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# FASB DISCUSSION MEMORANDUM—AN UPDATE

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DALE L. GERBOTH: Our games, we are told, mirror the society in which we live. At 4:40 p.m. on Sunday, July 24, 1983, I was persuaded. That was when George Brett of the Kansas City Royals was deprived, at least temporarily of a game-winning home run because of a rule infraction: pine tar on his bat extended above the lawful limit of 18 inches from the end.

No matter that the home-run ball struck the bat several inches above the pine tar. No matter either that pine tar does not affect the distance a baseball carries. A rule is a rule, ruled the umpire.

Nor did I take particular comfort when, several days later, the President of the American League reversed the umpire's decision, affirming the principle that "games should be won and lost on the playing field -- not through technicalities of the rules". In a rational society, it should not require several days and an executive decision for such self-evident wisdom to prevail.

Now, that incident, of course, is trivial. But it does indeed mirror an aspect of contemporary American society that is all too real and that goes a long way toward explaining why the Financial Accounting Standards Board (FASB) seems inclined to take pension accounting in the direction indicated by its Preliminary Views. That is the tendency for decision-making based on first-hand knowledge of particular facts to give way to decision-making based on abstract principles, expressed in highly detailed rules, and handed down by a distant authority. No competent umpire free to exercise his own good judgment based on the facts before him would have given even a moment's thought to disallowing George Brett's home run. Only when he was distracted by a rule that was at once too vague in its intent and too specific in its language was the umpire's judgment betrayed into error. And the hapless victim of the error, which was really the fault of the rule-writing authority, had then to appeal to that same authority for redress. In the late twentieth century, it seems, it is the victim who must return to the scene of the crime.

More serious examples are legion. Prices are set, employees are hired, students are promoted, laws are enforced, and criminals are sentenced, not so much because responsible people have decided that particular actions are appropriate in particular circumstances, but because central, usually distant, authorities have issued edicts preempting on-the-spot judgment. This is necessary, we are assured, to protect us from the chaos that would prevail if everyone was left to make his own decision.

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This, then, is the principal root of the FASB's Preliminary Views on Pension Accounting: a mistrust of individual judgment. To some extent, that mistrust is simply the accounting manifestation of the general mistrust of individual judgment that pervades contemporary American society. But it is intensified in accounting because we recognize that so much of accounting is based on convention. Pension accounting, in particular, relies heavily on convention. Actuarial cost methods are conventional; the techniques for spreading actuarial gains and losses and the periods over which they are spread are conventional; to a significant extent, actuarial assumptions are conventional. It is as if the accounting profession has come to realize that the ground we walk on is not solid earth but a fragile network stretched over an abyss; we look down through the net and are dizzied by the view of empty space yawning below. So we scramble frantically to what seems to be the solid ground of highly detailed rules.

Then, too, those of us who deplore the growing reliance on such rules have been put on the defensive by events in the last 15 or so years. First, we were hit with the accounting abuses of the "go-go" years in the late 1960s. Then came the rash of disclosures of off-the-books corporate "slush funds", illegal political contributions, and questionable payments to foreign government officials. Even closer to the accountant's home were the unexpected failures of a number of well-known companies: Penn Central, W. T. Grant, and Equity Funding, to name just three. In the clear light of day, it can be argued that many of those events had little to do with the level of detail in accounting rules, but they made it hard to argue for reliance on accountants' judgment in any sense.

I have taken the time to sketch this backdrop because it is important for us to understand that the detailed and restrictive rules proposed in the FASB's Preliminary Views does not reflect the mere caprice of the seven incumbents. Even though I oppose that direction, I am forced to recognize that it is to a great extent the result of powerful social forces that are at least as strong outside the accounting profession as within it, forces the Board would find very hard to resist, even if it had a mind to.

Those forces make it very difficult for the Board to continue the present approach to employers' accounting for pensions. That approach is based on Opinion No. 8 of the old Accounting Principles Board, which is one of the oldest standards on the books. It was written 18 years ago -- virtually in another geological age. Eighteen years ago, baseball rules specified only the maximum size of the bat, not how much pine tar could be rubbed on it. Eighteen years ago, employees could be hired and fired solely on the basis of their performance. Eighteen years ago, the "go-go" years hadn't yet "come"; Penn Central meant a railroad, not a financial debacle; McDonalds had sold only 2 billion burgers; and Gary Hart knew how old he was.

In that simple, artless age the rules of accounting were written by gentlemen for gentlemen, not as it now seems, by lawyers for lawyers. Accountants were expected to understand the meaning and intent of broad principles and to abide by them, making whatever on-the-spot judgments were necessary to adapt them to particular circumstances. And, by and large, they did, thereby adding substance to the adage that people generally behave as they are expected to. It was in that spirit that Opinion 8 was written, which does much to explain its relatively simple treatment of a complex topic.

Then, too, the authors of Opinion 8 seem to have viewed it only as a transitional pronouncement, intended to eliminate a few obviously undesirable practices and otherwise bring a degree of order to what was then a rather undisciplined area of accounting. They did not necessarily expect it to be the final word on the matter; the opinion itself suggested that further work might one day be necessary.

So when the FASB put the project on its agenda in 1974, it was in a sense taking up a matter left uncompleted by the Accounting Principles Board nearly a decade earlier. But first it had to take care of the difficult matter of the accounting by pension plans themselves, which it did in 1980 with FASB Statement No. 35. By then, of course, the Board had begun to realize just how complicated employers' accounting for pensions was going to be and decided to take it on in two stages. The Preliminary Views, issued in late 1982, was an attempt to reach tentative conclusions on broad fundamental issues to serve as a basis for proceeding with the more detailed issues in the second stage. The Board has now heard from its constituency on both sets of issues, and just two weeks ago held the first of what I am sure will be a long series of meetings before a standard is proposed.

