RECORD OF SOCIETY OF ACTUARIES
1986 VOL. 12 NO. 1

FINANCIAL ACCOUNTING STANDARDS BOARD (FASB) AND CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS (CICA) ACTIVITIES RELATED TO PENSION PLANS

Moderator: HARPER L. GARRETT, JR.
Panelists: YVON CHAMBERLAND
DARREL J. CROOT
JUDITH E. LATTA
Recorder: HARPER L. GARRETT, JR.

- o What is the reaction of plan sponsors?
- o How will the requirements affect pension expense and balance sheet liabilities?
- o How are the disclosure requirements being handled?

MR. HARPER L. GARRETT, JR.: As you all know, at the end of last year, the Financial Accounting Standards Board, affectionately known as FASB, issued Statement of Financial Accounting Standards No. 87, Employers Accounting for Pensions, and also Statement of Financial Accounting Standards No. 88 on Employers Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits.

At the end of this month, the Canadian Institute of Chartered Accountants will issue its document entitled "Pension Costs and Obligations," CICA Handbook Section 3460, the development of which has closely paralleled the development of FAS 87 and 88. Our purpose at this session is to discuss the reaction of plan sponsors to these new standards, and to describe how the requirements of the standards have or will affect pension expense, the balance sheet, and footnote disclosure. AT&T announced its first quarter earnings increased by $100 million or $.09 per share as a result of adopting the new pension accounting standard in the first quarter of 1986. That's $100 million per quarter for each quarter of 1986.

We have assumed a general familiarity on your part with FAS 87 and 88. I know a number of you have attended the Society of Actuaries excellent seminar on the new Pension Standards, the final session of which was presented here in San Diego yesterday. In addition, many of you have undoubtedly been reviewing with your clients or employers some of the implications of the new standards. What we hope to do is build on the knowledge you have already acquired, by sharing with you some insights of actuaries who have been intimately involved with implementing the new standards.

Our first panelist is Judith Latta. Judy is a Senior Consultant with Coopers & Lybrand in New York City. Darrel Croot is Consulting Principal with A. S. Hansen in New York City. Finally, we have Yvon Chamberland, Actuary with The Wyatt Company in Montreal.

Judy and Darrel have each been involved with a number of corporations which elected early compliance for their 1985 fiscal year. This means that Judy and Darrel have not only gone through the pension expense considerations and calculations for 1985, but they have gone through the considerations and calculations for 1985 disclosures, and they have already gone through the considerations and calculations for 1986 expenses. In short, they have crossed a lot of bridges that many of you are probably still approaching. Therefore, I believe you will find their discussions to be of considerable interest, and I hope, of some use to you.

Yvon has followed the development of the new Canadian Standards quite closely. He was named three years ago to the Committee On Relations With Other Professions On Pension Matters of The Canadian Institute of Actuaries and, he became Chairman of that committee in July of last year. He coordinated the response of the Canadian Institute of Actuaries to the CICA regarding its proposals for the Accounting For Pension Costs and Obligations. He will briefly outline the key features of the standard and give his views on its implication for Canadian companies.

Now there are two recent developments in this area, pertaining to FAS 87 and 88, that I would like you to be aware of. First of all, FASB has organized a Pension Implementation Group, comprised of representatives of the Big 10 Accounting firms, the National Association of Accountants, The Financial Executives Institute, and the American Academy of Actuaries. There are about 25 people in all. This group will hold its initial meeting on April 28 in Stamford, Connecticut. The 6 of us representing the Academy are drawn from the 2 Academy Committees that have been closely involved with this project recently; the Pension Accounting Committee (which I chair) and the Pension Committee of the Interim Actuarial Standards Board. The purpose of this Pension Implementation Group which FASB has formed, is to address some of the implementation problems and questions which have arisen in practice since the new Accounting Standards were published.

The second development that I would like to apprise you of is that the Pension Committee of the Interim Actuarial Standards Board will be issuing some Actuarial Practice Guidelines with respect to FAS 87. This will be issued as an exposure draft sometime this summer, with a Final Statement scheduled for fall or early winter. As the name implies, these Guidelines will deal only with actuarial considerations in performing the calculations required under FAS 87.

What this means is that by the time the FAS 87 scheduled effective date of December 15, 1986 arrives, the collective knowledge of auditors, actuaries and employers with regard to the "correct" way to interpret and apply FAS 87 will undoubtedly be greater than it is at this point in time.

That's all still some 8 months into the future; so we're particularly fortunate this morning to have with us three pioneers, who without benefit of Practice Guidelines or without benefit of Implementation Group opinions, have had to apply the new standards on very short notice.

With that, I now invite Judy Latta to share with you some of her experiences in dealing with what FASB describes as more understandable, more relevant, more useful, more representationally faithful, and more comparable pension accounting standards.

PANEL DISCUSSION

MS. JUDITH LATTA: There has been a lot of activity generated by the issuance of the new pension standards. For the most part, the activity to date has surrounded those companies favorably affected by early implementation. As a result, a large part of today's discussions will focus on those favorable situations. But by next year, we have to keep in mind that we will have the more difficult challenge of dealing with those companies that have delayed implementation because adoption of the new standards will significantly increase the annual charge to earnings in 1987, and will require the recognition of an additional minimum liability on the company's financial statements in 1989.

Having stated this bias that underlies most of the existing experience with the new pension standards, let's move on to the issues.

Under the new standards, companies will be required to select two interest rates. First, an assumed discount rate based on the rates at which the pension obligation can effectively be settled or eliminated. Secondly, an expected long-term rate of return on plan assets.

In estimating the discount rate, FASB 87 states that it is appropriate to look at available information about rates implicit in current prices of annuity contracts sold by insurance companies. This includes those rates published by the Pension Benefit Guaranty Corporation, and also rates of return on high quality fixed income investments currently available and expected to become available during the period the benefits will be paid. FASB has attempted to define an objective approach to establishing the discount rate assumption by using the settlement rate concept. However, by directing attention to fixed income securities, the door was opened to a range of assumptions that will undoubtedly be used by different companies.

There are several reasonable approaches that could be used to estimate the discount rate. One would start with a composite rate equivalent to the PBGC rates and would add a margin of 1% to 2% to the rate to reflect the more competitive market prices. Such an approach would result in a relatively narrow range of discount rates among different plans and would be consistent with FASB's settlement concept. As of the beginning of 1986, most plans would fall in the 9% to 10% range under this approach.

On the other hand, some companies will select the PBGC rates without adjustment, while other companies will look to high quality fixed income investments available in the market place. Using these approaches, a range of rates from 7% to 11%, as of the beginning of 1986, can be interpreted as reasonable under the new standards.

Now let's turn our attention to the investment rate of return. In selecting the investment rate of return assumption, the standard provides that appropriate consideration be given to the returns being earned by the plan assets and the rates of return expected to be available for reinvestment. By using an expected rate concept, FASB has allowed companies to use a subjective approach to establish the assumed investment rate of return, which is more in line with the traditional development of the assumed interest rate. However, because of the relationship between the investment rate of return assumption and the discount rate, many companies will have to reevaluate their existing interest rate assumption to make sure it is compatible with the discount rate.

On one hand, rates of return expected to be available for future investments do not significantly affect the discount rate assumptions, whereas, they should be reflected in the investment rate of return. Since by definition, future rates of return are more uncertain, the assumed future rates should reflect lower than current expectations. Taken alone, this would result in a lower investment rate of return assumption than the discount rate. On the other hand, an equity-oriented asset mix can reasonably be expected to achieve a higher return over the long term. This factor, taken alone, would cause the assumed investment rate of return to be greater than the discount rate of return.

Generally speaking, there is some overlap in the reasonable ranges of each of these assumptions. The rates used will reflect the relative weight a company assigns to, first of all, the objectives of the new standards, second, the company's capacity to withstand year to year fluctuations in net periodic pension expense and third, the desire for simplicity. I do think that those companies which have resisted increasing their assumed investment rate of return will feel increased pressure primarily because of the definition of the discount rate under the new standard.

FASB has stated that all economic assumptions should be consistent and should reflect the same underlying future economic experience, such as inflation. In particular, the salary progression assumptions should be consistent with the two interest rates. Based on a subjective view as to the expected long-term inflation rate, the portion of the three economic assumptions in excess of the inflation rate should be evaluated for reasonableness. This is an instance where the spirit of FASB is clear, but consistency is hard to evaluate. For instance, the discount rate assumption may be higher than expected due to opportunities that may be available in true market conditions to achieve a higher rate of return without a significant increase in risk.

