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ACCOUNTING AND FINANCIAL REPORTING FOR PENSION PLANS AND OTHER POST-RETIREMENT BENEFITS

Moderator: EDWARD H. DAVIS. Panelists: JULES M. CASSEL, MARVIN B. ENS, JACK C. FORSTADT*

1. FASB Exposure Draft
2. Canadian Institute of Accountancy Study
3. Financial reporting requirements of plan and employer
4. Special requirements for the financial reporting of insurance company funded plans

MR. EDWARD H. DAVIS: Before the panelists make their presentations, let me briefly outline the scope of our subject today by citing the wide range of interested parties who have become involved in pension accounting over the last few years.

First, of course, are legislative bodies and regulatory authorities. This includes the passage of ERISA by Congress; the Cost Accounting Standards Board, which is responsible for regulating pension expenses charged under defense contracts; and the Securities & Exchange Commission, which has expressed interest in the measurement of pension liabilities as it applies to publicly traded corporations.

Various segments of the accounting profession have also been involved.

- In this country, the principles-setting body prior to 1973 was the Accounting Principles Board of the American Institute of Certified Public Accountants. The APB is best known in the pension area, of course, for Opinion 8, promulgated in 1966, although some of their other Opinions also touch on pension accounting (e.g., Opinion 30 dealing with accounting for the disposal of a segment of a business).

- The successor body to the APB has been the Financial Accounting Standards Board. It is, or soon will be, involved in several important pension accounting projects: the two Exposure Drafts Jules Cassel will be discussing today, "Accounting and Reporting by Defined Benefit Pension Plans" and "Disclosure of Pension and Other Post-Retirement Benefit Information, an Amendment of APB Opinion No. 8", and the study the Board has on its agenda for next year on "Accounting by Employers for Pensions-Cost Measurement".

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- Marvin Ens will be discussing the pension accounting study being done under the auspices of the Canadian Institute of Chartered Accountants.

- Other individuals and groups within the accounting profession have also expressed opinions on how accounting for pension costs and liabilities can be improved. One of the most controversial proposals was contained in a monograph published three years ago by the Pension Research Council. The authors, Messrs. Hall and Landsittel of Arthur Anderson, recommended that one specified actuarial cost method be used for determining the pension expense of plan sponsors. Interestingly enough, the cost method they chose is one that would appear to be proscribed under the recently issued proposed IRS regulations on actuarial funding methods.

The actuarial profession has naturally been very busy in the pension accounting area, with several committees involved. One of these, the Academy Pension Actuarial Principles and Practices Committee, was until recently chaired by Doug Borton.

Increasingly, the investment community has shown interest in pension costs and liabilities.

- Investment analyses of individual companies and whole industries frequently focus on unfunded pension liabilities.

- The book authored by Messrs. Treynor, Regan, and Priest, published a couple of years ago, presented a new conceptual framework for analyzing the interrelationship between corporate finance and pension funding.

- Credit analysts and bond rating services take unfunded pension liabilities into account in assessing the credit worthiness of American businesses.

- It has even gotten to the point where stockholders are suing companies and their outside auditors claiming inadequate disclosure of the company's unfunded pension liabilities.

Finally, the business press has increasingly been focusing interest on unfunded pension liabilities.

- The most famous (infamous?) example was the Fortune article published in late 1977.

- Business Week has published articles annually for the last several years comparing the unfunded pension liabilities of many major U.S. corporations.

- Even the august New York Times has recently published several "scare" articles pointing out the magnitude of unfunded pension liabilities within American industry.

So, as you can see, pension accounting is indeed a "hot" subject these days.

MR. JULES M. CASSEL: I'm here today to discuss with you the Board's recent proposals regarding pension reporting. Throughout our efforts to develop those proposals, the Board and its staff have worked closely with members of the actuarial profession, and it is a pleasure to meet with this group of actuaries to discuss our progress. Specifically, I would like to give you today a status report on the various Board projects relating to pensions, including a brief summary of the two recent proposals and--since the deadline for comment has passed--I can also tell you a little about the nature of the responses we have received.

STATUS OF PROJECTS

As you are all probably aware, in mid-July of this year, the Board issued two Exposure Drafts that address financial reporting by and about pension plans. The first, "Accounting and Reporting by Defined Benefit Pension Plans," addresses reporting by the plan in its own financial statements. The second, "Disclosure of Pension and Other Post-Retirement Benefit Information," addresses disclosure about the plan in the plan sponsor's financial statements. Both Exposure Drafts deal only with defined benefit, not defined contribution, plans. Neither proposal is in any way intended to affect either the plan sponsors' accounting for pension costs or plan funding.

