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AUDIT GUIDE AND ACCOUNTING FOR PENSION COSTS

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CHAIRMAN PRESTON C. BASSETT: We are delighted to be here this morning to cover this subject that is very important to the future of our profession and I think at least somewhat important to the other profession of accounting.

As many of you know, we have had very close relations with accountants in the pension field--starting principally back with Accounting Principles Board Opinion No. 8, which dates back about eight years now. A few people in this room actually worked on APB Opinion 8 with the accounting profession.

We have had good relations with them over the years, and we hope to continue to have good relations, but we do have some problems. The problems are in understanding our relative role and how we can work with one another on these problems. So the panel today is going to address itself to some of these items.

Before we get under way, we have two guests here today and I would like to introduce them to you. I presume you are familiar with the Cost Accounting Standards Board (CASB) and perhaps you have had an opportunity to read their release that came out a few weeks ago. The two principal CASB members involved in working out requirements, suggestions, and so forth, are Mr. William Parker and Mr. Bernard Sacks.* Do you have some thoughts you would like to express to the group before we get under way?

MR. WILLIAM PARKER: Basically we are here to listen and learn from the professionals regarding the draft standard that was published on May 5. I want to emphasize that it is a draft. We hope certainly to get comments from the actuaries and others who will have to live with the standard if and when finally promulgated.

Bernie Sacks is really the main researcher on it. The draft standard is really a culmination of two years of work and I would like to take this opportunity to thank the many professional actuaries in public practice who have over that time given us their comments, have taken the time to meet with us and to help us come up with a standard that, hopefully, will be able to meet our Board's objectives, will not conflict with ERISA, and will not give actuaries any undo hardship. I would emphasize that we did not incorporate all the recommendations we received from professional actuaries, but I doubt very much that any one standard could do that. I thought it was only accountants who can never come to a consensus, but I am glad to see there are other professions that have some of the same difficulties.

*Mr. Parker and Mr. Sacks, not members of the Society, are members of the American Institute of Certified Public Accountants and the Federal Government Accountants Association.

MR. BERNARD SACKS: Just a word on the draft. It is an exposure draft, which means that it is not the final version yet. For those of you who are not familiar with the standards, when the final version comes out, it goes to Congress for 60 days and, if they do not take negative action, it becomes law. I think it is something that impacts everyone and we truly want comments from you.

I would urge those who are interested to get a copy of it, read it, and give us your comments. I also urge that if you do give us your comments, just do not say you do not like it. Rip it apart!! If you do not like it, tell us why. Better yet, give us recommended language; or even recommendations to delete material.

PROPOSED AUDIT GUIDE

MR. RICHARD M. KAYE: The audit guide we are talking about originally appeared in March of 1973 in proposed form. It is important to note that we are talking about the audit of pension funds. We are not talking about the audit of pension plans; we are not talking about the audit of pension expense. There has never been anything on the audit of pension expense really. APB 8 was on the accounting principles dealing with pension expense. The recently issued Financial Accounting Standards Board Interpretation No. 3 is also on accounting principles. There has never really been anything to speak of on auditing for expense; and here we are talking about the March, 1973 proposed audit of pension funds.

It is important to note this was obviously drafted before ERISA. There were some warnings to the drafters to wait until ERISA came, because many of the requirements they are talking about are going to be changed, perhaps, by ERISA. But they went ahead anyway and drafted this and a later draft prior to ERISA, perhaps hopefully trying to influence the outcome of what the Pension Reform Act would be.

I will not try to go over everything in the audit guide. There are many things that deal with nonactuarial matters that we are probably not concerned with; however, I will try to go over the things that do affect us as actuaries and some of the comments we have had as a group and as individuals, criticisms that we have had--things we feel we cannot live with.

The first thing is that the exposure draft required that market value be used. Well, this certainly goes against ERISA, and, as we found out, it goes against APB 8. I think it also goes against what we think of in terms of a pension plan. A pension plan is a long-term thing; using market value in anything we value is going to result in fluctuations back and forth. Can't you see a plan being overfunded one year and underfunded the next due to nothing else but the changing of the market value?

The accountant's reaction to this--at least the individuals with whom I have spoken--has been: "Well, it would be okay to use book or adjusted book or adjusted market, but if market is below that figure in our audit of the pension funds, in our opinion, we are going to have to qualify it." Qualify it by saying that everything is fine "except if"--assuming the market bounces back, or everything would have been fine except the assets are overstated, something on that order that does not sound too good. It does not sound good to the trustee and does not sound good to the plan sponsor.

In the era we are now in, the plan sponsor would be worried if their pension fund were audited and that opinion were given; and, again, the accountants might give that opinion because we used book or adjusted book or adjusted market instead of market and market was less than those figures. If they gave that opinion, they would probably be thinking in terms of the dangers of lawsuits stemming from the breach of fiduciary duties, because that does sound like something is wrong, such as the assets have gone down the drain.

As actuaries, not only do we find it inconsistent because we know a pension fund is a long-term arrangement, but we might be using a completely different method. If we are writing up assets--a certain percent a year or using an adjusted market method--look at the problems that are going to come when we try to tie the asset side of the audit to the liability side. It is not going to balance, and the use of market value is going to cause this imbalance.

Even in the one case where some actuaries have said let's use market, namely, on termination of a plan, even then the use of market value is of dubious value. Many times when a plan is terminated, the assets are not all liquidated; they are kept in the fund to avoid an income tax. The trust is kept in operation even when the plan is terminated, many times. There is not this big cash-out for market value, and again it is still a long-term thing even on plan termination.

Another thing is the liabilities that are shown. The latest draft wants a liability for accrued benefits and a liability for vested benefits. With respect to the liability for accrued benefits, what would that intend to show? I cannot see any purpose for that. We know a liability labeled a past service liability is merely a technique we use to allocate costs, to amortize so we could allocate costs to a proper period, consistent with good accounting which concerns itself with matching expenses and revenues; but it is by no means an accurate measure even if there were only one method, and there are many methods. It is not an accurate measure necessarily of what has been accrued to date. It depends on what we are talking about, a termination of plan, or going concern concept, or what have you. And, of course, with some methods we like--like the Aggregate Method--there is not even a separate recognition of past service so that would mean another valuation to be done just to determine some past service amount. Even if we use a method like a Frozen Initial Liability Method, we do not necessarily separately identify a past service amount after the first valuation.