At that first meeting, I was both surprised and encouraged to learn that the bulk of the discussion was devoted to the question of whether there is really enough of a difference between a defined benefit plan and and a defined contribution plan to justify different accounting requirements. Tim Lucas, the chief staff person assigned to the project, started the discussion by enumerating all of the reasons set forth in letters of comment suggesting that differences between the two plan types were not enough to justify different accounting treatment. Then followed a series of questions from the Board, most of which took the form of rebuttals to the reasons Tim had outlined. Our observer at the meeting speculated that Tim's purpose in this opening gambit was to find out how much sentiment there might be on the Board for continuing something like the present employers' accounting under Opinion 8 and that he found very little sentiment for it. We mentioned this to Tim after the meeting, and he allowed as how it wasn't a bad characterization of what took place. Obviously, it is still early, and one discussion is not sufficient basis for drawing conclusions as to what direction the Board's deliberations might ultimately take. Then, too, what I read into that one discussion may be influenced by my own biases. But I am encouraged to see the Board at least begin its deliberations by taking up a question that basic. It raises some hope that the Board is not necessarily committed to its Preliminary Views and, despite the social forces pressuring it, might back away from some of its less defensible conclusions.

From my perspective, the Preliminary Views contain two conclusions that the Board should back away from. The first is the proposal to place a pension obligation on the balance sheet as a liability. In my opinion, that would be a drastic step taken without sufficient justification. A step carrying with it the consequences of that one should, in my opinion, be taken for only two reasons. Either it must add information clearly needed by those who use financial statements -- information that cannot be communicated as well in any other way -- or the proposed addition to the balance sheet must clearly meet recognized and accepted criteria for balance sheet recognition. Neither of those two conditions had been met.

As to the first -- investor need for the additional information, if any, provided by balance sheet recognition -- it was not even dealt with in the Preliminary Views, absolutely nothing was said about user information needs in relation to the Board's balance sheet proposal. More important, it seems obvious that, whether the Preliminary Views said anything about user needs or not, that justification does not exist in fact. Nothing the Board proposes to put on the balance sheet can be presented better there than it can in footnotes to the balance sheet. In fact, as means of conveying information, footnotes usually are better than the financial statements themselves. It is also worth noting in this connection that those representatives of financial statement users who wrote to the FASB about its Preliminary Views were divided on the balance sheet presentation issue. Clearly, the Board's balance sheet proposal has not been justified -- in fact, probably cannot be justified -- by user needs.

The argument for balance sheet presentation in the Preliminary Views is solely of the second kind, the appeal to accepted criteria for recognizing a liability. I won't take up your time by rehearsing that argument and its counterargument. Suffice it to say that the volume of letters arguing that the criteria are <u>not</u> met is ample evidence that this justification for the proposal is too shaky to stand. While no one should demand that every last stubborn nonbeliever be convinced that recognition criteria have been met before the Board puts something on the balance sheet, I think the case for recognition must at least be beyond question by reasonable people, particularly if the consequences of balance sheet recognition are drastic and there exists an equally acceptable method of conveying the same information. In the view of a great many reasonable people, the criteria have not been clearly met, so this justification too cannot be sustained.

The second fundamental error in the Preliminary Views is the Board's great overestimation of the extent to which prescribing a single actuarial cost method can bring about comparability of pension expense measurement. I had some grasp of this earlier when I realized that the choice of actuarial assumptions can affect pension expense at least as much as the choice of actuarial cost method. And I learned much more about this weakness in the Board's proposal from the draft of the Hicks-Trowbridge monograph. In fact, as an accountant, I found the great value of that monograph to be its analysis of the complex interrelationship among actuarial cost methods, actuarial assumptions, amortization techniques, the ages of plans, and other factors. I hope the Board studies that monograph carefully. For if it does, I believe there is a good chance that it will recognize the limited extent to which it can attain genuine accounting comparability by means of highly detailed and prescriptive rules, particularly rules focusing on the choice of an actuarial cost method.

If the Board grasps the complex interrelationships of factors affecting pension expense, it might be persuaded to take a step that will have far-reaching and positive results, not only for pension accounting, but for accounting in general. That would be to write an accounting standard expressed in terms of the objectives it seeks to attain and leave the means of attaining those objectives to accountants and actuaries on the spot. It might, for example, state as an objective that pension expense be relatively constant as a percentage of compensation and leave the choice of actuarial cost method, actuarial assumptions, and the like to the judgment of those best situated to know what will attain that objective in a particular case.

While I would not want to quote odds, I think there is some chance the Board might change either or both of these positions. More disclosure about a company's pension obligation is certainly in store, and I get a sense that the Board might persuade itself that that is all that is needed, that balance sheet presentation would add little. And at its public hearing, the Board asked a number of questions about Arthur Young's recommendation that companies be permitted to use any expense computation approach that produces a specified expense pattern. What those questions might signify in terms of the Board's interest is impossible to say, but some interest was clearly present.

Before concluding, let me take a minute to bring you up to date on one other significant development in the pension project. That is the decision of the FASB to split off that piece of the project dealing with other postemployment benefits, principally life insurance and health care benefits. Many of us urged separation of that piece of the project from the beginning. We saw that pension issues were so dominating discussion that the issues relating to the other benefits simply were not getting the attention they deserved. The Board was persuaded and made the separation. That may actually advance the timetable for dealing with other postemployment benefits, since the decision as to their accounting is no longer tied to progress on the pension issue. But the timetable for that project has not yet been announced.

DANIEL F. MCGINN: We're here today to discuss a very heavy subject: the Financial Accounting Standards Board's proposals concerning pension accounting. Before examining these proposals, I'd like to say that it's too bad this session wasn't held ten days earlier. I can't think of a more appropriate occasion to discuss these proposals than April Fool's Day. How any student of accounting could take them seriously is beyond me. As you know, the FASB's proposals would:

- force a corporation to include in its balance sheet a pension liability and an intangible asset. This "asset" would be created at a plan's inception or by a plan amendment.
- mandate the use of a single method to calculate pension liability expense.

