

Dr. Paul B. W. Miller, CPA **Professor of Accounting** University of Colorado at Colorado Springs Colorado Springs, CO 80933-7150

SE STA

Dr. Paul R. Bahnson, CPA Professor of Accounting ... **Boise State University** Boise, Idaho 83725-1000

May 31, 2006

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



LETTER OF COMMENT NO. 236

File Reference No. 1025-300

Dear members of the FASB and staff:

We are writing to strongly support your efforts to create more useful financial reporting as proposed in your March 31 exposure draft, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans.

That progress will occur by moving relevant information out of the footnotes and onto the balance sheet. By improving the usefulness of financial statements, this move will diminish (but not erase) the blot on the integrity of the standardsetting process reflected in this quote from SFAS 87: "the delayed recognition included in this Statement results in excluding the most current and most relevant information from the employer's statement of financial position."

As you know, this move does not change the politically shaped and deeply flawed Rube Goldberg calculation of annual costs. Because you are deferring a more complete fix, we encourage you to create new disclosure requirements that will help statement users bridge the gulf between reality and the reported amounts. In particular, we believe the footnote should encourage them to substitute good information for the bad. This disclosure should be designed to allow users to (a) identify the economic effects of all events affecting fund assets and the liability, (b) easily generate unsmoothed measures, (c) understand the year's comprehensive income, and (d) determine how much of the reported annual cost was capitalized and expensed.

As we see it, current and proposed standards for pensions and OPEB don't produce useful information and are literally not in compliance with other fundamental acceptable principles. This Gordian knot deserves to be slashed, although we understand your desire to unravel it. In any case, your decision to leave the

income measure alone makes it essential that new disclosures help users bear with the situation.

Offsetting

Among the otherwise unacceptable practices in pension (and OPEB) GAAP, or "P-GAAP," is the offsetting of fund assets against the liability. This practice is patently rejected everywhere else. For example, mortgage debt is not subtracted from the book value of mortgaged property and accounts payable are not offset against cash because doing so obscures relationships between assets, debt, equity, and returns.

Covenants

Frankly, we don't mind a whit that the new standard threatens existing debt covenants by revealing that violations of the old limits were hidden by poor accounting.

If debtors are to receive any grace, it can rightfully come only by direct and specific action by their creditors, not from you and certainly not by your allowing inferior financial reporting to continue for even one day, much less another year. Your responsibility is to get truth into the statements as soon as you can and then it's up to debtors and creditors to renegotiate in light of that truth.

Aggregation and smoothing

As you know, the amount of annual cost under P-GAAP is an unfathomable aggregate. Because you won't be changing the calculation, we offer the following observations and recommendations.

Service cost: service cost is a labor cost, exactly the same as current accruals for payroll except that the cash flow is postponed and its amount is actuarially reduced. Service cost disclosures should clearly reveal whether it was assigned to production, R&D, SG&A, or something else.

Interest cost: elsewhere, interest is reported separately as a financing expense to help users assess the impact of debt. Although interest may be capitalized, SFAS 34 specifically prohibits adding it to inventory cost; thus P-GAAP doesn't comply with GAAP. As a result, new disclosures should show how much interest was incurred and where it ended up in the statements.

Prior service cost: according to P-GAAP, granting retroactive benefits creates employee "goodwill," a fiction that leads to deferring and amortizing the cost over projected worklives of affected employees. This flimsy rationale is even less credible now that SFAS 142 has done away with amortizing goodwill. Indeed, it has never been acceptable to recognize internally generated goodwill. The nature of and useful accounting for this spurious intangible needs rethinking.

Moreover, we're especially puzzled by the accounting that causes savings from reduced employee benefits to be amortized over the future. Apparently, savings

achieved by creating "badwill" are being offset against higher future costs produced by disgruntled employees. Obviously, this practice and its justification are irrational. A plan amendment produces a one-time cost or saving that affects only the current year's income. We recommend that the footnote reconcile the beginning and ending balances of unrecognized PSC to enable users to easily isolate the damage done to the statements by deferring and amortizing. In addition, the note should reveal how much cost or benefit ended up in inventory and various expenses.

