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

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- A discussion of recent or expected FASB and CICA rulings affecting pension plan sponsors.

MR. THOMAS. M. MALLOY: The recent FASB Exposure Drafts were preceded by extensive work on the part of the Board's project staff, going back several years. A major Discussion Memorandum drew significant comment from all corners of the pension industry. In an effort to further distill opinion, the Board issued a set of Preliminary Views, which was the subject of public hearings and substantial written comment.

In March of 1985 the FASB issued an Exposure Draft of a Proposed Statement of Financial Accounting Standards for Employers' Accounting for Pensions. The principle element of this Exposure Draft was that a single method for measuring periodic pension expense would be required. This method is essentially equal to the projected unit credit actuarial cost method, with service proration of benefits for salary-related plans. Unrecognized prior service costs would be amortized over the future service of employees expected to receive benefits from the plan. Experience gains and losses would be expensed on an amortized basis when the accumulation of unrecognized gains and losses exceeded the greater of 10 percent of plan assets or 10 percent of the benefit obligation.

The next major element of the Board's work represents a second major departure from current pension accounting practice. The March 1985 Exposure Draft requires employers to formally recognize a net liability in their statements of financial position whenever the present value of accumulated benefits exceeds the value of plan assets.

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The last major element of the Board's position is the use of current market values in measuring both periodic expense and the balance sheet obligation. The rate of return used in discounting the benefit obligations would be based on rates representative of annuity transactions in the current marketplace. Plan assets would be measured at market value.

On June 14, 1985, the FASB issued a second Exposure Draft dealing with Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination of Benefits. This Draft has been paired with the earlier proposal covering the basic accounting for pensions but has drawn much less attention to date.

MR. HARPER L. GARRETT, JR.: In discussing the Pension Accounting Project which the FASB has been studying for a number of years, an appropriate starting point is the public hearings in July and August of 1985 at which a number of interested parties testified concerning the FASB's latest Exposure Drafts on this subject. Essentially all of the key provisions of the Board's proposals were discussed, with opinions both for and against being presented. Therefore, these hearings (along with the more than 400 comment letters the FASB received) provide useful insights into the most recent thinking of a broad spectrum of affected parties.

On August 2, 1985, the FASB completed five full days of hearings on the Pension Accounting Project (Exposure Draft of March 22, 1985, and Exposure Draft on Curtailments of June 14, 1985). Three days of hearings were held in New York City and two days in Stamford, Connecticut. In total, 56 people testified representing 14 industry associations, 22 corporations, 7 of the "Big 8" accounting firms, 11 actuarial or investment consulting firms, 1 government agency--Pension Benefit Guaranty Corporation (PBGC), and 1 individual.

The Board's proposals contained in the March 22, 1985, Exposure Draft reflected the result of its efforts since the last public hearings in January 1984 on Preliminary Views. Among the changes from the Preliminary Views were that salary projections were no longer required in the calculation of the liability for balance sheet purposes. Instead, the Exposure Draft contains a minimum liability for unfunded accumulated liabilities to be placed on the balance sheet. The Board has also abandoned its articulation approach whereby the expense is the difference between successive years' balance sheets. In addition to the other requirements, the Exposure Draft would require extensive footnote disclosure.

The June 14, 1985, Exposure Draft on Curtailments generally required recognition of gains or losses in some circumstances in which current requirements are either ambiguous or do not permit recognition. Situations covered by this Exposure Draft included asset reversions and plan curtailments.

An overwhelming number of those appearing at the hearings were against the FASB's proposals, as expressed in the March 22, 1985, Exposure Draft. Although a number of witnesses did offer some

preliminary comments on the June 14, 1985, Exposure Draft on Curtailments, almost everyone said they were still reviewing it in detail; consequently, the major portion of my remarks will deal with the March 22, 1985, Exposure Draft on Employers' Accounting for Pensions. A summary of the opinions expressed follows:

1. All actuarial consulting firms were against most provisions in the Exposure Draft but were for increased footnote disclosure.

2. Six of the seven "Big 8" accounting firms testifying were generally against many provisions of the Exposure Draft. Those that were generally opposed to the Exposure Draft were, however, in favor of narrowing the number of permissible cost methods to a few or even to one method, although most preferred a cost compensation method rather than the projected unit credit method selected by the Board.

3. Practically all of the 22 corporations testifying were against many of the provisions in the Exposure Draft but were for increased footnote disclosure.

4. Most professionals and trade associations were against many or all of the provisions of the Exposure Draft but were in favor of increased footnote disclosure.

5. The PBGC was against the Exposure Draft, expressing considerable concern regarding the lessening of benefit security when employers change their funding method in order to conform to the suggested accounting method.

6. The Financial Analysts Federation supported the Exposure Draft. This was probably to be expected, since the FASB has claimed that one of the purposes of this project is to assist creditors and analysts.

7. Arthur Andersen & Co., while generally supporting the Exposure Draft, mildly chided the Board for departing from the Preliminary Views approach, of which Arthur Anderson & Co. was even more supportive.

Without question, the most controversial provisions of the Exposure Draft were the use of a settlement interest rate and the market value of assets in calculating the expense. Everyone who testified against these provisions noted the volatility in year-to-year expense that would result in a single company. Most noted that the Board's use of termination-type measures was totally inappropriate for the calculation of expense of an ongoing plan. Most witnesses suggested that a longer term interest rate should be used and that such a rate should be tied to the actual assets of the specific plan. Also suggested was that some type of smoothed market value should be used.

Probably the second most controversial feature of the Exposure Draft was the use of the projected unit credit cost method for calculating expenses. Those testifying against pointed out that not only would

corporations quickly swing over to using the projected unit credit method for funding in order to avoid all the balance sheet "debris" that would otherwise result from using projected unit credit for expense and some other method for funding, but also that projected unit credit was one of the weaker funding methods in terms of accumulating assets. Thus, a company that switched over to this basis for funding might find it had weakened the employees' benefit security in future years. Most witnesses testifying against this provision suggested either that the entire range of expense methods sanctioned in Accounting Principles Board (APB) Opinion No. 8 be preserved or that the choice be narrowed to projected unit credit plus one of the family of cost compensation methods (generally some variation of the entry-age normal method).