The primary purpose of these requirements, presumably, is to achieve greater uniformity and comparability in pension expense and liabilities as reported in corporate financial statements.

From an actuary's viewpoint, these proposals peculiarly define a corporation's liability and then infer the pension expense. In so doing they create a new definition of a pension liability and devise a new type of company asset. The yearly pension expense, for accounting purposes, then becomes the dependent variable -- regardless of the plan actuary's recommended range of contribution levels and company's actual contributions. For the first time, a corporation's commitment to a pension plan would be "liability-driven", rather than "expense-driven".

The approach, which would obviously impact the continuing plan funding policies of corporations, is especially peculiar since every plan's promise to pay retirement benefits is only fulfilled by the payment of contributions within a range determined by the plan's actuary to finance the plan adequately. These proposals would intervene in the normal process and superimpose strange new practices which are designed by individuals untrained in technical actuarial matters.

If the actuary's methods and assumptions are rational, responsible and consistently in phase with experience the actuary's recommended year-by-year contributions should fall within a reasonable range and ensure that the plan will fulfill its benefit obligations. This was the view of the APB 8 statement issued in 1966 which, in effect, acknowledged that a corporate pension liability or asset existed solely to the extent that contributions fell short of or exceeded the expense, determined on a consistent, long-term basis.

Specific Shortcomings of Proposals

The principal failures of these accounting proposals, from my viewpoint are:

1. The defined pension liability is no liability at all. This item is supposed to be the actuarial present value of all "accumulated plan benefits" to date, including projected future salary adjustments, if applicable. This present value would incorporate all actuarial discount assumptions (i.e. interest, mortality, employee turnover, retirement rates, etc.) and ongoing plan assumptions.

   How can this be a real liability when the so-called accumulated plan benefits would not be the basis on which benefits would be paid if the plan is terminated or curtailed in the future? For instance, a plan with normal retirement at age 65 might allow unreduced benefits at, say, age 62. Such a subsidy could readily be eliminated in a time of corporate financial stress and, certainly, upon the plan's termination. Similarly, portions of this so-called liability relating to ancillary benefits generally could be terminated under numerous circumstances, sharply altering future benefit obligations.

2. Inclusion of pension assets as company assets to offset the plan's so-called liability is also absurd. These assets are held in trust, they're not part of corporate assets and generally could never become part of such assets. The only exception is when a plan terminates, in which case assets not required to cover the benefit liability at that time may be recovered. Those circumstances, in turn, imply assumptions of a terminating plan, not an ongoing plan.

   If plan assets exceed liabilities under the proposal, the excess, presumably, would increase a corporation's net worth. This result essentially would conflict (1) with the sponsoring corporation's established pension plan funding policy reflected by the value of plan assets, and (2) with reality since the excess cannot be used for anything but plan benefits unless the plan is terminated and the plan provisions allow the excess to revert to the corporation. In any event, this excess is not necessarily a good estimate of the potential reversion if a plan were to terminate.

3. The "Intangible Asset" included in the proposals is utter nonsense. This artificial device is intended to offset the pension liability when the new rules first apply or when a plan amendment increases benefits. This so-called asset is to be written down, and the yearly amortized amount becomes part of the pension expense.

   According to the FASB, this amount is justifiably carried as an asset because it represents future economic benefits to the corporation; i.e. reduced turnover, improved productivity, reduced demands for wage adjustments and the like. It is surprising that a professional organization would dare to concoct such a rationale to justify what doesn't exist. It is well described as "intangible". Any respectable certified public accountant, in the absence of such an FASB rule, would be insulted by a corporation which suggested such a practice.

   Simply stated, the FASB has devised a new and confusing concept to replace the traditional concept of actuarial liability which is reasonably well understood and consistent with government regulations and required disclosure.

4. The "Measurement Valuation Allowance" is to be the repository of a plan's gains and losses - the results of differences between actual experience and the actuary's expected experience <u>plus</u> the effects of changes in actuarial assumptions. This is neither an asset nor a liability but, rather, a smoothing device to justify among other things, carrying at full "market value" a plan's assets that can rise and fall in value sharply from year to year. This item, like the intangible asset, is an artifice indicating the unreasonableness of the proposals.

Both the Intangible Asset and the Measurement Valuation Allowance are to be amortized annually by a percentage determined by dividing 100 by the period equal to the actuary's estimated average future working lifetime of the active group of participants included in the pension liability calculation. Since the annual write-downs of these amounts are based on the declining balances, artificial write-downs may be required if the average working lifetimes of the participants remains relatively level each year because, otherwise, neither the Intangible Asset nor the MVA will ever be fully amortized!

Because of the arbitrary and illogical amortization process for the MVA, a net pension liability could appear in the financial statements of a plan with assets in excess of the related liabilities.

<u>Concluding Remarks and Recommendations</u>

The FASB has clearly demonstrated by its proposals its intent to achieve uniformity in financial accounting for every defined benefit pension plan. But in doing so, it has constructed a framework which can lead to the reporting of meaningless and, more importantly, misleading information. If adopted, readers of financial statements will be confused, and the supporting data reported will be voluminous and complicated. Reconciling the artificial balance sheet and income statement results with actual funding practices and actuarial liabilities will challenge the imaginations of most professionals!

In place of the actuary's and plan sponsor's free choice of actuarial cost methods the FASB would substitute an accounting system which will truly obfuscate pension accounting. If adopted, these proposals will accelerate the demise of defined benefit pension plans as corporations strive to insulate net worth and corporate liabilities from the unpredictable impact on these amounts of experience under pension plans.

