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ANOTHER WORLD -- FASB

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35, 36, 87, 88, 106, 112. What do these numbers have in common? The panel will discuss the various FASB statements with which the retirement benefit actuary must deal. Emphasis will be on current developments.

MR. DENNIS M. POLISNER: I'd like to introduce the speakers who we have on our panel. Ken Dakdduk is with the FASB and has been involved in some of the FASB pronouncements that we'll be discussing. Ken will provide us with a perspective of what the FASB is all about and what its objectives have been in issuing these accounting standards that deal with various employee benefit plans.

Our second speaker will be Diana Scott. Diana's background is interesting. She also has been with the FASB, involved with some of these statements that we'll be discussing, and is now currently a consultant with TPF&C. She has been involved, from the client side, in the implementation and ongoing administration of these FASB statements. Diana will share with us some of the practical realities of dealing with clients and some of the problems that exist in dealing with these FASB statements.

Jim Colburn is a partner with KPMG Peat Marwick. Jim is a consulting actuary and has been heavily involved from an actuarial standpoint, as well as from an audit standpoint, dealing with client issues. He will provide some thoughts and insights on issues from an actuarial perspective; the utilization and implementation of the various FASB statements that we're talking about.

Just as a bit of general background, the purpose of this session is to gain greater understanding of the purpose of the statements that deal with employee benefit plans and some of the practical issues involved.

MR. KENNETH E. DAKDDUK: I am going to talk about the FASB, what it is that the board does, how it does it, why it does it, and the process it undergoes in order to do it. I will touch on some of the benefit accounting standards that Dennis mentioned. I'm not going to go into detail on them. I presume that you're very familiar with how those standards operate. I will try to give you some idea of what the board was trying to achieve when it established some of the accounting standards that we heard about, namely *FAS 35, 87, 88, 106,* and *112.*

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Well, since 1973 the FASB has been the designated organization of the private sector for establishing standards in financial accounting and reporting. From its inception in 1973, the FASB has been and continues to be our country's chief accounting rule maker.

The mission of the FASB is quite simply to establish and improve standards of financial accounting and reporting. That mission certainly includes issuing new accounting standards whenever necessary. But it also includes keeping existing standards up to date; for example, if there's been a change in doing business or a change in economics and the FASB thinks that the accounting should better reflect those changes.

The board's rules of procedure do require that the board perform all of these functions in an open decision-making process, which means that its meetings and its decisions and deliberations are essentially open to not only to public observation but also public participation in certain ways. The board also has to follow certain other conditions or precepts in the conduct of its business. It does have to be objective in its decision making. It also has to carefully consider the views of all of the constituents who provide it with input. It also has to look at standards that will be perhaps issued only when the expected benefits exceed the perceived cost of doing so. Bringing about any needed changes, the board is required to try to do so in ways that would minimize the disruption to the financial accounting reporting practice that exists currently.

Those are the types of guidelines that the board follows. They have been established primarily because the board's actions affect so many people that the board believes that it's important to be very evenhanded in its decision making.

One of the myths that you may hear about the FASB is that it is actually part of the American Institute of Certified Public Accountants. Another myth that some of you may have heard is that it is an arm of the federal government. In fact, every so often I receive letters from our constituents that have been addressed to the Federal Accounting Standards Board.

Well, standards that are issued by the FASB are officially recognized as being authoritative by the SEC and the AICPA. However, the FASB is not part of either of those organizations. As you know, the SEC does have authority by statute to establish financial accounting and reporting standards for publicly held companies, although it has historically left that to the private sector. Prior to the FASB, it was the AICPA that was the major standards setter in the U.S. It had a committee on accounting procedure that was in operation from 1936 to 1959, I believe. And it issued the accounting research bulletins (ARBs), and many of those are still in effect. From 1959 to 1973, the AICPA kind of changed gears. It still was the major standards setter, but it did set standards through the accounting principals board. And of course, it gave us the accounting practice bulletin (APB) opinions. And then in 1973, the AICPA ceded its standards setting authority to the FASB. And, as I said earlier, that made the board the chief accounting rule maker in the U.S.

Well, here's another myth that we hear from time to time. The board actually comprises many academics, and they sit around a table and talk about accounting issues on a very esoteric level. Well, of course, that's not true either. The board consists of seven members who do serve full-time. They are not part-time members, and they are required to sever all of the ties with the organizations that they came from before they start their appointments at the board. Each board member serves one five-year term and is eligible for another term of five years. So, in total, a board member can generally put in about ten years at the FASB.

The occupational makeup of the board members is intentionally diverse, but each of the board members has to have a fervent interest in accounting, finance, and business and also a desire to further improve financial accounting and reporting in the U.S.

In addition, none of the board members is permitted to represent the interest of any particular segment of the board's constituency. There has to be an independent and rather objective approach to standards-setting. Our current board comprises three individuals from public accounting, two individuals from industry, one academic, and a former securities analyst.

Well, these are the types of accounting statements or standards that the FASB issues.

FASB STATEMENTS

Board Issues	
Concepts	Broad general principles to guide Board
Standards	Binding under AICPA Rule 203
Interpretations	Clarify existing standards
Staff Issues	
Technical Bulletins	Timely guidance on applying existing standards

There are generally four types of documents that will emanate from the Board. Statements of financial accounting concepts are very important to the Board. Although they don't establish accounting rules and standards, and they don't require any changes in the application of existing accounting principles, they provide broad general principles that are really intended to help the board in solving problems.

For example, they set forth the characteristics of an asset or the characteristics of a liability. They discuss elements of financial statements, and they discuss things such as relevance and reliability and comparability of financial information, which are all very important to the board in standards-setting.