One thing is certain. The economic assumptions will vary over time. This leads to a number of questions. Must a company follow a consistent approach for determining the discount rate from year to year? The Statement is vague in this regard, but general accounting principles would tend to favor a consistent approach. Can the approach be linked to the approach used to determine the assumed investment rate of return? Although this is inconsistent with the spirit of the Statement, a reasonable compromise that is supportable under the standards should be possible in most circumstances. How much change in the interest rate environment can occur without forcing a change in the discount rate assumption or the investment rate of return assumption? There is no objective answer to this question. However, if concern is about volatility and is the real issue behind the question, it should be noted that the degree of volatility resulting from a change depends on the circumstances and in some instances may be less than anticipated.

Consider the consequences of reducing the discount rate assumption by 1%. Service cost increases, increasing net periodic pension cost. The interest cost remains relatively stable since the projected benefit obligation increases as the discount rate decreases. A loss would result due to the change in the discount rate potentially increasing net periodic pension cost, but we have to remember that the use of a 10% corridor may negate the impact.

Next let us assume a change of 1% in the assumed investment rate of return. This only affects the expected return of market related value of assets by 1% of the assets. Do these changes warrant a change in the salary progression assumption? Clearly, if the change is initiated because of the perceived change in the long term rate of inflation, the salary progression assumptions should reflect the latest predictors. However, if the discount rate changes merely in response to market opportunities, should the change be reflected in the salary progression?

As I said, there are no objective answers. What companies will have to do is understand what drives each rate in order to be able to derive a consistent set of economic assumptions.

Let's move on to smoothing alternatives. There are two primary smoothing techniques permitted under the standards. First, the use of averaging techniques to determine the market related value of assets and second, the use of the corridor for the recognition of gains and losses. Care should be taken in implementing these techniques. In some instances, you will find that the so-called smoothing techniques can also increase year-to-year volatility in the net periodic pension cost.

Assuming that the market conforms to modern portfolio theory, increases in the market value of assets should logically be accompanied by lower rates of return on fixed income securities, exactly what has happened in the market since the beginning of this year. If the corridor approach is used, the increase in the plan obligations due to the decrease in the discount rate may not be reflected in the determination of the net periodic pension cost; whereas if assets are valued at market, the increase in market value fully reflects it. As a result, two otherwise offsetting forces do not balance one another, and the net periodic pension cost is reduced by a larger amount than it would have been had no smoothing techniques been used.

Next, the standards also permit acceleration of amortization of gains and losses and/or prior service costs as long as the procedures are applied consistently from year to year. In fact, immediate recognition of gains and losses is permitted although it is not clear if prior service costs originating from increases in active participants' benefits could reasonably be amortized over a period as short as one year.

A less obvious acceleration technique is available to those plans that permit lump sum optional forms of payment. The recognition of gains and losses can be accelerated by treating the lump sum payments as settlements of plan obligations. Under settlement accounting, the maximum gain or loss subject to recognition in earnings equals the unrecognized gain or loss plus any remaining unrecognized net asset existing at the date of the initial application of the new standard. The pro rata portion of the maximum amount equal to the percentage reduction in the projected benefit obligation due to the lump sum settlements is recognized in earnings. In an ongoing plan, I believe this may be the only instance where the amortization of the net asset at the date of initial application can be accelerated.

The next question to look at is: Should a company implement the new standards earlier than required? For most companies, there are now only two choices -- 1986 or 1987.

The choice is clearly related to whether implementation is going to increase or decrease the annual provision for pension expense. It is important to evaluate how early adoption affects the determination of net periodic pension cost in the following years. If gains and losses and prior service costs are amortized over the remaining working lifetime of the employees expected to receive benefits, early adoption has a relatively minor impact on the following years as compared to deferring adoption. However, if smoothing techniques are used or if the amortization of gains and losses and/or prior service costs is accelerated, early adoption can significantly affect the following year's expense.

Let me address two other issues before turning things over to Darrel. First, the treatment of annuity contracts is worth noting. Under the new standard, benefits covered by annuity contracts are excluded from the projected benefit obligation if the contracts are irrevocable and involve the transfer of significant risk from the employer to the insurance company.

If the contracts are non-participating, the value of the annuity contracts shall be excluded from the plan assets. If the contract is participating, the participating right is included in the value of assets. A participating right is defined to equal the difference between the purchase price of a participating contract and the purchase price of a non-participating contract.

Many plans cover some benefits that were purchased under old participating annuity contracts. A reasonable approach that would satisfy the standards would be to value these obligations where annuity contracts have been purchased, and subtract that amount from both the plan obligations and the plan assets. If current reporting includes these amounts in both the plan assets and the liabilities, this will not change the funded status of the plan. Likewise, if the assumed discount rate equals the assumed long term rate of return on assets, the annual net period pension cost will be unaffected since the interest cost component and the expected return on plan assets would be reduced by like amounts. However, if different rates are used, the annual net periodic pension cost would be affected.

I would also like to touch on the treatment of excess benefit programs under the new standards. The standard states that these plans should be treated as a separate plan. Under prior procedures the excess benefits plan and the related qualified defined benefit plan were often treated as one plan providing the total benefits. The issue is for the most part academic in all aspects but one.

If the programs are treated as one plan, balance sheet accruals on prepaid pension costs are not identified separately for each plan. The balance sheet accrual amounts or prepaid pension cost amounts existing at the date of initial application of the new standards traditionally have not been allocated between the excess benefit plan and the qualified plan. Traditional allocation methods can create anomalous results. In addition, the maintenance of these amounts separately on an ongoing basis can easily evolve to situations where the balance sheet accruals bear no logical relationship to the underlying obligations of the plan. Realistically, these plans operate as one total program. There appears to be little, if any, added value of treating the plans separately and, in fact, treating them separately could create distorted reporting results for disclosure purposes.

Well that concludes my prepared remarks. I have noticed that each company I have worked with approaches these issues from different perspectives, and every time I read the Statements from a new perspective, I see new issues, or at least variations of issues.

MR. DARREL CROOT: I am going to try to continue this discussion by focusing more on some actual applications and illustrations of events that have happened with clients who did adopt the Statement for 1985. Before making a comment, I would like to say that at Hansen our approach is generally to take a very literal interpretation of the rules for selecting settlement rates. We used a rate that was inherent in an annuity contract or high grade corporate bonds. We used several techniques for developing that rate. One was to actually apply annuity contract rates to the population and then solve for existing rates. The second was to set up a theoretically immunized portfolio to solve for that rate, and the third was to attempt to use rates of bonds with comparable durations to the selected demographics of the company. The long term rate has typically been the rate that was used for funding purposes.

In discussing these new rules with plan sponsors, there is a general feeling that these rules represent bad accounting. However, since the rules are in effect, most of the clients I've talked to want to use these rules to maximize their own best interest. Harper gave me an illustration of a company that obviously operated in its best interest by adopting the new rules for this year. Last December, I was meeting with a client who had prepared some illustrations of how he thought the rules would affect him. It resulted in an 80% decrease in his pension expense for 1985. His response was, that as a good corporate citizen he was obligated to adopt the new rules.

I'd like to spend the rest of the time discussing some details of the applications in which we've been involved. I think these will illustrate some of the points that Judy has made. The first point I want to address is the question of volatility. To what extent should a company utilize the permissible corridor that Judy described and market related (or actuarial) value of assets.

FASB recognized that pension expense would be volatile. So, in an attempt to dampen this they permitted the use of a 10% corridor and actuarial value of assets.