The effective date for both proposals would be fiscal years beginning after December 15, 1979, and the due date for receipt of written comments on both was September 21. As of last week, we had received approximately 250 comment letters on the pension plans Exposure Draft and 200 comment letters on the disclosure Exposure Draft. The Board will begin its formal consideration of those comments next week. Our goal is to finalize both proposals shortly after the end of the year.

BACKGROUND ON DBPP

With regard to the background for the proposed Statement on accounting and reporting standards for defined benefit pension plans our efforts to establish such standards began primarily as a result of the passage of ERISA. As you know, ERISA established minimum standards for participation, vesting, and funding for employee benefit plans of private enterprises. It also established annual reporting requirements, which for many plans include financial statements prepared in accordance with Generally Accepted Accounting Principles. Although ERISA does not apply to plans of state and local governments, interest in financial information about such plans has increased since enactment of ERISA, and proposed legislation to establish reporting requirements for them was introduced last year. That legislation did not pass, but is expected to be reintroduced.

At present, there are no authoritative accounting standards applicable specifically to pension plans. In April 1977, after previously issuing a discussion memorandum and holding a public hearing, the Board issued an Exposure Draft of a Statement relating to Defined Benefit Pension Plans. Approximately 700 comment letters were received, many of which objected to the perceived costs of implementing that document. Since that time, the Board has worked closely with both the Department of Labor and the actuarial profession in an attempt to minimize conflicts, duplication, and costs while providing meaningful financial reports. Based on those activities and the comments of respondents, the Board made significant changes to the proposed standards and decided that a revised Exposure Draft should be issued for additional comment. The currently proposed standards would apply both to plans in the private sector and to plans of state and local governments.

CONTENTS AND DATES

The current proposal identifies the primary objective of plan financial statements as providing financial information to participants and others that is useful in assessing the plan's present and future ability to pay benefits when due. To accomplish that objective the proposed standards would require that plan financial statements include four basic categories of information. Those categories are, (1) information about net assets available for benefits, (2) information about changes in net assets during the reporting period, (3) information about the actuarial present value of accumulated plan benefits and (4) information about the effects of certain factors affecting the year-to-year change in the actuarial present value of accumulated plan benefits. Before reviewing the basic requirements for determining those four categories of information, let me explain as of what dates that information would be prepared.

The 1977 Exposure Draft would, in effect, have required that both net asset and benefit information be reported as of the end of the plan year. Many who commented on that Exposure Draft felt that determination of end-of-year benefit information was not practical and would cause increased actuarial fees. They indicated that most actuarial valuations are performed during the year using data as of the beginning of the year. After considering those comments, the Board decided that the perceived cost of requiring end-of-year benefit information at this time may exceed the potential benefits of such information. However, reporting both net asset and benefit information as of the same date is necessary for the financial statements to be useful in assessing the plan's ability to pay benefits. Therefore, the 1979 Exposure Draft would require that net assets and accumulated plan benefits be reported as of the same date, but would permit that date to be either the beginning or end of the plan year. Information about changes in net assets and changes in accumulated plan benefits would be reported for the same 12 month period, which if end-of-year benefit information were provided, would be the current plan year, or if beginning-of-year benefit information were provided, would be the prior plan year. Net assets at the end of the current year and changes therein for the current year would be presented in either case. Plan investments, other than contracts with insurance companies, would be measured at fair value. Contracts with insurance companies would be reported in plan financial statements in the same way they are or would be reported in Form 5500 for ERISA purposes.

REQUIREMENTS FOR BENEFIT INFORMATION

The primary benefit information to be reported would be the actuarial present value of participants' benefits, which would be determined in accordance with an assumption that the plan is an ongoing entity.

Accumulated plan benefits are defined as those future benefit payments that are attributable under the plan's provisions to employees' service already rendered. Their measurement would be primarily based on employees' history of pay and service. Future service would be considered only in determining employees' expected eligibility for benefits such as early retirement, death, and disability benefits. Automatic cost-of-living increases would be considered. Future salary changes would not be considered. To measure their actuarial present value, the measure of participants' accumulated benefits would be discounted for interest and adjusted to reflect the probability that they actually will be paid.

