mergers, buyouts or initial public offerings – IPOs.) For purposes of this practice note only, we are assuming that actuaries are acting as Specialists and that the reporting company "owns" its reported financial results.

In the context of this practice note, we have assumed that auditors consider actuaries (most commonly Responding Actuaries, but sometimes Reviewing Actuaries) to be "Specialists" when the auditors are reviewing pension and post-retirement benefit accounting results.

Accounting Standards

FASB – the Financial Accounting Standards Board (FASB) establishes the standards of financial accounting in the U.S. These standards govern the preparation of financial reports by nongovernmental entities submitted to the SEC, as well as other organizations (such as not-for-profit organizations) that are required to prepare financial statements under generally accepted accounting principles.

Auditors and Other Reviewing Bodies

Audit work is subject to scrutiny by many different parties. The following summarizes the entities that oversee Auditors. The Reviewing Actuary in the course of the audit seeks to gather supporting documentation from the Responding Actuary such that any questions regarding the financial statements asked by any one of the following bodies may be addressed.

SEC Staff – "The mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."

"The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public. This provides a

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[2] Interim PCAOB auditing standard AU 336, http://pcaobus.org/Standards/Auditing/Pages/AU336.aspx

common pool of knowledge for all investors to use to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions."[3]

PCAOB - The Public Company Accounting Oversight Board ("PCAOB") was established by the Sarbanes-Oxley act of 2002 to oversee the audits of public companies. The PCAOB is a private not-for-profit organization and is responsible for establishing "auditing and professional practice standards for registered public accounting firms to follow in the preparation of and issuance of audit reports."[4] Each year, the PCAOB reviews the work-papers from selected clients from an accounting firm to assess its work. Over time, the examinations from the PCAOB have grown in sophistication and depth. The PCAOB issues a report of its findings to the public.

A key part of the PCAOB's review includes the audit documentation. The required documentation is discussed in Auditing Standard No. 3[5], including:

> "Audit documentation should be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached." (Paragraph 4)

and,

> "This documentation requirement applies to the work of all those who participate in the engagement as well as to the work of specialists the auditor uses as evidential matter in evaluating relevant financial statement assertions. Audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement:
>
> 1. To understand the nature, timing, extent, and results of the procedures performed, evidence obtained, and conclusions reached, and
> 2. To determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review." (Paragraph 6)

Thus, many of the questions auditors will ask Responding Actuaries are directly related to the auditor's professional obligation to provide "sufficient documentation" under the PCAOB's rules. This includes documenting the work of a Specialist – including actuaries – as described under AU 336 / SAS-73 below.

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[3] Excerpted from the SEC's website: http://www.sec.gov/about/whatwedo.shtml
[4] http://pcaobus.org/Standards/Pages/default.aspx, "Standards"
[5]http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_3.aspx#auditdocumentationrequirement. *These quotations from Auditing Standard No. 3 are provided for background information only; nothing in this practice note should in any way be construed as an interpretation, pronouncement or application of auditing standards.*

Many actuaries will recognize that in spirit, the auditor's professional obligation to provide documentation under Auditing Standard No. 3 has parallels to the actuary's professional obligation to provide documentation under ASOP 41. [6]

Selected Guidance that May Influence an Auditor's Perspective

The following list is intended solely to give actuaries a flavor of the professional guidance under which auditors operate. It is illustrative only, and should not in any way be interpreted as binding, exhaustive or authoritative.

i. Professional Skepticism – Auditors are tasked with reviewing audit evidence in a critical manner with a questioning mind in order to ascertain the validity of such evidence. The balance between professionalism and skepticism may be explained as an approach where an Auditor "trusts but verifies." In situations that the auditor considers to be higher risk, more evidence may be requested from the Company or the Responding Actuary.

ii. PCAOB interim auditing standard AU 324 (formerly SAS 70 – Statement on Auditing Standards (SAS) No. 70 issued by the AICPA[7]) is a standard that sets forth the guidelines for reviewing the contracted internal controls of a service organization. It's commonly believed that AU 324 applies to recordkeeping and other administrative functions rather than to pension actuarial measurements.

iii. PCAOB interim auditing standard AU 336 (formerly the AICPA's SAS 73) provides guidance for Auditors in testing the work of a Specialist. In using the work of a Specialist:

- Auditors are not expected to be experts in all areas;
- Auditors may encounter material matters which are complex or subjective; and
- An Auditor may use the work of a specialist engaged by management as evidential matter to evaluate financial statement assertions.

