



ACTUARIAL STANDARDS BOARD

• **FOURTH EXPOSURE DRAFT** •

**Proposed
Actuarial Standard
of Practice**

**Selection and Use of Asset Valuation Methods
for Pension Valuations**

**Comment Deadline:
March 1, 2007**

**Developed by the
Pension Committee of the
Actuarial Standards Board**

**Approved for Exposure by the
Actuarial Standards Board
August 2006**

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TO: Members of Actuarial Organizations Governed by the Standards of Practice of the Actuarial Standards Board and Other Persons Interested in the Selection and Use of Asset Valuation Methods for Pension Valuations

FROM: Actuarial Standards Board (ASB)

SUBJ: Proposed Actuarial Standard of Practice (ASOP)

This booklet contains the fourth exposure draft of the proposed ASOP, *Selection and Use of Asset Valuation Methods for Pension Valuations*. Please review this fourth exposure draft and give the ASB the benefit of your comments and suggestions. Each written response and each response sent by e-mail to the address below will be acknowledged, and all responses will receive appropriate consideration by the drafting committee in preparing the final document for approval by the ASB.

The ASB accepts comments by either electronic or conventional mail. The preferred form is e-mail, as it eases the task of grouping comments by section. However, please feel free to use either form. If you wish to use e-mail, please send a message to **comments@actuary.org**. You may include your comments either in the body of the message or as an attachment prepared in any commonly used word processing format. Please include the phrase “4th Exposure Draft: Asset Valuation Methods” in the subject line of your message.

If you wish to use conventional mail, please send comments to the following address:

4th Exposure Draft: Asset Valuation Methods
Actuarial Standards Board
1100 Seventeenth Street, NW, 7th Floor
Washington, DC 20036-4601

Deadline for receipt of responses in the ASB office: **March 1, 2007**

Background

Pension Plan Recommendations A, B, and C were adopted and amended by the American Academy of Actuaries (Academy) during the period 1976 to 1983. In 1988, *Recommendations for Measuring Pension Obligations* was promulgated as an ASOP by the Interim Actuarial Standards Board and the Board of Directors of the Academy. In 1990, the ASB republished that standard as ASOP No. 4, *Recommendations for Measuring Pension Obligations*. In October 1993, ASOP No. 4 was reformatted and published in the uniform format adopted by the ASB,

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with a title change, *Measuring Pension Obligations*. In August 2006, the ASB released a third exposure draft of a proposed revision of ASOP No. 4, *Measuring Pension Obligations and Determining Pension Plan Costs or Contributions*.

The selection of economic and noneconomic assumptions, the actuarial cost method, and the asset valuation method are all key elements in the valuation of pension obligations. The evolution of actuarial practice made it necessary to update the guidance in these areas. The following provide such guidance:

1. ASOP No. 27, *Selection of Economic Assumptions for Measuring Pension Obligations*;
2. ASOP No. 35, *Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations*;
3. Proposed ASOP, *Selection and Use of Asset Valuation Methods for Pension Valuations*; and
4. ASOP No. 4, *Measuring Pension Obligations*, which is currently being revised to tie together the other three documents, provide guidance on actuarial cost methods, and address overall considerations in the selection of assumptions and methods for measuring pension obligations.

The proposed revision of ASOP No. 4 is being exposed concurrently with this proposed ASOP on *Selection and Use of Asset Valuation Methods for Pension Valuations*, and it is the ASB's intention, in order to achieve consistency, to adopt both final standards at the same time.

The comment letters on the exposure drafts of this proposed ASOP led the Pension Committee to conclude that both the use of market value and the use of a variety of asset valuation methods other than market value are generally accepted actuarial practices. In recognition of the many circumstances in which the actuary does not select the asset valuation method and the many different asset valuation methods that are in widespread use, this proposed ASOP treats certain practices as meeting the requirements of the standard provided they are appropriately disclosed. The proposed ASOP also separates considerations relevant to the choice of any asset valuation method, including market value, from those considerations that are relevant only to asset valuation methods other than market value.

Actuarial practice is evolving in light of the application of the concepts of financial economics to measuring pension obligations and determining pension plan costs or contributions. Some of the issues related to financial economics are discussed in appendix 1. The proposed ASOP is intended to accommodate the financial economics approach as well as traditional actuarial practice.

