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FASB DISCUSSION MEMORANDUM—AN UPDATE

Moderator: CRAIG A. OLNEY. Panelists: MICHAEL J. GULOTTA, PAUL B.W. MILLER, CHARLES L. TROWBRIDGE. Recorder: ROBERT F. DROZD*

This session will focus on the FASB Discussion Memorandum regarding the accounting of pension and other post-employment benefits. It will include an update on any FASB action and then will consider the responsibilities of:

- Accountants
- Plan sponsors
- Actuaries

MR. CRAIG A. OLNEY: I would like to introduce our panel in the reverse order of appearance, starting with myself. I'm Craig Olney, managing principal of A. S. Hansen's Milwaukee Office, and I will be talking on the other post-retirement benefits. The largest one being post-retirement medical care which, to my mind, might have a bigger impact on employers and their balance sheets than all of the pension plan discussions that have taken place.

Next to last will be Mr. Trowbridge, who has written a monograph with Ernest Hicks on the Preliminary Views Discussion Memorandum, a quite reasoned approach, offering four alternatives to the approach discussed in the Preliminary Views.

Mike Gulotta was recently appointed chief actuary of AT&T. He's chairman of the Financial Executive Institute (FEI) employee benefits subcommittee on pensions. He has testified before the FASB on behalf of the FEI on the Discussion Memorandum. His talk will be on the plan sponsor's perception of the Discussion Memorandum, giving a little bit of background; the impact on AT&T specifically; and then AT&T's views.

First to speak on the panel will be Paul Miller, whose primary interest, I believe, is in the area of politics and the role of standards setting at these various units. He has served 15 months with the FASB working on a Conceptual Framework Project.

MR. PAUL B. W. MILLER: To understand what the FASB has done, it would be helpful to have some history of the problems that pension accounting has created for accountants and users of financial statements over the last

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four or five decades. There is indeed a long history of controversy and a long history of authoritative literature providing guidance to accountants concerning pension costs, pension liabilities and other associated financial statement elements. The first authoritative pronouncement was something called Accounting Research Bulletin (ARB) 36, issued in 1948, which said basically that if you have unfunded annuities for past costs, they can be expensed over the future rather than being charged directly against stockholders' equity. That created a pattern for expensing events of the past over the future that accountants have stayed with since then. This particular bulletin was restated seven years later in Bulletin 43, with no change, but it was endorsed as being suitable accounting at that point. Some three years later another bulletin, No. 47, dealt with the vested benefit liability and indicated that it should be placed on the balance sheet with additional disclosure in the footnotes. That constituted generally accepted treatment of pensions for about 10 years when Opinion 8 was issued by a new authoritative body, the Accounting Principles Board (APB).

Opinion 8, speaking of politics, came out of a deeply divided board. In fact, it was so deeply divided that it endorsed two widely divergent views. One view said there was virtually no expense associated with pensions other than interest on any unfunded liability; whereas another group said there was certainly an expense factor related to the future benefits that were to be paid. Opinion 8 stated that either of these views would work. That's politics, folks. That's all it is. There was a substantial amount of footnote disclosure provided under Opinion 8 and some presentation in the balance sheet elements. An asset or liability could be presented, but both were far smaller than the total plan assets or the total obligation under pension. If past service costs were to be amortized over relatively long periods, there was very little direct guidance as to how long that would be. Generally, at least 12 years, but we find in practice 30 or 40 years, so that past costs are spread over long periods in the future.

In 1980, we again find a new authoritative body, the Financial Accounting Standards Board (FASB), dealing with pensions. In their statement No. 36 issued in that year, there was more footnote disclosure, but no change in what was presented in the balance sheet or the income statement. Significantly, the additional disclosure called for presentation of a measure of the nonvested benefits and market value of the assets. Interestingly enough, this statement had an aside that said this statement is only an interim step on the way to a more complete treatment. That was some four years ago when we were at an interim.

The legislative history of pensions shows that the issues have been very difficult. They've lasted over 35 years; they've outlived two authoritative bodies in accounting. In the view of more than a few observers, pension accounting issues will probably outlive the FASB. Some people have even said that it might speed up the demise of the FASB. In short, there are no easy solutions to these issues. Anyone who thinks they have an easy answer is misled and perhaps causing more difficulty than making a contribution. High stakes are involved in pension accounting because of large numbers. We're also finding some high stakes in terms of political influence over the outcome of the standards setting process in general. With respect to recent developments, the FASB has published a couple of documents in the last two years, Preliminary Views. I was at the Board when that was being prepared, but was not in on the deliberations that led to it. I do know that there was a great deal of discussion as to what to call it. Tentative Conclusions was considered too concrete, so they came up with an alternative of Preliminary Views. What that's emphasizing is the sensitivity associated with these issues and the difficulty of resolving them in a manner that's amicable.

The Preliminary Views document was intended to stimulate discussion. It was prior to the official step of an exposure draft, which is really an early version of a final pronouncement. It's an unusual step, but because of the issues, it was considered to be appropriate. A couple of main features of Preliminary Views, that I think will be discussed at length by some of the others: it would call for presentation on the balance sheet of a net liability or net asset, depending on the relationship of funding to the total obligation; it would also call for recognition of an intangible asset, for want of a better name, called informally "pension goodwill", corresponding to the economic value obtained by promising to pay employees for past service. Pension goodwill is probably as good a name as any. The expense would have four factors involved in it: interest on the total obligation, normal cost, amortization of this goodwill and would be reduced by any income from the plan assets, including changes in market value. Preliminary Views proposed a single actuarial method for calculations of the liability, and it also proposed an innovative means of smoothing out actuarial gains and losses. Some have said it's so innovative that it's better described as bizarre, but that's only an accounting joke. A discussion memorandum, which is a more typical kind of document also intended to solicit comments, was issued by the board in 1983. It got into a number of issues that were not addressed in Preliminary Views, one of which was post-employment benefits, which Craig will be talking about later.