Selected Sources of Relevant Guidance for the Actuary

In the course of preparing the work for purposes of the financial statement audit, the Responding Actuary has various sources of guidance and literature that may be applied in developing the work product. The following provides a reminder of some of the relevant guidance but is not an exhaustive list of all applicable materials.

<u>The Code of Professional Conduct</u> adopted by the American Academy of Actuaries, the American Society of Pension Professionals and Actuaries, the Casualty Actuarial Society, the Conference of Consulting Actuaries, and the Society of Actuaries. In general, the

[6] See, for example, section 3.2 of ASOP 41: "In the actuarial report, the actuary should state the actuarial findings, and identify the methods, procedures, assumptions, and data used by the actuary with sufficient clarity that another actuary qualified in the same practice area could make an objective appraisal of the reasonableness of the actuary's work as presented in the actuarial report."

[7] The American Institute of CPAs, the professional organization for Certified Public Accountants.

Code of Professional Conduct sets forth required standards of conduct for actuaries who are members of the aforementioned organizations, to support the actuarial profession and to fulfill its responsibilities to the public. Precept 2 of the Code of Professional Conduct refers to the Qualification Standards and states that an Actuary shall perform Actuarial Services only when the actuary is qualified to do so. Those qualifications include appropriate requirements for basic education, continuing education, and experience.

Qualification Standards (including Continuing Education Requirements) for Actuaries Issuing Statements of Actuarial Opinion in the United States promulgated by the American Academy of Actuaries. The purpose of the Qualification Standards is to provide the framework for actuaries subject to the Qualification Standards to assess whether or not they are qualified to issue a Statement of Actuarial Opinion. The Qualification Standards define a Statement of Actuarial Opinion to be "an opinion expressed by an actuary in the course of performing Actuarial Services and intended by that actuary to be relied upon by the person or organization to which the opinion is addressed."

Actuarial Standard of Practice (ASOP) No. 4 [Note: revisions pending] – Measuring Pension Obligations and Determining Pension Plan Costs or Contributions *(Assumptions and Methods.)* This standard applies to actuaries when performing professional services with respect to the following tasks:

- Measurement of pension obligations. Examples include determinations of funded status, assessments of solvency upon plan termination, and measurements for use in cost or contribution determinations;
- Assignment of plan obligations to time periods. Examples include contributions, accounting costs, and cost or contribution estimates for potential plan changes;
- Development of a cost allocation procedure used to determine costs for a plan;
- Development of a contribution allocation procedure used to determine contributions for a plan;
- Determination as to the types and levels of benefits supportable by specified cost or contribution levels; and
- Projection of pension obligations, plan costs or contributions, and other related measurements. Examples include cash flow projections and projections of a plan's funded status.

ASOP No. 21 – Responding to or Assisting Auditors or Examiners in Connection with Financial Statements for All Practice Areas *(Responding to Auditors).* This ASOP provides guidance to actuaries when providing professional services while responding to or assisting auditors or examiners in connection with an audit or examination of a financial statement. Actuaries who believe their work will fall into that situation are encouraged to read and understand the framework in the Standard of Practice.

ASOP Nos. 27 and 35 [Note both are pending revisions] – Selection of Economic Assumptions for Measuring Pension Obligations, and Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations.

<u>ASOP No. 41 – Actuarial Communications.</u> This standard provides guidance with respect to written, electronic, or oral communications. The standard sets forth the framework to communicate required disclosures; the scope of the work; the methods, assumptions, data, and other information to complete the work; and the development of the actuarial communication of the actuary's work product.

