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EMPLOYERS' ACCOUNTING FOR PENSIONS AND OTHER POST-EMPLOYMENT BENEFITS—BASIC ISSUES

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MR. JACK FORSTADT: Our topic is Employers Accounting for Pensions and Other Post-Employment Benefits - Basic Issues.

Originally, we were supposed to discuss a draft of the tentative conclusions of the FASB with regard to the Discussion Memorandum. That draft is not as yet completed, so we will fall back and discuss the Memorandum. There is enough controversy about the subject that the FASB has not come to any conclusions yet. One of the things that Tim Lucas will do is bring us up to date on the most recent developments. Tim is the principal author of the FASB Discussion Memorandum that we are discussing today. When Tim is done, John Kieley will respond to those issues. We hope that we will get that far in approximately an hour and leave a good half hour for your questions and comments. I believe Tim will be the focus of a lot of questions.

In my experience, actuaries frequently do not understand what accountants are trying to do, and accountants do not understand what actuaries are trying to do. This misunderstanding leads to lots of problems and, in some cases, hostility. There are some actuaries who, I believe, have commented that it is certainly appropriate that we be here in the land of Mickey Mouse to talk about accounting issues. I would like to proceed along the lines that we try to first understand what it is that accountants are trying to do. What is their mission as professionals? How can we, as professionals, help them achieve their goals?

The accountant should be a scorekeeper, recording: (1) what happens in the income statement, and (2) where we are now in the balance sheet. As such, the accountant should be neutral. The accountant's job is to record results--to tell it like it is or as it was--for the various bodies of publics that examine accounting statements - stockholders, lenders, and various other bodies.

Let's first look at this general principle, the matching of expenses to revenues. An expense is not an amount paid or contributed. It has nothing to do with cash. It is a cost attributable to the production of income; just as income is not necessarily a count of the cash brought in at a particular point in time. A simple example makes the point. We are all staying here at Disney World. Many of us paid a deposit ahead of time and then will pay a balance when we check out using a credit card. Disney World may not receive any cash from us during the time that we are staying here. Yet, the amount of money that we are charged for lodging is all income for this period. The income is not the cash received but the amount of revenue attributable to our stay.

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We can use the analogy of depreciation, which I find very close, by the way, to the problems that we face in accounting for pension expenses. This involves knowing what it costs to build this hotel and how to spread that cost over a period of years. It is not obvious how much of that cost is attributable to a particular period of time. There are various acceptable methods that are used to do that.

Clearly, though, the pattern of paying for the hotel should not influence the pattern of expensing or deciding what the cost attributable was. If Walt Disney was rich enough to pay for this hotel in cash when it went up, that does not mean that there is no cost attributable now. There clearly is.

In accounting for retirement benefits, we have the same problem. APB8 sets forth a principle that while benefits might be paid to people after retirement--and in this case we might not know exactly how much the benefits are going to be until people actually retire--the expense of those benefits should be attributable to the period of active employment. In other words, while I am working for Coopers & Lybrand, I am, hopefully, producing income for them; and at the same time, I am generating various types of expenses--one of them being our retirement expense. That retirement expense is attributable to the time I am working and not to the time after I retire.

This all sounds simple, and I probably have not created a lot of controversy so far; but in our day-to-day work, all of us, accountants and actuaries, keep getting confused with contributions to the plan, funding the plan, and accounting expense, and they are wholly different items.

Accountants are also concerned with consistency. Generally, when I speak to a group of accountants, I quote George Bernard Shaw's line which says, "consistency is the hobgoblin of little minds". That notwithstanding, it is a major issue for accountants.

Consistency is a very important issue in the accounting world. The general principle is that if there is more than one way of determining an expense or even an item of income, you ought to use the same way every year. If not, then the reader should know about it. That is important. If the score changes because management decided to do things in a different way but the facts are the same as in the previous year, then the reader should not be misled into believing that something radical happened.

I would like to make another comment on consistency. It seems that today more and more actuaries are changing actuarial methods. It probably has something to do with the economy and the need to change funding patterns. This can cause a great deal of difficulty, because in a publicly owned company, the SEC says that if you change any accounting method, you have to change to not only an acceptable method, but to one that is preferable for accounting purposes. We, as an accounting firm, need to ask the actuary to justify the change in method and state whether it is a preferable change for expense purposes. The answer we frequently get refers to funding patterns, which were irrelevant for expense purposes. So again, back to the basic principle. You have to understand what accountants are all about before you can start to approach the issue of preferability.

