

# Working With the ABCD

## Part II

**H**AVING LAID OUT THE INITIAL SCENARIOS and submitted our questions surrounding the selection of the discount rate under Statements of Financial Accounting Standards (SFAS) 87 and 106 in the preceding Workshop (see Page 58), here is how the ABCD responded.

Dear Mr. Rietz,

*On behalf of a group of concerned actuaries, you have asked the ABCD for its guidance regarding whether the actions of a consulting actuary in hypothetical scenarios involving the selection of the discount rate under Statements of Financial Accounting Standards 87 and 106 would constitute breaches of the Code of Professional Conduct. A copy of your request is attached.*

*The ABCD makes a finding of a material breach of the code only after a detailed investigation of the facts and circumstances of a particular situation. Hypothetical scenarios do not contain sufficient detail to support clear findings. However, they enable the ABCD to articulate the issues that are involved and the analysis we are likely to use in arriving at a finding. In this spirit, our response doesn't provide a definitive yes or no answer to the scenarios, but discusses the factors we would be likely to consider in analyzing a complaint involving these issues. In addition, we are not expressing any opinion regarding the specific arguments presented in the scenarios.*

### Summary of Hypothetical Scenarios

You have presented two basic scenarios with variations. (See Workshop, Page 58 of this issue.)

You pose three questions regarding these two scenarios. The remainder of this letter is a summary of the ABCD's response to these questions, along with a more detailed outline of the analysis the ABCD would go through before arriving at a decision.

#### **Question 1: Did either actuary materially violate the code in the advice given to the client regarding the selection of the discount rate?**

► **SCENARIO 1** Since the actuary's advice to the client was to adopt a discount rate that was determined using methodology that was appropriate, there clearly was no breach of the code by this actuary.

► **SCENARIO 2** Depending on the facts and circumstances, this actuary may have breached the code. If the recommended discount rate wasn't in accordance with

ASOP 27 (or ASOP 6), Precept 3 was probably breached. If the recommendation was inappropriate under FAS 87 or FAS 106 and the actuary knew or should have known that it was inappropriate,

then Precept 1 was probably breached. If the actuary didn't know the recommendation was inappropriate but should have known, it's possible the actuary breached Precept 2 by performing work without being qualified.

#### **Question 2: Did either actuary materially violate the code in using the client's selected discount rate and describing it as a prescribed assumption?**

► **SCENARIOS 1 AND 2** ASOP 27 and ASOP 6 permit the use of a prescribed assumption provided it's disclosed as such. The discount rate under FAS 87 or FAS 106 is a prescribed assumption, and the actuary disclosed it as one. Neither scenario contends that the actuarial communication was unclear. Thus, there was no breach of the code in using and disclosing the prescribed assumption.

ASOP 4 currently contains a requirement that an actuary disclose any long-term trend toward higher or lower cost in a pension plan due to continued use of the current assumptions. If the use of the prescribed assumption would create such a trend and it was not disclosed, then there may have been a breach of ASOP 4 and Precept 3.

#### **Question 3: Did either actuary materially breach the code in attempting to persuade the auditor of the appropriateness of a discount rate that was higher than the highest rate developed using methodology that was appropriate under actuarial and accounting standards?**

► **SCENARIOS 1 AND 2** If the selected discount rate was inappropriate and the arguments the actuary used in an attempt to persuade the auditor to accept it were inappropriate, then the actuary may have breached the code. If the actuary knew the arguments were inappropriate and still presented and supported them, even by implication, the actuary probably breached Precept 1. (It may be possible for an actuary to present the arguments as possible justifications for the higher discount rate without expressing or implying support, thus avoiding a breach of Precept 1, but

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we think this would be difficult to accomplish.)

If the actuary didn't know the arguments were inappropriate, but should have known, this may be evidence that the actuary wasn't qualified to perform the work, a breach of Precept 2. If the actuary didn't answer the auditor clearly, fully, and honestly regarding the discount rate assumption, this was probably a breach of ASOP 21 and Precept 3 and possibly of ASOP 41 and Precept 4. If the actuary was not careful to avoid misleading the auditor, the actuary may have breached Precept 8.