<u>ASOP No. 6 [Note revision pending] – Measuring Retiree Group Benefit Obligations.</u> This standard applies to actuaries when measuring any type of retiree group benefit obligation. Included in the scope of this standard are measurements made for the following purposes:

- Financial reporting, such as measurements made for purposes of compliance with Accounting Standards Codification Topic 715-60 (ASC 715-60). Note that ASC 715-60 was formerly referred to as Statement of Financial Accounting Standards No. 106 (SFAS No. 106);
- Cash-flow analyses;
- Plan funding, including the determination of participant contributions when such contributions are based on expected retiree group benefit costs;
- Cost projections, including those made in conjunction with establishing or modifying the plan's design; and
- Determinations of actuarial present values.

<u>ASOP No. 44, Selection and Use of Asset Valuation Methods for Pension Valuations</u> provides guidance to the actuary when performing professional services with respect to the following:

- Selection of an asset valuation method for purposes of a defined benefit pension plan actuarial valuation; and
- Appropriate disclosures regarding the asset valuation method used.

Each of the ASOPs related to pension and other postretirement benefit measurement issues (ASOPs 4, 6, 27, 35 and 44), indicate that any reference to selecting assumptions, selecting a cost allocation policy, or to modeling also includes giving advice on selecting assumptions, selecting a cost allocation policy, or modeling. For instance, the actuary may advise the plan sponsor on selecting assumptions for ASC 715-30 or 715-60 measurements, but the plan sponsor is ultimately responsible for selecting these assumptions. These standards apply to the actuarial advice given in such situations, within the constraints imposed by the relevant accounting standards.

How Responding and Reviewing Actuaries Can Understand Each Other

Commonly Asked Questions

1. The process of completing a year-end Company audit involves a great deal of work in a short period of time. What information and analysis can be provided early in the course of the audit in order to ease this year-end time crunch?

The key to making the audit run smoothly is having a schedule in place with the Auditor, Company, and Responding Actuary that sets forth a clear framework for the process. Some of the items that will be considered may be provided early in the process so that procedures can be completed well in advance of the applicable filing date. Examples of those items include the following:

- Documentation of employment events or plan changes that occurred during the year (or since the prior measurement date) along with the details of any mid-year remeasurements;
- The process used to determine if a curtailment or settlement was triggered and the basis for that conclusion;
- Changes in plan population or pay practices; and
- The selection process for market- or current data-sensitive assumptions. For example, while the discount rate needs to reflect year-end economic conditions, an assessment of the process that will be used to determine that rate (e.g., yield curve, bond portfolio) can be performed prior to year-end. Similarly, the process in place to determine claims costs for an OPEB valuation can also be assessed.

The selection and documentation of other assumptions that are not based on current market conditions or an analysis of current data, including turnover rates, retirement rates, mortality, medical trend rates, and expected increases in retiree contributions may also be able to be completed prior to year-end.

An ongoing dialogue during the year between the Company and Auditor (with inclusion of the Responding Actuary and Reviewing Actuary as appropriate) regarding applicable issues may also help ensure that the Auditor is comfortable with any approach proposed to the Company by the Responding Actuary.

2. Responding Actuaries work directly with the Company to develop the information the Company will need for its year-end audit. Why do Auditors still send an audit confirmation letter to the Responding Actuary requesting the same information?

An audit is a set of agreed upon procedures. The confirmation letters that are part of the audit would likely have gone through an internal review process to make sure that all the points are covered. While these letters may be redundant with regard to information already provided, they represent the auditor’s expectation of the materials necessary to begin the audit. In many cases, the duplicative request for information is simply a timing issue; the confirmation letter is simply sent to the Responding Actuary after the information has already been provided to the Company. In other cases, the actuarial information requested of the Company may be different than that requested by the Responding Actuary. For example, the confirmation letter to the Responding Actuary often serves as the framework of describing what is needed. Key to the process is gathering the relevant information. To the extent that the data requested is duplicative, the Responding Actuary, Company and Auditor can work together to identify the information that has already been provided and the information that is outstanding.

In addition, an Auditor or Reviewing Actuary may also want to receive information directly from the Responding Actuary rather than the Company to ensure that there are proper controls around the information provided.

3. Many of the items in the confirmation letter aren't the responsibility of the Responding Actuary to answer and would be better answered by the Company or another service provider – why are they included?