Actuarial gains/losses: the current crisis was exacerbated in large part by the losses caused by falling interest rates. These losses are called "actuarial" even though they are caused by being indebted for unknown amounts due at unknown dates. Of course, other adjustments are caused by real actuarial factors. For example, more employees are retiring early and living longer. Although these latter gains and losses are nominally different from interest-driven gains and losses, the ill-conceived policy of financing current operations with openended and risky debt generates real volatility. To help users comprehend what happened, these gains and losses should be fully disclosed. As with prior service cost, we recommend that the footnote reconcile the beginning and ending balances of the deferred actuarial gain/loss.

Investment returns: we have always been chafed by the P-GAAP practice of reporting expected returns instead of actual results. Imagine what damage would be done to the credibility of GAAP statements if all revenues and expenses were to be reported at management's expected amounts! This contrivance is transparently indefensible because it obscures truth. The best way to get volatility out of the statements is to eliminate real volatility, and we think managers will get rid of it only if they have to report it.

Because you aren't repairing the expense, you are obliged to require full disclosure of actual and expected returns in the *same* table, unlike SFAS 132, which puts actual returns in the asset reconciliation and the expected return in the annual cost tabulation. We recommend a new format that clearly reveals the real and P-GAAP amounts. (We have attached a prototype schedule, showing the 2005 numbers for General Electric's principal pension and OPEB plans.)

Corridor amortization: there is no better proof of the absurdity of P-GAAP than corridor amortization of accumulated gains and losses. Although this practice is clearly arbitrary and irrational, present footnotes present it as a legitimate component of annual cost. The resulting amount has NO connection with anything real and cannot be useful under any circumstance. Again, your decision to defer Phase 2 makes it incumbent on you to enable users' rational analyses by reconciling the beginning and ending balances of the deferred gain/loss account. This disclosure would also clearly reveal the results of terminations, settlements, and curtailments that will surely be triggered by the new standard.

Interim reporting

A recent conversation with a sophisticated financial statement user raised an issue that is described in paragraph B73 of the exposure draft.

Specifically, the individual asked what kind of information will be available in quarterly interim statements, now that the board has called for balance sheet recognition of the plan assets and obligation. The disappointment was obvious when it was explained that no changes in interim reporting are to be created.

We find the rationale in the draft to be inadequate in that they neglect the direct interests of financial statement users (and the indirect interests of the public at large) while favoring the nominal interests of financial statement preparers.

The first rationale refers to additional costs to implement that change. We point out that substantially greater additional costs will be incurred if the change is not implemented. Instead of having each employer approximate the current funded status at each interim date, your decision forces all financial statement users to either make that approximation (based on numerous suppositions about facts that the employer knows) on their own or make decisions under a great deal of uncertainty. The ultimate consequence is that users will face more risk and will demand a higher rate of return, thus increasing the employer's cost of capital. Indeed, it appears to us that leaving the status quo intact will actually increase financial statement preparers' total costs (including capital costs) more than requiring them to provide updates.

The second and third rationale are, we fear, equally inadequate, although we understand your desire to avoid controversy that could delay your time table for the project.

As an accommodation to the interests of financial statement users and the public, we urge you to include a provision in the new standard that highly recommends but does not mandate that each plan's status be updated in quarterly financial statements. This arrangement would encourage updating by managers who wish to fully inform their readers while challenging less forthcoming managers to justify their reticence. In addition, it seems possible that the recommendation would provide data for Phase 2 on the technical feasibility of interim updates and feedback from users on the usefulness of the disclosures.

