

**Michael A. Beprestis**  
**521 Graydon Ave., Apt. 7**  
**Norfolk, VA 23507**

Letter of Comment No: 5  
File Reference: 1025-PNU  
Date Received: 08/06/03

July 29, 2003

Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

**Re: Public Comment On Defined Benefit Pension Plan Disclosure (1025-PNU)**

Dear FASB:

As a current student of accounting, I wish to provide the following analysis as a contribution to the discussion on defined benefit pension plan disclosure revision. I am grateful for FASB's consideration of this issue and for the acceptance of these public comments.

Often unnoticed, defined benefit pension plans can provide a stable and predictable monetary source for the retired career employee, or they can represent multi-billion dollar liabilities that threaten the very survival of the company. Communicating the financial status of these pension funds in the language of accounting is where, I believe, deviation from fundamental accounting principles occurs and where the "truth" has become a pliable corporate tool.

A defined benefit pension plan is a financial entity that provides retirees from the sponsoring corporation with specific monetary (and sometimes health) benefits upon retirement.<sup>1</sup> This is in contrast to the simpler defined contribution plans which limit the size of the pension benefits collected by the retirees to amounts they individually originally contributed. It is because of the long-lived commitment inherent in defined benefit pension plans, that these plans are powerful tools to hire and retain large pools of skilled workers. Consequently, many of America's largest companies have defined benefit pension plans covering millions of current and former employees, and representing over \$1 trillion in pension fund assets.<sup>2</sup> While only reviewing the defined benefit plans of five companies in this paper, these companies represent a substantial amount of pension assets, and as will be detailed in subsequent sections, substantial inconsistencies.

---

<sup>1</sup> Kieso, Donald, Jerry Weygandt, and Terry Warfield. *Intermediate Accounting, Volume 2*. New York: John Wiley & Sons, 2001.

<sup>2</sup> Schilling, Gary. "Pension Pain." *Forbes* Sep. 2002: 144

**Table 1. Selected Pension Fund Values (2001)\***

<u>Company</u>	<u>Fair Value of Pension Fund</u>
General Motors	\$78,607
Verizon Communications	53,278
General Electric	46,777
Boeing	33,849
Qwest Communications	13,166
<b>Total</b>	<b>\$225,677</b>

\*All amounts in billions, taken from their annual reports

## **I. Expected Returns on Real Assets**

In the financial media, much of the attention regarding questionable pension fund accounting is focused on the notion of expected return on pension assets. From this one consideration flow a series of financial and accounting activities that at best present a consistent long-term view of the fund's obligations and assets, and at worst, misrepresent the financial viability of the fund and provide non-economic gains for the company supporting the fund. While some of these results were considered appropriate and reasonable at the time the Financial Accounting Standards Board (FASB) adopted the pension fund standards,<sup>3</sup> recent market events have resulted in pension fund financial information that is contrary to many of the underlying principles of accounting.

To understand why expected return on pension assets is such a contentious issue, some explanation is first needed. Pension funds retain large amounts of money to not only provide for current retirees, but also to use as investment principal so that the investment gains can help meet future payout liabilities. If the fund does well with its investments, the company may not be needed to contribute to the pension to meet the payout needs of the retirees. However, if the fund losses that investment principal through poor investment choices, the company sponsoring the pension may have to contribute substantial amounts to re-establish the financial viability of the pension fund. The difficulty in analyzing pension fund data is that FASB rules allow companies to *assume* a rate of return on real pension fund assets. These assumed returns, while lacking any real economic substance, are used for financial reporting purposes irrespective of how the fund actually performed on its investments. The following pension fund financial information illustrates this scenario.

