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EMPLOYERS' ACCOUNTING FOR PENSIONS AND OTHER POSTEMPLOYMENT BENEFITS–BASIC ISSUES

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1. Present accounting rules and background in connection with pension plans
2. The purposes for pension accounting rules in general
3. The nature of pension arrangements and the implications of their character for:
   a. Corporate liabilities and net worth
   b. Periodic charges to corporate income on account of pensions
4. Effect of actuarial gains and losses and the relationship of non-pension post-retirement benefits to pensions, from an accounting viewpoint

MR. LEONARD MACTAS: The subject of accounting for pensions is a tough one conceptually. It's an area which is very vital to the public interest in many sectors of our economy: participants, shareholders, government and users of financial statements generally. The actuarial profession has been interested in accounting for pension plans longer than any of the other groups, and I include the accounting profession in that. Prior to 1967, it was conventional practice for pension expenses to be accounted for on the basis of whatever the sponsoring corporation put into its pension fund. About the only ones who rode herd on employers were actuaries. We've had rules consisting of actuarial cost methods and guidelines that we've learned on the way to becoming fellows or associates of the Society, and that intelligence generally served public needs in the area of pensions up until 1966. In that year the American Institute of Certified Public Accountants promulgated Opinion Number 8, which covers accounting and disclosure for the financial effects of defined benefit pension plans. That instrument became effective generally in 1967 and has guided the determination of pension expense and financial disclosure since that time. In the very recent past the Financial Accounting Standards Board (FASB) has promulgated a document called Statement Number 36 which amends Opinion 8 as to disclosure, so there's been a little bit of development in the Opinion 8 area that has been completed. The current project we're discussing is the work of the FASB on the balance of Opinion 8, in effect, which really deals with accounting itself, and I'm sure that we'll hear about other deliberations on the disclosure issue which may go beyond the present state of FASB 36. We'll hear from Barbara Eversberg first with some observations on the Discussion Memorandum (DM) issued by the FASB, which is the focal point of our meeting today. Following that, some broad observations about the character of the DM from Jack Schechter, and then Betsy Hollowell will give us some clues as to what current FASB thinking is.

MS. BARBARA J. EVERSBERG: I'm happy to be here to talk about employers' pension costs with you. Because I work for an accounting firm I don't necessarily think that I'm more qualified to speak on this topic than

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any other actuary, but I'm probably much more experienced with dealing in the kind of playful jesting that goes on between the two professions. I'm sure most of you have been teased by some accountants at one time or another that an accountant is just an actuary with personality. Well, I want to give you a couple of tips on how to tease an accountant if you ever get the appropriate opportunity. You might try saying an accountant is just an actuary with a great pair of legs. I think the actuarial profession is doing a pretty good job of recruiting women, but the accounting profession, as far as what I can see at Coopers & Lybrand, is doing a spectacular job. Every year we have a new class of staff accountants come in, and at least 50% are women, so that's one piece of evidence that the accounting profession can demonstrate exceptionally good taste. If you're particularly bold and like to live dangerously, you might naively ask if FASB stands for the fine art of screwing up the books. But be prepared for a comeback, because there's plenty of potential with FSA or MAAA or all the initials that we tag on behind our names.

The DM pointed out some perceived deficiencies in current accounting for pension costs. I'm going to go over those four and give my opinion about whether I agree, or maybe I'll just make a comment that's intended to provoke discussion. I'm also going to discuss briefly the nature of the employers' obligation; that was one of the philosophical issues in the DM.

The DM took a quote from a financial analysts federation publication that said, "Accounting for pension fund liabilities may be the last area of corporate reporting that is conspicuously deficient. The results are not comparable from company to company and the results are not comparable from year to year for the same company." As far as the first part, I just want to throw out a question, I don't have a real firm opinion. Is it absolutely necessary or desirable for the results to be comparable from company to company? In particular, is it desirable or necessary for the results to be comparable when the companies aren't comparable? And as far as the second part is concerned, I think this quote was made before FASB 35 and 36. With the publication of those two FASB documents -- where present values, accumulated benefits, vested benefits, net assets, the interest rate, things that previously were not required to be disclosed are being disclosed -- the deficiency that results were not comparable from year to year has been satisfied.