Within certain guidelines, the selection of assumptions would still rest on the actuary's judgement. The proposed standards would require that each significant assumption must reflect the best estimate of the plan's future experience solely with respect to that assumption.

As I mentioned a few moments ago, the Board and staff worked closely with members of the actuarial profession in developing these proposals. That cooperative effort consisted primarily of working with a committee of the American Academy of Actuaries to develop a method of determining benefit information that would be both meaningful and workable. A number of the requirements for determining benefit information I just mentioned represent changes from the 1977 Exposure Draft and resulted from that cooperative effort. As proposed by the Board, the underlying basic methodology for determining benefit information for plan financial statements will, we believe, provide information that will also be acceptable for completing certain information in Schedule B of Form 5500 and is also consistent with the Academy's Interpretation 2.

The last two categories of required information relate to the changes in net assets and changes in accumulated plan benefits. The requirements for the latter category also represent a change to the 1977 proposals, which would have required that the effects of all significant factors affecting the year-to-year change in the benefit information be presented in a reconciling Statement format. Many who commented on those proposals, including many actuaries, expressed concern about the perceived complexity and expense of developing that information. However, most actuaries we talked with agreed that disclosure of at least certain factors that significantly affect the year-to-year change in the benefit information is needed for users to understand that change. Therefore, the current proposals require, as a minimum display, only disclosure of the significant effects of factors such as plan amendments and changes in actuarial assumptions. They do permit, however, presentation of a full statement of changes that would include the effects of certain other factors.

As I mentioned at the outset, the comment period for the revised Exposure Draft ended about a month ago. We've not yet completed our analysis of all the comments. However, I can mention a few items on which a number of people have commented. In the area of asset information, several respondents have focused on the requirement that assets other than contracts with insurance companies be presented at market value. They believe that either historical cost or some averaging method should be used so as to avoid reporting the effects of possibly short-term market fluctuations. The requirement for market values reflects the Board's belief that such information is the most relevant information about the plan's assets that is consistent with the primary objective of plan financial statements. The proposed requirement for market value was viewed by the Board as providing reliable, unbiased, and comparable information to users of plan financial statements. It is also viewed as a more appropriate basis on which to measure periodic investment performance.

In the area of requirements for determining benefit information, a number of comments are directed at the requirements for selection of assumed interest rates. The Exposure Draft requires that assumed rates of return shall reflect the expected rates of return on plan investments during the periods for which payments of benefits is deferred and shall be consistent with the returns realistically achievable on the types of assets held by the plan and the plan's investment policy. To the extent that existing assets enter into assumed rates of return, the values of those assets used in estimating the assumed interest rates shall be the values presented in the plan's financial statements. Rather than market values, some respondents would prefer to report plan assets at the actuarial asset value in order to smooth-out any short-term market fluctuations. They would similarly adjust the assumed interest rates so that any change would occur only when it is apparent that "long-term" interest rates

have changed. The Board's proposed position is based on its belief that any meaningful comparison of accumulated benefits with net assets must be based on information determined on a comparable basis. Many actuaries, I believe, share that view. Discounting benefits at expected rates of return of current plan assets based on their current market values and future plan assets provides that comparable basis. The staff believes some objections to the interest rate requirements are based on a misinterpretation of some discussion that appears in the Basis for Conclusions section of the document; some respondents apparently think assumed interest rates would change each year by the full amount of the change in current market short-term interest rates. Since assumed interest rates reflect expected rates at which future assets can be invested as well as rates of return on existing assets, that normally would not be expected to be the result. And it is the longer-term investment climate that we're primarily focusing on--not the interest rates for the immediate future unless, of course, significant benefit payments are going to be made during that period, then for those benefits such rates would be appropriate. Because long-term interest rates do not remain static, it is possible, given the current environment, that such rates could change, admittedly by perhaps small amounts, each year.

Other comment letters have disagreed with the exclusion of future salary increases as a factor to be considered in determining employees' accumulated benefits. Individual Board members' views differed on that issue. Some thought that benefits attributable to future salary increases should not be considered earned until the related compensation is earned. Others were influenced by the American Academy of Actuaries Committee's strongly held view against recognizing salary progression.

All comments we have received, both on the few issues that I've enumerated and on a host of others, will be carefully considered prior to the issuance of final standards. Whether the proposals will be changed, I do not know.