**Table 2. Expected vs. Actual Pension Fund Returns (2001)\***

	<u>General Motors</u>	<u>Verizon Comm.</u>	<u>General Electric</u>	<u>Boeing</u>
<i>Assumed Return on Fund Assets</i>	7,521	4,811	4,327	3,452
<i>Actual Return on Fund Assets</i>	(4,444)	(3,063)	(2,876)	(7,150)
<b><i>Difference between actual and assumed returns</i></b>	<b><i>(\$11,965)</i></b>	<b><i>(\$7,874)</i></b>	<b><i>(\$7,203)</i></b>	<b><i>(\$10,602)</i></b>

\*All amounts in millions, taken from their annual reports

<sup>3</sup> Financial Accounting Standards Board. *Current Text, Volume 1*. New York, NY: John Wiley & Sons, 2000.

As Table 2 illustrates, the analysis of pension fund returns can be very deceptive when using expected return on plan assets as prescribed in FASB standards. On the surface, what appear to be strong returns in the pension fund, are really assumed gains masking significant asset losses. As users of financial information, retirees would be very interested in evaluating the financial health and viability of their pension funds. Additionally, stockholders, bond rating agencies, and other users of financial information would be very interested in evaluating the timing and extent of any needed contributions by the company to the pension fund to meet all liabilities. Given the size of the pension funds, and their potential to incur multi-billion dollar liabilities upon the company, distinguishing between real and assumed financial information is essential.

## II. Implications of Expected Return

The implications of using expected return on pension assets are numerous and substantial. While not exhaustive, the following examples shed light into the depth and complexity of this issue.

- Determination of financial health.** As is evident by the actual return on pension assets in Table 2, 2001 was a difficult year for many pension plans. The terrorist attacks of September 11 and the technology bubble conspired to weaken the markets considerably from the strong growth exhibited in the preceding years<sup>4</sup>. Pension funds lost considerably in these markets as they invested assets to meet future needs. As companies experience real losses on pension fund assets, yet report assumed gains on those same assets, many investors began to question the financial health of the fund. If plan assets continue to fall, the company will have to make-up that shortfall with increased contributions. Despite assuming gains that never appeared, many of these companies are now confronted with the reality of multi-billion dollar pension fund liabilities.

What remains difficult for users of this financial information is the clarity to which this liability information is presented. Does an \$11.9 billion difference in asset returns at GM, in one year, imply some amount of pension funding liabilities for the company in that year or the coming year? Likewise, questions are raised when GE has not contributed to its pension fund since 1987 despite watching the fair value of its pension fund decline from \$50.2 billion at EOY-1999 to \$37.8 billion at EOY-2002.<sup>5</sup> In addition to the questions of pension fund solvency, GE has been able to steadily increase the amount of pension assets recognized on its balance sheet each year despite the decline in real pension value. Only through the reversal of undisclosed actuarial assumption in its pension fund in 2002 was GE able to avoid recognizing potentially billions in pension fund liabilities and continue the trend of positive pension fund contributions to the balance sheet.

**Table 3. General Electric Pension Asset Calculation\***

	2002	2001	2000	1999
Funded Status	\$4,545	\$14,583	\$21,222	\$24,721
Unrecognized prior service cost	1,165	1,373	1,617	699
Unrecognized net actuarial loss (gain)	8,356	(3,541)	(12,594)	(16,850)
SFAS 87 transition gain	0	0	0	(154)
Net pension assets recognized	\$14,066	\$12,415	\$10,245	\$8,416

\*All amounts in millions, taken from the annual reports

<sup>4</sup> Dow Jones Industrial Average Historical Performance. 4 Mar 2003  
<http://www.djindexes.com/jsp/IndustrialAverages.jsp?sideMenu=true.html>.

<sup>5</sup> General Electric Corporation. 2002 Annual Report

A similar picture can be shown for Verizon Communications which has seen the real value of its pension fund decline from a high of \$59.1 billion at EOY-1999, to its current value of \$38.6 billion at EOY-2002.