The DM lists four perceived deficiencies in accounting for pension costs. Too many actuarial cost methods are possible, is one. Certain obligations should be recognized as liabilities and are not, is two. The actuarial cost methods artificially smooth out the pension costs, is three. And four, there's too much latitude in actuarial assumptions.

Too many actuarial cost methods, too much variety in amortization practices. Well, there are a variety of acceptable depreciation schedules, acceptable ways of recognizing revenues from sales, and acceptable inventory methods, so I don't see any reason why there shouldn't be a half a dozen acceptable actuarial cost methods. It would be a good idea for the accounting profession to learn their names and how all the actuarial cost methods work. This would enhance their respect for the actuarial profession, it would enhance communication. Besides, I had to learn all those depreciation schedules when I studied for the actuarial exams, and I thought that enhanced my life. Now, it

didn't enhance my life the way some other things have, but I feel I'm better off for knowing the sum of the year's digits and straight line vs. 200% declining balance, or whatever. So I do not think that the variety of actuarial cost methods is a deficiency.

The second deficiency that the DM addresses is the failure to recognize obligations as liabilities. As part of its conceptual framework, FASB issued in December 1980 a work called "Elements". This work identified and defined some of the building blocks of financial statements, assets, liabilities and so forth. According to Elements, a liability is a probable future sacrifice of economic benefits arising from present obligations, and a liability has to have three essential characteristics to qualify as a liability. There has to be a duty or a responsibility to transfer or use assets when some specified event occurs; that's one. The second is that the enterprise has little or no discretion to avoid this future sacrifice. And the third is that the transaction or event that obligates the enterprise has already happened. Pretty clearly, a pension plan carries with it a responsibility to transfer or use assets when someone retires. The enterprise has very little discretion to avoid the future sacrifice. It's possible that somebody is not going to be vested, that some vested person will die, even that the company will go bankrupt or the plan will be terminated; but none of those things are going to happen at the discretion of the company. The third quality is where all the debate takes place. The transactional event that obligates the enterprise has already happened, so there can be various philosophies as to when the obligation takes place for the pension benefit. Does it take place as an employee provides a service? When the employee completes enough service to be vested? When the employee completes enough service to become vested and then lives to collect benefits? At the furthest extreme, the employee would have to complete enough service to become vested and live to collect benefits, and that would only obligate the employer for the first payment; he'd have to live for the second payment before the employer would be obligated for it. My personal view as an employee is that my employer becomes obligated for my pension benefit when I complete the vesting service. I've been with Coopers and Lybrand for 3 years, and I don't feel that they're obligated in any way to provide a pension benefit for me. So if the FASB should come out and say that liability should be recorded on the balance sheet, they will have to address the event that triggers the obligation.

The third deficiency that the DM addressed was the artificial leveling of pension costs. Considering the nature of the pension obligation, and the number of estimates that go in to trying to measure what's happening, that's inevitable, and is not a deficiency. There's just no way to accurately measure the pension cost for a particular period. Given the circumstances, smoothing is not only not inappropriate, it's probably desirable.

The last deficiency is the latitude in selection of actuarial assumptions. This is the area that the actuarial profession should really get moving on, because the accounting profession is very aggressive. I think that there should be a range of actuarial assumptions. There's no set of assumptions that's appropriate for every plan, and there's not even a set of assumptions that's exactly appropriate for one particular plan. So elimination of a range would be completely inappropriate. There are assumptions that are inappropriate, and a profession should set guidelines and require its members, if

they deviate from those guidelines, to explain themselves. We wouldn't have any less freedom than we have now, its just that we would be required to explain when we deviate from what is considered to be reasonable. The accounting profession may underestimate the effect of assumptions other than interest rate and salary scale. The interest rate is involved in all financial calculations, so they'll be involved in that. There's just no way you can keep them out of that; economists deal with it, all investors deal with it, all present values involve the interest rate. The salary scale is also pretty easy to understand; the average person on the street has an idea of how salaries are going up. So there's just no way we are going to keep that assumption to ourselves. But turnover, mortality and the other assumptions are where the actuary really has command, and we should be aggressive in taking charge over this area.