Recommendations

A practical resolution of the need for adequate disclosure of pension plan information can be achieved without a revolution in pension accounting. The Conference of Actuaries in Public Practice has published its own "Preliminary Views on an Actuarial Standard for Pension Disclosure". If the principal features of these "Views" are adopted, adequate disclosure can be achieved without eviscerating current accounting practices, without drastically increasing the administrative costs of maintaining a pension plan, and without so negatively impacting the future of defined benefit pension plans.

The Conference's "Preliminary Views" propose that actuaries prepare a package of disclosure information which would present, in concise form, information concerning pension funding and expensing sufficient for any user. The disclosure package would show, for a series of years:

- Essential actuarial data reported in the Plan's Funding Standard Account;
- Pension Expense;
- Aggregate Funding Indexes, to present actuarial data independent of the cost method;
- Data to show the funded status of accumulated benefits;
- Statistical data to disclose any obvious changes in census characteristics.

Finally, statements by the plan actuary would be included to describe the company's expense and contribution policies, explain changes during the most recent year and disclose any contingent obligations.

In light of the Conference's disclosure proposals which already have been favorably received by the actuarial profession, and the numerous uncertainties which would be introduced by the FASB's proposals, it seems clear that a "fresh look" is needed.

The FASB proposals go through numerous machinations to imply sophistication and objectivity, but they fail the "smell test". They represent a totally unnecessary intrusion by the accounting profession into actuarial matters for which accountants are untrained. To the extent that adequate disclosure is not currently available, there are far easier ways to achieve it. In any case, misleading disclosure is not adequate. Finally, if these proposals are adopted, they will have a chaotic impact on the apparent, but not the real, financial condition of corporations and will accelerate the rate of termination of "defined benefit" pension plans.

J. MATTHEW SINGLETON: Proposals to alter past accounting for pensions have always been controversial and emotional issues in the United States. Not only does change itself generate controversy but the subject of pensions is an emotional one that touches millions of Americans. The controversy and the emotion become even more understandable when the pension issue is viewed in the context of a broader area of social concern, appropriate accountability for pension promises made in the past that are to be settled in the future and the ability of our key institutions to perform on those promises. Throughout our society we find evidence of promises that have been made and of current concerns about the capability of those promises being met. The public's growing interest is broadly based and deeply felt, as well it should be.

A number of important events have had profound effects on both the status of pension and other retirement programs in this country and our confidence in them during the past few decades. These events include:

- an increase in the number of employees covered by pension plans,
- a significant increase in the rate of inflation and the resulting need to enrich pension benefits,
- the growing ratio of retirees to active employees, and
- the growing coverage and costs of health care benefits provided by employers.

No doubt each of you is intimately familiar with these trends.

Within the broad topic of pension accounting, what are the key issues and concerns? On the one hand, we have entities, both privately and publicly owned companies and governmental units, that have contractually or effectively promised employees certain benefits to be settled in the future for services they have rendered in the past. On the other hand, we have millions of individual citizens who, by agreement, contract, or action of law, have effectively foregone current compensation for services rendered in exchange for future receipt of specified amounts. All potential recipients have a justifiable concern about whether adequate provision has been made currently to meet the promises that have been made.

One aspect of the adequacy of current provisions relates to funding planning, the accumulation of sufficient cash to meet future payments. Another aspect, possibly somewhat less obvious, relates to accountability planning, the effect of those promises on current measurements of the enterprise's success, with resultant effects upon product pricing policies, capital raising costs, dividend policies, and current and prospective tax burdens. Planning in these areas is vital to the long term success and perhaps even the survival of the entities involved.

Recently, certain types of promises to make future payments have been criticized because of perceived short-comings in funding and accountability standards. The fiscal problems of the Social Security System in the United States have been the most notable culprits of these criticisms and concerns. Some even perceive that certain public sector entities, including the U.S. government, seek to solve their short-comings by transferring funding burdens to the private sector. Within the private sector, concern exists that certain entities will try to shift funding burdens to other entities or to future generations. In our society accountability at any point in time is often murky and those who expect to receive retirement benefits are frustrated when seeking effective remedies to perceived shortcomings.

In light of these very real concerns, the current FASB project might be characterized as a forthright attempt to achieve an improved level of understanding and accountability for pension costs. It is understandable that criticism of the Board's conclusions would be sharp and emotional. Those who would be directly affected wonder why they, and not others, are expected to shoulder the major burden of improvement for acknowledged deficiencies in current accountability for past promises. But improvement is needed nonetheless and we support the FASB project as a necessary catalyst.

With these ideas in mind, I plan to spend the next few minutes discussing some of the major issues surrounding accounting for pensions and the FASB's recent proposals to address these matters.

The first key issue is whether a liability should be recognized on the balance sheet. We believe that one should. That liability should be measured as the actuarially computed present value of pension benefits attributable to employee service already rendered to the extent the obligation has not yet been funded. A defined benefit pension plan involves the employer's promise to provide future pension benefits in exchange for current employee service. The pension promise creates economic impacts that should be measured and reported at the time that service is rendered.

Some have argued that defined benefit pension plans or trusts serve to insulate the employer from legal liability. That argument is difficult to sustain from an accounting and an economic point of view. The employer's obligation is to provide for all promises with regard to defined benefits. It is not merely an obligation to make contributions to the plan as in the case of a defined contribution plan. For a defined benefit pension arrangement, the plan is only a vehicle for discharging responsibilities of the employer. An economic liability exists and should be accounted for when it arises, whether the form of the transaction produces a legal liability. The legal notion of a liability is too closely tied to what would prevail in liquidation to be broadly useful in accounting for a going concern.