Now, as to the vested liability, we have the same problems. I could see some justification for showing that. Perhaps I could see an interest if the plan were to terminate; what is the unfunded vested liability? But here again we have similar problems. ERISA's concept of an unfunded vested liability is different than we had ever thought of in terms of plan termination heretofore. In the context that we are now going towards, it is not really that bad. We are not unfunded to the extent of 100% vesting because the only liability the Pension Benefit Guaranty Corporation imposes on us is not for the total unfunded vested benefits that would arise on plan termination, but only those that would have existed prior to termination. So if a man is 60% vested when the plan terminates, he becomes 100% vested, but you are only liable to the PBGC for, and the PBGC will only reimburse up to, the 60% vested.

But again on the vesting we have the same problem--how are liabilities going to be related to assets and what is that going to mean? Are the assumptions to be used on termination of a plan going to be the same as those used for purposes of getting the vested benefit liabliities under a going concern concept? Is it going to be a projection anticipating future terminees, or is it just going to deal with present people that are already vested?

This whole concept of relating to market value the assets and liabilities is kind of dubious because an asset is a definite figure. I think market value can be definitely determined--if you seek hard enough, even if an appraiser has to be sought--but the liability can never be a definite factor. It is only an estimate, and maybe it is somewhat unique to our profession, but it is only an estimate of the future based on many assumptions.

Some other general comments we, as actuaries, had were that the actuarial information was too little, misleading, or out of context. If only those two figures are shown, what about the future contributions or the present value of future normal costs, and where does it seem to call for that? And, like anything else, the less you show the more misleading it could be. What we really want is some kind of separate report. We need separation of responsibility--separate reports showing our usual information, and, towards that end, you know we are working on generally accepted actuarial principles that might go into something like that. Just showing a couple of items would be terribly misleading.

To me the most important issue is the reliance issue. The proposed audit guide said that you cannot rely on the actuary. In essence that is what it said, and the guide came out before ERISA. This is different than ERISA, too. ERISA states, I think, that the accountant can rely on the actuary if he states that he is doing so. The way the audit guide appears is that no reliance is allowed, which is another way of saying that they are going to try to pick our assumptions, pick our methods or at least evaluate the same. They are going to get into an area, there is no question about it, that they are not qualified to be in. And to me that is the biggest issue. ERISA hopefully will influence them to change their mind about that or to change the guide to allow reliance.

The audit of assumptions that they are anticipating doing, i.e., looking at our actuarial assumptions, is fine if they want to see if we are consistent from year to year. It is fine if they want to ask us what is the effect of changing assumptions; but to do anything other than that, such as looking at our methods or assumptions, I just cannot buy.

It has been raised and suggested by some members of our profession that the answer is that the auditors look just at the assets and we look at the liabilities. On its face I think that makes a lot of sense. Why should they be auditing the liabilities? Why don't they just stick to their usual approach and see what securities are in the fund and what is their value.

And I believe we should be looking at not only the liabilities but the difference between assets and liabilities as well.

The one problem I see in this approach is in the responsibility for data received for use in our annual actuarial valuations that are used to determine pension expense. At least our company says, and the previous company that I worked for said, ". . .based on the data we received from the company and the assets received from the trustee. . ." But now if we are taking this position that we should be auditing, as the term has been used, the liabilities and auditing the difference, I think there might be a question whether we are going to be responsible for good data sent by the client. Maybe their definition of plan compensation does not agree with the compensation they are sending, or the same with eligibility. If they did not interpret the eligibility correct and we did not get the correct people, we should not be put in a position to be responsible for that. Frequently we are not at the client's office other than when he has a special problem or to deliver the actuarial valuation. We are certainly not auditors and we cannot be, but on the other hand, if we are going to be hit with this responsibility, we have to audit the liability and audit the difference.

The audit guide that was originally issued talked about accounting and auditing as one body--the American Institute of Certified Public Accountants (AICPA). Since then there has been a little split off. The AICPA is responsible for auditing techniques, and the Financial Accounting Standards Board (FASB), which you are familiar with from FASB Interpretation No. 3 that was issued after ERISA, is responsible for generally accepted auditing principles. So now there is that separation of powers in the latest draft of the audit guide. But, in summary, the guide even as it now exists goes against our traditional rules of the long-term nature of pension plans in that it makes the accountant an expert, or attempts to, and of course he is not. The whole accrued benefit concept is out of whack.

And then there are our own professional conduct standards. The way the guide is set up, there is going to be no explanation on matters which our guides say we have to explain. It is incomplete for numerous reasons, and the name of the actuary would not be shown.

CHAIRMAN BASSETT: The audit guide that was put out a little over two years ago was referred to higher authorities in the accounting profession and subsequently was shelved for the time being because of the switch from the Accounting Principles Board to the reorganization with the Financial Accounting Standards Board. Now the basic issues, such as how assets should be valued, how liabilities should be shown, and reliance on actuaries has been turned over to the Financial Accounting Standards Board for their consideration. They have appointed two task forces to look into these problems along with several others. The first task force is on accounting and reporting for employee benefit plans and the second task force is accounting for costs of pension plans.

The former task force is actively at work at the present time. We have two members of the actuarial profession on that task force--Claude Poulin of the United Auto Workers and myself. The second task force has not yet got under way.

REVISION OF ACCOUNTING PRINCIPLES BOARD OPINION NO. 8

MR. VINCENT M. TOBIN: Rather than just talk about the revision of APB Opinion 8, I would rather cover the disclosure of the cost of pension plans in general.

It seems to me that, of all the questions and problems that we are faced with these days as actuaries and consultants, none is being looked at by so many different parties with so many different interests. The Financial Accounting Standards Board is concerned about shareholders. The Cost Accounting Standards Board is concerned about the government getting properly charged for cost of pensions. ERISA is concerned about the participants, and even the SEC is getting into the act by being concerned about the investing public and investment analysts.

When it comes to any kind of financial disclosure, I think there are two extremes. One is to disclose absolutely nothing, and that was the approach we all took prior to the promulgation of APB Opinion 8 in 1966. The other extreme seems to be to disclose everything, and that is the approach taken by ERISA.

Somewhere in between there must be the right answer. The disclosure requirements under Section 103 of ERISA seem to be so overwhelmingly comprehensive as to stagger the imagination.