The last issue is comparability. Basically, this has to do with a set of facts changing. If the set of facts change, the reader ought to know that the change in the score was due to the change in the facts and not due to action or management of the company.

I believe that two-thirds of General Motors' income this year would have been wiped out if they had used the same pension interest assumptions they had used in the previous years. It is most important, I believe, for the reader to understand that. The counter argument is frequently made that it is really the company and the company's management who decide to change the plans, to change the facts. It is really the company's management that has a large part in the say as to when to recognize the different economic conditions. I dare say that General Motors might have been successful in arguing to their actuary that maybe they should recognize the change in interest next year instead of this year, or perhaps even the year before. So the comparability issue can become a little thorny because sometimes the facts change due to a management decision. Nevertheless, they should be disclosed.

The issues of comparability and consistency in generally accepted accounting principles apply in comparing a company's statement with that company's statement in previous and subsequent years. However, there is an overriding desire on the part of many people, including, I believe, the FASB, to see accounting statements of all companies comparable and consistent with each other. That is, not only from year to year within one company, but General Motors should use the same accounting techniques as Ford, Chrysler and American Motors so that their financial statements would be comparable. As I read the economic community and the accounting community, their "druthers" would be to have everybody do it the same. That is where you would start from. You would have to convince them that flexibility would be appropriate in a particular instance. There was a quote in the Discussion Memorandum that would illustrate this point, and I think it sets the stage for Tim's comments. "Accounting for pension fund liabilities may be the last substantial area for corporate reporting that is conspicuously deficient. The information is piecemeal and imprecise, data is not comparable from company to company and not always from year to year in the case of the same company." That statement is a good introduction to Tim's remarks as to why we have this Discussion Memorandum and where we are going.

MR. TIMOTHY S. LUCAS: Let me begin by expressing my appreciation to the Society, to Jack and to all of you for inviting me to come down here and be with you today. Jack's comments were very appropriate. There has, in fact, been an unfortunate gap between actuaries and accountants in the past. The lack of mutual understanding has been disadvantageous to our respective professions.

I welcome this meeting as an opportunity to try, at least, to narrow that gap. I hope to learn more about what an actuary sees when he looks at a pension plan, and I will try to explain what a pension plan might look like through an accountant's eyes.

The two views are different. They should be different, because the objectives and goals of the two professions are different. If each of us could understand the other's view, perhaps we could close that gap and work together to achieve our objectives.

Jack asked me to start out by saying a few words about the Board's Conceptual Framework Project. That is a difficult assignment because, for one thing, when I start talking about the framework, I do not stop at a few words. Secondly, the framework is complex and difficult. It would take a lot more time than we have here to explain it. I would like to say a few words about

what it is and what it is trying to do. If I run on for more than what you define as a few words, Jack, you can cut off the microphone.

In essence, the Board's conceptual framework is an attempt by the FASB to define and rationalize what accounting is, or what it should be, and why. Different accountants, and even different members of the FASB, do not necessarily agree about the extent of change in present accounting practices likely to result from the framework effort. Some of them view the framework as primarily a logical description of existing practices with, perhaps, some fine-tuning of the practice that has grown up over the years in ways that might not be quite consistent. Others, including some Board members, expect the conceptual framework will pave the way for more significant changes.

Regardless of the extent of change, the framework is expected to help the Board find logical, consistent answers to accounting problems. Some of these accounting problems have been debated within accounting circles for decades. They have been repeatedly subjected to solutions that did not end the debate.

One of these recurring problems is pension accounting. Some of the others, to put it in perspective, are accounting for inventory, foreign currency, inflation, and depreciation.

The FASB's conceptual framework started out by defining the objectives of financial reporting. Accounting has been around for quite a while. You might ask if it is necessary, at this late date, to figure out why we were doing it. But the objectives had not been written down and agreed upon. We found that writing them down and trying to argue about our differences was quite helpful.

The primary objective the Board identified is to provide information that is useful to investors, creditors and other users of financial statements; and specifically, useful in making financial decisions. Without that decision usefulness, there would be no need for, or justification for, accounting or financial recording.