Investment policy is a good example of this. The request serves a couple of different purposes. First, requesting the same data from multiple sources provides corroboration of the information being provided. Second, requesting the information from the Responding Actuary (with the knowledge and approval of the Company that engaged the Responding Actuary) enables the Auditor to confirm what the Company and Responding Actuary have discussed to aid in providing the Responding Actuary with correct information on which to base the actuarial measurements.

4. Many of the answers to questions in the course of the audit seem really obvious. Why is this?

Obvious is a subjective term. What is obvious to the Responding Actuary may not be obvious to an Auditor, peer reviewer, or PCAOB inspector. The literature may call for a specific method or process but there may be situations where the method is applied incorrectly or with a different variation than would be considered standard. The question is asked so that the Auditor can better understand, especially in cases where the answer may not be so straightforward, whether the method used is appropriate within the context of the guidance.

A good example of this situation is the method used to measure the benefit obligation which is required under the accounting standards to be the projected unit credit method. Since the method is prescribed, why is the Responding Actuary asked to identify it? In many cases, just saying "projected unit credit" without providing further details on the specifics of the calculation may not unambiguously identify the particular flavor of projected unit credit used or how benefits are attributed to periods of service. For example, complex or multiple formula plans, cash balance or other hybrid plans, or nonqualified plans often require significant interpretation of the term "projected unit credit." These interpretations – part of an employer's accounting policies – need to be properly documented so that the auditor can form an opinion as to their appropriateness.

And, in practical terms the Auditor needs to document the response, even if the Auditor (or Reviewing Actuary) is relatively confident of what the answer would be.

5. What do audit standards generally require for an actuarial report?

Audit standards do not have specific requirements for the content of an actuarial report. The ASOPs do have requirements, however, and the expectation of the Reviewing Actuary is that the report will conform to those standards.

Some of the key items (albeit not all) that a Reviewing Actuary will look for include the following:

- Identification of the actuary responsible for the measurements;
- Acknowledgement of the purpose of measurements;
- Acknowledgement of the appropriateness of the work for the purpose intended;
- The qualifications of the actuary including relevant credentials and an acknowledgement of qualification;
- An affirmative statement regarding the validity of the results for the intended purpose;
- Any relationships to the Company that may need to be disclosed;
- Summary of data, assumptions, methods, and plan provisions used in developing the measurements; and
- Assessment of reasonableness of assumptions.

While it may not be possible to eliminate all possible questions that a Reviewing Actuary may raise, one approach to reduce the number of questions would be to discuss in the report any questions that the Responding Actuary raised while preparing the report and the resolution of those questions. For example, if the Responding Actuary raised a question regarding the sources of gain/loss while preparing the report, a brief commentary on those sources might address a similar question from the Reviewing Actuary.

6. What information does a Reviewing Actuary consider in assessing the demographic assumptions?

No one answer covers every case. The Auditor will first want to identify the factors that the Company (and Responding Actuary) considered in selecting the assumptions as its "best estimate."

In some cases, actual experience is credible enough to periodically perform an experience study. In these situations, the Auditor would like to have a copy of the study report and be able to understand how the results of the study were reflected in the selection of the assumptions. In other cases, the Company may look to industry or national data to develop the assumption. Again, the Auditor is looking to identify which factors the Company considered.

In any case, when assumptions are changed, the Auditor will want to identify the information that was considered and understand why the new assumptions are now considered to be the best estimate.

7. What does the Reviewing Actuary usually do with the summary of plan provisions?

As noted above, plan provisions are used by the Reviewing Actuary to understand the interplay between the plan provisions and assumptions. For example, in a plan that provides a heavily subsidized early retirement benefit yet assumes all employees retire at normal retirement age, the Company may be asked to support how not incorporating rates of retirement produces a representative actuarial liability.

This summary is also used by the audit team to see that the appropriate plan provisions have been reflected in the measurements.

8. What special information is usually required when a plan pays lump sums?

For plans offering lump sum payments or other accelerated payouts, accounting standards specify that each of the significant assumptions "reflect the best estimate solely with respect to that individual assumption[8]." For a plan that pays lump sums, there may be assumptions about the proportion of the employees expected to take the lump sum option and the factors used to convert the pension annuity to a lump sum. The Reviewing Actuary may be asked to support or provide the underlying rationale for these assumptions.

