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DO ACTUARIES NEED STANDARDS?

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IT is a great honour for an accountant to be invited to deliver the Students' Society 1984 Jubilee Lecture. When the *Financial Times* defined an actuary as "someone who found accountancy too exciting",[1] I realized that accountancy might be a suitable subject for this Jubilee Lecture.

I note that the Institute of Accountants and Actuaries in Glasgow played a pioneering role in the evolution of the accountancy profession in Scotland during the latter half of the last century.

So the paths of the actuarial and accountancy professions have met, and indeed crossed, on a number of issues, and we have a great deal in common, most of all perhaps a belief in the power of presenting an argument through numbers. Like you, we have members in practice and in commercial employment, we form professional opinions which we express in reports and we are concerned with problems of measurement; also we each have our own procedures, assumptions, jargon and rules, all of which are confusing to the uninitiated.

Standards in accounting

The standing of a profession in the eyes of the public is judged by the standards of its members, both ethical and technical. Failure to meet these standards is a cause for concern both for the profession concerned and for the general public. Codification of these standards serves two useful functions, one internal and one external. It reminds members of what is expected of them, and informs the public of what they can expect from the profession. The Accounting Standards Committee (ASC) is the premier accounting committee concerned solely with technical issues as opposed to issues concerning the ethics of the profession.

Let me explain how we came to be set up.

In the late 1960's the boom in stock market prices led to an unprecedented number of takeover bids and the setting up of the Panel on Take-overs and Mergers to administer and enforce the City Code. A by-product of these takeovers was the public exposure of inadequacies in accounting practice which led to the formation of the Accounting Standards Steering Committee, as we were originally called.

In 1967 the directors of AEI, which was the target of a bid by GEC, forecast a profit for the year of £10 million. The bid succeeded and GEC subsequently announced that AEI had made a loss in 1967 of £4·5 million. Only £5 million of the £14·5 million shortfall was attributed "to matters substantially of fact"; the remaining £9·5 million was said to be due to "adjustments which remain matters substantially of judgement". "How can this be?" people asked.

The answer was quite clear to accountants, who were familiar with the diversity of available accounting bases and the important part played by judgement in determining accounting profit. The integrity of accounts is dependent on the adopted policies being applied consistently. Consistency is a fundamental concept not only of accounting, but of any form of statistical presentation. However, in a takeover situation it is often the case that the accounting policies of the acquired company will be changed to those of its new master; the results measured on the new basis may be quite different from those measured on the old.

A year later, in 1968, Courtaulds were involved in a bid for International Paints which resulted in a brush with the Take-over Panel. The Chairman of Courtaulds subsequently received wide publicity when he announced that he had written to the President of the English Institute of Chartered Accountants complaining about the plethora of generally accepted accounting principles. In particular he was concerned about the problem of reconciling profits calculated on pre- and post-acquisition principles.

Perhaps the critical turning point, as far as the accountancy profession was concerned, was the Pergamon affair in 1969. Robert Maxwell had agreed to sell Pergamon Press to Leasco Data Processing Equipment Corporation, who had requested their accountants to look into Pergamon's financial affairs. Questions were raised concerning Pergamon's treatment of profits on sales of back issues. Eventually the offer was withdrawn and a Board of Trade investigation set up.

The foundation of the Accounting Standards Committee (ASC)

It is clear from these examples that accountants and accounting policies were very much under public scrutiny at that time. A Canadian professor of accounting at Edinburgh University, Edward Stamp, wrote a seminal article for *The Times*(2) putting forward his arguments for a new approach to the development of accounting; at the time few realized the impact that this would have on the accountancy world. The article critized the accountancy profession on two counts: the multiplicity of accounting principles (such as the numerous acceptable ways of valuing stocks and work in progress) and the auditors' lack of independence. The brevity of the auditor's report did not escape the sharp end of the academic's pen either.

The accountancy profession responded speedily under the able leadership of my first predecessor Sir Ronald Leach, then President of the Institute. The Council of the ICAEW published a 'Statement of Intent on Accounting Standards in the 1970's'(3) announcing its intention to advance accounting standards along the following lines:

(i) narrowing the areas of difference and variety in accounting practice;
(ii) disclosing accounting bases;
(iii) disclosing departures from established accounting standards; and
(iv) exposing major proposals on accounting standards for consultation.

