AMERICAN ACADEMY *of* ACTUARIES

February 10, 2006

Mr. Robert H. Herz
Chairman, Financial Accounting Standards Board
401 Merritt 7
P.O. Box 06856-5116
Norwalk, CT 06856-5116

Re: Phase I of the project to reconsider pension and other postemployment benefit accounting

Dear Mr. Herz:

On behalf of the American Academy of Actuaries' Committee on Pension Accounting,[1] I commend the Board on its decision to pursue a thorough reconsideration, consistent with its other broad commitments, of pension and other postemployment benefit (OPEB) accounting, which in its current form lacks transparency.

We are sympathetic to the Board's decision to break the project into phases, with phase I limited to recognition issues and phase II devoted to the more difficult measurement issues. However, we are concerned about two aspects of the phase I program.

Those aspects are –

- *Use of the projected benefit obligation (PBO) under Statement of Financial Accounting Standard 87 (SFAS 87) to measure a balance sheet pension liability*. We believe that the PBO is inconsistent with the common understanding of a balance sheet liability. The accumulated benefit obligation (ABO) represents, at least during phase I of the project, a more appropriate measure.[2] A temporary use of the PBO as a balance sheet liability may be reversed on reconsideration in phase II, but needless damage to companies and plans will already have occurred.

- *Disallowance of measurement dates in advance of the statement date.* We agree with the Board's conclusion that eliminating prior measurement dates improves transparency. We are concerned, however, that a requirement to determine discount rates and asset values *precisely* at the statement date will cause major inconvenience with little benefit to statement users. We would prefer to see the standard permit the use of estimated discount rates and asset values that have been determined within a reasonable period of time before the financial report date.

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[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

[2] The ABO is present value of benefits accrued to the valuation date. The PBO is the present value of benefits accrued to the valuation date, but reflecting assumed pay increases between the valuation date and the assumed date of retirement. In pay-related plans, the PBO will usually exceed the ABO.

Discussion

Measuring pension obligation by use of the PBO

Mandating the PBO for use as a balance sheet liability in phase I of the project preempts the outcome of conceptual issues that the Board is expected to address when it considers measurement issues in phase II. We believe that the Board may reasonably conclude, in its phase II deliberations, that the PBO is inappropriate and may substitute the ABO or some other measure that is often less than the PBO. Mandating the PBO in phase I is likely to result in increased liabilities for many plan sponsors, a result that will have the unintended effect of discouraging the continuation of defined benefit plans. When a more appropriate measure is selected in phase II, damage to participants and sponsors will have already occurred and cannot be easily repaired. We think that the Board should review this measurement issue before going forward with the mandate. We analyze the issue as follows:

1. *Inclusion of the effect of future salary increases in a liability appears to be in conflict with Concept Statement 6.* Paragraph 36 of Concept Statement 6 provides, in part, as follows:

   > "A liability has three essential characteristics: ... (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened."

   With respect to clause (b), we note that there is ample evidence that employers have unilaterally withdrawn from an obligation to consider future compensation levels in paying defined pension benefits. With respect to (c), we note that the existence of a defined benefit plan does not create an obligation to increase pay in the future.

2. *Including future salary levels misrepresents the value of the contract*. We assume that salary and total compensation are under the control of employer and employee, and that salaries are set to keep total compensation competitive. So long as both parties stick to ABO pricing, both parties emerge each year with a fair exchange. Increases in pension value can be easily coupled to increases in compensation.