Some believe that the employer's unfunded pension obligation is not sufficiently certain and measurable for balance sheet recognition. They argue that it requires many actuarial assumptions about events that will not take place for many years. These people are not persuaded that balance sheet presentation of such a soft number provides more useful information than footnote disclosure. This argument, however, seems inconsistent with *common practice. Substantially the same actuarial assumptions are required* to measure pension expense today as would be used under the FASB proposals. We believe that an employer's unfunded obligation is capable of practical measurement at the time it arises. Certainly you will agree that known and tested actuarial techniques are currently available to perform this measurement. Furthermore, the Board considered these measurement concerns but concluded that the relevance of the information is sufficient to compensate for this lack of precision. It also concluded that footnote disclosure is not an adequate substitute for balance sheet recognition of a real economic liability.

The second key issue has to do with measurement of pension expense. Pension expense is part of a total compensation package, but one whose cash payment has been deferred. In effect, a worker bargains to take part of the fruits of his or her labor in cash currently, and part in cash after retirement. Both of these parts are properly attributable to the period in which the employee works. The amount of pension expense for an accounting period should be measured by the change in the liability during that period, i.e., other than changes resulting from funding and from plan changes and actuarial gains and losses. Pension expense arises as the services of the employees are performed. Accounting acknowledges that liability recognition and expense recognition are integrally related, in fact, are two aspects of the same transaction.

The pension expense that should be reported is not necessarily the same as the amount to be funded in a given year. Accounting and funding have different goals. The purpose of accounting is to measure economic resources and obligations and changes therein. Funding is a finance consideration that can be determined using any one of a number of actuarial methods consistent with the funding objectives and circumstances of a particular plan and its sponsor.

Recognition of pension expense under the FASB's Preliminary Views is conceptually similar to current accounting practice, in that it includes the following components:

- the increase in the pension benefit obligation attributable to employee services during the period;
- interest on the net unfunded liability;
- amortization of past or prior service costs arising from plan initiations and amendments; and finally,
- amortization of actuarial gains and losses.

However, it is important to recognize that the amount of pension expense under the Preliminary Views will differ from current practice for two reasons. First, the FASB proposes the use of a uniform actuarial approach in lieu of the acceptable alternatives permitted under APB Opinion No. 8; and, second, the required amortization pattern, the period for the effects of plan changes and actuarial gains and losses, will generally result in more rapid recognition than current practice. Depending upon the circumstances of an individual employer, the combined effect may result in an increase or a decrease in pension expense from that reported under current practice.

A third significant issue is measurement of the pension liability. In measuring the unfunded liability to be reflected in financial statements, the uniform method based upon the terms of the plan is to be used by all employers. The method that the FASB believes to be appropriate is based upon the present value of the benefits earned to date by employees in accordance with the plan's formula, years of service for many plans. The key element is that the liability is based upon service rendered to date by present employees. Differences or similarities among companies, based in turn upon differences or similarities in facts and circumstances such as makeup and mortality, would continue to be reflected in the Board's proposed measure of the liability based upon the plan's formula and through the selection of employer-specific actuarial assumptions. However, differences and similarities among companies would not be driven by accounting differences.

For pension plans that define benefits in terms of the employee's future salary, such as final pay or career average pay plans, estimated future salary levels should be considered in the measurement of the pension benefit liability. In calculating that liability, however, the defined benefits should be discounted to their present value using an interest rate that takes into consideration an estimated rate of inflation that is equivalent to the cost of living increases built into the employer's estimated future salary levels. There is an obvious need for consistency or correlation between the inflation rate implicit in the discount rate and the one included in the estimate of future salaries.

Another important issue has to do with the accounting of the intangible asset. Under the FASB's proposal, the increase in the pension liability resulting from plan initiation or amendment is to be reflected in the balance sheet as a separately displayed intangible asset to be amortized to expense over the average remaining service period of active employees. The intangible asset represents expected economic benefits to be realized by the employer as a result of past plan amendments or the initiation of the plan. The expected economic benefits in a particular case may include reduced employee turnover, improved productivity and reduced demands for increases in cash compensation. Plan initiations or amendments are almost invariably made by management with the view of benefitting operations in future periods rather than only the period of adoption.

The last issue I want to highlight today is accounting for actuarial gains and losses. The effects of experience gains and losses, changes in actuarial assumptions, and certain changes in the value of plan assets are to be accumulated in the separate measurement valuation allowance which is amortized to expense over the average remaining service period of active participants. The unamortized balance of the measurement valuation allowance would be added to or subtracted from the net pension liability or asset reflected in the balance sheet. The measurement valuation allowance is viewed as a practical means of reducing the volatility of the net pension liability and the periodic charge to pension expense, while at the same time explicitly disclosing the total impacts. The Board has recognized the popular view that accounting for pension costs should not be overly impacted by short-term economic considerations. In addition, a prospective spreading of the effects of the actuarial gains and losses is consistent with current practice, in that most of the actuarial funding methods currently used as a basis for accounting for pension costs include some similar means of eliminating volatility.

Although many other issues are raised and discussed at length in the Preliminary Views, let me stop now in the interest of time to recap these remarks. We believe that the thrust of the Preliminary Views is sound. This is because it reflects the economic realities of pension promises. We acknowledge, however, that there are many important implementation issues yet to be resolved. No major change in accounting principles can be completely painless. The Board has recognized that adoption of the Preliminary Views will be problematic and as a result it has proposed some very liberal and flexible alternatives for implementation to ease these problems. While the use of alternatives will unfortunately result in an extended period of non-comparability among companies, ultimately improvements will be achieved. We look forward to that achievement.

BARNET N. BERIN: In the hopes of increasing the attendance at this session we put an announcement into all the folders that we would discuss the recent Hicks-Trowbridge analysis of the FASB Preliminary Views. It was funded by the Actuarial Endowment Research Fund and is called "Employer's Accounting for Pensions: An Analysis of the Financial Accounting Standards Board's Preliminary Views". It's important to realize that this is sub-titled "Authors' Draft-March 1, 1984", so hopefully any comments given will be considered.