The Statement also announced the formation of the Accounting Standards Steering Committee, now called the Accounting Standards Committee, to implement these proposals. Over the 14 years of its existence the ASC has produced 20 Statements of Standard Accounting Practice, and more are waiting in the wings.

Present constitution of the ASC

Although it was originally formed by the ICAEW, the ASC is now a committee of the Consultative Committee of Accountancy Bodies (CCAB), the umbrella of co-operation between the six major accountancy bodies. Membership of the ASC, its sub-committees and its working parties, is both part time and unpaid, although there is a full-time secretariat of four.

The present constitution of the ASC provides for a maximum of 20 members, each of whom is appointed for a 3-year term renewable once only. Five places are reserved for users of accounts (who need not be accountants) and, while each of the governing bodies is entitled to at least one of its members on the Committee at all times, selection is on the principle of the best man for the job, representing the three constituencies of preparers, users and auditors. However, members are not delegates of sectional interests; rather they are required to act in the general interest of the community and the profession as a whole. The members are appointed by the CCAB.

Topics are identified for consideration in various ways. Interested parties may request that a particular problem be addressed by the ASC; changes in the law may give rise to matters requiring attention; or a topic may be under study by the International Accounting Standards Committee or an overseas standard-setting body. Once a topic has been selected for addition to the ASC's list of projects, the first stage is to commission research.

A working party is then formed comprising accountants from practice and industry and, where appropriate, others such as the actuaries who are currently serving on the working parties dealing with pension scheme accounts and pension costs in company accounts. Members must have both expertise in the subject concerned and the necessary time.

It is their task to do the detailed work, the technical drafting of the proposed standard and the consultation. Consultation is both direct, in the form of discussion meetings with parties known to have a particular interest, and indirect in the form of public exposure of standards for comment prior to implementation.

It is not only the views of ASC's constituents that need to be taken into consideration. The implementation of the EC Fourth Directive in the guise of the Companies Act 1981 introduced far more rigid standardization of accounting into the law. Certain requirements, previously only contained in accounting standards, were included in the Act and given the force of law. Any accounting practice proposed by the ASC must not conflict with this ever-increasing volume of statute law, and must also take into account overseas and international accounting standards.

Standard setting is therefore a balancing act. Having developed a proper and technically supportable argument for the method of accounting proposed, it is necessary to balance the various interests: we often find ourselves torn three ways among the preparers, who want minimum disclosure, the users who want maximum detail and the auditors who want absolute certainty. But compromise is not enough, we have to find a path that raises standards of accounting and advances the state of the art; we have to show leadership as well as sensitivity to the demands of our constituents.

I should emphasize that it is not the purpose or the intention of the ASC to lay down "a comprehensive code of rigid rules"[(4)] for all aspects of financial accounting. Instead, accounting standards "deal only with matters which are of major and fundamental importance and affect the generality of companies",[(5)] and "regard should be had to the spirit of accounting standards as well as to their precise terms".[(6)] Accounting standards are therefore pillars of wisdom rather than tablets of stone.

The ASC reviews existing standards from time to time to determine whether there is a need for revision. This may arise from changes in legislation or other circumstances that suggest the standard should be amended following a period of practical application. Reviews of existing standards are carried out in the same way as the development of new standards.

Self-regulation

Company accounts are required by law to give a "true and fair view". These four words are more than a phrase, they are a term of art; for a definition it is necessary to turn not to a dictionary but to the courts. But judges, being experts in law not accounting, are guided by the best practices of professional accountants. It is the function of the ASC to formulate what it considers should be generally accepted accounting principles, and hence essential to a true and fair view.[(7)]

Accounting standards are an unusual case of self-regulation, in that their impact extends beyond the profession that develops them and imposes them on its members, to other preparers and users of financial statements. Hence accounting standards must be both generally acceptable and broadly understood.

Not only does this place extra responsibility on the shoulders of the standard-setters; it can also create problems of enforcement. Because our enforcement powers are slim we have to convince others of the merits of our proposals through the ineluctable logic of our argument. Through consultation we ensure that we rule by consensus.

