

ASOP 51

Interpretive Notes/Disclosures

Exposure Draft

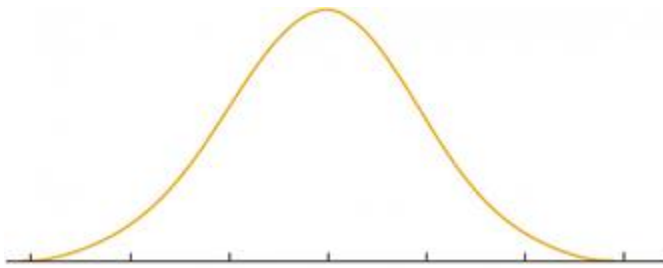
June 2021

The ASEA Discipline Committee has compiled sample disclosures to comply with ASOP 51 in the context of ASEA actuaries' practices.

ASEA strongly encourages its members to review the ASOPs and to make use of the ASEA Discipline Committee's ASOP Interpretive Notes/Disclosures. These notes are intended to assist ASEA members in providing professional services that are consistent with generally accepted plan practice for similarly situated Principals. They offer non-binding, advisory guidance on how practitioners can practice in a manner that is consistent with the ASOPs while accommodating the challenges and limitations of individual assignments. Based on the nature of the engagement, the actuary may choose to use the full sample disclosure or pertinent sections.

Disclosure of Risk

The results of any actuarial valuation of a retirement plan are based upon estimates of future events (such as investment returns, timing of mortality, timing of termination of employment). Like any such prediction, the outcomes can be viewed graphically with a curve, that would look something like this:



While the expected outcome is near the center of the curve, actual outcomes could, due to various events, such as lower than expected returns on assets, or increases in life expectancy, push to either extreme, causing the plan to be either significantly over funded or underfunded. As can be imagined, if returns were a negative 30% (as happened in many plans in 2008) or some other, potential, but unlikely event occurred, then the funded status of the plan would be significantly eroded, which could require either a loss of benefits for some participants (generally restricted to participants who are also owners of the plan sponsor) or a significant increase in the funding obligation of the plan sponsor, or both. If the plan sponsor wishes, a more detailed analysis could be made to measure the potential likelihood of these adverse events, and the impact on the plan, participants and sponsor of these events.

Disclosure of Potential Risk

The results provided in this report are based on various assumptions regarding future events identified herein. These assumptions, although in accordance with appropriate actuarial guidelines, are inherently based on uncertain future events. Thus, fluctuations in future results (as compared to assumed results) are to be expected and, as such, create an element of risk with regard to future required funding, future funding levels (which will impact the availability of certain benefit options, most notably lump sums) and future benefit security (i.e. upon plan termination, how well funded the plan is)

Future actuarial calculations may differ significantly from the current calculations due to many factors including:

- plan experience differing from that anticipated by the economic and demographic assumptions reflected in this report
- Changes in assumptions in future years, some of which may be mandated
- Changes in the plan provisions, including a decision to freeze or terminate the plan (as contrasted with the assumption used in the report that there will be no future plan amendments)
- Changes in applicable law

The above list is not intended to be a complete and exhaustive list but identifies certain key areas to be aware of. Following is more information on a few of these key areas:

Investment Risk

Deviations in actual investment returns from expected returns are to be anticipated, so the plan's future assets, funding contributions and funded status may differ significantly from what is presented in this valuation report. Higher than expected investment returns will generally decrease the required and deductible contributions to the plan and improve the funded status. Conversely, lower than expected returns will generally increase the required and deductible contributions to the plan and decrease the funded status. Deviations may also impact the potential for changes in assumptions used in future valuations. The investment policy should be selected with an eye towards the acceptable level of risk. The plan assets should be invested in a prudent and diverse manner; however, investment returns are still subject to fluctuation. It is important to review and update the plan investment and funding policy, as needed, to reflect changes to the plan sponsor and the plan, as well as the economy and the continued viability of the individual investment choices. Consideration should also be given to various items including the level of employer contributions to the plan relative to the plan funded status, plan expenses, benefit distributions and participant demographics.

Asset Liability Mismatch

The plan's liabilities are backed by plan assets. Generally the value of plan assets and the value of plan liabilities change separately and are not directly correlated. The change in assets are based upon actual returns achieved by the investments, while the change in liabilities are based upon either future anticipated returns or mandated assumptions. If the change in asset value is different than the change in liability value due to a change in interest rates, the funded status will either increase or decrease. The selection of investment policy can either increase or reduce the level of this risk.

Interest Rate Risk (assumed discount rate)

For a small plan, the determination of the interest or discount rate to be used in the actuarial valuation is one of the major factors in determining the current value of future plan benefits. Generally speaking, these rates are mandated by law, with different rates mandated for different purposes.

The discount rates are set to estimate the current value of future plan benefits. Generally, the rates used in the actuarial valuation are based on average yield curves.

Thus, the discount rates will change from one year to the next. If the yield curve decreases (either due to a downward moving average or decreases in market rates), then future discounted values will be greater than current values had the averaged rates remained unchanged. Conversely, if yield curves increase, then the future discounted values will be less than expected had the averaged rates remained unchanged.