**Table 4. Verizon Communications Pension Asset Calculation\***

	2002	2001	2000	1999
Funded Status	\$768	\$12,167	\$22,089	\$26,145
Unrecognized prior service cost	752	817	54	(560)
Unrecognized net actuarial loss (gain)	8,295	(4,547)	(15,153)	(21,973)
SFAS 87 transition gain	(44)	(160)	(272)	(427)
Net pension assets recognized	\$9,771	\$8,277	\$6,718	\$3,185

\*All amounts in millions, taken from the annual reports

As a user of financial information, the seemingly mixed messages in Verizon and GE's determination of pension assets is an inherent flaw of the complexity in current pension fund calculations and presentations. As the two preceding tables indicate, the funded status (a measure of real fund assets less actuarially determined long-term pension payout liabilities) for both companies has decreased dramatically over the four-year period from 1999 to 2002. At the same time, to measure the pension assets recognized over that same period one would assume these are the results of healthy, growing pension funds. These indeterminate indicators underscore the difficulty in assessing the financial health of a pension fund. Does the rapid decline in funded status indicate impending pension fund contributions from the sponsoring company to maintain adequate solvency? Conversely, is the trend of increasing pension asset amounts recognized on the balance sheet a better indicator of the pension fund's long-term solvency?

- Non-varying rate of return.** Another aspect of the assumed rate of return on pension assets is the determination of the rate itself. For many companies, this rate has not changed in many years (if at all), and hovers at 9 – 10%. When viewing these return assumptions from a long-term perspective, they would seem appropriate. The dilemma in using these historical rates is that short-term vagaries in the market, and hence actual returns on pension assets, can create periods of excess gains and losses. Because assets are continuously being paid out of the funds to meet the needs of retirees, short-term returns must be evaluated to ensure adequate funds for current period payouts. While the original intent of FAS 87 was to provide a “smoothing approach” to pension gains and losses over time, the use of assumed returns is deceptive and misguided. To ignore periods of significant deviation from historic market rate of returns is to further exacerbate the problem of fairly presenting the financial position of the pension fund.
- Risky investment choices.** Given the substantial year-over-year investment losses recorded by these pension plans, the question has to be raised whether the use of assumed rates lessens the sensitivity of the pension plan managers to be more conservative in their investment choices. If pension losses can be simply brushed over by assumed gains that in turn bolster the net income of the company, where is the immediate disincentive to minimize investment risk exposure? An indicator of investment portfolio risk can be gained by analyzing the asset allocation of the pension investment. A recent survey of defined benefit pension plans finds that 55% of pension assets were invested in equities in 2002<sup>6</sup>. At a time when asset

<sup>6</sup> “The P & I 1,000.” *Pensions & Investments* 20 January 2003: 40.

preservation should be the paramount consideration for a pension fund manager, allocating such a high percentage of funds assets into equity investments is proving to be a risky investment indeed.

### III. Connection Between Pension Gains and Income Statement Results

Perhaps the most troubling aspect of current pension fund accounting, yet the issue rarely questioned in the media, is the opportunity for pension fund gains, assumed gains at that, to be carried into the income statement of the corporation. In 2001, many companies were able to increase their net income by applying excess pension gains, calculated using assumed rates of return, against real operating costs. Additionally, detail of this application is only brought to light in fleeting remarks within the annual report and no itemization of the treatment is provided in the income statement. This can be a significant source of cost reduction for the company as evidenced below:

**Table 5. Income Statement Impact of Excess Pension Plan Gains (2001)\***

	Verizon Comm.	General Electric	Boeing	Qwest Comm.
Net income statement cost reductions from excess pension gains	\$1,320	\$1,480	\$785	\$343
Net Income	\$389	\$13,684	\$2,827	(\$4,023)

\*All amounts in millions, taken from their annual reports

In the case of Verizon Communications, what would have been a reported loss was instead a gain for the year because of “pension credits” applied against operating expenses. In the case of Qwest Communications, they conveniently note that Selling General & Administrative (SG&A) expenses were reduced by the excess pension gains.<sup>7</sup> This would appear to be a gross misrepresentation of the financial resources and liabilities of the corporation as pension fund assets cannot be withdrawn at the whim of management to contribute to the income statement. Additionally, these actions appear to be contradictory to the intent of FAS 87 when it prescribes, “In applying accrual accounting to pensions, this Statement retains three fundamental aspects of past pension accounting: *delaying recognition* of certain events, reporting *net cost*, and *offsetting* liabilities and assets.”<sup>8</sup> The immediate recognition of costs, or “pension credits”, was never the intended outcome of FAS 87.