   Consider what happens with PBO pricing. The employer will have "paid" more than the employee will have "received" for a year of service. The employer may freeze or terminate the plan and take a curtailment gain. This moral hazard, from the employee's point of the view, is only avoidable if there is an enforceable multi-period contract between the employer and the employee. Except in the government sector and in some negotiated plans (which are usually not salary-based), recent experience confirms that such multi-period contracts don't exist or are not enforceable. Thus, there is no basis for the employee to assume that he will be entitled to anything more than his accrued benefit and, if he does so, he will have accepted lower current pay in return for a renegable promise of his employer.[3]

3. *Including future salary levels in pension liabilities does not provide shareholders with the most relevant information about the current value of their obligations*. Balance sheet liabilities presumably represent shareholders' economic obligations as of the statement date. Unless an obligation to increase future pay levels exists, beyond the level of competitive rates, there appears to be no justification for including the value of future salary increases directly in the balance

[3] The argument in point two is taken from Jeremy Gold: "Retirement Benefits, Economics and Accounting: Moral Hazard and Frail Benefit Designs" (*North American Actuarial Journal*, Vol. 9, Num. 1, January 2005, p 88 et seq.).

sheet. Few, if any, preparers have undertaken such an obligation, and accordingly, few, if any, preparers include an allowance for future salary increases in their balance sheets.

Is there any reason to treat salary increases differently if the preparer sponsors a final-pay defined benefit plan? The plan, if not amended, will pay benefits indexed to pay but the plan sponsor makes no commitment to increase the pay itself. An employer that commits itself to providing competitive total compensation has not thereby committed itself to recognizing future pay increases by offering a defined benefit plan. PBO accounting would force recognition of future salary increases for sponsors of defined benefit plans but not otherwise, a distinction for which we see no justification.

4. *The PBO cannot be settled while the ABO can*. Since pay is under the control of the sponsor, no insurance company will accept an obligation to pay benefits based on future pay levels to be set independently by the annuity purchaser. Settlement accounting under SFAS 88 appears to recognize that only the ABO can be settled. The lack of marketability of the excess of PBO over ABO is a strong indication of the lack of economic substance to the PBO.

5. *Recognition of the ABO is consistent with use of the accumulated postretirement benefit obligation (APBO) under SFAS 106 for eligible employees and retirees*. The APBO includes an allowance for postretirement health care cost inflation. Unlike salary escalation in a pension plan, however, health care cost inflation is outside the employer's control. Thus, based on the contractual exchange, fair value, and settlement theories outlined above, using the ABO under SFAS 87 would be compatible with using the APBO for eligible employees under SFAS 106.[4]

6. *Recognition of the ABO is a reasonable extension of accounting under SFAS 87*. The excess, if any, of the value of the ABO over the fair value of assets is recognized in the balance sheet in some cases. It would be a logical extension of current practice to require that the difference between ABO and fair value of assets be *the* balance sheet entry in all cases while eliminating the intangible asset.

7. *Some historical comments on the PBO*. In a traditional final-pay plan, the increase in value of the accrued benefit for each unit of pay raise increases rapidly with increasing age and service. In order to recognize the ultimate projected benefit more evenly over an employee's career, actuaries devised the projected unit credit method (PUCM) many years ago as one means of ensuring a relatively level contribution flow in a final-pay plan. By design, the PUCM attributes more cost than the benefit earned in the early years, and less cost than the benefit earned in the later years. Mathematically, the consequence is to build up a reserve in excess of the value of accrued benefits.

   When the PUCM is used as an actuarial funding method, the PBO is an intermediate result in the determination of the contribution and is not inherently meaningful by itself. In 1985, FASB adopted the PUCM as the only acceptable cost allocation method. However, the PBO remained an intermediate result that appeared only in the footnotes, except in the limited context of purchase accounting.

   One reason given for moving the PBO (net of assets) to the balance sheet is that it would merely confirm what FASB had in mind in 1985 and get rid of the objectionable "off balance sheet"

[4] For an actuary's view of measurement problems with the APBO, see Jeffrey P. Petertil: *Measuring Terminable Postretirement Obligations*, (North American Actuarial Journal, Vol. 9, Num. 1, January 2005, P. 112 et seq.).

implications of current accounting. We do not think it is so simple. In 2006, placing the PBO on the balance sheet would not simply straighten out today's bookkeeping, it would significantly change it and should be so treated.