I'd like to spend just a few moments now on the other Exposure Draft that was also issued in July, which addresses disclosure by plan sponsors. That proposal is a response to a perceived lack of credibility in present disclosures about companies' pension commitments. Present accounting requirements in this area are contained in APB Opinion No. 8, adopted in 1966, which requires footnote disclosure of the amount of any unfunded vested benefits. In addition, the SEC requires that unfunded prior service costs be disclosed in filings with that agency. A number of articles have appeared recently indicating the growing size of the two amounts and relating them to the amount of corporate profits and stockholders' equity.

As you well know, unfunded prior service costs can vary widely depending on the actuarial method used. Many methods are presently acceptable for determining employers' pension cost. However, they can produce different amounts, or no amount, for prior service costs. In addition, the unfunded prior service costs can vary further depending on how the plan's assets are valued--at cost, market, or on some other basis.

Probably a part of the problem is that prior service costs is a term developed by, used by, and generally understood only by actuaries. You know its limitations. Unfortunately, others, including some analysts, are using that terminology (and the amounts reported as "UPSC") for a purpose it was never intended to serve, namely, as an indication of the benefits accumulated by employees as of a given date and thus as an indication of the sponsor's commitment, or liability, to the plan at that date.

The Board's proposal would amend present accounting rules to fill the need for a better understanding by financial statement users of the amount of benefits that have been accumulated by employees. We are proposing that employers disclose the asset and accumulated benefit information that would be developed under the requirements of the pension plans Exposure Draft. This would be a significant improvement over amounts presently disclosed since the figures would be determined on a comparable basis among companies, and cover both asset values and aggregate accumulated benefits. Because the information for most domestic plans would be readily available from the plan's financial statements, the cost to significantly increase the usefulness of the disclosures should be within acceptable limits.

We are also proposing that employers disclose the significant actuarial assumptions used in determining the actuarial present value of accumulated benefits and the method of measuring plan investments.

At the same time, the Board is proposing that companies disclose information about additional post-retirement benefits other than pensions. The most common post-retirement benefits are continuation of life insurance and medical benefits. For those types of benefits, the employer would include in its financial statements:

- a description of the benefits,
- a description of the accounting policies being followed with respect to those benefits and
- the amount of the related expense incurred during the year.

The Board sees the proposed disclosure requirements as an interim step in its reconsideration of the entire area of accounting by employers for pensions. Among the comment letters received thus far on the disclosure proposals, many of those who disagree with them object to what they see as a "piecemeal" approach to reconsidering APB Opinion No. 8. That brings me to the final project on the Board's agenda relating to pensions which is a reconsideration of the entire area of accounting by employers for pension costs.

I'm sure most of you are aware of the attention this topic has received in recent years. Hardly a month goes by without an article appearing in some business publication that discusses some aspect of accounting for pensions. Apart from the accounting issues, many people have suggested that pensions will be one of the key social issues of the 1980's.

Critics of current accounting practices under APB Opinion No. 8 think there are too many alternative methods available for determining employers' pension costs, that the actuarial assumptions are not always realistic, that employer financial statements do not take into account their obligations that exist under ERISA or under an ongoing plan, that unfunded amounts reported by the plan should be liabilities of the employer, and so on.

All these questions need to be carefully considered, particularly with the increased national attention on pensions. We have appointed a pension cost task force that is made up of actuaries, financial analysts, corporate financial executives, and members of the accounting profession. The task force will advise the Board and staff throughout the Board's due process procedures. The Board's study in this area will consider all of the cost,

liability and disclosure issues related to pensions and other post-retirement benefits, including such areas as actuarial methods and assumptions, asset valuation, and the matter of symmetry between plan and employer accounting. We anticipate issuing a discussion document on this subject next year. That document will set forth the issues, address the pros and cons of each, and serve as the basis for a subsequent public hearing. Whether changes in present practice will be required is not known. However, should some change be necessary, an Exposure Draft will be issued for public comment after the hearings, probably not before 1981.

Before closing, I'd like to reiterate that the cooperation and help of the actuarial profession has been extremely valuable in the Board's progress thus far in the area of pension reporting. The continued help of the actuarial profession is essential both to successful implementation of the eventual final standards and to the Board's reconsideration of accounting by employers for pensions. You can also make a significant contribution by educating your clients and others about the Board's work in this area. We recognize that pensions and pension reporting are very complex and highly technical subjects--subjects that are not adequately understood by many who will be involved either with preparing or using information about pension plans. I encourage each of you to participate actively in the educational effort that must take place in the next few years. Some of you may not agree with the changes taking place--that is understandable. But if the private sector does not respond positively to our changing environment, there are those outside the private sector that are prepared to step in and fill the void in a manner that they deem best. I believe most, if not all of us here, believe the private sector is better suited to the task.