Conclusion

Please know that we praise your resolute willingness to enter into the P-GAAP minefield. You have responded promptly and taken a good first step. Because your predecessors deferred reporting the truth, the whole truth, and nothing but the truth, it falls to you to serve the capital markets' needs by requiring complete and comprehensible disclosures. Despite the superficial, even fatuous, arguments you will find in other letters that focus only on preparers' needs, you must address financial statement users' needs by providing more information in a format that facilitates analysis and accountability.

In addition

Two additional items are attached to this letter.

The first is the previously mentioned prototype schedule that we recommend be adopted for supplemental disclosures of information related to defined benefit pensions and post-retirement benefits other than pensions. Its aim is to put in one place all the information that financial statement users need to know in a format that is more readily interpreted.

The second is the text of our column that appeared in the May 15, 2006, issue of *Accounting Today* (page 16). This material provides counterarguments to claims by respondents that expose the weakness and often self-serving nature of their comments on this draft. We have attached it because it will be a useful addition to the public record of support for the proposed changes.

Sincerely,

Paul B. W. Miller, Ph.D., CPA Professor of Accounting Paul R. Bahnson, Ph.D., CPA Professor of Accounting Chair of the Department

Paul

General Electric Principal pension plans				Col	mprehens	ive	Income	_		
2005	Asset	-	Liability	Prio	r Service	D	ef. G/L	Ani	nual Cost	
Beginning balance	\$ 46,665	\$	39,969	\$	1,260	\$	7,481			
Actual/expected return	4,558	;					(673)	\$	(3,885)	
Employer contributions	106	•					-			
Employee contributions	174		174							
Benefits paid	(2,407	')	(2,407)							
Service cost			1,359						1,359	
Interest .			2,248						2,248	
Actuarial loss	63	ς,	1,988				1,988			
Amortization of PSC					(256)				256	
Amortization of Def. G/L*							(351)		351	
Annual change	2,431		3,362		(256)		964	\$	329	
Ending balance	\$ 49,096	\$	43,331	\$	1,004	\$	8,445	,		
Funded status				\$	5.765	Ove	rfunded			
Decrease in Comprehensive Income \$ 708										
Year-end deduction from eq	uity			<u> </u>	9,449					

Disposition of annual cost

	Percent	Ε	xpected	5	ervice	1	nterest		PSC		G/L*		
	(assumed)		return		cost		cost	Arr	ortization	Amo	ortization		Total
Ending inventory cost	10%	\$	(389)	\$	136	\$	225	\$	26	\$	35	\$	33
Cost of goods sold	50%		(1.943)		680		1,124		128		176		165
SG&A	15%		(583)		204		337		38		53		49
R&D	20%		(777)		272		450		51		70		66
Other	5%		(194)		68		112		13		18		16
Total	100%	*	(3.885)	\$	1.359	-	2.248	- 5	256	\$	351	•	329

* Gain/Loss Amortization Beginning asset balance Corridor (10%) Beginning deferred loss Excess deferral Predicted worklife (inferred) Adjustment for 2005

\$ 46,665 \$ 4,667 \$ 7,481 \$ 2,815 8.0 years \$ 351

Proposed disclosure General Electric OPEB plans

OPEB plans		<u>Compréhensive Income</u>								
2005	Asset	L.	iability	Pric	r Service	D	ef. G/L	Ann	ua/ Cost	
Beginning balance	\$ 1,652	\$.	9,250	\$	2,747	\$	1,004			
Actual/expected return	 107						31	\$	(138)	
Employer contributions	675									
Employee contributions	41		41							
Benefits paid	(856)		(856)							
Service cost			243						243	
Interest			507						507	
Actuarial gain			(55)	ı			(55)			
Other			(46)	ı	(12)		(8)			
Amortization of PSC					(326)				326	
Amortization of Def. G/L*	 				, ,		(70)		70	
Annual change	(33)		(166)		(338)		(102)	\$	1,008	
Ending balance	\$ 1,619	\$	9,084	\$	2.409	\$	902			
								,		