Beyond the misrepresentation of operating costs, the net income implications can be dubious given the current post-Enron and WorldCom environment. Many senior management performance compensation packages are tied to the financial performance of the company. For the management team at Verizon, the application of excess pension gains allowed for a positive net income in 2001. While maybe technically correct, there are obvious ethical concerns raised by associating real asset declines in the pension fund to management payouts made possible only through assumed pension gains. As Dennis Beresford, former chairman of FASB notes, “Pension income doesn’t belong to a company. A company holds pension money in trust for its employees...Someone who wanted to

<sup>7</sup> Qwest Communications. 2001 Annual Report

<sup>8</sup> Financial Accounting Standards Board. *Original Pronouncements. Accounting Standards as of June 1, 2000*. New York: John Wiley & Sons, Inc., 2000

could purposely choose bad assumptions to manipulate financial results.”<sup>9</sup> Responding to this issue, General Electric and Verizon have recently removed the inclusion of pension fund “gains” from the income statement, but only for the calculation of year-end bonuses for senior management.<sup>10</sup>

#### **IV. Possible Solutions?**

While there appear to be obvious problems with pension fund accounting, the technical complexity and financial implications of making changes to this system have, until recently, stalled any proposal from being further developed. Breaking this trend of inactivity, and responding to popular and congressional pressures, FASB has added pension accounting to its agenda for review.<sup>11</sup> Though not expected to produce an exposure draft until late 2003, and an accounting standard until 2004, FASB’s acknowledgment and undertaking of this issue should yield many positive improvements. Certainly, the body of pension accounting knowledge that has been gained through the hyper-growth period of the 1990’s, the sharp stock market declines of the past three years, and the professional and ethical bombshells of Enron, WorldCom, et. al. have created an opportunity to not only understand the full spectrum of problems and provide substantive solutions, but also provide the political fortitude to see those proposals become standards. While not knowing the exact task FASB will undertake in their review of the pension accounting rules, the following proposals represent possible solutions that may be considered.

##### **1. Clarify the separation of pension and corporate entities.**

Without having to step too deeply into a re-writing of ERISA,<sup>12</sup> there does appear to be some immediate actions that FASB could undertake to at least restrain any artificial “pension income” from leaving the pension fund. The dysfunctional nature of current pension fund accounting rules is only made worse by allowing contrived income to be applied against real operating costs without even the necessity of itemization on the income statement. A pension should only represent a potential liability to the sponsoring company, and never a source of gains. Any short-term excess gains of the pension fund should be, as FASB originally intended in FAS 87, be retained within the fund without the period-over-period income statement impact currently being exercised by industry. The only circumstance in which the company would recognize the fund is when funding levels necessitate a liability on the company to support adequate pension funding levels.

##### **2. Establish requirements for independent rating of pension funds.**

I view this as a key determinant in bringing consistency and visibility to the pension fund issue. Just as bond rating agencies are an important market tool recognized and monitored closely not only within a corporation but in the financial markets, a similar type of pension rating system should be established. Pension funds could be graded on several factors including investment diversity, funding status, actuarial assumptions, variance from reality of assumed returns, and health of the corporation to meet any funding liabilities. This could not only bring needed visibility to individual pension funds, but would more easily promote best practices between different fund operations in their use of growth and obligation assumptions.