8. *A comment on purchase accounting*. We note that the unfunded PBO is recognized as a liability by an acquirer under Paragraph 74 of SFAS 87. Consistent with the views expressed previously, we believe it is the unfunded ABO that should be so recognized and hope the Board will address this matter at an appropriate time.

Measurement dates other than statement dates

Under current practice, it is permissible to use a measurement date up to three months before the statement date. It is also acceptable to project either data or earlier valuations to the measurement date, taking into account significant interim events.

We agree that using the statement date as the measurement date is preferable. Our concerns lie with the wishes of the preparer who wants to publish accurate results as early as possible after the statement date (for example, Dec. 31). Note also the Securities and Exchange Commission (SEC) has been pressing preparers to publish results earlier, and accurate[5] results are often needed only a few business days following fiscal year-end in order to prepare for Boards of Directors meetings two or three weeks into the fiscal year. Our specific concerns are as follows –

1. Availability of asset values. We continue to research the availability of timely asset values, especially from entities abroad. First indications are that asset values may not be readily available, especially if the reporting entity's fiscal year-end differs from the statement date of the preparer; if plan trustees need to gather information from several asset managers; or if plan assets include investments that don't have published trading data (private placements or insurance contracts, for example).

2. *Determination of the discount rate*. Only a minority of sponsors have systems in place that enable them to produce several hypothetical valuations with varying discount rates, and then later choose the appropriate valuation based on market conditions at the end of the year. It would greatly simplify and accelerate the valuation process, without significantly impairing the quality of the valuation results, if the preparer could choose a discount rate before the end of the year and have to modify it only if bond rates changed significantly in the interim.

3. *"Last possible moment" determinations of discount rates do not improve the value of the estimate.* Determination of an ABO, and even more so a PBO, is a statistical exercise in which the reliability of the estimate is no better than the reliability of the least reliable factor entering into the calculation of the estimate.[6] Of the inputs to the actuarial calculation of the PBO, the employee data may be a year out of date and the discount rate may, in large part, be a theoretical construct.[7] Thus, insisting on the use of a discount rate based on market conditions as of the last possible moment should not be expected to improve the reliability of the estimate.

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[5] "Accurate" in the sense that they are the numbers that will appear in the financial statements, not necessarily that they are more accurate than statistical estimates can otherwise be.

[6] In many cases, the ABO can be hedged with financial instruments of suitable quality, or an insurance company can sell an annuity for the obligation. The PBO, when it exceeds the ABO, is always a statistical estimate for which there is no market.

[7] Discount curves or indices for calculating SFAS 87/106 liabilities have been constructed by Citigroup, Merrill Lynch, the actuarial consulting firms, and other financial houses. They differ significantly for a number of legitimate reasons, including the sparseness of reliable data at the longer maturities. Choosing a discount rate may come down to choosing among a number of theories of future interest rates, none of which can be confirmed in today's market.

4. *Alternative proposal on selecting a discount rate.* We would prefer to be able to choose a discount rate based on market information as of no more than 60 days before the statement date and use that rate to determine obligations as of the statement date, provided that market rates had not changed significantly in the interim. The as-of date should be consistent from year to year. As before, we believe that the additional reliability gained by waiting until the statement date would be small compared to the additional administrative burden.

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Members of the committee are pleased to be able to offer these comments as you begin your reconsideration of accounting for pensions and OPEBs, and are prepared to provide any needed technical assistance. If you have any questions or would like to discuss the contents of this letter, please contact Heather Jerbi, the Academy's senior pension policy analyst at 202-785-7869, Jerbi@actuary.org.

Sincerely,

William J. Sohn, MAAA, EA, FCA, FSA
Chairperson, Committee on Pension Accounting
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Cc: Mr. George Batavick, Member, Financial Accounting Standards Board
Mr. Peter Proestakes, Pension Project Manager
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