Consultation is also a principal feature of standard setting overseas. In America the Financial Accounting Standards Board (FASB), which is independent of the accountancy bodies, issues accounting standards in its own name which are recognized as authoritative both by the accountancy profession and by the Securities and Exchange Commission (SEC). Indeed, the SEC will not accept accounts for filing if they contain a qualified audit report. Despite this sanction, which makes FASB Standards compulsory for large companies, the FASB takes consultation very seriously.

Professor Gower has expressed doubts whether the present position in the United Kingdom whereby standards are enforced without legal backing can continue to be maintained. I must agree with him that "to translate . . . standards into statutory rules would be undesirable, for it would impose an excessive rigidity and make it still more difficult to adjust speedily to changing conditions".[8] However, I would also question whether more indirect powers of enforcement, such as exist in the United States of America, are necessary either.

Insofar as accounting standards are deemed essential to the "true and fair view" required by company law there are no major problems with their enforcement, and in this respect there does not seem to be any need to change the status quo. To maintain this situation we must continue to consult widely both to ensure that we get our standards right, and are seen to get them right by preparers and users of accounts. Inflation accounting, SSAP 16, appears to be an exception in that it calls for supplementary statements the presence of which is not regarded as essential to a true and fair view.

Pension scheme accounts

The lack of an appropriate legal framework for pension schemes has been highlighted repeatedly, most recently by Professor Gower. We now have the Government's proposals set out in a consultative document which recognizes "the need to involve the accountancy and actuarial professions in the detailed accounting standards and guidance".[9] The need for consultation with accountants is clear from the consultative paper; the influence of actuaries seems to have been brought to bear already.

Pension scheme accounts have been on the ASC's work programme since 1980, when it set up a working party to prepare a discussion paper on the subject.[10] This was published in 1982 and posed the question "what information needs to be given for a clear and open presentation of the affairs of the pension scheme?" The answers ran to over 900 pages and formed the basis for the next stage of the project, the publication of an exposure draft (ED 34)[11] containing recommendations on the form and content of pension scheme accounts.

The ASC does not consider it appropriate to issue a standard in the absence of a statutory framework requiring pension schemes to publish annual reports and distribute them to members. ED 34 is, therefore, a proposed Statement of Recommended Practice (or SORP for short) rather than a proposed Statement of Standard Accounting Practice (or SSAP). This, of course, does not prevent a standard from being issued once the promised legislation is in place.

There is an important difference between SORPs and SSAPs. SORPs are prepared and issued by the ASC itself, whereas SSAPs are prepared by the ASC but issued by the Councils of the six major accountancy bodies. SSAPs are mandatory because the Councils have the authority to impose them on their members and non-compliance generally results in an audit qualification. Compliance with SORPs, on the other hand, is not mandatory and it is not necessary for either the accounts or the audit report to refer to any departures. SORPs are intended "as a stimulus to accounting thought and improved practice".[(12)] They should be "of such a quality and status as to be widely respected and compliance will be encouraged".[(13)]

It is widely accepted that the annual report of a pension scheme should comprise a trustees' report, audited accounts, an investment report and an actuarial report. The trustees' report and investment report inform members of the general activity, history and development of the scheme and the investment policy and performance of the fund.

ED 34 makes recommendations only on the accounts, but recognizes "that the form and context in which such accounts appear could have a significant effect on the overall message conveyed to the reader".[(14)] Pension scheme accounts require to be read in conjunction with a meaningful actuarial report although neither forms a part of, or should be subsumed into, the other. Consequently, the exposure draft recommends that accountants and auditors should insist on being made aware of the contents of the trustees', investment and actuarial reports in order to satisfy themselves that the accounts and auditors' report are not presented in a misleading form or context. Actuaries would presumably wish to make similar enquiries about the accounts and the audit report.

The exposure draft also recommends that *all* investments should be included in the accounts at market value rather than historical cost.[(15)] I say *all* investments because this includes long-term insurance policies which are often regarded as being different from other assets of the scheme and excluded from the accounts. In 1981 the Pensions Research Accountants Group (PRAG)[(16)] suggested four possible values which might be used to represent the market value of an insurance policy: current surrender value (or net realizable value), assignable value (or current market value), premium value (or replacement cost) and actuarial value. The ASC agrees with PRAG that an actuarial value adjusted by subsequent receipts and payments is likely to be the most practical valuation method.