Concept statements are developed under the same due process that the FASB follows when it issues accounting standards and statements. At this time, there are six concept statements. When you hear references to the board's conceptual framework, that reference is to the six concept statements.

Now, of course, the board does issue accounting standards. Those are the accounting rules that have to be applied if financial statements are going to be prepared in accordance with GAAP. As of today, there are 117 of those standards.

The board also issues FASB interpretations. An interpretation clarifies, explains, or elaborates on an existing accounting standard that has been issued either by the board or by a predecessor of the board, the APB or the ARB, if those pronouncements are still in effect.

To issue a statement or an interpretation requires a five-to-two majority vote of the Board. So essentially, five board members have to support the document and approve its issuance, or it isn't going to be a final document, and it will not come out in final form.

The last item is technical bulletins. Technical bulletins do emanate from the board, but they're actually developed and issued by the FASB staff. Such bulletins generally address issues that aren't directly covered by existing accounting rules. And I think the real key to a technical bulletin is that it can only be issued if it's not expected to cause a major change in practice for a significant number of companies. The cost of implementing a technical bulletin could not be expected to be very significant and also cannot create a new or novel accounting practice.

There is, of course, another type of staff document that is issued in addition to a technical bulletin. And that's the questions and answers books, the implementation guides that the FASB staff has periodically issued. Of course, Q&A books have been out on pension accounting, income tax accounting, and accounting for loan origination fees, and last month a Q&A book on *FAS 106* for postretirement benefits was issued.

Here is the GAAP hierarchy:

GAAP HIERARCHY
SAS NO.69

Level	
A	FASB statements and interpretations, APB opinions, and AICPA accounting research bulletins
B	FASB technical bulletins, AICPA audit guides, and AICPA statements of position
C	FASB EITF consensus and AICPA practice bulletins
D	AICPA accounting interpretations, FASB "Q&As," and industry practice
E	Other accounting literature

There are standards that exist that possibly may touch on the same area. And when you're in doubt, you look to this to determine which one has the highest level in the hierarchy. That's generally the one that should control and be your guide.

At the top of the list at level A are FASB statements and interpretations. They're the highest level GAAP that you can look to. They're up there with the ABPs and the ARBs that are still in existence. As you can see, staff technical bulletins are at level B. So they're the second highest level of GAAP. They are not quite as authoritative, if you will, as level A. But Level B, I guess, is better than C, D, and E.

Staff Q&As are at level D. And the reason they're down at level D is because Q&As don't normally undergo the extensive due process that a standard or a technical bulletin would undergo. We also have an arm of the FASB, called the emerging issues task force (EITF). It is basically commissioned by the FASB to respond to emerging issues or issues that require a quick turnaround. When it members issue a consensus, it ends up in the level-C category of the GAAP hierarchy. So, they are a little bit higher than the staff Q&As, but certainly below technical bulletins and below the FASB standards and interpretations.

I have heard the myth that the FASB operates from an ivory tower. People think the Board members just kind of sit and set standards at will and don't really think about all the issues and fully consider them. Well, once again, that is not true.

To place a topic on the agenda, the board must first look to the pervasiveness of the problem. To what extent is the issue troublesome to users, to preparers, to auditors, or to others who may look to financial information? And to what extent is there a diversity of practice? Also, what's the likely duration of the problem? Is the problem that the board perceives something that's merely transitory or is it likely to persist?

I think perhaps post retirement benefits other than pensions was a good example of something that was deemed by the board to be a situation that was not transitory but would, in fact, persist because of factors such as health care costs increasing, increased longevity, and early retirement.

The board also has to consider whether there are any alternative solutions to the problems being looked at currently. Basically that consideration involves assessing to what extent one or more alternative solutions might be able to be developed that might serve to improve financial accounting and reporting just as well. Another factor to consider: is the solution technically feasible? In other words, can the board develop a technically sound solution? Or, should the project that it is considering be put on the back burner until another project is complete? Perhaps a good example of that is the board's stock compensation project.

The FASB first added accounting for stock compensation to its agenda back in 1984. But shortly after it decided that it needed to resolve some other fundamental issues concerning liabilities and equity and how those are defined before it could resolve the accounting for stock compensation plans. Because those issues were already being addressed as part of the board's financial instruments project, it decided to put the compensation project on hold pending further progress on the financial instruments project.

The last consideration is the practical consequence of issuing a standard and even adding a project to the agenda. The board does have to consider the extent to which an approved accounting solution will be accepted in the market. And it also has to consider when addressing a particular subject, or maybe not addressing, the extent to which it might cause others to act. And who are those others? Well, certainly the SEC for public companies and even Congress could be one that could act in place of the board or as a result of what the board has done.

Unfortunately, I think we're seeing a little bit of that with Congress getting involved in some of the stock compensation debate. For those of you who aren't aware, several pieces of legislation have been introduced in Congress that would either support the FASB's work on stock compensation or would tell the SEC to ignore anything that the FASB finally comes out with. So, once again, those are factors that have to be considered, and I would put them in the last category of practical consequences.

It isn't possible to evaluate all of these items in exactly the same way for every project, but the board does find that identifying these factors helps to bring out consistent decisions regarding what goes on the board's agenda. I keep mentioning agenda, and agenda decisions do rely on advice from many of the board's constituents. The sources that we rely on comprise a fairly diverse group from our constituency.

We have the regulators, who comprise the SEC, Congress, and federal and state agencies. We have the users, who are basically the shareholders, analysts, rating agencies, and lenders. In practice, we have the AICPA and the accounting firms. The preparers are in the last category. Preparers would be groups like the Financial Executives Institute, the Business Round Table, various industry groups, etc.

