ASSOCIATION OF ACA CONSULTING ACTUARIES

An approach to applying the principles within Technical Actuarial Standards

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Each Technical Actuarial Standard (TAS) published by the Financial Reporting Council (FRC) contains a number of principles,all of which need to be considered when carrying out actuarial work that is within the scope of that TAS.

There are more than 70 principles across the Generic TASs (TAS R, D andM) and the two Specific TASs (the Pensions TAS and the Transformations TAS) that are relevant to pensions work.

This documentsets out an approach actuaries may wish to use in relation to these principles. It has been developed with pensions work in mind, and has not considered the two other Specific TASs (the Insurance TAS and the Funeral Plans TAS).

1. Sub-division of principles

It is possible to sub-divide the principles set out within the suite of TASs into the following:

- **Core principles** – these reflect things to bear in mind or actions to take when preparing actuarial information. They are about the way in which one approaches an issue, rather than the documentation of actuarial judgement or the communication of actuarial information. Many of the principles in the Specific TASs, in particular, fall into this category.

- **Documentation principles** – these concern matters that should be kept on record in some way, so that it is clear to a "technically competent person" what process was undertaken on such matters as data checking and the assumptions used in models. These principles mostly occur in TAS D and TAS M, but can also feature in the Specific TASs.

- **Reporting principles** – these cover the communication of actuarial information to the *user*, typically via an *aggregate report*. The FRC intends that the reporting principles are such that the recipient obtains appropriate and understandable actuarial information for his or her needs (for example, in relation to making a decision). Reporting principles comprise almost the whole of TAS R, and arise to at least some extent in all the other TASs (Generic and Specific) other than TAS D.

The approach to applying the principles as set out in this document is of particular relevance to the reporting principles.

2. Applicability, materiality and proportionality – some initial thoughts

It is our understanding that the principles set out in all of the TASs are only applicable where relevant in the specific context. Where they are, a *materiality* judgement can then be made as to the extent (if any) to which the principle must be applied. If the judgement is that it should be applied in full or in part, then the actual application of it should be done in a proportionate way.[1] Both the materiality and the proportionality judgements shouldbe exercised in a reasoned and justifiable manner.

A definition of "material" is set out in the Scope & Authority and in each TAS, but proportionality is not defined. For both terms, judgement is required.

The concept of applicability followed by the possibility of materiality and then proportionality judgements seems to be most suited to the application of the reporting principles. The concept can nevertheless also be applied to the core and documentation principles, but perhaps in a more streamlined manner:

- Once it has been established that a core or documentation principle is applicable to a piece of actuarial information, it is unlikely (although still possible) that the principle could be deemed immaterial. This differs from reporting principles, for which it is generally easier to judge that, in specific circumstances, a piece of information indicated by a principle would not influence the user's decision-making.
- However, 'proportionality' will still be an important principle for determining the extent of the documentation to be done and in the case of at least some of the core principles, the amount of thinking and research to undertake before deciding how to proceed (for example, the range of 'relevant information' to consider when deriving assumptions under D.2.3 of the Pensions TAS).

3. Materiality

"Material" is defined as follows:

> *"Matters are material if they could, individually or collectively, influence the decisions to be taken by users of the related actuarial information. Assessing materiality is a matter of reasonable judgement which requires consideration of the users and the context in which the work is performed and reported."*

For reporting principles the consequence of this definition is a focus on ensuring that all relevant topics are covered in the *aggregate report* so that the *user* is equipped to take the *decision*.[2]

Sections B.1.2 of each of the generic TASs, the Pensions TAS and the Transformations TAS enable a principle in the TAS to be ignored if it is felt that it would not have a material effect on the *decision*.

As mentioned in 2.above, the materiality judgement may not come into play so much in the application of core and documentation principles.

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[1] Strictly speaking the TASs do not 'require' proportionate work, but permit application of the principles to be scaled back if to do otherwise would be disproportionate. However, in its FAQ 1.2 the FRC states that "proportionality is required by all TASs" and notes that disproportionate work might constitute a departure from the TASs.

[2] But noting that the reporting principles contained within section E.3 (the Scheme Funding Report) of the Pensions TAS are somewhat different in that they are not being provided as part of an *aggregate report* and that they are to be regarded as "material" with the level of detail being a matter of judgement.

4. Applying the principles through categorisation

Following the approach outlined at the beginning of2. above, each principle can be assessed in turn and categorised into one of the following three groups:

(a) The principle is not applicable.

