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PENSION PLAN ACCOUNTING UNDER FINANCIAL ACCOUNTING STANDARD (FAS) 87

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Recorder: DIANNE WEITZENKAMP

- o Discussion of initial experience under Financial Accounting Standard 87
- o How have plan sponsors reacted?
- o What assumptions are being used?
- o Further guidance from Financial Accounting Standards Board staff
- o Work of Interim Actuarial Standards Board

MR. JAMES A. STINCHCOMB: The new Financial Accounting Standards 87 and 88 make major changes in the accounting and disclosure of defined benefit pension plans -- qualified or non-qualified, domestic or foreign, funded or unfunded.

Since these new standards were issued in December 1985, a number of formal programs have been under way to help with their implementation. In spring 1986, FASB staff established an Implementation Group of industry representatives to help the staff identify and solve problems that arose in applying the standards. Since then, the staff has been drafting a set of Questions and Answers to provide further guidance. The staff hopes to publish its Standard 87

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Questions and Answers by the end of this month. It has not yet completed a first draft of Questions and Answers under Standard 88.

At the same time, the Interim Actuarial Standards Board, a part of the American Academy of Actuaries, has undertaken to provide educational material and guidance to actuaries performing calculations under Statements 87 and 88. The resulting exposure draft was circulated to Academy members a couple of months ago.

I would like to announce that Barnet Berin and Eric Lofgren have written a paper setting forth formulas relating the various quantities that must be calculated from year to year under Statement 87. The paper will appear in Volume 39 of the *Transactions.*

We are very fortunate to have three panelists who have been heavily involved in pension accounting issues.

Our first speaker, Jerry Spigal of Towers, Perrin, Forster & Crosby's New York office, is a member of the FASB Implementation Group. He has been a very active member of the IASB's Pension Committee. Prior to recently joining TPF&C, Jerry spent nine years with Peat Marwick, where he often assisted in pension plan audits and helped several clients implement Statements 87 and 88 for 1985. Jerry will discuss the Statements from an actuary's point of view and bring us an update on the activities of the IASB.

Our second speaker will be John Stewart, a member of the Accounting Principles Group at Arthur Andersen's Chicago Headquarters. John is a member of the American Institute of Certified Public Accountants and the Illinois CPA Society. He has served on committees for both organizations, as well as task forces of the Financial Accounting Standards Board. John has been a frequent writer and speaker on accounting topics and, like Jerry, is a member of the FASB's Pension Implementation Group. John will discuss Statements 87 and 88 from the auditor's point of view.

Our final speaker, Dave Dusendschon, is Staff Vice President in charge of Accounting Standards at Kimberly Clark. He has extensive prior experience in public accounting with Price Waterhouse, serving on both their audit staff and their National Office Staff. He is a member of the Financial Executive Institute's Committee on Corporate Reporting, and he is one of the two corporate members of the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants.

MR. JERAULD G. SPIGAL: I will comment on several aspects of FAS 87 implementation.

The Pension Committee of the Interim Actuarial Standards Board is a group of pension actuaries representing a wide range of practices. It includes an insurance company representative, a corporate actuary, two small plan actuaries, an actuary for a union, and several actuaries from the major consulting firms. We have been appearing before the FASB on and off for several years, and three or four of us are on the FASB's Pension Implementation Group.

When FAS 87 was published, we decided that it would be helpful to provide some guidance to our fellow actuaries about how to perform the required calculations under FAS 87. Our most recent meeting was last Wednesday and Thursday, and at that time we reviewed the 30 or so letters that we received in response to the request for comments on our exposure draft. The FASB's response was 30 pages long, almost twice as long as the exposure draft. Nevertheless it was thoughtful, and helped us understand FASB's position on several issues.

In describing the work of the committee, I think it will be helpful first to discuss what FAS 87 is, and our responsibility as actuaries as it relates to this new accounting standard.

What is FAS 87? It is a statement of Financial Accounting Standards. These are the accounting rules for determining an enterprise's profit and loss. The FASB sets the rules, and companies are supposed to follow those rules when they present their financial statements to the public.

The company -- the employer -- is responsible for all the figures in its financial statements. Management and the board of directors must take responsibility for the correctness of the published financial statement.

Sometimes the company hires outside experts to assist in the preparation of the financial statement. One example would be to hire an appraiser to help set a balance sheet value for its real estate holdings.

Auditors "audit" the financial statement presentation. The auditor is responsible to the public. He, and he alone, is responsible for "sign-off." The financial statements are the company's, but the sign-off is the responsibility of the auditor. Auditors also sometimes hire experts to assist them in the audit. For example, they might also hire a real estate appraiser to assist in the evaluation of the company's appraisal.

As independent consultants, actuaries act as advisors to management in helping them determine the appropriate charge to income and balance sheet accruals for pension expense. The company must take ultimate responsibility, but we have the responsibility to provide them with expert, professional advice.

The Academy and Society By-Laws and regulations govern how we give that advice. Merely because we are offering advice about compliance with an accounting standard rather than IRS or statutory requirements does not change our responsibility to provide professional, expert advice.

Auditing standards for FAS 87 have not yet been written. Therefore, we do not know what standards will be applied to the audit of actuarial information. The auditors are the "enforcers" of the accounting standards set by the FASB. Each audit firm will develop its own standards, and each auditor will need to evaluate the facts and circumstances of each audit to determine the level of work necessary to satisfy himself that the pension expense and balance sheet values are fairly presented in accordance with FAS 87.

FAS 87 does not require that an actuary certify to the results of the calculations. Nevertheless, there are at least two possible certifications that employers and auditors may request:

1. We could certify that, given the assumptions selected by the employer/ plan sponsor, the actuarial values presented have been determined in accordance with our understanding of FAS 87.

2. Separately or in addition, we could certify that the discount rate, the expected long term rate of return on plan assets, and other assumptions have been selected in accordance with FAS 87.

I believe that many employers and auditors will request one or both of these sign-offs, and, in informal discussions, the FASB staff has indicated that it would expect both sign-offs.

Our responsibility is to understand the requirements of FAS 87, and to offer advice to our clients so they can make an informed decision about pension expense and balance sheet entries.

Going on to the details of the exposure draft and FAS 87, I call your attention to several paragraphs. First, look at the last words of FAS 87 on page 22: "The provisions of this Statement need not be applied to immaterial items."

Look at FAS 87 paragraph 10:

- The use of reasonable assumptions is discussed

- FAS 87 sets out accounting objectives, not specific computational means

- Use of estimates, averages, and shortcuts is acceptable, if "results are reasonably expected not to be materially different from the results of a detailed application."

This provides us with a great deal of leeway in assisting our clients to comply with FAS 87.

In draft copies of questions and answers that the FASB staff has circulated, the staff states several times that the facts and circumstances of the situation are to govern the application of the accounting rules.

The IASB exposure draft covers materiality in paragraphs 1.5 to 1.7. It is the employer who determines whether something is material. You, of course, need to supply the judgment as to whether an estimated value is "reasonably expected not to be materially different" once you understand the threshold of materiality.

The employer's financial statements cover so many items in addition to pensions, that there is no way the actuary can make decisions about materiality. This must be discussed with the plan sponsor, and ultimately with the sponsor's auditor, if it comes to that. So, in evaluating what work needs to be performed, it would be appropriate to discuss the size of pension expense and the range of expense with the employer before you begin.