The second step that the Board took was to try to describe in a formal document the characteristics that serve to make financial information useful. Characteristics the Board identified included: understandability, relevance, reliability, neutrality and comparability. There are several other qualitative characteristics discussed in the document, which is approximately 100 pages long. This includes quite a bit of discussion of what we mean by these terms. The terms by themselves tend to have a "motherhood" ring. Who could be against relevance or in favor of irrelevance? When we try to describe what we mean by relevance, and what makes information relevant and understandable or reliable, we learn something about the kinds of information we should be presenting. The first two statements, the one on objectives and the one on qualitative characteristics, tend to build the foundation for the framework to follow.

Neutrality and comparability, I believe, are particularly relevant to the pension project and some of the problems we have been struggling with over the last year. Neutrality might also be called even-handedness. Standards should not be deliberately slanted to try to achieve a particular result, or to achieve a result that is either favorable or unfavorable for a particular interest. Neutral accounting means to report what is and what happens, as Jack said. If we were to try to set accounting standards in such a way that

we could achieve a particular goal, no matter how worthwhile that goal might be, that would destroy the usefulness of the information, because it destroys the even-handedness that users rely on. It does not matter what set of decisions or what types of accounting information you look at. There are almost always two sides to a question. It could be argued that pension accounting should be structured in such a way that it reports the lowest possible cost, or a lower cost with some method that might allow a whole range of costs based on management's choice. That action would encourage employers to provide pension benefits, because the provision of pension benefits is desirable as a goal.

Neutral accounting advocates would argue that you cannot do that. You have to try your best to report the actual cost - what really happened. Accounting should not favor the interests of the shareholders, or employees, or retirees, any of those persons, over the interests of the others. The user should be able to rely on, and have confidence in, the financial information.

Having talked about objectives and characteristics that make information useful, the Board proceeded to try to define the kinds of information that have the desired characteristics, the kinds of information that are useful parts of financial reporting, or are useful to the decisionmakers. At this point, the connection between what I am talking about and financial statements, as we all know them, begins to emerge more clearly.

Useful information includes information about a company's economic resources, what accountants call assets, and also about the claims to those resources. Claims to resources include obligations the company has to transfer resources to others, or liabilities and residual or ownership claims.

Useful information also includes information about changes in those assets and liabilities. If the company has more assets this year than they did last year, that is worthwhile to know.

We can think of financial statements as a standardized way of presenting this information for easier use. Each type of information - whether it is assets, liability, changes in assets or increases or decreases - each type of information has its own place in the structure. The user who is familiar with the system can always go to the same place for a particular type of information. Ideally, all of the information of a particular type, for example, all information about obligations, will be found in the appointed place. That is particularly important, because the parts of the system are arithmetically related in specified ways, and they include summarizations or totals. If one part is left out or put in the wrong place, some of the other parts will be adversely affected or misstated.

The financial reporting system that I described includes three primary financial statements. First there is the statement of financial position, or the balance sheet, which shows the resources, or assets, on one side and the claims to those resources on the other side. Then there is the statement of income, which provides information about the events that change assets and liabilities. We ordinarily think of an income statement as being made up of revenues and expenses. Jack made some comments about matching expenses with revenues. The concept goes back a long way in accounting. Think just a moment about what is a revenue and what is an expense. The Board has defined revenues as, basically, increases in assets. In some cases, a revenue may be represented by a decrease in a liability. If you have a revenue, some asset

is increased. Conversely, an expense is a decrease in an asset, or the incurring of a liability. At least in a purely conceptual sense, we can measure all of our assets and liabilities, and have a handle on our revenues and our expenses. Now that is different from cash flow. That brings me to the third statement.

The third statement provides additional information about changes in assets and liabilities, but with an emphasis on cash, because information about cash flow and about cash balances is of particular importance. Cash inflows may or may not coincide, as Jack pointed out, with the acquisition of assets. For example, a cash inflow may result from borrowing or from the sale of part of a plant. The third statement is frequently called a statement of changes in financial positions.

The primary financial statements are supplemented by information in the notes to the financial statements. Notes provide additional information about the elements that are recorded in the statements. They also provide information about the company which does not fit the basic structure of the financial statements.

That is enough about accounting in general. What about pension accounting?