9. What information does a Reviewing Actuary usually consider in assessing the mortality assumptions?

No specific mortality tables are mandated but when the selected mortality assumption deviates from what the Auditors observe as common practice, they may ask the Reviewing Actuary or Responding Actuary for clear documentation of why the particular table selected provides a best estimate assumption. In certain cases, this documentation may include the quantification of the impact of using a different mortality table.

10. What does a Reviewing Actuary typically look for as support of the discount rate? Is more support required if a hypothetical bond portfolio or bond matching model is being used?

The accounting standards and SEC guidance expect that the discount rate will:

- Reflect yields available on high-quality fixed income instruments;
- Reflect the plan population and plan provisions; and
- Be determined based on economic conditions as of the measurement date.

[8] Accounting standards codification ASC 715-30-35-42

While this accounting guidance provides some indication of the basis of the rate, alternative approaches/methods to support this rate are used in practice. Thus, the support needed for the discount rate for any given situation depends on the approach taken. For a yield curve, considerations include whether or not the curve is reflective of high quality bond yields, whether the application of the curve to the cash flows is appropriate, and whether the comparison of the pension benefit obligation to the discounted cash flows is reasonable. For an index, good documentation could be expected to include information illustrating why that particular index is appropriate for that population. If a hypothetical bond portfolio is used, the bond model and underlying bonds will both be reviewed. The individual bonds are likely to be more heavily scrutinized because of the very limited number of bonds typically used.

As time has passed, the level of sophistication in selecting a discount rate has increased as has the scrutiny of the rate selected. While Companies may have in the past used a relatively simplistic basis to select the discount rate (for example, based on an index or what other Companies were using), the widespread availability and ease of use of more complex tools has created an environment in which Companies choose to use those more refined tools – often at the individual plan level. The corporate environment has also evolved and the stakeholders of public Companies are more aware of the effect of this assumption, providing yet another level of scrutiny. As a result of these developments, it has become increasingly common for Auditors to request a detailed description of the method used to select the discount rate and the supporting analysis documenting the rationale for the discount rate selected.

In addition, if a Company has changed the procedure for estimating the discount rate, the Auditor and Reviewing Actuary may want to know how the new procedure improves the quality of the estimate or how changes in facts and circumstances have made the new procedure more appropriate.

11. What is the purpose of providing separate documentation supporting the discount rate for each of the Company's plans when some of them are really small and insignificant?

ASC 715-30-55-170 states that: "Judgment shall be applied to determine what is significant for each pension plan (the unit of accounting) based on facts and circumstances." A similar standard applies for other postretirement benefit plans. Therefore, the expectation may be that the discount rate is supportable for each plan individually. To the extent there are deviations from that practice, the impact of using a different discount rate may be considered within the context of audit materiality. As discussed below, "materiality" is a very specific concept to an Auditor. Accordingly, rather than indicating that the impact is "immaterial," the Responding Actuary or Company is encouraged to provide the dollar impact of the change (or a ceiling on the impact) so that the Auditor can assess the financial impact.

In certain cases, several plans may have similar demographics and the same discount rate may be supportable for each. The Reviewing Actuary may ask the Responding Actuary to provide documentation or reasoning to the Company that supports their conclusion that two plans have demographics that are sufficiently similar that the same discount rate may be used. In other cases, the Company may elect to use one discount rate for all plans perhaps based on the largest plan. This approach may be permissible, but not without a valid basis and articulation of the reasons as to why this is the case. The more the Responding Actuary can do to provide solid support for each of the plans, the easier the discussion will be. The Reviewing Actuary will likely want to receive additional information that may include the relevant facts and circumstances on which the conclusion was made, and whether the same rate was supportable for each plan. Such information would need to be based on conditions as of the measurement date.

12. What documentation can be provided that supports the long term rate of return on plan assets?

The Auditor first wants to know the Company's process (including the factors considered) in selecting a particular rate as its best estimate. The Auditor may also ask the Responding Actuary to discuss the factors considered in the Responding Actuary's assessment of the rate.