APB Opinion 8 back in 1966 seemed to take a more reasonable approach in trying to get in between the disclosure of nothing and the disclosure of everything. Basically there were five requirements for disclosure: 1) that a plan existed, 2) a statement as to the company's expenses for pensions, 3) a statement as to the accounting and the funding policies, 4) the excess, if any, of the amount of vested benefit liability over the assets, and 5) the nature and effect of any significant changes that occurred during the year (which was probably the most comprehensive). This last item called for disclosure of changes in either the actuarial cost method, the actuarial assumptions, the funding period, prior service costs, or the treatment of gains and losses.

Now basically these requirements from APB Opinion 8 formed a compromise and gave us a good starting point into the disclosure area. Now some of these requirements were quite commendable, and I think others were rather irrelevant and inconsistent.

The entire amount of disclosure called for under APB Opinion 8 appears in the financial footnotes of the annual statement of the company with just a few exceptions. The exceptions are prepaid expenses, accrued pension costs, and the amount of unfunded benefits if there were a legal liability for the payment of benefits over and above amounts available in the trust fund.

The Opinion contained sample language as to the footnote. I am getting into this area because I would suggest to the accountants that they be a little more careful as to their wording if they come out with more sample footnotes.

I have read many footnotes and, if there is any consistency between them, it is that they contain two rather meaningless statements. The first is that the company and its subsidiaries have several pension plans covering substantially all of their employees including certain employees in foreign countries. I have seen that in many footnotes but I really do not know what it means. It does not add much to my store of knowledge, and I would even think that in some cases small grocery stores in the middle of Ohio have made that reference to their employees in foreign countries.

The other is that the policy of the company is to fund pension expense accrued. That does not add much to my store of knowledge either.

If they are going to include anything like these two statements, they need to be more detailed, or they should just leave them out. They should state something about what the pension plans are all about such as, "our salaried employees are covered by a plan which is based on final five year earnings," or "hourly employees are covered by negotiated contracts which will be revised in the next three years" or "which are negotiated under a contract which is to expire in the next three years."

The second negative point is that the sample footnote gave the dollar amount which resulted from any change in the actuarial cost method. Well, this seems to be rather meaningless and uninformative if you do not state what the cost method is.

On the positive side, however, there was required the disclosure of the pension expense for the year and the period over which any prior service cost was being funded. I certainly think these were worthwhile and a step in the right direction.

One thing that did bother us on several occasions was the extent, or the absence of any comment on the extent, to which the contribution or the expense for the year had been reduced because of the recognition of unrealized appreciation.

Again on the right side, or a step in the right direction, was the disclosure of a vested liability figure. I am not completely endeared to vested liability. I disagree with Dick, and I think the figure that should be disclosed is the accrued liability. As a matter of fact, it is required by ERISA, so at least we are going to have to calculate the darn thing. We might as well tell the whole world what it is.

Now, as Pres has already said, the Financial Accounting Standards Board, which is a group created by the accountants to replace the Accounting Principles Board, as I understand it, is going to be reviewing the Opinion.

One of the changes that is being discussed, as mentioned before, is the disclosure of unfunded prior service cost. This seems to me to be a completely useless piece of information, as I am quite sure you will all agree. It depends to such a great extent on just what the company's funding policy has been in the past, what the actuarial methods are, and so on, that I would strongly encourage the accountants to forget about that amount.

I think a useful piece of information to the shareholders of a company is the comparison of the accrued liability with the market value of the assets. I hate to say that because I will get into a lot of trouble with a lot of actuaries, but, as long as we do not stand up here and say this is an unfunded amount but rather state what the accrued liability figure is, and then let who-ever wants to compare it with the market value of the assets, I think that is a step in the right direction.

Again, to restate what I have touched on already, information must be disclosed and I do not see that there is any way to avoid it. I think it should be meaningful, relevant, unambiguous, and consistent. In addition to what I have already mentioned, I would suggest the following be disclosed in either the financial footnotes or in the financial statement which will deal only with the pension plan.

I would suggest a disclosure of the actuarial assumptions and the cost method, not only the ones that were used for determining the pension expense but also the assumptions and method that were used for determining the accrued liability.

I am not looking for a standardization of the calculation of the accrued liability. We have two widely different methods--going concern and termination of plan--one is appropriate at one time, and the other is appropriate at another time.

If we tell the world what we are doing, then I think we will stand a better chance of retaining the right to pick the method. If we just state what the accrued liability is, then we are going to be subject to criticism.

I would also strongly suggest that we disclose in the financial statement of the pension plan the value of the assets that we have used in determining the pension expense for the year or the pension contribution.

Up to this point my remarks have been addressed solely to the disclosure that would be required by the accountants. I did mention that there is another party, which is the SEC, that is extremely interested in disclosure. As a matter of fact, it appears that they would not even wait for the rules and regulations under ERISA to come out before issuing their rulings.

In a talk given some time in 1974, John C. Burton, who is a chief accountant with the SEC, addressed some remarks to the problem of disclosure and accounting. The following are quotes from that speech: "Careful examination of pension accounting and disclosure is clearly overdue and the act, that is ERISA, should service as a healthy stimulant to the Financial Accounting Standards Board and to the Securities and Exchange Commission to undertake this necessary review. The Commission must decide how much information a reasonably prudent investor and his financial interpreters ought to have about the financial implications of pensions."

He goes on further to state: "The Commission has identified the Financial Accounting Standards Board as the body which it will look to in providing leadership in the private sector for improving accounting principles and standards."

He went on further and attacked the fundamental accounting approach for pensions. He points out that the actuary's discounted cash flow concepts are a major departure from accounting thinking, that the discounting technique used by the actuary reduces current pension expense by amounts which are expected to be earned in the future on the investment of pension funds and that this reduction occurs whether or not the funds have been invested, whether or not they are even available.

He feels that this violates two accounting principles; namely, the principle of nonanticipation of income and the principle that offsetting expenses and revenues should not be netted on the income statement.

Another of his important points is that the concepts in APB Opinion 8 have the effect of omitting from the balance sheet a substantial pool of funds whose investment may significantly affect the future financial status of the company. Also, a very substantial liability is omitted.

He then tries to tie it all together. He states, "There is much to be said for an accrual of pension costs on a basis which would exclude the investment factor from the computation." He hypothesizes recording pension funds in a special class of long-term assets on the corporate balance sheet with the fund income appearing on the income statement.

