

ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH®

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Letter of Comment No: 75
File Reference: 1025-200
Date Received: /o/28/03

28 October 2003

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1025-200—Proposed Statement of Financial Accounting Standards: Employers' Disclosures about Pensions and Other Postretirement Benefits.

Dear Mr. Smith:

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR)¹ is pleased to comment on the Financial Accounting Standards Board's (FASB) Proposal, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (the "ED"). The FAPC is a standing committee of AIMR charged with maintaining liaison with standard setres who develop financial accounting standards and regulate financial statement disclosures, and with responding to new regulatory initiatives. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

General Comments

We are perplexed and troubled by this regressive proposal. We fail to understand the calculus which declares, in effect, that if investors and other users of financial statements are to receive marginal improvement in financial disclosure, then they must be prepared to pay for that gain by giving up information previously determined by both standard-setters and users to be essential to the analysis, understanding, and use of the statements.

¹ With headquarters in Charlottesville, VA, and regional offices in Hong Kong and London, the Association for Investment Management and Research® is a non-profit professional organization of 67,200 financial analysts, portfolio managers, and other investment professionals in 116 countries of which 54,940 are holders of the Chartered Financial Analyst® (CFA®) designation. AIMR's membership also includes 127 affiliated societies and chapters in 46 countries. AIMR is internationally renowned for its rigorous CFA curriculum and examination program, which had more than 100,000 candidates from 143 nations enrolled for the June 2003 exam.

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The FAPC believes that the loss of information that would occur if this ED were to be issued in its current form is significantly greater than the benefits users would receive from the new proposal. Consequently, we would prefer the disclosures under Statement 132 to those provided in the ED.

At the same time, we are concerned about the process that has led to the issuance of this ED. Paragraphs A33, A40, and A41 shed some light on the deliberations:

The Roard recognizes that pension and other postretirement benefit disclosures are substantial and that the benefits derived by users of financial statements should exceed the costs of compliance. In light of the disclosures added during this project, the Board considered eliminating certain disclosures required by Statement 132. Specifically, the Board considered eliminating the reconciliations of beginning and ending balances of the fair value of plan assets and benefit obligations and instead focusing on ending balances and key categories of activity not disclosed elsewhere...In Statement 132, as described in paragraph B16 of this Statement, the Board required disclosure of the reconciliations of the benefit obligation and fair value of plan assets. The Board reasoned that the reconciliations would provide a format for more complete disclosure that would be more understandable to users of financial statements. In this Statement, the Board concluded that while the reconciliation approach may be more complete and financial statement preparers are accustomed to providing it, a more focused approach would be more useful to users of financial statements. [paragraph A33; emphasis added]

Three Board members disagree with the Board's decisions (a) to eliminate the reconciliations of beginning and ending balances of the fair value of plan assets and the benefit obligation and (b) not to require the disclosure of net benefit cost by income statement line item. [paragraph A40; emphasis added]

...The basis for conclusions of Statement 132 indicates that the then-Board considered eliminating those reconciliation requirements as part of its deliberations of Statement 132. The then-Board's decision to retain the requirements was based on input from financial analysts. In discussing the disclosures that should be required by this Statement, the Board obtained significant user input, none of which conflicted with the conclusion about the usefulness of the reconciliation requirements reached by the then-Board in developing Statement 132. The three Board members question why the Board would remove reconciliations whose usefulness was established as part of the development of Statement 132, in the absence of evidence indicating that usefulness of those disclosures has diminished. [paragraph A41; emphasis added]

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In summary, in the deliberations leading to Statement 132 the Board determined that the reconciliations "would provide a format for more complete disclosure that would be more understandable to users of financial statements." This conclusion was based upon input from analysts. Similarly, in the process leading to issuance of this Proposal, input from analysts was again sought, and the conclusion remained the same, that the information was useful in the analysis and use of financial statements. The disclosure was useful then, it is useful now, but without further evidence to the contrary or new logic supporting the decision, the disclosure has disappeared from the proposed requirements.

The standards regarding the financial statement recognition and disclosure of pension and other retirement benefit obligations and costs are among the most problematic areas of financial reporting at the present time. When it was issued, Statement No. 87 represented an advance over the then-required financial reporting for pensions. However, the financial statement recognition provisions which permitted much of the unfunded pension obligation to remain off-balance-sheet, combined with the dense labyrinth of cost-deferral and smoothing mechanisms, worked to ensure that little of the economic status and changes in the status of the plan reached the company's financial statements in a timely fashion. Indeed, costs and other losses could be deferred for more than a decade under the provisions. These infirmities in the Standard do not serve the needs of investors and other users of the statements well.

Statement 132 had the objective of compensating for, if not curing, the recognition problems embedded in Statement 87. This amendment provides the critical information, on a line-by-line basis, that analysts and other users need to adjust the financial statements to more completely reflect the economic status and changes in the status of the benefit plans. These adjustments are essential if investors and other users are to properly value assets and understand the potential effects on operations of the company's risk exposures. In addition, the reconciliations provide consistent, clear, and understandable disclosure across all reporting companies.