Funded status

\$ (7,465) underfunded \$ 440 \$ 3,311

Increase in Comprehensive Income Year-end deduction from equity

Disposition of annual cost

-	Percent (assumed)	xpected return	Service cost	1	nterest cost	Αn	PSC ortization	G/L* ortization	Total
Ending inventory cost	10%	\$ (14)	\$ 24	\$	51	\$	33	\$ 7	\$ 101
Cost of goods sold	50%	(69)	122		254		163	35	504
SG&A	15%	(21)	36		76		49	11	151
R&D	20%	(28)	49		101		65	14	202
Other	5%	(7)	12		25		16	4	50
Total	100%	\$ (138)	\$ 243	\$	507	\$	326	\$ 70	\$ 1,008

 Gain/Loss Amortization
Beginning liability balance
Corridor (10%)
Beginning deferred loss
Excess deferral
Predicted worklife (inferred)
Adjustment for 2005

	0.350
\$ \$	9,250 925
\$	1.004
š	79
•	1.1 years
\$	70

"Top 10 Absurd Comments on Pension Accounting"

Miller and Bahnson

Accounting Today, May 15, 2006.

On March 31, the Financial Accounting Standards Board issued its anticipated exposure draft that proposes significant changes in accounting for defined benefit pension and health plans. As we explained a couple columns back, it will recognize net plan assets and/or liabilities, accompanied by accumulated comprehensive income for deferred gains and losses that are currently off-balance sheet.

Because of the large amounts and the generally bad news this new accounting will declare more openly, FASB will be inundated with many negative comments from defenders of the status quo bad accounting. How do we know? Chalk it up to our decades of FASB-watching experience.

We wrote this column to give the board a hand by anticipating ten likely absurd comments along with our candid rebuttals. How will this help? For one, it's possible our critiques may stop some pointless letters from being sent. For another, FASB's folks don't get to voice the sort of things that we do, so maybe they'll take vicarious pleasure in our comebacks.

No. 1 – There are no real liabilities to be recognized.

If there are no liabilities, then why are you paying all those benefits? What about the binding contracts that commit you to paying them? If those obligations aren't liabilities, then what on earth are they?

Oh, you say that you can unilaterally back out of them at anytime? Right. We'd like to know what attorneys are giving you that advice so we never seek their counsel. You're living in denial if you think you can just cut off benefits. Because of the public relations nightmare, it can't and won't happen.

No. 2 - No one knows for sure how big the liabilities are and the balance sheet will lose reliability by introducing imprecise numbers based on prognostications.

For one thing, the most imprecise number that you can report is zero. Yet, that number is used when liabilities aren't recognized. As to the general inappropriateness of predictions, perhaps you can see why we think the same problem exists for all allocations, especially depreciation. The big difference, of course, is that actuaries re-estimate the pension and other benefit liabilities every year using the latest evidence. When was the last time you recalibrated your depreciation prognostications?

This comment is even more inane when it comes from managers who created the obligations. What does it say about their stewardship if they committed to those future benefit payments without knowing what they're worth? Any managers who make this argument should be driven out of town on a rail.

No. 3 – Financial statement users won't know how to interpret balance sheets.

This one cracks us up as much as it did twenty years ago. Get a life! Rub shoulders with some *real* users. Think about it. Do they just ignore off-balance sheet obligations? Do they think those huge off-balance sheet debts aren't destroying your creditworthiness (and credibility)? If you need proof, read the CFAI's report entitled *A Comprehensive Business Reporting Model: Financial Reporting For Investors.* Page 1 cites pension plans as a prime example of how real values on the balance sheet will improve accounting. Quit harboring the thought that markets are dumber than you. In fact, they're smarter than any of us.

No. 4 -If we have to recognize a net pension liability, we'll violate our debt covenants.

Well, how about that? Who would benefit most from knowing you're actually over the line on your covenants? It's the same people you promised you would control your appetite for debt! Keep in mind that these proposed accounting practices won't make you violate the covenants. They will only reveal that you have already done so.