The advance publicity for this session indicated that the Board had hoped, as Jack mentioned, to have its initial set of tentative conclusions by this time. Unfortunately, we are not quite there yet. We are still working on it. The issues in this project have proven to be as complex and difficult as we expected. They involve not only an understanding of the nature of the pension plan and its economic effect on the employer, but also, they involve defining how that plan's resulting obligations and expenses fit into the financial reporting system that I discussed a moment ago. Those issues have turned out, in fact, to be a significant early test for the usefulness or the viability of the Board's conceptual framework project.

What I would like to do now is give you a brief overview of what I regard as the most important of the basic issues that the Board is struggling with. I will say a few words about answers with some discomfort, as we are not yet to any kind of real answers on this project. Any tentative conclusions we may have are subject to change. Three fundamental issues contain the heart and soul of the pension project.

First, consider the case of a newly established company that has just completed its first year of operations. The company has a defined benefit, final pay pension plan. The Discussion Memorandum and the discussions so far have concentrated on the single employer defined benefit, final pay formula pension plan. Each employee of this mythical company has rendered one year of service at this stage. Now, obviously, this case is carefully structured to avoid the complications of any kind of prior service cost. In this case, we all agree, at least on the Board, that there has been some expense, and as a result, there is a liability - an obligation has been incurred for benefits promised under the plan. We all agree on that, but what is the amount of that expense or that liability? In accounting terms, we debit expense and credit a liability; but we have not yet decided how it should be measured. Perhaps more importantly, should there be a variety of measurement methods to choose from? Is the obligation of the company somehow changed by the selection of an actuarial method or by the factors that lead to the selection of an actuarial method?

A majority of the Board members are currently ready to support the idea that there should be some standardization, in the terms of the measurement of the obligations - at least for plans that are similar.

I would like to point out again that the measurement of the company's obligation is fundamentally a different problem from the decision of how to fund it. That is, the amount of obligation that has been incurred under the plan, the amount of the obligation for benefits that have already been earned, is one thing. The budget of the company for paying it off, or the maturity schedule of that obligation is something else. The arguments that we have heard for flexibility in funding, based on the company's financial needs and circumstances and other factors, seem to us to be quite compelling. Certainly management has considerable latitude to arrange the maturity or payment of the other obligations that appear on the balance sheet, without in any way implying the financial report should show something other than the total amount of the obligation. The pension question is further complicated by the fact that a number of future events will affect the amount that is ultimately paid out in benefits. Those future events require a number of assumptions under any of the approaches that are likely to be considered.

That leads me to the second of the three issues. As you all know far better than I, experience may not unfold exactly in accordance with the assumptions that are used to estimate the obligation. As time goes on, experience gains and losses emerge, and assumptions may be adjusted. The question from an accounting point of view is, should those events, those changes, be recognized as they occur? Should we adjust the recorded liability so that each successive statement shows the best or most current estimate of the obligation?

A case can be made for that kind of immediate recognition. At this time, a majority of the Board is leaning toward some kind of a forward looking, or prospective, recognition. That leaning is based on an understanding of the estimated nature of the assumptions and a concern about the fluctuation of the liability that would likely result from immediate recognition. Fluctuations that perhaps reflect primarily changes in an estimate, or the mechanics of a measurement process, rather than actual events.

The third of the three basic issues is the question of prior service credit. We have put it off to some extent, but we cannot avoid it all together. If we are really trying to measure the obligation that exists under a pension plan, and if that obligation is in some way a function of the benefits that are promised to an employee, we ask ourselves - is it logical that two plans that promise the same set of benefits to identical employee groups should produce essentially the same obligation? Would that be true even though one plan had been in effect for a number of years and the other was recently amended to provide the benefits, or recently established? The Board has tentatively decided that an incremental liability does arise when an amendment is made that grants prior service credit. However, the Board is also convinced by arguments that prior service credit is granted with the expectation that future benefits of some kind will flow to the company in return. As a result, the Board has tentatively decided that the benefits expected to result from the plan should be recognized as an asset. That is, the plan amendment would be recorded as an increase in the obligation, but it would have no immediate impact on either equity or income. The Board has not, as yet, developed even a tentative answer for the question of how to measure that obligation or the resulting asset.

We have quite a way to go with this project. The decisions I have described are tentative and subject to change as we explore the issues further.

Once we have a whole and, hopefully, coherent set of answers to the first set of questions, we will proceed to additional questions that are likely to be equally difficult.