The actuary is in the best position to perform the calculations required under FAS 87. In order to do this, it may be necessary to collect some information that you had not previously collected, for example, the balance sheet accruals (see paragraph 1.8 of the exposure draft). This could include amounts expensed but not contributed in the current or prior years, amounts funded but not expensed, amounts remaining unamortized from prior asset reversions, and amounts remaining from prior plant closings under APB 8 paragraph 31. This information is needed in order to perform the expense and balance sheet calculations.

By the way, the auditor cannot "officially" perform these calculations, because the auditors cannot audit their own work. If the auditors were to perform the FAS 87 calculations (hired as the auditor and not as the actuary), they would be in technical violation of their independence requirement.

Paragraph 2.2 of the IASB exposure draft mentions the Projected Unit Credit Actuarial Cost Method. Be careful with footnote 8 in FAS 87 paragraph 40 and paragraph 42. A simple application of the service pro rata methodology will not produce an answer that meets the FAS 87 requirements in all situations. For example, if a career pay plan has a past service update or a change in accrual percentage, then the Projected Benefit Obligation (PBO) and Service Cost must be determined in a manner that reflects that weighting. Basically, the Service Cost is to reflect the value of the "projected" benefit accruing in a particular year, and the PBO must be consistent with the Service Cost.

Temporary supplemental early retirement benefits and subsidized early retirement benefits are two other examples of benefits which should be valued carefully. Excess benefits plans and supplemental executive retirement plans are other examples, since these do not usually have clearly defined entry dates and accrual rules.

Measurement dates are very important and are discussed in paragraph 2.3 of the IASB exposure draft. The FASB's questions and answers will include several about measurement dates. There is a great deal of flexibility allowed in the choice of measurement date(s).

First, the measurement date can be as much as 3 months before the financial statement date (FAS 87 paragraph 52). In addition, while paragraph 53 requires measurement dates when certain events occur, it also allows multiple measurement dates, so long as the dates are consistent from year to year. Consistency is very important in order to avoid the appearance of manipulating the financial statement results.

If there is only one measurement date each year, the values determined as of that date establish the expense for the following year. That is, the discount rate used to determine the end of year disclosure values is the rate which will be used to determine the expense in the following year. It would be silly if the employer's best estimate of the December 31 settlement rate was 8% on February 1 when the disclosure values were determined, but changed to 9% on June 1 when the 1/1 valuation was completed.

Note that multiple measurement dates can help to relieve some of the "problem" of setting the following year's discount rate before the end of the current year.

The employee information used to determine values as of the measurement date must reflect the actual employee population and its characteristics as of the measurement date. If projections of earlier values are used, they must be adjusted to reflect significant events -- pay increases, settlements or plant closings, for example.

The actual Fair Value of assets is assumed to be available as of the measurement date. The Board's comments indicate that it does not expect employers to project the value of assets.

Wow!

The FASB doesn't care how PBO or Accumulated Benefit Obligation (ABO) projections are made, only that the resulting values meet the criteria of paragraph 10: that results be "reasonably expected not to be materially different from the results of a detailed application." Thus, the population could be projected, the liabilities could be projected, or some other method could be used.

What if a projection from 1/1 results is used to determine the end of year PBO and ABO, and then, when the actual next year 1/1 calculations are performed and the projected PBO and ABO are compared with the "actual," they are significantly different? This could potentially be a very serious problem.

If the plan is well funded, and the fair value of the assets exceeds the ABO, then only the footnote values are affected, and the problem is small.

If the plan's fair value is less than the ABO so that a Minimum Liability is required on the employer's balance sheet, then the problem could be serious. If there is an accumulated actuarial loss so that the intangible asset is less than the minimum liability, then the problem is very serious because the published financial statement reflected a reduction in shareholder equity due to that accumulated loss. If the new "actual" calculations result in a materially different reduction in equity, then the financial statement will need to be reissued, and if the employer is an SEC registrant, I suspect that a mess of paperwork will need to be filed.

KEY → The moral is this: make very sure that the projections, if any, are very accurate, especially for poorly funded plans. Find out all you can to make the best projections you can, and if necessary, investigate with your client the possibility of collecting fresh data within three months of the financial statement date.

The discount rate is required to be the employer's best estimate of the rate at which the pension obligation could be settled. The FASB's view of this is easier to understand if you think of the discount rate as a series of rates, a duration based vector of rates, each the assumed rate of return for some future year. Then, the weighted average rate for two plans may not be the same, and the weighted average rate for the PBO may not be the same as for the ABO, but the duration based vector will be the same for the various plans of the same employer and for the PBO and the ABO.

With regard to the "Market Related Value" (MRV) of plan assets (paragraph 2.5 of the IASB exposure draft), the draft questions and answers have indicated very strongly that the FASB expects the MRV to be very closely related to the Fair Value.

Interest on the normal cost (IASB exposure draft paragraph 2.7) must be included somewhere in the determination of Net Periodic Pension Cost (NPPC). In the FASB's examples, it is included with the Service Cost. The Board has indicated since then that it can either be included with Service Cost or with the Interest Cost element of NPPC. It is my preference that it be included with the Interest Cost element because that seems to make it easier to show how costs develop from one year to the next, but the Board has left it to the financial statement preparer to choose.

The Expected Return on assets for the year (IASB exposure draft paragraph 2.8) is a function of the Market Related Value, not the Fair Value of assets. It is this Expected Return which is compared to the actual return to determine the actuarial gain or loss from investments for the year. The return should be adjusted to reflect expected cash flow (i.e., contributions and benefit payments) during the year.

The beginning-of-year determination of the Net Periodic Pension Cost and the end-of-year presentation are different (paragraph 2.10 of the exposure draft), but the numerical result is the same.

The actuarial gain and loss calculation (paragraph 2.11 of the exposure draft) is very simply the difference between the expected "unfunded PBO" and the

NOTE actual year-end (or measurement date) unfunded PBO. Note that Fair Value of assets is used in this calculation even though the MRV of assets is used to determine the Expected Return on assets.

Naturally, no gain or loss is possible on the Balance Sheet figures (the Prepaid Pension Cost/Pension Liability) because these values always change with interest at the assumed rate.

The amortizations required by FAS 87 (paragraph 2.12 of the exposure draft) are the amortizations of principal only. The interest component is contained in the net of the Interest Cost and the Expected Return.

The IASB exposure draft's suggested handling of a mid-year plan change (paragraph 2.15) has been soundly rejected by the FASB staff. The exposure draft stated that the impact of a mid-year plan change could be determined based on prior year-end measurement date values. FASB staff have told us that if there is a significant mid-year amendment, then the entire NPPC for the balance of the year must be based upon a mid-year measurement. This creates an interesting dilemma. What if the additional cost of just the plan changes is not significant, and therefore does not require a measurement under FAS 87 paragraph 53, but the change in cost resulting from the change in discount rate since the last measurement date is very significant? Does that call for a new measurement or not?

The staff seems to have reaffirmed that the correct amortization period for a plan with no actives but with many deferred benefits is the expected future lifetime of those expected to receive benefits. This may not be very reasonable, but it is apparently acceptable.

The gain or loss amortization (paragraph 2.18 of the exposure draft) is the minimum gain or loss amortization. The 10% corridor need not be used. If a corridor is used, the test is to be a "fresh start" each year. That is, the cumulative unamortized actuarial gain or loss is compared to 10% of the greater of the PBO or MRV, and any excess is amortized -- there is no requirement to continue any gain or loss amortizations begun in prior years.