MR. MARVIN B. ENS: The Canadian Institute of Chartered Accountants (CICA) initiated a study of accounting for pension costs in fall of 1978. The Accounting Research Committee (ARC) of the CICA appointed Mr. Ross Archibald, an accountant and professor from the School of Business at the University of Western Ontario, to undertake the proposed study. Mr. Archibald is supported by a study committee consisting of two consulting actuaries, an accountant in public practice, an accountant from industry, and an accountant on the ARC staff.

Mr. Archibald was asked to prepare a study which would communicate to accountants the nature and implications of actuarial outputs for proper accounting disclosure. The terms of reference given to Mr. Archibald were as follows:

1. Identify and analyze the nature of pension costs and liabilities.

2. Analyze and interpret for accountants the main actuarial assumptions and methods in use and, in light of relevant accounting theory, assess and explain their influence on accounting for and the disclosure of costs and liabilities in financial statements.

3. Consider the possibility of reducing the number of actuarial methods acceptable at the present time for determining total pension costs and allocating such costs to accounting periods.

4. Communicate the research findings in a form appropriate to an audience of accountants.

The study group restricted these terms of reference to their application to accounting by employers for defined benefit pension plans.

It should be made clear that Mr. Archibald was not asked to make recommendations with respect to the contents of the CICA Handbook, which establishes Generally Accepted Accounting Principles in Canada. Of course, if the study should provide evidence that accounting treatments prescribed in the Handbook could be refined or improved, it is expected that the ARC would undertake to make such changes. However, Mr. Archibald was not constrained by some of the practicalities which would apply if his recommendations dealt directly with Handbook requirements.

Before indicating the results of Mr. Archibald's study, I would like to review very briefly the current situation with respect to accounting for pension costs and liabilities in Canada:

- current pension costs (i.e. normal costs) determined using the common actuarial methods are acceptable for accounting purposes,

- past service costs arising from plan introduction or amendments are to be charged to operations over a reasonable period of time, which may or may not correspond to the amortization period for funding purposes,

- 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 (this is done by means of a footnote),

- actuarial gains and losses are recognized in the current period or in the period prior to the next actuarial valuation, and

- the annual pension cost is the current cost plus the past service charge plus special provision for unfunded vested past service benefits plus adjustment for actuarial gains or losses.

This then provides the situation faced by Mr. Archibald.

In spring of this year, a preliminary draft of Mr. Archibald's study, entitled a Circulation Draft, was released to invite comments from the actuarial and accounting professions. The conclusions and recommendations presented in the Circulation Draft may be briefly summarized as follows:

Conclusion 1. At the present time, the best information on pension plans available to accountants are the figures presented in the actuarial report prepared by the actuary for funding purposes. That is, the normal cost, amortization payments required to eliminate unfunded amounts, and the unfunded liability for vested past service benefits as determined in the actuarial report may be used for accounting purposes. This is not a change to the current situation.

Conclusion 2. Unfunded past service obligations qualify as true accounting liabilities. Obligations for vested and unvested benefits alike should qualify as true accounting liabilities. Even though benefits which are not vested at the valuation date may not be a legal liability, the "economic reality" is that a

certain percentage of the unvested benefits will become vested and will eventually be paid. Applying the going concern assumption and recognizing that accounting liabilities should reflect "economic realities" rather than strict legal liabilities only, Mr. Archibald concluded that no distinction between vested and non-vested benefits can be justified. The recognition of unfunded non-vested liabilities as well as unfunded vested liabilities would be a change to the current situation.

Conclusion 3. Because of practical considerations, footnote or other supplemental reporting of unfunded liabilities may at the present time be preferable to balance sheet treatment. The practical considerations mentioned include the following:

i) Actuarial valuations may not be prepared every year or may not be available promptly after each year end.

ii) Unfunded liabilities may fluctuate dramatically from year to year.

iii) No asset valuation basis can be specified at this time.

Conclusion 4. Unfunded actuarial obligations determined using level cost valuation methods are not appropriate for use as accounting liabilities for balance sheet purposes, and normal cost determined using level cost valuation methods are not appropriate for use as accounting cost. This would be a departure from the current situation, where no actuarial cost methods are excluded.