The third most controversial item was the balance sheet liability entry. Most of those testifying against the Board's proposal felt that APB No. 8 practice should be preserved (whereby the only liability is the excess of accumulated expense over the amount funded). Many seemed to feel that the Board would probably not agree to this and suggested that a compromise position, using this minimum liability, would be to change it from unfunded accumulated benefits to unfunded vested benefits. In addition, probably half of those testifying against having any minimum liability in the balance sheet noted that the Board had not permitted a balance sheet asset when the assets of the plan exceeded some appropriate liability measure. They found this to be an inconsistent accounting practice.

The fourth most controversial feature was the Board's recommended period of amortization for past service liability. All of the auto companies and many other corporations favored continued use of 25- or 30-year amortization. They were concerned about the period being shortened, particularly with respect to negotiations, where the clear inference in the Exposure Draft is that such past service liabilities might have to amortized over a 3-year period. In addition, most of those testifying preferred the current level amortization approach instead of the Board's front-loaded recommendation.

Finally, the one provision upon which everyone seemed to agree was that too much footnote disclosure was being requested. This seemed unfair to many, particularly in view of all of the other requirements in the Exposure Draft. My personal view is that while most of those opposed to this Exposure Draft would have accepted unlimited increased footnote disclosure if it were in lieu of accounting entries in the financial statements themselves; virtually no one was prepared to accept both. Although most of those testifying against other provisions in the Exposure Draft felt that additional footnote disclosure was a better solution, they were critical of several of the specific items the Board had suggested for footnote disclosure, most notably the 1 percent sensitivity test. They objected to this on the grounds that it would add unnecessary expense for plan sponsors as well as provide potentially misleading information, since the numbers are nonlinear (i.e., the differences created by an increase from 7 to 8 percent will not be the same as the differences created by an increase from 10 to 11 percent).

Many of those who were supportive of the Exposure Draft were, nonetheless, somewhat critical of the volatility issue and seemed to feel that more smoothing was necessary. The Financial Analysts Federation, under questioning, noted that it would like to see more description of the various funding methods being used. When asked if footnote disclosure might not suffice, it responded that, while this would help, it made more sense to put the resulting numbers in the financial statement where they rightfully belonged.

The first FASB open meeting following the public hearings was held in early September 1985. Since then, the staff and Board have been hard at work addressing a number of the concerns which were expressed at the hearings. I found that the testimony and interchange between the Board and staff members and those testifying at the hearings provided interesting insights into the thinking of both the FASB and its constituency. It seems reasonable to conjecture on certain changes that may now be made.

It appeared almost certain that the FASB would take action to dampen the volatility caused by the use of a settlement interest rate and market value of assets in calculating pension expense. Indeed, this was the first topic it addressed following the hearings. The most direct way of accomplishing this would be for the Board to recommend use of a longer-term interest rate, perhaps one tied to the underlying plan assets, which would essentially be close to an explicit interest rate currently used for funding purposes. Similarly, using some type of actuarial asset value, perhaps a four- or five-year averaging of market values, would reduce the volatility created by the Board's use of market value.

The FASB has initially rejected this direct approach, instead maintaining its original inputs (i.e., settlement interest rate and market value of assets) and exploring adjustment of the computation of the pension expense. The staff's recommendation to the Board expressed the feeling that to change the inputs would weaken the conceptual underpinnings. Another reason for suggesting this approach was that the staff had been unable to frame in writing a description of some longer-term interest rate which would not invite interpretations that might lead, in practice, to a wide range of rates (e.g., 5-14 percent). The staff has recently asked certain parties interested in the pension project for their comments on the Board's suggested solutions to reducing volatility. While it remains to be seen how this particular issue will ultimately be resolved, the FASB's revised approach, although it does reduce volatility somewhat, will probably not satisfy its constituency.

The FASB is probably going to retain the minimum liability on the balance sheet, although this may be changed to unfunded vested benefits. Similarly, I think that the FASB is wedded to the idea of having the amortization period be related to the expected service life of the current employees. Although it may modify the Exposure Draft language somewhat, I suspect that the amortization period will be fixed and related to the demographics of the group, rather than the wide range that is currently permitted.

The question of the projected unit credit cost method versus a wider choice of methods is a tougher question on which to speculate. Members of the American Academy of Actuaries (AAA) Committee on Pension Actuarial Principles and Practices, along with members of the Academy's Pension Accounting Matters Committee and a representative of the PBGC, recently met with the Board and staff to discuss the results of the recent Academy cost method study. It was apparent during the hearings that neither the staff nor the Board had yet had an opportunity to spend much time reviewing this study, which was completed in April 1985. The September 1985 meeting served to help the Board understand the interrelationships between cost methods and demographics, as well as the relationships among the various cost methods. Currently, the Board still feels that the method proposed in the Exposure Draft is theoretically correct. However, several members of the Board have previously stated that if they could be shown that there was not a significant difference in costs produced by the various commonly used methods, then they would not wish to prescribe one method, due to the added expense this would cause their constituents.

Occasionally during the hearings, the Board adopted an intriguing technique when questioning witnesses, asking something to the effect of, "Suppose we stayed with APB No. 8 accounting. What changes would you recommend that we make in it to resolve some of our concerns?" At least one witness responded that that had not been the question with which he had been confronted; his written response was directed to the Exposure Draft, which seemed to be a revolutionary change. He felt that the question as stated was one which he had not even had a chance to consider in detail but which he felt was a much better question, and he wished the Board had taken that tack at the outset.

In summary, there is no question that the Board does not have the broad support of its constituency on this Exposure Draft. In fact, one of the largest corporations pointed out in its written response that, if the Exposure Draft were adopted, it could hardly be called "generally accepted accounting practice" since it was not generally accepted by the Board's constituency.