No. 5 — We won't be able to retroactively increase benefits because the charge will reduce equity right away. That will take away our negotiating flexibility and strikes will be more likely.

Unbelievably, GM management added \$2.2 billion to its projected benefit obligation as recently as 2003 through plan amendments. We're pretty sure management felt comfortable giving that money away because the *reported* cost would be spread over the future instead of hitting the bottom immediately. Of course, deferred recognition cuts both ways because the gains from today's hard fought benefit reductions are also postponed. Isn't it funny how what goes away can also come back to bite you?

Instead of phony deferrals, we favor telling the truth and letting chips fall. We don't see any validity in not telling the truth to gain some ostensible good outcome or avoid an allegedly bad one. It's not just bad ethics, it's bad economics.

No. 6 – Comprehensive income will be too volatile.

Snicker, giggle. The ruse of putting comprehensive income in equity was invented as a political compromise to reduce income statement volatility, starting with SFAS 12 on marketable securities and SFAS 52 on foreign currency translation. Back then, preparers complained that revealing volatile results of risky activities would interfere with their ability to engage in them. It was a clear application of "Let's hide the facts in plain sight and the markets won't see them." The goofy compromise of not reporting income on income statements bought their silence but created nonsense.

Complaints that the new accounting will make other comprehensive income volatile would be nothing short of ludicrous. It's investing in securities and creating open-ended long term promises that creates volatility, not accounting for them.

No. 7 – We can't possibly get an actuarial estimate done by the end of the fiscal year.

A nagging problem addressed in the draft is the puzzling process of adding actuarial estimates from different dates and calling the total meaningful. Technology has obviously improved since the mid-1980s when the old FASB allowed employers to use numbers from dates other than the balance sheet date. But, you can be sure that someone will raise this complaint, if only to try to slow down the board. Well, it's a nonstarter. Welcome to the 21st century, where those ancient limitations don't exist any more.

No. 8 – If you issue this standard, we'll terminate our defined benefit pension and medical benefit plans.

Of course, the idea behind reporting useful information is to help rational decisions be reached. If presenting the truth about bad decisions will cause fewer of them to be made, then the information is serving its purpose. If the only thing sustaining your company's plans is inferior financial reporting, then perhaps termination is a good idea.

No. 9 - If you issue this standard, we're going to cut off our contributions to the board.

Although this threat was seldom delivered to FASB directly, at least some constituents implied that they who held the purse strings should get their way. Sarbanes-Oxley eliminated that possibility and FASB no longer even accepts contributions. Opponents to progress can forget about this club. That era is over.

No. 10 – Who wants to change anyway? This is nothing but an ivory tower solution that doesn't consider the real world.

We have recently read lots of things about pension accounting, and we've yet to come across any credible call for keeping the present Rube Goldberg system intact because it's good accounting. In fact, the literature is full of complaints that GAAP has aggravated the pension crisis by covering up the truth. In fact, the exposure draft proposes only very minor modifications compared to what many are demanding.

Instead of complaining about this pin prick, get ready to put the full assets and liabilities on the balance sheet. Count on seeing the interest incurred on these huge debts being combined with other interest costs instead of being treated as a labor cost. Count on seeing all gains and losses reported in earnings, not smoothed beyond recognition. Unless management gets rid of risk, reported income will be just as volatile as the real income. Bye bye to twenty-year old

nonsensical compromises and "Hello, Truth." If anything was ivory tower and out-of-touch with reality, it was SFAS 87 and 106.

Our closing thoughts

So, we hope our critiques will cut down on the worthless comment letters to our friends at FASB. We also hope you found catharsis in seeing public responses to fatuous arguments you normally bear in silence. We don't expect to be 100% effective, and some may even aim their wrath at us. We'll gladly take it for you. All we ask is that you move quickly into Phase 2 and create real reform.