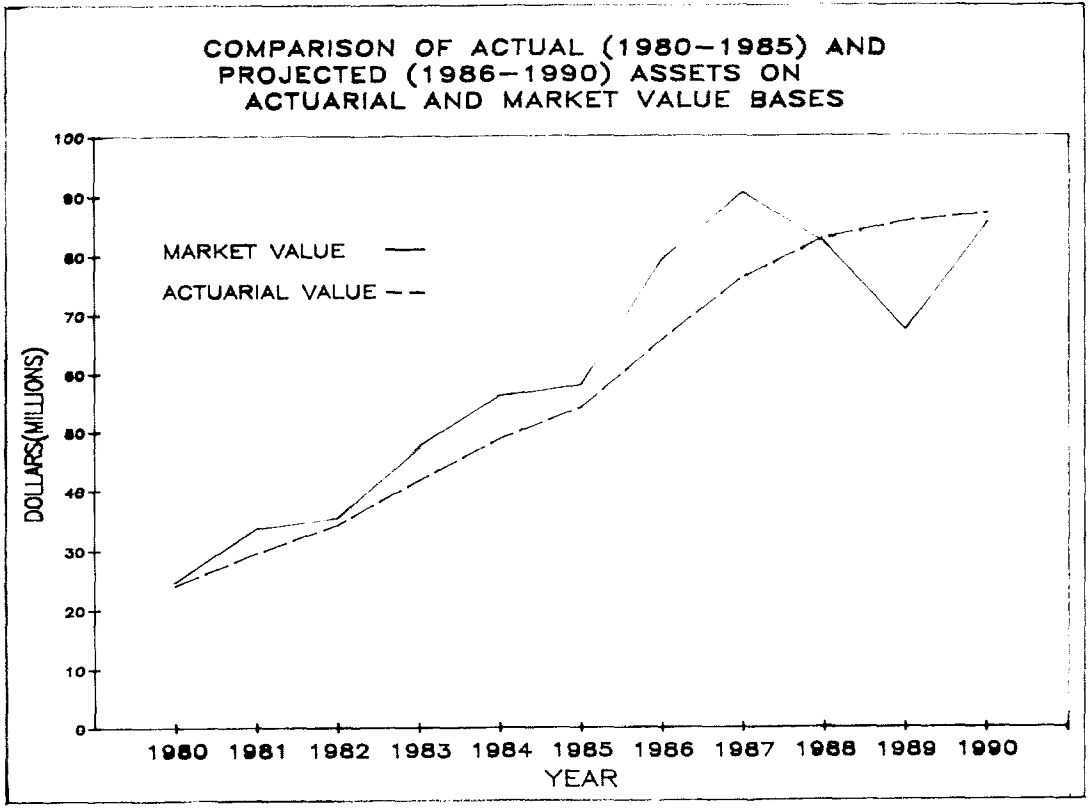
There are a number of possible scenarios that could be used to illustrate the effect of volatility, but as a general rule, over a long period of time, use of the maximum corridor and maximum smoothing that are inherent in an actuarial value will typically result in the least volatility. In attempting to illustrate that there are some traps which you can fall into, we made some projections utilizing the years projected forward from 1986 through 1990. We assumed in making these projections that the investment experience and inflation would reproduce the experience of 1972 through 1976. The reason we selected these years is because they are reasonably consistent with those prior to 1985, and they had volatility.

To illustrate this point, we graphed the market value and the actuarial value of assets of one client's plans for the last five years. We then projected it through 1990 based upon the assumptions shown. As you can see from Graph 1, from 1980 through 1985 the difference between the actuarial value and the market value was relatively small. From 1986 forward, when we projected the years 1972-76, we got the desired volatility. The point is, if you take a recent five year history and use that as a basis for your modeling, you may not illustrate the potential volatility inherent in the new FASB rule.

The next thing we did was to project the volatility and expenses for a plan that adopted FAS 87 for 1985 (Graph 2). In these projections, we used the regular assumptions for turnover, salary scale, and investment return. We thought that they were explicit assumptions and were consistent with the current inflation rates. We assumed in these projections that the work force would remain constant over the period of time.

The following are the economic assumptions that were used in this forecast. We assumed a 3.4% inflation index rate in 1986, 8.8% in 1987, 12.2% for 1988. 1989 was 7.0%, and then it dropped back to 4.8% in 1990. The settlement rates were 10% for 1986, 8.5% for 1987, 10% for 1988, 12% for 1989 and then 9% for 1990.

GRAPH 1


COMPARISON OF ACTUAL (1980–1985) AND
PROJECTED (1986–1990) ASSETS ON
ACTUARIAL AND MARKET VALUE BASES
MARKET VALUE
ACTUARIAL VALUE
DOLLARS(MILLIONS)
0
10
20
30
40
50
60
70
80
90
100
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
YEAR

GRAPH 2

ASSUMPTIONS USED IN FORECAST OF EXPENSE UNDER SFAS NO. 87

Year	Increase in Consumer Price Index	Adjustment to Salaries A/C Inflation	Total Investment Return	Settlement Rate at Beginning of Year
1986	3.4%	0	14.3%	10.0%
1987	8.8	4.5	-8.4	8.5
1988	12.2	8.0	-17.1	10.0
1989	7.0	3.0	28.1	12.0
1990	4.8	1.0	21.7	9.0

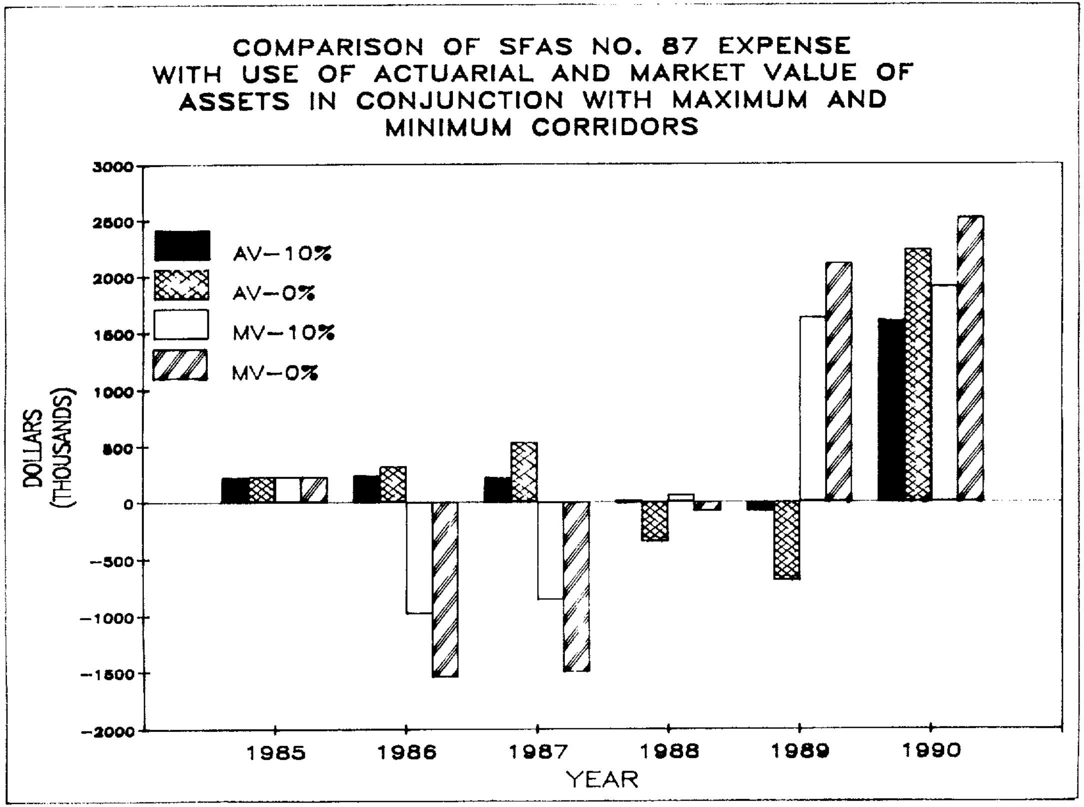
Graph 3 shows net periodic pension expense for 1985. The expense determined on the projected basis assuming maximum smoothing in the left bar, 10% corridor and actuarial value of assets. The middle bar (the cross hatches) is actuarial value of assets with no corridor. Market value and 10% corridor is the clear bar. The right bar represents market value and no corridor. The smoothing in this illustration in this volatile period is greatest if you use the maximum permissible smoothing of actuarial value of assets and 10% corridor.

Graph 4 looks at this from a slightly different approach. We plotted the variance from the cost using an actuarial value and a market value. The zero line in this case is actuarial value and 10% value.