Attempting to predict the Board's progress on this project has given me a new respect for the task that actuaries face when formulating assumptions about the future. My prediction record is not very good. Predicting when we will finish each of the current steps is akin to predicting when interest rates will come down. As an accountant, I can admit complete ignorance of future interest rates. As an FASB staff member, I can only fall back on humility and reserve the right to adjust my predictions as experience unfolds.

We hope to publish some kind of tentative conclusions and the second set of questions this year. The document containing the conclusions and the questions will solicit comments from the public, including the actuarial profession. It is likely that we will hold a second set of public hearings for further comments after that comes out. That would lead us toward an exposure draft, perhaps some time during the year 1983.

MR. FORSTADT: Thank you, Tim. That was most interesting. John is now going to give his thoughts.

MR. JOHN KIELEY: I would like to start off by saying that the Discussion Memorandum itself took a fairly narrow focus on the broad subject of post-retirement benefit plans, looking only at defined benefits and final average pay kinds of plans. There is a risk in making decisions in regards to those kinds of plans. The decision may not be appropriate for other kinds of plans. You may find yourself in a trap years down the road as we struggle with different issues. That is certainly a thought provoker.

First, let's talk a bit about the question of whether a pension plan is really a liability from an accounting sense. Is the obligation an accounting liability? First of all, it has been recognized for a good number of years that a pension plan is not a gratuity. Even when a plan is approved, it is not done gratuitously - either for active employees or for existing retired employees. It is done with the expectation that the plan is going to reward employees who work a little bit harder, and the reward for that improvement is going to be enjoyed by the company over a long period of time. But when we talk about matching expenses and revenues, it is important to recognize that the company does not receive all of the benefits of the plan improvement or the establishment of the plan when the plan is adopted or approved. The benefits enjoyed stretch over a good number of years.

Also from a liability side, Tim mentioned that the liabilities are usually some claim on company assets. In the case of a simple trusteed plan, I am not sure that those assets are really available to company creditors. In certain cases any actuarial excess is. In the majority of plans, that is not the case today. It is important, when talking about assets and liabilities, that we recognize the pension asset should not go on the left-hand side of the balance sheet. Maybe it is appropriate to have a net unfunded, if there is any liability at all there, show up on the corporate balance

a balance sheet or in a footnote in an annual report, may not be complete disclosure. It may also be misleading to the users whom we are trying to serve. In the multi-employer area, we also have to recognize some asset sales situations when our clients may be selling a company whose employees are covered by a multi-employer plan. There may be some lingering liability, even though there was no liability at the point of the sale.

Concerning foreign plans, a number of our clients have foreign subsidiaries or divisions. Typically, there are tremendous termination liabilities.

For insured plans - insured is a funny word. One of the big risks is having a client classify a plan as being an insured plan, but it is really not insured at all. It may be the insurer's fault. The plan may be funded under some kind of an IPG or DA arrangement, where there may be some reserves put away for retirees. The majority of the liability may not be the insurance company's at all. That liability for the retiree may be grossly overstated under the reserving method used, with a very low interest rate.

MR. FORSTADT: In trying to kick off the question and answer session, I would like to raise one issue that has been a lingering one; that is, given the users of the financial statements, how useful is information on pension liabilities? How useful is that information to the public which is reading the statement? Let's also assume for the minute that the multi-employer numbers are included.

The second part of the question is - if it is useful to the creditors, rather than the investing public, is it more appropriate to include such information with all the details, for the creditors to make an informed decision, or is it more appropriate to put such information in another format - some other report that is available to the public, but not something that would take up three pages in the corporate annual report.

What I would like to do now is give you all a chance to comment or question any of us. I will ask Tim a question or two to start the dialogue, and if we do not get anyone to the microphone, I know John and I have lots of questions.

Couldn't there be two ways of looking at the various accounting statements that you described? One could focus on the balance sheet or the statement of financial position and merely say that the income statement is a mathematical reconciliation between the two. In that case, one starts to focus on accrued liabilities or other retirement benefits, and the income statement or expense item merely winds up being the difference between two years. The other way of looking at it is to look at the expense item and the income. The balance sheet is merely a build up of previous year's income and revenue. This is a very fundamental issue. Would you or the Board have any comments on that as to which way you might be going?