Both of these documents were intended to solicit comments and I can say that they were very successful in soliciting comments at the hearings that took place in January. Like all FASB projects, most of the comments received were objections. As a rule of thumb, 90% of responses on any issues that the board presents to the public are objections to the Board's presentation. In this case, the percentage was probably higher than 90% and somewhat stronger, more pervasive and many of them were actually very ineffective because of the strength of their complaints. This particular project generated a kind of response that is very ineffective - a number of people sending identical letters. This doesn't work. In summary, the FASB ran some ideas up the flagpole, not very many people saluted, in fact, a lot of people showed up with chainsaws to cut it down.

I talked with Tim Lucas, Project Manager, just about a week and a half ago, and got a briefing on the current thinking of the Board, which takes quite awhile. I want to summarize it. Other post-employment benefits are now a separate project. Craig indicated that there are some very large amounts there. I think that's true from all that I understand. Furthermore, the accounting is presently on a pay-as-you-go basis for most companies, with the result that a change from pay-as-you-go to some accrual method is going to produce a very large change; whereas for pensions that have been accounted for somewhat on an accrual basis, the change described here in Preliminary Views is probably not as large as that particular one. Some have questioned the measurability of the amounts associated with post-employment benefits. Tim stated his personal opinion, and I agree with it, that any number for a liability is more defensible and sensible than reporting zero. That, of course, is not an official Board position.

With respect to the pension project itself, the board is beginning a series of meetings to tackle the issues. It meets every week, and from what Tim had to say, about every other week there will be some pension issues on the agenda. They plan to meet regularly over the summer and an exposure draft officially is to be published by the end of 1984. Tim indicates it's unlikely that it would be any sooner than that, with some probability of it being later. That's certainly consistent with the record. As an overview by Tim, I solicited at least one simple comment from him: it's inconceivable that either the status quo will remain intact or that Preliminary Views will be adopted as originally proposed. So we can look forward to some sort of change, but it probably will not be to the extent of Preliminary Views.

With respect to the issue of whether a liability should be recognized, the board is split. There are seven members; according to Tim the split is 2, 2, 2 and 1: 2 yes, 2 no, 2 maybe and the chairman is saying "There's a lot of good points". There is some likelihood, I'm not going to go out on that limb very far, that vested benefits will be accepted as a suitable compromise from the Preliminary Views and the status quo, which gets us back to ARB 47, in effect. Some are interested in doing more to buffer the income statement against the volatile expense. That's a significant issue with preparers of financial statements. An answer that's being discussed is nonarticulation. Without getting technical, basically what that means is some portion of the expense would go around the income statement, directly to the stockholders' equity. That's the news in foreign currency translation and one or two other areas in generally accepted accounting.

There is a great deal of interest in keeping one actuarial method, although it's not necessarily the one described in Preliminary Views. I don't know which alternatives are popular. I deliberately asked Tim not to tell me for fear that I would embarass myself talking to you about them. There is some interest in reducing the amortization period for past service costs. As I indicated before, APB No. 8 is somewhat vague, with the result that many preparers have adopted fairly long amortization periods. The Board is leaning toward something similar to the Preliminary Views that would tie the amortization period to the work life of individuals and would be related to a specific employee population rather than an overall number that would apply to all companies. It's clear that the footnote will be expanded and changed from its present configuration. The specific points to be covered in the footnote will depend on what ends up in the financial statements.

Craig asked me to express an accountant's view. I will give you this accountant's views. I am not speaking here as a representative of the Board or of anyone other than myself. My conceptual preference, which is one of three levels of my views, is that we should: put the best measure of the full liability on the balance sheet; put plan assets on the other side of the balance sheet; recognize something like pension goodwill, but amortize it fairly quickly - something corresponding to the useful life of the goodwill, not the useful life of the employee - which means, I suppose, five minutes or infinity, whichever comes first. I'm not really sure how much past service costs provide future benefits, but I would prefer a relatively short period for that. My own view with respect to volatile expenses and volatile income is if that's what's happening, the users ought to know about it. Then, if they want it smooth, they can do the smoothing. Now I am somewhat of a radical in my view of accounting, but I'm a professor and that's what I'm paid to be.

I can propose, at another level, a pragmatic compromise very much along the lines the Board is leaning. Let the expense be smooth, but provide plenty of disclosure so that sophisticated users can do unsmoothing. Go with vested benefits, put the plan assets on the balance sheet, put goodwill on the balance sheet, and provide lots and lots of footnote disclosure. That's probably what we're going to end up with.

Now at a third level I want to give you a political observation and read a quotation. It says, "The Committee believes that accountants opinions about accounting for pension costs does not yet crystallize sufficiently to make it possible, at this time, to assure agreement on any one method, and the differences are likely to continue for a time." Unfortunately, that's a quote from ARB 47 and it's 28 years old. Accountants have disagreed long enough, and I think it's time we move forward. The political process that the FASB is wrapped up in has proven to be very effective in protecting the status quo, and that process is not going to give up. So it's going to take some more time, but I think time is about to run out.