All of these groups provide the board with quite a bit of input on the types of projects that ought to be added to its agenda. Contrary to popular belief, the board really doesn't have to look for projects to add to the agenda. This group really does keep the board busy with many different suggestions on what ought to be looked at next. And it was actually based on the actions and input from this group that the board added to its agenda in 1974 the projects and accounting for employee benefit plans and accounting for pensions.

Both of those projects were actually added partly in response to the actions of the regulator group, primarily with the passage of ERISA, and in response to certain criticisms by the other three groups. Basically, the criticisms involve perceived efficiency and Opinion 8, which of course was the applicable standard on accounting for pensions before *FAS 87* was issued.

Basically, APB 8 was criticized for the flexibility that it permitted to employers in choosing between various actuarial cost methods. Critics asserted that flexibility could produce different pension amounts in similar situations, and, therefore, they were very unhappy that it resulted in the lack of comparability in financial information from company to company.

Another reason, by the way, for adding the agenda project on accounting for pensions and other postemployment benefits was that at the time, in the 1970s, there really wasn't much in the way of accounting literature that addressed specifically the accounting for postretirement benefits or postemployment benefits. And, of course, as the significance of the cost of those benefits grew, the lack of accounting became a bigger issue.

So, what did the board actually hope to achieve by developing in 1985 a standard for accounting for pensions, and, of course in 1990-92 standards on postretirement and postemployment benefits? Well, certainly an improvement in financial accounting reporting was a major goal. And, of course, that type of goal is certainly consistent with the board's mission statement that I mentioned a moment ago. The board basically wanted to enhance the relevance and representational faithfulness of an employer's financial statements. It wanted the employer to provide basic information on the cost of benefits that would be useful to the financial-statement users. And in the case of pensions, it really wanted that information to be comparable and more understandable than what was used in the past under Opinion 8. Did the board achieve that goal? Well, many say yes, to the extent that pension accounting is now more consistent from company to company. Many believe the board has improved financial reporting.

Many also say yes to that question, to the extent that financial-statement users now have information on an employer's obligation to provide postretirement benefits and postemployment benefits. And, of course, we're talking primarily about retiree medical benefits, severance benefits and disability benefits.

On the other hand, there are those who actually believe that financial reporting has been improved, but maybe the degree of improvement is more modest compared with what could have been achieved. For example, some have pointed to certain inconsistencies among the board's benefit accounting standards, including inconsistencies with past standards. And they feel that those inconsistencies may have hindered the achievement of the degree of improvement the board wanted to achieve.

One example that I hear from time to time that some cite as an inconsistency is a consideration of future salaries and reporting pension costs. Under Opinion 8 and certainly under *FAS 35*, of course, employers look to current salaries when they measure costs and obligations. Future salary increases aren't considered. But, of course, in measuring your projected benefit obligation (PBO) and your service cost under *FAS 87*, the board concluded that estimated future compensation levels should be projected and considered if the plan's benefit formula does provide for that.

Now some have argued that an employer can't have a present obligation for a future salary increase, because those future salary increases are really dependent upon future events, such as future inflation, promotions, or improved productivity. And they also argued that if you look at the board's own definition of a liability that's contained in the concept statements that I mentioned earlier, that definition would exclude future salaries, because it defines liabilities in terms of past events.

Another aspect of the accounting that some point to as an inconsistency involved the attribution period. Statement 106, of course, specifies an attribution period that generally runs from the date of hire to the date of full eligibility. Most pension plans, however, accrue pension benefits to the plan's normal retirement age, so in the case of pension plans, the full eligibility date and the normal retirement date can often be the same. That means that attributing postretirement benefits to the date of full eligibility could result in the pension and postretirement benefits being attributed over different time periods, even though the postretirement benefit usually is not paid until the pension benefit is paid. There are those who believe that financial reporting would be better served if those periods were the same.

Of course, I think there's a significant and obvious difference between these three standards, involving the treatment of transition. *FAS 87* requires amortization over future periods, *FAS 112* requires immediate recognition, and *FAS 106* gives the employer a choice between the two methods.

Knowing that these employers are dealing with standards that essentially emanated from the same project back in the 1970s, some observers have basically said that the board was clearly inconsistent with respect to the transition provisions of each of these documents. Well, that may seem so on the surface, but actually, the board established the transition rules in each of these documents, based on rather well-reasoned views. The basic view, and the one that's really espoused in *FAS 112*, is that from a conceptual standpoint, the immediate recognition of the transition amount is appropriate, and it would be in line with existing accounting rules on adopting accounting changes that require a cumulative-effect adjustment.

The magnitude of the pension transition amount for *FAS 87* was deemed to be so significant by the board that it compromised its conceptual position. It required the transition amount to be recognized over future periods. Although the board did consider offering employers a choice between immediate recognition and amortizing the amount, it rejected that choice because it felt that would result in a lack of comparability, given the wide range of pension practices that existed under Opinion 8. With *FAS 106*, however, the board believed that even if it tried to achieve complete comparability, it probably wasn't going to be able to do that, because at the time *FAS 106* was being deliberated, Technical Bulletin 87-1 allowed accounting for employer costs for postretirement benefits to be immediately recognized.

Frankly, even before *FAS 106* would have been issued, that bulletin was still effective. Employers would have had yet another opportunity to adopt accrual accounting by using immediate recognition. So the board decided that it was not going to preclude the transition obligation from being immediately recognized. Obviously, there are other factors, but I think the point is that these transition provisions were established by the board with a purpose in mind, and they certainly weren't done in any degree in a haphazard way.