Regarding amortization of Prior Service Cost, FAS 87 paragraph 26 says that "consistent use of an alternative amortization approach that more rapidly reduces the unrecognized cost of retroactive amendments is acceptable." You might think that immediate recognition of every amendment would be acceptable. It isn't. The period of amortization must be the period of economic benefit.

The amortization period formulas in the exposure draft (paragraph 2.20) were not commented on by the FASB. FASB specifically said it was not commenting on the "actuarial equations." At least we came up with one thing FASB didn't shoot down. The formulas are intended to provide you with some guidance. If the assumption as to when, during the year, a decrement occurs differs from that implicit in the formulas, then the formulas need to be adjusted. Use your judgment.

Anyway, the staff agrees that in calculating the average-future-service amortization period, small benefits need not count, and the return of employee contributions does not count. The staff is talking about participants expected to receive an employer-provided benefit when determining the amortization period. It is also talking about non-zero benefits. Therefore, the amortization for ERISA excess plans and SERPs will be different from the amortization for an underlying qualified plan. Each plan must be treated separately.

FAS 87 paragraphs 27 and 41, which discuss shortened amortization periods and routine updating patterns, could be very important for some plan sponsors. As actuaries we can advise and inform the employer of the effect of shortening the amortization period or recognizing a routine updating pattern, but it must be the employer's decision as to whether to reflect one or the other in the Net Periodic Pension Cost or the routine pattern in the PBO and ABO. Clearly, we need to support our clients in their discussions with their auditors.

Floor offset plans are very difficult to work with. Are these really different from social security offset plans or contributory plans or plans that offset a prior plan accrued benefit? Well they are, but we on the IASB committee have not agreed on a single method to value these plans, and our final guidelines will not recommend a single method.

Recognizing the effect of the new tax law is an interesting question related to FAS 87 paragraphs 41, 46 and 47. Apparently, if the plan language incorporates the 415 limits by reference and would therefore be automatically "amended" because the law changed, then that is a plan change as of the date the law is signed. On the other hand, treatment of the new tax law's vesting requirement is different. First it is not effective until 1/1/89, and second, the employer could implement it in several different ways. Therefore, until the employer makes a specific commitment to change the plan's vesting, a plan change probably need not be recognized.

The PBO disclosed at year end should equal the PBO used to determine the following year's cost, if the measurement dates are the same. Clearly the assumptions are the same. If there is a second measurement date, then of course the assumptions and the PBO need not be the same.

Automatic cost of living increases specified in the plan are to be included in the ABO. Future changes in benefits are also to be included, if they have already been agreed to. For example, if an increase in past service benefits has been negotiated to take effect in a future year, that must be included in the current year's PBO and ABO.

The statement seems to say that future increases in the 415 limit are not to be recognized in the ABO, but that is not consistent with the rest of paragraphs 46-48. The staff has been reviewing this question, and a question and answer will be issued.

Over the past few years many actuaries have told me how unhappy they are that the FASB is setting standards for actuarial practice, and eliminating our use of actuarial judgment and expertise. At the same time, we have found that many of the questions that the FASB is responding to have come from actuaries! In fact, the FASB staff has told me that it has been surprised at the number of questions from actuaries and at the lack of knowledge of many of the questioners.

FAS 87 is not a cookbook. If we keep asking questions which we could answer by using our actuarial knowledge and judgment, then the FASB will be pleased to respond with a cookbook. That will not be helpful because it will remove options and deal with only the trivial situations. Use your judgment to develop solutions that you can recommend to your clients. FAS 87 is intended to "specify accounting objectives rather than specific computational means of obtaining those results." It is your actuarial expertise that can help your client develop specific computational means consistent with the objectives of FAS 87.

But above all, remember we are acting as business advisors to management, and are constrained by our requirements to act in a professional manner and to provide expert advice. Just because we are providing values to satisfy an accounting standard does not mean that the guides to professional conduct do not apply.

MR. JOHN E. STEWART: I will talk about several different areas:

1. surveys regarding FAS 87 and FAS 88,

2. some of the developments at the FASB and how auditors and accountants will perceive them,

3. the relationship between actuaries and accountants, and

4. the auditor verification letters that many actuaries will receive in the future.

I will then list some of the issues that have been discussed, not all of which have been resolved.

SURVEYS

There have been many surveys about Statements 87 and 88, obtaining mixed results. One survey of chief financial officers indicated 56% of them thought that the new pension accounting was better than the old accounting. However, a survey of pension officers indicated that only 32% felt that FASB really had made an improvement in pension accounting.

Only 18% of the CFOs plan to modify their investment policies to decrease volatility, a concern that many companies have expressed about the new accounting. Yet of the pension officers who were surveyed, 88% thought that the new accounting rules would somehow have an economic consequence in terms of changing the plan, changing the investment policy and changing funding approaches.

There was one area of consistency: 35% of the CFOs, including 62% of the Fortune 1000 sample, were going to apply the new accounting earlier than required. The pension officers surveyed indicated that 40% of them expected their companies to apply the new accounting rules early. Even though a lot of things have been said pro and con about the new accounting, it is interesting that a lot of companies are anxious to apply the new rules before they become mandatory.

DEVELOPMENTS AT THE FASB

The FASB staff is developing two booklets of 160 questions and answers on Statements 87 and 88. The purpose of the booklets is to aid in the implementation of the new rules. Drafts of the booklets are being reviewed by those who participated in the April 28, 1986, Pension Implementation Group meeting sponsored by the FASB.

Once published, how will accountants view the booklets in terms of their degree of authority? Auditors look to the FASB as the primary body that sets accounting standards in this country, and the SEC looks to that body, so auditors will put great importance on the questions and answers. Even though it is not a board document, auditors will look to the questions and answers, the staff document, as the guidance needed. There will be some issues that will not be finally resolved in the questions and answers certainly. Some of the questions and answers will be controversial, and some of those will be brought to another group, FASB's Emerging Issues Task Force. That group has already dealt with a couple of such issues:

- Transfers of excess assets from a terminating defined benefit plan to an ESOP to avoid the excise tax under the new law.

- Fourth quarter settlements/curtailments when using an end-of-third-quarter measurement date.

With regard to companies that are adopting the new standard earlier than required, my experience is that they fall into three groups:

1. Overfunded companies, as measured against the PBO, are adopting early to have a favorable impact on operating results.

2. Companies that terminated their plans in the past and reestablished new defined benefit plans can, by adopting the new accounting standards, in some cases bring part or all of a deferred credit from the balance sheet into income immediately. This is perceived to be favorable to some companies.

3. The third category is a very narrow group which recently terminated defined benefit plans and did not reestablish them or instead established defined contribution plans. Under the old accounting, income is recognized immediately when the proceeds are received if the new plan is a defined contribution plan. Under the new accounting it is also immediate income. However, under the old accounting, auditors classify the income as an extraordinary gain, very low on the income statement and often not given credit by those analyzing the company. Under the new accounting rules, that gain is above the line, as accountants call it, closer to operating income. Therefore, this change, while having no bottom line impact, causes a change in the geography of the income statement.

AUDITOR'S RELATIONSHIP WITH THE ACTUARY

Clearly, Statements 87 and 88 provide a fundamental change in how companies account for pension plans, but they also increase the auditor's ability to be involved in the process. There are two reasons for this.