The FAPC's long-standing view has been that disclosure is not a satisfactory substitute for full and appropriate recognition in the financial statements. However, if the standards do not require such recognition, then it is imperative that sufficient clear and complete disclosure be provided to allow users of the statements to correct the deficiencies in the financial statements.

The Board indicates in paragraph A33 that it is concerned about the tradeoff between the benefits realized by users and the costs to providers of providing the information. We would cast the debate somewhat differently. Because the underlying standard fails to provide full recognition in the financial statements of the effects on the firm of the pension and postretirement benefit contracts, a huge and very costly burden has been shifted to those for whom the statements are prepared, analysts, investors, and other users. These costs include those related to gaining the needed understanding of pension

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and postretirement benefit contracts, ERISA funding requirements, the disclosures provided in the notes, and mastery of the elaborate adjustment process required to reflect the effects of the contracts in the statements. These adjustments must be made for every company followed by the user, and in every year. In contrast, the cost to the preparer is only that incurred in inserting the already-available data into a single disclosure format each year.

AIMR regards such adjustments to the financial statements as so important that all candidates who sit for the CFA examinations are tested on their understanding of the required techniques before receiving the CFA designation. The techniques and information about the interpretation of the disclosures can be found in Chapter 12 of one of the required texts in the curriculum, *The Analysis and Use of Financial Statements*, by Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried, third edition (Wiley).

The FAPC is also concerned that the FASB declines to require certain choices that the preparer has made, pursuant to Statements 87 and 106, to be disclosed. Specifically, the FAPC believes that companies should disclose the measurement date and the method of valuing assets in determining expected return on plan assets and the unrecognized gain or loss subject to amortization. Each of these items affects the ability to compare one company to another and to estimate the effects of changes in the environment on reported GAAP earnings. Neither of these items requires the preparer to collect information that it does not already have. The FASB continues to do a disservice to investors by failing to require these choices in accounting policy to be disclosed.

Similarly, it is important that investors and other users know where in the company's financial statements the costs or cost components are recorded. For large companies with pension and postretirement benefit plans, these costs are not only material, but, on occasion, larger than operating income or the residual net income. Moreover, the placement of the costs, which can change from year to year, can have a highly material effect on the gross and operating margin, and result in major movements in stock prices. Consequently, we cannot agree with the rationale provided in paragraph A27 for the decision to not require disclosure of the placement:

...The aggregate amounts of net periodic benefit costs are generally relatively insignificant in relation to individual income statement line items.

We will address the importance of sensitivity analysis and interim disclosures in the Specific Comments section.

Specific Comments

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Issue 1

We agree that disclosure of the *actual* asset allocation as a percentage of the fair value of total plan assets would be useful to investors in assessing the expected risk and returns of the assets and in evaluating the reasonableness of the assumed rate of return. Disclosure of the range of the actual asset allocations over the period would also be useful in making the evaluations. We do not believe that disclosure of the target allocation would add significantly to the disclosure. Disclosure of the expected long-term rate of return on a weighted-average basis would be useful in evaluating the reasonableness of the assumed rates of return.

The FAPC does not believe that the proposed disclosures regarding debt securities would be a significant enhancement. Not only can other contractual provisions affect the likely effective term of the securities, but managers do not necessarily invest in the securities with the intention of holding them to term.

Issue 2

The amount of the accumulated benefit obligation (ABO) is of limited usefulness in most analyses and decision contexts of interest to investors. Thus, we would not strongly endorse the proposal to again require disclosure of the ABO. Understanding fully the components of the projected benefit obligation (PBO), and the changes affecting the PBO, are of much greater usefulness.

Issue 3

The estimated or projected future benefit payments and employer's contributions may provide useful information. For example, it may be helpful to compare the forecasts to the actual benefit payments. In addition, they may be useful, in conjunction with the duration of the obligation, in evaluating the adequacy of the plan assets to meet future payment requirements and future employer contribution requirements. However, the projected payments are subject to considerable uncertainty and are affected sharply by economic conditions, restructuring decisions, provisions in the benefit plans and the like.

On the other hand, we believe that disclosure of the *actual* cash benefit payments made to beneficiaries, which are not subject to forecasting uncertainty, is essential in order to understand the changes in the plan assets, the PBO, and possible demands on the company's cash flows. We would like to know all of the components of the cash benefit payments made, including employer payments.

In the case of other postretirement benefits, we would want to know the amounts of participant contributions as well.

<u>Issue 4</u>

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We believe that a tabular format for disclosure of the key assumptions would increase consistency and transparency, and would provide much-needed information about changes in the assumptions.

Issue 5

We do not believe that there should be a two-tiered system for financial disclosure for public and nonpublic companies. The distinction owes more to historical practice than to economic effect. For example, many nonpublic companies raise capital by issuing substantial amounts of debt and debt-related instruments as well as certain types of equity instruments. We believe that investors in these securities should have the same information available regarding profitability and risk as do investors in equity securities.