MR. OLNEY: Thank you Paul. I'd like to introduce Mike, who will now give a little more of the background on the Discussion Memorandum and then a plan sponsor's views toward what should happen.

MR. MICHAEL J. GULOTTA: I'm pleased to be here to discuss the FASB's work on pensions and other post-employment benefits. As Paul said, there are two projects now. In my mind, the project in the area of pensions is probably the single most important development in the area of defined benefit pension plans since ERISA. The project can significantly change the way employers account for pensions, specifically: the way these obligations are recognized, balance sheet disclosures, balance sheet recognition, and the way that net income is determined. The project can also impact the way employers view defined benefit pension plans and what role defined benefit pension plans play in a company's compensation program. As Craig indicated, I'm going to give some more background on the Preliminary Views and, in addition, I'll be providing AT&T's position, which I might add, is a position that is not dissimilar from the position that's been expressed by other companies.

The FASB's projects on employer accounting cover three major issues. First, balance sheet recognition of pension obligations is one of the areas being considered by the Board. Second, how pension expense should be determined. Lastly, now a separate project because it is so important, is how to account for other post-employment benefits, including post-retirement group life insurance and post-retirement group health insurance. I might add that the Board's conclusions with respect to other post-employment benefits are also going to have a very significant impact how these post-employment benefit programs are put together by employers in the future. Currently, we're essentially on a pay-as-you-go basis for most of these programs. If one were to accrue on an actuarial basis, i.e., accruing in advance over the active working lifetime of the employees, the expense will increase very, very significantly and impact net income.

With respect to balance sheet recognition, the Preliminary Views proposes that a net pension liability, and it could turn out to be an asset, would be equal to the actuarial present value of accumulated plan benefits, which is essentially the number that is disclosed currently in FASB 36 except that a salary scale would be added. From that actuarial present value we would subtract the market value of assets, then there would be a further adjustment called the measurement valuation allowance. The measurement valuation allowance is the unamortized actuarial gain or loss or the unamortized change in the accrued liability resulting from a change in actuarial assumptions. Off-setting the liability would be an intangible asset and there are various transition approaches that a plan sponsor could take if the Preliminary Views are implemented. One is the Prospective Transition Approach. If one has a liability, offsetting that liability would be an intangible asset, call it employer goodwill. However, if the Preliminary Views were implemented, then when a plan was amended and past service credit was granted, the present value of accumulated plan benefits would be increased, and in order not to immediately impact the balance sheet, an offsetting intangible asset would be placed on the balance sheet. As I mentioned earlier, there could be a net pension asset if the market value of assets exceeded the accumulated plan benefit present values. A net asset would be shown on the balance sheet offset by a deferred asset, or maybe we'll call it employer badwill.

As far as the determination of pension expense is concerned, the Board's proposal in Preliminary Views is that one actuarial method would be used by all. The FASB's choice is the Projected Unit Credit Method with a service prorate. The amortization of the intangible asset and the measurement valuation allowance would be done much more quickly than is currently the practice under APB 8 and ERISA.

With respect to post-employment benefits, final standards are to be issued in a separate project. The Board was concerned that when post-employment benefits was part of the pension project, it was not getting the attention that it really deserved. Since it can have such a significant impact on expense going forward, and possibly on the balance sheet, the Board decided to split the project into two projects which would proceed concurrently.

In my opinion, the Board will probably require accrual over the active service lifetime on an actuarial basis of certain post-employment benefit costs. Costs of post-employment benefits include group life and group health, etc. I personally don't believe, at least on a conceptual basis, that very good arguments have been advanced against accrual on an actuarial basis. There are some practical problems to be addressed; but conceptually, there aren't many strong arguments against recognizing these costs over the active working lifetime of employees. The Board has not gotten to this point yet, but if the Board took the next step of saying there is a liability which is recognizable on the balance sheet, and to date the Board has only addressed the expense portion of this problem, there could be a very, very significant impact on balance sheets.

Finally, I have one more comment on accounting for other post-employment benefits. From a practical point of view, there are some very unique problems in quantifying present values. I would tend to agree that some number is better than no number at all, but there are so many variables in measuring the present value of post-retirement group health insurance. For example, to tick off a couple of them: the rate of inflation in medical care, which in some years was double-digit and in other years, as in 1983 as measured by CPI, was less than 7%. Over the 30 years ending in 1983 it was about 6%, yet at the end of the 1970's it was double-digit. Then there are problems with respect to what part of the cost of medical care will Medicare bear going forward. So there are some very unique problems in quantifying present values of health insurance which do not exist in measuring present values of post-retirement pension benefits.