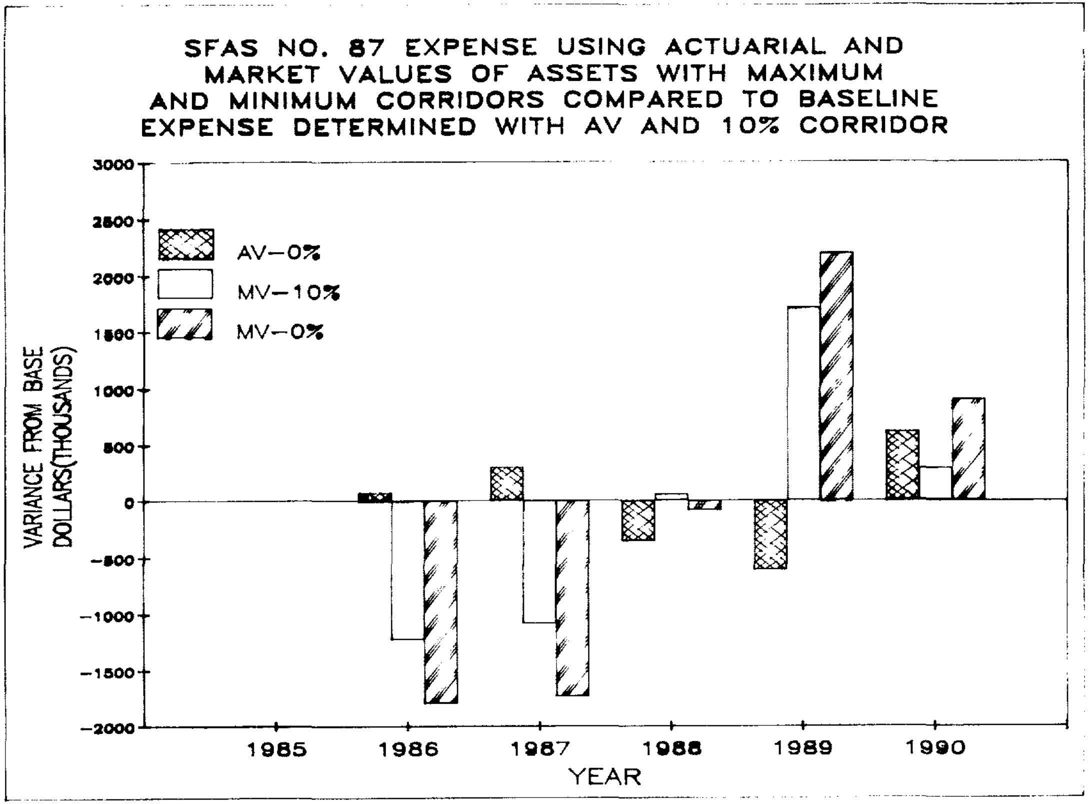
Graph 5 looks at it from a slightly different perspective and shows the old adage that figures don't lie but liars figure. We plotted the variance from market value and zero corridor, and now the results look different. It looks as though use of an actuarial value and a corridor is the most volatile. The point is there are so many unusual things that are happening because of the interplay of settlement rates, and long term rates that you can very easily mislead yourself.

Now I would like to switch gears a little bit and talk about the effect on pension expense, or as FASB defines it, the net periodic pension cost of the relation between settlement rates and long term rates. As I indicated a moment ago, Hansen felt that we should follow the rules literally using relatively high settlement rates consistent with the definition. In most cases, a long term rate would be the rate that is currently used for funding. However, it might be argued that a somewhat higher rate could be justified on the basis that real rates of return on fixed income investments are significantly above long term averages. If a portion of a fund is immunized or has long term bonds with appropriate call protection, a separate long term rate might be utilized for that portion of the assets. This would increase the long term rate. In a well funded plan, this can have an even greater impact on expense than a change of the same amount in settlement rate. This is particularly true in plans with significant retired liabilities or basically an older plan. In the previous illustration, the long term rate was 7.5%. If that is increased to 8.5%, the investment credit is increased by 13.33% (i.e. 8.5% divided by 7.5). Depending

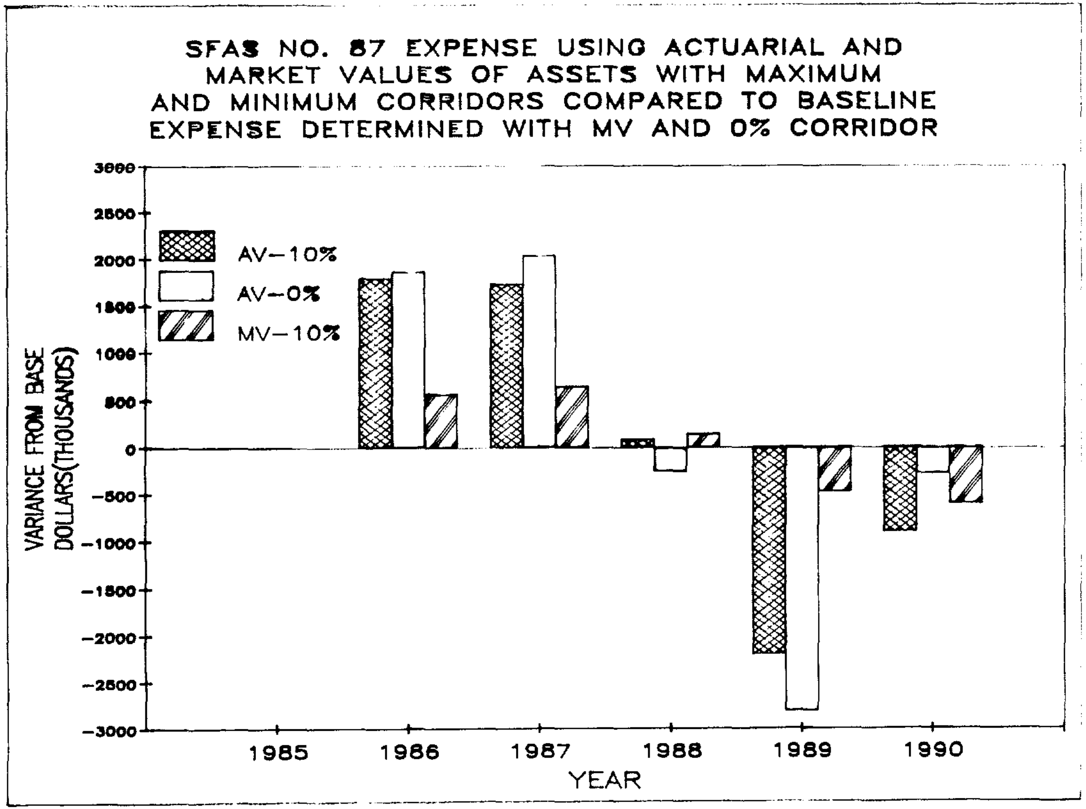
GRAPH 3


COMPARISON OF SFAS NO. 87 EXPENSE
WITH USE OF ACTUARIAL AND MARKET VALUE OF
ASSETS IN CONJUNCTION WITH MAXIMUM AND
MINIMUM CORRIDORS
AV–10%
AV–0%
MV–10%
MV–0%
DOLLARS
(THOUSANDS)
3000
2500
2000
1500
1000
500
0
–500
–1000
–1500
–2000
1985
1986
1987
1988
1989
1990
YEAR

GRAPH 4


SFAS NO. 87 EXPENSE USING ACTUARIAL AND MARKET VALUES OF ASSETS WITH MAXIMUM AND MINIMUM CORRIDORS COMPARED TO BASELINE EXPENSE DETERMINED WITH AV AND 10% CORRIDOR
AV–0%
MV–10%
MV–0%
VARIANCE FROM BASE DOLLARS(THOUSANDS)
3000
2500
2000
1500
1000
500
0
–500
–1000
–1500
–2000
1985
1986
1987
1988
1989
1990
YEAR

GRAPH 5


SFAS NO. 87 EXPENSE USING ACTUARIAL AND
MARKET VALUES OF ASSETS WITH MAXIMUM
AND MINIMUM CORRIDORS COMPARED TO BASELINE
EXPENSE DETERMINED WITH MV AND 0% CORRIDOR
VARIANCE FROM BASE
DOLLARS(THOUSANDS)
3000
2500
2000
1500
1000
500
0
-500
-1000
-1500
-2000
-2500
-3000
AV-10%
AV-0%
MV-10%
1985
1986
1987
1988
1989
1990
YEAR

upon the relative size of assets and PBO and demographics, this could have an even greater impact on costs than a 1% change in Settlement Rates.