Just briefly, I want to touch on the nature of the employer's obligation. There are two major views. Is the employer's obligation in a pension plan to make contributions to the plan, or to provide benefits? Before ERISA, there were stronger arguments to just make contributions. But with ERISA, it's easier to defend the argument that the employer has an obligation to provide the benefits. He has more obligation than just to make contributions; he would have to make additional contributions if any of the experience is unfavorable to the plan. If his obligation is only to make contributions, what is the difference between a defined contribution plan and a defined benefit plan? The popular view is that pensions are a form of deferred compensation, and that the employer's obligation is to provide the benefits. Under that view there are two subviews and I find this philosophically interesting, because as far as measuring the results, I get the same answer. I'd be interested to know if anybody has viewed this differently. If you accept that the employer's obligation is to provide benefits, is the obligation to each employee, or to the group as a whole? Even if you believe that the obligation is to each employee, there's so much uncertainty as to what any individual employee is going to do that we use actuarial techniques to estimate how many people are going to be vested, how of many of those are going to live to retirement, what the average salary scale is going to be. And so, it's almost irrelevant what your philosophical view on the obligation is; the measurement would be done using actuarial techniques. I found that tremendously interesting, because sometimes the philosophical point of view has a major impact on how the measurement will take place. In this case, the two philosophical viewpoints lead to the same measurement of the pension cost and whatever liability has occurred.

MR. JACK SCHECHTER: What I'm planning to do is give a brief overview of the DM, and the pension accounting project as a whole of which the DM is the initial stage. Betsy Hollowell will talk about tentative conclusions; my comments will hopefully present the flavor of what the memorandum is trying to say, but there will be some personal biases reflected. But first just a diversion. The title of the session is "major issues in accounting for employer benefits" and that's what the DM is all about. But an item which really hasn't been addressed sufficiently is, what is the methodology of the DM, what is FASB's methodology in this project and probably on other accounting projects?

Reading through the DM brings to mind a true story. I have friends who rent

an apartment in a two family house. The landlord lives on the first floor. Every six months the landlord comes up and says, I need an increase in my rent. My friend says, you know we have two small children, do we really have to do this? So the landlord says, well, let me go back downstairs and ask my sister if we really have to. A few days later the landlord comes back and says, sorry, my sister made me do it. Now, my friend is not an actuary, but he's a smart guy nonetheless, and eventually it dawned on him that he's never met the sister. He's heard about her every six months, but he's never seen her. After a couple of years he went down to the landlord and said, you know, I'd like to meet your sister. Tears rolled to his eyes as he said, oh -- she just passed away.

As you read through the DM, they introduce the basic philosophical issues, which Barbara discussed. Throughout that first section, they also introduce the conceptual framework, which is defined as follows: "The FASB conceptual framework is a coherent system of interrelated objectives and concepts that is expected to lead to consistent financial accounting and reporting. It prescribes the nature, function, and limits of financial accounting and reporting." As you read through subsequent sections which address each of the specific eight issues, the DM refers to the conceptual framework and specifically it refers to the "Elements", which is short for the "elements of financial statements of business enterprises". This is one of the four concept statements that the FASB has issued to date as part of the conceptual framework. The DM refers to definitions which are culled from the concept statements, one such definition being that of a liability, which Barbara read to you. Others which appear are definitions of items such as assets. This structure of the DM really has perplexed a large number of observers in the actuarial community and the business community. A lot of people have felt APB8 has worked pretty well throughout the years. Perhaps liability disclosure is not what it should be; some people have felt that statement 36 has rectified that a bit. But the DM seemed to many people to be an academic exercise, like going back to the geometry text where you state axioms from which you derive theorems. Very much like the sick sister who inscrutably demanded that rent increases come forth, the FASB has set up an inscrutable authority which is called the conceptual framework. I was going to say this is a strategy on the FASB's part, but it's not nefarious; it may just be subconscious, and I think it's pretty much a reflection of human nature. People create authorities to which they refer.

What is the nature of this authority, the conceptual framework and the definitions which are brought forward from that? Tim Lucas and Betsy Hollowell co-authored an article in the Journal of Accountancy, which I will paraphrase: "The definition of liabilities is primarily a description of current practice, a formal description of the kinds of things accountants already think of as liabilities." The definition of a liability which Barbara quoted from one of the concept statements is really based on established practice, on sort of a gut feeling of what a liability is. The conceptual framework is also a codification of things which are widely accepted as generally accepted accounting principles. One question I have is, if the definition of liabilities is supposed to reflect current accounting principles, don't current generally accepted accounting principles (GAAP) say that pension unfunded liabilities are not reflected on the books? Why should that aspect of current GAAP not somehow appear in the definition of liabilities? That's the way

accountants have been thinking of pension liabilities for some time now. There's not a fixed standard which is a liability, but a concept, a condensation of what accountants have been thinking these years.