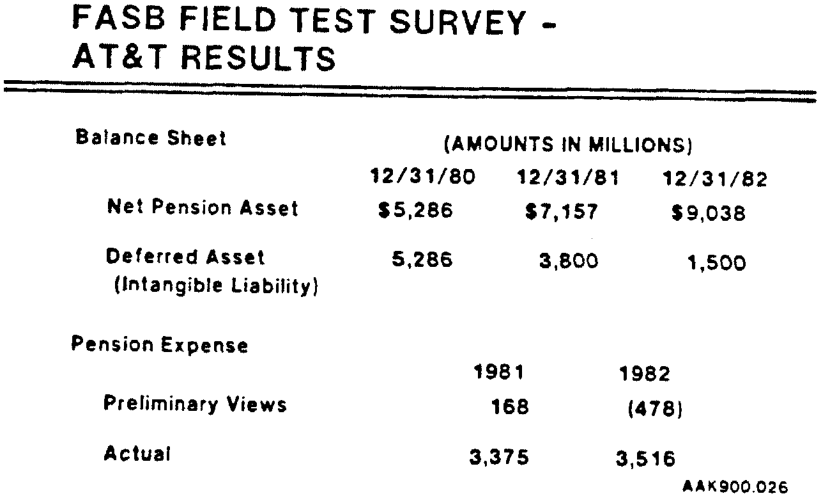
The problem with the FASB approach from AT&T's point of view is that the FASB rejects commonly used methods of determining pension expense. Entry Age Normal would not be permitted for expense determination purposes nor would Aggregate, Attained Age Normal, etc. The Board adopts one method and one method only, that's Projected Unit Credit. This method, with respect to an individual, charges less now, more later. There is a great volatility of expense with the approach that is outlined in the Preliminary Views, much more than corporate America likes to see in pension expense. Corporate America also feels it is unjustified volatility.

The Preliminary Views essentially reverses management's prior policies of expensing for pensions. Let me expand upon that. If you consider for the moment that liability on the balance sheet would be equal to the present value of accumulated plan benefits over the market value of assets and offsetting that would be an intangible asset, well that intangible asset will be amortized to expense, increasing expense going forward. Thus, the result is that the FASB is concluding that employers have not expensed enough in the past. That excess of accumulated plan benefits or liability over the accumulated assets must be made up going forward. Likewise, if the reverse situation occurs, that is, an excess of assets over the accumulated plan benefit present values, there would be a deferred asset which would be amortized to reduce expense going forward so that if the funds accumulated exceeded the present value of accumulated plan benefits, you're essentially reversing that accumulation of expense in the future.

In the past, we've rejected the use of Unit Credit and current market value in determining pension expense because of a number of considerations and a number of concerns: First, from a regulatory point of view, we felt that the method does not allocate the costs of pensions properly over the generations of rate payers. Second, with respect to funding, a problem with the Preliminary Views is that if the Preliminary Views were adopted in their current form, there would be a significant impact on the funding of pension plans. Specifically, I would venture to guess that there may be a decreased level of funding in those cases where the assets at the time of the implementation of the Preliminary Views exceeded the accumulated plan benefits. Of course, this could impact the exposure to the Pension Benefit Guaranty Corporation and we should be concerned about that. Another concern is a budgeting concern. With the volatility of expense, budgeting becomes very difficult. In the cases in which there is an excess of accumulated plan benefits over assets, there could be an impact on debt/equity ratios and even a violation of loan covenants.

To determine the balance sheet and the net income statement impact of Preliminary Views, a field test survey was performed in cooperation with the Financial Executives Institute. Participating in that field test survey were 40 large defined benefit pension plans. The results in general were that most companies would have a net pension liability but there would be lower expense charged to the income statement.

Here are the AT&T results in the field test survey.



FASB FIELD TEST SURVEY - AT&T RESULTS

Balance Sheet	(AMOUNTS IN MILLIONS)		
	12/31/80	12/31/81	12/31/82
Net Pension Asset	$5,286	$7,157	$9,038
Deferred Asset (Intangible Liability)	5,286	3,800	1,500

Pension Expense	1981	1982
Preliminary Views	168	(478)
Actual	3,375	3,516

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If the Preliminary Views were implemented on December 31, 1980, we would have had a net pension asset of about $5.3 billion dollars. This would have been offset by an intangible liability, a deferred asset of an equal amount because we would have chosen to use the Prospective Transition Method, of $5.3 billion dollars. That $5.3 billion dollar net pension asset would have increased to $9 billion dollars by the end of 1982, partly because of the fact that during that period we continued to fund using the Aggregate Cost Method. The deferred asset would decline from $5.3 billion to $1.5 billion, primarily because of plan amendments granted during that period. A very significant item is pension expense. Actual pension expense for AT&T and all the Bell System companies, including Western Electric and Bell Laboratories, etc. and all of its subsidiaries, was approximately $3.4 billion dollars in 1981. Under Preliminary Views it would have been $168 million or about 5% of the actual expense. In 1982 the actual expense was $3.5 billion, while under Preliminary Views, a profit from the pension plan of about $500 million would have arisen. That's a $4 billion swing in expense. We're not unique in this regard, others have also reported income, but not to that extent, under Preliminary Views.

Preliminary Views was issued in November, 1982. There was a second Discussion Memorandum covering defined contribution plans, and multi-employer plans and plans other than U.S. plans, issued in April, 1983. A field test survey was done in the fall of 1983, and of course, public hearings were held in January, 1984.

At those public hearings there were 59 presentations made. The hearings went on for five days. Presentations were made by all of the big eight accounting firms, with seven generally opposed to Preliminary Views. A number of industry groups appeared, most notably the Business Roundtable, FEI, and the ERISA Industry Committee, all opposing the Preliminary Views. A number of corporations including IBM, GM, AT&T, as well as actuarial firms, made presentations at those public hearings.

We felt that it wasn't enough to voice our disagreement with the Preliminary Views. That's clearly inadequate and not at all constructive. We felt that we needed to propose an alternative. We did oppose balance sheet recognition and the mandated use of one actuarial cost method, but we went on to propose that the solution is increased disclosure. We did not object to the FASB's concern that current accounting for pensions is inadequate. It is inadequate. However, we did not believe that balance sheet recognition or the use of one method was either conceptually appropriate or necessary. We gave the FASB a specific set of disclosures which we thought would enhance comparability, and in AT&T's 1983 annual report, we implemented that proposal.