He has some more interesting comments. He complains that APB Opinion 8 did not make any attempt to limit actuarial cost methods, and that gains and losses could be recognized in a number of different ways, and most important, that companies may exercise wide discretionary choice over the amount of pension expense.

While striving for consistency in accounting for pension plans, Burton does recognize that actuarial assumptions are necessary. He also allows that it is not practical to define a single set of actuarial assumptions, but would leave the choosing up to the actuary. He also recognizes that the interest assumption is a rather arbitrary guess as to actual investment results.

Here are some of his recommendations. He said that communications must be differentiated, based upon the user's ability to use them. I think that makes a lot of sense.

He says that the average run-of-the-mill investor does not need a lot of information. He would like to know what the pension expense was for the past year and maybe something about unfunded accrued liability. However, the analyst really has the right to a substantial amount of additional information. Most of the items that he would look for are required under ERISA and he allows that they will make substantial use of the disclosure in EBS-2. But he also calls for the anticipated impact on corporate income and liquidity of pension expense over the next five years and for a review of the effect of the past five years' experience on the current year.

He looks for a disclosure of the sensitivity of pension costs to changes in the interest assumption. He looks for a statement as to any significant difference between the actuary's assumptions and what the experience was in the past year, and also the cost effect of each of the differences.

So much for the SEC. I am going to touch very lightly on the Cost Accounting Standards Board, simply because I think it touches very closely on what I have been saying about APB Opinion 8 and the SEC.

Here the proposed regulation would require that each actuarial assumption stand on its own feet, which is a departure from the requirement of ERISA that we try to come up with a set of actuarial assumptions that form our best estimate in the aggregate. Also, the Cost Accounting Standards Board would tell us that we have to eliminate the important actuarial cost method of aggregate funding. I am quite sure the whole CASB problem will be touched on later in more detail.

In closing, I would like to say that, with so many adverse groups requiring financial information on pension plans, the possibility for confusion among the various users of these disclosed items will be magnified.

There will certainly be a tendency for each user to not just look at the information that has been prepared for him but also to cross-check against what is being disclosed to other parties. And if there is not some consistency among the requirements of these four bodies, then the user is going to be in a worse situation than he ever has been. I think it is a situation where too much information will be of no value at all.

I think my major complaint, though, is the tendency on the part of all of these groups to dictate actuarial cost methods. I would think that, if we are willing to disclose more information as to why we are doing what we are doing and how we are doing it, they would be well advised to leave the choosing of the methods up to us.

CHAIRMAN BASSETT: You will be glad to know that even Sandy Burton of the SEC agrees that what we now furnish, namely, unfunded prior service costs, is a meaningless figure so he has at least come around to the conclusion that what we are doing now is not very good. I do not know that what he proposes is going to help, but we certainly hope it will.

APB Opinion 8 concerned itself only with the consistency of costs within a corporation from one year to the next. In other words, the thrust of APB Opinion 8 was to produce consistent costs within a corporation. No attempt was made under APB Opinion 8 to develop costs that would be comparable between corporations, and this subject is an important one. Our financial analysts have particularly stressed that they would like to be able to compare costs between corporations.

COMPARABILITY OF PENSION COSTS ON FINANCIAL STATEMENTS

MR. M. DAVID R. BROWN: The attention of the accounting profession in both Canada and the U.S. has, in the past, been largely focused on the development of standards to ensure that the treatment of pension costs for a given company was consistent from one year to the next. Increasingly, however, a much more complex problem is being raised, that of comparing the effect of pension costs and liabilities on the financial statements of different companies in the same industry or, for that matter, in different industries. Financial analysts, the accounting profession, and plan sponsors themselves have expressed interest in this kind of comparison. An actuary whose daily work involves him in a wide variety of plan designs, employee populations, and funding arrangements will instinctively recoil from the oversimplification and standardization which may seem implicit in the quest for comparability. Nevertheless, I believe that there is a certain validity to this quest and that we, as actuaries, should start giving some serious thought to avoiding the worst pitfalls and overcoming the most obvious obstacles. Let us just briefly run down a list of these pitfalls and obstacles.

1. Plan design. A company with a final-pay plan has a different kind of "pension cost" from one with a career-average or flat benefit plan, in the sense that the actuarial estimate of cost is much less reliable for the final-pay plan than for the others. A similar comment applies to an employer with a "30 and out" optional (and therefore unpredictable) early retirement provision. Where pensions are bargained, with a resulting pattern of repeated periodic (if not entirely predictable) improvements, how should this be reflected in comparing pension costs?
2. Employee population characteristics. The age/service distribution of the employee group is obviously a significant factor in intercompany cost comparisons. Some would argue that differences in this area result in "real" pension cost differences which tend to be a function of the maturity of the industry in which the respective companies operate. For example, it is part of the general environment in which, say, a steel company conducts its business that it has a relatively high age/service distribution as compared to a company in, say, the electronics industry.
3. Actuarial assumptions and methods. These have an obvious bearing on reported pension costs and even after allowing for the reduction in variations of methods and assumptions which is likely to result from ERISA, this will still be an important factor.

A little reflection on these sources of differences in pension costs from one firm to another leads one fairly quickly to pose the problem in slightly different terms: Where pension costs differ from one firm to another, to what extent can the differences be described as "real" differences and to what extent do they result from selection by management and/or the actuary of the methods, arbitrary or otherwise, of recognizing the "real" costs? When the problem is restated in this way, we can see what a slippery slope we are getting onto.

I think most actuaries would agree that "real" pension costs are determined by the concrete benefit provisions of the plan and by the actual occurrence of objective events, such as salary increases, employee decisions to retire, actual investment experience, and so on. All these things do, in fact, differ from one firm to another and, presumably, the seekers after "comparability" of pension costs would agree that such underlying differences should, in fact, be reflected in reported pension costs. What they are seeking, then, is to avoid "arbitrary" or "artificial" differences which are traceable, on analysis, to imperfections in the process of actuarial estimation and forecasting. And here is where we, as actuaries, have to be extremely careful. We have to do whatever we can to make sure our clientele and the users of their financial statements understand the essential nature of what we do; that what we are primarily engaged in is a process of long-term forecasting which is subject to continuous revision in the light of emerging experience. If we find that our forecasts have been based on assumptions that are shown by a persistent pattern of experience to require revision, then we will adjust the assumptions appropriately so that the year-by-year incidence of estimated cost which we calculate will gradually approach the "true" year-by-year cost. These year-by-year reported costs should not, therefore, change abruptly but should follow a relatively smooth progression in the direction of a more accurate reflection of "true" costs. What this means is that we have to be especially on guard against two dangers which might otherwise accompany the search for comparability:

1. A tendency to standardize actuarial assumptions, funding methods, and liquidation periods for unfunded liabilities. Such standardization is bound to conflict with the objective of progressively more accurate estimates of the "true" picture which, as noted, will not be uniform but will vary in many particulars from one case to another.
2. Abrupt discontinuities in the progression of reported pension costs arising solely from revisions in the actuarial assumptions and methods. Such discontinuities do not, in fact, reflect changes in the underlying or "real" cost picture and can only lead to distortions in any attempt to make comparisons of these "real" costs.

