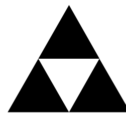

AMERICAN ACADEMY *of* ACTUARIES

October 27, 2003

Mr. Lawrence W. Smith
Director, Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Smith:

I am writing on behalf of members of the American Academy of Actuaries'[1] Pension Accounting Committee and appreciate the opportunity to comment on FASB's proposed statement on employer's disclosures about pensions and other postretirement benefits. We agree with significant aspects of the exposure draft but have elected to comment only on those issues where our point of view suggests changes. Pension and health actuaries are responsible for generating much of the information that is used in the disclosures required by Statements 87, 106 and 132, which have given us a detailed understanding of the benefit obligations, the cash flows and the use of plan assets. It is from this perspective that we offer the following comments on the disclosure exposure draft.

For some of the proposed new requirements, we believe that information as presented may not be useful or may even be misleading to the financial statement reader. For other requirements, the cost of compliance may not justify the benefit provided. In some instances, we believe that additional disclosure should be considered. The comments below will provide you with the details on these issues.

Plan Assets

Issue 1: This proposed Statement would require disclosure of information for each major category of plan assets. The broadest categories of assets for which this information would be required are equity securities, debt securities, real estate, and all other assets. Disclosure by narrower asset categories and additional information about specific assets within a category would be encouraged if that information is expected to be useful in understanding the investment risks or expected long-term rate of return on assets. The following information would be required to be presented for each major asset category:

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

a. **Percentage of the fair value of total plan assets as of the date of each statement of financial position presented**

b. **Target allocation percentage or range of percentages, presented on a weighted average basis**

c. **Expected long-term rate of return, presented on a weighted-average basis.**

In addition, this proposed Statement would require disclosure of the range and weighted average of the contractual maturities, or term, of all debt securities.

In general, we support those provisions in the exposure draft that call for increased information on the allocation and fair value of assets. However, in one respect, the exposure draft calls for information that either does not exist or may provide no additional useful information to the analyst.

In selecting the long-term rate of return assumption, statement preparers often rely on the advice of actuaries. One method, the *building-block method*, of selecting a long-term rate of return assumption is to calculate a single long-term rate of return as the weighted average of the long-term rates of return assumed for each asset category. The weighting would ordinarily be in proportion to the midpoint of the target allocation ranges. This method assumes, in effect, that the investment portfolio will be periodically rebalanced to agree with the target ranges. However, nothing in the actuarial standards of practice suggests that this is the only method of computing a long-term rate of return, and that some actuaries recommend other models.

For example, some actuaries recommend, and their clients use, a model that assumes a lower rate of return consistent with the yield on high-grade governmental or corporate bonds. This model is independent of both the actual and target investment allocations by category. Actuaries and preparers who use this methodology do so because they do not believe it is appropriate to bring into income the risk premium on equities or lesser-grade bonds until the risk is borne and the return is achieved.

Other preparers, especially smaller companies, do not have a clearly articulated investment allocation policy. They will tend to select a single long-term rate of return assumption that appears to be in the middle-of-the-road when compared to what other preparers are doing.

Some plan sponsors develop a long-term rate of return assumption using a total portfolio approach, either by using historical returns or by projecting future portfolio returns. Portfolio approaches take into account the benefits of diversification and rebalancing.

Knowing the elements that go into the building blocks does not help the analyst to evaluate investment quality or management acumen. It would be much more helpful to discuss the investment strategy of the plan sponsor, if any, and indicate the investment quality of the assets being held or planned to be held.

If the Board retains the proposed structure, we ask that more specific guidance be provided. In presenting the expected long-term rate of return, on a weighted average basis, it is unclear

whether the weightings are based on actual or target allocations and whether they reflect beginning of the year, end of the year or average for the year.

Cash Flow Information

Issue 3: This proposed Statement would require disclosure of:

a. **A schedule of estimated future benefit payments included in the determination of the benefit obligation, as of the date of the latest statement of financial position presented, for each of the five succeeding fiscal years, and the total amount thereafter, with separate deduction from the total for the amount representing interest necessary to reduce the estimated future payments to present value**
b. **The employer's contributions expected to be paid to the plan during the next fiscal year beginning after the date of the latest statement of financial position, showing separately:**
    1) **Contributions required by funding regulations or laws**
    2) **Additional discretionary contributions**
    3) **The aggregate amount and description of any noncash contributions.**

The exposure draft proposes the disclosure of estimated future benefit payments for the next five years and an aggregate amount thereafter. We would like to ensure that the Board considers various theoretical and practical issues before instituting this new disclosure.