The questioning by the Board at the public hearings, in my opinion, was looking for a middle ground. The status quo was clearly not appropriate, but Preliminary Views was meeting with considerable objection.

The FASB's current timetable calls for an exposure draft in late 1984. However, the ED probably will not be published by then. A final standard is currently scheduled for 1985. I think both projects, the pension project and the post-employment benefits project, are two extremely important projects to all corporate America, to actuaries, and to accountants, and I think actuaries and accountants should continue dialog on this subject. Hopefully, we will jointly resolve the current problem of inadequate accounting for pensions.

MR. OLNEY: Next I would like to introduce Mr. Trowbridge, who has written a response to the Preliminary Views, a quite reasonable response, giving four alternatives.

MR. TROWBRIDGE: I take this opportunity to make actuaries aware of a monograph, in course of preparation, which will be an analysis and a critique of the FASB's Preliminary Views. We now have what one might call an exposure draft, circulated, but not very widely, for comment.

This monograph, written by Mr. Ernest Hicks and myself, will be published later this year under the joint sponsorship of the Actuarial Education and Research Fund (AERF) and the Pension Research Council. Mr. Hicks is a CPA, now a professor of accounting at Ohio State University, who in the mid-1960's authored the study which led to the issuance of APB 8, the current standard for pension accounting. My own long-time interest in pension accounting evolved from an earlier interest in pension funding.

The purpose of the Hicks-Trowbridge effort is neither to attack the PV nor to defend it. Rather, the purpose is to narrow the differences between Preliminary Views and its critics. The authors eventually make some suggestions as to how the Preliminary Views Accounting Method (PVAM) may be modified to make it more acceptable.

After an introductory section three chapters are devoted to a discussion of three important issues raised by PV. The first of these is the question of showing a pension related liability on the employer's balance sheet. The second is the relationship between pension accounting and pension funding. The third is the issue of comparability, the basis for the FASB's recommendation that Pension accounting be standardized.

Chapters 5, 6 and 7 make up a technical analysis of the PVAM. Chapter 5 is largely explanatory, Chapter 6 is illustrative, and Chapter 7 is a critique. We find that the most important deficiencies in the PV method arise from the very rapid recognition of the initial past service liability, resulting in a steep cost curve and an incompatability between the PVAM and IRS and ERISA rules as to funding.

Finally Chapter 8 offers the authors suggestions as to how the PVAM might be modified, to make the method more acceptable, but at the same time meeting many of the FASB objectives. There are four of these "alternatives" in all, ranging from the first, which accepts most of the PVAM, to the last, which accepts almost none of it. We're trying to be as constructive as we can with the PV and yet we're trying to modify it in ways that will make it more possible for people to accept.

The status at the moment, as I stated, is that we do have a draft of it. It is out for comment. We aren't distributing it widely and I can't offer it to people who just might be interested. The actuaries that actually have it at the moment are either those who are on the Pension Research

Council or the AERF Board, two of our sponsoring institutions, and members of the Board of the Council of the Pension Section of the Society of Actuaries, of which I am Chairman. The most important place we put it at the moment, is with Tim Lucas. Tim has made a preliminary response to it and seems to be taking it seriously. We'll be having continuing dialog with him which is just starting.

What effect it will have I'm not going to say. We very deliberately didn't make it a part of the January hearings. We're not in the position of advocating anything, we're just trying to bring some sense out of what I think is presently chaos.

MR. OLNEY: One of the items that almost seemed to be a tail-end thought was post-employment benefits. As I said at the beginning of this panel, this has the biggest potential for really impacting balance sheets, expense accruals, etc., especially after studies that we have performed for some major clients. First I'd like to go through what has happened at the discussion that took place at the FASB at the beginning of this year.

The responses towards this particular portion of the Discussion Memorandum ran about 50-50. Unlike what Paul had said, 80-90% against, on this particular issue it was about 50-50 whether benefits should be accrued or not. Almost all the accountants, actuaries and academicians said that these benefits should be accrued in some manner, and after that point disagreed widely in what that manner should be, but they seem to have some agreement on the problem of measurement of this liability.

For industry, about one-third agreed that the benefits should be accrued in some manner or the other. Two-thirds of the industry said no, it should not be accrued. The primary reason, I understand, is that it's not a liability. The industry's saying that while we're providing these benefits and have no intention of stopping them; tomorrow, should we want to, we can step in there and tell the retiree that we can stop his benefit. Now, I'm not too sure I agree with that, nor am I sure that causes it to not be a liability.

I would like to give you what the Academy of Actuaries, in their response to the Discussion Memorandum, said on Issues 19 and 20. The Academy agreed that there are sufficient differences between pensions and other post-employment benefits to justify treating the latter as a separate project. But then they went on to say it is their tentative conclusion that the cost of other benefits should be accrued in a manner consistent with current accounting for pensions, however, much more research needs to be completed on the nature of these obligations: the degree of employer discretion with respect to the termination of these benefits; the measurement problems including the extent to which anticipated future cost escalation should be recognized. Further, when the Board has reached tentative conclusions they should be subject to extensive field testing before any substantial change in accounting requirements is proposed. In line with this, in a report that the American Academy of Actuaries task force on post-retirement life and health benefits prepared, findings are that there has been a failure to recognize the future costs of post-retirement welfare benefits in the financial statements of many corporations. I'd like to point out there are corporations who now are recognizing post-employment medical benefits on the balance sheets. The nature of corporate obligations for these benefits varies but some obligations are permanent enough to warrant advanced cost recognition and the recommendation was that the Academy Subcommittee on Accounting Matters now advance this project to the point of developing an opinion on the principles and practices for accruing the cost of these benefits.