The notion that it is possible to devise some simple index or standard measure of comparison is, I think, a mistaken one, for two reasons. First, it is based on a gross underestimate of the complexity and interaction of the determinants of pension costs. And secondly, it appears to require a comparison of unlike or incommensurable things: plans with open-ended or unpredictable benefit provisions where the standard deviation in the estimated cost is bound to be high, as against plans whose benefits are such that the reliability of the cost estimates is much greater. In short, my concern is that standardization will leave the user of financial statements <u>worse</u> off in this whole area than he is now, rather than better off, because he will think he is making valid comparisons when in fact he is not. What would be helpful to the user of the financial statements would be disclosure of three pieces of information.

1. The actuarial cost method. I think we <u>could</u> use some standardization of terminology here to reduce the apparent multiplicity of methods to no more than three or four general categories of method. A complete description of the actuarial cost method for this purpose would include an indication of the treatment of actuarial gains and losses and the period over which any supplemental liability is being liquidated.
2. Some indication of the ratio of assets to liabilities for accrued benefits.
3. Whether there have been any significant changes from the previous year,

either in the plan itself or in the actuarial cost method, and, if so, what the effect of such changes is.

Now what the financial analyst or other user of a company's statements would do with this information would be essentially what they now do with other areas of accounting practices which differ from company to company but which are disclosed in the statement. Some of them would use it intelligently and draw valid conclusions, and others, no doubt, would not. The point is that we should not agree to solve what some of these users see as a problem for them by imposing standardized but nonvalid criteria of cost measurement. What does the financial analyst do now when he compares, say, a company in a capital-intensive industry with one in a labor-intensive industry? He gets the facts and uses his judgment. All I am saying is that, if he wants to take account of differences in pension costs, he should do the same thing.

COST ACCOUNTING STANDARDS BOARD

MR. KAYE: The Cost Accounting Standards Board, which gets its authority in a legislative way, is not part of any special professional being. Right away, therefore, we think of government contracts. Its purpose, I think, is uniformity for determining pension costs under federal contracts.

As soon as I hear the word uniformity, it gets right back to this question: If we are talking about consistency between years, that is fine; if we are talking about consistency between companies, then I do not know the answer as that might well mean having assumptions and methods dictated. And when, in fact, we go through some of the things in the CASB events, I think we are seeing that the assumptions and methods are in a real sense being dictated.

There are three sections of the CASB draft standard. One is the composition of pension costs, another is how you are going to measure it, and the third is the allocation of pension costs among periods.

Composition of costs first of all includes the normal costs. The amortization periods are 10-40 years if begun prior to, or 10-30 years if begun after, the rules come into effect unless the plan was effective January 1, 1974, then it is 10-40 years. This is almost exactly what ERISA says about amortizing prior service costs.

It also has the component of actuarial gains, subtracted if it is a gain and added if it is a loss. This eliminates a couple of actuarial methods where the actuarial gain is not separately recognized but is spread routinely through the normal costs, like the aggregate method or like any frozen initial liability method. And, a minor thing, a potential component of costs which is important in cost-plus contracts is any excise tax under the new law resulting from underfunding. This, presumably, would not be part of the cost nor would any interest on late payments of the normal cost. You cannot get credit for that or call that part of your cost.

Measuring the components of costs is where we get into the issues. The first thing I read is that it says it must be an individual method. If separate recognition of gains did not eliminate the aggregate method, then this would. Gains and losses recognized separately eliminates any frozen initial liability methods.

Past service must also be recognized separately. I guess that eliminates, over and above what has already been eliminated, the individual level premium method (which is not used too often anyway).

Now the next thing is normal cost. Another one of the components has to be a percent of payroll. It seems to have said that and, of course, we would have to do it on a $5 a month service plan. Would we have the data to do that? We do not usually request data on salaries on plans like that.

The assumptions must be based on historical experience and, if not or if it differs, we must explain.

I really think that, if you take that literally, it is almost dictating our assumptions. If there were some uniform measure of determining what the yield was the last few years, and they are saying that we have to use that yield, that is dictating the assumptions. There is no real room, as I see it, for projecting the future. At least if you do, it must still be tied back to those historical assumptions. This differs from ERISA. ERISA clearly allows the actuary to use his best estimate of future events.

Historical assumptions, if all our assumptions have to be based on historical experience, is going to mean additional expenses. It is expensive for a valuation to be made. An experience study is going to have to be done more often than we would usually do it. One of those components of cost was not the expense of the actuarial valuation, which could go up quite a bit.

The other item, which I think Vince touched on, was that each actuarial assumption has to be reasonable. This, too, differs from ERISA under which the assumptions in the aggregate must be reasonable.

Finally, there is no asset valuation method that I saw in the draft that has been left unanswered, so I think the two key points we are concerned with are the actuarial methods, which seem to be limited to the individual entry age normal and the unit credit methods. These are the only two methods we could possibly use. The assumptions taken literally are really dictated by historical experience, and each assumption has to stand on its own.

The last thing was the allocation. It seems to deal in unfunded plans, saying, if you have not funded and you are not compelled to fund, you should not count that as part of your cost for a period even though APB Opinion 8 would require you to establish expense for that period. If you are compelled to fund by union contract or what have you and you have not funded, you could count that as part of your expense in a cost-plus contract.

We have until July 7 to respond to this draft.

