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Letter of Comment No: 55

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GERALD I. WHITE, CFA
PRESIDENT

October 24, 2003

Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference 1025-200, Employers' Disclosures about Pensions and Other
Postretirement Benefits

Dear Sir:

General Comments

I am writing this letter as someone who has been a financial analyst and investment advisor for more than thirty-five years. I have represented the analyst community in the financial reporting process, served on FASAC and several FASB task forces, and taught financial statement analysis at the graduate level. While many Board members and staff are familiar with my background, I have attached some biographical information to this letter.

The exposure draft, despite some merits, represents a step backward in the disclosure requirements for pensions and other postretirement benefits. Statements 87, 88, and 106 replaced the "black box" of prior accounting standards governing such benefits with an understandable set of standards with greatly increased transparency. Statement 132 improved those standards by strengthening disclosures, increasing the transparency of benefit accounting. The requirement that plan sponsors provide a reconciliation of the benefit obligation and plan assets addressed shortcomings in the disclosure requirements of Statements 87 and 106 by fully disclosing the factors that change the benefit obligation and plan assets over time.¹

¹ Previously the effects of acquisitions/divestitures and foreign currency changes were undisclosed, making full analysis of benefit plans so impacted difficult or impossible.

The ED, in contrast, would eliminate the reconciliation requirements, returning to the pre-Statement 132 world of semi-disclosure. As discussed more fully below, the reconciliations permit financial statement users to understand the effects on the benefit obligation and plan assets of:

1. Acquisitions and divestitures
2. Foreign currency changes
3. Actuarial gains and losses
4. Plan curtailments and settlements
5. Plan amendments
6. Plan cash flows
7. Sponsor cash flows

While part of the negative effect of the elimination of reconciliations would be offset by other (new) disclosures, the overall effect of the ED would be to reduce the information set available to financial statement users. While several of proposed new disclosures would be helpful, I would greatly prefer the status quo to the proposed standard.

Responses to Specific Issues

Issue 1, Asset Allocation

Asset allocation [paragraph 5d(1)(a)] would be a useful disclosure because it would allow financial statement users to evaluate the riskiness of plan assets and the reasonableness of the assumed rate of return on plan assets (ROA). Disclosure of the expected ROA by asset class would assist the second evaluation. Disclosure of target allocation percentages would be only marginally beneficial. It would be sufficient to require plan sponsors to describe any significant change in asset allocation that has taken place since the balance sheet date or is planned.

The proposed disclosures for debt securities [paragraph 5d(3)] would have only marginal benefit. The contractual maturities of a bond portfolio may be a poor estimate of the effective term due to call and other prepayment features.

Issue 2, Disclosure of Accumulated Benefit Obligation

The requirement to disclose the ABO was eliminated by Statement 132. While the ABO is occasionally useful, I believed at the time that the reconciliation requirements of that standard were far more useful and that giving up the ABO was a worthwhile tradeoff. My view has not changed; there are other disclosures that are more useful for more companies.

Issue 3, Cash Flow Information

In theory, these disclosures should be very helpful to users in making cash flow forecasts. In practice however, near-term forecasts of benefit payments and contributions are difficult to make. Benefit payments depend on the retirement rate and, for plans that permit lump sum payment elections, retiree decisions. Contributions depend on changes

in plan status, alternative investment opportunities, and “political” considerations.² While it would be useful to compare actual cash flows with management forecasts, there are other disclosures that I deem more important.

It is more important to know the actual cash flows related to the benefit plans. Such disclosure is provided by the reconciliations of plan assets and obligations currently required by Statement 132. Requiring that plan sponsors report benefits paid directly by the sponsor separately from those paid by the plan would enhance that disclosure.³

Issue 4, Tabular Format for Key Assumptions

The proposal would improve transparency at minimal cost. It would, in particular, eliminate the lack of clarity about when assumption changes affect the income statement. For example, while most plan sponsors use the year-end discount rate to compute service and interest cost during the following year, some change the discount rate during the year. Interim period assumption changes are often undisclosed.

Issue 5, Nonpublic Entities

I have long believed that the distinction between public and private entities is an artificial one. Many “private” companies have a significant number of creditors or stockholders. I believe that all companies with benefit plans should have the same disclosure requirements.

Issue 6, Sensitivity Information

I have argued in the past for such disclosures. However, as I believe that sensitivity information for pension plans is far less useful than for postretirement health plans,⁴ I agree that the benefits of such data would be limited.