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First Exposure Draft

The first exposure draft of this ASOP, then titled *Selection of Asset Valuations for Pension Valuations*, was issued in December 2001, with a comment deadline of May 15, 2002.

Thirty-four comment letters were received and considered in developing modifications that were reflected in the second exposure draft.

Second Exposure Draft

The second exposure draft of this ASOP was issued in October 2003 with a comment deadline of April 30, 2004. Fifteen comment letters were received and considered in developing modifications that were reflected in the third exposure draft.

Third Exposure Draft

The third exposure draft of this ASOP was issued in September 2005 with a comment deadline of February 28, 2006. Five comment letters were received and considered in developing modifications that were reflected in the fourth exposure draft.

The most significant changes from the third exposure draft are as follows:

1. Section 3.3, Further Considerations for Methods Other Than Market Value (now 3.4), was revised. Section 3.3.1, Relationship to Market Value (now 3.3), which provides guidance to the actuary when selecting an asset valuation method, was separated from sections 3.3.2, Bias (now 3.4.1), and 3.3.3, Different Treatment of Realized and Unrealized Gains and Losses (now 3.4.2), which require disclosure of characteristics that an asset valuation method other than market value might have.
2. Section 3.3.2, Bias (now 3.4.1), was revised. As in the third exposure draft, the actuary is required to consider whether changes in the asset valuation method produce significant systematic bias. The proposed standard makes the following changes:
 - a. the reference in the third exposure draft to “a series of changes” in the asset valuation method was removed; and
 - b. the example in the third exposure draft was revised for clarity and a second example was added.
3. Section 4.1.4, Prescribed Asset Valuation Method, was modified for consistency with the proposed revision of ASOP No. 4.
4. Sections 1.2, Scope, and 4.4, Deviation from Standard, were revised to reflect language

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proposed by the ASB concerning compliance with applicable law and deviation from the standard.

The Pension Committee thanks everyone who commented on the previous exposure drafts.

Request for Comments

The Pension Committee appreciates comments on all sections of this proposed standard, and would like to draw readers' attention to the following issues in particular:

1. Is any of the guidance in this proposed ASOP inconsistent with the guidance in the third exposure draft of the proposed revision of ASOP No. 4?
2. ASOPs typically contain a clause that describes what an actuary should do when, in the actuary's professional judgment, a deviation from one or more provisions of the ASOP would be appropriate. With respect to such deviations, the ASB is proposing new language that appears in sections 4.4–4.4.2 of this proposed ASOP. Is this language appropriate and clear? If not, how should it be changed?

The Pension Committee thanks former committee members Thomas P. Adams, Arthur J. Assantes, Lawrence Deutsch, Bruce C. Gaffney, Lawrence A. Golden, John F. Langhans, Michael B. Preston, Phillip A. Romello, and Joan M. Weiss for their assistance with drafting this proposed ASOP.

The ASB reviewed the draft at the August 2006 meeting and approved its exposure.

Pension Committee of the ASB

David R. Fleiss, Chairperson

David L. Driscoll	A. Donald Morgan
David P. Friedlander	Timothy A. Ryor
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PROPOSED ACTUARIAL STANDARD OF PRACTICE

**SELECTION AND USE OF ASSET VALUATION METHODS
FOR PENSION VALUATIONS**

STANDARD OF PRACTICE

Section 1. Purpose, Scope, Cross References, and Effective Date

- 1.1 Purpose—This actuarial standard of practice (ASOP) provides guidance to the actuary when performing professional services with respect to the following:
- a. selection of an asset valuation method for purposes of a defined benefit pension plan actuarial valuation; and
 - b. appropriate disclosures regarding the asset valuation method used.
- 1.2 Scope—This standard applies to the actuary when performing professional services with respect to selecting or using an asset valuation method for any defined benefit pension plan that is not a social insurance program as described in section 1.2, Scope, of ASOP No. 32, *Social Insurance* (unless an ASOP on social insurance explicitly calls for application of this standard). Throughout this standard, any reference to selecting an asset valuation method also includes giving advice on selecting an asset valuation method. For instance, the actuary may advise the plan sponsor on selecting an asset valuation method, where the plan sponsor is responsible for selecting the method.
- The actuary should comply with this standard except to the extent it may conflict with applicable law (statutes, regulations, and other legally binding authority). If compliance with applicable law requires the actuary to depart from the guidance set forth in this standard, the actuary should refer to section 4 regarding deviation from standard.
- 1.3 Cross References—When this standard refers to the provisions of other documents, the reference includes the referenced documents as they may be amended or restated in the future, and any successor to them, by whatever name called. If any amended or restated document differs materially from the originally referenced document, the actuary should consider the guidance in this standard to the extent it is applicable and appropriate.
- 1.4 Effective Date—This standard will be effective for any actuarial valuation with a measurement date six months or more after adoption by the Actuarial Standards Board.

