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Financial Accounting Standards Board
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LETTER OF COMMENT NO. 22A

Subject:
Pension Roundtable

Ladies & Gentlemen:

Thank you for inviting me to participate in the roundtable on pensions. I appreciated the opportunity to provide input, and hope the Board felt the time you invested was worthwhile.

The discussion around ABO vs. PBO in the morning was quite animated, and time limitations forced you to cut off discussion and move to another topic. As a result, some of the good questions asked by the Board were never directly answered, and I'd like to take this opportunity to provide feedback on those specific questions. Please note that these comments represent my personal view and are not necessarily the views of my employer.

1. Q: How should FASB limit use of available information?

   A: They should not. However, I believe that the key question is how the information should be used. The question is a general question applicable to many situations, but it was asked in the context of the salary assumption. Expectations of both future salary and future service should be used in determining the present value of all benefits to be paid (PVB). However, the question facing the Board is how to attribute that PVB to each year of service. I believe the appropriate attribution method is one which results in a past service liability equal to the value of the benefit the employee has earned as of that date. This means that benefits created by future salaries and future service credits are attributed to the year in the future that they are earned—which by definition excludes future service and salary credits from today's liability.*

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* Another way of saying this is that attribution should be based on the amount of benefit earned to date, then the value of that benefit should then take into account assumptions as to the likelihood and timing of payment. (Employers may unilaterally freeze pension plans so that future salary increases and future benefit service no longer affect plan benefits. But, at least under US law, employers can't unilaterally stop crediting vesting and retirement

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This type of attribution produces a value that may in some cases be larger than the ABO, depending on how ABO is defined; that issue can be resolved by "properly" defining ABO. Perhaps in infrequent situations the value could even exceed PBO as currently defined, but it does not logically follow that PBO is a proxy for the correct value. Some individuals have indicated that the use of PBO is appropriate because the "error" associated with the ABO is approximately equal to the excess of PBO over ABO. I believe this approximation is mathematically inaccurate, and smacks of the old use of implicit assumptions that the Board previously disallowed.

2. Q: If I start a job that offers a pay related pension plan, my expectation is different than if I am offered a non-pay related plan. Shouldn't that expectation be reflected in the liability?

   A: The expectation is clearly different. However, the expectation of base compensation if you are offered $100,000 annual compensation vs. $50,000 is also different, but no liability is recorded in either case. The pension plan promise is made in return for a year of the employee's labor, and the value of that promise should be earned over that year. To the extent the promise includes an increase in benefit caused by an increase in pay, the expense for the year should encompass the cost associated with the increase in pay. In this way, the value of that pay increase, be it paid in cash compensation or as a benefit increase, will be expensed in the year the labor was provided. (To the extent the promise of an additional benefit is irrevocable regardless of whether the employee works the year, then I believe that benefit, including expected salary increases for future years, may be correctly attributable to prior service and included as a liability. However, that type of irrevocability is extremely rare, in my experience.)

3. Q: If the PBO overstates, then to what construct do you compare?

   A: The basis for comparison should be the economic obligation of the employer. In some cases that obligation is not thoroughly defined, and is subject to legal interpretation and outcome of court cases. To that extent, FAS #5 principles should apply. But when that obligation is clear cut, the obligation should be the liability. As previously noted, that obligation is most similar to an ABO, although the details of ABO measurement may need refinement. In pay related plans, the PBO will equal the economic obligation only by coincidence. Phase 2 will address appropriate measurement, but since the PBO construct does not correlate with the economic obligation, ABO is the more valid measurement in the

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eligibility service -- factors that help determine value, because the law requires that the employer continue to count future service for these purposes, even if the plan is terminated.)

meantime.

4. Q: How can we compare defined benefit accounting with defined contribution accounting when the former places investment risk on the employer and the latter places it on the employee? (I believe this was actually Scott Taub's question, not a Board member's.)

   A: The acceptance of investment risk is essentially a financing decision by the employer, and doesn't relate to attribution. This can be demonstrated by comparing two plans:
   1. A fully insured final pay plan. (Employers can choose to insure plans by buying deferred annuities for benefits that have been earned to date. This used to be fairly common, but is now relatively rare in the U.S.)

   2. A service weighted defined contribution plan that has a benefit formula which has been designed to have an annual contribution equal to the benefit earned each year under (1.). This means the two plans provide identical benefits.

   From an employee perspective, these plans are different because, in the case of the fully insured final pay plan, the employee bears no investment risk, while in the case of the service weighted defined contribution plan, the employees bears all investment risk. More importantly though, from the perspective of the employer who is accounting for these plans, they are equivalent.

   The accounting for the defined contribution plan is obvious. The following demonstrates the accounting for the defined benefit plan under both a PBO and ABO approach:

	ABO	PBO
Assets*	$0	$0
Liability	0	Effect of Future Salary Increases
Expense		
Service Cost	Value of benefit earned (same as DC Plan)	Value of benefit earned, times ratio of expected salary at termination to current salary
Interest Cost	0	i * PBO
Expected Return	0	0

Amortizations	0	PV of unexpected salary fluctuation ÷ average future working lifetime

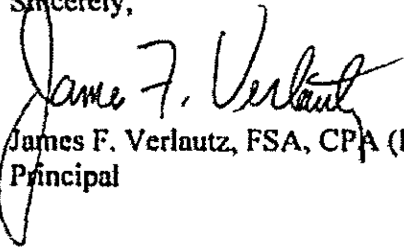
*No assets because all money is sent to the insurance company.

For the identical benefit and amount of investment risk assumed by the employer, the ABO accounting produces results identical to dc plan accounting. PBO accounting produces a different result because the form of the plan is different even though the substance is the same.

This example can then be extrapolated to the case where the employer does not insure the benefits. In that case the employer holds assets and liabilities, and the expense should reflect the financing risk/opportunity (the Board has already indicated that Phase 2 will include analysis of valuing the financing component). However, assuming an appropriate settlement rate is used, the choice to self-finance should not affect the service cost. Since the service cost is uniquely determined by the attribution method, it seems clear that the ABO method is the one which is comparable to DC plan accounting.

I hope these answers are of use to you. I would be pleased to answer any questions you may have.

Sincerely,



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