As discussed in accounting standards, the expected long term rate of return on plan assets is the expected return on those assets currently invested – over the lifetime of those assets. Accordingly, the rate has a long term perspective.

Further, the accounting standards and SEC guidance require that the Company provide a narrative discussing the development of this assumption. While a Company may consider surveys in their selection process, the other Companies included in such surveys may not have the same investment strategy or philosophy as the Company being audited. Accordingly, simply referencing survey information without adapting that information to the Company's specifics is not as helpful as providing a more robust discussion.

13. Is the long term rate of return on assets being reviewed for the current year expense, the following year expense, or both?

The year-end disclosure shows the expense determination for the year just ended, so the assumption is reviewed for the year that just ended. Practically speaking, the Company is also planning for the next fiscal year and the assumption would likely need to be used in the development of the pension expense for that year. As a result, a review of the rate for the coming fiscal year may also be desired as well. This review is particularly important when there is an anticipated change in the assumption.

14. How does a Reviewing Actuary evaluate significant events?

The Company, not the Auditor (or Reviewing Actuary), is responsible for assessing any particular event to determine whether or not it is significant. Based on that analysis, the Auditor then assesses and audits the policies and procedures used in the determination of whether the event was significant and the consistent application of these policies and procedures to future events. For example, in determining whether a curtailment has occurred, the common measure is a significant reduction in headcount or future years of service – but the employer ultimately decides what level of reduction is significant. In addition to curtailments, the Company may also need to evaluate events such as plan amendments, settlements, and plan mergers or spin-offs. Discussing these types of events with the Auditor to gain acceptance of the accounting treatment at the time they occur instead of reviewing them at year-end can help avoid unnecessary surprises.

Given the subjective nature of determining significance, one of the challenges is how to actually measure it. Is it just the change in the benefit obligation? How much extra the Company would have to book due to the event? Or, how much expense would change following the remeasurement? With no specific guidance in the literature, the role of the Reviewing Actuary is to assist the Auditor in understanding the Company's process and policy in place to evaluate the event and then determine whether the Company has followed its stated policy.

The materiality of a significant event will ultimately depend on the particular situation but will be considered both in relation to the plan and the financial statements of the Company. While erring on the side of being conservative may be considered by a Company, treating a particular event as significant may set a precedent for the future.

15. What process is used by the Reviewing Actuary to evaluate trend rates?

As discussed above, the Reviewing Actuary first works with the Auditor to learn the basis for the assumption – how trends were selected and what factors were considered in the selection process. Companies can help facilitate this review by having a well-documented selection process. Like other actuarial assumptions, the trend rate is intended to be a best estimate and the Auditor will seek to know how the Company concluded that these trend rates were the best estimate of future trend.

16. What information is necessary to support the initial claims cost?

This parameter is the starting point for the application of trend to develop future claims. As discussed in ASOP No. 6, initial claims may be based on a manual rate or on Company experience or a blend of the two. The Reviewing Actuary is striving to identify the process followed, including whether there were adjustments for large claims. Accordingly, an actuarial report that provides some detail regarding the development of the initial claims is more helpful than one that simply presents the initial claims amounts.

As with any change, if the approach to developing the initial claims is modified, the Reviewing Actuary and Auditor will look at the drivers of the change and in particular the <u>current</u> circumstances leading to the change.

17. What other factors are considered in assessing the appropriateness of assumptions for an OPEB plan?

Key to assumptions in OPEB plans is the underlying question of the credibility of the block of experience in the plan. For many Companies, plan experience may not be sufficiently credible and actuaries will rely on other data sources such as national surveys to develop assumptions. At other times, pre- and post-Medicare retiree experience may be blended, or active experience may be blended with retiree experience to develop a more credible data set. The Reviewing Actuary will want supporting documentation to ensure that the ultimate claims cost and age-related morbidity factors developed effectively reflect retiree-only rates that are appropriate for an OPEB measurement. This particular concern is frequently raised when considering early retirees who pay the same rate as actives (which may imply a “hidden” subsidy being paid by the employer).

18. In an instance where a Company has both an OPEB Plan and Pension Plan, should there be consistency in assumptions used for each plan?