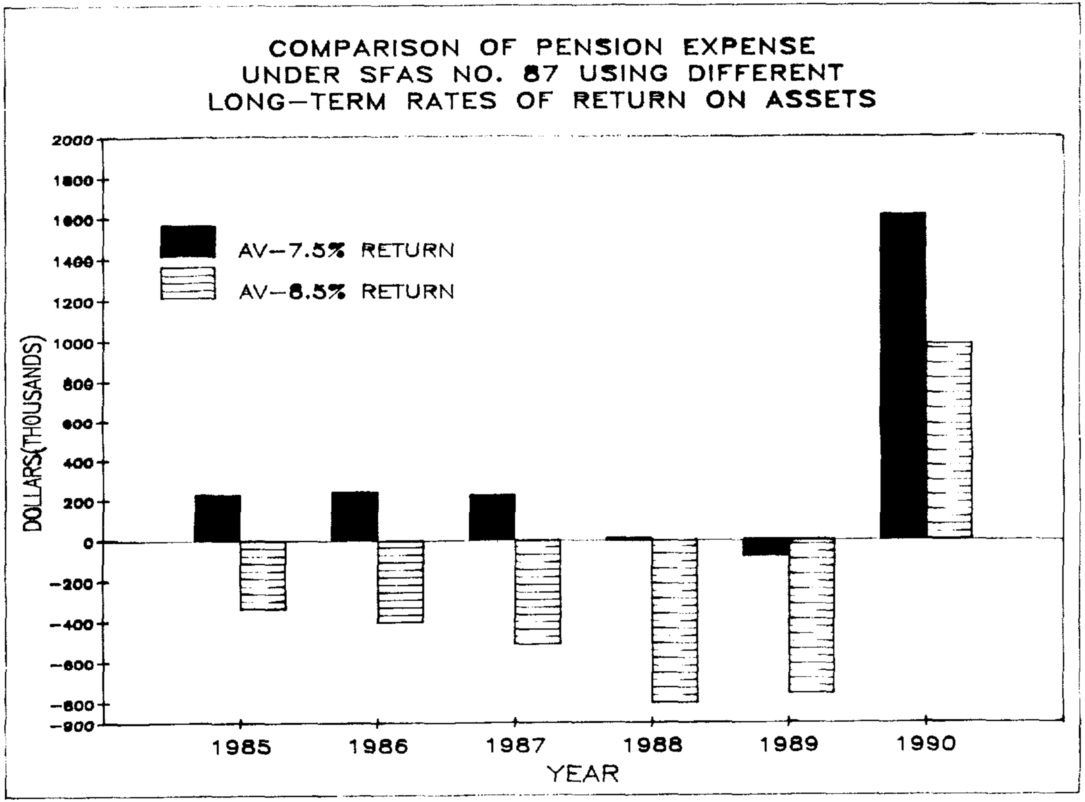
Graph 6 shows the effect of a 1% change in the long term rates, increasing the 7.5% to 8.5%. The cost for this plan was 3.5 million. Based upon this particular plan and the scenario that we projected, if we increased the long term rate by 1%, the settlement rate could be reduced by approximately 1.5 to 2% in each of the five years that we have illustrated and the settlement rate would also have the same costs as the original costs that we looked at. This gives you an idea of some of the complexities involved in the application of the new rules and trying to project what the costs might look like.

The next thing I'd like to take a look at is the thing that Judy referred to as the purchase of annuities. What happens when you purchase annuities? In this same plan, we examined the possibility of purchasing annuities for all retirees.

We assumed that the settlement rate would be the same as the rate at which we purchased these annuities (Graph 7). The 1986 gain was $12,700,000. That takes into account the previously unrecognized gains attributable to those people for whom we purchased annuities. The cost before was $246,000. If we purchased annuities, costs for 1986 become a negative $170,000. It's lower again in 1987, and only in 1988 does the cost after you purchase the annuities exceed the cost prior to the purchase of annuities. Logically, you would think that when you immediately recognize the gain up front of $12.7 million, you would no longer be spreading that gain through future cost, and therefore, the cost would rise. As you can see, it did not work that way for three years. My client in this illustration was very actively considering this with the observation that FASB has repealed the old rule that there is no free lunch.

The next subject I'd like to address briefly is the impact on union negotiations of the new rules (Graph 8). Under the old rules, if you had a plan that provided a dollar a month times years of service, from year to year the cost of increasing that benefit by $1 was about the same. Under the new rules, this is no longer true. Each year the cost can change depending upon the settlement rates. This can cause a real dilemma for a company that is trying

GRAPH 6


COMPARISON OF PENSION EXPENSE
UNDER SFAS NO. 87 USING DIFFERENT
LONG–TERM RATES OF RETURN ON ASSETS
AV–7.5% RETURN
AV–8.5% RETURN
DOLLARS(THOUSANDS)
2000
1800
1600
1400
1200
1000
800
600
400
200
0
–200
–400
–600
–800
–900
1985
1986
1987
1988
1989
1990
YEAR

GRAPH 7

EFFECT OF PURCHASING ANNUITIES FOR RETIREES AS OF 1/1/86

1986 GAIN: $12,700,000

	No Purchase of Annuities	Purchase of Annuities
1986	$ 246,000	$ (170,000)
1987	228,000	75,000
1988	3,000	16,000
1989	(81,000)	152,000
1990	1,619,000	1,906,000

GRAPH 8

COMPARISON OF INCREASE IN COST PER EMPLOYEE
FOR $1 INCREASE IN BENEFITS
SFAS NO. 87 vs APB8

	1983	1984	1985	1986
Settlement Rate	11.25%	10.50%	11.00%	10.00%
Plan A				
SFAS No. 87	$66.23	$75.65	$85.68	$106.16
APB8	72.97	71.43	72.29	77.42
Plan B				
SFAS No. 87	$67.29	$76.37	$94.70	$116.09
APB8	77.11	80.75	87.72	94.39
Plan C				
SFAS No. 87	$11.05	$14.50	$20.75	$30.39
APB8	36.86	40.73	44.37	47.85

to negotiate benefit improvements. To illustrate this point, we actually computed costs from 1983 through 1986 for three sample plans of one of our clients. Now remember, I said that during that period rates were relatively constant. We had a 11.25% settlement rate in 1983, 10.5% in 1984, 11% in 1985, and 10% in 1986. For Plan A, costs under the new accounting rules were slightly lower in 1983: $66 per employee for a $1 increase in benefit. That rises to $100 by 1986. Costs for funding purposes were $73. This rose to $77 by 1986. In Plan B, costs were $67 in 1983, $76 in 1984, $94 in 1985, and $116 in 1986. This is an even greater rise. For funding purposes, under the old accounting rules it's $77, $80, $87 and $94. The higher costs in later years represent some changes in demographics in that plan. The final plan starts at $11. The cost in this is clearly much lower under the new accounting rules because of the makeup of this group. However, it rises to $30 at the end of the four year period compared to costs rising from $36 to $47 in the actual funding.

The problem here is, how do you advise a client of what a $1 increase in his pension plan is going to cost him? How does he negotiate that once he understands these situations? You can take the one approach in which you say what we have to fund is our true cost of the plan and you can negotiate on that basis. The problem with this is, that is not what will affect his financial statements. I think this is another example of a case where the credibility of an employer with his union may be stretched if you try and explain the difference to them. If he shows a substantial reduction in pension costs through the adoption of the new rules, there will be a significant effort on the part of the union to attempt to recapture some of that through improvements in benefits, even though it's only a paper gain.

Just to summarize, there are a number of problems in working with the new rules. Those companies that adopted the rules for 1985 are beginning to get into these problems. In advising clients, it's very important that they understand the interrelationship between settlement rates, long term rates, and all the other factors such as smoothing and actuarial value. We'll now talk about Canadian rules which, as I understand, are much more logical than those that FASB has promulgated.

FASB AND CICA ACTIVITIES RELATED TO PENSION PLANS

MR. YVON CHAMBERLAND: One thing's for sure, the more I learn about FASB, the more I feel I have the easy life in Canada as compared to the actuaries in the United States. Of course there is a counter aspect to that; my friends in the United States are going to get higher fees.

The Canadian accountants have struggled for many years with the question of accounting principles for pension costs and obligations. In January of 1985, the Accounting Standards Committee of the Canadian Institute of Chartered Accountants issued an exposure draft indicating their philosophy on the matter. The ideas that were expressed in the exposure draft will sound familiar to you. The CICA wanted to have accounting figures that were going to be independent from the funding contributions. It wanted to have one uniform actuarial cost method that would be applicable to all plans. This method is the accrued benefit actuarial cost method projected with pro rata on service. The CICA wanted to recognize the impact of future salary increases in the current accounting period. The increased cost resulting from plan amendments, changes in assumptions, or experience gains and losses were not to be recognized immediately in income, but were to be amortized prospectively over the expected remaining average service life of the participants. Assets were to be valued at market, or at a market-related value which gets the market value over a period of no more than 5 years.