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Section 2. Definitions

The terms below are defined for use in this actuarial standard of practice.

- 2.1 **Actuarial Valuation**—The measurement of relevant pension obligations and, when applicable, the determination of the actuarial value of assets, periodic costs, or contributions.
- 2.2 **Actuarial Value of Assets**—The value of pension plan investments and other property, used by the actuary for the purpose of an actuarial valuation (sometimes referred to as *valuation assets* or *market-related value of assets*).
- 2.3 **Asset Valuation Method**—A method used by the actuary to determine the actuarial value of assets.
- 2.4 **Market Value**—The price that would be received to sell an asset in an orderly transaction between market participants at the measurement date (sometimes referred to as *fair value*).
- 2.5 **Measurement Date**—The date as of which the actuarial value of assets is determined (sometimes referred to as the *valuation date*).
- 2.6 **Prescribed Asset Valuation Method**—A specific asset valuation method that is mandated by law, regulation, or other binding authority. For purposes of this standard, the plan sponsor would be considered a binding authority to the extent that law, regulation, or accounting standards give the plan sponsor responsibility for selecting such an asset valuation method.
- 2.7 **Principal**—A client or employer of the actuary.

Section 3. Analysis of Issues and Recommended Practices

- 3.1 **Overview**—The measurement of a pension plan's assets and the relationship between the plan's assets and its obligations are integral to the valuation process. The asset valuation method potentially affects the timing and amount of future plan contributions or costs and the plan's ability to satisfy its benefit obligations. Consequently, the actuary should use professional judgment to select an appropriate asset valuation method.
- 3.2 **Considerations in Selecting a Method**—The actuary should consider the following factors when selecting an asset valuation method:
 - 3.2.1 **Purpose and Nature of the Measurement**—The actuary should consider the

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purpose and nature of the measurement when selecting an asset valuation method. It may be appropriate for the actuary to select different methods for different purposes. For example, for purposes of determining contributions to an ongoing plan, the actuary may consider selecting an asset valuation method that smoothes the effects of volatility in market value on the pattern of contributions. As a second example, for measurements in conjunction with a plan termination, the actuary should consider selecting an asset valuation method that produces an actuarial value of assets that represents the value of assets expected to be available for distribution (i.e., net of any significant liquidation or surrender charges reasonably expected to be incurred).

- 3.2.2 Objectives of the Principal—The actuary should consider the objectives of the principal to the extent such objectives have been communicated to the actuary, are relevant to, and not inconsistent with, the purpose of the measurement, and are consistent with the actuary’s responsibilities under the *Code of Professional Conduct*. For example, when the principal is a plan sponsor and the purpose of the measurement is to determine annual contributions, the actuary should consider plan sponsor objectives such as a desire for stable or predictable contributions or costs, or a desire to achieve a target funding level within a specified time frame.
- 3.2.3 Multiple Asset Valuation Methods—The actuary may select different asset valuation methods for different classes of assets. For example, the actuary may determine that it is appropriate to use a smoothing method for equity investments and market value for fixed income investments.
- 3.2.4 Adjustment of Asset Values for Timing Differences—Sometimes asset values as of the measurement date are not available. In these situations, the actuary should select an asset valuation method that adjusts the value of the assets for the time between the date as of which asset values are available and the measurement date. Such an asset valuation method may reference appropriate published asset indices or involve an adjustment using another reasonable method.
- 3.2.5 Use of Actuarial Assumptions—To the extent that actuarial assumptions are used as part of an asset valuation method, the actuary should be guided by ASOP No. 27, *Selection of Economic Assumptions for Measuring Pension Obligations*, and No. 35, *Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations*, in selecting those assumptions. Furthermore, the assumptions should be consistent with the other assumptions used in the actuarial valuation.

It may be appropriate for the actuary to select different assumptions for different purposes. For example, the actuary may select an assumption to project asset values for a few months that differs from the long-term expected return assumption.