Aside from whatever theoretical or practical correctness there is or is not in the Board's proposal, there are some other considerations for the final decisions. The Board, which left the January 1984 hearings on Preliminary Views perhaps feeling that it had gotten itself out on a limb with its constituency, now appears to have simply jumped from one limb to another with this Exposure Draft. The FASB may find it somewhat difficult to depart significantly from its current position even if it wanted to. In fact, Arthur Wyatt, one of the seven Board members, is reported to have said in a recent talk to the Chicago Chapter of the Financial Executives Institute that the Final Accounting Statement to be issued at year-end will be essentially unchanged from the Exposure Draft, with the possible exception that some disclosure requirements may be lessened.

Possibly a more important determinant is that two of the seven Board members' terms expire at the end of 1985 (also the target date for the

final accounting statement). Clearly, the staff and the remaining Board members would like to resolve the issues without involving new Board members. On the other hand, both the staff and the Board appreciate that they probably have never undertaken a more difficult project than pension accounting, nor one to which the majority of their constituency (including accounting firms) has been so opposed both theoretically and practically.

MR. TIMOTHY S. LUCAS: The product of the Board's efforts is not perfect. In fact, we are still working to improve upon it.

The Board's involvement with pension accounting actually started in 1974, only eight years after the issuance of the predecessor pronouncement, APB No. 8, in 1966. From 1974 through about 1980, the primary involvement was with plan accounting. In 1981, we saw the first printed evidence of the Board's involvement with employers' accounting, a Discussion Memorandum, followed by public hearings in July 1981. That was followed in 1982 by the Preliminary Views and in 1983 by an additional Discussion Memorandum. Following that we did a field test and held another set of public hearings in January 1984, after which we separated the project on other benefits. The Exposure Draft on Other Benefits and the Final Statement on Other Benefits Disclosure Terms were issued in 1984. In March 1985 the Board issued the Exposure Draft that we are primarily concerned with here. The additional Exposure Draft on Terminations and Curtailments was released in June 1985, after which we had the public hearings of July and August 1985, bringing us up to date. The intention was to have a final statement or statements in the fourth quarter of 1985.

We spent most of the month of August 1985 digesting the over 400 plus comment letters that we had received, gathering and organizing the additional evidence that had been provided. Around the first of September 1985, we started Board meetings, which will continue through November 1985, at which the Board will reconsider all of the major issues and all of the decisions previously made in light of the additional evidence that has been provided. I want to share a list of the most significant issues and comments that the Board's staff extracted from the public hearings.

Volatility was the number one issue, and we presented that to the Board immediately at the first meeting in September 1985. At that meeting, the Board agreed that we should make changes to reduce the extent of volatility. The primary objection regarding volatility was to year-to-year changes in net pension cost, primarily as a result of the changes in assets and the discount rates, and secondarily due to the changes in other assumptions. The Board agreed to make some changes to reduce volatility but has not been convinced, however, that the best way to do this is to abandon the use of the market value of assets or to abandon the discount rate that reflects, at least to some extent, current long-term market rates.

Many of those appearing at the public hearings and responding in writing agreed with the validity of these basic inputs, at least for the purpose of providing information about a plan's funded status. That

is, many people agreed that for disclosure of the accumulated benefits and the asset amount, the fair value called for by Statement 36 is an appropriate measure and that a consistent discount rate would be one that looks at current market rates or settlement rates. The Board believes that these inputs also add to the relevance of some of the components of net pension costs, for example, the compensation component. If we are using a current settlement or market rate in making the expense computations, then the compensation component can be described as an approximation to the cost, in today's market, of the benefits that are accruing during the current period.

Given the Board's desire to retain these inputs, the staff was asked to try to develop a way of reducing the volatility. Several respondents from the actuarial profession provided us with suggestions that led us to a potential solution to the problem. Basing its conclusions on the comment letters, the staff has developed an approach which is intended to reduce the volatility while retaining the basic inputs from the Exposure Draft. The approach, which has been released to a limited number of interested parties, would retain the fair value of assets and the settlement rate as inputs and would adjust the amortization of the net gain or loss.

The process being tested is one that takes the gains and losses arising in a particular period, including the effects of changes in assumptions, and admits those gains and losses to the amortization process over a five-year period at the rate of 20 percent each year. After five years, the entire gain or loss would become part of the amortization process. To the extent that there are offsetting unadmitted losses or gains in the subsequent five years, you would have an offsetting process. That is, if you had a $100 gain in year one and an $80 loss in year two, those two amounts would offset except for the initial $20 that already had been admitted.

The other feature of the amortization can be described as negative interest. Basically, it would be an amount equivalent to interest on the net unadmitted gain or loss. Thus, what is amortized is a percentage of net admitted gain or loss, less interest on the net unadmitted portion. The net effect of this is to reduce the volatility of net pension cost, which is otherwise caused by the return on assets, interest expense, and compensation components.

The process of exposure and comment is not complete; the Board will be looking at this further and may make more changes. It is certainly not a foregone conclusion that we will not return to a process of averaging the market values and doing something else with the discount rate. The Board has had some difficulty, however, describing how it would phrase an interest rate or discount rate requirement which is different from the settlement rate. That likely would involve two different discount rates: one to be used for expense and the other to be used for the disclosure of the funded position. This in turn opens up the possibility of some increases in disclosure.

The second issue for the staff was the disclosure question. Quite a number of respondents commented that the disclosures called for by the

document were excessive. The Board has not yet addressed that question but will be considering it. I would anticipate that the Board will probably reduce the package somewhat. One of the more contentious items is the sensitivity amount, and it may be one that the Board will opt to drop.

After volatility and disclosure, the volume and the intensity of comments drops off considerably. The next three items are, in my opinion, essentially tied for third place on the issue list. The first of these is the "single method" (projected unit credit) and "level of cost produced" question. While the Board has not yet resolved this question, we did have a meeting on September 11, 1985, with the AAA Committee. We have done significant work in analyzing the data that were provided by the AAA study and are awaiting some additional information. Both the meeting and the data have been very useful, adding to our understanding not only of the accounting but of the relationship between funding and accounting as well. While the Board is continuing to work on this issue, I haven't seen anything yet that would cause me to change the staff's recommendation to the Board on the method question. Still, the staff recommendations don't necessarily have a very high correlation with Board decisions on different issues.