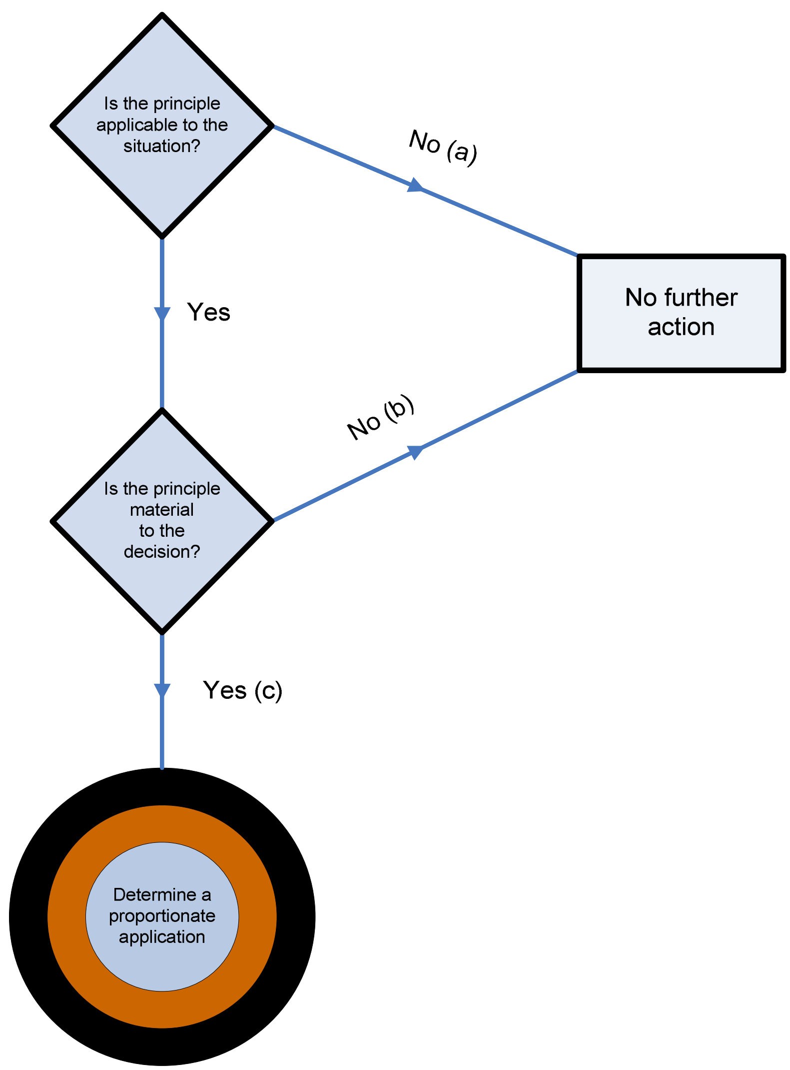
(b) The principle is applicable but its inclusion is not *material* to the *decision* to be taken by the *user*.

(c) The principle is applicable and its inclusion is *material* to the *decision* to be taken by the *user*.

Category (a) would largely be a matter of fact; (b) and (c) would require more judgement. In exercising the judgement it will be important to reflect on the *decisions* for which the actuarial information is being supplied and consider the needs and situation of the *user*, especially if time has moved on since the work was commissioned.

Only items falling within (c) need be considered further. For each of these, judgement would need to be exercised as to what is a proportionate application of that principle.

The process is demonstrated by the following flowchart:



The appendix to this document illustrates the application of this system through an example.

The nature of some*Reserved Work* is such that it is feasible that there might be no substantive reporting principles that fall within (c) above because thewritten work does not lead to any*decision* by a *user* (any decision having already been taken).For such work, the question arises as to whether there is any need to include specific statements normally required byTAS R, such as those relating to the purpose of the report (C.3.3) and to compliance with the TASs (C.3.11). However, the work is likely to have required the application of core and documentation principles and in any event, it may still be appropriate for the*user* of the report to be informed that the work is within scope of the TASs and that it complies.[3]

5. What about proportionality?

Applying the proportionality principle is a little more tricky.