There were a lot of actuaries there, so we had a pretty good exchange of opinions. The accountants on one side were satisfied with the one method; they wanted to have only one set of assumptions and forget about the market-related value of assets. They wanted only strict market value. On the other hand, the actuaries were concerned about the cost of the changes; they thought that recognizing more than one method was more adapted to the individual circumstances of each plan or the individual circumstances of the employer. This is exactly what the accountants were trying to avoid. Actuaries pushed for additional disclosure because of the little meaning of the required disclosures, and they were ready to consider restrictions in the amortization periods. All these reactions were reviewed by the Accounting Standards Committee, and in January of 1986, they agreed to new rules that will be effective for large Canadian companies for fiscal years starting after December 1, 1986. Companies can elect early compliance if they want to. The new rules will be published around the end of April. They are identical to the exposure draft with a few minor clarifications. So the Canadian Institute of Chartered Accountants came to basically the same principles as FASB, but there are still many technical differences. As Darrel said before, "We've got the easy life". One exception to that easy life is the benefit allocation method. Both bodies took the benefit allocation method as being the right family of allocation techniques. While FASB elected to go for the actuarial accrual of plan benefits, the CICA continued its choice of the projected accrued benefit with pro rata on service so that there is no difference for a final earnings plan where you have no maximum period and no graded benefits. However, if you do have graded benefits or maximum credited service, you will have a difference between the two methods. The CICA's philosophy on that was that the intervening accrual pattern was irrelevant. What was important was the benefit that was actually going to be paid to the employee, and the service period that he worked for the company.

On the matter of salary projections, they both recognized future salary increases. FASB went further than I had initially anticipated when I read the final FAS in which it said that a history of regular increases in benefits for a career average plan could be deemed to be a commitment to a final average formula. In that case, FASB seemed to require that you would determine your pension costs on the basis of a final average formula. The CICA did not go that far. Basically it is looking at the promise versus the plan formula. The CICA is saying that accounting on the basis of the plan formula would be accounting for form rather than substance. And what it wants to account for is the promise. It's not clear in my mind as to what the promise is if it's not in the plan document, but there may be some interpretation that remains to be done there.

On the question of assumptions, both bodies agree that they don't want to have the funding assumptions in most cases. The basic reason for that is, the funding assumptions are not the best accounting estimates. In both bodies, we'll have the assumptions selected by management. The difference between the two is the interest rate definition. While FASB concentrated on settlement rates which will produce costs that will be more volatile than the prior cost figures, the CICA indicated that it wanted the discount rate to be identical to the expected return on plan assets. So the assumptions will be a lot less volatile than they are expected to be in the United States, but there will be less uniformity. We will avoid, on one hand, the discrepancy between discount rate and the expected return on plan assets which seem to be creating quite a bit of problems in the United States. One thing that might be worthwhile is immunization. Because the CICA is going to be looking at the expected return on plan assets, immunization will be possible in Canada. On the matter of asset valuation, both bodies put the interest on market values but are willing to accept market-related values. It is interesting to note that on this matter of asset valuation, the Canadian Institute of Chartered Accountants focused on the consistency of the actuarial assumption or the expected return on plan assets with the asset valuation method. Basically, it said that if you are using market value, maybe your expected return should be close to the market interest rate. On the other hand, if you are using a smoothing technique for your assets, you could have a more stable interest rate assumption.

Regarding the balance sheet items, the CICA did not adopt the unfunded accumulated benefit obligation as a liability of the plan sponsor. Basically, the only balance sheet items in Canada are the accrued or prepaid pension costs. There are a lot of differences with the amortization. The rule in Canada, as compared to the U.S., is very simple to understand. Everything is amortized over the expected average remaining service life of the participant. So in Canada, there is no minimum 15 year period. Also, we are not looking at the group of participants expected to receive benefits. We are just looking at all the plan participants. There is no 10% corridor in Canada. Everything is amortized and is reflected in the pension cost as amortized. In the United States you can, if the accountant feels that it is appropriate, select a shorter amortization period. In Canada, the shorter amortization period is recognized but would be considered to be a departure from the norm. Therefore, it probably would have to be explained to the auditor.

On the matter of disclosure, as I said before, the only required disclosures in Canada are the present value of the accrued benefits attributed to service prior to the reporting date, and the market related value or the market value, whichever is being used by the plan sponsor. Of course, in the United States, you have a long list of items to be disclosed. On this matter, it is interesting to note that the CICA definitely lacks support for the small amount of disclosure that it will require. Two-thirds of the submissions that we received wanted to have more disclosure than their minimum. However, the CICA decided to leave it to each enterprise to decide the appropriate disclosure to follow. Those of you who work for insurance companies might be interested to note that group annuity contracts in Canada are not exempted from the accounting standards. In other words, people will have to do the calculations unless they drop out of the group annuity contract altogether. They are going to do the calculation for the projected accrued benefit with pro rata on service. Most companies having group annuity contracts will end up with the net liability figure on their balance sheets.

Overall, the new standards have been relatively well received in Canada. I believe actuaries were shocked initially when they came out, but I think they have recovered since. The item where the CICA definitely lacked support was the question of disclosure. However, it was solved by asking so little, that most companies are going to end up disclosing more than the minimum. The long term implications as far as I can see for actuaries in Canada is that we are going to learn to deal more with auditors. We are going to have to get involved in the planning stage of the auditing process. We're going to have to document our assumptions better and explain them better both to management and to the auditors. We can't continue to select our assumptions in an ivory tower. We are going to have to be able to answer questions such as what is the probability that you are going to meet your expected return? Why did you take this assumption for this plan and not for this other plan? We are going to have to deal with the materiality issue. What is acceptable to us and what is not acceptable to us. What is acceptable to the auditor? Basically, I disagree with those who feel that auditors will compete with actuaries. As a matter of fact, I think we've become more respected by auditors as they learn more about our business. In some quarters, I believe we had a pretty shoddy reputation as manipulating accounting figures. That will change to the extent that we rise to the challenge in front of us. Overall, I'm very positive about the new rules in Canada for our profession. As I said before, we are going to have the easy life, but you are going to have the fees.

MR. RICHARD O. ELLIS: I have a question for Judy. I believe you mentioned the maximum amount of gain that you can recognize under a settlement. If I have a spinoff termination prior to implementation and take a reversion. I set up an amortization of that amount under the old rules. Can you tell me what you think the maximum amount of gain would be when I implement?

MS. LATTA: You are saying it is handled under APB 8, business combination. The standard, at the end, has the transitional paragraphs as far as how to handle the existing balance. I don't think it's clear exactly what is the appropriate way to handle the transition from the old standards to the new standards.

MR. ELLIS: I'm speaking in particular of one question. It gives you the maximum amount of gain as A or B, whichever is less. A is the unamortized amount related to the reversion.

MR. GARRETT: B is any unrecognized net asset for the plan existing at the time of transition.

MR. ELLIS: In this situation it would be 0.

MR. GARRETT: It could be 0.

MR. ELLIS: That is what I'm afraid of.

MS. LATTA: It can be.

MR. ELLIS: Your assets are gone. So it's a spin-off termination. I don't have any assets in the plan now.

MS. LATTA: There are inconsistencies as to whether you should adopt the standards before you do this sort of transaction or if you should do the transaction and then adopt the standards. It shouldn't happen and it can in principle. It is strictly form over substance and should not result. But it does.

MR. ELLIS: That's sort of the answer I got from the accountant.

MS. LATTA: At least we are consistent in our answer.

MR. GARRETT: It absolutely does and Judy is right. I'd advise anyone, who is thinking of having a reversion this year and then deciding whether to elect 87 and 88 this year or next year. You better do it both ways because it can make a big difference.

MR. CHRISTOPHER "KIT" MOORE: One of the items on the agenda referred to the reaction of plan sponsors. We had some comments in the first two presentations about the plan sponsors which had elected to comply early and were the winners. I've been having some expressions of resistance from plan sponsors that may well be classed among the losers with the new rules, and I was wondering if the three speakers might have some comments about the reactions that they are getting from plan sponsors and where they think this is going to go? The kind of comment I've been getting is: "I'm sorry about the new rules, but we have other things on our mind right now and we are going to carry on as we wish." I've talked then about the possibility of unqualified opinions, but the plan sponsors have indicated that they are going to carry on as they wish.