MR. LUCAS: You have hit on a fundamental question that is the very heart of the conceptual framework - one that is quite contentious at this point - certainly not just with respect to pensions. We call that the "revenue and expense" approach versus the "assets and liabilities" approach, or "who's driving". Is the balance sheet derived from the income statement, or is the income statement derived from the balance sheet? Under the Board's definitions, the two are not mutually exclusive; that is, if we have got it right,

sheet. If the company does show it on the balance sheet, what measure of liability should it be? Should it be the PBGC kind of 30% net worth figure, or should it be some expanded figure?

With respect to pension accounting, our job as actuaries is to allocate the eventual cost of the pension plan to different periods of employment. I get nervous when the Board starts talking about standardization. We all recognize that standardization of assumptions is not appropriate. I do not think that standardization of methodology is either. The IRS has issued a list of the appropriate actuarial funding methods that may be used. Very often a method is chosen for very good business reasons and accounting reasons. We all know instances where the accounting reasons may not have been as good as we would have liked, but there is considerable flexibility for employers to choose different methods that are most appropriate from an accounting standpoint. It is not appropriate to choose one actuarial funding method to apply to all pension plans, or even to all final average pension plans.

It is also important to bring up a laundry list of other items that may be appropriate in determining the expense from a profit and loss point of view that are not currently permitted, for example, using open group valuation to anticipate the true eventual cost of this pension arrangement, should we bring in future participants. Another example is an assumption concerning post-retirement increases, if that has been the company's practice. Shouldn't we be using explicit assumptions in each and every category rather than assumptions which, in the aggregate, make sense?

Tim also mentioned amendments to plans. When a plan is amended, the past service benefit applies to all service. The question of recognizing that liability gets back to the question of whether the pension plan is a gratuity or not. The normal case is that a plan is improved with the expectation that it is going to help future revenue sources and provide some benefit to the corporation. That is also true with retiree increases. If negotiated, then typically the benefit improvement to the active is reduced for the cost of the retiree increase. If not negotiated, it is often done with the expectation that such action is going to spur active employees to produce at a higher level than they otherwise might. This is particularly true for employees in the age 55 to 65 bracket.

One of the key questions that we have been struggling with is, "What is the real likelihood a corporation will actually experience this unfunded liability?" Should there be some probability attached to that risk? Is it appropriate to require only a disclosure of unfunded liability if there is a material probability that the plan will terminate. From a complete disclosure point of view, is it more appropriate to provide the users of these financial reports with the total unfunded liability regardless of whether that may ever materialize or not?

For welfare plans, there is a tremendous hidden obligation for retirement benefits like life insurance and Medicare supplements. The numbers can be substantial and are really hidden now. Whenever we are talking about pension obligations, we should include welfare obligations.

For multi-employer plans, I think we have all read a lot about the new legislation. The major point is that for a number of our clients, the multi-employer termination obligations far exceed any termination obligation in a single employer plan. To disclose single employer liability, either on

then the revenues and expenses that are the changes in those assets and liabilities will be right, and vice versa. It does not matter where we start. That may be true at a very high conceptual level, but when we get into practice, the two approaches can lead to significant differences. It would be fair to say that accounting over the past twenty years has moved in the direction of the "revenue and expense" approach. That is, the income statement is the more important of the two. The balance sheet has been described as debits and credits that are waiting their turn to flow through the income statement. However, the Board might be perceived as moving back some. There is a temptation to describe the Board as nearly balanced on the question.

MR. FORSTADT: Your answer would do justice to either a politician or an actuary.

MR. JOHN AGATSTON: In the Board meeting yesterday, you kept saying "tentative". You did a very good job of explaining everything. I want to hold you to what you said. There were very important implications in the things you were saying.

MR. LUCAS: As it stands now, the way the liability gets on a balance sheet is either through some type of merger or acquisition; more commonly the purchase as opposed to a pooling of interests. There may be a difference between the accrual and the funded amounts. There is probably a bigger difference than is commonly realized. I think most actuaries and accountants think it would usually be the same number. Whether there will be some type of liability on the balance sheet depends on whether it is funded or not funded. It clearly depends on the extent of funding. If the funding is such that the asset equals the liability, then the two will cancel out. One of the questions the Board discussed that I did not mention was whether the plan assets and the liability should be placed on opposite sides of the balance sheet. A case can be, and was, made that that would be more meaningful and a more useful disclosure than netting the two. The Board has tentatively concluded that they should be netted. At this point, I do not foresee that they would move away from that. So if the company decided to fund the amount that was measured as expense in the initial year, then there would be no net liability on the balance sheet.