The Study is by two people very well-known in the field. It is a well-written and interesting discussion of the FASB's Preliminary Views, although arriving late in relation to the hearings on this subject which were held in January. Hopefully, the FASB, and others, will have the opportunity to read and consider this eight chapter, four appendix, 94 page study.

For the purpose of this Panel Discussion, here are some general comments followed by a brief discussion of the individual sections:

1. The significance of the IRS/ERISA rules on funding and contributions is mentioned only briefly. If the accounting pension expense is inconsistent with the minimum funding requirement, or the deductible limits on contribution, or the full funding limitation, this creates an unpleasant situation that could have severe implications for any employer so involved. There are signs (the FASB Field Test) that this is quite possible.

2. There is no mention that APB 8, November 1966, strongly recommended that the pension expense and the actual pension contribution made to the pension fund be different and that companies, accounting firms and others tried this duality for about five years. This was abandoned in the early 1970's and the prevailing practice, as the text mentions, is that pension expense equals pension contribution. In effect, the accounting profession and their clients tried the system

and abandoned the dual basis for pension expense and pension contribution.

3. The significance of Title IV of ERISA, the PBGC requirements and the PBGC insured vested unfunded liability are ignored. This is important because the liability of the PBGC is real, in the event of pension plan termination, and the use of PBGC actuarial assumptions (in effect at the valuation date) is a useful step in obtaining uniform and consistent reporting.

4. While the FASB can point to a general accounting definition of a liability and argue that there is a pension liability, there is a general accounting precept that no such liability should be adopted unless the users understand and will not be misled. This is a clear instance where this could occur.

5. All the numerical testing is based on one hypothetical test case followed over time. This is akin to a field test of one, with a prescribed plan, investment and actuarial experience and ignores, to a large extent, the real world of pension funding.

6. The relationship of actuarial gains and losses to the self-correcting nature of pension funding mathematics should be mentioned.

7. The study is disappointing in the way it discusses the stability of the Preliminary Views amortization factor missing practical considerations as groups expand and contract.

Chapter I

Background and Introduction

This is an excellent introduction to the subject. The notes at the end of this chapter, and at the end of each of the eight chapters, are quite helpful and form useful background material.

Chapter II

Three Views of Pension Items In An Employer's Balance Sheet

This chapter addresses the question of how defined benefit pension plans should affect the balance sheet of the sponsoring employer. The issue is whether the unfunded amount is a liability in the accounting sense.

View 1 answers in the negative. View 2 answers in the affirmative while View 3 would include the liability in the employers balance sheet but would also include a pension amount on the asset side of the balance sheet. View 1 is correctly identified as the prevailing view. View 2 is referred to as a newer view. For what it is worth, View 3 is even newer, but this is not stated.

Statement of Financial Accounting Concepts No. 3 is given prominence as defining a liability which, in turn, gives rise to the question of a liability for a pension plan in an accounting sense. Unfortunately, there is no reference to the thrust of accounting theory, and accounting definitions, being geared to usefulness and understandability. If a proposal cannot be understood, there is a fundamental failure; and this is, of course, to be avoided.

Note 5 points out that a pension plan provision which affects the employer's commitment has two aspects: the plan can be amended or terminated in the future and the employer's commitment will not exceed the amount of the pension fund. There should be mention of the PBGC liability and the relationship between the lesser of 30 percent of net worth and the PBGC insured vested unfunded liability.

Chapter III

Pension Accounting vs. Pension Funding

The history of this issue is divided into four eras, the last part being APB 8. Under era 2, it is mentioned that "contrary to the conventional wisdom, Actuarial Cost Methods were first used in determining the balance sheet liability in era 2 plans, and hence had an accounting purpose originally." Most plans were pay-as-you-go during the period and, from what I can determine, few introduced a balance sheet liability.

Something is lost in describing era 4 as, "when the employers had the choice, most were willing to fund in accordance with the accounting required by APB 8...." What is missing is that from 1966 until the early 1970's, APB 8 "average" contributions were common in valuation reports. Subsequently, these were dropped as companies preferred that their actual pension contributions equal their pension expense accounting contributions. In effect, employers and accounting firms tried and dropped the dual approach.

There is some guesswork in the following quote:

> Under APB 8 employers are free to choose either the single or the dual approach, and to operate successfully under either. Preliminary Views, though it clearly has the dual orientation, is silent as to funding. It follows that the employer's freedom to choose the single approach continues under PV, provided that the PVAM is "compatible" with the IRS and ERISA rules as to funding.

The Field Test of the Preliminary Views suggests that the pension expense may be outside of the IRA/ERISA range of tax deductible contributions, whereas APB 8 is compatible with IRS/ERISA rules.

Chapter IV

Comparability And Consistency In Pension Accounting

The APB 8 minimum is more than normal cost plus interest, including a provision for vested benefits as well.

It would have been useful to reproduce the following statement and mention the Enrolled Actuary's responsibilities and signed statement on Schedule B (Form 5500) to this effect:

> "...in my opinion the assumptions used in the aggregate (a) are reasonably related to the experience of the plan and to reasonable expectations, and (b) represent my best estimate of anticipated experience under the plan."

The dismissal of the usefulness of pension contribution as a percentage of total U.S.A. payroll is unfortunate. Whether the pension formula is simple or complex, it has been developed to generate a certain percentage objective in terms of final average pay. This suggests that pension costs might be expressed as a percentage of compensation by dividing an employer's total pension cost by total payroll. Companies often budget pension costs this way and several of the funding methods (spread gain) develop normal costs as percentages of payroll. By making this simple calculation, we shortcut a lot of otherwise detailed analyses: costs by type of benefit formula, by type of funding method, by actuarial assumptions, by length of amortization period, and so on. The pension cost expressed as a percentage of payroll will reflect all of these elements and enable relatively simple comparisons of pension costs over various time periods, or comparisons of these costs against those of other employers in a particular industry.