MR. GARRETT: I think the idea about the unqualified opinion may be some bravado right now because I think that, if any of your clients do need to ever go for loans from the bank or anywhere where they have to show that they follow generally accepted accounting principles, they will not be under generally accepted accounting principles. I don't think that is a viable course for a publicly held company. It's possible, but I don't think it is viable. I guess the losers could be grouped among those which may have a minimum liability on their balance sheet. Also among the losers could be clients that deal with the Defense Audit Contract Agency, or utilities. Some of the strategies there that are at least talked about are keeping the assumptions very conservative. It's going to be very tough to go to a utility board for an increase and explain why you have negative pension expense and that you are asking for a rate increase. Those are some of the types of problems. One strategy that many of these people are using is just taking the stated effective dates. With regard to those negatively affected people getting together to try to overthrow this, if that is implied in your question, the SEC has overall jurisdiction on financial reporting of companies in the United States, and FASB operates under their aegis. The SEC has, in the past, stepped in on several of the things that FASB issued and changed those things or overruled them. It's highly unlikely that the SEC will do that since it is fully supportive of this document. In addition, unfortunately, I'm afraid that the losers are in the minority at this point in time. It may be that some of the winners today will feel like losers a few years down the pike, but FASB had the good fortune to issue this statement at a time when the economic situation was such that many winners were very happy. As Darrel's client said, good corporate citizens can comply with this statement because it was in their best interest. FASB also was very shrewd in having staggered implementation dates because that diffused what might otherwise have been the ground swell of people getting hit at the same time. People can pick their implementation times, and it's been good for some and not so good for others.

MR. CROOT: Even in those situations where a company will have a higher expense and will have a liability, there is still opportunity to examine the potential impact. We have a client in the smokestack industry, and they have some large liabilities which will appear on the balance sheet when they adopt it. In looking at the settlement rates, if you think the settlement rates may drop, the hit could be less by adopting early rather than postponing it because of the application of the corridor. By looking at the later part of 1986, you'll know what the settlement rate will be for 1986, and you'll know what the rate will be for 1987, or you will have a pretty good idea of what it might be. If interest rates have dropped significantly between 1986 and 1987, it might be in the best interest of the client to adopt for 1986. The additional cost attributable to declining settlement rates in 1987 might be a loss that would be within the corridor.

MR. CHAMBERLAND: One of the items that comes to mind is the question of the materiality issue. We have to remember that the client is concerned about its income statement in total and its balance sheet in total to the extent that the pension cost may not be material. They might be able to get away with keeping the old system. However, they would have to prove to their auditor that their decision to stay with the old figures is not material for purposes of their financial statement.

MS. LATTA: Clients are reacting differently to this statement. In particular, I have one client now who is using a very conservative interest rate assumption and does not really want to see the pension expense reduced. This client really doesn't want to cash in right away. What it is trying to do is basically buffer the initial date of application of the standards in order to not cash in on the first round, thus giving itself some cushion to work from. Initially, the reaction was to not implement until 1987 -- not always the right answer. In this situation, the same client is the client which traditionally has updated its career average pension plan, and it may anticipate doing one in 1987. If the client implements in 1987, the treatment of the transitional asset as of the date of implementation is defined by the standard and has to be over the remaining working lifetime of the group expected to receive benefits. However, if the client implements in 1986, it could use some acceleration of that amortization of the update, and this could be the way in which to buffer how low expenses would go. There is no one answer that we can tell you. This is basically the clients call. We are giving them advice. The auditors will eventually sign off on what they've done, either agreeing, or if they are disagreeing, finding some middle ground. But different clients are attacking this from different perspectives. It's easy for the client that has the big assets. It's just a matter of how much do you want. It really comes down to that at some point in time.

MR. GARRETT: The client can also carry this surplus that it has now and it can cash it in at any point in future time when earnings are fluctuating by purchasing annuities and taking a gain there. I want to emphasize what Judy said if you are not already aware of this or haven't been that close to it. There is only one generalization about this whole thing, and that is not to generalize on any specific case or try to generalize. You just can't. We've run tests, like Darrel did, on the smoothing techniques and the actuary would find it totally different from what he had imagined it would be. Then the actuary would have to go back and track through it to find out why it wasn't coming out exactly the way he thought it would. It's because it's just a totally new technique that most of us are not familiar with -- having separate interest rates for assets and liabilities.

MR. K. ERIC FREDEN: I'm interested in the practical problems you might run into with respect to calculating the disclosure items as of the financial statement date, and how you dealt with those?

MS. LATTA: I haven't run into any particular problems on the practical discrepancy between information being available as of the end of the year. The clients that I am working with had started this so far in advance that they made sure that everything was in place. What I see, though, as relief for the practical problems, is the endorsement of use of approximations in the statement. I think that would basically be our out if the valuations traditionally are not available by disclosure date. You can use generally effective approximation techniques and even change the discount rate certainly by the end of this year. If the interest rates do not recover, we may see companies reducing their discount rates. But for that, at least for the larger companies, we were able to approximate the effect. A lot of us have done a lot of analysis at that point, and we could change just about any number any way because we've done so many variations. I think that we are going to hone our techniques as far as approximations and will tend to use them more.

MR. CROOT: The one thing we can't approximate is the audited market value of assets which must appear in the statement. Many of the banks, at least the banks which I have been familiar with and have been dealing with, cannot provide year end audited statements of assets in time to complete the statement. That means you're forced into backing up to within the 90 day period permitted under FASB. That is a problem. It's not a big problem, but it is just more detail in my opinion, and it adds a lot more confusion to the statement when you show these 90 day numbers.

MS. LATTA: Just one more expansion on that. It is interesting if someone does try to use the 90 day relief period. There is some question as to what is appropriate the first year of implementation. Certainly, on an ongoing basis, foresight will not be 20/20. Therefore, you will have to be using estimates of December 31 or September 30 numbers as your disclosure date -- the measurement date. However, in the first year of implementation if that decision is not made until the end of 1986, I think there is a valid argument to be made for a one-time exception to using September 30 dates. This is an argument that has to be won with the company's accountants, the controller's department, as well as with the auditors, however, there is some room for variation which I have seen some companies get very concerned about.

MR. CHARLES BARRY H. WATSON: I have a question for Yvon. I do a lot of work in the international area with multi-national companies. One of the problems that occurs when looking at FASB and the CICA regulations is trying to arrive at an approach to producing the figures for pension plans which plausibly satisfy both sets of requirements. Therefore, I was very interested in Yvon's comments on the differences. There seem to be some differences which can potentially mean that you can't satisfy both sets of accounting requirements with one set of figures. Therefore, we're going to have to have one, two, three, or four sets of books depending upon what we are doing. I think one of the problems is the question for what group of employees you are determining the average future lifetime. I think, at the moment, you can be somewhat creative on this issue. Perhaps when the committee which Mr. Garrett referred to comes out with its pronouncements, some of that creativity in the United States will be eliminated. One difference that we have seen which Yvon did not mention, had to do with the particular group of employees and the time at which we are looking at them. In order to average that, according to our interpretation of the CICA requirements, you seem to have to look at the employee group each year when you have had particular gains, losses or other amortizable items. Thus, you would have a series of these groups of employees and therefore, potentially a different period of amortization every year as you went along. I would be interested in Yvon's comments on whether or not he feels that the flexibility which the Canadian system allows would permit you to somehow collapse that into a more reasonable group of amortization periods. The other point here is we have received some reasonable assurance that the question or the promise would indeed permit you to look at the final average formula rather than the career average.

MR. CHAMBERLAND: Basically, I agree with what you are saying. The career average plan, being updated regularly, would be looked at as being a final average plan. That is my understanding of the reading in the discussions I have had. Concerning the question of amortization, in Canada each amount gets amortized over the average remaining service lifetime, and it sticks with that amortization period. If you have in 1986, say, $1 million that you amortize over ten years, the amount of amortization would be $100,000 a year for the following 10 years. If, at the end of 1987, you have another $1 million, and your average remaining service lifetime is still 10 years, you would not change the first amortization schedule. I'm not sure whether you can recalculate the U.S. amortization every year. I don't think you can.