Now, the DM is based within the conceptual framework, and it presents eight different situations for response by interested parties. The eight issues are phrased in terms of plan situations.

Plan situation 1 is sponsored by a single employer; covers only U.S. employees; provides defined benefits based on final salary; is funded by contributions to a trust; is covered by ERISA; the plan and employer are not in financial difficulty, and the plans are expected to continue in operation; no credit for service before plan inception; no amendments; and no actuarial gains or losses or assumption changes. So, you're dealing with a plan where you would ordinarily not expect to have any unfunded past service liability. The first plan situation is used for presenting the first 3 issues.

The first issue is, what part of the obligation to provide future benefits should be recognized as a liability on the employer's balance sheet? The first issue strikes me as a diversion, because most respondents to the DM felt it was unlikely that the total gross liability and the total assets would ever appear in the balance sheet. The real issue is whether the net liability, or the unfunded liability, has to appear on the balance sheets. That question is discussed in issues 4 and 5 for the second plan situation. But for issue 1, relating to the gross liabilities, there are several possibilities as to when one would view the employer as incurring a pension obligation:

1. The amount attributed to employee service up to the balance sheet date.

2. The amount of contributions to the plan before the balance sheet date, using an actuarial cost method. This doesn't have to be the cost method that the employer actually uses to fund the plan, though that can be one of the alternatives.

3. The benefits on a termination basis. This reflects the legalistic view, in that there's no call on an employer's net worth by the PBGC or by any other parties until the plan is terminated.

4. The vested benefits.

5. The amount due or payable to current retirees.

6 "Other", presumably no amount.

As far as current practice in this regard, based on APB8, the only amount that should be shown on the balance sheet would be the difference between prior charges to income and amounts which were funded prior to the balance sheet date, and those are shown as accrued or prepaid pension expense; or, if there's any legal obligation above amounts paid or accrued, such as ERISA minimum funding amounts. APB8 says no unfunded prior service cost should be shown on the balance sheet or otherwise. There are certain situations, though, where current practice is to record an unfunded pension liability. In those cases the liability which is typically recorded is the unfunded vested

liability. Accounting Principles Opinion 16 states that generally, when a company acquires another enterprise and accounts for that enterprise as a purchase of assets, rather than a pooling of interests, the unfunded vested liability for the acquired corporation should be shown on the acquiring corporation's books. Also, there's a fairly widespread practice -- though I don't think there are any official FASB or APB pronouncements on it -- that in the event of plant shutdowns or sales, the employer will record the unfunded vested liability on the shutdown date. This may happen in roughly half of such occurrences, but I don't think it's a mandatory practice.

The second issue in the first situation is, what amount should be recognized and expensed on the employer's income statement? As with APB8 and current practice, the official pronouncement is that the expense should be determined using one of the allowable actuarial cost methods, irrespective of the amount funded. In actual practice, most employers do expense the amount they fund and there are just minor exceptions to this. For example, if you make use of a funding standard account credit balance, or if a plan is fully funded, you may end up expensing a slightly different amount than you funded. The DM's possibilities for what you should expense: First, the increase in liability during the period, reflecting the common sense notion that the expenses and liabilities should somehow be related to each other. Second, the amount attributed to employee service during the period, even if you're not showing balance sheet liabilities. Third, the contribution to the plan under an actuarial cost method; this is basically current practice. The rationale for this possibility is that many people do believe the obligation is to fund the plan, to make contributions to the trust. Other possibilities are solicited by the DM.

Issue three in the first plan situation is: If the liability or expense is recognized based on employee service, how should the cost for pensions be attributed to periods of service? The major question is: How do you attribute the benefit payable at retirement over an employee's active service? You're dealing with accrual accounting and you want to match expenses against revenues. Employee service is what goes into producing revenues, so you want to attribute the cost of the pension to that service. There are two basic approaches, and much of what I say should sound familiar because these approaches do mirror actuarial cost methods. These are the benefit approach and the cost approach.