Issue 8, Reconciliation Requirements

This is the most important issue in the exposure draft. The reconciliation requirements result in a fully transparent accounting system; loss of these data would be a significant step backward in benefit plan reporting.

Statements 87 and 106 greatly improved the financial reporting for pension and postretirement plans. Despite the smoothing provisions of those standards, financial analysts were able to create reasonably accurate analyses of such plans in most cases.⁵

² In 2003 many companies have increased contributions in response to investor, employee, and rating agency concerns about the adequacy of pension funding.

³ Some companies report benefits paid in the reconciliation of plan assets that differs from benefits paid reported in the reconciliation of the benefit obligation.

⁴ For postretirement benefit plans, the sensitivity to the health care trend rate conveys important information regarding whether the employer or the employee bears the risk of health care inflation rates that differ from those expected. See page 436 of White, Sondhi, and Fried, *The Analysis and Use of Financial Statements* (Third Edition, 2003, John Wiley) for illustration.

⁵ The first edition of White, Sondhi, and Fried (1993) showed how to use the Statement 87 and 106 disclosures to prepare reconciliations of plan assets and obligations.

However such analysis was hampered by fuzzy disclosures by some plan sponsors and by the undisclosed effects of foreign currency changes and acquisitions/divestitures. Foreign currency changes affect both assets and obligations for nondomestic subsidiaries. Acquisitions (divestitures) add (remove) assets and obligations from the consolidated group. As these effects were never disclosed, analysts could not perform the reconciliation, thereby losing the effects on affected companies of actuarial changes, plan amendments, and other events that affect plan assets and obligations.

Statement 132, which resulted primarily from analyst complaints about the need for greater transparency, transformed the disclosure system. As a result financial statement users can now see all of the elements that affect plan assets and obligations. Thus they can adjust financial statements, if they wish, to alternative measures of benefit status and benefit cost.⁶

Full reconciliations permit the financial statement user to see the effects of all of the following factors:

1. Acquisitions (divestitures) of entities add (remove) plan assets and obligations from the consolidated group, under both the pooling and purchase methods of acquisition accounting. Nondisclosure of these effects can make it impossible to estimate the effects of factors 3 - 7.
2. Foreign currency rate changes affect both plan assets and obligations of nondomestic subsidiaries. Nondisclosure of these effects can make it impossible to estimate the effects of factors 3 - 7.
3. Actuarial gains and losses are an important measure of the reasonableness of management's assumptions. While the effects of changes in the discount rate and rate of compensation increase receive much attention, other undisclosed assumptions also result in actuarial gains and losses. Reconciliation of the benefit obligation enables users to see the entire amount of actuarial gains and losses.
4. Plan curtailments and settlements can have significant effects on benefit cost as well as plan status.
5. Plan amendments result in unamortized amounts that may affect benefit cost for many years. Frequent amendments may also suggest that the benefit obligation is understated.
6. Plan cash flows are often a leading indicator of sponsor cash flows. Benefit payments can be highly variable over time.
7. Sponsor cash flows represent the immediate effect of benefit plans on the corporate sponsor. Such cash flows are usually very different from benefit cost (reported or alternative measures).

The exposure draft would remove the information set that provides the needed transparency for the accounting for pensions and other postretirement benefits. Financial statement users would be forced to rely on guesswork, hampering analysis and reducing

⁶ Chapter 12 of White, Sondhi, and Fried (Third Edition, 2003) demonstrates such analysis.

the efficiency of financial markets.⁷ I disagree completely with the statement in paragraph A33 that scattershot disclosures are “more focused” than are reconciliations.

Issue 9. Disclosures Considered but Not Proposed

I agree, for the most part, with the Board’s conclusions. However I disagree with respect to the following disclosures, which should be required:

e. Classification of benefit cost:

Variations in benefit cost over time may result in significant effects on reported gross margin and on S, G, and A expense as a percent of sales, both important measures of corporate performance. Without knowing where those effects appear, financial statement users may draw misleading conclusions about management performance. The proposed disclosure should be virtually costless to preparers.⁸

I believe that paragraph A27 misses the point. While the distinction between operating and financing elements is important, this provision would elicit data about the effect of changes in benefit cost on income statement ratios that are used to measure corporate performance and, in some cases, value securities. It is simply untrue that these effects are “generally relatively insignificant in relation to individual income statement line items.” Security prices can be affected by variations that may seem small to an accountant, but are seen by investors as significant indicators of trend.