MR. GARRETT: There are three different amortization schedules in the U.S. For any amendment, you calculate an amortization schedule at the time of the amendment based on the expected lifetime then. If you are going to amortize gains and losses, you calculate an amortization schedule at that point in time. The transition credit amortization schedule is locked. The other two are recalculated.

MR. CHAMBERLAND: Of the basic difficult items to reconcile, one is the method. If you have a plan where the different method will generate a different result, that would be very difficult to reconcile. The other thing that might be difficult to reconcile is, if your U.S. clients decide that they want to use the corridor aspect, that might also create some problems with Canada.

MR. GARRETT: Mr. Watson's question reminded me of Yvon's comments about the meaning in the FASB documents of Paragraphs 27 and 41 which have gotten a lot of attention. These paragraphs deal with the so-called accelerated amortization, or, as, it's been inferred, union negotiations. Paragraph 41 deals with updates of career average, ad hoc COLAs. Apparently, the FASB intended these paragraphs to be permissive. The reason for this was to accommodate responders to the exposure draft who had plans which those responders did want to expense for them this way. The FASB unfortunately didn't come out sounding permissive, it came out sounding mandatory.

MR. DONALD S. GRUBBS, JR.: I have a question regarding valuation dates that differ from the fiscal year. If I have a calendar year plan for which I do a valuation on January 1 and I want to project for the fiscal year that is starting on October 1, and the discount rate is 9% on January 1 but could be 7% on October 1, could I use the 9% that I used on January 1 for October 1?

MS. LATTA: My understanding is no. The measurement date has to be selected within 90 days before the beginning of the fiscal year for which you are reporting. In general, you can rely on calculations made as of that measurement date for up to a year unless significant events have occurred. Significant events are not really defined, but in most ongoing plan situations, we can continue to rely on these calculations. I think your rate has to be determined as of the measurement date which is defined to be either October 1 or as July 1. Therefore, you could use that valuation on January 1 and adjust it if you now think the rate has gone to, say, 7%. As long as your approximations are reasonable, that would still be acceptable.

MR. GARRETT: I agree. In other words, you could roll your data forward with increased service and so-forth, but the assumptions are the things that the FASB is really concerned about at that point in time.

MR. CROOT: For disclosure purposes, the rate must be appropriate for the date at which you value the assets. The reason for that is, if you pick a date other than the disclosure date, the bond price will be reflective of interest rates in effect at that time.

MS. NEELA RANADE: What I'm concerned about is the way some of the language in FAS 87 is being interpreted, particularly the language regarding the settlement rate, the interest, and assets. I have heard that some people think that long term rate of return on assets should not be less than 200 basis points below the settlement rate. As actuaries, these two rates have to be totally separate. The settlement rate should have nothing to do with what the long term expected rate of return is. What I'd like Mr. Garrett to do is to shed light on this committee that is talking to accountants and what the outcome is likely to be.

MR. GARRETT: As you probably know, there's a long answer to this. The one thing that actuaries are trained in is choosing assumptions so that we try not to get mechanical rules. We try to leave it up to the individual practitioner.

If you read FAS 87, nowhere does it talk about actuarial assumptions, and you should keep in mind that they are assumptions for expense. The problem is, they look a lot like actuarial assumptions, and when you start using those same assumptions for Schedule B purposes, you are going to have to think about it. The answer to your question seems to be an accepted latitude right now on the one side. As Judy pointed out, if you are using modern portfolio theory and you came out with a 12% settlement rate based on fixed income, and any of your portfolio on which you are basing the long term interest rate happens to be equity, you'll be led almost automatically to the idea that your interest rate will be higher than the discount rate. There are a lot of us who feel very uncomfortable with that. Darrel said his company is taking the stance that the long term interest rate is roughly equivalent, if not equivalent, to the funding interest rate. I happen to be more in that camp in terms of a comfort level. I think you are talking about some different things. You're talking about PBO instead of PBV -- all the benefits -- so there might be some slight difference.

MS. RANADE: I would agree that the long term expected rate of return, if you are using explicit assumptions, has to be the funding interest rate, and I think the profession wouldn't want the accountants to try to tie it to the settlement rates. I hoped we would have an example, like in Canada, in which accountants basically decided to leave the actuaries to choose the interest rate.

MR. GARRETT: I can tell you now, I don't think you're going to see an actuarial guideline that restricts your freedom in this choice. I think you do want to keep in mind that if you go along with a 14% interest return for FAS 87 as your explicit best estimate, you shouldn't be surprised if someone comes back to you later asking you why you were not funding on that. I think you have to decide your own comfort level with things like that.

MR. CHAMBERLAND: There is just one thing I'd like to bring up about Canada. The accountants didn't leave the actuaries alone regarding the assumptions. The assumptions are to be selected by management. If management decided to use an interest rate that was unrealistic and if management had the possibility of meeting the calculation, it could use that interest rate. It would have to justify that rate to the auditor. You don't have to use the actuaries' rate.

MR. GARRETT: This is a topic we could spend another 1 1/2 hours on, so let me emphasize what he is saying. This is something that has to be agreed to by the auditor. The practice is really not that much different than it used to be, in the sense that, even though the people say the actuary chose the assumptions, I think most actuaries discuss those assumptions with the employer. This same process should go on now.

MS. JUDITH D. SPIGAL: I have two questions. First, I am wondering whether you find any or many plan sponsors which are planning to use duration related interest rates with FASB -- whether they be discount or other duration related rates with a long term expected rate?

MR. CROOT: We have not made any calculations using duration related rates, but we have derived a rate using that process. Then we use a single rate for the calculation. To the best of my knowledge, I think we've done that in all the plans in which we have been involved. We have considered use of separate rates to classes of assets in the long term rates, but again, I don't believe that we have ever done it. I don't think any company has ever adopted that policy and used an average rate.

MS. SPIGAL: The second question is I was wondering, if you had a dedicated portfolio for a portion of the assets prior to adopting FASB, is the dedication essentially not recognized under FASB?

MR. GARRETT: That is right. You would have to value everything at the discount rate regardless of whether you invested it at 15% five years ago.

MS. SPIGAL: So you might take into account a higher return on certain assets such as the ones that used to be called dedicated, but you would not explicitly say the rate on dedicated assets was different. Is that correct?

MR. CROOT: I think you can. If you had a GIC and no market value, and a 15% rate, I think it's pretty easy to justify using 15% on that. But a dedicated portfolio will rise and fall depending upon interest rates. That presents a slightly different problem, however, I think you can clearly separate them and apply a different rate to it.

MR. GARRETT: I'm not sure I agree with that. I think that if the rates were perfectly locked -- if they were guaranteed that would happen.

MS. LATTA: I think we have to differentiate between the assumed return on assets. Clearly, you can differentiate where the assets are currently invested and how the portfolio is structured. But as far as the obligations themselves, we don't have the latitude to recognize that we have some matching as far as the assets and the obligations. It's the obligation that is locked, and we cannot use an immunized rate. That I believe to be true.

MR. GARY T. BAYER: On a technical viewpoint, I keep hearing about the average remaining service of people expected to receive benefits. Is that implying you would exclude people who are non-vested?

MR. GARRETT: That is implying that you have to drop out the pieces of the people who don't reach vesting. What that does is extend your period.

MR. BAYER: The other question I have concerns a plan with employee contributions. Does the service cost include the employee derived portion of the benefit, and if that is the case, does a prepaid or accrued pension expense or employee contribution enter into that also?

MR. GARRETT: My understanding is that FAS 87 is intended to apply to the employer's portion, but that's an area that still needs some clarification.

MR. BAYER: It can get pretty messy if you start trying to strip out the employee contributions as far as the assets and go.

MS. LATTA: Using the techniques to strip out the employee's contributions, whether it's this year's employee contributions or whether it's the level portion that will be funded by employee's contributions, adds a definite complication to the whole process. That seems to be true of all contributory plans and everything we do with them. This is one more wrinkle in the statement. I would agree with Harper that it is a net service cost.

MR. BAYER: In that situation, can employee contributions be excluded from the assets?

MS. LATTA: No, because they are in the projected benefit obligation. The way I would envision it, the projected benefit obligation and all the measures of obligation would include all benefits accrued to date. Therefore, the assets would include all the assets. For the service cost, which is the measure of accrual of benefits this year, pension expense will only be charged for the portion the employer is responsible for. However, we have to recognize that there is another inflow to the fund, the employee contributions, which will make up the difference and bring everything into line as of the end of the year.