The next issue tied for third on the list is the amortization of prior service cost. The Board met on that question and discussed it at some length on September 18, 1985. The Board retains a clear preference for some link between recognition of prior service cost and the remaining service period of the employees. There was a close vote, however, on how much flexibility for more rapid amortization to allow. This is one of those areas where the intent of the majority of the Board members is not entirely clear. We will undoubtedly have some more discussion of exactly how to phrase the requirements of the document in that area, and some changes appear evident. In particular, there was considerable sentiment for allowing a straight line or a level principle amortization over the average remaining service period as an alternative to the declining balance method prescribed in the Exposure Draft.

The last issue tied for third on the list is asset and liability recognition. We spent months arriving at a compromise that none of the Board members are completely satisfied with but that at least five of them could live with. At the September 25, 1985, meeting, the Board tentatively agreed to retain the compromise position that was in the Exposure Draft.

There were a variety of additional lower priority issues raised at the public hearing. While I cannot give a complete list, I will share some that were mentioned by more than one respondent.

One of the underlying fundamental ideas in the Exposure Draft which was challenged by some was the issue of whether the cost ought to be reflected over the service life. The Board reconsidered that at the September 5, 1985, meeting and reaffirmed its belief that pension cost is a form of compensation and, as such, should be recognized in the periods in which the individuals render service.

There were some respondents who suggested that we should allow anticipation of plan amendments by incorporating an assumption about certain plan amendments into the expense determination. The particular focus was on career-average and flat-benefit plans, and on certain postretirement increases. There are some situations in which indexing or informal, de facto indexing exists. The Board agreed that under certain circumstances, and with disclosure, anticipation of certain plan amendments would be appropriate.

There were several questions raised about insurance contracts, particularly annuities. Because these questions overlapped with the June 1985 Exposure Draft on Settlements, they have not yet been addressed.

A number of people suggested that there were special problems for those employers who were either rate regulated or government contractors, because of the relationship between their reported expenses and their revenues. The Board has reconsidered these questions and did not opt to put special provisions into the document for those employers. The Board's basic position is that there is nothing that makes the cost of a particular pension plan different, just because a company is a rate regulated utility or a government contractor.

There were a number of questions raised about foreign plans. The Board opted to delay the required application of the standard to foreign plans for an additional two years. Thus, foreign plans would not be required to apply the standard until 1989. Beyond that, the Board declined to make changes to exclude foreign plans, although we will be discussing some possible changes to the disclosure requirements for foreign plans.

A number of questions have been raised about multiemployer plans concerning the disclosures proposed in the Exposure Draft. The chief focus was the requirement to disclose any withdrawal liability. There were some questions raised about how the document handles the employer with multiple plans. A particularly sensitive point is the requirement that, if you have an overfunded plan and an underfunded plan, you must show them separately in the disclosures. You must recognize the liability for the underfunded plan and are not allowed to net the asset you're not recognizing for the overfunded plan.

There were a number of practical questions raised concerning the measurement of the liability as of a particular date and the assets as of the end of the year, as well as the application of the document to quarterly reports. Those also are on our agenda for fall of 1985. Questions on business combination, some questions on the special disclosures that were allowed for small businesses, and some transition questions complete the list. Transition, always a difficult area, is one of the areas where we may see some changes in the Exposure Draft. I expect most changes with regard to the amortization pattern of the overfunded or underfunded amount as of the initial date of the application.

Much remains to be done. The Board has made it clear to the staff that it desires to complete this stage of pension accounting by the end of 1985.

A number of people have been concerned about the timing of the second Exposure Draft on Settlements and Curtailments, particularly with regard to the possibility of applying it early to situations that occurred in 1985. If everything happens on schedule, it would be appropriate and possible to apply the document early to account for a 1985 reversion. We have not completed our analysis of the approximately 104 comment letters received to date, and many are still coming in. Nothing I have seen in those comments indicates that we are likely to see significant changes in the document. Certainly the responses to that document overall have been more positive than the responses to the other, and not just because everybody is busy criticizing the other. Many of the documents we received on the Settlements document were quite thoughtful and evidenced that people had had an opportunity to concentrate on it. It is our intent and our plan to issue that document in the fourth quarter of 1985 as well, but that document cannot by its very nature precede the issuance of the other one.

MR. M. SERGE L. POIRE: I have been working with the Accounting Standards Board in Canada for six years, and I am now a part of the Accounting Standards Board as an external expert. As the first member outside of the accounting profession, I have been trying to represent common sense rather than the actuarial profession.

The project in Canada started in 1965 when the present handbook section was promulgated. The current project effectively commenced in June 1977, after which people started to realize that they lacked literature on it. In 1978 there was a study, which was followed by the publication in 1981 of a book called Accounting for Pension and Cost Obligation by Ross Archibald. From 1981 to 1984, we went through 19 versions of a Statement of Principles; the nineteenth one was approved in June 1984 and, subsequently, turned into an Exposure Draft. This Draft was approved in November and published in January 1985.

The basic concepts in the Exposure Draft are important. The going-concern concept leads Canadian thoughts; taking a long-term view rather than recommending a market value of assets or using market interest rate in valuing the obligation.

The accrual concept is an issue of accounting versus funding. Everybody has to realize that funding deals with cash flow while accounting deals with accrual. This is a basic distinction. Cash-flow accounting is not an approved accounting principle at this point. Many corporations do not like to have to use two different numbers, but some of them are already doing so when cash-flow requirements are very different from accounting. For them, it will not be very different. Where the problem arises is with companies which have long-term funding policies that would equate to accounting policies and who now wonder why they would have to produce two different numbers instead of having a single number.