First, many valuation systems have been programmed with iterative steps that sum together many paths of possible outcomes. Commutation functions and present value factors that value level streams of payments are often imbedded in these routines. As a result, they have not been programmed to capture and isolate the total expected payments for each individual year of the future. To capture this will require varying degrees of modifications to software systems, some of which could be significant. If the Board decides to retain this (or any similar) disclosure requirement in the final Statement, the Pension Accounting Committee strongly recommends delaying the effective date for one year. Many users will believe they are seeing the expected benefits (rather than the projected benefit obligation (PBO) or accumulated postretirement benefit obligation (APBO) based benefits) and we suggest that this would be the more appropriate disclosure, particularly in light of our further comments.

Second, we are concerned the user of financial statements may misinterpret the information. The disclosed information is the benefit stream being valued (i.e., benefits accrued to date, adjusted for future contingencies other than service) rather than the expected actual, total benefits payable. If the user of this information expects to use this as a distribution of probable future cash flow, the proposed disclosure information may be misleading. For plans that provide lump sum benefits, many actuarial systems value the cash flows as if they were annuities. To reflect the higher value of lump sum payments, an adjustment is made in the postretirement discount rate. Cash flows presented on this basis would be extremely misleading.

Third, the benefit cash flow for the first five years, plus the aggregate cash flow for the remaining years, minus interest, does not always equal the benefit obligation. Often, the benefit obligation is adjusted to reflect administrative expenses, settlement options, and other factors. As a result the arithmetic will appear not to work and the reader may be misled and confused by the irreconcilable differences in this disclosure.

Fourth, for plans accounted for under FAS 106, expected cash flow disclosures are encouraged by actuarial standards. It should also be noted that the benefit cash flow for these plans in the first five years is relatively small. Compared to pension plans, the long-term benefit payments are normally much more significant. In this case, the five-year cash flows will not provide much useful information. The most significant part of this disclosure will be the large proportion of payments beyond five years and the large interest reduction. The size of these undiscounted payments is likely to influence even more plan terminations beyond those that occurred after the issuance of FAS 106.

Finally, Paragraph A22 states that the reason for this disclosure is to "assess… how well asset maturities align with benefit payments." We are concerned that the proposed disclosure will be misinterpreted in this context. For funded plans, the asset disclosure information is not sufficient to make this comparison because a variety of cash flows are not represented, such as future contributions from which benefit payments may be made immediately, as well as dividends and other normal changes in holdings that produce cash through active asset management. For unfunded plans such as most postretirement benefit plans accounted for under FAS 106, there are no asset maturities to align with the benefit payments. While the cash flow information for unfunded plans may provide information about future payments from the employer, it does not provide any information about the plan's ability to meet its obligations.

In addition to the benefit cash flows, the proposed standard would require the next year's expected contribution with the required portion and the discretionary portion shown separately. We believe the information required is generally not available at the reporting date and estimations of these amounts will not produce useful disclosure. As mentioned above, the assessment of how well asset maturities align with the benefit payments is incomplete because a variety of cash flows are not represented. The inclusion of one year's contribution may give the impression that future contributions have been considered when, in fact, only a small piece of those future inflows is considered.

Further, it may not be possible to provide the information required. For a calendar year plan and corporate fiscal year, the required contribution may not be available until well after the financial statements are issued. For example for the plan and fiscal year ended December 31, 2003, the 2004 required contribution is not due until September 2005. It is common for the valuation that develops the required contribution not to be available until late 2004 or even sometime in 2005. Any discretionary contribution above the required minimum is usually not know until a date following the issuance of the actuarial report and often times not until the deadline date 21 months following the end of the fiscal year.

In summary, the Pension Accounting Committee recommends that the benefit payment disclosure described in Issue 3(a) and the contribution disclosure described in Issue 3(b) should not be included in the final Statement. We believe it will be too misleading and possibly misinterpreted by various users of financial statements. As an alternative, the

disclosure of information about the duration of the benefit obligation would allow the reader to make assessments about alignment of the asset portfolio with the benefit obligation.

Nonpublic Entities

Issue 5: This proposed Statement would retain the more limited disclosures for nonpublic entities required by Statement 132. Of the new disclosures that would be required by this proposed Statement, all would be required of nonpublic entities except for interim-period disclosure of the components of net periodic benefit cost recognized.

Statement 132 provides for reduced disclosures by nonpublic entities. The exposure draft requires nonpublic entities to disclose most of the additional and modified information that will be provided by public companies. Users of financial statements of nonpublic companies have the same needs as financial statement users of public companies. The information not required by Statement 132 for nonpublic entities is normally readily available. We do not see the need to continue to have two standards for disclosure. The Pension Accounting Committee believes that the disclosures for public and nonpublic entities should be the same.