To date the FRC has not provided a definition of proportionality in any of its TASs, nor in its Scope & Authority document. *Proportionality* is, however, referred to in sections B.1.3 of TAS R, TAS D, the Pensions TAS and the Transformations TAS and section B.1.4. of TAS M. Each section states:

> *"Nothing in this standard should be interpreted as requiring work to be performed that is not proportionate to the scope of the decision or assignment to which it relates and the benefit that* ***users*** *would be expected to obtain from the work."*

The Pensions TAS and the Transformations TAS also say*"What work is proportionate is a matter for judgement and might depend on factors such as the expertise of* ***users*** *in the matters being reported on and their needs."* It is understood that the FRC will extend this wording to the generic TASs in due course.

There appear to be two possible interpretations of the first statement:

- Thestatement at face value is quite clear thata principle that is otherwise *material* can be disregarded (without further consideration or comment) in specific situations.

  For example, one may be able to argue that,although a number of principles are *material* to the *decision*, the *decision* itself is immaterial to the *user*and therefore there is no benefit to the user from incurring any cost by complying with that principle. Given this, one can choose not to apply certain principles, although it may be appropriate to confirm the degree of importance the *user* associates with the *decision* before doing this, and professionally one would want to ensure that whoever is impacted by the *decision* to be taken by the *user* is not adversely affected by the choice not to apply certain principles.

- An alternative viewpoint is that, whilst materiality might be regardedas an "on/off" switch[4], proportionality is akin to applying a dimmer switch once the light has been turned on (noting that although the light can be turned down, it can never be entirely switched off). This would mean that having decided a principle is material, it would not be appropriate to use the proportionality argument to justify then doing nothing, thereby ignoring the principle.

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[3] The FRC has sought to address this issue in its FAQ1.9.

[4] Strictly speaking the FRC uses materiality to determine whether a principle can be departed from (which could be in full or in part), rather than whether or not it is applied (ie in full).

The argument that the ‘proportionality switch’ can never be switched off entirely does not appear to be supported by any explicit wording inthe TASs.

As to what is appropriate in any given matter, this will be driven by the individual circumstances applying to that *user*, to that *decision*, at that time. It is not possible to give any generalisations as to what is proportionate in this document and the Working Group reminds actuaries that, as with many aspects of applying TASs, they will need to apply their own judgement.

Advising on pension scheme commutation factors

An actuary is providing advice on a set of commutation factors for a new pension scheme. The advice is subject to the Pensions TAS (by virtue of C.1.18 of that TAS) and through this the three generic TASs. As it is a new scheme with no accrued benefits, the Transformations TAS cannot apply in this case. The trustees are responsible for setting the final commutation factors and the employer has no discretion over commutation terms.

In this case, the *user* is the trustees as they have a decision to make – to decide on the final commutation factor assumptions. The scheme administrator will "use" the table of commutation factors based on the agreed assumptions and the sponsoring employer may also make use of the factors, but neither have a *decision* to make based on the advice that will only be sent to the trustees and so are not *users* in the TAS context.

By way of illustration of how the TAS principles can be divided into the three groups mentioned in section 4 of the main text, set out below is a possible categorisation of some of the reporting principles withinTAS R. It is provided only as an illustration and is not intended to be definitive.

Category (a) – principles that are not applicable

Compare with previous aggregate reports provided for a similar purpose (TAS R C.5.17): not applicable as this is the first time the commutation factors have been set for the new pension scheme.

State any differences between the assumptions used or recommended in different parts of the work (TAS R C.4.4b): not applicable as only one set of assumptions have been used in this case.

Category (b) – principles that are applicable but their inclusion is not material to the decision to be taken by the user

Project results for future corresponding calculations (TAS R C.5.20): the commutation factors are to be reviewed every three years, but it was not judged to be material to provide an estimate of future commutation factors. (Although some trustees would wish to see projections of the possible development of the factors, to gauge the impact of future improvements in longevity for example, in this case the trustees have decided that for this exercise they are content to select the factors based on the current, short-term position because they have power to set the factors and review them periodically.)

Category (c) – principles that are applicable and their inclusion is material to the decision to be taken by the user

State purpose, users and who commissioned the work (TAS R C.3.3): this important principle is expected to be material for all work. Compliance should be straight-forward in most cases and would not be limited in its application through a proportionality argument.

State capacity in which addressees or users are expected to use the work (TAS R C.3.6): it was judged material and proportionate to explain that the actuary is only advising on the assumptions and that the trustees are responsible for setting the final factors.

Describe rationale for assumptions used (TAS R C.4.6): this was judged material as the trustees are responsible for the final factors. It was judged proportionate to provide a brief description of how the assumptions were derived and how they compare to those in the Statement of Funding Principles, drawing out the reasons for the small number of differences.