Conclusion 5. Appropriate disclosure for pension plans would include total assets, total liabilities, the present value of future normal contributions in the case of level cost methods, the asset valuation method, the market value of assets, a description of the actuarial cost method, key actuarial assumptions (interest, salary scale, mortality, terminations), and pension fund operating statements and pension fund assets in comparative format. This information should be presented as a supplementary statement to the main financial accounting statements.

Conclusion 6. The accrued benefit valuation method which prorates projected benefits (using a salary scale) uniformly over years of employment has been selected as the most desirable actuarial cost method for accounting purposes. Salary projection would be required in the case of final average earnings plans and career average plans. For flat benefit plans, benefit projection would be necessary from a conceptual point of view, but would probably not be possible from a practical point of view.

Conclusion 7. Pension liabilities and costs determined using the specified accrued benefit valuation method should also be disclosed in the supplementary statement. As an aside, the preliminary report's conclusions that information from the actuary's funding report is acceptable for accounting purposes would appear to be in contradiction with the conclusion that results using level cost valuation methods are inappropriate for accounting, and that an accrued benefit method with salary projection should be used. The connecting link between these apparently contradictory conclusions is the recommendation that information on the prescribed preferable basis be reported as supplementary information during a transition period.

These seven recommendations and conclusions form the major portion of Mr. Archibald's conclusions.

It may be of interest to note the major reasons why level cost valuation methods were considered inappropriate and why the accrued benefit method with salary projection was selected as the preferred method. Mr. Archibald felt that the projected pension at retirement was the proper focus of attention using the going concern assumption and assuming that the economic reality of salary and pension benefit increases must be recognized. This final pension would have to be allocated over an employee's years of service. Since any allocation method is arbitrary, a simple method should be used. Level cost methods and the constant percent accrued benefit valuation selected in the Hall and Landsittel book would not provide a simple method of allocating the total benefit. The accrued benefit valuation which prorates the final pension benefit over years of service is a simple method of allocating the benefit to an employee's years of service. It also happens to be a common method for funding final earnings pension plans in Canada. Although this brief explanation does not do justice to Mr. Archibald's position, it does give an indication of his reasoning.

There are also a number of issues addressed in the study where no conclusion or recommendation was given in the preliminary Circulation Draft. A number of the noteworthy unresolved areas are as follows:

1. No attempt was made in the study to specify actuarial assumptions appropriate for accounting purposes.

2. Mr. Archibald's personal preference for valuing pension fund assets at market value was noted. However, the Circulation Draft concluded that it was not appropriate to require pension fund assets to be valued at market value since there is no requirement that marketable securities included in ordinary corporate balance sheets be valued at market value.

3. No recommendation was made concerning the period over which the cost of a plan amendment should be expensed. Mr. Archibald's final report may recommend that benefit liberalizations be written off over a period approximating active employees' future working careers, with 20 years being an acceptable approximation. An exception might be made for ad hoc increases for pensioners.

4. No recommendation was made concerning the period over which actuarial gains or losses should be expensed. The final report may contain a recommendation that gains and losses be amortized over the active employees' future working careers, with 20 years again being an acceptable approximation.

MR. DOUGLAS C. BORTON: At a meeting not far from here just about a year ago a leading government official in the pension area referred to the "hot war" between the actuarial and accounting professions. It is true that the FASB and the American Academy of Actuaries have had their differences in attempting to resolve some aspects of the very difficult subject of measuring the obligations of an on-going pension plan. However, I would hardly describe the relationship between these two organizations as a "hot war." Rather I would say that over a period of time a mutual respect and working relationship has evolved, which in the long run can be only beneficial to the users of the financial statements of defined benefit pension plans and the statements of plan sponsors.

You may recall that when the FASB released its original exposure draft on accounting and reporting for defined benefit pension plans in April 1977, the Academy expressed serious concerns about several areas.

For example, the Academy pointed out that there is no single measure of pension obligations which is appropriate for all purposes. However, the Academy also recognized that there was considerable pressure from a number of sources, including governmental agencies such as the Department of Labor and the SEC, for a reasonably uniform method of measuring these obligations. Therefore, the Academy offered to develop guidelines and the FASB agreed to consider the resulting product in its revision of the 1977 exposure draft.