Note that the ABCD does not believe that ASOP 27 applies to discussions between an actuary and an auditor once the client has selected the assumption. The scope of ASOP 27 is stated as the selection of or giving of advice regarding the selection of economic assumptions. Since the auditor isn't selecting the economic assumption but reviewing an assumption selected by the plan sponsor, the actuary's communications with the auditor are outside the scope of ASOP 27.

### Materiality of Any Breach

If the ABCD determines that a breach of the code occurred, it must also determine whether the breach was material, not in an accounting sense, but with respect to the code. Factors that might be considered in judging materiality include the significance of the effect on the actuarial results, the potential effect on users of the results (e.g., investors or management), and the obviousness of the breach. If a breach is material, the ABCD will either counsel the actuary or recommend discipline, depending on the facts and circumstances. If the breach is not material, the ABCD may decide to issue guidance or counsel the actuary.

### Summary

As this discussion demonstrates, even a seemingly straightforward aspect of actuarial practice, the use of a discount rate assumption selected by the client under accounting standards, involves the application of several Precepts of the Code of Professional Conduct and associated ASOPs. In addition to the general requirement that the actuary perform services with competence and integrity, the code and ASOPs provide that any advice given to the client concerning the discount rate should be consistent with ASOP 27 and the applicable accounting standards. Using prescribed assumptions that aren't reasonable under those standards is permitted, but advising the use of or defending inappropriate assumptions may be a breach of the code. And ignorance about the inappropriate nature of the arguments or assumption may not be a defense but an indication that the actuary is performing services without being qualified to do so.

I believe these comments respond to your request for guidance.

Sincerely,  
Frank S. Irish  
ABCD Chairperson

# OUTLINE OF LIKELY

**B**efore looking at the individual questions, the ABCD would consider which precepts of the Code of Professional Conduct (the code) and which of the Actuarial Standards of Opinion (ASOPs) might apply to the situation, since the role of the ABCD in investigating a complaint is to determine whether there was a material breach of the code.

### A. Applicable Code of Professional Conduct Precepts:

1. Precept 1 requires that an actuary act honestly, with integrity and competence, and perform actuarial services with skill and care.
2. Precept 2 requires the actuary to perform only work for which he is qualified. Precept 3, which requires that services be performed in accordance with actuarial standards, is breached if any ASOP is breached.
3. Precept 4 requires that actuarial communications be clear and appropriate to the circumstances and audience.
4. Precept 8 requires the actuary to take reasonable steps to prevent misuse of the work product.

### B. ASOPs

1. ASOP 4, Measuring Pension Obligations, applies if the plan is a pension plan.
2. ASOP 6, Measuring Retiree Group Benefit Obligations, applies if the plan is a retiree group benefit plan. ASOP 6 references ASOP 27.
3. ASOP 21, The Actuary's Responsibility to the Auditor, applies to any communications between the actuary and the auditor.
4. ASOP 27, Selection of Economic Assumptions for Measuring Pension Obligations, applies to both pension and retiree group benefit plans.
5. ASOP 41, Actuarial Communications, applies to any communication of the results.

**Question 1: Did either actuary materially violate the code in the advice given to the client regarding the selection of the discount rate?**

### A. Did the actuary's advice satisfy the applicable ASOPs and Precept 3 of the code?

1. ASOP 27 applies to advice given regarding economic assumptions for pension and group benefit obligations. ASOP 6 also applies to group benefit obligations.
2. Did the actuary's statements to the client regarding the appropriate discount rate constitute "advice" as defined in ASOP 27? Yes, ASOP 27 does apply.
3. Did the actuary's advice to the client satisfy ASOP 6 or ASOP 27, as appropriate?
  - a. **SCENARIO 1:** Yes, according to the scenario, the advice was appropriate under the ASOPs, so there was no breach.