The matching principle is most important, and it applies in the U.S., too. You cannot have expense-driven and balance-sheet-driven accounting at the same time. At some point, you have to choose between a level contribution and a level expense. You either allocate

the cost first, with the benefit allocation becoming a by-product, or you start with the benefit allocation with the cost becoming a by-product. The matching principle drove the accounting profession in Canada to say that a defined benefit pension plan promulgates the level of benefits to be delivered. Therefore, we must allocate the benefit first, because that is what matches the expense with the income. Thus, by having a pension plan, a company has an indirect compensation program, and the matching principle will call for matching the earning of that benefit to the service rendered.

The consistency, or comparability concept is the one used most often to argue that only one method should be used, so that the results would be more comparable. I do not agree with this argument; it is effectively replacing professional judgment with a "kitchen recipe."

As actuaries, we calculate the present value of prospective benefits, for which you need three inputs: the plan document, the employee population (it helps if the population is calculated), and the assumptions.

Regarding the plan document, there is no change in the thinking of the CICA in Canada; only the benefits that are included in the document and committed to at this point will be accounted for. There is no anticipated change that would allow ad hoc adjustments or future career pay improvements to become a part of the accounting.

The employee group is the foundation of any amortization that will occur, as it is in the U.S. The remaining working lifetime of the employees is still what is used for the purpose of amortizing any unfunded or unaccounted obligation.

In regard to assumptions in Canada, the only standard is to use "management's best estimate." The risk is that people will interpret best estimate as being market value, but it is clear in the Exposure Draft that a long-term view is being promulgated rather than a short-term one. If you read only the italics, it says "management's best estimate," which can lead to the use of market value and, in turn, to volatility, but that is not the intent of the Exposure Draft.

Regarding assets, the Exposure Draft says that any market-related valuation technique can be used, so, of course, market value would be acceptable. If you want to use a long-term view and still relate it to market value, you can use any smoothing technique as long as the number of years used in that smoothing is at least five. This is the only point that is not likely to change.

The next major step is the choice of an actuarial method for accounting purposes. This will determine the extent of the current service contribution or future expense and the unfunded portion not covered by assets. The CICA has proposed forcing one actuarial method--the same one as in the FASB Exposure Draft. This is a contentious issue in Canada. The validity of a single method has often been questioned. Nevertheless, let me give you the rationale behind this choice.

The first conclusion that we came to almost four years ago is that there is no single method that meets all the requirements. This was very disappointing because if we had found that one method was better than the others, we could have terminated the project.

The second major conclusion is that basic accounting principles call for allocation of benefits to service rendered. Since we have to allocate benefits, we have to disallow the family of methods dealing with level contribution. This leaves us with the benefit allocation family of methods, which consists of three methods: (1) projected unit credit prorated on salary, (2) projected unit credit prorated on service and (3) simple natural accrual with salary and service (as you would show on employee statements). Because any interim events between entering the plan and retirement are irrelevant, all you have to look at is the ultimate promise made and allocate it on a straight-line basis over the service of the individual. Since you are saying that interim salaries are irrelevant, it would be inconsistent to take the projected benefit and prorate it on the sum of salaries. Thus, you are left with only one method and, in fact, have no choice but to project the benefit and prorate linearly based on service.

The only additional rationale for prescribing a single method is that, if there is no perfect method, it is best to impose one so as to aid in the comparability and the understandability of the results. Based on these tremendously convincing arguments, we proceeded to force a single method, which is the projected unit credit prorated on service.

There is still discussion in Canada as to whether there should be a forcing of one method, or even one family of methods. The current thinking is that probably the benefit allocation family will be required because the focus would still be on the liability driven by a benefit allocation. On the other hand, there might be a change concerning the projection of salaries, saying that the plan document itself will give you the allocation pattern of that benefit. To project all benefits and prorate by the same method is not reflective of the economic reality of pension plans. For example, if you have a career pay plan, the benefit being earned in each year is not related to future salaries, so there should not be a salary projection. In some final pay plans, depending on how they are worded, it very well might seem that the earning of that benefit is being done year after year. This is not true, however. If you ask whether, as of today, you have earned your future salary, the answer is clearly no. If you have not earned it, there is no reason to project salaries. Your expense is a reconciliation between two obligations, and there is no obligation for future salaries as they are a future event. There is a high probability in Canada that this change will be made and that the allocation procedure will not be arbitrary but will be left to the plan document itself.

Once the component of the expense attributable to future service is decided (as a function of the method being used), the next question is how much of the unaccounted portion to use in the current expense. In Canada, the choice of the amortization period is much more flexible than the FASB requirements. Any rational and systematic method can be used, as long as it is spread over the expected average remaining

working lifetime of the existing population. Obviously any amendment to the plan is recognized. If you change assumptions, then these are accounting estimates already requiring a smoothing. If gains and losses appear in the long term, the nature of the plan would call for a long-term amortization. There is no distinction between amendments to the plan and gains or losses; everything is amortized over the remaining working lifetime, and any method that is used systematically and rationally would be permitted.

Regarding disclosure, there are only two things that are required in the Exposure Draft: (1) the assets and (2) the value of the pension obligation at that point. There is no balance sheet recognition except for the difference between the contribution and the expense, but this is already a current handbook requirement. Because the methods and assumptions are not totally reliable and might be volatile, it has been said that balanced recognition at this point should not be done. There is some flack in that argument in that, if you say that the expenses are a reconciliation of two things that you are not sure enough about to put on the balance sheet, there is little reason to force it for the income statement. Salability should be a third element. The 148 comment letters which were submitted to the CICA indicate that the balance sheet recognition is not at all salable in Canada.

There is a possibility of some changes in disclosure. Aside from the two required disclosure items, there are other disclosure elements which are considered desirable. One item which is not on the list of desirable disclosures in Canada is the assumptions used. There has been a great deal of caution in disclosing assumptions in financial statements. My prediction is that assumptions will become a desirable disclosure but will not be a required disclosure.

There could be some further changes with respect to the desirable disclosures. The general description of the plan might be required, as well as a description of the asset valuation method. If we retain the market-related requirement, then there will be a need to disclose the method used to come up with the assets.