First, Statements 87 and 88 are logical accounting frameworks. This is different from pension accounting under APB Opinion 8, under which pension expense was primarily the net result of an actuarial computation. Under

Statement 87, the actuary will still have primary responsibility for many of the basic calculations, for example, the projected benefit obligation and service cost, which are actuarial calculations that accountants are unable to do. However, other components of the net pension cost and the funded status of the plan result from accruals and deferral and amortization of costs and certain gains and losses. These are accounting calculations that auditors are well qualified to test. Now the "black box" mystery of the actuarial valuation is not as mysterious as it was before. Auditors now can see all of the pieces, and some of them are just accounting items. That will increase the auditors' ability and, therefore, their need to become more involved in the auditing of the numbers.

Second, under Statement 87, companies now must select explicit assumptions on which pension calculations are based. This means that each individual assumption must represent the company's best estimate of future events. Under APB Opinion 8, the assumptions could be implicit, that is, the aggregate of the assumptions was presumed to produce a reasonable result, to which the actuary could attest, even though individual assumptions were not best estimates. Under the new rules the auditors now have the ability (and, therefore, the responsibility) to assess whether the company's assumptions comply with Statement 87.

In summary, while auditors will continue to rely significantly on the actuary as in the past, auditors are responsible for reviewing and testing the application of Statements 87 and 88. They ultimately have responsibility that those numbers are not materially wrong and that the financial statements are fairly presented.

THE AUDITOR'S FOCUS

Auditors will focus on issues that I think they have the expertise to deal with.

Consider first the assumptions. Accountants can relate to the economic assumptions, i.e., discount rates, long-term investment rates, salary progression rates and the interrelationships among them, and determine if they are reasonable given the guidelines established. So accountants and auditors will be much involved with these kinds of assumptions. I think auditors look to actuaries for primary guidance on the establishment of the other types of assumptions, such as mortality, turnover, and retirement ages.

Auditors need to be involved with census data. It is the census data that ultimately produces the PBOs and the service cost numbers. Therefore, the auditors need to do some testing of it to make sure that the base on which the actuary relied in generating numbers is reasonable. If the census data is not prepared accurately, then the numbers coming out will not be accurate.

The computation of pension costs has six or seven elements. Service Cost will be a number that actuaries will have primary responsibility for developing, and auditors will turn to the actuaries as experts. Interest cost, return on assets, amortization periods for Prior Service Costs, amortization of transitional amounts, gains and losses occurring in the year, and amortization of prior actuarial gains and losses are all numbers and concepts that accountants relate. Therefore accountants will be much involved in the auditing of these numbers and concepts.

In determining the funded status of the plan, it will be the auditor's responsibility to make sure that the market value of plan assets is correct.

Auditors will be relying on the actuaries' expertise as specialists for the company to determine pension obligations -- PBO, ABO and vested. Unrecognized costs, gains and losses, Minimum Liabilities and the other items in the reconciliation of the funded status of the plan to the amounts in the financial statements are things that auditors find very natural and therefore will be involved in.

Other areas that auditors will focus on significantly are those where management judgment or alternative choices exist within FASB 87. The auditors will be involved in making sure that those judgments are reasonable. For example, in the amortization of Prior Service Costs, you can use the declining approach, or you can use the more simplified straight line approach. That involves a choice. Also, auditors will need to be involved in the determination of the period to make sure it is appropriate. In smoothing actuarial gains and losses, companies can use market related or not use market related assets. They can choose the minimum amortization approach, or they can choose more rapid amortization approaches. Again, where there are choices, auditors may want to be involved so that the choices are appropriate if the recommended method in Statement 87 is not followed.

Auditors will want to be involved in understanding the company's decision to amortize transition effects over 15 years or over the average remaining service period to make sure that it is acceptable under Statement 87.

Measurement dates are at year end or within 3 months, again a choice. Auditors would like to be involved so that they can understand the choice and give advice to their clients as to the pros and cons of using a measurement date other than the balance sheet date. Auditors will want to be involved in determining what happens if a company changes its choices from one year to the next. If the company sponsors many plans, are the choices consistent from plan to plan or, if they are not, is there some reason not to be consistent? Auditors would like to be involved in that process.

Curtailments and settlements are sometimes very difficult to account for and have very significant effects on the company's financial statements. Therefore, the auditors' involvement is needed as well as the actuaries'.

AUDITOR VERIFICATION LETTERS

What will auditors be asking actuaries to furnish when doing the audit of the financial statements? Actuaries will be asked to furnish directly to auditors specified information (or a copy of the actuarial report) relative to the Net Periodic Pension Cost and related financial statement disclosures computed in accordance with Statement 87.

Information to be furnished includes pension obligations, assets, unrecognized gains and losses and related assumptions and whether the cost method is in conformity with Statement 87. Actuaries will be asked to provide a plan description to make sure that they are dealing with the same plan that the auditors think we are dealing with. Did the actuary anticipate under paragraph 47 any future plan amendments and, if so, how was that done? If a market related asset value was used, which method was used?

Auditors would want to know if there are any significant changes in methods of amortizing gains and losses from the actuary's last valuation or measurements. The auditors would also ask for any information the actuary has on settlements or curtailments. Different auditing firms will take different approaches, but all will be asking the actuaries for information that they used in determining the values for their clients. It is a way for us to obtain outside verification that the numbers presented in the company's financial statement are proper.

AREAS OF RECENT QUESTIONS/HOT TOPICS

There are a lot of attempts being made to dampen volatility, which is perceived to be bad by many companies. Some of the approaches are appropriate and some of them are not. A corridor approach to the selection of settlement rates is a methodology which, in my view, is not appropriate. The use of dual settlement rates is causing a debate between the FASB and an actuarial firm.

Are excess benefit plans separate plans, or can they be combined with the underlying qualified plan? The FASB and I believe they should be treated separately, but that is a debate at the moment.

Paragraph 41, involving the anticipation of plan amendments, and paragraph 27, directed more toward union plans that are negotiated frequently, are creating difficult issues. The FASB staff and the implementation group do not have any concrete answers, which is understandable because of the very judgmental nature involved.

Is rolling forward from a measurement date creating any problems? I do not see it creating any problems at the moment. Jerry articulated well that the goal of the roll forward is to provide numbers that are appropriate. Otherwise, the next valuation or measurement may discover material misstatements in the financial statements.

Statement 87 applies to foreign plans but with a delayed effective date (for calendar companies, 1989). I have not had a lot of questions in this area. I am sure the debate will heat up as we near the 1989 implementation date.

Mergers and split-ups of plans are generating questions which the FASB will deal with in the questions and answers.

The use of overfunding in pension plans to pay post employment medical benefits is generating accounting questions. The Merging Issues Task Force has discussed but not resolved this issue.

What will be the impact of this on utilities -- public companies that have their rates set by a public body? What is the interaction between Statement 87 and FASB Statement 71?

Business combinations under Statement 87 and APB Opinion 16 are presenting some interesting questions and some confusion.

The whole area of deferred tax accounting is creating some issues when the amount deducted is different from the amount expensed, as well as in some other areas. The Financial Accounting Standards Board has recently released an exposure draft that would change significantly some areas of our current approach to deferred income tax accounting. When meshed with the new tax law, there will be lots of interesting questions. This new accounting standard will probably become final next year, and it does interact with pension accounting.