# ABCD ANALYSIS

- b. **SCENARIO 2:** The advice may have violated ASOP 6 or 27, depending on the specific facts. If the advice did not apply the relevant ASOP(s) appropriately, there was a breach of the ASOP(s) and Precept 3.

## B. Did the actuary act with integrity and competence as required by Precept 1?

1. Was the actuary's advice appropriate under FAS 87 or FAS 106? Was it based on methodology that is appropriate under the accounting standard? Was it based on an approximation method that was expected to produce a result not significantly different from the result expected from a more precise method?
  - a. **SCENARIO 1:** Yes, according to the scenario, the advice was appropriate, so there was no breach of Precept 1.
  - b. **SCENARIO 2:** The advice was based on methodology that may not have been appropriate under the accounting standard. A detailed investigation of the methodology used and its appropriateness would be required. If the methodology is determined to have been inappropriate, further analysis is needed to determine if it constitutes a material breach of the code.
2. If the advice or the methodology was inappropriate, did the actuary know that the advice or methodology was inappropriate under the accounting standards or ASOPs?
  - a. If the actuary did know, then the actuary probably breached the Precept 1 requirement to perform services with integrity.
  - b. If the actuary did not know, should the actuary have known?
    - i. If the actuary is reasonably expected to have known, the actuary probably breached Precept 1, performing work with competence.
    - i. If the actuary is not reasonably expected to have known the methodology was inappropriate, then there was no breach of Precept 1.

## C. Was the actuary qualified to do the work as required by Precept 2?

1. If the actuary provided advice based on methodology the actuary did not know was inappropriate but should have known, there might have been a breach of Precept 2, performing work only when qualified to do so.
2. Was the appropriateness of the methodology something that a qualified actuary was expected to know?
  - a. If so, then there was probably a breach of Precept 2, depending on the significance of the lapse in knowledge.
  - b. If not, then there was probably not a breach of Precept 2.

3. Is there any other evidence that the actuary is unqualified to perform the work?
  - a. If so, then there may have been a breach of Precept 2.
  - b. If not, then there was probably not a breach of Precept 2.

## D. Was any breach of the code that occurred material?

1. Materiality is considered with respect to the Code and is not an accounting term in this context. Factors the ABCD might consider in determining the materiality of any breach include:
  - a. the significance of the difference in the results;
  - b. whether the difference might have an effect on others, such as investors or lenders, through the stock price or bond rating or cost of borrowing;
  - c. whether the inappropriateness of the methodology was obvious.
2. If any breach was material, discipline would be considered.
3. If no breach was material, guidance would be the probable outcome.

## **Question 2: Did either actuary materially violate the code in using the client's selected discount rate and describing it as a prescribed assumption?**

### A. Were the calculations performed and disclosed in accordance with ASOPs as required by Precept 3?

1. Do the code and the ASOPs permit the actuary to use a discount rate selected by the client for accounting under FAS 87 and FAS 106, even if that rate is inappropriate under the ASOPs or the accounting standards?
  - a. ASOP 6 and ASOP 27 permit an actuary to use prescribed assumptions, provided they're disclosed as such.
  - b. According to the scenario descriptions, the actuary disclosed the use of prescribed assumptions in the actuarial communications.
  - c. The use of the prescribed assumption did not violate the ASOPs or Precept 3.
2. Was the actuarial communication clear and appropriate to the audience?
  - a. If so, then there was no breach of ASOP 41 or Precept 4.
  - b. If not, then there may have been a breach of ASOP 41 and Precept 4.
3. Were the assumptions and their effect such that disclosure of any long-term trend toward higher or lower costs was required under paragraph 6.3.g of ASOP 4 for a pension plan? (NOTE: This requirement does not appear in the exposure draft for a revised ASOP 4.)