These are the current hot issues. The question of salary projection is still a big issue, but it is obviously linked to the question of forcing a single method. I do not think that disclosure is that major an issue. It has been said that more disclosure should be required, but I do not expect to see a lot more unless somebody is prepared to pay for putting it on microfiche and providing readers to all financial statement users. I do not think asset value is a hot issue anymore now that the market-related issue is basically settled. Thus, we are left with the crucial issue of whether or not we force a single actuarial valuation method.

What I call the "decision tree" is the process that the Board in Canada must go through. On the first branch there is the pension obligation. If you are looking at the pension obligation alone, it is clear that the benefit allocation drives the whole process. If the benefit allocation drives it, then the benefit allocation family of methods has to be used in order to come up with an obligation.

The next question is whether or not you should project salaries. To me, the clear answer is no, because there is no obligation for future salaries at any point. In the Exposure Draft the answer given has been that you should project salaries. This in turn leads to the question of allocation and whether a choice between salary and service allocation methods should be given. The answer given in the Exposure Draft was that no choice should be given. Because interim salaries are irrelevant, we cannot allocate on that entity.

The second branch of the decision tree responds to the question as to whether or not the pension expense is a reconciliation of two obligations. The answer that has been given in Canada has been that it is a reconciliation between two obligations. Therefore, you have to go through the trouble of allocating the difference and then adding both the current service contribution component and the allocation or amortization of the unaccounted portion.

I think that the answer to the question of whether the pension expense is a reconciliation between two obligations is no. The real question is: What is the best estimate of the long-term cost of that plan? If this is what we are working towards, there should not be any forced method to answer that question. We should focus on the question and give an appropriate answer, rather than live with the illusion that by forcing a method we will have comparable results at the end.

The next question is whether there should be a choice of amortization methods. The Board's answer is that, as long as it is a rational and systematic method, it is allowed.

In conclusion, the real issue is under which of the two schools of thought do we wish to operate--with financial statements that are balance-sheet driven or income-statement driven? In the United Kingdom, they have chosen to use the expense or the income statement. In the United States, it has been a balance-sheet or obligation-driven environment. In Canada, we are split between the U.K. and the U.S. The Exposure Draft in Canada, even if I am totally against it, is a good Exposure Draft based on the premises used. What is being discussed now are the premises themselves. Somebody will have to take a hard look at accounting policies and decide upon these basic premises. Once you agree with the premises, everything else is logical. It is not the time to discuss the details of implementation, but rather the time to face the basic decision. On this issue, there is no unanimity. The 148 opinions received at the CICA are divided, which makes the decision a tough one.

My prediction is that computers and kitchen recipes will replace judgment to a certain degree, because that is the current trend. We will hit the brick wall at some point and wake up. Still, I think we will probably have to suffer a little bit more before common sense prevails.

MR. HOWARD GRACEY: I am the chairman of the American Affairs Committee of the Institute of Actuaries in England and the Faculty of Actuaries in Scotland. We in the U.K. have been identifying similar problems to your own. For instance, disclosure is a live issue with us,

and it probably brings forth just as great a volume of criticism as your own proposals for disclosure. We in England enjoy a much greater degree of flexibility as actuaries in determining pension costs and reporting. My committee's main concern is that, as U.K. parents of U.S. subsidiaries, we must make sure that what happens in the U.S. subsidiary accounts does not have adverse effects in the U.K. parent account. We are similarly concerned about U.K. subsidiaries where we have to satisfy both U.K. and U.S. requirements. Recently, there have been several takeover situations in the United Kingdom--purchases and sales of subsidiary companies--where considerable confusion has arisen over placing a value on the company. We could not identify one figure for the value of uncovered liabilities in the pension fund. I have noted with great interest that foreign plans will be covered by the FASB requirements by the deferred date of 1989. It may well be that British actuaries would like to take the opportunity to respond to the continuing discussion as it proceeds.

MR. RICK A ROEDER: I have a question on the concept of having a net pension liability carried forward on the books. When I was taking CPA exams, it was my understanding that the FASB had already issued Statement No. 5, which addressed contingent liabilities. To summarize that statement as I understand it, there would not be a balance sheet liability carried on the book for a contingent liability unless it was both probable to occur and reasonably estimable. I view an employer's liability for a pension plan as a contingent liability, and I have not seen anything in the prior views that would dovetail your work with that preexisting statement.

MR. LUCAS: The FASB Statement No. 5 excludes pensions because, at the time the Board was debating that statement, it already knew it had a pensions project. Nevertheless, the basic concepts of Statement No. 5 are carried forward in this Exposure Draft. It is the Board's clear view that at least the accumulated benefit obligation is probable as that term is used in Statement No. 5 (probable that the employer will make payments to pay it off) and that is reasonably estimable. A contrary conclusion that the accumulated benefits cannot be reasonably estimated, would, under accounting theory, preclude recognition on the books of any pension expense and would also probably preclude an unqualified opinion on the financial statements. There is a provision in accounting to cover an obligation that is suspected to be sizeable but cannot be measured, and it is a qualified opinion. It is an opinion that says these financial statements are a fair presentation, except for or subject to the amount of pension expense that cannot be measured. So this course, while not very appealing, is a possibility.

MR. DAVID R. KASS: I want to comment on volatility and the matter of expensing pension costs over active working lifetimes. On the matter of volatility, all of the conversations I have heard start off with the premise that volatility is inherently bad. I suspect if we were to acknowledge that it exists and that the attempt to measure it on the inherent basis once a year on each fiscal point is going to identify volatility, then we might perhaps proceed to ask whether or not this volatility is management's fault. If somehow we could identify what, in fact, has happened and give management a good report card, maybe

there would be a solution. I point this out because I am aware that there have been some controversial issues in the accounting field dealing with foreign currency. I have an instinctive response that there may be some similarity in the principles involved, and I wonder, under the heading of volatility, whether there is some way of avoiding sweeping it under the rug by identifying it forthrightly but still not putting the blame on management.

On the matter of amortization of additional expense over the active working lifetime, the fact that this is practically the only thing that everyone agreed upon makes me worry that it is probably wrong. Concerning the benefit upgrade for retirees, the proposal is to deal with this over the retiree's lifetime. What has that second equally straightforward conclusion got to do with any logic surrounding the first? Why is the economic benefit derived over anything having to do with anybody's lifetime?