DEVELOPMENTS IN CANADA

MR. BROWN: The practicing auditor in Canada is theoretically guided on the subject of accounting for pension costs by a section of the "Accountant's Handbook" published by the Canadian Institute of Chartered Accountants. This material originated in a research bulletin developed in the early 1960's by the Research Committee of the CICA at about the same time as APB Opinion 8 was being developed by the AICPA in the U.S. The precepts of the Accountant's Handbook do not have quite the same binding status that the Opinions of the Accounting Principles Board did have in the U.S., but the practicing accountant is expected to take them seriously and to be prepared, if challenged, to justify any deviation from them; or, I suppose, to qualify his certificate on the financial statements if the precepts have not been strictly observed. They constitute, in any event, a prima facie indication of "generally accepted accounting principles."

The apparent general objectives of the Handbook material are laudable enough: To ensure that corporate earnings are not unduly manipulated by year-to-year variations in the handling of pension costs and to ensure adequate disclosure of unfunded liabilities. Unfortunately, the Handbook then prescribes some rather dubious practices to accomplish these objectives. For example,

> The present value of vested past service benefits, to the extent that it has not been charged to operations, should be recognized in the accounts as a deferred charge offset by a liability. Such liability would, of course, be reduced by any related funding payments. (CICA Handbook, Section 3460.20)

I might say that I have never observed this suggestion applied in practice, although I have encountered many cases where the vested past service benefits are not yet fully funded. In most cases, the accountant does not even request the necessary information to discover whether there is any unfunded liability for vested past service benefits.

Another quotation from the Handbook is:

> An adjustment in pension calculations brought about by an actuarial re-evaluation should be included in the pension costs of the current period or allocated to operations over the period which is expected to elapse before the next revaluation. (CICA Handbook Section 3460.22)

What this seems to mean is that actuarial gains and losses must be fully reflected in the next following accounting period, or, at the very least, spread over the period to the next valuation, which is typically three years in Canada. Again (with one exception which I will describe in a moment) I cannot recall any instance of an accountant or auditor requiring this practice to be followed.

The general indifference of practicing accountants and auditors in Canada to the procedures prescribed by the Handbook is either a great tribute to their good sense and practical judgment or else an indication of laxity in the enforcement of professional standards of practice among them. Conceivably, it is both. In any event, leading members of the profession in Canada will now concede that the Handbook material is, at the very least, outdated, since it ignores the effects of pension benefits legislation and changes in recent years to income tax regulation on the pension plans of most Canadian companies. Ironically, a few accounting firms have belatedly been attempting to insist on some degree of conformity with Handbook practices, even where such conformity conflicts with legislative requirements or with the practice of a U.S.parent or with manifest common sense. One of our own clients was questioned by the "research partner" of its auditing firm when its reported pension costs increased dramatically over the previous year. It was explained to him that the increase was largely due to a Canadian regulatory requirement to fund over 5 years an "experience deficiency" which resulted from salary increases greater than those assumed by the actuary. The research partner of the auditing firm then decided that pension costs should have increased even more, since according to the Accountant's Handbook this actuarial deficiency should be recognized in current cost, or, alternatively, spread over a three-year period. When it was pointed out that the company was obviously giving very serious recognition to the cost associated with the experience deficiency by funding it over a 5-year period and, further, that APB Opinion 8 (which then governed the audited statements of the U.S.parent, with which the results of the Canadian subsidiary were consolidated) prescribed the spreading of actuarial gains and losses, this Canadian auditor subsided and was never heard from again on the subject.

The fact is that accounting practice in Canada on the question of pension costs is not in a very satisfactory state from anybody's point of view, whether it be the companies whose statements are published, the readers of those statements in the financial community, or the accounting and actuarial professions. Practice varies widely, and no one seems sure how to deal with situations such as that of one major Canadian company which recently switched from the entry age normal to the aggregate-cost method, with the result that a footnoted unfunded liability of a very large amount in one year was replaced in the next year by a statement that the company's pension plan had no unfunded liability. The fact that government regulators of pension funds do not require audited financial statements of the funds, plus the fact that securities regulators have had relatively little to say, so far, about uniformity or rationality of pension cost accounting does much to explain the present situation in Canada. However, pension costs are of rapidly growing significance in the operation of many Canadian companies and it seems unlikely that the Canadian accounting profession will much longer be able to ignore the subject as effectively as they have been doing. Variations in practice can no longer be dismissed (in a favorite accounting expression) as being "not material." From the actuaries' point of view, the passivity of the accounting profession in Canada on this question has been a kind of blessing, albeit a negative one. However, it would seem that we will soon be faced with the familiar problem of educating the influential members of our sister profession to the dimensions of the problem and doing our best not to be overwhelmed by their large numbers and high visibility in the business community.

GENERAL DISCUSSION

MR. JAMES F. A. BIGGS: I first have a specific question that I would like to address to Vince and then I do have some comments that I would like to make.

Vince, you indicated, I think quite rightly, that this unfunded past service cost number that people have been asking us for and we have been giving is essentially a meaningless number, but then you later talked about giving, I believe, the accrued liability, and you used that term a number of times. Are you specifically talking about the accrued liability in the sense of the actuarial cost method that is being used for the plan, or are you talking about the present value of accrued benefits for this reporting purpose?

MR. TOBIN: The latter--the present value of accrued benefits.

MR. BIGGS: Which, essentially, is the number that the Audit Guide was asking for?

MR. TOBIN: The present value could be on either a going concern basis or a termination of plan basis, but the basis should also be disclosed, in my estimation.

MR. BIGGS: There is an old line that says, "If you can keep your head when all about you are losing theirs, maybe you do not understand the situation."

I have sat in a number of "quasi-bitch" sessions of this type over the last couple of years in which my fellow actuaries and I complain about the fact that all of these multiplicity of people--the FASB, the AICPA, the CASB, etc., are asking us for the wrong things, and they are asking us to get them in the wrong way. That suggests to me that maybe we have not done a very good job of looking to the real needs of the people who are using our output, and of defining ourselves what we have to produce and how we should produce it in order to meet these genuine needs.

Now, turning to certain specifics on the panel's comments partly in relation to this comment, like Dick Kaye, I have spent a lot of time denouncing a number of things that were included in the proposed Audit Guide for pension funds. On the other hand, I think you have to recognize that the guide was directing itself to a very real felt need, namely, that the people who are interested in pension funds, whether it be the sponsoring employer or more importantly the participants, feel a need to know "How is our fund doing?" The auditor's concern is that a statement of assets does not tell him anything. If you tell him that the assets went up by a million dollars, it does not tell him anything if the liabilities may have gone up by two million or half a million dollars.