On the surface and to the extent the plans cover a similar participant group, the expectation is that the assumption sets would be the same. In some circumstances, however, the characteristics of each plan may support differences in assumptions and documentation of those situations is helpful. For example, it may be appropriate for a pension plan with actuarially equivalent early retirement benefits to assume a single retirement age. On the other hand, for an OPEB plan with employer-provided early retirement benefits, the absence of early retirement rates may result in an understatement of the benefit obligation. Another example often seen in practice is the marriage assumption. While there may not be actual differences between the pension and OPEB plan assumptions, the disclosure of the assumption in the OPEB plan often incorporates both the percent married and election percentage in a single assumption. In this situation, a clarifying question may be required from the Reviewing Actuary to determine consistency. For example, the marriage assumption in an OPEB report may indicate 40% when in fact the percent assumed to be married is 80% (consistent with the pension report) and the anticipated election percent is 50%.

19. What information would be appropriate to evaluate settlements and curtailments? Are the detailed calculations and support for assumptions as of the remeasurement date required?

The goal of the supporting documentation is to provide the Auditor evidence that the one-time charge or credit to the income statement is appropriate. To reach that conclusion, review of the actual calculation documenting the determination of the charge or credit may be warranted. The amount of information needed will sometimes vary based on facts and circumstances. To the extent that the event has more significant repercussions for the Company’s financial results, more supporting information may be requested.

20. Can remeasurements be reviewed during the year so that Companies can avoid year-end surprises? What information is required to be reviewed and how/when can it be provided to the Auditor?

Remeasurements are most likely reported in a quarterly financial statement. The Company would ordinarily be talking with the Auditor throughout the course of the year, and the same information required for a year-end review would typically be required for a review of an interim remeasurement.

An ongoing dialogue between the Company and Auditor (with inclusion of the Responding Actuary and Reviewing Actuary as appropriate) regarding any non-standard approaches is advisable to ensure that the Auditor is comfortable with any approach proposed by the Company (or proposed to the Company by the Responding Actuary).

21. Do all measurements have to be performed as of the measurement date?

The short answer is "yes." ASC 715-30-35-62 provides that "the measurement of plan assets and benefit obligations required by this Subtopic shall be as of the date of the employer's fiscal year-end statement of financial position" with exceptions noted. Similar requirements also apply to other postretirement benefit plans. While pension and OPEB measurements are expected to be as of a particular date, it is not necessary that all procedures be performed after that date. As with other financial statement items requiring estimates, much of the information can be prepared as of an earlier date and projected forward to account for subsequent events (for example, employee service). Adjusting the calculation relies on the Responding Actuary using skills and expertise to reflect all of the information that is known in order to adjust the calculations. Inherent in the process of adjusting the information, one has to make best estimate assumptions to appropriately reflect the changes occurring over time. When considering a roll-forward, it is important to keep in mind that while the assumptions used in the broader calculations are long-term, the roll-forward period assumptions will be expected to reflect the short-term environment. Thus, the Responding Actuary will likely seek information supporting the assumptions used in the roll-forward as well. This support will generally be based on communications between the Responding Actuary and the Company so that the Company can identify trends over the past year (including, for example, how pay increases have performed compared to expected or differences in turnover from expected— even if not resulting in a curtailment) to be satisfied that the data being used is as close as possible to what it would be if it were actually collected as of the measurement date.

22. In a roll-forward year, is additional documentation on how this roll forward was calculated required?

Yes, the Reviewing Actuary will want to know how the roll forward was performed and what adjustments (if any) were made. At times, this roll forward is relatively straightforward and little additional information will be needed. In other cases, the Reviewing Actuary may ask for additional information and detail.

23. What does materiality mean?

Actuaries, and some Company personnel, often use the term "material" loosely. For an Auditor, however, "materiality" is a very specific concept. Auditors determine what is or is not material by looking at many items in different contexts; it is not simply a concept of significant digits but rather involves an accumulation of differences and may cross over many years. This accumulation and cross-over creates a situation that sometimes results in seemingly small numbers being identified as material for financial statement purposes. As a result, much time is spent reviewing the sources of what could be material differences when a possible issue arises.