Now, last but not least, I think some question the degree of improvement in financial reporting by simply looking at the complexity of the standard. And I think many people answer the issue of improved financial accounting and reporting by saying they probably have improved it, but just to a degree. But wouldn't it be great if these things were a lot simpler to do? And certainly some of the complexities that have occurred in those standards have led to many implementation questions. The board certainly can't anticipate all of those questions, but, of course, when necessary, the staff has tried to help out with the issuance of Q&As.

I think Diane and Jim are going to talk a little bit about some of the practice problems they face in applying the standards. So I'm not going to touch on any of them.

Nothing new is currently in the works, but *FAS 87, 106,* and *112* are not likely to be the final step in the evolution of accounting for pensions and postemployment benefits.

MR. POLISNER: Now Diana Scott will share some of her views on some of the practical issues and the application of these statements.

MS. DIANA J. SCOTT: As Dennis mentioned, I come with a rather interesting perspective. I am a CPA by background. I spent 12 years in public accounting. I went to the FASB, where I met a number of you in my role as a project manager in *FAS 106*, and now I'm a benefits consultant. So you might at first blush at a lot of what I'm going to say, or think my heavens she is being irreverent, but I'm really trying to be very realistic in my remarks.

Ken mentioned that the law of the FASB is to develop standards that improve the usefulness of financial reporting, and that clearly drives everything the FASB does. One of the criticisms that people always make is that the board doesn't consider the social implications. I recall when *FAS 87* was about to be issued, the world was running around saying, you can't do this all of the defined-benefit plans are going to have to convert to defined-contribution plans. And, of course, that never happened.

When *FAS 106* was getting ready to be issued, everybody kept running around saying, you can't possibly do this, you're going to cause all of the retirees in the country to lose their retiree medical benefits. And, of course, that didn't happen.

But the issue here really isn't that the board is ignorant to those social implications, but rather that the board doesn't have the ability to take those into consideration. It acknowledges up front that it is in business to improve the financial statements on which investors make their decisions. And it's up to Congress and the government to deal with all of the social issues.

I want to talk a little bit about *FAS 87*, *FAS 106* and *FAS 112*, from the perspective of someone who's trying to be fairly realistic about the shortcomings of some of those statements. And as one who wrote one of them, I'm trying to be objective in saying that certainly there are things that we could have done better.

FAS 87 and *FAS 106* are often criticized for being too much like a cookbook. And I'll tell you, after having seen *FAS 112*, I'll take a cookbook any day. In my view, *FAS 112* is one of the loosest standards that's ever been issued. The staff at the Board kind of says, well you guys asked for it, and you got what you were asking for. I'll go back to cookbooks any day.

In my view, the biggest advantage of *FAS 87* was the fact that it conformed practice, and that's really the objective of most of the standards that the FASB puts out. But there are a certain number of shortcomings, and some of them we'll be seeing, probably, for the first time this year.

The first is that the discount rate is a rate that is based on rates at which an obligation could be effectively settled. Unfortunately, the majority of the people who apply the standard don't appreciate that effectively settled doesn't really mean settlement rate. What the Board was really looking for, as described in one of the Q&As for *FAS 87*, was the risk-free rate. Essentially if you were to go to an insurance company that was going to settle the obligation, it's not the rate it would charge you, it's the rate it would be anticipating -- what underlying investment return would it be anticipating on the assets that it would purchase to annuitize the obligation?

The board more or less clarified that issue in *FAS 106*, but unfortunately, we did it more in the basis for conclusions, where we talked about the fact that rate is to represent a current rate of return on high-quality, fixed-income investments with maturities that match the expected accounting of benefit payments. The key here is that it's current rates of return.

That's great, except that every other assumption that's being used in the measurement process is looking longer term. You know, what is our expected long-term salary growth? What is our expected long-term rate of return on plan assets? We may be assuming a higher return on plan assets than we're currently experiencing, but our discount rate is forced to look at environment. Of course, that has some rather onerous impacts in that it can cause companies to trigger a minimum liability for the first time, because the measure of the obligation is so much higher as a result of the low interest rate driving a low discount rate. In fact, we've seen interest rates come down 150 basis points just this year.

So you have a situation in which a company that has always been in an overfunded position, or a company maybe that doesn't even have the ability to make contributions to the pension plan, is going to be triggering a minimum liability under *FAS 87*, a potential charge against equity. There's nothing that it can do about it. It's not that the company wasn't prudent in its investing. Its just that it was a victim of what happens to be a low-interest-rate environment.

The other thing that can happen with interest rates coming down that we have seen in our experience is that because the measure of the PBO increases so significantly, as a result of the low interest rate, it can throw off a huge remeasurement loss, and in some situations that loss is enough to throw the company outside the gain/loss corridor. In one situation, I saw that the net periodic pension cost in 1994 can go up 75%, just because all of a sudden we're thrown out of the gain/loss corridor and have to start recognizing some of those net losses. I'm not saying that's a bad thing. I'm just saying that that's certainly going to be a situation that we're going to see this year, and in many cases for the first time.

I have to admit the corridor is one of the things I hate about *FAS 87* and *FAS 106*. The right answer is to immediately recognize gains and losses all at once. The corridor is some magical way of hiding gains and losses until you hit a certain point. Then, all of a sudden, you blow through the corridor, which is easy to do after one year under *FAS 106*. All of a sudden, for some arbitrary reason we're recognizing gains and losses. That corridor approach and the market-related value of plan assets, which I also think is an extremely complex and difficult-to-understand approach to measurement, were done solely to nullify the critics of the FASB who said, oh, you can't possibly ask us to recognize gains and loses as they occur.

So it's one of those situations where the good news is, we have a great way to help you mitigate the volatility in net periodic cost.