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3.2.6 Additional Considerations—When selecting an asset valuation method, the actuary should consider other known, relevant factors such as the following:

- a. the plan’s investment policy (or, where no stated policy exists, the plan’s actual investment practices);
- b. the characteristics of the asset classes in which the plan is invested (for example, the volatility of the return of each asset class and its correlation with plan obligations);
- c. the plan’s expected future cash flows and liquidity needs;
- d. the period of time over which the plan’s assets are expected to be held; and
- e. the characteristics of the method used to measure the pension obligation (for example, whether the pension obligation is measured on a mark-to-market basis).

3.3 Relationship to Market Value—If the considerations in section 3.2 have led the actuary to conclude that an asset valuation method other than market value may be appropriate, the actuary should select an asset valuation method that is designed to produce actuarial values of assets that bear a reasonable relationship to the corresponding market values. The qualities of such an asset valuation method include the following:

- a. Given the inherent volatility of markets, the asset valuation method is likely to produce actuarial values of assets that are sometimes greater than and sometimes less than the corresponding market values.
- b. The asset valuation method is likely to produce actuarial values of assets that, in the actuary’s professional judgment, satisfy both of the following:
 1. The asset values fall within a reasonable range around the corresponding market values. For example, there might be a corridor centered at market value, outside of which the actuarial value of assets may not fall, in order to assure that the difference from market value is not greater than the actuary deems reasonable.
 2. Any differences between the actuarial value of assets and the market value are recognized within a reasonable period of time. For example, a formula addresses differences between the actuarial value of assets and the market value in a manner that, in the actuary’s professional judgment, is rational, systematic, and produces an actuarial value of assets that is expected to

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converge toward market value at a pace that the actuary deems reasonable, assuming constant asset returns in future periods.

In lieu of satisfying both (1) and (2) above, an actuarial valuation method could satisfy section 3.3(b) if, in the actuary's professional judgment, the asset valuation method either (i) produces values within a sufficiently narrow range around market value or (ii) recognizes differences from market value in a sufficiently short period.

A plan's investment policy may provide that fixed-income securities are expected to be held to maturity and holding such securities to maturity is not inconsistent with the plan's investment practice and expected cash flow needs. In such situations, an asset valuation method that uses amortized cost for such securities is deemed to bear a reasonable relationship to market value relative to those assets.

3.4 Further Considerations for Methods Other Than Market Value—When using an asset valuation method other than market value, whether the asset valuation method is a prescribed asset valuation method or one that is selected by the actuary, the actuary should consider the following:

3.4.1 Bias—If the asset valuation method has significant systematic bias, the actuary should disclose such bias in accordance with section 4.1. An asset valuation method has significant systematic bias if, in the actuary's professional judgment, the method's design is expected to produce a distribution of actuarial values that is skewed toward understatement or overstatement relative to the corresponding market values.

The following paragraphs are intended to clarify the meaning of bias for purposes of this standard.

- a. An asset valuation method does not have significant systematic bias solely because it has one or both of the following characteristics:
 1. the asset valuation method would produce actuarial values of assets that are consistently less than (or greater than) the corresponding market values during sustained periods of increasing (or decreasing) market values; or
 2. the asset valuation method would produce actuarial values of assets that approach the corresponding market values asymptotically, assuming constant asset returns in future periods.
- b. Changes in the asset valuation method may produce systematic bias toward significant understatement or overstatement relative to market

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value. For example, resetting the actuarial value of assets to market value only when the market value exceeds the actuarial value of assets under the normal operation of the asset valuation method may constitute significant systematic bias in the *de facto* asset valuation method toward overstatement relative to market value. Another example would be a retroactive change in asset valuation method during a significant market decline that takes advantage of a previous market peak.

- c. Examples of asset valuation methods that have significant systematic bias include the following:
 - 1. an asset valuation method that is designed to produce a value consistently below market value if, in all time periods relevant to the application of the asset valuation method, the actual return on market value of the assets subject to the asset valuation method were equal to the actuary's expected return on those assets (such as the average value methods described in sections 3.11 and 3.12 of IRS Revenue Procedure 2000-40 applied to a portfolio including a significant proportion of equities); and
 - 2. an asset valuation method that produces an actuarial value of assets equal to a smoothed value that is subject to an asymmetrical corridor around market value, such as not more than 105% of market value or less than 80% of market value.