One good example is General Motors. Assuming that its benefit costs relate entirely to its non-financial segment, both the level and change in total benefit costs was highly significant when comparing 2002 with 2001 profitability. As shown in the table below, the 2002 increase in total benefit cost was equal to one percent of sales. If all of this cost is included in costs of goods sold (COGS), it explains the entire increase in cost of goods sold as a percent of sales. Put differently, the gross margin (sales less COGS) was unchanged except for the effect of benefit cost.

If, on the other hand, benefit cost is included in S, G, A expense, then gross margin was lower in 2002 than in 2001. The reduction in S, G, and A expense (from 10.6% to 9.4% of sales) in this case would be even greater as that ratio was increased by one percentage point.

⁷ Some may argue that few financial analysts perform the types of analysis discussed here. Corporate officers sometimes argue that “sell side” analysts never ask detailed information about benefit plans. However tens of thousands of analysts worldwide have passed through the Chartered Financial Analysts (CFA) program in recent years and have been tested on their knowledge of benefit plan accounting. Even if many analysts do not specifically question management about their plans, I believe that the disclosures are impounded into stock prices by those investors who use the disclosures. Finally, interest in pension plan disclosures has increased greatly recently as lower interest rates and negative market returns have decimated the funded status of many major corporate plans. In my experience, analysts participating in conference calls now frequently ask about benefit accounting.

⁸ The FASB Task Force on Financial Performance Reporting discussed separate reporting of benefit cost at its meeting on February 26, 2002. My recollection is that there was little disagreement that separate reporting, which would have the same effect as the proposed disclosure, would be beneficial.

This illustrates the importance of knowing which income statement line item(s) includes benefit cost so that this factor can be considered when evaluating corporate performance.

General Motors

Years ended December 31		
Data in \$ millions		
Benefit cost	2001	2002
Pensions - US	\$ 146	\$ 1,260
Pensions non-US	404	545
Other benefits	<u>3,722</u>	<u>4,110</u>
Total benefit cost	\$ 4,272	\$ 5,915
Change in cost		1,643

Automotive Segment

Sales	\$ 151,491	\$ 159,737
Cost of goods sold	(135,620)	(144,550)
S, G, A expense	<u>(16,043)</u>	<u>(14,993)</u>
Operating income	\$ (172)	\$ 194

% of sales

Cost of goods sold	-89.5%	-90.5%
S, G, A expense	<u>-10.6%</u>	<u>- 9.4%</u>
Operating income	- 0.1%	0.1%

Total benefit cost	2.8%	3.7%
Change in cost		1.0%

Source: Data from General Motors 10-K Report, Year ended December 31, 2002

(new) Use of the Market-Related Value of Plan Assets

In my experience, use of the market-related value of plan assets to report return on plan assets is virtually never disclosed, although it can sometimes be inferred. A requirement to report when that method is used would be virtually costless but would help financial statement users forecast benefit cost.

Issue 10. Interim Disclosures

The proposed disclosures would be beneficial by allowing financial statement users to better understand the impact of changes in plan status, assumptions, and other factors (i.e. acquisitions/divestitures and foreign currency changes) on interim benefit cost. Under the current system such effects are hidden until issuance of the full year financial statements. Interim disclosures would also facilitate estimation of full year benefit cost.

Issue 11, Effective Date

The effective date and transition provisions are appropriate. Any new disclosure requirements should be readily available. As there are no changes in accounting standards, transition costs to preparers should be minimal.

Conclusion

I urge the Board to adopt a final statement that would incorporate relatively few new disclosures, while leaving the current Statement 132 disclosure system in place.

My second choice would be no new standard at all. The proposed new disclosures, while sometimes helpful, would be a poor price to pay for loss of the reconciliations required by Statement 132.

If there are any questions, I would be pleased to respond.

Sincerely,

A handwritten signature in cursive script, appearing to read "Bernard J. Lento".

GERALD I. WHITE, CFA

President, Grace & White, Inc. Investment Counsel

Brown University, AB 1966

New York University, MBA 1971

Chartered Financial Analyst

Association for Investment Management and Research (AIMR):

Member, Financial Accounting Policy Committee, 1970 - 2000

(Chairman 1976 - 1987)

Distinguished Service Award (1987)

C. Stewart Sheppard Award (1995)

Adjunct Professor of Accounting, New York University

Stern School of Business (1978 - 1995)

Co-Author, *The Analysis and Use of Financial Statements*, Third Edition

(Wiley, 2003)

Member, FASB Task Force on Financial Performance Reporting