AMERICAN ACADEMY of ACTUARIES

August 18, 2005

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

Re: Project to revisit SFAS 87

Dear Mr. Herz:

On behalf of the members of the American Academy of Actuaries'[1] Pension Accounting Committee, I would like to raise several issues that are of concern to the pension community and need to be addressed when FASB considers pension and other post-retirement benefit accounting. I am also pleased to be able to offer the services of our committee as a resource for your deliberations.

Background

The staff of the Securities and Exchange Commission (SEC) recently issued a report (the SEC staff report)[2] that was critical of certain aspects of pension and other post-retirement benefit accounting. The report included a recommendation that FASB undertake a joint project on pension accounting, when resources permit, with the International Accounting Standards Board (IASB).

Pension accounting is governed by several related standards — the most significant is SFAS 87, *Employers' Accounting for Pensions*. FASB is now engaged in three major projects that are likely to impact reconsideration of SFAS 87, because they impact FASB resources and because the conclusions of these projects have obvious relevance to pension accounting. These projects are –

- the fair value measurement project
- the financial performance reporting by business enterprises project
- the conceptual framework ("convergence") project

Any review of SFAS 87 might also involve reconsideration of SFAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* since the two standards deal with related matters and are similar in approach.

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis, and serves as the public information organization for the profession. The Academy regularly prepares testimony for Congress, provides information to federal officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also supports the development and enforcement of actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

[2] United States Securities and Exchange Commission, Office of the Chief Accountant et al: *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers,* released June 15, 2005

Even under current GAAP, accounting for retirement benefits differs in several respects from accounting for other financial assets and liabilities. The SEC staff report noted the following as areas of difference that it did not think were justified:

- Retirement plan assets and liabilities, unlike other financial assets and liabilities, are not usually consolidated into the sponsor's balance sheet.
- Assets may not be valued consistently with the rules for the valuation of other financial assets.
- Actuarial gains and losses may not be recognized immediately but may be amortized into income over a period of time.
- Changes in assets or liabilities due to a change in assumptions may not be recognized immediately but may be amortized into income over a period of time.

Discussion

Actuaries are well acquainted with the design, funding, and accounting of defined benefit pension plans. SFAS 87 reflects, in several ways, accounting and actuarial thinking as it existed in 1985 when SFAS 87 was issued. In particular, SFAS 87 reflects the traditional view of pension actuaries that, because pension promises are extremely long-term, contribution and cost stability are critical to continuation of the plans.

Future accounting standards are likely to provide greater transparency to the users of financial statements, though potentially with greater volatility of periodic results. Plan sponsors and participants are concerned that too great a concentration on short-term results will lead to unnecessary plan terminations and employers exiting the defined benefit system. To that end, we hope that FASB addresses the following issues when it reconsiders pension and other postretirement benefit accounting:

- *Separation of pension expense into "operating" and "non-operating" components.* Arguably, the only part of net periodic pension cost that is compensation expense (and thus includible in operating earnings) is the cost of benefits accruing in the period. This cost item will include current service cost — the cost of benefits accruing as a result of the normal operation of the plan — but it will also include a portion of the additional past service cost due to plan amendments. How quickly past service amendments should be recognized remains an open issue. Plan sponsors might be less concerned about the additional volatility that arises from the use of fair values if the financial statements made clear that investment and financial items embedded in pension expense, such as the return on invested assets and interest on the obligation, were non-operating items.
- *Future salary changes.* The current service cost and the projected benefit obligation (PBO) now reflect an assumption about future salaries. Under the long-term view of pension cost in SFAS 87, it clearly made sense to project salary growth. However, if pension assets and liabilities are marked to market in the balance sheet, FASB should consider whether the accumulated benefit obligation (ABO) is not a more appropriate measure.
- *Discount rate structure for determining liabilities.* The FASB might wish to consider whether the discount assumption used to determine the pension obligation should be made consistent with (1) the standards emerging from the fair value project and (2) any redefinition of the measure of the liability itself, such as the substitution of ABO for PBO. The experience of the actuarial profession in the construction of yield curves should prove useful in your deliberations.
- *Consistency and principles-based accounting.* Defined benefit plans encompass a wide range of designs. The most popular new designs have all included defined contribution elements (cash balance plans, variable annuity plans). In recent discussions with FASB on cash balance and lump sum benefit

accounting, our concern was that new FASB guidance would cause such plans to be treated inconsistently with other defined benefit plans. Now that SFAS 87 is likely to be addressed in its entirety, we think it is possible to set standards for defined benefit accounting that would avoid creating inconsistencies that would foster "accounting-based design."

- *Other post-retirement benefits.* The SEC staff report's criticism of pension accounting extended to accounting for other post-employment benefits (OPEBs) under SFAS 106. Although the report didn't explicitly call for FASB to reconsider SFAS 106, FASB might wish to do so as part of a broad-based reconsideration of retirement plan accounting. The two standards are sufficiently similar for there to be some savings in resources by combining the projects. However, unlike pensions, OPEBs are usually unfunded, they are often revocable, and their measurement involves the estimation of future medical cost inflation.

Conclusion

Members of the Pension Accounting Committee are ready to assist you in your project, much as we did in your consideration of cash balance issues. Further, if FASB does include SFAS 106 within the scope of its pension project, the Academy's Joint Committee on Retiree Health is also available as a resource.

If you have any questions or would like to discuss any of the issues contained in this letter further, please contact Heather Jerbi, the Academy's senior pension policy analyst (202.785.7869; Jerbi@actuary.org).

Sincerely,

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Chairperson, Pension Accounting Committee
American Academy of Actuaries

Cc: Mr. Lawrence Smith, Director, Technical Application and Implementation Activities and EITF Chair
Ms. Suzanne Q. Bielstein, Director, Major Projects and Technical Activities
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