The benefit approach is what we normally think of as a unit credit type of actuarial cost method. So, you get the classic question: since the pension is based on final salary, what part of that pension should you attribute to each year of service, despite the fact that in the current year salary is lower than it ultimately will be. There are three possibilities. One is the accumulated benefits, which is a classic unit funding method. You just look at the benefit earned, the accrued benefit as of the end of the year, subtract out the accrued benefit as of the beginning of the year, and the value of the difference is the normal cost attributed to that year. The other alternatives are projected-benefit type approaches. You determine for each employee what his projected benefit will be at retirement taking into account expected salary increases, and you allocate that projected benefit to each year of service. You can do that in two ways: you can allocate a level amount of that projected benefit to each year of service, or you can allocate the projected

benefit as a level percentage of compensation each year. Each year the normal cost under either of those methods is a present value of the amount allocated to that year, and the accrued benefit is just the present value of benefits allocated to all prior years. As a funding method, most of you are probably aware that the benefit-compensation approach is not viewed as a reasonable funding method by IRS. That really doesn't say one thing or another regarding the method as a reasonable accounting method, though.

The cost approach is one of the entry age normal cost or FIL methods, where you determine the present value of projected benefits at retirement and fund those projected benefits on a level premium basis. You can fund the projected costs either as a level amount per year, which is the cost/years-of-service approach, or as a level percentage of compensation, which is the cost/compensation approach. As I said before, APB does recognize most reasonable actuarial cost methods, except terminal funding, for purposes of expense recognition.

Those are the major issues. How to account for changes in a plan or new plan is issue four, and issue five is how to account for actuarial gains and losses. These will show up among the tentative conclusions Betsy Hollowell will be discussing.

MS. BETSY HOLLOWELL: I welcome this as an opportunity to learn more about how actuaries view pension plans. And hopefully it's an opportunity for we accountants to explain the way we see a pension plan to you. Obviously, our views are going to be different because we have different objectives and we are trying to accomplish different things. Recently, there was an article in Accountancy Age, which is an English magazine, and one of the editorials referred to Don Kirk's staff (by the way, Don Kirk is the Chairman of the Board of the FASB) as the messengers of old who used to bring bad news. And we all know what happened to those people, the article said. So, sometimes I get the feeling that the article is really telling it like it is.

I'm going to talk to you about what the Board has decided, their tentative conclusions. As was mentioned earlier, Tim Lucas, who is the project manager on this job, and I wrote an article for the Journal of Accountancy, and in that article we expressed our views as to what we thought at least part of the answer ought to be in pensions. I don't intend to get into my viewpoint here, because some of the things that the Board has decided I am in full agreement with, and with others I would have chosen a different answer had it been left to me. But the purpose of my visit is try to explain to you what we have decided to date.

But first I'd like to talk a little bit about what the Board is. The Board was established in 1973; it is an independent seven-member board. It operates under the oversight of a private foundation called the Financial Accounting Foundation. This foundation is sponsored by national organizations representing accounting academicians, certified public accountants, security analysts and investment advisors, corporate financial executives, management accountants, investment bankers and brokers. Statements of financial accounting standards issued by the Board establish new standards of accounting and reporting, and also amend those that have previously been issued. Collectively, these standards reflect the continuing process of establishing and

maintaining generally accepted accounting principles in the United States. The FASB standards are officially recognized as authoritative by the Securities and Exchange Commission. This was done in accounting series release #150. They're also recognized under the Code of Ethics of the American Institute of Certified Public Accountants, and under the CPA licensing statutes, regulations and practices of the 50 states. The seven members of the Financial Accounting Standards Board serve full time; they have diverse backgrounds. They must possess a knowledge of accounting, finance and business and a concern for the public interest in matters of financial accounting and reporting. Board members are appointed for five year terms and are eligible for re-appointment for one additional five year term. They are required to sever all connections with firms or institutions they served prior to joining the Board. At the current time we have three Board members who have public accounting backgrounds; one from government, one who was a financial analyst; and an academic from Stanford University. Standards are passed by a majority vote of the Board -- that is, a four-to-three vote. On pensions, we have four-to-three votes on all of the tentative conclusions that I am talking about today. The only problem is, it's not always the same four that are agreeing. So we still have a long way to go in this project because even though we have agreement on each step of the process, we don't have the same four people agreeing all the way down the line. When we come to the very end and we put all these conclusions together and write the document and the Board members have to vote, we may have disagreement again; the standard may not be passed as I am telling you now. So, everything I say to you about tentative conclusions -- consider them extremely tentative, and maybe you should consider them leanings as opposed to tentative conclusions.