Measurement Date(s)

Issue 7: This proposed Statement generally would not require disclosure of the measurement date(s) used to determine pension and other postretirement benefit measurements when different from the fiscal year-end date. Disclosure of the measurement date(s) would be required when an economic event occurs, or economic conditions change, after the measurement date(s) but before the fiscal year-end, and if those changes may have had a significant effect on plan assets, obligations, or net periodic cost, had the fiscal year-end been used as the measurement date. The nature of the significant changes also would be described.

For companies with early measurement dates, this new requirement may prove to be very burdensome. In effect, it means that companies will need to have a process to evaluate if their disclosure and expense results would have been significantly different if the results had been prepared at year-end. For example, companies will have to evaluate what discount rate they would have chosen at the fiscal year-end **and** if the new rate would make a significant difference in the measurement of liabilities and expense. In addition, users of financial statements still will not be able to know with certainty which companies used an early measurement date and which did not (except for those companies that make an explicit disclosure).

Thus, instead of the proposed requirements, we believe that the Board should simply require the disclosure of the measurement date for all companies, with no requirement for companies to evaluate post-economic changes for their significance. Not only will this relieve companies of a compliance burden, it will actually provide users with better information since they will know the "as of" date of the information provided. Users of financial statements can then evaluate for themselves whether they think the disclosure amounts should be adjusted for short-term changes in general economic conditions following the measurement date.

For companies that do not use the same measurement date for all of their defined benefit plans, we suggest an additional disclosure to indicate the percentage of the PBO and fair value of assets associated with each measurement date. For example, "For plans subject to Statement 87, measurement dates of September 30 and December 31 are both used. 60% of the PBO and 55% of the fair value of assets reported are for plans with a September 30, 2003 measurement date, while 40% of the PBO and 45% of the fair value of assets reported are for plans with a December 31, 2003 measurement date." Of course, there would be a parallel requirement for plans subject to Statement 106.

Reconciliations of Beginning and Ending Balances of Plan Assets and Benefit Obligations

Issue 8: This proposed Statement would eliminate the requirement in Statement 132 to provide reconciliations of beginning and ending balances of the fair value of plan assets and benefit obligations. This proposed Statement would instead require disclosure of ending balances and would retain key elements of the reconciliations that are not disclosed elsewhere, such as actual return on assets, benefit payments, employer contributions, and participant contributions. As such, this proposed Statement would provide a more focused approach for key items previously included in the reconciliations.

Should the reconciliations, as required by Statement 132, be eliminated or retained and why?

We believe the reconciliation of assets and obligations is readily available, useful to analysts, and should be retained. These reconciliations provide the best means for users of financial statements to understand the changes that occur in the assets and obligations. Often times the change from year to year is the result of unusual activity such as a Curtailment or Settlement, a plan amendment or other items. The reconciliation required by Statement 132 allows the reader to gain a complete understanding of the underlying causes of such changes. The elimination of these reconciliations will make it difficult to fully understand the progress of the benefit obligations and the assets that support those obligations.

Disclosures in Interim Financial Reports

Issue 10*:* This proposed Statement would require disclosure of the following information in interim financial statements that include a statement of income:

a. **The amount of net periodic pension and other postretirement benefit cost recognized, showing separately the service cost component, the interest cost component, the expected return on plan assets for the period, the amortization of the unrecognized transition obligation or transition asset, the amount of recognized gains and losses, the amount of prior service cost recognized, and the amount of gain or loss recognized due to a settlement or curtailment**

b. **The employer's contribution paid, or expected to be paid during the year, if significantly different from previous disclosures pursuant to paragraph 5(g) of this proposed Statement, showing separately (1) contributions required by**

funding regulations or laws, (2) additional discretionary contributions, and (3) the aggregate amount and description of any non-cash contributions.

Are the proposed disclosures needed for users to understand the financial condition, results, and cash flows associated with pension and other postretirement benefits? Should additional disclosures be required? Should either of the proposed interim period disclosures be eliminated?

The proposed interim financial statement would be misleading and not very useful to users. In most instances, the determination of pension expense for the year is not determined until the second or third quarter of the year. For lack of any better estimate, the required disclosures for the first and second quarters would have to be one-fourth of the prior year's pension expense. This may or may not be a good estimate. Once the current year's expense is determined, the difference between the current year's expense and the amount disclosed for the first two quarters would be recognized over the remaining two quarters. This may produce skewed results over the year.

Effective Date and Transition

Issue 11*:* The provisions of this proposed Statement would be effective for fiscal years ending after December 15, 2003. The interim-period disclosures in this proposed Statement would be effective for the first fiscal quarter of the year following initial application of the annual disclosure requirements. The disclosures for earlier annual periods presented for comparative purposes would be restated for (a) the percentages of each major category of plan assets held and (b) the accumulated benefit obligation. The disclosures for earlier interim periods presented for comparative purposes would be restated for the components of net benefit cost. However, if obtaining this information relating to earlier periods is not practicable, the notes to the financial statements would include all available information and identify the information not available. All other disclosures, other than those identified above for restatement, would only be required to be presented as of the date of the most recent statement of financial position.