3.4.2 Different Treatment of Realized and Unrealized Gains and Losses—If the asset valuation method treats realized gains and losses differently from unrealized gains and losses, the actuary should disclose this difference in accordance with section 4.1. An asset valuation method treats realized gains and losses differently from unrealized gains and losses if it would produce different results depending upon whether an asset is sold or held. When such a method is used, an increase in asset turnover, as might happen if the plan changes investment managers, can cause a significant change in the actuarial value of assets.

Examples of asset valuation methods that treat realized gains and losses differently from unrealized gains and losses include the following:

- a. an asset valuation method that uses the average of book value and market value;
- b. an asset valuation method that immediately recognizes realized gains and losses and gradually recognizes unrealized gains and losses; and
- c. an asset valuation method that uses the product of the book value of assets

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on the measurement date multiplied by a five-year average of the ratio of market value to book value.

- 3.5 Assets that are Difficult to Value—Some assets do not have a readily established market value, such as certain insurance contracts, real estate, or other property. In determining the value of such assets, if audited financial statements do not provide an appropriate market value, the actuary may consider appraisals by qualified independent experts, recent sales of similar assets, the present value of reasonably expected future cash flows, or other appropriate methods. The value, so determined, may be treated as market value for purposes of this standard.
- 3.6 Reviewing the Asset Valuation Method—Once an asset valuation method has been selected for a particular purpose, at each subsequent measurement date, the actuary should consider whether the selected asset valuation method continues to be appropriate for that purpose. The actuary is not required to do a complete reassessment at each measurement date. However, if a significant change in the principal's objectives has been communicated to the actuary (see section 3.2.2), the actuary should review the appropriateness of the asset valuation method. Furthermore, if the asset valuation method is other than market value, the actuary should review the appropriateness of the asset valuation method if an event such as the following has occurred:
- a. a significant change in the plan provisions affecting cash flow (such as adding a lump sum payment option or freezing or terminating the plan), in the actuarial cost method or funding policy, or in participant demographics;
 - b. a significant change in the plan's investment policy (such as adding a new asset class or significantly changing the proportion of assets invested in each class); or
 - c. a prolonged significant deviation from market value.
- 3.7 Level of Refinement—The actuary should exercise professional judgment in establishing an appropriate balance between refined methodology and materiality. The actuary is not required to use a particular type of valuation method or to select a highly refined method when it is not expected to produce materially different results than would a less refined method. For example, it may be reasonable to assume that benefit payments are evenly distributed throughout the year, rather than reflecting the actual timing of each payment.
- 3.8 Reliance on Data or Other Information Supplied by Others—When relying on data or other information supplied by others, the actuary should refer to ASOP No. 23, *Data Quality*, for guidance.
- 3.9 Documentation—The actuary should prepare and retain documentation in compliance with the requirements of ASOP No. 41, *Actuarial Communications*. The actuary should also prepare and retain documentation to demonstrate compliance with the disclosure requirements of section 4.1.

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Section 4. Communications and Disclosures

- 4.1 Disclosures in Actuarial Reports—When issuing an actuarial report, as defined in ASOP No. 41, the actuary should follow the applicable disclosure requirements in ASOP No. 4, *Measuring Pension Obligations and Determining Plan Costs or Contributions*, and ASOP No. 23. In addition, the actuary should disclose the following:
- 4.1.1 Asset Valuation Method—The actuary should describe each asset valuation method used in the measurement in sufficient detail to permit another actuary qualified in the same practice area to reproduce the calculation if the actuary were provided with the necessary asset data.
- 4.1.2 Market Value and Actuarial Value of Assets—The actuary should disclose the market value and actuarial value of assets. If multiple asset valuation methods are used, in accordance with section 3.2.3, the actuary should disclose the market value and actuarial value of the assets subject to each asset valuation method. With respect to assets whose market value is determined under section 3.5, disclosure shall include the amount of such assets and a description of how the value of such assets was derived.
- 4.1.3 Changes in Asset Valuation Method—The actuary should describe changes, if any, in the asset valuation method from the method previously used for the same measurement purpose. The actuary should disclose the general effects of any changes in words or by numerical data, as appropriate.
- 4.1.4 Prescribed Asset Valuation Method—The actuary’s communication should state the source of any prescribed asset valuation method, including any assumption used as part of the asset valuation method. In addition, the actuary should evaluate whether a prescribed asset valuation method selected by the plan sponsor is reasonable for the purpose of the measurement and, if necessary, make appropriate disclosure in accordance with ASOP No. 4.
- 4.1.5 Bias—If, in the actuary’s professional judgment, the asset valuation method, or changes in the asset valuation method, has significant systematic bias toward understatement or overstatement relative to market value, as described in section 3.4.1, the actuary should disclose the direction of the bias and the general effects of such bias in words or by numerical data, as appropriate. For example, if the asset valuation method used to determine the plan’s contribution requirements is one of the methods described in section 3.4.1(b), the disclosure might state the following: “This asset valuation method is biased above market value, resulting in lower contributions over time than would be expected if an unbiased method were used.”