# OUTLINE OF LIKELY ABCD ANALYSIS *(continued)*

- a. If so, was the disclosure included in the actuarial communications?
  - i. If so, then there was probably no breach of ASOP 4.
  - ii. If not, then there probably was a breach of ASOP 4.
- b. If not, then there was no breach of ASOP 4.

## **B. In Scenario 2, was the characterization of the discount rate as a prescribed assumption a breach of Precept 1?**

1. Is an assumption selected by the client under FAS 87 and FAS 106 still considered a prescribed assumption even if it's the assumption recommended by the actuary?
  - a. The ABCD believes that an assumption selected by the plan sponsor can still be described as a prescribed assumption even if the plan sponsor selects the assumption recommended by the actuary.
  - b. Therefore there was no breach of Precept 1.

## **C. Was any breach that occurred material?**

1. If any breach was material, discipline would be considered.
2. If no breach was material, guidance or counseling would be probable outcomes.

### ***Question 3: Did either actuary materially breach the code in attempting to convince the auditor of the appropriateness of a discount rate that was higher than the highest rate developed using methodology that was appropriate under actuarial and accounting standards?***

#### **A. Was the discount rate selected by the client in fact inappropriate for purposes of FAS 87 or FAS 106?**

1. If not, then there was no breach of the code.
2. If so, continue with the analysis.

#### **B. Were the arguments used by the actuary to defend the selected discount rate inappropriate for purposes of the applicable ASOPs, FAS 87, or FAS 106?**

1. If not, then there was no breach of the code.
2. If so, continue with the analysis.

#### **C. If the arguments were inappropriate, was the actuary's use of the arguments in discussions with the auditor a breach of ASOP 27?**

1. Is a discussion with an auditor about the appropriateness of the discount rate after it has been selected by the client covered by ASOP 27?
  - a. The ABCD believes it's not. Paragraph 1.2 of ASOP 27 limits the scope to "the selection of economic assumptions..." and "giving advice on selecting economic assumptions." Since the auditor is reviewing the client's selected assumptions and not selecting them, ASOP 27 does not apply. However other parts of the code and ASOPs do, as discussed below.

#### **D. If the arguments were inappropriate, was using them a violation of Precept 1?**

1. Did the actuary know the arguments were inappropriate?

- a. If so, then there may have been a breach of Precept 1, performing services with integrity. Proceed to next step in analysis.

- b. If not, should the actuary have known they were inappropriate?

- i. If not, there was probably no breach of Precept 1. (This is unlikely unless the circumstances are such that most qualified actuaries would be unable to discern whether the arguments were inappropriate. Nevertheless, it's a question the ABCD would need to answer in each situation.)
- ii. If so, then there may have been a breach of Precept 1, performing services with competence, depending on the answer to the next step. In addition, there was a possible breach of Precept 2, performing services only when qualified to do so.

2. How did the actuary present the arguments to the auditor?

- a. If the arguments were presented as possible rationales for the auditor to consider without any statement or implication that the actuary supported any of them, there may not have been a breach of Precept 1. We expect that it would be difficult to accomplish this, and may depend on the actuary's understanding of the auditor's expertise. It's more likely that the arguments can be treated as hypothetical if the actuary knows the auditor is very knowledgeable about the discount rate requirements or will be discussing the issues with another qualified actuary.
- b. If the arguments were presented as the actuary's arguments or there was stated or implied support for them, then there probably was a breach of Precept 1.

#### **E. Were the actuary's communications with the auditor clear and appropriate to the audience and did the actuary answer questions clearly, fully, and honestly?**

1. If so, then there was probably not a breach of ASOP 21, ASOP 41, and Precepts 3 and 4.
2. If not, then there may have been a breach of ASOP 21, ASOP 41, and Precepts 3 and 4.

#### **F. Did the actuary's use of the arguments serve to mislead the auditor?**

1. If so, then there was probably a breach of Precept 8.
2. If not, then there was no breach of Precept 8.

#### **G. Was any identified breach material?**

1. If any breach was material, discipline would be considered.
2. If no breach was material, guidance or counseling would be probable outcomes.