As most of you are aware the Academy Committee on Pension Actuarial Principles and Practices did develop guidelines last year in the form of Interpretation 2, which relates to the calculation of the actuarial present value of accrued benefits under an active plan. Interpretation 2 indicates that an appropriate measure of the accrued liabilities under an ongoing plan is to evaluate the present value of the accrued benefits based on historical information. The basic approach is that the obligations of the plan at any time represent the value of the benefits which would be payable if the accrued benefits were frozen but the plan sponsor remained in existence and employees continued to earn eligibility credit for future service. Special rules apply for benefits, such as flat benefits, which are not directly related to an employee's service and thus cannot be deemed to have accrued fully for service in the past. In general, if such a benefit is one which will eventually vest in the participant, e.g., a supplementary benefit which is payable upon retirement, it should be fully accrued by the time the participant first meets the eligibility requirements for the benefit. If it does not vest, e.g., an active service death benefit, it should be fully accrued by the time it is expected to become payable according to the actuarial assumptions.

It should be noted that an accrued benefit actually has two elements, namely, the amount of the benefit and the conditions under which it will become payable. Thus, even under a relatively simple plan, a participant could have several accrued benefits, e.g., a service retirement benefit which is payable in full at 65 or on an actuarially reduced basis earlier, a disability benefit which is payable on an unreduced basis upon disablement before age 65 and a spouse's benefit which is payable upon death in active service.

The interpretation recommends that an explicit approach be utilized in selecting the assumed rate of investment return for these calculations. However, it also points out that an actuary may choose to use a different degree of conservatism than in the interest rate used for the regular valuation. It is anticipated that the regular assumptions would be used for other purposes, e.g., rates of turnover, death and retirement. Although future salary increases would not be anticipated, automatic cost-of-living adjustments in post-retirement benefits would be taken into account.

It should be noted that Interpretation 2 is consistent with Interpretation 1, which was previously issued by the Committee as a guide to the calculation of the present value of vested benefits under APB Opinion No. 8.

The Committee has received many inquiries from actuaries about the application of Interpretations 1 and 2.

At the outset it must be emphasized that these are guidelines which cannot cover every conceivable situation in detail, but which provide guidance to actuaries in making these calculations. Since the methodology of Interpretation 2 is complex, actuaries are encouraged to use simplified methods and reasonable approximations where the effect on the total results will not be material. It should be kept in mind that the present value of accrued benefits will not be used to determine contributions.

A question which frequently arises concerns the conditions under which a benefit is vested. The Committee believes that a benefit is vested if a participant would be entitled to the benefit if he voluntarily terminated employment at the time as of which the calculation is being made. Thus an active service death benefit never vests, since the participant must remain in service and die while still in service in order to qualify for the benefit.

While the FASB was working on the revisions to its original Exposure Draft, Senator Lloyd Bentsen of Texas proposed amendments to ERISA which would have specified the methods to be used in calculating the accrued liabilities of pension plans.

In testifying on the proposed legislation, Ian Lanoff of the Department of Labor indicated that it was not necessary because the Department intended to revise Schedule B of Form 5500 so that the following information would be required.

- Present value of vested benefits
- Present value of accrued benefits based on historical information
- For final pay plans, present value of projected benefits taking future salary increases into account, pro-rated by the ratio of present service to projected service at retirement.

Mr. Lanoff indicated that a comparison of these amounts with the market value of the assets would allow participants to measure their present benefit security, while the minimum funding information on Schedule B would show participants how the on-going obligations of the plan were being met.

The concept of projecting and pro-rating for final pay plans was, of course, not reflected in the FASB's original draft. However, in its deliberations

on revising the draft, the FASB quite properly decided to consider whether an accrued liability amount which was related to future salary increases should be reported on plan financial statements. After a public hearing at which representatives of the Department of Labor and the Academy appeared, the FASB announced that it had decided to adopt an approach under which future salary increase would be ignored, the actuary would select the assumptions and beginning of the year values would be acceptable. The Academy was gratified when Mr. Donald Kirk, Chairman of the FASB, testified to this effect at a public hearing on the proposed revisions to Schedule B. Subsequently these recommendations were incorporated into Schedule B for 1978 and later. It should be noted that they were in line with the recommendations of the Academy, although the Academy continued to emphasize that no single number is appropriate for measuring pension obligations for all purposes.

There is some confusion regarding the selection of assumptions in making present value calculations for Schedule B. The introduction to the new form which appeared in the Federal Register indicated that these assumptions should be reasonable in the aggregate. On the other hand, the instructions to Schedule B say that each individual assumption should be reasonable. The form itself makes provision for using assumptions to determine the present value of accrued benefits which differ from those used for minimum funding purposes. Both the actuarial value and the market value of assets appear on Schedule B, although the market value is placed closer on the form to the present value amounts. Therefore, there is some implication that it is intended for the present value of accrued benefits to be compared to the market value of assets.