Another thing that's unique about *FAS 87* and *FAS 106* is that you have the opportunity to have a measurement date that's prior to year-end. That's nice, because companies and their actuaries don't want to be running around in January going absolutely crazy trying to do all of the clients' valuations within the first four weeks of the year. This gives companies the opportunity to set an earlier measurement date and go into year-end with numbers that they think are really reliable.

The strange result of that, however, is that if you choose a measurement date that's let's say three months prior to your year-end, let's say September 30, and you have an event that occurs in October or November or December, for example, in which you have an open window and you're curtailing benefits under the plan, that effect is not going to be recognized in your financial statement, because it occurred after the measurement date. So you'll have an event that occurred in one fiscal year but won't be realized in your financial statement until the next, other than for footnote disclosure that says, by the way we did have this other event, and it did have a tremendous cost.

Under *FAS 106* I should say that the substantive plan provisions are a blessing and a curse. The reason a substantive plan was introduced was because it would be onerous to ask companies to measure an obligation based on the deductible and other cost-sharing provisions. Twenty years from now a $100 deductible is meaningless, *so it made more sense to say, how is this plan evolving?*

The downside, though, is trying to understand what the substantive plan is and the fact that different rules apply to bargained-versus-nonbargained plans. What we're finding is that it's kind of anything goes, because the auditors are buying off on anything that's going to make their clients happy.

The good thing about *FAS 106* is that it got companies to focus on a really huge liability that nobody had really been focusing on. We kind of knew it was there, but you didn't know how much it was. Sometimes if you don't know, it's better to forget about it. When companies finally realized they couldn't forget about it and they started looking at *FAS 106*, we found that it was three times bigger than our worst nightmare. And so, you really now have the opportunity to help your clients find ways to manage that liability. I think if there's anything good that came out of *FAS 106*, it is that it got companies to focus on this obligation, because you can't manage what you haven't measured.

The other thing I like about *FAS 106* is that you have the opportunity to immediately recognize the transition obligation. And under *FAS 87* the board said, well the transition asset or obligation really comprises amounts that would have been recognized on a delayed basis; like the effect of plan amendments and gains and losses, which are recognized on a delayed basis. But with *FAS 106* we could look at it and say, well that might be part of it, but the bigger part is that companies have never recognized the cost that would have been recognized in the past. So it's much more like the cumulative effect of a change in accounting that would be immediately recognized. Many companies took advantage of that opportunity to get the transition amounts behind them and get their financial statements where they really should be, showing the full liability for their retiree medical.

I think the biggest problem with *FAS 106* is that it came out five or ten years too late. I think that's the fault of the accounting profession, the FASB, and the actuaries. We all should have worked harder to focus on the fact that this was an issue before we had to deal with significant increases in Medicare costs, with people retiring earlier, and all these issues that contributed to a mushrooming retiree medical obligation.

But unfortunately, we all blew it. I think the FASB learned from that experience and maybe overcompensated for that by coming out with *FAS 112* so that it wouldn't fall into the same trap five years down the road.

Ken alluded to the fact that there are inconsistencies between *FAS 106* and *FAS 87*, and I think that results in an unfortunate amount of complexity. With *FAS 106* you almost want to sit down and say, now what is it that I want to amortize? I need a matrix to figure out what period I'm going to recognize it over. Gains and losses are over full service, but attribution of the obligation and amortization of prior service is over service to the full eligibility date. There were good bases for doing that, but it does add unnecessarily to complexity.

Even as an author of *FAS 106*, I never knew the distinction that the staff was drawing between a plan amendment and a curtailment. And if you haven't looked at the Q&A, I strongly encourage you to get it. I do think it's quite helpful in understanding and implementing *FAS 106*.

What I find really unusual is that I and many others have always had the notion that, if, for example, I decide that I'm no longer going to provide retiree medical benefits for future retirees, I've essentially curtailed their benefits. I would have treated that as a curtailment. I thought that clearly met the definition of a curtailment. What I'm finding is that the staff is saying that's a negative plan amendment, and the effect is a negative plan amendment and a curtailment. The effect is extremely onerous in my view. Not only do we record a negative plan amendment, but then when we recognize the curtailment, we're recognizing a portion of the remaining transition obligation that relates to the people whose benefits aren't even affected.

For example, many companies have changed their plans to go from a 55-10 plan to you get benefits if you provide ten years of service after age 45. Individuals who were receiving benefits under the old plan, but who were under age 45, have now had their benefits essentially eliminated.

You then have a negative plan amendment, you've taken away benefits that had been attributable to earlier years, and you've eliminated anything that you had accrued for those people. But that's not really true. You've done that, but now you have a curtailment, and you have to look at your remaining unamortized transition obligation that relates to everybody who's 45 or older, including retirees. You have to take a portion of that as a cost of making this change. I think that that's a bit of an unusual result, but its an anomaly of how you look at plan amendments and curtailments.

I find that even now I still have to read through the situations that are described in the Q&A to help me understand a plan amendment and a curtailment.

Moving on to *FAS 112*, I think it is the statement that everybody loves to hate. I haven't talked to anybody in the accounting firms who likes *FAS 112*, and I think the reason starts with the title, which is misleading. It says Employers Accounting for Postemployment Benefits. Then you read the small print that says, postemployment means anybody who is either an inactive employee or an inactive or terminated employee of the company. But inactive employees are on disability. I guess I wouldn't have thought of them as being postemployment; I would have said they're out on disability leave. That's the first hurdle I have to overcome with *FAS 112*.

The staff is very defensive about the title and about *FAS 112*. I'm going to try not to be overly critical, but I will point out what I feel are some of the shortcomings.