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- 4.1.6 Different Treatment of Realized and Unrealized Gains and Losses—If the asset valuation method treats realized gains and losses differently from unrealized gains and losses, the actuary should include disclosure similar to the following: “This asset valuation method treats unrealized gains and losses differently from realized gains and losses. Thus, asset turnover can cause a significant change in the actuarial value of assets.”
- 4.2 Disclosures in Other Actuarial Communications—The actuary should be guided by ASOP No. 41 when considering which of the disclosures in section 4.1 should be included in an actuarial communication that is not in the form of an actuarial report.
- 4.3 Prescribed Statement of Actuarial Opinion—This ASOP does not require a prescribed statement of actuarial opinion (PSAO), as described in the *Qualification Standards for Prescribed Statements of Actuarial Opinion* promulgated by the American Academy of Actuaries. However, law, regulation, or accounting requirements may also apply to an actuarial communication prepared under this standard, and as a result, such actuarial communication may be a PSAO.
- 4.4 Deviation from Standard—If, in the actuary’s professional judgment, the actuary has deviated materially from the guidance set forth elsewhere in this standard, the actuary can still comply with this standard by applying the following sections as appropriate:
- 4.4.1 Material Deviations to Comply with Applicable Law—If compliance with applicable law requires the actuary to deviate materially from the guidance set forth in this standard, the actuary should disclose that the assignment was prepared in compliance with applicable law, and the actuary should disclose the specific purpose of the assignment and indicate that the work product may not be appropriate for other purposes. The actuary should use professional judgment to determine whether additional disclosure would be appropriate in light of the purpose of the assignment and the intended users of the actuarial communication.
- 4.4.2 Other Material Deviations—The actuary’s communication should disclose any other material deviation from the guidance set forth in this standard. The actuary should consider whether, in the actuary’s professional judgment, it would be appropriate and practical to provide the reasons for, or to quantify the expected impact of, such deviation. The actuary should be prepared to explain the deviation to a principal, another actuary, or other intended users of the actuary’s communication. The actuary should also be prepared to justify the deviation to the actuarial profession’s disciplinary bodies.

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Appendix 1

Background and Current Practices

Note: This appendix is provided for informational purposes, but is not part of the standard of practice.

Background

Historically, actuaries have selected various methods to determine the actuarial value of pension plan assets for different measurement purposes.

Current Practices

Actuaries use both market value and asset valuation methods other than market value. The latter asset valuation methods are usually used for smoothing the effects of volatility in market value on plan costs or contributions, or achieving consistency between the valuation of assets and obligations.

An asset valuation method that is intended to smooth the effects of market volatility typically reflects the market value of plan assets in some fashion. This is accomplished through a variety of commonly used techniques, such as the following:

1. smoothing some components of the return on market value or the difference between actual returns on market value and expected returns;
2. requiring that the actuarial value of assets fall within a specified range, such as 80% to 120%, of the market value; or
3. recognizing differences between the actuarial and market values of assets over a specified time schedule.

Actuaries often select different asset valuation methods for different purposes, such as for determining cash contribution requirements, determining employer accounting costs, or assessing the plan's funded status upon plan termination.

Actuarial practice is evolving in light of the application of the concepts of financial economics to measuring pension obligations and determining pension plan costs or contributions. Actuaries who apply a financial economics approach generally advocate the use of market measurements of assets (and obligations) and, to the extent that smoothing of contribution or cost requirements is considered desirable, accomplishing this through means other than smoothing the assets.