I do not think the FASB is in a position to say that we need to set standards that will result in the right funding. We do not know what the "right" funding is. But, one of the factors that may legitimately impact the "right" amount of funding is a good measure of the obligation and the expenses that are involved.

Accounting needs to report how much was funded. Accounting also needs to report how much of an obligation was incurred, or how much of an expense was incurred. The key is that those may be different.

MR. FORSTADT: I would like to throw out just an idea that occurs to me in thinking about funding versus accounting.

Would not accounting and funding be better off if the two were divorced? There are some marriages that are just not made in heaven, and maybe this is one of them. I have certainly heard many people discuss situations where accounting considerations caused the company to make funding decisions that might not have been ideal, if accounting was not going to have any impact.

The opposite may also be true. Funding and cash flow considerations may cause reporting that is less than the most informative possible. So, perhaps if we could separate the two, we might be happier with the results.

You could go one step further, though, and say that the accounting can also affect the plan design where the liabilities are on the balance sheet. If employers understood the obligation they were taking on, they would not take it on.

From the FASB's point of view, it is troublesome to say we need to hide this because if everybody understands it, they will not do it. I run into this in the public plan area a lot. With respect to the recognition of gains and losses, the Board's leaning is towards some kind of prospective recognition where the gains and losses would be spread in some way. It is one of those tentative leanings that is still up in the air.

MR. LUCAS: We have discussed changes in assumptions and experience gains and losses. We have separated them to the extent that we could, but we talked about them in the same sessions. The Board's tentative leaning is the same. As mere accountants, we have some difficulty keeping straight in our minds how to draw the line between the two.

MR. FORSTADT: Are there any other questions?

MR. JOHN C. NEAL: The general public does not recognize the difference between an accountant and an actuary. It is a very serious remark. Can we have two approaches for the unfunded liability - one for federal legislation and one for provincial legislation? I think you are running into the same problem. The general public does not appreciate the problem. You are being very optimistic to say that that marriage was not made in heaven. Whether you like it or not, that is where the general public wants it to have been made and that is who we are serving.

Let me share with you a problem we have had in Ontario. Perhaps you can respond to a solution. Under the Ontario system of Workman's Compensation, benefits to existing claimants have been periodically upgraded by the legislature with no promises or guarantees for future increases. However, since 1975, they have, on an annual basis, sometimes with a couple of years delay, provided improvements in the pension benefits based on the Consumer Price Index. When should we recognize this? Is it a real liability of the system? Should we start charging current employers the cost of the accrued liability which, without CPI adjustments, is $2 billion, but with CPI adjustment is $5 billion. We are talking about a lot of money in the Ontario economy. We decided to phase the interest rate down over a number of years. That handles the balance sheet. For revenue we go even further. We say the unfunded liability that emerges as the interest rate decreases will be amortized over five years. In effect, we have a double amortization in there. It would be very interesting to hear your response to that.

MR. KIELEY: If you are using an adjustment in the interest rates, is that just for post-retirement or for all employment years to anticipate the CPI adjustments?

MR. NEAL: Well, Workers' Compensation is, in effect, one year term. We are going to phase the interest rate down from 8% to 2-1/2%, maybe. There is a double factor in there. Obviously, our investment income is improving with our new business. That makes things more complicated.

MR. FORSTADT: I would like to draw an analogy to the question that you have raised - post-retirement medical benefits. Assume that retirees are promised post-retirement medical benefits. If these retirees retire early, which is becoming prevalent today, the post-retirement medical benefits are basically a continuation of a medical plan that they had while active, and it continues until 65 when they become eligible for Medicare. There are some opinions, both legal and otherwise, that say this is a legal obligation of the company. That is, if retirees base their retirement in part on the fact that they anticipate these retiree benefits, it is a legal obligation of the company. My question is: Shouldn't that obligation be recorded? I know that it is common in the steel industry to completely pay for retiree benefits.

I would be interested in how you feel about whether that should be recorded on the balance sheet as a liability. If you are going to record it as a liability, then when does it become a liability? Do you start expensing as people work or just as they retire? That is a very similar situation to your Workers' Compensation situation. In your case, they are improved, but anyway, an obligation exists. When do you start recognizing that obligation - before or the moment it happens? Tim, would you take a quick crack at it?