A second shortcoming is that the standard is extremely general. That is a polite use of the word. And it's kind of short on telling you what the true intent of the standard is. If we would say, well what we're really trying to do is eliminate the use of cash-basis accounting for postemployment benefits, that would be fine. You do find those words somewhere. But then you have to go through all kinds of gyrations to decide if this plan is one that should be accrued for under *FAS 43* because it has certain aspects of accumulation. Even though it provides a more generous benefit than the service-related plan, am I able to structure the plan in such a way that I can say that it's not a benefit that accumulates, so I can't reasonably estimate, and I can fall under *FAS 5*? In my view, and I've shared this with the FASB, it would have been much better to say, if what you were really trying to do is get rid of cash-basis accounting, then at a minimum, you should be accruing for these benefits under *FAS 5*, which says that when the triggering event occurs, you should accrue the expected cost of benefits to be provided as a result of that event, whether it's disablement, severance, or whatever it might be.

Instead, the board decided that there were situations where companies might be accruing under *FAS 43*, because a benefit accumulates and it didn't want to preclude that. Well, I don't think my alternative would have precluded that, but what we find now is that companies are trying to find ways to argue that something that accumulates doesn't really accumulate. Worse than that, auditors are saying, well, I think *FAS 112* is a really dumb statement, and so, even though I agree with you that this disability benefit is one that accumulates over service, because I think this is a dumb standard, I'm not going to make my client apply it. This puts actuaries and consultants in kind of a tough situation.

For example, you sit down with your client and you say, here is what the rule is, and here's how you're supposed to apply the rule. You're doing what you think is a good thing and explaining what *FAS 112* says. This benefit is one where you earn a greater benefit with additional service, and it needs to be accrued under *FAS 43*. Then the auditors come in and say they think that's dumb, recording a $20 million liability is ludicrous, it's probably more like $1 million, which is immaterial, so ignore it. We turn out looking a bit foolish, and I've run into that in more than one situation.

Another situation that you'll find to be fairly sticky is what's the distinction between a sick day or a sick-pay program and a short-term disability program? I've run into this issue on a number of occasions, and Ken and I have recently discussed it. Many companies don't have short-term disability programs, but they have a sick-pay program that is intended to act as a short-term disability plan. So accountants are going to look at the substance of the program.

The fact that it's called a sick-pay plan doesn't mean that you can ignore it. But *FAS 43* says, if you have a sick-pay plan and the benefit is one that is a nonvesting benefit, even though it may accumulate, if it doesn't vest you can ignore it.

Well that's great, except when they got to *FAS 112* the word *occasional* was inserted. It says if you have an occasional sick-pay program you can fall under *FAS 43*, and you can get this exclusion that says you don't have to accrue for it. But I don't think there's general agreement on what *occasional* means. Now, in talking to Ken and to his contemporaries at the board, what was intended is that if you have a sick-pay program, that provides a nonservice-related benefit and the amount of sick days an individual can earn during a year is no more than would be necessary to take occasional sick days, and you can use your judgment as to what that means. Even though an individual can accumulate all of those sick days, that doesn't fall under *FAS 112*, because the individual sick-pay plan does not provide for more than occasional sick days in any one year.

One other problem with *FAS 112* is the fact that there are no examples. That, I believe, is a real shortcoming. It's one thing to say, here is what we mean, but you know a picture is worth a 1,000 words. I really do wish that the document would have included some examples of what was intended, because I think we would have a much better understanding of it.

Is it true, Ken, that you're putting together an article for *Highlights* that will address some of these questions on *FAS 112*?

MR. DAKDDUK: That is true. I'm not sure if I'll go into any of the topics that you've mentioned. But we are planning something. Stay tuned.

MS. SCOTT: Summing up, I would say that my biggest frustration is not as much with following the rules, because being an accountant I'm used to having rules and I feel comfortable with rules. My frustration comes more from not having enough rules and finding that auditors are ignoring the rules that are out there, and that's the area that I find the most challenging and the most frustrating, because auditors are supposed to be independent. It's OK for consultants to be a bit aggressive; our role is to help management come up with creative ways of addressing issues. But you always like to think that the auditors are independent as they sign their names as independent public accountants.

In my experience, it's been kind of unfortunate that what they seem to be losing sight of is that they should be working for the shareholders. And instead they say they are working for management. Management writes the paycheck, and so they're going to help management achieve its financial goals.

I guess being on the benefit consulting side now, my role is to say to my clients, here's what the rules say. If you want to deviate from the rules, that's between you and your auditors. But I'm not going to suggest that you just blatantly ignore *FAS 112* or whatever.

I will say, though, that because of the accountant's disregard for what the rules call for, particularly in the discount-rate area, the SEC has chosen to take some action. You may or may not be aware of the letter that the SEC distributed to the Emerging Issues Task Force a few weeks ago that focused on the discount rate. This letter arose out of frustration on the part of the SEC that companies discount rates are all across the board, that there is no notion of a current rate of return on high-quality, fixed-income investments, when you're looking at ranges anywhere from 5.75% to 11% all as of December 31, 1992.

So the SEC has put out a letter that really states verbatim from *FAS 106* what the intent of the discount rate is, that discount rates are current rates of return, and that as interest rates are changing, we should be reflecting those changes in the discount rates that we use. But then the SEC went a little bit further and said, essentially thinking we know how judgment works, and we know that there are many views of what high quality is, we're going to put some parameters around those views. It went on to specify that its view of high quality is a AA or higher rated bond. This is a bit more narrow than what many actuaries I've worked with have viewed as being high quality.

So you might want to be aware of that as you're meeting with your clients before this year-end, because we're more likely to see discount rates this year, at least if the SEC view prevails, that are much more like 7% than 8%.