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Instead of smoothing the “inputs” to the valuation (i.e., the plan’s obligations and assets), they limit smoothing, where desirable, to the “outputs” of the valuation (for example, plan costs or contributions). Traditional actuarial practice that involves smoothing inputs (for example, the use of an asset valuation method other than market value) is sometimes called “front-end smoothing,” as opposed to actuarial practice that limits smoothing to the outputs, which is called “back-end smoothing.”

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Appendix 2

Comments on the Third Exposure Draft and Responses

The third exposure draft of this proposed ASOP was issued in September 2005 with a comment deadline of February 28, 2006. Five comment letters were received, some of which were submitted on behalf of multiple commentators, such as by firms or committees. For purposes of this appendix, the term “commentator” may refer to more than one person associated with a particular comment letter. The Pension Committee carefully considered all comments received, and the ASB reviewed (and modified, where appropriate) the proposed changes. Summarized below are the significant issues and questions contained in the comment letters and the responses to each. The term “reviewers” includes the Pension Committee and the ASB. Unless otherwise noted, the section numbers and titles used below refer to those in the third exposure draft.

SECTION 1. PURPOSE, SCOPE, CROSS REFERENCES, AND EFFECTIVE DATE	
Section 1.4, Effective Date	
Comment	One commentator believed the effective date should be extended, preferably to one year after adoption.
Response	The reviewers extended the effective date from four months to six months after adoption to coordinate with the expected adoption of ASOP No. 4, <i>Measuring Pension Obligations and Determining Pension Plan Costs or Contributions</i> .
SECTION 2. DEFINITIONS	
Section 2.4, Market Value	
Comment	One commentator suggested that the definition be revised to capture the nuance that market value is not technically the price for which an asset might potentially be sold, but rather the price for which a security was sold, and then that price was used to value the asset of a third party holding a position in that same security.
Response	The reviewers reconsidered the definition and decided to modify it to be consistent with the definition of “fair value” in Statement of Financial Accounting Standards No. 157, <i>Fair Value Measurements</i> (September 2006).
SECTION 3. ANALYSIS OF ISSUES AND RECOMMENDED PRACTICES	
Section 3.2.2, Objectives of the Principal	
Comment	One commentator suggested eliminating “a desire for stable or predictable contributions” as an example of an objective of the principal, noting that plan sponsors want flexibility.
Response	The reviewers made no change, believing that many plan sponsors are concerned about having stable and predictable contributions. For example, many public employee pension plans and multiemployer pension plans are interested in maintaining stable and predictable contributions. Moreover, the proposed standard offers this as an example of an objective of the principal.

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Section 3.2.6, Additional Considerations	
Comment	One commentator suggested inserting “measurement” after “obligation” in the phrase “the characteristics of the obligation.”
Response	The reviewers agreed and changed the wording in a similar fashion.
Comment	One commentator suggested revising the language to allow for the fact that the actuary may not know all “relevant factors” that may be important to the selection of an asset valuation method.
Response	The committee agreed and inserted “known” before “relevant factors.”
Section 3.3.1, Relationship to Market Value (now 3.3)	
Comment	Two commentators wrote that if an asset valuation method satisfied either the requirement of section (b)(1), that the asset values fall within a reasonable range around the corresponding market values, or section (b)(2), that any differences between the actuarial value of assets and the market value are recognized within a reasonable period of time, it was unnecessary that it satisfy the requirement of the other section. One commentator asked why section (b) requires an asset valuation method to satisfy sections (b)(1) <i>and</i> (b)(2) and then seems to state in its final paragraph that an asset valuation method may satisfy either (b)(1) <i>or</i> (b)(2).
Response	The reviewers believed that a method generally should satisfy both requirements. The final paragraph in section (b) is intended to accommodate situations in which either the range around the market value is sufficiently small or the period of time over which differences between actuarial value of assets and market value are recognized is sufficiently short so as to make the other test largely irrelevant.
Comment	One commentator wrote that the example in section (b)(1), which includes a uniform corridor above and below market value, may not be appropriate. The commentator stated that it may be appropriate in some circumstances for an actuary to use a corridor that is not uniform, particularly one that makes the actuarial value of assets lower than market value. The commentator also wrote that section 3.3.2 (now 3.4.1) implies that an actuary may use an asset valuation method that has significant systematic bias and questioned why this section seems to restrict the actuary’s ability to select an asset valuation method that has significant systematic bias.
Response	First, the reviewers note that the corridor is intended only as an example. The reviewers also note that this section applies to actuaries when <i>selecting</i> , or giving advice on <i>selecting</i> , an asset valuation method, and current section 3.4.1 applies to actuaries when <i>using</i> an asset valuation method. The reviewers believed that in some circumstances, an actuary who exercises professional judgment may conclude that an asset valuation method that has significant systematic bias is appropriate for the purpose of the measurement. The reviewers note that the actuary should disclose the use of an asset valuation method that has significant systematic bias in accordance with current sections 3.4.1 and 4.1.5.
Comment	One commentator suggested that the reference to the “plan’s investment practice” be deleted from the last paragraph of this section, concerning the use of amortized cost for bonds and other income securities in certain situations, because it is unnecessarily restrictive. The commentator noted that an investment manager can trade securities within a portfolio without materially changing the expected cash flow and wrote that the proposed standard should not subject similar portfolios to different requirements solely because the individual securities in one portfolio are not intended to be held to maturity.
Response	The reviewers believed that the use of amortized cost should remain limited to situations in which securities are expected to be held to maturity.