The FASB's Revised Exposure Draft accepts Interpretation 2 as the appropriate method to determine the amount of a participant's accrued benefit. The supporting material also indicates that it is intended that the actuarial present values should be the same as those reported on Schedule B. However, the plan audit is based on the market value of the assets and no provision is made to report their actuarial value in the statements themselves or the footnotes. The draft indicates that the actuarial present value calculations should be based on an interest rate which reflects "the expected rates of return on plan investments during the periods for which payment of benefits is deferred and shall be consistent with the returns realistically achievable on the types of assets held by the plan and the plan's investment policy" based on market value. The implication here, as well as from the background information and the sample notes to the financial statements, is that the actuary should use a different interest rate each year to calculate the present value of accrued benefits. In its comments to the FASB, the Academy expressed the view-point that the use of a stable interest rate, which would not be adjusted each year for short term fluctuations, would produce more significant information for participants and other interested parties since the actuarial present value would be determined on comparable assumptions from year to year.

There were several other areas of the 1977 exposure draft which were of concern to pension actuaries.

PBGC plan termination annuity rates would have been used even though the objective was to estimate the plan's obligations on a going concern basis.

Moreover, the use of these standard rates would have removed the actuary's involvement in setting the actuarial assumptions. Therefore, we are pleased

that the revised draft permits the actuary to set the appropriate assumptions, although as I mentioned many actuaries feel the basis for selecting an appropriate interest rate is too restrictive.

The original draft also would have required a complete reconciliation of the present value of accrued benefits from year-to-year. Since most actuaries feel this type of analysis would be of minimal value to participants, we are pleased that the revised exposure draft does not require one if the actuarial values are presented in notes. However, there is some confusion as to why a reconciliation is needed when the actuarial values are presented in a statement format.

In commenting on the revised exposure draft, the Academy also recommended that any explanatory material which the actuary feels to be important, including the actuarial value of assets, be included in the footnotes to a plan's financial statements. This approach would help actuaries discharge their professional responsibilities within the guidelines of the various actuarial bodies.

A simple procedure would be to furnish the actuarial information for a plan's financial statements by incorporating Schedule B, and the attachments thereto, into these statements. For plans which are not subject to ERISA a similar type of schedule could be used. This method of presentation would have the further advantages of reducing the cost of preparing plan financial statements and insuring consistency between the amounts reported on the financial statements and Schedule B.

As Jules Cassel has mentioned, in July the FASB also released an Exposure Draft to amend APB Opinion No. 8. If the draft is adopted, plan sponsors will be required to report the present value of vested and non-vested accrued benefits on their corporate financial statements, together with the market value of assets and any non-funded accounting accruals. For employers with more than one plan, the total amounts will have to be reported separately for those plans where the assets exceed the present value of accrued benefits and for those plans where it does not.

The proposal also would require employers for the first time to report information about non-pension post-retirement benefits. The existence of such benefits, the methods being used to account for them and the amount of expense charged would have to be disclosed. In view of the many methods now being used to determine these charges, it seems to me that it would be more appropriate to defer the introduction of these requirements until the actuarial profession has had an opportunity to determine acceptable methods of funding for these types of benefits. It is by no means clear that the traditional actuarial cost methods used for pension plans are the best methods to pre-fund other post-retirement benefits.

It should be noted that all of the actuarial present value calculations which I have discussed involve an on-going plan. Nevertheless, the natural inclination of most participants will be to view the reported amounts as a measure of their benefit security upon plan termination. Actuaries are well aware that the liabilities of some plans will increase dramatically if they are terminated, because additional benefits will be triggered and, if the employer goes out of business, subsidized early retirement benefits will start earlier. Moreover, unless the plan is fully funded, classes of participants will not share equally in the assets because of the priority rules in ERISA.

It should be kept in mind that under a final average salary plan future salary increases generally should be taken into account in order to fund the plan on a sound basis. This means an appropriate accrued liability for funding purposes may be considerably higher than the present value of accrued benefits to be reported on Schedule B and financial statements.

These differences illustrate the fact that no single measure of accrued liability is appropriate for all purposes. As Jules Cassel indicated in his remarks, explaining the reasons for these differences in a manner which can be easily understood by participants and other interested parties, offers a real challenge to all pension actuaries.