Yesterday, I talked to the FASB about how this project is going. It has been spun off into a separate project, recognizing the importance of the item, to be headed by Betsy Cropsey at the FASB. It was formed into a separate project February 8 of this year and will go on concurrent with the pension project. In addition, there are several Board members that consider this project of prime importance, and it is extremely important, as important as the pension problem, probably more important. Betsy is to finalize the project schedule by June 30, 1984. This schedule should include whether or not they're going to have exposure drafts, discussion memorandums, preliminary views, tentative conclusions, or whatever. Just because the schedule to get the schedule is not to be completed until June 30 doesn't mean that they're not working on it right now. There is concern over whether a benefit can be stopped. They are looking at what's happened in cases where employers have actually curtailed post-employment benefits. They are also working with some attorneys, looking at the law with regard to these benefits.

A second problem: can it be measured and really how do you measure it? This involves both post-employment life insurance benefits and post-employment medical benefits. For post-employment life insurance benefits there doesn't seem to be much of a problem. In fact, many are already pre-funding or pre-accruing post-employment life insurance benefits through pension plans. The medical is an entirely different animal. As Mike was saying, there are several variables involved that have definite impact on the costs; only a few of which we have good handles on. I'll get more into that in a project and give you some results where we actually tried to put a liability on the post-employment benefits. In addition, the Financial Executives Institute Research Committee Foundation has funded a project on this benefit, with Coopers & Lybrand working on the modeling and Hewitt on the survey of post-employment benefits: What are they and what can we do with them?

Mike could you add any more to that?

MR. GULOTTA: They have been working on the project for almost a year now. Initially, it was intended that it be done very quickly and conclusions presented at the public hearings. That did not work out. It is a very, very involved project and requires the resources of two researchers. Coopers & Lybrand had been involved extensively in the FASB pension project, doing a research study on the field test survey, and are now involved in this one. Hewitt Associates is also currently involved. I think the decision was made to include Hewitt because they have a database on post-employment group health insurance benefits.

MR. OLNEY: Do you have any idea when the results will be out?

MR. GULOTTA: No, I have no idea.

MR. OLNEY: But the Board is continuing with the study and hopefully will have something a little bit more concrete as to the schedule to complete this project by the end of the second quarter.

Next, I would like to go into what impact this particular project could have on employers, either through the accruing of expense for post-employment benefits prior to the actual retirement of the employee, or the impact on the balance sheet should the liabilities for these benefits have to be placed on the balance sheet. To start, I'd like to say there are several industries where this cost, even on a pay-as-you-go basis, is of major importance. There are some industries I'm working with, a rubber industry in particular, where there is one retiree for every active employee. There's a steel industry that has undergone extensive layoffs where they have four to five retirees for every employee. There are some industries that are really at a low ebb, as far as active employees go, where there are up to ten retirees for every active employee. You can imagine that even on a pay-as-you-go basis, the medical costs are uncontrollable. It's making the industry, for the mere fact of the post-employment medical benefits, non-competitive.

What is disturbing is that these benefits were given away, literally, during negotiations. I'm not sure the corporate sponsors had any idea what they were doing; what the expense of these benefits were. In fact, one client gave it away in lieu of a small increase in the pension plan. They knew what the increase in the pension plan would cost, and the impact it would have on the bottom line in the year that they were negotiating. They felt that there would be no impact on the "bottom line" for this post-employment medical benefit so why not give it to them. The result of that negotiation, and this is a major company, is that if we were to review the liability for that give-away, it would completely wipe out their net worth last year.

An actual study was completed in the early part of 1982, before the Discussion Memorandum came out, based on data in 1981 using assumptions that appeared reasonable in the early part of 1982, which might not appear reasonable now with inflation a little bit better under control. It was a study of the retirees, solely the retirees, not the active employees. The average age of the retiree in this group was about 71. The average spouse was 67. There were some dependents in this post-employment benefit and the average age there was 20. This was a typical womb-to-tomb type medical benefit. First dollar coverage, basic plus major medical and a continuation of the active coverage after retirement with adjustment for Medicare reimbursement, which is important. Of these retirees, 20% were less than age 65, of the spouses, 40% were less than age 65. The average cost on a pay-as-you-go basis for each retiree in 1981 was $551 reflecting the Medicare reimbursement. The average cost per spouse was $732, much higher, probably reflective of the significant number of spouses that were less than age 65 and not eligible for the reimbursement. In this group there were 1,933 retirees, 1,279 spouses and I couldn't find the number of dependents, but it was not a significant number. The cash flow in 1981 on a pay-as-you-go basis for this group was $2.3 million dollars.