Statement 88 is perceived as an opportunity for some companies to trigger settlement accounting and instant income by purchasing annuities. That is generating some novel new types of participating annuities that enable the company to retain upside potential and the ability to manage its existing portfolio. In my view, some of these novel new annuity products do not qualify as settlements under Statement 88.

Corporate divestitures are generating some interesting questions when a part of the pension plan is spun off with a subsidiary.

What this demonstrates is that anything complicated, which pensions are, presents a lot of questions as soon as something new comes out. I think the FASB is doing a very good job in trying to respond to people, and I think it is trying to work with both the accounting profession and the actuarial profession as well as the corporate constituents to provide timely guidance in a complicated area.

MR. DAVID W. DUSENDSCHON: I will outline Kimberly-Clark's general approach toward implementing the requirements of FAS 87 and review our involvement in (or reaction to) the many steps leading toward the issuance of FAS 87.

My comments will be those of an accountant; not an actuary. Therefore, I will focus on:

- financial reporting
- the measurement of pension costs for accounting purposes, and
- required footnote disclosures.

I will not focus on pension funding issues or on other pension matters that may be indirectly affected by FAS 87, such as ERISA or IRS matters.

My only observation on funding is that it is more likely to be different from pension expense now than it was in the past. The minimums and maximums of ERISA and the IRS are not based on the new accounting rules. And FAS 87 is much more restrictive than APB 8, under which it was very common for pension funding and expensing to be equal.

I will also give you some notion of what our objectives were when implementing FAS 87, and finally, how we made a number of the choices that are available under the rule.

In order to give you a feeling for how this developed, let me first acquaint you with the perspective that the FASB has on pension accounting (and where it may be taking it in the future) and the perspective that many of us in industry have on the subject.

INCOME STATEMENT VERSUS BALANCE SHEET

There are two fundamentally different approaches toward accounting. One focuses attention on the income statement and tries to match income and expense items in the same reporting period. Accruals and deferrals on the balance sheet are used to permit this matching process on the income statement. The matching approach is embraced by historical-cost oriented accountants and is the primary focus of most of the existing GAAP requirements.

The other approach to accounting focuses on the balance sheet. Balance sheet proponents attempt to measure assets at realizable amounts and to measure liabilities at amounts at which they will be settled. These "modern" accountants let the income statement take up the slack between asset and liability measures. These folks do not care whether there is any reasonable matching of costs and revenues on the income statement, as long as the balance sheet moves closer to "value."

Pension accounting highlights these two fundamental differences about as clearly as any issue the FASB has yet tackled.

In his dissent to the new statement, Board member Vic Brown appears to have embraced the matching focus when he stated that "he would establish an objective that net pension cost be charged over the service lives of the existing work force such that the net pension cost would be a level percentage of current and expected compensation of the work force."

APB 8 had a similar focus. And many of us in industry supported APB 8 because it resulted in a predictable and non-volatile level of pension costs and, more important, resulted in a rational recognition of pension cost.

We at Kimberly-Clark argued the APB 8 approach with the FASB when we responded to the Board's February 1981 Discussion Memorandum. For your information, the

DM was a neutral document that attempted to surface the key issues in pension accounting and solicit views of interested parties.

Again in 1983 when we responded to the Board's Preliminary Views on pension accounting, we argued for a continuation of APB 8 accounting. Under Preliminary Views, we would have had to record an accounting liability for a final pay or career average plan very similar to the actuarial liability that would be measured.

In other words, the present value of pension benefits earned, including the effects of future compensation increases, would be reflected as a liability on our financial statements. The liability would be shown net of the fair value of pension assets held in the trust. This accounting would be followed despite the fact that many of us believe such an "actuarial obligation" fails to meet the Board's own definition of an accounting liability, and the assets really don't belong to the company reporting them!

Again, in 1983, we were one of 30 or so companies on the Financial Executive Institute's Committee on Corporate Reporting that voluntarily applied Preliminary Views to two of our major plans. The results of the field test were assembled with significant help from our actuaries from The Wyatt Company and shared on a confidential basis with the FASB. Again, we argued for a continuation of the APB 8 approach.

For perspective, our actual pension expense under APB 8 for 1979 through 1982 (the test period) for one of our major plans, on an index basis, was 100, 96, 101 and 108. These are fairly tight and consistent levels of pension expense.

Under Preliminary Views, our pension expense with a prospective 1979 start date, on the same index basis, was much higher and more volatile. It was 216, 201, 121, and 145.

Using the alternative retroactive start date (which pushes a lot of the pension costs into beginning retained earnings) yields pension costs on the same index basis for 1979 through 1982 of 139, 130, 56 and 86.

The volatile levels of pension costs under Preliminary Views were obvious! Similar messages were sent to FASB by the other participants in the field test. Apparently the FASB listened, somewhat, because FAS 87 isn't as bad as it could have been.

However, despite the field test input, public hearings, and hundreds of comment letters, the matching concept of APB 8 was not the one embraced by the new rule. It is clear the Board favors preeminence of the balance sheet in pension accounting. In fact, the Board stated in paragraph 107 that:

> It would be conceptually appropriate and preferable to recognize a net pension liability or asset measured by the difference between the projected benefit obligation and plan assets, either with no delay in recognition of gains and losses, or perhaps with gains and losses reported currently in comprehensive income but not in earnings.

The net effect of the Board's preferred approach would be to combine the net pension assets or obligations with the accounts of the sponsoring company just as we do now when we account for an equity affiliate, or as many companies do when they account for a non-consolidated finance subsidiary. The contra entry to the net asset or obligation would be to stockholders' equity. And the change in net assets or liabilities from year to year would be reflected directly in income of the plan sponsor.

This approach would cause the accounting results of the sponsoring entity to become much less relevant and reliable than they currently are.

It would also add unpredictable and unnecessary volatility to reporting earnings. (Remember the 87 point drop in the Dow Jones Industrials on September 12, 1986 -- this is about a 5% point drop in asset values in one day -- this would be reflected directly in the sponsor's income statement when it occurred on the pension fund assets.)

In many cases, yearly pension gains or losses would exceed the normal operating results of the sponsoring entity. (How many 87 point days either up or down in a year -- or quarter -- could occur before the gain or loss gets to be "big bucks" and would exceed the operating profit of all but the very largest entities?)

PENSION PLAN ACCOUNTING UNDER FAS 87

As I said earlier, the Board's long-term goal for pension accounting is buried back in paragraph 107. In the actual statement itself, the Board stopped short of consolidating the net pension obligation or asset because to do so would be too great a change from past practice. However, we have not heard the last word on pension accounting. In FASB's view "Statement 87 is a worthwhile and significant step in the evolutionary search for more meaningful and useful pension accounting," and the FASB states "that pension accounting in 1985 is still in a transition stage."

Maybe most of us, or at least those of us with grey hair, will be retired before the more enlightened and meaningful pension accounting model is dusted off and activated as a GAAP requirement. I'm certainly one who hopes so.

If you study Statement 87 carefully, you will see that it is constructed to permit reaching the Board's longer-term goal quite easily. Pension expense under FAS 87 is comprised of:

- *Service Cost* -- the increase in the projected benefit obligation (PBO) for pension benefits earned in the year,

- *Interest Cost* -- the increase in PBO due to the passage of time,

- *Actual Return on Plan Assets* -- the change in fair value of plan assets for reasons other than contributions by plan sponsors and payments to retirees, and

- *Accruals and Deferrals* -- for amortization of plan amendments and gains and losses over appropriate periods of time.