Are the proposed effective date provisions and transition appropriate? If not, what alternative effective dates and transition would you suggest and why? If individual disclosures require additional time to compile, please describe the nature and extent of the effort required.

In general, we feel that the proposed effective date for full implementation of the new disclosures should be postponed until a reasonable period after publication of the final standard, although portions of the standard may be relatively easy to implement on an earlier time frame.

Assuming that the final standard is not issued until well into November, at the earliest, employers may not have enough time to respond for December 31, 2003 disclosures.

Many employers are already wrestling with the challenge of meeting the Security and Exchange Commission's (SEC) accelerated reporting schedule, which is also first effective for fiscal years ending after December 15, 2003. As a result, late-breaking, extensive changes

to the pension footnote impose additional undue burdens on employers trying to plan for and prepare results on an accelerated timetable.

Practices and procedures are already set up to develop and communicate the disclosures under FAS 132. It is significantly more expensive to try to retrofit a new disclosure template for this year's disclosure than it would be to plan for and include a new disclosure template in next year's process.

Many companies have availed themselves of the option to use a measurement date that precedes fiscal year-end so that they have enough lead-time to prepare disclosures and financial reports. Changing the requirements after many of those measurement dates have already passed (and work has already started) is akin to changing the rules in the middle of the game and imposes significant extra costs on those employers and their advisers.

These issues may be particularly acute for those employers who have plans outside the United States. In these cases, the lead times are often longer, and much of the work for disclosure under the current standard will be either well underway or nearly completed by the time the final standard is published. An early effective date thus imposes a significant cost to gather, process, review, and reformat the needed data.

As described in our response to Issue 3**,** the benefit payment stream underlying the benefit obligations is not directly accessible from many valuation systems and requires reprogramming to develop. We encourage FASB to allow a reasonable amount of time for development, programming, and testing of the needed software modifications.

As an alternative, we suggest either a delayed implementation schedule (for example, fiscal years ending at least 4 to 6 months after the issuance of the final standard), or a staggered implementation. For example:

> For fiscal years ending after December 15, 2003, retain the current disclosures (including the reconciliation of benefit obligations and plan assets) but add the asset classification table (as described in our response to Issue 1), the total contribution expectation for the coming year, the total accumulated benefit obligation, and the information about the measurement date (as described in our response to Issue 7).
>
> For fiscal years ending after December 15, 2004, reformat the disclosures to the new standard, and add the information about cash flows and other items that were not included in the prior year's disclosures.

The staggered approach allows employers to work within the existing framework and processes, while at the same time increases disclosure and transparency of information that truly is easily available.

Other Items

In addition to the items discussed in this letter, we would ask the Board to consider the following issues as well.

1. Disclosure of the market related value of assets (MRV) when different from the fair value. The MRV is an important element in the determination of pension or postretirement benefit cost. The reader should understand that MRV is being used, its calculated value, and the amount by which it differs from fair value.

2. The disclosure of the method under EITF 88-1 used to calculate the accumulated benefit obligation (ABO). EITF 88-1 allows for two options for the calculation of the ABO. These two options can produce dramatically different values, which affect the additional minimum liability, net periodic pension cost, and the PBO. Where applicable, the reader should understand which of these two options was used.

The Pension Accounting Committee appreciates the opportunity to provide these comments. If you have any questions about our comments or would like any clarification about any of the points discussed in this response, please contact Dennis Polisner at (312) 665-5254.

Very truly yours,

Dennis M. Polisner, FSA, MAAA
Chairperson, Pension Accounting Committee
American Academy of Actuaries

Members of the American Academy of Actuaries' Pension Accounting Committee include: Dennis M. Polisner, Chairperson, EA, FSA, FCA, MAAA; Mark Beilke, Vice Chairperson, ASA, EA, MAAA; Stephen A. Alpert, EA, FCA, FSA, MAAA, MSPA; Paul W. Barker, EA, FSA, MAAA; John L. Bartz, ASA, EA, FCA, MAAA; Curtis M. Cartolano, EA, FCA, FSA, MAAA; Arthur L. Conat, ASA, EA, MAAA; Donald Elbum, ASA, MAAA; Kenneth L. Friedman, EA, FCA, FSA, MAAA; Emily K. Kessler, EA, FSA; Wendy E. McFee, ASA, FIA, MAAA; James J. Rizzo, ASA, EA, MAAA; Diana Scott; William J. Sohn, EA, FCA, FSA, MAAA; John T. Stokesbury, EA, FCA, FSA, MAAA;