The conceptual framework has been mentioned here today, and it is something that I believe is going to be very important to accounting as a whole. In essence, the framework is an attempt by the FASB to define and rationalize what accounting is now and what it should be, and to give reasons for that. Different accountants have different views about what accounting is or what it should be, and some of the Board members disagree too. Some people view the framework primarily as a logical description of current practice, with some fine tuning that's going to be necessary. Other people see it as a first step in making significant changes in the way accounting is done and what it means. At the moment we can't predict which way the conceptual framework is going to be, but I would like to point out that accounting, like everything else, is an evolutionary process. We don't expect black to change to white overnight just as accounting rules aren't going to change overnight; things happen gradually. Regardless of what happens with the framework, its purpose is help the FASB find logical, consistent answers to accounting problems. Many of these problems have been debated for years; and among those problems, of course, is pension accounting. The other two, which Barbara Eversberg mentioned in particular, are inventories and depreciation. Several people have said that pensions are no different than these two other areas, and that since management has choices in these areas, pensions are no different. Well, we should be rather careful using that particular argument, because there is a good possibility that the Board is going to be reexamining inventories and depreciation also.

We do have four concept statements finished in the conceptual framework at this point. The first one is called "objectives", and the main focus of that

document is that objectives define what financial reporting should do. The primary objective is described as providing information that is useful to investors, creditors and others in making financial decisions. Because without decision-usefulness there is no need or justification for accounting or financial reporting. The second document that was issued in the conceptual framework project was called "characteristics", and tried to describe the things that would make information decision-useful. Some of those characteristics are: understandability; the numbers have to be relevant to what the investor or creditor is looking for; they must reliable; they must be neutral; and they must be comparable from one company to another.

Comparability requires that everyone use the same rules in preparing financial statements, just as it does when you're playing a game and everyone has to use the same scorecard. Barbara Eversberg asked if comparability was necessary in financial statement reporting for pensions; I believe it is. It is necessary for two companies that have the same situation, the same kind of plan to be reporting accounting numbers that are comparable. Funding? Certainly not, because companies do have different situations, different financial objectives, so in no way should funding have to be the same. But the accounting, in order for people to look at a company and judge where it stands, must be in some way comparable.

The other characteristic that I'd like to spend just a moment thinking about is neutrality. Pensions obviously are a very political issue, and we have had a lot of things to think about so far as economic consequences go. And we at the Board do consider that, we do not just look at theoretical issues. But we also must think about neutrality when we write statements. If we look at neutrality as being something like even-handedness, or telling it like it is, we must say that standards cannot deliberately be slanted, or try to achieve results favorable or unfavorable to a particular interest or cause. To alter accounting standards to try and achieve some other goal, no matter how worthwhile, would eventually destroy the usefulness of accounting. I recognize that, if pension liabilities were to be put on the balance sheet, it would cause a lot of confusion and there would be time that would be necessary to have debt covenant straightened out, and other ramifications. But let's keep in mind that if it is a liability, and liabilities are normally reported on balance sheets, in order to be neutral that's where we ought to put it.

We were also talking about the definitions of a liability and what "elements" are. Elements, as Barbara said, are building blocks of financial statements. They are economic resources (or assets) and the claims to those resources. Information that is useful also includes changes in assets and liabilities and cash flows.

Financial statements are a standardized way of presenting information so that it's easier to use. Each type of information has its own place. Users of financial statements are familiar with where these items are placed, and they can always go to the same place in the statement to find a particular type of information.

It's particularly important that the parts of the system be related to each other, and they are, because the statements include summarizations and totals. If one part is left out, or put in the wrong place, the other parts

of these statements will be adversely affected or misstated. Assets and liabilities and equities are shown on the statement of financial position (balance sheet), the income statement has a place for revenue and expenses, and the statement of changes in financial position displays the sources and uses of cash. The primary financial statements are supplemented by notes that provide additional information about the elements included in the statements. The notes also provide information about the company that does not fit into the structure of the statements.

That is a very brief summary of what the conceptual framework is talking about in financial statements in general. Obviously, there's a lot more to it that what I have had the opportunity to discuss with you here today. But now we're going to move on to pension accounting, which is what I'm sure you're all more interested in.