Consequently, we believe that nonpublic entities should be required to prepare the same disclosures for pension and postretirement benefit plans and their effects on the company's operations as do public companies.

Issue 6

Because the estimates of the obligations as well as the costs for pension and postretirement benefit plans are directly dependent upon the assumptions employed in the estimation process, we believe that the sensitivity of the amounts to changes in the key assumptions should be required to be disclosed. Also, companies are permitted to change these assumptions, and do with some regularity, producing highly material changes in the measures of both obligations and costs. Investors and other users should be able to evaluate the potential effects in assessing the funded status of the plans and the potential effects on the income statements.

<u>Issue 7</u>

To the extent that measurement dates may differ from one plan, or one company, to another, we believe the usefulness of the disclosures would be enhanced if these dates were required to be disclosed. If the measures have changed significantly from the measurement date to the balance sheet date, these changes should be disclosed as well.

Issue 8

We have discussed our views at length in the General Comments section regarding the proposal to "eliminate the requirement in Statement 132 to provide reconciliations of beginning and ending balances of the fair value of plan assets and benefit obligations." To reiterate, we believe that the reconciliations are essential to users' understanding of the effects of the plans on companies' profitability and cash flows, and the risks that they pose to their future operations. To eliminate this requirement would result in a major

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reduction in analysts' ability to understand and interpret the financial statements, and a significant decline in the transparency of the companies' operations and future commitments.

We urge the Board in the strongest possible terms to reconsider the decision to eliminate the requirement that firms provide the reconciliation or, alternatively, to table this Proposal and allow Statement 132 to stand without amendment.

Issue 9

We have discussed in the General Comments the issue addressed in (e), whether the

...Amounts and classification of net periodic pension and other postretirement benefit cost or income recognized in the statement of income, showing separately the amounts of net benefit cost or income included in each line item in the statement of income and reported for each period for which a statement of income is presented...

should be required to be disclosed. We will repeat our comments that it is important that investors and other users know where in the company's financial statements the costs or cost components are recorded. For large companies with pension and postretirement benefit plans, these costs are not only material, but, on occasion, are larger than operating income or the residual net income. Moreover, the placement of the costs, which can change from year to year, can have a highly material effect on the gross and operating margin, which can result in major movements in stock prices. Consequently, we cannot agree with the rationale provided in paragraph A27 for the decision to not require disclosure of the placement.

We believe that the disclosure should be provided on a line-by-line basis.

Similarly, the weighted-average duration of the pension obligation, item (h), is a very useful measure in assessing (1) the potential adequacy of the plan assets to liquidate the obligation and, if the assets can be projected to be inadequate, (2) the expected demands on the company's operations. This is especially important because the participant profiles can vary widely across plans with consequent effects on benefit payment distributions. The Board expresses the view in paragraph A20 that disclosure about the duration of the obligation:

...Would not enable users of financial statements to reliably assess the degree to which plan asset and benefit obligation cash flows are aligned. Two different sets of cash flows could have similar durations but significantly different amounts and timing.

We agree that different sets of cash flows can have similar durations but significantly different amounts and timing. However, the duration is the best measure available and is widely used in the financial markets for this purpose. In addition, market practice generally supplements the duration measure with projected cash flows for the first three to five years, depending on the application. We have discussed our general support for such disclosure in Issue 3. Thus, we believe that the combination of the duration and the projected near-term annual payments will achieve the objective.

Issue 10

We believe that required interim disclosure of the net periodic pension and other postretirement benefit cost recognized would be a substantial improvement. This disclosure would enable investors to determine not only the periodic effect on the financial statements of the costs, but would allow them to better project the cost on an annual basis.

<u> Issue 11</u>

We agree with the proposed effective date and transition. Any improvements to financial disclosure should be required at the earliest possible date.

Concluding Remarks

In conclusion, we believe that the Board should at a minimum:

- Retain all of the Statement 132 disclosures, including the reconciliations
 of beginning and ending balances of the pension benefit obligation and
 plan assets;
- Build on and improve these disclosures by requiring
 - Sensitivity analyses for key assumptions;
 - Line-by-line income statement disclosure of the amounts of net periodic pension cost recorded in those items; and
 - o Interim disclosure of pension costs and employer contributions.

Other disclosures, while providing some improvement, are less important.

The FAPC is pleased to have an opportunity to provide their comments on the Board's Proposal, *Employers' Disclosures about Pensions and Other Postretirement Benefits*. If the Board or staff have questions or seek amplification of our views, please contact Rebecca McEnally (1-434-951-5319 or rebecca.mcenally@aimr.org), or Jane Adams (1-212-418-6915 or jane.adams@maverick.com). We would be pleased to answer any questions or provide any additional information you might request.

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Respectfully yours,

/s/ Jane Adams

/s/ Rebecca Todd McEnally

Jane Adams, CPA Chair, Financial Accounting Policy Committee

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Rebecca McEnally, Ph.D., CFA Vice President, Advocacy, AIMR

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