No doubt there are arguments rooted in actuarial theory that could be advanced against the appropriateness of this basis, but, given the objective of measuring the size of the fund as a whole, it is a convenient method of placing a reasonable and consistent value on the policies. This is a matter on which ED 34 specifically requests comments and the views of actuaries would be welcome.

Although we have not always seen eye to eye on matters of mutual concern I believe there is common ground between accountants and actuaries on the matter of pensions, and that we are very close to finding it. This is not before time, because the ASC first established a working party to consider accounting for the costs of pensions in company accounts back in 1975.

Accounting for pension costs

Accounting for the cost of pensions involves the allocation over the employee's working lifetime of the amount ultimately required to provide pension benefits for that employee. This is not necessarily the same as funding, which is a matter of financial management and based on different principles from the allocation of cost.

Cost allocation is straightforward when the cost is known and the only thing to be decided is how to allocate this cost over time. For example, an item of machinery may have a purchase price of £1,000 and be expected to have a useful life of 10 years, in which case it is not unreasonable to recognize an annual depreciation charge of £100. Similarly, if it will cost £1,000 to provide a pension for an employee when he retires in 10 years time, an accountant might account for an annual pension cost of £100. Of course it is not this simple. Not only is the total cost of £1,000 uncertain, it is also subject to revision, perhaps to £900 or £1,100 in future years. While there may be numerous acceptable ways of funding this employee's pension, including a down-payment of £1,000, not all of them necessarily meet the accountant's criteria for cost allocation.

An oversimplification perhaps, but the problem, like the proverbial exam question, is simple; it is the solution that is difficult.

The fundamental objective of a funding plan is to accumulate sufficient assets out of which to pay pensions as they fall due—and there are many ways of achieving this. Similarly, there may be more than one way of meeting the accounting objective, which is to match the cost of pensions with the benefit derived from the employees' service by charging the cost of pensions against profits on a systematic basis over the employees' working lives. This is intended to produce a charge which is a substantially level percentage of the current and expected future pensionable payroll on the current actuarial assumptions.

The emphasis of this approach is on the charge in the profit and loss account, rather than on the balance sheet position. Provided that the accounting objective is met, there need be no restriction on the actuarial valuation methods and assumptions used.

Our counterparts in the USA, the FASB, have indicated a preference for an alternative approach concentrating on the balance sheet liability. Under this approach the pension cost for the year is the difference between the net pension liability at the beginning and end of the year adjusted for payments during the year.

The FASB also proposed the use of one standard actuarial valuation method.

The ASC pension costs working party made a written submission to the FASB setting out their views and explaining why they did not support the FASB's preliminary conclusions. In addition to this submission, a representative made a presentation at the public hearings in New York in January. If we are to believe the press reports of these hearings, the FASB is in for a far rougher ride on this subject than the ASC.

Whilst a standard dealing with acceptable methods of accounting for pension costs is the ultimate objective, the ASC, being great believers in the merits of accounting disclosure, have already issued an exposure draft, ED 32, dealing with "Disclosure of pension information in company accounts".[17] ED 32 requires disclosure "of sufficient information to enable users . . . to gain a broad understanding of the significance of pension costs . . . , liabilities, . . . and commitments". The ASC believes that the requirements of ED 32 will meet the special need for informative reporting in this area. The working party has studied the submissions on ED 32 and proposes to issue a consultative Statement of Intent on pension costs before preparing the eventual standard.

The international dimension

Although the ASC is the sole body setting accounting standards in the UK and Ireland, there is also an International Accounting Standards Committee (IASC) which develops International standards. We have an obligation to use our "best endeavours" to incorporate these in our own standards; they do not have direct application here as they do in some countries. The IASC have already issued a standard, IAS 19, on "Accounting for Retirement Benefits in the Financial Statements of Employers" and also have a project on "Accounting for Retirement Benefit Plans".

International standards are generally more widely drawn and less prescriptive than those of individual countries as they must reflect the differing circumstances of the IASC's members. There would be less scope for differences in accounting treatment both within and between countries if accounting theory provided us with a simple set of decision rules that could be applied in any situation. That would make the business of setting accounting standards much easier; it might even eliminate the need for standards altogether. As it is there is a need for standards which the ASC is attempting to meet. I do not see that need going away.