MR. POLISNER: Jim Colburn will give you some views from the actuarial perspective, the role of the actuary and the application of these statements and some of the practical actuarial issues that he encounters in his practice.

MR. JAMES T. COLBURN: We've heard from the CPA who's working for the actuarial firm. Now it's time to hear from the actuary who's working with the Big Six.

I have outlined my speech, Rules for Survival for an Actuary in the World of FASB. It really represents nothing more than an outline of the kind of things that I want to address.

The first three items are very basic items, and would seemingly not require much discussion, although in my many years at Peat Marwick and in my experience with *FAS 87* and *FAS 106* sometimes the basics are somewhat overlooked. The basics I'm referring to are the role of the actuary, the responsibilities of the parties that come to play with respect to financial statements, and then back to the actuary's responsibility for the assumptions.

There are three specific roles for the actuary in FASB issues:
- Advise on the selection of the assumption,
- Calculate and attest to the values to be reported, and
- Respond to inquiries of the auditor.

The second one is obvious. We do calculate and attest to the values that are produced and that have been used by our clients in their financial statements. The role that we probably like the least is to get inquiries from the accounting firm to respond to a lot of information, which we merely say is to look in our actuarial report.

But if you really want to know about the actuarial reports, it's very seldom that I see an actuarial report that really does answer the questions that the auditors need. Maybe if we change our actuarial reports, we wouldn't be having that trouble.

The first one, interestingly enough, is to advise on the selection of the assumptions. I consider that to be a role of the actuary, but it surprises me how often I run into a situation in which the actuary refuses to get involved in that. I think what's happened is actuaries have been burned once or twice; they say, talk to your auditors on what your discount rate ought to be. That's specifically where they might say that. I haven't heard them say that about the other assumptions.

It seems to me that it is not the role of the actuary to defer and say, that's your auditor's responsibility. In truth, the selection of assumptions is the responsibility of the client. Who is more qualified to give advice to the client on those assumptions than the actuary? I truly encourage that; if you're in a scenario and you're going to be there by the end of this calendar year, don't be fearful of being the bearer of bad news on the selection of assumptions. Bad news will likely develop as a result of the need to lower the discount rate. But in my opinion, I don't believe you should put yourself in a position and say, let your auditors choose or you choose and check it out with your auditor. I think you need to be more proactive in setting those assumptions. There's nobody better equipped to advise on the selection of the various assumptions than the actuary. We've been doing it all of our lives, and there's no time to quit just because the accountants come up with some rules that perhaps narrow the parameters of our selection.

By the way, my views are truly my personal views. My views are not the views of Peat Marwick. I'm not a CPA. I'm an actuary who is trying to deal with FASB issues just like you are.

The financial statements of the plan are indeed the responsibility of the plan administrator, which is usually the employer. The financial statements of the company are the responsibility of the company, and they're not the responsibility of the auditor. The auditor's responsibility is to clearly determine in the overall, whether the financial statements are fairly represented, whether they are consistent with the statements of prior years, and whether they are presented in a manner that's consistent with GAAP.

They're not responsible for the discount rate. They're not responsible for all those things. They're merely responsible for the financial statements being presented in whole, fairly representing the financial picture of the plan, if that's the case, or the company.

The actuary does have a responsibility, because we are professionals skilled in the calculation of very significant numbers that go into those financial statements.

What are our responsibilities in selecting assumptions? Again, I suggest that with FASB we don't have an ultimate responsibility for those assumptions. But we're certainly positioned and we ought to give advice on the selection of the assumptions. Unlike Schedule B and unlike the situation under ERISA in which we attest and say that in our opinion the assumptions are reasonable, and we sign our name to those assumptions, there's no place where we have to do that with the FASB numbers that we develop. The only thing that might bear on us is to the extent that we follow the Academy guide to professional conduct if we're going to calculate numbers, and if we're going to use assumptions that in our opinion are not reasonable, we must disclose that fact. From my perspective, that's our responsibility for setting the assumptions.

In implementing many of the FASB issues, a number of issues come up. A lot of it evolves around the language difference that has existed between actuaries and accountants. I would suggest to you that most actuaries in their actuarial reports are trying to stay with their own language, to try to resist using the kind of language that you'll find in FASB. But to me they will be doing their clients a better service by adopting the kinds of language that exists in the FASB statements, in which our numbers are going to be used.

There's an interesting difference, and again this is an actuary speaking, we've come to grips over the years, and we're going to have it this year, with what constitutes a change in estimate and what constitutes a change in principal. I've seen firms get in trouble because they have misunderstood this issue. As we see these discount rates fall this year, we may also see the salary assumptions fall as well. People may say that the salary assumption of 6%, perhaps if we revisit that, ought to only be 5%. Well that is indeed a change in estimate. The company could conclude today that future salary increases might be lower than what it thought it was a year ago. We've changed our estimate. You might say, is that the same thing, if we change the discount rate from 8.25% to 7.25%? In my view, I don't consider that a change in estimate.

The discount rate is tied to a particular benchmark. It represents what you could settle your obligations at, or something similar to that. If the process of arriving at that number last year was 8.25% and this year it's 7.25%, that's not a change in estimate.

But if we happen to also choose to change the salary scale, in my opinion that is a change in estimate. Now, not that that's a dramatic issue. But I would suggest that if you are going to change the salary assumption, if you're going to change any of the assumptions, the mortality table for example, you may be aware that a change in estimate does have a responsibility for the employer. And that is to essentially measure what that effect is. To the extent that effect is material to any of the numbers or to readers of the financial statements, the company would be obliged to report what the effect of that change in estimate is.