Stability in the Chamber of Commerce study of costs as a percentage of payroll, and other similar studies, confirm this as a useful supporting statistic which should be disclosed, since it rarely can be determined from published financial statements.

Several points about actuarial funding methods recognized under ERISA should be made:

1. They are self-correcting mathematical models. All are equivalent over time in generating the required reserve at retirement.

2. The IRS/ERISA requirements add to the discipline of these specific funding methods by stipulating minimum and maximum amortization periods.

Many readers of the Preliminary Views would disagree with the statement that "the PV makes no attempt to standardize funding" since the employer will prefer, based on the experience of the past, that the pension expense and the actual pension contribution to the fund be as close as possible, if not equal.

It is disappointing that no mention is made in this chapter of the PBGC insured vested unfunded liability because this amount and the ratio of market value to PBGC liability provides a measurement basis that could lead to comparability and consistency in disclosure information.

Chapter V

<u>The Preliminary Views Accounting Method</u>

Equation (1), for the Measurement Valuation Allowance, appears to include an extra term: the amortization factor multiplied by the actuarial gain.

The pension expense is equal to the normal cost plus interest on the unfunded liability plus an amortization term. In effect, it is an approximation to the immediate gain funding method contribution based upon the normal cost plus amortization of the expected unfunded liability less the actuarial gain.

It is disappointing that no reference to the volatility of the Preliminary Views' amortization factor is mentioned. While it is stated that "r can be expected to have a relatively wide range," the impression is left with the reader that it will not in practice. Actually, with surges and decreases in the group covered by a pension plan, this amortization factor can behave erratically.

Chapter VI

Illustrations

This chapter is based on the premise that a hypothetical example of the action of one pension plan over 30 (or more) years is appropriate to illustrate Preliminary Views and several alternatives introduced by the authors. In essence, this is a field test of one plan, atypical at that, and one set of actuarial assumptions. No one in this plan is ever under age 30 and mostly the actuarial assumptions work perfectly.

The authors state that "the funding possibilities are theoretically unlimited, but for the purposes of illustration are reduced to four." This statement ignores ERISA/IRS requirements.

The authors, in Index Pattern D, state that "the employer chooses to fund by the PVAM, a pattern that may become common if the PVAM goes into effect." This ignores the problem of meeting ERISA/IRS requirements for tax deductions if the Preliminary Views became the basis for accounting expense and for making contributions to the plan.

Assuming no gains or losses means the Measurement Valuation Allowance is zero and this assumption doesn't fairly display the Preliminary Views' method. Pages 15-16 do attempt to indicate the effect of a single gain in a single year and a single loss in a different year.

Chapter VII

Critique

It is unfortunate that in several places the authors state an assumption and follow with a statement that this "implies nothing as to our individual opinions." I, for one, would like to know the authors' opinions.

There is a discussion of the importance of actuarial assumptions in the calculations and how this affects comparisons, but no mention of possibly adopting the PBGC assumptions/calculation as solving a good part of the comparability problem.

In a footnote, there is mention that "assuming no deaths or employee withdrawals prior to retirement (very reasonable assumptions under some circumstances)." The operative words are "some circumstances" and a study read by nonactuaries will not realize that such valuations are few in practice.

There are statements conveying precision about the early years of a new plan, or what happens after 30 years, that accurately reflect the one example but should not be generalized.

On the bottom of page 8, a similarity is mentioned between the handling of the MVA, except for the amortization factor, and the "frozen initial liability" method. I don't think this holds, but rather, as mentioned earlier, there is a comparison with an immediate gain contribution involving the expected unfunded liability.

Chapter VIII

Suggestions

This chapter contains some alternative approaches involving 1/15 or 1/30 amortization factors and two methods with assets/liabilities on the balance sheet and two methods without such additions. The last is close to the APB 8 contribution.

Appendices

Since the one example figures so prominently, the description of the hypothetical pension plan and the actuarial assumptions, both in Appendix B, should be reviewed.

Reviewer's Conclusion

The Financial Accounting Standards Board's rule-making body is at odds on the issue of accounting for pension plan expense with most of the accounting firms and most of the clients of these firms. By not expressing their preferences on this issue and by presenting alternatives, several of which are close to the proposal being analyzed, the authors have succeeded not so much in defusing a difficult situation (surely their intention), but in presenting something for everyone. For it or against it, you will find something of value in this well-written, interesting study.

JOSEPH POPLASKI: I'm just wondering if anyone did any kind of investigation into sensitivity? We all know these liabilities are driven by our assumptions. Has any consideration been made of what, for example, the effect of a 1% change in the interest rate would do to the liabilities as being better disclosure information on really how sound the plan is.

MR. GERBOTH: I think there was some recognition of that given in the Board's field test that Bob referred to earlier. I don't know how, off the top of my head I can't remember, how extensive that sensitivity analysis was, how well it was done, but there was some attempt to recognize it and to quantify it. Again, I'll leave to you to evaluate the success with which they did their evaluation and analysis.

MR. BERIN: I'm not a particular fan of that kind of a project, telling you something meaningful about either the stability or the cause of the insolvency of the plan. From 1935 to 1970, Social Security used the minimum and maximum range to define their contributions and this worked well. For a few years starting in 1971 they dropped it for sensitivity testing, after which the minimum and maximum approach was resumed. The sensitivity testing really depends upon the person making the test and having enough stated conditions and goals to make it meaningful. IRS and ERISA define a range of contributions.