Conclusion—Do actuaries need standards?

In this talk I have provided you with a brief history of the events leading up to the formation of the ASC, followed by a description of the process by which standards are developed. Our work on pension scheme accounts and pension costs is of particular concern to actuaries, so I have outlined the present situation on these topics and the differences between accountants' views on accounting for pension costs in the UK and the USA.

I strongly believe in the principle of self-regulation and the role of standards within such a framework. I have long felt that there is a need for the actuarial profession to provide the same sort of guidance to its members as that provided by the ASC to accountants.

Earlier I drew comparisons between the rôles of the actuary and the accountant. The similarities include the use of a plethora of methods and assumptions and the potential for conflicts of interest which arise when the employer pays the fees. Pensions are the topical issue of the day; there have been reports from the OPB, consultative documents from the DHSS, public hearings at the FASB, exposure drafts from the ASC, and more besides. But plainly, with pensions under the spotlight, actuaries could find themselves in the situation that we found ourselves in 14 years ago.

Now that the Councils of the Institute and Faculty of Actuaries have adopted the guidance notes for actuarial reports to the participating employers and trustees of pension schemes, I hope that similar guidelines dealing with reports to members for inclusion in the annual report will be forthcoming. The DHSS imply such a requirement in their recent consultative document.[9] They have also proposed that this report should include brief details of the actuary's methods and assumptions. The need for standardization of terminology is paramount if there is to be no restriction on the actuary's freedom of judgement in choosing the method of valuation and the underlying assumptions. The argument that such information would not be understood by members can no longer be advanced if statutory annual reports are to be aimed at the expert pension adviser rather than the reader whose expertise lies in non-financial matters. I understand that a Codification of Funding Methods is forthcoming; the ASC will welcome its publication.

With the co-operation of the actuarial profession on ASC working parties and the codification of actuarial standards I foresee improved financial reporting by both companies and pension schemes. This requires leadership within and co-operation between our respective professions.

I am aware that the title of this lecture, "Do actuaries need Standards?", is provocative. Clearly, in a number of senses actuaries, like other learned professionals, both need and enjoy the highest standards. But there is not yet a full recognition within the actuarial profession of the need for a codification of professional practice so that we laymen may know and understand what you professionals are saying. Accounting is a language. We in the ASC concern ourselves with the meanings of words in that language: is there not a similar role to be played by the Institute of Actuaries?

REFERENCES

(1) *Financial Times*, 8 November 1983.

(2) A fuller account of these events and the text of Professor Stamp's article are given in STAMP, E. and MARLEY, C. (1970) *Accounting Principles and the City Code: The Case for Reform*. Butterworths.

(3) Reproduced in *ICAEW* (1982) 'Accounting standards 1982' p. 20.

(4) ACCOUNTING STANDARDS COMMITTEE (1971) 'Explanatory foreword to SSAPs' paragraph 8.

(5) ACCOUNTING STANDARDS COMMITTEE (1983) 'Review of the standard setting process' paragraph 3.5.

(6) ACCOUNTING STANDARDS COMMITTEE (1971), *op. cit.*, paragraph 10.

(7) See HOFFMAN, L. and ARDEN, M. H. (1983) 'Legal opinion on "true and fair"' reproduced in *Accountancy*, November 1983.

(8) GOWER, L. C. B. (1984) 'Review of Investor Protection' Cmnd. 9125. *HMSO*, paragraph 6.40.

(9) *DHSS* (1984) 'Greater security for the rights and expectations of members of occupational pension schemes' paragraph 24.
(10) Accounting Standards Committee (1982) 'Pension scheme accounts: a discussion paper'.
(11) Accounting Standards Committee (1984) ED 34 'Pension scheme accounts' (*ASC*, 1984).
(12) Accounting Standards Committee (1983) 'Review of the standard setting process' paragraph 3.8.
(13) *Ibid*, paragraph 5.2.
(14) Accounting Standards Committee (1984), *op.cit.*, paragraph 5.
(15) *Ibid*, paragraph 31.
(16) Pensions Research Accountants Group (1981) 'Valuing insurance policies for accounts purposes' PRAG/NAPF.
(17) Accounting Standards Committee (1983) ED 32 'Disclosure of pension information in company accounts'.