The net of the first three items in pension expense (service cost, interest cost and actual asset returns) is mighty close to the change in the net pension obligation or asset which I referred to earlier.

The final item in the list -- accruals and deferrals -- is designed to permit delayed recognition of certain events that have occurred in the PBO or plan assets. It would not be too difficult for the Board to conveniently drop this final piece of "pension expense" when it feels that it is time to move to the "more enlightened basis" of pension accounting.

WHEN TO IMPLEMENT

Now that I have given you a hint as to my position on the Board's objective of full consolidation of pension accounts with those of the sponsoring reporting entity, I will get off my soap box and share with you the way in which Kimberly-Clark plans to implement FAS 87.

Statement 87 must be adopted by 1987 for plans in the U.S. and by 1989 for plans outside the U.S. Because early adoption was permitted, some companies began using the rule in the fourth quarter of 1985, more are expected to do so in 1986, and the balance will adopt in 1987. I expect the rule will be adopted for some foreign plans as late as 1988 or 1989, especially when the new actuarial information on such plans may be sparse or otherwise difficult or expensive to obtain.

At Kimberly-Clark, we plan on adopting the rule in the fourth quarter of 1986 for our major plans in the U.S. and Canada. (We are also currently determining implementation schedules for all other plans -- none of which are material.)

We were simply not in a position to adopt FAS 87 in 1985 because it was issued as a final statement too late in the year for us to react quickly enough. As an aside, I'm sure you have noted that many of the companies that did adopt in 1985 reported "gains" due to transition from the old pension rules to the new ones. In many cases, these transition adjustments substantially reduced 1985 pension costs or caused them to become negative, and thus created pension income.

In our case, the income statement effect from adopting FAS 87 would not have been very significant in 1985 (nor is it expected to be so in 1986) due to several factors that I will discuss later. Thus, from an income statement perspective, we had no reason to either accelerate or delay adoption of the rule. Why then are we thinking of adopting in 1986 rather than waiting until the required date of 1987?

On the one hand, we have already been following the projected unit credit method -- which is the only sanctioned method under FAS 87 -- to determine pension costs under APB 8. Therefore, we will receive no large transition effect from changing to the projected unit credit method. Some companies which were using an actuarial method that calls for more rapid expense recognition are discovering that they will record a substantial "transition adjustment" credit which will be used to reduce pension expense rateably over the next 10 to 20 years, depending on the age of their workforce. That simply will not be the case with us.

On the other hand, we believe that more favorable circumstances exist for adopting the rule in 1986 (and determining our "transition adjustment") than will exist for adopting it in 1987. One of the important determinants of the "transition adjustment" is the settlement rate chosen to discount the pension obligation to its present value. Because the general level of interest rates is higher on January 1, 1986, than it is expected to be at the start of 1987, we believe that adopting FAS 87 in 1986 will be more advantageous than waiting until 1987. The spread between asset values and PBO will be smaller for us at the start of 1986 due to the higher discount rate we are permitted to use in 1986. The decline in the settlement rate during 1986 and its effect on the PBO will not be reflected in pension costs until 1987 or later when the "loss" gets large enough to require amortization. I will speak to the amortization issue later.

One of the dramatic changes in pension accounting caused by FAS 87 is the need to use a current settlement rate to discount pension benefits to their present value. Under APB 8, there was no such "current interest rate" requirement. For that reason, it was not uncommon to notice some companies using discount rates substantially below current rates of interest.

Under APB 8, as long as all assumptions together with the chosen actuarial method resulted in a reasonable measure of pension costs from year to year, the spirit of the rule was met. In contrast, we are now required to use a current settlement rate.

Examples of settlement rates under FAS 87 are:

- rates implicit in the current prices of annuity contracts

- published PBGC rates, or

- rates of return on high-quality fixed income investments.

After considering these examples, we decided to reject annuity rates. Although they may generally be objective, they may become less so if insurers are deluged with requests for hypothetical annuity rates. (How often have you found the price of lamb chops to be lower, when the butcher is sold out?) Further, annuities cannot cover settlement of that portion of the PBO that represents the effects of future compensation increases.

We also rejected using the rates published by the Pension Benefit Guaranty Corporation. Although those rates are readily available and verifiable, they are clearly the least relevant source of the settlement rate because most organizations (ourselves included) could settle pension obligations at much more favorable rates through the purchase of annuities, or by use of immunized bond funds.

We were left with the choice of rates of return available on high-quality fixed income investments. Although a substantial portion of our pension funds are invested in securities other than fixed income securities, such as equities or similar assets, we are precluded from using the expected rate of return on securities actually comprising (or expected to comprise) the fund.

Perhaps this prohibition is appropriate because some entities may have unfunded pension plans and the use of rates of return on assets actually comprising the fund would be an impossibility. Nevertheless, we chose the rate of return on high-quality fixed income investments as our settlement rate.

There is no requirement under FAS 87 that the investments used to determine the settlement rate be confined to risk-free government securities. Therefore, we attempted to construct a portfolio of Baa's or better corporate securities that would match up with projected pension payments many years into the future. It was the rates of return on this "hypothetical immunized bond portfolio" that gave us our settlement rate. At January 1, 1986, that rate was approximately 10%.

Frankly, if we had used a little less conservatism in constructing our portfolio, the settlement rate may have increased by perhaps as much as an additional point or so. Conversely, use of risk-free government securities would have trimmed a point or so from the rate.

HOW TO IMPLEMENT

Because pension accounting under FAS 87 is described unambiguously and in such a straightforward manner in the statement, I won't attempt to paraphrase the multitude of detailed rules and choices that have to be made when implementing the rule for the first time. I will, however, share with you some of the general objectives we had in the implementation process and in the required selection of alternatives.

In order to emphasize my observation on clarity and understandability of FAS 87, as you have already heard, the FASB has formed a Pension Implementation Group which has studied a variety of situations under the rule. I believe it has already dealt with about 160 questions and answers on implementation. I probably don't have to say anything more about clarity and simplification. But I must mention that the only thing I have seen lately that rivals the simplicity of FAS 87 is the "simplified" Tax Reform Act of 1986.

RETURN ON PLAN ASSETS

One of the most complicated features of FAS 87 is the discussion about returns on plan assets, including the variety of choices available for recognizing gains and losses.

Return on plan assets equals the difference between the value of plan assets at the beginning and end of the year adjusted for company contributions and pension payments. The trick comes in how to measure *return* and *value*. We are given three choices:

- *Actual return* on *fair value*

- *Expected return* on *fair value*

- *Expected return* on *market-related value*

Market-related value of plan assets is a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years (for example, a five-year moving average or a twenty-quarter moving average). Most of us refer to this value as the actuarial value of assets.

Once returns on plan assets are measured, the gain or loss may be either reflected immediately in pension cost (or deferred until the following year) or deferred and "maybe" amortized to pension cost on a formula basis.

In all instances, actual return on the fair value of plan assets is required to be displayed as an element of pension cost in the notes to the financial statement.

When I first read the requirement, I thought that the results of the field test and industry discussions with FASB "on the need to look at pension costs on a long-term basis and the need to avoid unnecessary volatility in the income statement" had fallen on deaf ears. A few pages later, I breathed easier when I saw that a contra adjustment is made to actual returns:

- *If* one of the alternative return on asset measurements is used,

- Or *if* deferral and amortization of gains and losses is followed.

