AMERICAN ACADEMY *of* ACTUARIES

May 31, 2006

Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: File Reference No. 1025-300. Proposed Statement of Financial Accounting Standards — Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)

Dear Sir or Madam:

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 postretirement benefit (OPEB) accounting, which in its current form lacks transparency. In this letter, we repeat, for the most part, comments made in our February 10 letter on the subject to Mr. Robert Herz.[2]

We are sympathetic to the Board's decision to break the project into phases, with Phase 1 limited to recognition issues and Phase 2 devoted to the more difficult measurement issues. However, *we are concerned about the Board's decision to use 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 1 of the project, a more appropriate measure.[3] A temporary use of the PBO as a balance sheet liability may be reversed on reconsideration in Phase 2, but undue damage to companies and plans will already have occurred.

On another matter, although we agree with the Board's conclusion that eliminating prior measurement dates would generally improve transparency, we have found instances where using a later measurement date would require greater reliance on estimates and thereby result in less, rather than greater, transparency.

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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 basic thrust of our earlier letter — against the inclusion of a salary scale component in the pension obligation — remains the same. In addition, with respect to the accumulated postretirement benefit obligation of SFAS 106, we reflect the views expressed in a separate comment letter from the Joint Committee on Retiree Health of the American Academy of Actuaries; we take note of some counterarguments to our position in the exposure draft; and we share with the Board some problems that will be faced by preparers if early measurement dates are disallowed.

[3] The ABO is the 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 1 of the project preempts the outcome of issues that the Board is expected to address when it considers measurement and income statement issues in Phase 2. We believe that the Board may reasonably conclude, in its Phase 2 deliberations, that the PBO is inappropriate and may substitute the ABO or some other measure that could be less than the PBO. Mandating the PBO in Phase 1 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. If and when a more appropriate measure is selected in Phase 2, damage to participants and sponsors will have already occurred and cannot be easily repaired. We recommend the Board 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 adhere 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 rescindable promise of his employer.[4]

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

[4] 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.).

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 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.

We cannot discern 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 though 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 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.

6. *Some comments on the history of 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, or smoothed, 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 intended in 1985 and get rid of the objectionable "off balance sheet" 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.

7. *A comment on the income statement.* For the reasons given, we believe that the net periodic pension cost should also be determined without allowance for future salary growth. Under the Board's two-phase approach, if the Board settles on the ABO (or

something other than PBO) to measure the obligation in Phase 1, there would be a period of time when the balance sheet liability and the income statement were at variance. We believe a short-term discrepancy of this sort is preferable to allowing the balance sheet liability to be driven by an inappropriate income statement number.

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.

9. *A comment on the use of the accumulated postretirement benefit obligation (APBO) under SFAS 106 for eligible employees and retirees*. Nonpension postretirement benefits differ fundamentally from pension benefits and raise significant measurement issues. Another Academy committee, the Joint Committee on Retiree Health, in its own letter to the Board, notes problems with the APBO and recommends that the Board reevaluate the measurement issues before changing balance sheet liabilities. Because the APBO is in need of redefinition, it is not appropriate to judge the suitability of a pension measure (ABO, PBO or other) by analogy to the APBO.

   We do note that APBO liability for life insurance benefits may include an allowance for future salary growth. Consistent with our views on recognizing future salary growth in the balance sheet, we suggest that SFAS 106 be amended either in Phase 1 or 2 to eliminate the salary growth component.

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 valuation results to the measurement date, taking into account significant interim events.

We agree with the Board's conclusion that eliminating prior measurement dates should improve transparency. However, we have found instances where using the later measurement date could result in less, rather than greater, transparency.

1. Some classes of asset information are hard to come by quickly. These include assets held overseas, assets held in insurance companies, nonpublicly traded assets, and trusteed assets where the plan year differs from the sponsor's fiscal year.

2. Since (1) the actuarial valuation process is often complex and time-consuming, (2) the discount rate will not be know until after the statement date, and (3) financial statement entries may have to be made shortly after fiscal year-end so that financial statements can be filed within 60 days after the statement date, we believe that the actuarial valuation under the proposed standard may have to be based on interpolation or other shortcuts. In such case, any gain in transparency attributable to using a discount rate determined at the statement date could be lost through the substitution of an estimating process for a full-scale valuation.

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Members of the committee are pleased to be able to offer these comments as you reconsider 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
American Academy of Actuaries