Actuarial reports often state items "considered" but identified as having no material impact on results. From an Auditor perspective, it would be more helpful for the Responding Actuary to quantify (perhaps with an upper bound) the effect of the issue.

24. What may be considered to be "clearly trivial"?

As with materiality, no clear cut definition for "clearly trivial" exists, but the "clearly trivial" threshold is much lower than the materiality threshold. The consequences of crossing the "clearly trivial" threshold are less severe in that the disclosure is noted as a passed adjustment to the audit committee and an indication that there is a disagreement with management regarding certain items in the financial statements. Because of increasing scrutiny and oversight, management is often uncomfortable acknowledging disagreements with the Auditor and resolves these items before the financial statements are finalized.

As with materiality, in order for the Auditor to evaluate whether an item is "clearly trivial," the difference needs to be quantified. This quantification allows the Auditor to accumulate these adjustments across the entire audit engagement to determine the point at which the adjustments may become relevant in the aggregate.

25. What about the concept of preferability?

This concept is also defined in the Auditor's domain. When a company wishes to change from one acceptable accounting method to a different acceptable accounting method, the auditor must agree that the new method is "preferable" to the old one. Preferability involves comparing different but otherwise acceptable approaches and identifying any approach as having an advantage over other approaches that are available in the context of the Company's particular facts and circumstances. A common example seen in practice is the method of amortizing actuarial gains and losses. In most situations, faster amortization of gains and losses would be considered "preferable" to slower amortization.

While the Auditor will ultimately determine whether the elected method is preferable, some considerations may be as follows:

- What effect will changing an approach have on the income statement or the balance sheet?
- Does the approach move the reporting towards or away from marking to market?

26. Responding Actuaries may present an idea to a Company that the Auditor indicates would be a change in accounting method –what does this mean?

If a Company changes an accounting process and the Auditor determines that change in process to be a change in accounting principle, the Company is required to disclose what the differences in the financial reporting would have been if the new method had been used since the inception of reporting. Clearly, completing this task on an exact basis requires significant time and effort. While the Auditor's first inclination may be to follow "the letter of the law," the Auditor may be open to discussing approximations or estimates (sometimes referred to as "computational shortcuts" in the accounting standards) as a possibility. In any case, it is important to have a dialogue with the Auditor so that all parties agree that the financial statements are providing appropriate information.

The recommended course of action when a Responding Actuary proposes any change to an accounting process is to involve the Auditor early to evaluate whether the change will be considered a change in accounting principle or simply a change in process or estimate.

27. What is an "error in previously issued financial statements"?

The accounting standards codification defines this term as, "An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in the application of generally accepted accounting principles (GAAP), or oversight or misuse of facts that existed at the time the financial statements were prepared."[9]

A non-standard, though acceptable, approach or estimate is not an error in previously issued financial statements (of course, a non-standard approach may also warrant a deeper level of review). The use of the term "error" does not necessarily imply that the actuary made a mistake or did not comply with professional standards—the actuary may have followed the company's instructions perfectly but the instructions or data provided were inappropriate or insufficient.

Examples of errors in financial statements include issuing financial statements that are based on significantly incomplete or inaccurate census data or which otherwise do not reflect all relevant information that was known (or knowable) to the Company as of the measurement date.

In the case of a potential error in previously issued financial statements, the Auditor may ask questions such as:

- What was done this year and how was it done in the past?
- How long has it been done this way?
- What is the quantification of the difference?

If such an accounting error is identified and is determined by the Company or Auditor to be material, the Company's financials for the affected periods may need to be restated. Doing so could involve a significant amount of work and could negatively affect how the

[9] ASC 250-10-20

Company is viewed in the marketplace; particularly if financial statement users view the restatement as reducing the credibility of the Company's other published financial results.

Final Thoughts

As a reminder, this Practice Note is meant only to provide some insight into the audit review process for a retirement plan. It is not intended to set forth standards of practice or provide audit guidance. This note provides perspective and background information on retirement plan audits from the perspective of the Auditor, Responding Actuary, or Reviewing Actuary, and shows that all share a common goal of providing well-documented evidence that the information reported for the retirement plans appropriately represents the value of those plans.