So there is the problem of coordinating these numbers, or in some way coordinating our efforts so that the user of the statement can get information which is meaningful to him.

The second point is this question of reliance on actuaries. The phrase obviously is an unfortunate phrase. I think our friends, the accountants, have done absolutely a dismal job of communicating their problems to us. Let us draw a distinction between being unwilling to rely on the actuary and not stating one's reliance on the actuary. Fundamentally, what the accountants are saying in their Audit Guide, both with respect to life companies and with respect to pension funds, is that, if they are issuing a report with respect to the total statement, they must assume responsibility with respect to that total statement.

Certainly they rely on the actuary. They work with the actuary, since commonly it is his numbers that they are using. They are placing trust and faith in the actuary but in doing so, they thereby, in effect, assume responsibility for this trust and faith that they have placed. Therefore, they decline to, in effect, divide that responsibility by stating in their opinion the fact that they have placed reliance on the actuary.

Turning to your comments for a moment, Vince, at one point you were talking about the methods which we select. I am not sure that, in the real world, this is always true, and I am not sure that it properly should be true, in that I think, in many cases, it is the responsibility of the actuary to expose the client to alternative methods and to the consequence of those alternative methods. I think a very strong case can be made that the ultimate selection of the method, which should be one which properly fits, among other things, the employer's financial condition and objective, should be made by the employer, subject, obviously, to the actuary's approval.

I think, and this was a comment that John Hanson made in an earlier session today, actuaries frequently look upon the situation as one in which they alone are selecting methods, they alone are selecting assumptions and presenting them or imposing them on the employer. If you look at it from that point of view, in a sense any suggestion that the employer makes as to assumptions or methods becomes improper pressure, improper interference. I do not think that is a real world situation. I think the employer has a proper and meaningful role in the selection of assumptions and methods, provided that the result is within the range of assumptions and methods which the actuary in fact regards as reasonable.

Dave, you were talking about the disclosure problem. I think that possibly a first step towards solving this disclosure problem, particularly in relation to comparability, might be a requirement that the footnote disclose whether or not the actuary believes that the costs as determined can reasonably be expected to remain level for the foreseeable future, or whether in fact a conscious decision has been made to use a cost method and assumptions which will produce either an escalating or, in unlikely circumstances, a declining set of costs. I think that might be at least a first step toward some degree of meaningful disclosure.

MR. KAYE: I just wanted to say that I generally agreed with what Jim was saying on the employer's input into picking assumptions and methods. If I did not agree with that, then my future with a particular client would be rather short-lived. However, there is no doubt about it, we have the final say as to what the method and assumptions are, so I do not think there is really any difference of opinion between Jim and myself.

LEROY B. PARKS, JR: I have both a question and also an observation regarding the proposed rules of the CASB.

First of all, I want to hear an expression as to whether or not these rules will be binding on all government contracts or whether the contractors can actually negotiate and have these rules not be operative in their particular situation.

Secondly, I am concerned that these rules are going to be somewhat too restrictive. I have a real world situation where a client has the choice of shutting down an operation or else accepting a government contract and perhaps running the operation for the five-year duration of that contract and then closing down the operation. This client feels that the true pension expense for which they seek a reimbursement should be the difference between the guaranteed benefits at the beginning of the contract and the guaranteed benefits at the end of the contract. This difference is probably several times the amount of the expense that would be allowed under the proposed regulations and this particular client probably would not be interested in accepting a contract unless they could get a reimbursement substantially greater than what would be provided for in the CASB standard.

MR. PARKER: Actually, in answer to the question of whether, if finally promulgated, this cost accounting standard would have to be followed by a company having a negotiated defense contract with the government covered by cost accounting standards, yes, he would have to follow it.

Regarding the second question involving a company that is talking about one particular segment undertaking a rather short-term contract in which no future business is foreseen and therefore is undertaking a greater risk, the business would like to get more money from the government during the term of that contract over and above the costs that would normally be assigned to that contract. He has the perfect right to do so but it should be part of profit. This problem is involved in other costs besides pension costs. It is involved in depreciation. He buys some equipment that will last beyond, say, the term of a five-year contract. What are you going to do? He says that he has no use for it after the contract. It again should be part of the profit. I hope that answers that question.

I would like to say a few more words. I did not intend to get involved, since Bernie or I expressing our interpretation of any provision of the standard is just not proper. If it does not state by itself what it means, we are all in trouble. I would like to receive comments that it does not or how people interpret it or what it does. Dick, for example, read our provision dealing with assumptions as saying that you have to stay with prior experience. We do not feel that it does, and that you properly should take into account what you expect is going to happen. What we are trying to do is create some visibility in that area. There is the word "significant" in it--where there is a significant difference between what your prior experience has been and what you expect to happen, that you somehow disclose why you have that difference, properly recognizing that what we are dealing with is long-range estimates of cost which no one can guarantee. We all recognize that when you are dealing with a cost-plus contract, one could look at what the assumptions are and understand by such disclosure why there is any significant difference, and the word "significant" is very important.

I have one other word on assumptions. It was mentioned that the provision in this draft standard talks about individual assumptions where ERISA deals in the aggregate. I do not think we really end up with any difference because, here again, to do an audit of the assumptions used is the only way you have to look at them individually. Every one of our standards built into the objectives of the Board is material. If in the aggregate it makes no difference, then certainly you are not violating the standard at all, but we feel we are really not that far from ERISA. What we are talking about is visibility, looking at each standard. But there is no material difference when you take all your assumptions together and it makes no difference, and there is no violation of the standard.

One other point that I wanted to make is that perhaps people do not understand the legislative objectives of the Board. The law speaks about uniformity and consistency. We are looking for accurate charges to government contracts. You should consider that, for most defense contractors, the level of business with the government differs yearly; it goes up and down. There are more terminations of contracts. I am not talking about the termination of the fund, but the termination of the contracts or completion of contracts where a large number of people have to be laid off. It is very important to get the charges properly by years because contracts end and new ones begin. This is really something that you, as actuaries, are not concerned with nearly as much as we have to be.

Many of the things that were said here today about accounts I frankly agree with. For example, on APB Opinion 8 they say to disregard the funding. You can make your own computation for the books. Forget about what you are actually doing with funding. I think that is ridiculous. I do not think there should be any large differences between accountants and actuaries with regard to how you measure funding.