I mentioned change in principal, and I'm sure I'm going to be walking in dangerous waters here when I try to describe what I mean by a change in principal. For example, there might be a company that adopted *FAS 87* in 1987, and in that process adopted using the amortization of gains and losses without using that 10% corridor. And now when we have this loss that's likely to occur as a result of a lower discount rate, it may decide to implement that corridor this year. I would venture to say that is indeed a change in principal. It is much different than a change in estimate. It presupposes a higher standard before you go to the process of changing a principal. I think it presupposes that by all standards it's preferable; it certainly, may, in fact, require a catch-up. It's not the kind of thing that you might do once and thereafter begin to apply the numbers with that change in principal. You may find that you'll have to go back and find out that if you had done that from the beginning, you'd have to bring forward and catch up with a change in principal.

There are many other examples of a change in principal. But there truly is a difference between change in principal and change in estimate. And I'm sure I haven't done it justice, but these are issues that in truth we do need to bring to our CPAs, our accountants, and even the chief financial officers (CFOs) of our clients. They will generally have a better understanding of those issues before we start talking about some of these changes.

Relative to our daily lives and FASB, one of the things that's been difficult for us is coping with all of the interest issues that we have to deal with. I just mentioned a few of those. We essentially have to address all kinds of interest assumptions in our actuarial reports. The discount rates are either settlement rates or rates that are available on high-quality, fixed-income investments, assuming that there's a difference.

There's the long-term return on assets that is used in *FAS 87*. There's the interest rate we use for *FAS 35*, present value of accumulated benefits. There's our Schedule B interest rates and there are probably at least two there. There's a current liability rate. There's a funding rate. There are actuarial equivalencies inside the plan document. And there are even multiple rates in there if you're talking about lump-sum distributions. And then there are PBGC variable premium rates. And truly one of the more difficult parts of our assignments is to bring some order to that so that it makes sense to our clients when we describe all those rates.

I get troubled often in *FAS 35* because I see many actuarial reports. Typical actuaries even among our very largest companies, in my opinion, do a very poor job of identifying the interest rate that is used for the present value of accumulated benefits that is going into the financial statements. They almost always shortcut the description there. Sometimes they specify, and I commend those actuaries who do. They say this rate was based on, or these values are based on, this interest rate.

More often than not they say to refer to the assumptions page on what the interest rate is for these numbers. And you go back to the assumptions page and there's a description of their funding assumptions, the interest rate, the interest for current liability, and the interest for *FAS 87* long term. Nothing is said about *FAS 35*. And some of the largest companies do this. In fact, the CFO of the company might think that current liability is the rate they're using. And I know generally speaking that's not what they're using. You might surmise it's the long-term return on assets, or the discount rate, or the funding rate.

In truth, we end up having the auditor and the CFO either guess or call the actuary, which rate is it? But I don't understand why we can't put on our reports for *FAS 35* that this is the rate we use. By the way, as you approach the end of this year, most companies and many actuaries will essentially shortcut the process and use the accumulated benefit obligation for *FAS 87* as the same number for present value of accumulated benefits for *FAS 35*. Generally speaking, that is an acceptable process for getting to those numbers, assuming you are comfortable with that assumption. It's close enough that that's acceptable. But in this year, when you lower your discount rates and produce a different present value of accumulated benefits, you might want to revisit and rethink, do I want that number to be my *FAS 35* present value of accumulated benefits? The standard for choosing your *FAS 35* interest rate is different than the standard for choosing your discount rate. There's a similarity, but there is a difference. And, I'm sure that for *FAS 35* the interest rate you use for present value of accumulated benefits is generally speaking the rate of return you expect on your plan assets. Diana made the point that that's very different from the discount rate.

There is, in *FAS 35*, an option to use the rate at which you could settle your obligations, just like there is in FAS 87. But my guess is that's not the rate you probably want to use, because that ends up being a lower rate than all the standards we use in both discount rates and *FAS 35* rates.

Diana mentioned the word *remeasurement*. I think she was referring to the measurements to take place at this next measurement date, such as December 31. Often there are questions, when is there an obligation to remeasure in the middle of the year? Or interim measurement? And there is the very fact, for example, that interest rates have fallen, such as they have since January 1, 1993. As of June 30 they had dropped significantly and have even continued to drop. Is there any obligation as a result of that? Is that the kind of an event that would, under *FAS 87*, call for a remeasurement or a recomputing of the costs from that point forward? My answer to that is no. That's not the kind of event that suggests a remeasurement. However, if you do have an event like a curtailment that has occurred during the year, curtailments generally require remeasurements to take place. And if you're going to do a remeasurement because you had a curtailment in midyear, you're obligated to use an appropriate discount rate at that remeasurement date. But choosing when and if you need to have remeasurements is one of our practical problems we need to deal with.

Is the PBO an appropriate measure in accounting? Part of the problem is using the salary-scale assumption for coming up with the PBO. I haven't had any problem with that, and I think most actuaries agree and understand that is a relevant part of the pension expense, except where you employ the rules of purchase accounting when one company buys another. There it becomes a very sensitive and very difficult issue. Because when one company buys another, the rules of purchase accounting require that the buyer essentially calculate the PBO, and if it exceeds plan assets, it has to book that entire difference and represent it as part of its cost of acquisition. That can become a very difficult issue, particularly if you're negotiating price. The seller is saying it's not a real live liability, and if we include that in the price, you can acquire the plan and then terminate the plan or curtail it and cut off the effect of future obligations. Yet on the other hand, the buyer will say it doesn't intend to do that, and this is going to be part of the price and it's going to have to go on the balance sheet. So it becomes a difficult issue with respect to purchase accounting. Other than that, it hasn't been a problem for me.