We looked at the variables that would have an impact on costs. The easy one is mortality - that's no problem, we just use the GA 1971. Sex -

that's pretty much a given. What surprised me was the cost between male/female from our health insurance actuaries: In the older ages, a female health care cost is about 80% of a male cost. Medicare reimbursement - we've tried all kinds of different things to get a handle on this and what we used was the actual reimbursement that occurred in 1981 reflecting only those retirees that were over age 65. Age medical needs grow as age increases. Utilization - used a little econometrics on what was going to happen there. Inflation and discount - for both inflation and discount we used 8%. The result for this group was that the present value of the retiree benefits using the 8% inflation/8% discount was $67 million dollars. Then our actuaries run amok and decide, well what happens if we start changing assumptions and we've got 11 different scenarios where Medicare reimbursement actually gets better, which is completely unthinkable, to inflation gets worse, which is thinkable. But the best case was pretty much standard status quo except that the discount rate would be raised to 12% and the inflation rate left at 8%, a 4% differential. That would lower this present value to about 1/3 of the previous value or $22 million dollars.

To get a better idea, and one that you can use on your own groups, look at this plan on a per retiree basis. The present value of a retiree's benefit was $17,913 and that was with this average age of 70.7. The average present value on a per spouse basis was $25,459, once again reflecting the spouse's average age of 67, the fact that a lot of spouses were less than age 65, and that this was a basic industry type group, most retirees were male, most spouses were female. On a per unit basis, per retiree unit with probably about 3/4 of a spouse, it was $35,440 per retiree. The best scenario, with the 4% differential between discount and inflation, was $12,000 per unit. You can imagine what the liabilities would be for a standard company with 3 or 7 actives per retiree, and the unmanageable size of this for companies that are sitting there with 4 retirees per active employee or possibly up to ten retirees per active employee. Needless to say, the numbers here are immense, and rightfully so, are subject of a separate project at the FASB.

I would like to leave time for some questions and answers, but first does anybody have any rebuttal, primarily Paul versus Mike or Mike versus Paul?

MR. MILLER: Very frequently, comments to the Board talk about, and many of them are poorly veiled threats, that if you go ahead with this standard, we're going to change our practices, and the practices are always negative: We'll quit funding or we'll discontinue our pension plan. That's really unlikely and the Board interprets those threats that way. The Board is also committed to a policy of neutrality. That what it should try to do is come up with useful information and then let the chips fall. If it turns out that people have a much larger liability than they've told folks, the Board's position is going to be - let's report that liability and then let users, investors and/or preparers make appropriate adjustments to their behavior. This happened, especially in foreign currency. People said you can't make us have volatile earnings because we're operating overseas, and the Board's initial response, which finally wore down, was when you chose to operate overseas you exposed yourself to risk and risk is reflected in volatility. So the Board's view is very much one of neutrality and cannot get tied up very much in terms of the economic consequences of selecting a particular way of looking at what it considers to be reality. But being a political body as well as an accounting body, it's obviously going to respond in some way to those sorts of things, but the threats are not very successful. I don't think AT&T has expressed a threat, but many of the comment letters that I had an opportunity to review had very overt sorts of threats.

MR. GULOTTA: I agree with Paul that the Board must, as a practical matter, consider economic consequences, and it must proceed with it's policy of neutrality. However, let's examine the economic consequences of the Preliminary Views relative to plan amendments. Plan amendments which typically grant credit for past service would, under the Preliminary Views, generate an increase in liability and an offsetting intangible asset. The intangible asset is a very questionable asset on the balance sheet, so it's likely that the liability would be recognized much like debt, but the asset would not be recognized. When that happens the way in which plan sponsors put amendments together or grant increases in pensions is going to have to change. That's rather mild as opposed to shifting from a defined benefit plan to a defined contribution plan. But I do think the first example that I gave, changing the way in which you grant amendments, would likely happen. At least many employers are concerned. I think there would be some terminations of pension plans if the Preliminary Views were to become a final standard. I don't know if they'd be rampant, but some companies certainly would reexamine the role of the defined benefit pension plan in the corporate compensation package given the fact that it is going to have such an impact on its balance sheet, and given the fact that it is going to have such an impact on its income statement. So the threats in some cases may be veiled, in other cases they may be very real. In any event, the Preliminary Views would have a definite impact on the way employers approach defined benefit pension plans and the way benefit improvements are granted.

MR. VICTOR MODUGNO: Don't you think that the financial markets will see through the noise of these accounting changes? I mean, do you think they're going to have any real effect?

MR. MILLER: That's an interesting point and it's one that tends very frequently to get overlooked. A very reasonable view of the market is that it's composed of individuals, and at the top of that market are a bunch of people who really know what they're doing. They are aware of liabilities that are not recognized, they're aware of assets, like pension goodwill, that are not recognized, and have incorporated those factors in their prices that they've established as being reasonable. All that an implementation would do would be to alter the data that goes into that model. Instead of their best guess, they have a number that's prepared and made public and has some sort of verification associated with it. I think to a certain extent some of the controversy is out of scale with what's really going to happen.

MS. ANNA M. RAPPAPORT: I agree with your statement about pensions, but I think on medical it's a very different situation. The numbers are very large and there's no way to figure out whether people have plans or not and the level of variation that's possible is enormous. You have no idea what these numbers can look like until you've done a couple of valuations. It's quite an experience, and if the companies don't realize it, it blows them out of the water when they see the numbers.

MR. OLNEY: When we did a study, not the one that I gave you the numbers on, but another study, which is a Fortune 100 company, quite large; we gave them the numbers, their net worth disappeared and as the consultant was giving the study, the CFO sat there and started laughing. The consultant is going through these very serious numbers, they're big, they're huge and why are you laughing? What else can we do? It's there. It exists. They have given away the post-retirement medical benefits, it is a liability and I do agree with you that up to now I haven't seen much disclosure on annual reports that even indicate whether they have such a plan, let alone the size of the numbers.