MR. LUCAS: Some of the "Basis for Conclusion" section of the Exposure Draft agrees with some of your comments. In particular, the point is made that volatility is not necessarily bad and that, when we are reporting on a phenomenon that is inherently volatile, the resulting report should be volatile or else it is not representationally faithful. Nevertheless, this project probably demonstrates as clearly as any that financial accounting standards are set in a somewhat political arena in the United States, and I suspect in Canada as well. The extent to which the Board can impose its conceptual will is limited. We are trying hard to achieve an acceptable answer, and volatility is one of the most difficult areas for us. Once we have agreed that we are not going to recognize the entire change in the fair value of assets as an expense and once we have acknowledged that we are going to spread some of those gains and losses in the future for various reasons, then the amount of smoothing or the amount of volatility reduction becomes a question that is difficult to answer. We anticipate that the information about the volatility will be part of the package (some of it will be in the disclosures) and that there will be some additional volatility of balance sheet accounts in some cases as a result of this statement. The process is one of making incremental steps in the direction of more meaningful information, including the inherent volatility.

Your second question was about amortization over the active working lifetime. There are many situations in accounting where a cost of one kind or another has to be assigned to a number of periods. Maybe the simplest one is when purchasing a factory. The objective is to spread that cost, recognizing the cost in the accounts over the periods benefited. In the case of the factory, we try to estimate how long it will last and how long it will be providing services. In the case of the pension benefit, the Board's conclusion is that the reason a company took on that obligation is to obtain the services of the employee. Therefore, like salaries or other types of compensation, there should be an effort at least to recognize those costs over the period in which the employee worked. Regarding retirees, a majority of the Board probably conceptually would prefer to expense retiree amendments. The desire or the willingness at this stage to anticipate those amendments reflects that preference to some extent. However, for practical reasons, the

Exposure Draft and the Preliminary Views before it have concluded that retiree amendments should be spread in some way, and for convenience, we will treat them the same as amendments for actives. That certainly is a decision that could be challenged on a number of levels, but that is where we are and the reasons for being there are primarily practical.

MR. POIRE: On the volatility issue, my first comment is that I do not think there is anything wrong with volatility itself. That depends on what you feel the purpose of financial statements is. If it is used to compare one obligation to another, you might have a volatile result that could well be reflective of the reality of the earning of the accrued benefit. If is it meant to reflect the long-term cost of the plan when you are trying to compare companies, then the volatility issue is not as important. Volatility is not wrong per se but must be put into the context of what users of financial statements want it to be.

Regarding the question on retirees amendments, in Canada it was perceived that if an employer makes ad hoc adjustments for retirees, it is in the perspective of active employees noticing it and hoping it will happen to them as well, thus, obviously increasing the productivity of the staff tremendously. So when you are trying to match the cost of that update with the income and the expense this year, you then do it through the active people.

MR. DONALD E. FUERST: In the Preliminary Views, salary progressions were included in the determination of the obligation which was going to be reflected on the balance sheet. There was quite a bit of opposition to that and comments were directed to the Board trying to get across the idea that people did not view future salary obligations as a current obligation or current liability. When I read the Exposure Draft, I was quite pleased to see that evidently the Board changed its viewpoint a bit and seemed to concur with the idea that future salary obligations were not current obligations. As I read on I became quite disturbed to see that, in a business combination, you would include salary progression in the determination of the obligation to be reflected on the balance sheet of the acquiring company. If the Board truly did come to the position of saying that salary progression is not a current liability, then I would like you to comment on why the Board feels that, in the situation of an acquisition or a merger, suddenly this is something which is a current liability and would be placed on the balance sheet.

MR. LUCAS: The salary progression question has been and remains contentious. The business combinations area is one we have not readdressed yet. The Board did not conclude that the salary progression is not a present obligation. The Board concluded in Preliminary Views and reasserted in the Exposure Draft that fundamentally its belief is that, under the terms of the plan, an obligation for service rendered to date comes into being based on that service. Without that conclusion, the Board could not justify recognition of expense based on salary progression. When you recognize this year's expense, including an estimate of future salaries, that is by accounting definition the recognition of a liability based on future salary. Now the question is should we also recognize the liability that is based on future salaries that

arose because of plan amendments. The Board for practical reasons decided that recognition of the full liability at this time is simply not possible nor practical. Consequently, the Board went to the minimum liability approach where we said we will recognize this portion that people are less concerned about but will not attempt to recognize what we think is the entire liability.

That explains the difference from business combinations. In the business combination case where we are looking at a new basis of accounting, through APB Opinion No. 16, we are looking at a new start on fair value of accounting across the board. We do not have the same practical problems in recognizing the whole thing, and indeed we create some practical problems if we do not do so. If you do not recognize the liability based on the whole obligation, assuming that the plan is going to continue, then you have to make a statement about how you are going to amortize it over periods after the acquisition.

MR. PETER J. MORGAN: I am also from the U.K. At the moment, we have the FASB, the Canadian Accounting Standards Board, and the Accounting Standards Committee in the U.K. all proposing different standards which are to some extent inconsistent. There are a number of large international companies with interests in Canada, the U.S., and England, which may have to comply with these standards in due course. What importance do the FASB and the Canadian Accounting Standards Board place on getting a common standard?

MR. LUCAS: We have been following developments in the pension area in Canada and the U.K throughout this process. There is a movement afoot right now to try to set up a meeting later this month between representatives of those three organizations to explore areas in which harmonization might be appropriate or possible. We pay a great deal of attention to that. We would like to see something that would be as compatible as possible, but we do not attach so much importance to it to say that we will not try to venture in any way beyond what the U.K. and Canada can agree to. That would abrogate our responsibility to improve financial accounting in the United States. There are limitations to what we could accomplish not only because of differences in the economic situations but also because of differences in the marketplaces and in the users who rely on the statements. I doubt that a common standard for all three countries is likely soon, but there may be a number of areas where we can reduce the differences.