The most volatile and unpredictable pension costs will result from actual return on fair value of pension assets without deferral and amortization. Here asset value run-ups (or run-downs) during the year would be reflected in their entirety in the calculation of the current year's pension cost.

On the other hand, the least volatile and most predictable pension costs will be derived from the use of expected return on market-related value of plan assets (with deferral and amortization). Here, value changes are smoothed to the maximum degree possible and the difference between actual and expected returns would be reflected in amortization only when the difference exceeds a kind of "DMZ" or corridor.

Consistent with our overall philosophy and the desire to smooth out the peaks and valleys in pension costs, we chose "expected return on market-related value of plan assets with deferral and amortization."

THE CORRIDOR

A unique concept of FAS 87, and one that I, quite frankly, have trouble understanding without an illustration, or a coaching session from my staff, is the use of a corridor in which unrecognized gains and losses reside until they get large enough to require amortization to pension expense.

The gains and losses in the corridor include:

- the difference between actual asset returns and expected asset returns

- changes in the PBO due to settlement rate changes.

The size of the corridor is based on 10% of the greater of the PBO or value of plan assets at the beginning of the year. Once amortization is triggered, it continues until the remaining gain or loss no longer exceeds the corridor.

Depending on the yearly movement in the value of plan assets or the PBO, this amortization may run for a few years, then stop for a few more years, and then start again as either a debit or a credit to the income statement, depending on which side of the corridor the excess resides!

For the life of me, I can't fit the amortization approach into the balance sheet concept that I described earlier. It's closer to the income statement concept, a concept that was rejected by the majority of the Board. (Perhaps the FASB put volatility in to satisfy the balance sheet people and took it out, through the amortization process, to pacify the income statement people.)

Nevertheless, the corridor is part of FAS 87 and one which we plan to use to smooth out the volatile changes in asset and obligation measures under FAS 87.

OTHER ACCRUALS AND DEFERRALS

Two other types of items require deferral and amortization under FAS 87. However, unlike the previous ones, these deferrals require amortization over the expected remaining lives of employees until completely written off, notwithstanding the size of the corridor.

These other accruals and deferrals are:

- Gains and losses from plan amendments

- Transition adjustment

Plan amendments will be amortized generally faster under FAS 87 than they were under APB 8. We had previously used 30 years and will now be using 15 years.

The transition adjustment is based on the difference between the PBO and the fair value of plan assets when the rule is first applied. The transition adjustment will be written off over the expected remaining lives of active employees or 15 years.

ANOTHER ITEM THAT DIDN'T AFFECT KIMBERLY-CLARK

One of the most controversial items of FAS 87 is the need for certain employers with sharply underfunded plans to display on their balance sheet an additional liability when the ABO exceeds the fair value of plan assets. (The ABO is the same as the PBO without the effects of future salary increases.)

I am happy to report to you that our assets are comfortably in excess of our ABO, so we will not have the additional liability problem.

I view the additional liability requirement to be primarily an elevation of certain footnote information on funded status of the plan to balance sheet display. In most cases, the contra to the liability will be to an intangible asset rather than stockholder's equity. It is my understanding that no direct write off of the intangible asset is required. Rather, the excess of ABO over plan assets is remeasured each year. The liability will gradually be eliminated by growth in pension plan assets or by increased levels of pension accruals under other requirements of FAS 87.

Nevertheless, presenting a substantial additional liability on the balance sheet could have an adverse effect on debt to equity ratios. Also, the tangible asset may not be valued highly by analysts compared to the obligation. It's possible that the liability may be counted 100 cents on the dollar but the asset counted at only a fraction of the reported amount.

My final point relates to disclosure requirements under FAS 87. There were 251 out of 256 commentators who thought disclosure was excessive. Here the old saw of "everything you wanted to know but were afraid to ask" may have been behind the FASB's drafting efforts. As I count them, there are at least 22 separate and distinct items of information requiring disclosure for a single defined benefit plan. Disclosures for multiple plans can be aggregated in many cases. The most controversial disclosures in my view are:

- Actual return on plan assets may or may not be important to a particular company depending on the other side of the entry. (Is actual return reflected directly in pension costs or is the difference between actual and expected return deferred and amortized by the corridor approach?)

- My feeling is that display of actual asset returns could be confusing to readers and management and may not add to comparability between entities.

- Rate of compensation increase may be misconstrued by unions or other employees to be something other than it is intended to be.

MR. DONALD S. GRUBBS, JR.: From the viewpoint of a consulting actuary, so far FAS 87 has been great. It has generated some interesting work for us and some interesting fees. As we look forward though, more small companies are going to deal with this, and not all small companies have the two year extension. Next year I have to do FAS 87 work for one client with only 10 employees. I am concerned about the client's reaction to the difference between actual and expected actuarial fees. Does anyone have any comment as to how I might minimize that difference?

MR. DUSENDSCHON: You could always adopt a defined contribution plan and get out from under it.

MR. STEWART: I think there will be some additional cost involved in the year of application, but I think once we are all used to this, the ongoing costs will not be any different from what we do now. Yes, there will be some new costs but also some additional understanding in this area once we establish a routine.

MR. PETER B. BRESLIN: Mr. Stewart, you mention under FAS 88 that you felt that participating annuity deals will not qualify as a settlement. Could you tell me what features of that kind of deal would make it not qualify?

MR. STEWART: I think some participating annuities do in fact qualify, since FAS 88 specifically says so, but there will be some that I think will not. The statement says that an annuity purchase qualifies as a settlement if you transferred substantially all or the majority of the risks and rewards of ownership of the assets and the obligation to a third party. What we are finding is that some of the new annuities do not transfer very much of the rewards of ownership and in effect try to permit the company to retain most of what they otherwise would have received. For example, in effect the insurance company gets 40-50 basis points in the event of a catastrophe because the assets transferred are significantly in excess of the ABO. There is not a lot of risk that is transferred to the insurance company. The question is, "How much different is the company or the plan from what it was the day before it gave the money to the insurance company?" It is not easy to tell. For example, there was an article in *Forbes* about a transaction involving a very large U.S. company which bought participating annuities, but the company must have concluded that it did not qualify as a settlement because it did not trigger instant gain or loss. Another very large company which entered into a similar settlement concluded that it did qualify. What is troubling to me is that I am not sure that the FASB fully understood how participating annuities work, and it certainly did not anticipate the subsequent activity. One of the Board members did though because he dissented to Statement 88 thinking this might happen. We will consider the difference between the amount of assets transferred and the ABO. If it is a very significant difference, and the plan sponsor retains the upside and might even be able to manage the assets, in my view that does not qualify as a settlement because I do not believe that much has changed from what it was before. If the cushion is more in the normal range of what traditional participating annuities have been, then it would qualify as a settlement. Either way it goes, we are going to see a lot of controversy.

QUESTIONER: Mr. Stewart, Kimberly-Clark's method of selecting its settlement rate seemed to produce the ability to generate a corridor. Mr. Dusendschon came up with 10% and he mentioned the ability to possibly move that as high as 11% or drop it as low as 9%. How would you respond to that?