MR. LUCAS: We really have several aspects of that question on the table at the moment. There is one problem in that the term "legal obligation" is not well defined. Most, if not all, legal obligations are accounting liabilities. However, the converse is not necessarily true. Legal status, whatever that means, is not a requirement for accounting liability status. So it would not necessarily depend on whether it was a legal obligation. This is a case that relates to the Canadian Workers' Compensation situation. There are situations where companies, by their actions or their policies, establish moral obligations that are sufficiently binding to be the basis of accounting liabilities. This can happen over a period of time. The first time you amend the plan to take care of some inflationary catch-up, you may not have created a suggestion that you are going to again, but after you have done it repeatedly, a pattern is established. One analogy to that is a vacation pay plan. It has been established in accounting for some time that you might have a liability for a vacation pay plan, even though you had not ever written down the fact that you were going to give vacation pay - just by continuing to pay it year after year and, in fact, fostering the expectation that you would. I think either from a "revenue and expense" and "let's match our costs and our revenues" point of view, or from the point of view that says we are trying to measure our obligations, that you can make an excellent case in the post-retirement benefits cases. Whether you are talking about medical, life insurance or whatever, a liability and an expense of some kind will arise during the period that the individual works. The Board has not decided that question yet. It has not really come up for discussion yet. It will, right after we get tentative conclusions for the questions we are working on right now. But in my own opinion, an excellent case can be made for recording it in some way over the life of the employee, which does parallel with the pension.

MR. FORSTADT: What about the current obligation for existing retirees or poeple who are on Workers' Compensation? In other words, how do we get from where we are to where we think we ought to be?

MR. LUCAS: That is really a transitional question. Transition is one of the subjects I want to say a few words about in this afternoon's session. There are a number of things we could do that would be more ingenious and perhaps less painful than just debit expense, credit liability for the overhanging balance.

MR. FORSTADT: I would like to make a reactive comment. A lot of us have looked at the obligation for post-retirement medical for different clients. Mechanically, it is not that difficult to calculate. It is the same type of assumptions we have to make for retirement plans, plus a few more - trying to anticipate what Medicare will do. I do not think we, as a profession, should shy away completely from the subject or try to get out of the subject, because of the difficulty in assessing what an obligation might be.

The information that is in a financial statement does not necessarily have to be precise or to the penny. Indeed, the information that the accountants generate that goes into the financial statements is not precise.

Many companies are dropping cents as time goes on. That has been a topic of some discussion in accounting. Showing cents on a balance sheet or income statement suggests a precision that is not, in fact, inherent in the numbers. There are a number of estimates, other than pension, that create the lack of that kind of precision in any set of financial statements.

MR. JOEL RICH: The use of one particular number that shows on the balance sheet will give the idea that the accountant has said that this is the correct number. If everybody is going to use it whether it is right or wrong, you are going to have a lot of disappointed consumers if you do not make more of an educational effort or some kind of backup sheet to show exactly what went into that number.

MR. LUCAS: I agree that the educational process must go along with any kind of change in accounting. I also agree that we do need some disclosures in addition to that one number. But the structure is such that we cannot avoid the need to have one number. I agree with your main point that we will have disclosure ahead of us as one of our future topics. We have some interesting thoughts on that. I understand the Academy has a committee that has undertaken to think about what kinds of disclosures might be appropriate. I will be watching for their conclusions.

We talked about divorcing the funding of pension arrangements from accounting. Taxes may be an example of how that can happen, because tax accounting has become quite separate from financial accounting. In fact, I would go so far as to say that it would be remarkable to find a company where they were the same. It would indicate very poor tax planning.

MR. FORSTADT: I would like to leave you with a thought. Back to basic premises. Understand what the accountant is trying to do. Consider, as an illustration, two automobile companies, say Ford and General Motors, that both have a UAW Pension Plan which, for all practical purposes, is identical.

Yet these two companies use different actuarial methods. Put yourself in the place of the user of the financial statement. You have two companies in the exact same business with the exact same plan that has been in existence for the same period of time. Yet you are getting

radically different expense numbers, which would mean probably radically different income numbers. Is that fair? That gets down to the heart of the problem. When I speak to financial analysts, that drives them wild. They do not know how to make an adjustment looking at the two. Even though they see that there are two different methods, they do not know what the difference will provide. So let me leave you with that provocative thought.