MR. POIRE: It is the same in Canada except that time is running out. Everybody wants that project to be finished by the end of 1985.

MR. RALPH J. BRASKETT: Virtually no concern has been given in these discussions to the complexity of doing two valuations, one for the government (so we can sign the schedule B) and one for accountants. Most of my clients are not public companies, but they do go to the banks to borrow money. The banks want a sign-off from my clients' accountants, who have enough trouble understanding APB No. 8 and FASB No. 35 and 36 without this added complexity. Many of these people have defined benefit pension plans where assets in the plan exceed the present value of vested benefits. I have some real

questions as to why plan sponsors with 50 and 100 life plans should have to go through all this. My other concern is that this is just another nail in the coffin for defined benefit plans. It certainly goes counter to the concern of the PBGC that single-employer plans are failing too quickly. For too many people, having to expense one number on the balance sheet and fund a different number in their pension plan is just a little too complex.

There is one good thing that will come of this. Corporate raiders are looting pension plans to pay for the companies they took over, which they got at a bargain because there was no balance sheet recognition of the present value of accumulated benefits versus assets. Some of that will stop, which may be a good thing especially if they recognize when there are excess assets in the plan, at least in terms of the value of the company. In much of the rest of this, however, we are creating a tremendous number of problems for medium and small employers who have final pay plans that are reasonably well funded by reasonable long-term actuarial assumptions. I am concerned about how the FASB expects to force the insurance companies to give us fair market values on their assorted group annuity contracts when an insurance company gets an exemption from the government for having to provide these values, and the companies provide them instead on insurance company cost basis.

MR. GARRETT: The first concern you raised on the added cost of valuations was also a concern that the AAA referred to in their submission. We looked at that, using a sampling of different consulting firms. We picked valuations where the fee ran in the neighborhood of $5,000, $50,000, or $100,000. The increase in valuation cost including all costs associated with the valuation and the report preparation ranged from 30-100 percent with the median being 50 percent in the transition year on a $5,000 valuation. In subsequent years, the range would be 20-75 percent with the median being a 30 percent increase. The percentages were lower for higher cost valuations. The increased cost to the Board's constituency in implementing any final standard has always been a concern of the Board. In fact, that is one of the precepts of the FASB: you do not effect a change in accounting unless there is a real value to be received. My personal feeling is that, although that was a concern back at the time of the Preliminary Views, it has since gotten swept aside. The project has taken on a life of its own, and as more things are added, the cost has gone up. Many of the members of the committee were a little surprised when they actually talked with some of their clients about some of the issues. The Board will have to make a decision on how bad the current system is in terms of what it is reporting. Is taking everybody to one method and charging these additional costs to people who still want to keep some flexibility in funding worth it? There is a large body of employers who feel that it is just not worth the trouble, because there are not that many employers trying to evade anything despite the fact that there are a number on different funding and expensing methods.

MR. POIRE: In Canada, many actuaries use the projected unit credit method for funding purposes. That was used as an argument that the cost would not be too high since many are already using that method.

I think that argument is faulty because most of the cost will be in the explanation and in the time spent by management rather than generating numbers. The extra computer time that will be required to generate the numbers is marginal because, if you are already producing on the entry-age level basis and you have a computer, it is not too costly to come up with the numbers. Having to explain it will create a lot more confusion, and that will generate much additional cost.

MR. LUCAS: Ten years hence when we have some experience about how much it did cost in reality, we may still be arguing about whether the benefits outweighed the cost. The assessment or estimate of costs and benefits from any accounting change is always among the most difficult things that the Board has to do. We are trying to make a comparison between two quantities, neither of which we can measure. There is no reliable or quantitative way to measure the benefits of better, more understandable information, and there is no way to get a good estimate of the costs before a change is made, or even after the change is made in many cases. The Board does its best in trying to assess that and to make judgments in terms of the cost and the benefits. We will be looking at a number of things we can do to reduce the cost impact, and we are always looking for ways to increase the value of the resulting information. There is no perfect answer. The Board has to make a judgment on whether the value of improving the information statements is greater than the cost of doing so.

MR. BRASKETT: This will lead more medium-sized employers to defined contribution plans, getting their one-shot reversion of their assets, especially if we change the tax law in this country to penalize reversions. What we will wind up with is nice accounting, except for all the unfunded supplements that are floating around in public companies. This will lead us to more unfunded promises to pay than we are getting under the current system. I hope that this concept can be communicated because this is what I have seen when employers have relied on the defined contribution plan for significant periods.

MR. DAVID M. LIPKIN: The basic differences between unit credit and the entry-age normal family are (1) that the entry-age normal projects the benefit and (2) that it recognizes the increasing cost factors as an employee gets older. Why has the FASB chosen to recognize one of these differences, using salary progression in calculating expense, but not the other? That seems inconsistent. Also, in regard to the PBGC involvement, I think there are participants who will be harmed if this proposal goes through because there are cases where unit credit is not appropriate and will hinder and impede the appropriate funding of the plan. It seems naive and irresponsible of the FASB to say that the employer can fund differently than they expense. Many employers will always fund and expense the same way, and if you recommend an inappropriate expensing technique, it is going to lead to an inappropriate funding technique and the loss of benefits.

MR. LUCAS: One of the topics that we discussed at great length with the AAA Committee and that we will be considering again is the question of what is an "inappropriate funding method." The Board and the staff achieved a better understanding of what might constitute an

inappropriate funding method. Recognizing that our objective is not to have a funding method, the Board within its other constraints clearly would like to have its accounting method result in an appropriate funding if followed as a funding method. One of the significant things that came to light out of that AAA study is that you cannot take projected unit credit, unit credit, or entry-age normal methods by themselves without defining the amortization or prior service cost and assigning to it a label of appropriate or inappropriate. Based on the rough working definition of appropriate, it seems that the amortization of prior service cost question is no less important than the method question and, in fact, is the thing that more often tended to drive the examples we were working with into what we had labeled as the inappropriate camp. We are working in that area but have not finished our considerations of it yet.