MR. STEWART: The stated goal is to come up with the best estimate, but we know that there are different methods of getting to that best estimate. I assume that Kimberly-Clark will continue to use its methodology from year to year until it finds a different one that it thinks is more representative of cost to settle. The corridor that I mentioned was the following approach, which I believe is not acceptable under Statement 87: this range from 9% to 11% is the range from the lowest to the highest. Mr. Dusendschon picked 10% falling within that range, but he looked to long-term bonds to get that number. Next year the corridor approach would say that if the corridor has moved around but you are still within the corridor at the end of that period, then any rate within the corridor is appropriate. So if the settlement rate you picked today stays within this corridor, you would not have to change your assumption. Therefore, this would limit volatility. I believe that is not appropriate because you have not continued to follow the method you picked. The method that Kimberly-Clark picked was high quality bonds. It cannot, in my view, change to say the PBGC rate the next year and perhaps a half percent over the PBGC rate the following year. It should stay with the basic methodology that it has. I did not perceive from Mr. Dusendschon's comments that Kimberly-Clark had set itself up to use the corridor approach for the settlement.

QUESTIONER: So if you came up with the 9 to 11% corridor, and you were at 10% this year, with your same portfolio extremes next year, if you came up with a corridor of 8 to 10%, you would say Mr. Dusendschon could not keep 10%. He would have to drop to 9%, assuming that the relationships stayed the same.

MR. STEWART: Whatever Mr. Dusendschon's method produced, he picked the Baa.

MR. DUSENDSCHON: I think John got the essence of what I was trying to convey. In trying to figure out the appropriate settlement rate, we looked at a variety of different instruments and concluded it was a faithful representation on our part to use the Baa rated corporates or better as the rate. We were not thinking about establishing a corridor that we could bump around in. Had we chosen from the very outset to use government bonds, the rate would have been lower. If we had used full quality corporates, the rate would have been higher. As John observes, we would be stuck with that until we could figure out some other way to convince everyone that we made the wrong judgment in the past. It is not our intention to jump around in that so-called corridor.

MS. DIANNE WEITZENKAMP: When will the questions and answers be published?

MR. SPIGAL: FASB is talking about the end of October 1986 for Statement 87, but later for Statement 88.

MR. STINCHCOMB: Regarding this process of rolling forward the beginning of the year results to get an estimate of end of the year values for the purposes of the footnote disclosure and, in the case of an underfunded plan, for the purposes of balance sheet entries: if a particular plan sponsor does not have underfunded plans so that all I am concerned about are the footnote entries, do you, from the auditing perspective, feel that the problem of getting accurate estimates is as great as in the underfunded situation?

MR. STEWART: I agree with the comments that Jerry made. The auditor's concern would be heightened if the roll forward had more direct impact on the balance sheet, but just because the roll forward is in the footnote does not mean that it is not important. We would turn to the actuary as the expert to determine whether that roll forward is a reasonable approach to approximate the results of another measurement at the end of the year.

MR. SPIGAL: In the IASB exposure draft comments, some people specifically asked whether the company had to take account of salary increases during the year or other types of actuarial gains and losses in that roll forward. The actuary has to have to come up with a number that reasonably represents the PBO or the ABO he would calculate with all the information at hand. He has to take into account actual salary increases, changes in the group, plant closings, settlements, anything else that might have happened to the group. The actuary is not calculating the expected value for the footnote, but rather the actual end of year PBO and ABO.

MR. STEWART: One thing that is really very important is that if the actuary uses this roll forward, he does have to use new settlement rates at the end of the period even though he rolls forward the census information. The actuary has to use the end of period settlement rates and the fair market value of plan assets at the end of the period. Those are not roll forward numbers, those are the real ones, and clearly the new settlement rate will have to be worked into the roll forward.

MR. ALLEN C. WEAVER: What do you do about changes in the law during the course of the period? These would be the changes that you know are going to hit integrated benefits, offset benefits and the loss of the 415 limits, which you mentioned earlier, but also the other changes that affect the actual structure of the plan.

MR. SPIGAL: We discussed that question with the FASB staff, and it depended upon whether the employer had some choices as to how it was going to implement a particular change. I thought that FASB was counting angels on pins again, but clearly, if the plan references the section 415 and the law changes, then the plan changes. If that is a significant change according to paragraph 53, then you must have an interim measurement date when President Reagan signs the law. I do not think that will happen a lot. It was the staff's very preliminary opinion that changes such as vesting or integration did not have to be recognized in cost or disclosure until the employer had made a specific commitment as to how the plan was going to be changed.

MR. STEWART: One thing that has not been focused on is that next year, when this has to be applied to public companies, they must do it in the first quarter of 1987. They cannot wait until the end of 1987 and then restate the prior quarters. You can in 1986, as Kimberly-Clark is doing, but next year since APB 8 will disappear for public companies, you do not have until the end of the year to get implemented.

MR. SPIGAL: We explored with the Board the question of more than one measurement date during the year. For example, if your client wants to disclose end of year values based upon a 9/30 measurement date, that, of course, is acceptable. But the staff told us the other day that, if you do indeed disclose as of 9/30, then the first quarter net periodic pension cost in the following calendar year must reflect the values determined as of 9/30, even, if before the end of the first quarter, you have collected actual 1/1 information and completed your actuarial calculation. So even though you have two measurement dates, for example, a 9/30 measurement date to get your end of your disclosure and a 1/1 measurement date to produce your cost for the following year, the 1/1 cost determination would only be for the last three quarters of the year, assuming you finished it for the end of the second quarter. And the Net Periodic Pension Cost for the first quarter of the year would be that cost determined for the 9/30 to 12/31 period of the prior year, based upon the 9/30 measurement. Is everybody confused on that now?

If you have a measurement date, you must have a period that reflects the cost determined based upon that measurement date. You cannot skip a cost determination. For example, say you used the 9/30 measurement date, and then before the first quarter results were presented the next year, you had collected actual 1/1 employee information and computed the Net Periodic Pension Cost for the full calendar year. The FASB staff says you cannot do that. The first quarter costs for the following year must be based upon the 9/30 measurement.

MR. STEWART: For the subsequent three quarters you can use the updated information.

MR. SPIGAL: That is right. By the way, there was some discussion that the FASB staff was thinking about designating an actuarial valuation for ERISA purposes as a significant event which would trigger a FAS 87 measurement, which would not be a good thing.

MR. STEWART: I have one other comment about using other than year end measurement dates. Suppose you have been on Statement 87 for some period of time, but you are using a 9/30 measurement date. Then in the fourth quarter of the year you buy annuities to settle part of your PBO and that generates a very large gain because the plan is overfunded. In what calendar year should that settlement gain be reported? There is some belief that since you are on a 9/30 to 9/30 year, that for pension accounting purposes, a settlement that occurred after the measurement date belongs in the next fiscal year, not in the fourth quarter. Even though you bought the annuities in the fourth quarter, the settlement gain would be reported in the following year.

I know the FASB staff is taking the position that if all you did was buy annuities, the result belongs in the next fiscal year of the employer, not in the fourth quarter. I find that position hard to understand, and I am not satisfied that it has been ultimately resolved.

MR. SPIGAL: So it will ultimately be resolved when the auditors come in, say that is or that is not appropriate, and you can publish the financial statement.

MR. STEWART: Ultimately it will be resolved at the FASB. I believe that question will come to the Emerging Issues Task Force for more discussion. But there are some consequences other than practicality of using other than year end measurement dates that you should be cognizant of when your clients pick other than year end. While it may ease the time constraints, it is a lot harder to understand, at least in my view.