The advanced publicity for this session indicated that the Board hoped to have its initial set of tentative conclusions by now, and believe me I wish it did too. But it doesn't, we aren't quite there yet. The issues in this project have proven to be very complex and difficult. They involve not only understanding the nature of the pension plan and its economic effects on sponsoring employers, but also defining how the plan fits into the financial reporting system that I have just discussed with you. These pension issues have turned out to be a significant early test of the usefulness and viability of the Board's conceptual framework.

Since the DM did cover eight basic issues, I would like to discuss the three that we see as the most important. First, as we discussed earlier, the DM considered a very simplified plan situation where there were no complications for prior service cost, and it was a US plan. We can take that just one step further and consider that we have a new company that has just been established. It has been in operation for one year and established a pension plan on the day it started business; the employees now have worked for one year. We come to our first major issue: after the first year of operation, how much expense and liability should be recognized by the sponsor of the defined benefit plan? That leads us to the question of, how do we measure what happened that very first year? This brings up other questions as to how should we "measure". Should there be just one method or should we have a variety of methods? Is the obligation somehow different between one company and another? The majority of Board members support the idea that there should be a single approach to measuring the obligation for similar plans and they believe that approach should be based on a benefit methodology. They have not as yet decided whether or not the benefit methodology should be prorated on service or compensation. They have decided tentatively that salary progression should be included, so it will be a service or compensation prorated approach. They have also discussed the interest assumption. There was some discussion of using PBGC interest rates, but they certainly have not said they were going to do that; they haven't really discussed at all how to measure the interest rate assumption. All they have decided at this point is that since we're including salary progression, then we have to have an interest rate assumption that would be proper to use with salary progression.

As we accountants keep pointing out, the measurement of a pension obligation is a different problem than deciding how to fund it. The amount of the obligation, as we view it, is quite different than funding it, or the budget that's necessary to pay it off with a maturity schedule. The arguments for flexibility in funding, based on a company's financial needs and circumstances, we believe are quite compelling. Certainly management has a considerable latitude to arrange the maturity or payment schedule of other obligations, without implying that the financial report should show less than the total amount of the obligation that they're paying off. But the pension question is further complicated by a number of future events that will affect the amount ultimately paid out in benefits. These future events require a number of assumptions under any of the approaches that the board should select, and experience does not unfold exactly in accordance with the assumptions that we make. As times goes on we will have experience gains and losses, and it will be necessary to change actuarial assumptions. Thus we have the second difficult major question to resolve: should such events be recognized as they occur by adjusting the liability, so that each successive financial statement shows the best, most current estimate of the obligations? Well, in accounting, theoretically, a case can be made for immediate recognition of experience gains and losses and changes in actuarial assumptions. But at this time, the majority of the Board is leaning towards some kind of forward looking or prospective recognition. That leaning is based on an understanding of the approximate or estimated nature of the assumptions, which could result in fluctuations in the liabilities that reflect primarily changes in estimates rather than actual events. So, at the present time the Board is not leaning toward increasing a liability as a result of experience gains and losses. They are planning to amortize or expense them over some future perod.

Then we move on to the third question, and that is prior service. If we're really trying to measure the obligation that exists under a pension plan, is it not logical that two plans that promise the same set of benefits to identical employee groups produce essentially the same obligation? Would that be true even if one plan had been in effect for many years, and the other was recently established or amended? So the third question involves what do we do when we amend a plan, or when we initiate a plan that gives credit for prior service. Do we recognize an increase in the liability or not? The Board has tentatively decided that there should be an increase in the liability, and that an intangible asset should be reported for the amount of the increase in the liability that is related to prior service cost. The reason the Board has decided on the intangible asset is that they have been convinced that there are benefits that result to the plan sponsor as a result of adopting or amending a plan, and that there should be no immediate effects on income and expense as a result of plan amendment. Therefore, they intend to amortize the intangible asset over some future period. At this time the Board has not decided over what period they will amortize intangible assets, nor over what period they will amortize experience gains and losses.