Longevity and Other Demographic Risks

Option 1 - Small plan where the cost of the death benefit to plan is the same as 100% vesting (i.e. PVAB (adjusted potential minus value of any insurance policy plus proceeds of policy), other benefits (like early retirement, disability, delayed retirement) are actuarial equivalent of AB, and no pre-retirement decrements

The current funding assumptions assume that the plan will not terminate and that all participants will continue in employment until the plan's normal retirement age (or if past normal retirement, will retire now). Of course, participants may die, terminate, become disabled, or retire either before or after the plan's normal retirement age. Because of the nature of this plan, the timing of payments impacts the ultimate cost of the plan. In other words, for example, paying a benefit now would create a different funding amount than if paid at normal retirement age due to the difference between the rates specified in the plan for determining the currently due benefit and the assumed rate of return for funding purposes. Additionally, overall mortality rates change over time (i.e. life expectancy in the U.S. changes). Longer life expectancy increases the costs under the plan.

Option 2 - Small plan where the cost of some benefit is subsidized, or that will lead to a substantial gain (like not death benefit), but there are no assumed decrements.

The current funding assumptions assume that the plan will not terminate and that all participants will continue in employment until the plan's normal retirement age (or if past normal retirement, will retire now). Of course, participants may die, terminate, become disabled, or retire either before or after the plan's normal retirement age. Because of the nature of this plan, there are some benefits for which the timing of payments impacts the ultimate cost of the plan. In other words, for example, paying a benefit now would create a different funding amount than if paid at normal retirement age due to the difference between the rates specified in the plan for determining the currently due benefit and the assumed rate of return for funding purposes. The maximum impact of this difference can be seen as the difference between the Funding Target used for funding and the Present Value of Accrued Benefits. But there are other benefits which could significantly alter the funded status of the plan (e.g. subsidized early retirement benefits). Because of the size of the plan, the likelihood of such an event is small, and therefore has been ignored even though, should such an event occur, it could be significant, particularly if multiple events occur simultaneously (for example, multiple employees retiring early at the same time). Of course, the impact of such an event on the plan sponsor may have significant repercussions on the ability of the plan sponsor to fund the plan (such as the death of an owner), but that is beyond the scope of this report. Additionally, overall mortality rates change over time (i.e. life expectancy in the U.S. changes). Longer life expectancy increases the costs under the plan.

Option 3 - Small plan where the cost of some benefit is not subsidized, but there is an assumption of delayed retirement for the owner.

The current funding assumptions assume that the plan will not terminate and that some participants will continue in employment until the plan's normal retirement age, but that some participants will delay retirement. Of course, participants may die, terminate, become disabled, or retire either before or after the plan's normal retirement age. Because of the nature of this plan, the timing of payments impacts the ultimate cost of the plan. In other words, for example, paying a benefit now would create a different funding amount than if paid at an assumed retirement age due to the difference between the rates specified in the plan for determining the currently due benefit and the assumed rate of return for funding purposes. The maximum impact of this difference can be seen as the difference between the Funding Target used for funding and the Present Value of Accrued Benefits. In the case of the assumed delayed retirements, the earlier retirement would cause an increase in plan liabilities. Of course, the impact of such an event on the plan sponsor may have significant repercussions on the ability of the plan sponsor to fund the plan (such as the death of an owner), but that is beyond the scope of this report. Additionally, overall mortality rates change over time (i.e. life expectancy in the U.S. changes). Longer life expectancy increases the costs under the plan.

Option 4 - Smaller plan where the cost of some benefit is subsidized, or that will lead to a substantial gain (like not death benefit), and there are decrements

The current funding assumptions of the plan assume that some participants will receive their benefit prior to normal retirement. Of course, participants may die, terminate, become disabled, or retire either before or after the plan's normal retirement age at rates different than assumed. Because of the nature of this plan, there are some benefits for which the timing of payments impacts the ultimate cost

of the plan. In other words, for example, paying a benefit now would create a different funding amount than if paid at an assumed retirement age due to the difference between the rates specified in the plan for determining the currently due benefit and the assumed rate of return for funding purposes. But there are other benefits which could significantly alter the funded status of the plan (e.g. subsidized early retirement benefits). Because of the size of the plan, some variance from the assumption is inevitable, and appears as a gain or loss each year. There are chances of significant variances (for example large numbers of participants taking early retirement in a single plan year) which, while highly unlikely, could significantly alter the funded position of the plan. Of course, the impact of such an event on the plan sponsor may have significant repercussions on the ability of the plan sponsor to fund the plan (such as the death of an owner), but that is beyond the scope of this report. Additionally, overall mortality rates change over time (i.e. life expectancy in the U.S. changes). Longer life expectancy increases the costs under the plan.

Contribution Risk

The Funding Method required to be used determines the plan's minimum required contribution. However, contributing only the minimum amount does not guarantee that the plan will be sufficiently funded, at any intervening time, to pay its liabilities. Accordingly, employers should consider contributing more than the minimum required contribution. Also, such additional funding can lead to funding flexibility in the future, if the business has a less profitable year, while maintaining the plan's funded status.

Care should be taken not to significantly overfund the plan. If a decision is made, for whatever reason, to terminate the plan, excess assets (above what could be distributed to plan participants through an increase in plan benefits) could revert back to the plan sponsor and could be subject to an excise tax at a rate as high as 50%. Employers with significant excess assets due to investment return or high contributions should consult with the plan's advisors to ensure that the effects of potential excise taxes are minimized.

Conversely, if the plan funded status is below 100%, there would not be enough money to pay plan benefits. Generally, this will require either additional contributions to fully fund the plan in order to terminate, or, in certain circumstances, benefits may be limited.

Additional Assessment of Risk

Based on the scope of the engagement, a numerical analysis of the impact of potential variations in any factors discussed above on the future measurements for this plan was not performed. If interested in considering a more detailed projection analysis, please call to discuss this further. Of course, any projection analysis would be based on more assumptions and would be subject to greater volatility, so it would be less of a predictive analysis and more of an understanding of the impact that certain hypothetical variations could have to the plan.