There is a good index developed in this paper and in submissions to the Board, which is very simple: actual pension contributions in the U.S.A. divided by actual U.S.A. payroll for everybody. It turns out to be quite a stable number.

PRESTON C. BASSETT: Bob, one of the gentlemen mentioned that the Conference of Actuaries in Public Practice has developed a counter-proposal for what the FASB is proposing. Has that had general support from our profession, has it been widely distributed, who is backing it, where does it stand, does the FASB think that this is what we are in favor of? I don't know much about it.

MR. MCGINN: I don't have any up-to-date information, but it was sponsored by the Conference and was distributed, I believe, to all of the members of the Conference and the American Academy of Actuaries with a questionnaire, that asked their views and so forth. I don't have the statistics, but I have seen them, and the overwhelming statistics were in favor. The biggest problem that was stated related to small plans and the degree of disclosure information that this disclosure package implied and how it might impact the smaller plans. I must admit, I have not seen an update of it since last September when I saw the first results of it, but I do believe that the Chairman of the Pension Committee for the Conference actually distributed this information to the FASB at the January hearings, but I am not positive of that.

MR. BASSETT: Was the comment made that this had the general support of the profession?

MR. MCGINN: I believe so. The overwhelming reaction was favorable.

MR. BERIN: If you think about it, the FASB is the rule-making body for the accounting profession, an elite group, in the nice sense not in the derogatory sense, but they have painted themselves into a corner. They have made a proposal that the majority of accountants and the majority of their clients and the majority of outside firms such as represented here are opposed to. The important thing is to give them a sensible way out of this, as an alternate. So the actuarial profession hasn't simply said that you are intruding on our areas and that you are doing it very badly. They have said that, but they have said other things such as here is a sensible way to resolve the differences. The fascinating question is will the FASB compromise. We simply don't know the answer.

NATHAN MOSCOVITCH: This question of disclosure has some fascinating aspects to it. We had an instance in Chicago a few months ago, where the Chicago Transit Authority pension plan was the subject of both union negotiations and legislation in the state legislature that was rather a "hot" situation. In the course of this, the Chicago Tribune printed an editorial in which they picked up a statement that was made in the audit report, the footnote about the present value of accumulated benefits. In this report it was stated that the market value of the assets of the plan were 135% of the present value of accumulated benefits and therefore this plan was way overfunded and the rest of it you can tell from there.

Now it seems to me that this kind of disclosure is pretty bad for the whole situation, due to the fact that the plan was being funded in a fairly adequate way with a funding period of something like 20 to 25 years and so on. I am curious to know whether anybody else has run into this kind of thing and whether there isn't something that we as actuaries perhaps ought to do to see to it that the kinds of disclosure that get made are more realistic and more to the point.

MR. BERIN: Unfortunately, you are describing most probably the FASB statements 35 and 36 statistic which is widely distributed in the United States. When it issued those statements, the FASB tightened up a bit the old APB 8 calculation and unfortunately did nothing to shed any light on the actuarial assumptions that would be used in that particular calculation. One could argue that it is closer to a termination liability. The burden is on the reader unless there is sufficient text.

MR. MCGINN: I have a comment that might be of some value. One of the ideas of the Conference Pension Committee was to see if we could convince all the enrolled actuaries to attach this disclosure statement to Schedule B and make that sort of a mandatory attachment; otherwise, it would never see the light of day since the accountants always look to market values and a good many actuaries don't use market values, they use actuarial value of assets. Perhaps with an averaging process, that information would have shown the contrary situation in Chicago that maybe the benefits were fully funded or almost funded but not overfunded. I think that is one of the great problems with using the full market value personally and most of the trust funds that we are involved with will not use market value. They use, I think because of our recommendations, an actuarial value, so we do have some averaging. We don't use this measurement valuation allowance technique, we just do it directly.

MR. BERIN: For an example, I believe that AT&T, in their footnotes showing that statistic, qualifies it quite extensively and hopefully the people in Chicago will begin to qualify.

MR. GERBOTH: This particular problem you described, that of taking two numbers and comparing them and coming up with erroneous conclusions based on them, would, in fact, be exacerbated if the Board goes ahead with this proposal to put these numbers on the balance sheet, because that will give greater focus to just two of many numbers that an intelligent person trying to evaluate the status of a pension plan should have available and be aware of. This was the kind of thought that I had in mind, when I suggested that you can usually do a better job of disclosing complex information if you focus the disclosure on the footnote rather than on something that goes into the balance sheet, because what goes into the balance sheet obviously is limited to a number or two and that gives the particular numbers that find their way onto the balance sheet an emphasis that they don't deserve. Obviously even footnotes are limited in their ability to communicate a great deal of complex information but certainly they can do that kind of job much better than can a balance sheet presentation without the misplaced emphasis that the latter would carry with it.

MR. SINGLETON: I think the question of emphasis is an important one here. One thing to remember is that if the FASB's proposal is adopted there will be liability information in the financial statements but that does not mean that the disclosure would not follow as well. So I think it would provide a continued opportunity to make qualitative judgments about other effects on the pension liability in addition to a simple analysis of the number itself.

I listen to this situation and I wonder whether the kind of information that you are talking about in this particular case is not at least useful on a relative basis. True it is a snapshot, it is a picture of the status of the plan based on one measurement technique at a point in time. Maybe from an actuarial perspective, the plan was not significantly overfunded, but certainly the kind of information you are referring to would be meaningful in a comparative analysis with other similar plans at that point in time and certainly there would be some underlying information value in what was presented.

MR. GERBOTH: It is true that a number put on the balance sheet could have some qualifications which would remove some of the stain from it. That puts me in mind of somebody else's observation, that it is a bit like taking a tranquilized skunk to the opera: if the skunk is sufficiently tranquilized it won't do any harm, but that doesn't change the fact that the beast shouldn't be there to begin with.