We are dealing with contracts between the government and the contractor. We are not really trying to dictate unnecessarily to the actuaries as to what they have to do with methods or the kind of assumptions they should use, but the only way that we can get some consistency and unformity in their charges year by year, which is an objective and a mandated objective of the Board, is, we feel, to make some restrictions.

Dick was probably interpreting the standard when he said that we do outlaw the aggregate cost method for the reason that there is no visibility of the gains and losses if, for example, you should have a large termination. The government undertakes some cost to pay when they terminate a contract. They want to be offset somehow for what happens to the fund as they let a lot of people go who are not vested, and yet the fund continues. This is the kind of information we need. If you can find a way to tell us how to do that and still allow a greater flexibility in the choice of method, we will be happy to do so.

I think that is about all I have to say. I do not know if Bernie wants to add to that. Bernie always has a couple of words; he has been working on this thing for over two years.

MR. SACKS: One of the reasons, as Bill said, that we do not want to do much talking is that we do not go around with the standards deciphering them. In the regulating business or regulation-writing business, what we say is much more important than what we mean. If it is misinterpreted, we want to know.

No, we do not intend dictating what the actuarial assumptions should be. If the standard gives that impression, we would like your comments on it and where it gives that impression. All we want is to be told what the assumptions are and what the bases are for them. An oversight on our part was, in computing normal costs, that we fully intended that head count be used where benefits are not based upon pay. That is a slipup that would not be included in the final version.

In actuarial cost methods, I think accountants think in terms of cost methods differently than actuaries. I think actuaries think in terms of cost methods as a technique for funding a pension plan. We think of a cost method as a means for assigning a cost to the cost accounting period. When you are talking about limiting the cost methods, we are not talking about limiting the techniques you have for funding the plan. From an accounting point of view, we are talking about determining what should be assigned to a period. We are narrowing the option in that regard, whereas APB Opinion 8 leaves it wide open.

MR. JAMES G. OZARK: I would like to comment briefly about the use of the aggregate cost method in the CASB proposal, or rather the lack of use of it. I guess the objection to it was that a gain and loss is not specifically identified, and I disagree with that. Barnet Berin's book Fundamentals of Pension Mathematics, in fact, goes through a demonstration that shows that, under an aggregate cost method, there is a gain or loss developed which is equivalent to the gain or loss developed under the entry age normal method. It is, in fact, expressed as the present value of compensation calculated as of the current valuation date times the difference in a normal cost percentage between the current valuation and the previous valuation.

Berin simplifies it somewhat by ignoring new entrants, but I would think that that problem could also be handled, and, in fact, an aggregate cost method could be permissible under the standards. If we want to think in terms of gains and losses after change in the normal cost percentage and if we want to get back to a dollar figure, just multiply that change in percentage times the present value of compensation and you have essentially the same number.

MR. TOBIN: I have to agree with Jim that gains and losses can be broken out on the aggregate cost method and can be broken out on any method. We can give you the dollar amount of gain or loss from any one of the assumptions assuming we have the computer capabilities. Some of the bigger firms have it, but I am quite sure many of the smaller firms would be very hard-pressed; however, the main point is that it can be done and it is being done.

MR. BYRON FRENZ*: As a CPA, the interaction is interesting to me right now. The impression that Mr. Kaye has left with me is that you actuaries do not particularly like the fact that an accountant will audit your assumptions or make comment on them. Yet, I can recall a meeting with the Wisconsin Institute of CPAs at which we spent quite a long time on our liability with respect to the calculation done by the actuary. Several of the firms indicated that they do audit your assumptions, that they do, in fact, at times retain other actuaries to review your work, and that they feel that, if they accept your work without audit of the assumptions, they would be liable for any losses.

MR. KAYE: I think there is a fine line between auditing the assumptions and whether they are going to use broad guidelines or look at each assumption. You do rely on professionals. Auditing Procedure No. 33 talks about relying on professionals, and it seems to me you are not going as far as you are able to on the reliance on actuaries. We look at actuarial reports each year and we certainly look at what has been happening, but mainly for consistency. Certainly we have seen 3% interest rates and felt compelled to comment; but it is more a matter of degree we are talking about than 3%. I think there are some general things that one can say are unreasonable. It is where you draw the line. It seems to me that this reliance concept goes both ways. It also states that the actuary, if he so chooses, can rely on the accountant. If the accountant is going to bring in another actuary to check on the initial actuary, then the actuary should bring in another accountant to check on the first accountant. It can go both ways.

CHAIRMAN BASSETT: I have one question now, that I have been waiting to ask. It is on disclosure. It has to do with footnotes, and it deals with the importance to the reader of the footnotes, or generally to the plan participant. It is the footnote that says we should disclose the unfunded liability for vested benefits. My reasoning is that if, under APB Opinion 8, it was put there to give the plan participants a measure of their security in the event the plan

*Mr. Frenz, not a member of the Society, is a Certified Public Accountant.

were terminated, then this whole concept has to be changed because now those benefits are insured, or, at least, a part of them is insured. If we are looking for disclosure to plan participants, do we not have to first determine the liability for insured benefits and say that it is being taken care of.

Secondly, there is the liability for termination. Even there you have to presumably somehow bring in the fact that, if the assets are deficient, the company then becomes liable for 30% of their net worth. Now this becomes interesting to the stockholders. We have another bit of information on this unfunded liability that is in a footnote. The stockholders certainly would be interested to know if they might be tagged for 30% of the net worth of the company, but the participant is more inclined to want to know the difference between the liability for vested benefits and the insured benefits. I have not seen that even suggested anywhere. Does anyone want to comment on that?

MR. BIGGS: This is purely a personal thing. I never thought the unfunded value of vested benefits was a number that was worth calculating. It never had any particular significance. It might have particular significance in some plans where, in fact, plan termination allocations and provisions give special priority in vesting. That was not always true. Frequently, on termination everyone became vested. I can see no reason for continuing to perpetuate the calculation and reporting the present value of vested benefits. I can readily see reporting this in the annual statement of the employer of the company. The unfunded accrued liability is being used simply because that is the number that the employer now has specific statutory obligation to fund over a particular period in time. Secondly, the unfunded insured liability number is significant, because that is the figure against which the 30% figure applies.