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Section 3.3.2, Bias (now 3.4.1)	
Comment	<p>One commentator disagreed with the requirement that the actuary disclose that an asset valuation method has significant systematic bias, believing that a full description of the asset valuation method is sufficient for the user to determine if the method is biased.</p> <p>The commentator also suggested that, if this section were retained, it should be limited to those instances in which the actuary <i>believes</i> that an asset valuation method has bias, rather than those in which an asset valuation method <i>has</i> bias.</p> <p>Finally, the commentator believed that it is inappropriate for the proposed standard to require the actuary to disclose that a prescribed asset valuation method has bias, as it puts the actuary in a position of evaluating whether a legally required method has characteristics that could be considered undesirable by readers of the disclosure.</p>
Response	<p>Regarding the first point, the reviewers did not believe that a full description of a biased asset valuation method is always sufficient for all potential users to recognize that the method has bias. Regarding the second point, the reviewers believed that the existing language, in which the determination of whether an asset valuation method has significant systematic bias is based on the actuary’s professional judgment, makes the addition of the word “believes” unnecessary. Regarding the third point, the reviewers note that the word “bias” is intended to be descriptive and not pejorative and that the existence of bias in an asset valuation method does not necessarily make the method an inappropriate method, given the purpose and nature of the measurement. Consequently, the reviewers made no changes.</p>
Comment	<p>One commentator wrote that the phrase “a series of changes in the asset valuation method” was vague. Another commentator thought that the example in section (b) was unclear.</p>
Response	<p>The reviewers deleted the phrase “a series of,” revised the example, and added a second example to clarify the meaning of the section.</p> <p>The reviewers also deleted the first example in section (c), because such an asset valuation method would not produce actuarial values of assets that bear a reasonable relationship to the corresponding market values as described in section 3.3.1 (now 3.3). Moreover, the reviewers did not want readers to misinterpret the example as a suggestion that the use of the lesser of the actuarial value of assets and the market value of assets in the calculation of the full funding limit was an asset valuation method, which was not the intent.</p>
Section 4.1.4, Prescribed Asset Valuation Method	
Comment	<p>Two commentators opposed the requirement that the actuary disclose that, in the actuary’s professional judgment, an asset valuation method prescribed by the plan sponsor is not reasonable in light of the purpose of the measurement. One commentator wrote that the requirement places a higher standard on the actuary’s judgment.</p>
Response	<p>The reviewers believed that such a disclosure requirement is appropriate and necessary to prevent the actuary’s work from being misused. The reviewers believed that the disclosure requirement in the proposed revision of ASOP No. 4 regarding prescribed assumptions and methods should apply to asset valuation methods as well. Accordingly, the committee revised the section to refer to a similar disclosure requirement in the proposed revision of ASOP No. 4.</p>

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Comment	One commentator was concerned that this requirement to disclose would apply only to a plan sponsor but not a governmental or accounting body.
Response	The reviewers believed that situations in which the plan sponsor exercised discretion were distinguishable from circumstances in which governmental or other entities exercised rulemaking authority with general applicability.
Comment	One commentator was concerned that this disclosure requirement could be part of a public communication (such as an attachment to a Schedule B) that could put the actuary in disagreement with his or her client.
Response	The reviewers believed that the disclosures required by the proposed standard could be contained in a cover letter, in an attachment to Schedule B, or in some other medium, depending on what is appropriate in the actuary's judgment.