At the most recent meeting on this subject, the Board tentatively decided that all of the pension related elements should be grouped together in a footnote with a net balance shown in the statement of financial position; that net balance may either be a liability or an asset. The elements in this disclosure would be as follows. First, the gross benefit obligation or liability, which is broken down between accumulated benefits and the portion that would

result with a salary progression being included. From that we would deduct pension assets, which are to be stated at fair value. Then, there is a measurement valuation allowance to be included, which will be the changes in the liability that occur as a result of experience gains and losses, changes in actuarial assumptions and changes in asset values. The Board also decided that, rather than reporting the intangible assets on the balance sheet and reporting the increase in the liability as a result of plan changes on the balance sheet, they would also admit the intangible assets in the footnote. So we come down to a number that would be taken to the balance sheet, this number of course depending on which funding method the companies would use. This may very well turn out to be an asset as well as a liability, especially depending on how long an amortization period the Board decides to use for actuarial gains and losses. So at this point, the Board has decided to put a number on the balance sheet, whichever side it winds up on.

As you can see, we still have a very long way to go on this project. We are at the very beginnings of what is a very tentative answer at this point. We hopefully plan to publish these tentative conclusions by the end of the year along with a second set of more detailed issues that will discuss other things like disclosure of all kinds of plans, foreign plans, that sort of thing.

MR. MACTAS: There has been some semi-formal actuarial activity interfacing with the FASB. The Academy has a Committee on Pension Accounting that focuses on these issues, as well as other issues of pension accounting interest. It has presented some testimony to the FASB, and selected actuaries have done so as well on their own.

One of the fundamental gulfs between the actuarial community and the FASB staff on this project is on the character of the pension obligation itself. One of the elements of a liability that you heard read before was that in order for an item to be considered a liability in the accounting sense, the events which have given rise to the obligation must have already occurred. It's unfortunate, in a sense, that modern pension planning defines benefits with a formula that includes an employee's length of past service, because it tends to divert attention from what the character of a pension plan obligation is, at least from the actuary's point of view. The prevalent opinion among actuaries is that it's a deferred wage, that is, a piece of an employee's work; it is not being paid for currently, but will be paid for in the future by way of the pension. And therefore it is an exchange of an employee's current services for a future pension benefit expectation. More particularly, the majority view of actuaries is that the exchange is between the employer and the group of employees that he has working for him now, as that group will change in the future. An employer can't take an employee on the threshold of retirement and increase his benefit, or establish a pension plan that relates to all of his years of past service, and justify the cost of the pension to stockholders for the one year of service that employee is going to render. Rather, it's an exchange with that group of employees; the employer gets value from the group of employees for having created a benefit with that formula. And so we question whether the exchange, the rendering of service which justifies the recording of this item as a liability has really taken place at the outset, or at the amendment, of a pension plan which relates benefit improvements or initial benefits to past service.

Betsy mentioned that accounting is not so much concerned with the actual funding of pension plans. There are many cash flow reasons why employers may want to vary the amount they contribute from the amount that they charge as an expense. A key example might be the desire on the part of a corporation to take advantage of maximum tax deductible opportunities, contribute more than pension expense for a while and be able to get some tax benefits. Still others in a time of cash flow stress might want to temporarily cut back contributions. The actuarial community would agree that these considerations should not affect how much is expensed on the company's financial statements. However, these relate to permissable amortization periods for past service cost, and they're transitional and temporary at best. The issue is whether or not there should be flexibility in using actuarial cost methods of one variety or another. Let me pit two extremes against one another: the unit credit type, which seeks to fund earned benefits as defined in the plan document; and the more conservative entry age normal approach, which essentially takes pension plan costs and tries, over employee careers, to level the costs themselves rather than focusing on the benefits. When an employer uses the entry age normal cost method, he's not just trying to jockey his expenses around. He's making a statement as to what the long term funding of his pension plan will be. A company that uses the entry age normal method doesn't just come up with current costs that are about 50% higher than under the unit credit method. He's making a statement as to his current intention for eventual asset accumulation. If a company is willing to make the conservative statement that they want to fund their plan entry age normal -- which may mean accumulation of assets in the long run of 150% of the value of accrued benefits -- it doesn't make any sense to say that company should accrue cost on the unit credit method, and thereby develop on its books a permanent prepaid pension expense asset. They're making a statement which has real value when they say, we're going to fund our pension plans entry age normal. If two companies have the same plan, the same employee group and their actuaries make the same assumptions, but one uses the unit credit method and the other uses the entry age normal method, I submit that, as long as the methods meet reasonable criteria for acceptability, they should be expensing their plans on a different basis. These are not the same scenarios, because the companies are making different statements as to what they hope to achieve with the long term pension fund accumulation.