---

<sup>9</sup> Evans, David. “Pension Bomb.” *Bloomberg Markets* Feb. 2003: 31-38

<sup>10</sup> McLaughlin, Tim. “GE, Verizon to alter bonuses.” *The Philadelphia Inquirer* 23 Feb. 2003. 23 Feb. 2003 <<http://www.philly.com/mld/philly/business/5236533.htm>>

<sup>11</sup> Financial Accounting Standards Board. “FASB Adds Projects to Its Agenda on Employee Stock Options and Pensions.” 12 Mar. 2003. 26 Mar. 2003 <<http://www.fasb.org/news/nr031203.shtml>>

<sup>12</sup> ERISA (The Employee Retirement Income Security Act of 1974) was specifically enacted to provide legal protection to benefits of participants in defined benefit pension plans.

A potentially greater benefit could be realized from the use of rating agencies by association pension ratings to pension insurance obligations. Specifically, the Pension Benefit Guaranty Corporation (PBGC) could better associate pension insurance premiums to the rating level of individual funds. Presently, the PBGC charges \$19 per participant per year, with incremental fees only appearing once the fund is determined to be unfunded. Unfortunately, for many pension plans currently maintained by the PBGC, waiting until the pension was deemed unfunded, and then seeking greater premiums from the company, only exacerbates the financial difficulties of the company and further jeopardizes the viability of the pension fund. If the PBGC used fund ratings to increase premiums at earlier signs of trouble, while the company is still financially functional, then; 1) companies would have a greater incentive to maintain the health of the pension fund, 2) users of financial information would have greater clarity in determining the timing and extent of potential additional liabilities, and 3) a more incremental funding approach would be available for both the companies paying the pension premiums, and for the PBGC in meeting its own funding requirements. As Steven Kandarian, executive director of the PBGC, noted in recent testimonial before Congress, "The funding targets are simply not high enough for the plans of companies at the greatest risk of termination."<sup>13</sup>

### **3. Use actual return on pension assets instead of assumed rates.**

If the original intent of using assumed rates was to provide a smoothing mechanism to short-term fluctuations in pension funds, that objective can still be achieved with the use of actual returns and a greater adherence to the principles already present in FAS 87. The amortization of periodic pension gains and losses, as currently defined in FAS 87, can still be accomplished using actual return on plan assets. A smoothing process can still be achieved, but with increased financial clarity through the use of real returns on assets. This is the approach the International Accounting Standards Board (IASB) has taken with enactment of International Accounting Standard (IAS) 19, and it can be a model for FASB consideration.<sup>14</sup> Additionally, addressing the issue of how pension liabilities are to be presented in financial comprehensive financial reports, the IASB has considered formalizing the recognition of pension liabilities as a distinct item in comprehensive income. Both of these measures would add clarity and consistency to the reporting of pension information, regardless of how the underlying calculations are done. The IASB standards could provide an existing framework for revisions to FAS 87.

## **V. Summary**

If there were lessons to be learned from the accounting professions experience with the Enron, it is that following the letter of GAAP can sometimes result in missing the intent of GAAP, and that the accounting profession should always strive to improve the relevancy, clarity, and consistency of its accounting standards. These are also the principles that should guide any revision of the pension fund accounting standards. Although the current state set of standards has been described as, "not perfectly logical, totally complete, or conceptually sound,"<sup>15</sup> the accounting profession is in a unique position to make substantive and well-informed changes to the accounting rules that govern pension funds.

---

<sup>13</sup> Strobe, Leigh. "Pension plans face record shortfalls." *The Virginian-Pilot* 12 Mar. 2003: D3

<sup>14</sup> *International Accounting Standards Board*. 2003. *Employee Benefits (Convergence Topics)*. January 21.

<sup>15</sup> Kieso, Donald, Jerry Weygant, and Terry Warfield. *Intermediate Accounting, Volume 2*. New York: John Wiley & Sons, 2001.