MR. MILLER: A couple of points. Again, my view of the market that I described a little while ago. I'm concerned with public markets in which financial analysts are closely involved with management, frequently interviewing management and may even know more about that company than management does. I think in those situations it's unlikely that the market is going to be surprised by the existence of these benefits. For smaller companies that are not publicly traded I think that is a problem.

A second response that I would make, forgive me if it sounds like a placebo, but let's not confuse the message with the messenger. If these benefits have been promised and an obligation exists, let's not yell at the accountants for uncovering it and requiring its disclosure. What we've got is a serious problem, maybe it's a social problem, certainly it's a managerial problem that benefits have been promised without an adequate measure of the costs of those benefits. Let's not add to the confusion by somehow covering that up and not reporting it. Now whether it goes in a footnote, whether it goes in management's letter, whether it goes in the financial statements is a more complicated issue. But let's not suggest that no information should be revealed. Let's not confuse the accountants with what's been uncovered.

MR. GULOTTA: I have one comment on the post-employment benefit issue. I agree with Anna, that you can really get blown out of the water. The risk here is that employers, when they see these numbers, are likely to take some immediate action. Most post-employment benefit plans, health insurance plans for example, are service benefits. They're not limited. In other words, inflation automatically results in an automatic increase in benefits. It's likely, if employers had to accrue for these benefits on an actuarial basis, or worse if the liability were to be recognized, there would be significant changes in the way these benefits are delivered. Perhaps as opposed to service type benefits, i.e., your unlimited benefit per day in the hospital and usual "customary and reasonable" surgical benefit, you'd have dollar limits on room and board and you'd have surgical schedules becoming more prevalent than they are today. Again, that is an economic consequence. I think the Board is aware of that economic consequence and at the same time the Board needs to be neutral and disclose what the impact of the current practice is.

MR. MILLER: I consider that a very positive thing. You mentioned it earlier with respect to changing the way plan amendments are created or implemented because of the accounting. I think that's fine as long as the accounting information has led you to a rational decision. Change, per se, I don't consider to be bad if it's a positive change that makes things better, and I would applaud accounting for bringing that about. If it's a negative change, then that's something we should deal with.

MR. GULOTTA: There's one point that I failed to mention. If the Preliminary Views became a final statement the way in which the employers would make plan amendments, if they're resourceful enough, would result in change, but the ultimate benefits delivered would be no different. In other words, plan amendments could be fashioned to circumvent liability recognition. When you amend a plan, our view is that you amend the plan in exchange for future service, and a plan amendment is much like a salary increase in exchange for future service. Why not amortize that cost over the future working lifetime of active employees? If accounting were such that the plan amendment granting past service credit would have to be recognized as a liability, employers would find a way around that, so the end result would be the same, that is, the same level of benefits being delivered. It's only the vehicle, the way it was delivered, which would be different. The substance of the transaction would be unchanged.

MR. CECIL J. NESBITT: How much of this do you foresee will be extended to public employee plans, both for pensions and post-retirement benefits where the problems exist?

MR. OLNEY: From my own experience, I am a consultant on a couple of public employee plans, we've already done some studies as to the post-employment benefits. The county commissioner was getting concerned with the rapid escalation of pay-as-you-go costs and asked us to see what they had gotten themselves into. So speaking from the experience of one consultant, they're starting to look at it. As far as a regulatory body you'd have to ask Paul.

MR. MILLER: Specifically, the FASB acted last year to eliminate application of Statement 36 to public employee retirement. Another development that's taken place is the creation of GASB (Governmental Accounting Standards Board), specifically, to deal with these governmental accounting issues. That's a whole other set of politics, different from the politics that the FASB has to deal with, and with some struggle that was finally brought about. All I can say is read ARB 47, accountants do not yet have common opinions on this issue, and it will be some time before they are resolved. I wouldn't look for any kind of authoritative action on pensions for public employees in a decade.

MR. OLNEY: Paul, is this new group part of FASB and what happened to the old group that was located in Chicago?

MR. MILLER: The old group, the NCGA?

MR. OLNEY: Yes, that one.

MR. MILLER: The National Council on Governmental Accounting. GASB is technically separate from FASB, but they are both under the management of what's called the Financial Accounting Foundation. The Foundation has the responsibility of raising the funds and appointing members to the board. So FASB would be a separate arm of the Foundation, separate from GASB. GASB will have one full-time member and four part-time members.

The FASB has seven full-time members, at least initially. I think there are some real difficulties yet to be worked out, as to jurisdiction and everything else, but they're moving ahead on that point. I don't think pensions is going to be their first statement, however.

MR. ROBERT L. KATZ: This is a quick question for Paul. There's been some rumor about having an actuary on the FASB board and I wondered whether that's purely rumor or if there is any serious consideration being given to it.

MR. MILLER: I've been away from the board for about 9 or 10 months, but based upon what I perceive is the politics that get people appointed to the FASB, that's not a very good rumor. Actuaries, present company excluded, generally are not that involved with accounting.

MR. OLNEY: Are there actuaries on the staff?

MR. MILLER: No, there are none. There would be actuaries on the task force which advises the staff and the board on issues, but I think it's highly unlikely that an actuary would be appointed to the board. There are so many different kinds of issues that are not related to pensions, that it would be unproductive to have an actuary there.

MR. OLNEY: I would like to thank our panelists for their views and discussion.