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VIA E-MAIL to director@fasb.org

October 24, 2003

Letter of Comment No: 26
File Reference: 1025-200
Date Received: 10/24/03

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
File Reference No. 1025-200
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Subject:

Exposure Draft — Proposed Statement of Financial Accounting Standards on Employers' Disclosures about Pensions and Other Postretirement Benefits

Dear Mr. Smith:

Mercer Human Resource Consulting is pleased to present our comments on the Exposure Draft of a proposed statement of financial accounting standards, *Employers' Disclosures about Pensions and Other Postretirement Benefits*. As the largest global actuarial firm, we are significant providers, consumers, and interpreters of the information in the pension and post-retirement plans footnote. We support the Board's continuing efforts to provide financial statement users with meaningful, reliable, relevant, and useful information.

While we agree that many elements of the Exposure Draft enhance the usefulness of the information presented and are available at reasonable cost, certain items of the additional disclosure are of little value or relevance, do not achieve the desired objectives, and/or are available only at high cost.

For convenience, we have arranged our discussion according to the issues outlined in the Exposure Draft.

Summary of recommendations

The table on the following page summarizes our concerns and recommendations. Each of these items is explained in greater detail, below.

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Issue	Recommendation	Rationale
1. Plan Assets	Disclose current allocation only.	Current allocation is the most useful measure of current risk.
	Eliminate target allocation, expected return by asset class, and information about debt securities.	Other information is forward-looking material subject to management discretion, and may not be meaningful, relevant, or reliable.
2. Defined Benefit Pension Plan Accumulated Benefit Obligation	Include in disclosures.	Useful and readily available.
3. Cash Flow Information	Eliminate schedule of projected benefit payments.	Not relevant; doesn't achieve objective; costly to obtain.
	Include only a range of total contributions; do not segregate required and discretionary.	Uncertainty as to amount, arbitrary distinction between "required" and "discretionary."
4. Assumptions	Include the proposed table.	Information is readily available and adds to clarity.
5. Non-public Entities	No comment.	Not much difference in required disclosures; we believe auditors will ask us for the complete information anyway.
6. Sensitivity Information about Changes in Certain Assumptions	Exclude from disclosure.	We agree with the Board's discussion and rationale.
7. Measurement Date(s)	Disclose measurement date annually.	"As of" date is an integral part of the measurement process and is readily available.
	Eliminate the disclosure of significant economic events or changes.	If the measurement date is disclosed, users can make their own judgments about events after the measurement date. Added value of disclosure does not justify the added cost.

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Issue	Recommendation	Rationale
8. Reconciliation of Beginning and Ending Balances of Plan Assets and Benefit Obligations	Retain current requirements under Statement 132.	Information is readily available and adds to clarity; we believe auditors will ask us for the information anyway.
9. Disclosures Considered but Not Proposed	No change.	We agree with the Board's rationale in all cases.
10. Disclosures in Interim Financial Reports	Eliminate disclosure of net benefit cost by component; instead disclose only material changes in total contribution range, actual contribution, or actual net periodic benefit cost.	Cost of preparation, uncertainty of amount, risk of misleading/confusing investors or employees.
11. Effective Date and Transition	December 15, 2003, if requirements are modified in accordance with our recommendations. Otherwise, fiscal years ending 6 months after publication of the final statement.	Information for recommended approaches is reasonably available as part of current process. Additional information proposed is difficult and costly to gather, particularly on short notice with no opportunity for advance planning.

Issue 1 – Plan Assets

a. Actual allocation percentage.

We support the disclosure of the percentage of the fair value of total plan assets invested in each of four broad asset categories (equity securities, debt securities, real estate, and other assets) as of the date of each statement of financial position presented. This information is reasonably available for most plans and is both relevant and reliable, as we understand those terms in *FASB Concepts Statement No. 2*. Having this information should greatly enhance users' ability to assess the market risk and potential variability of the plans' assets. Preparers should also be encouraged to provide additional narrative discussion in unusual circumstances — for example, when a large portion of the portfolio is temporarily invested in cash due to a substantial contribution immediately before the measurement date or because the plan is in the process of changing investment managers.

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In fact, this information is sufficient to enable knowledgeable users of financial statements to understand a company's investment strategy and market risks and assess the expected long-term rate-of-return assumption.

However, we note that the aggregation of asset pools across plans, currencies, countries, investment strategies, and other circumstances may diminish the representational faithfulness of the aggregate amount.

b. Target allocation percentage, presented on a weighted-average basis.

We do not support the required disclosure of the target allocation percentage (or range of percentages) for each asset category. The proposed disclosures exceed the detail required for other corporate assets held for investment, and represent forward-looking statements about future management decisions, events, and circumstances that may be out of place in a financial reporting context (as described in *FASB Concepts Statement No. 1*)¹. In addition, for many employers, the target allocation ranges on an aggregated basis will be broad and, thus, not meaningful to financial-statement users. The disclosure of the actual allocations at each measurement date is far more meaningful and is sufficient to satisfy the needs of financial-statement users.

c. Expected long-term rate of return, presented on a weighted-average basis.

We do not support the required disclosure of expected long-term rate of return for each asset category. Disclosure of these rates is not meaningful, creates confusion, and raises more questions than it answers. Users with a "reasonable understanding of business and economic activities [who] are willing to study the information with reasonable diligence"² should be able to form their own opinion about the expected return assumption based on the asset allocation provided in part *a.* above. Financial analysts who have an outlook that differs from management's estimate may easily make the appropriate adjustment to the expected return component of pension expense.

¹ Although not included with financial reporting, information about management's intentions and assumptions may be appropriate to include in the Management's Discussion and Analysis. However, we understand this to be beyond the scope of the Exposure Draft.

² *FASB Concepts Statement No. 1*, para. 34.

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While we understand that many users have expressed dissatisfaction with the use of an expected return-on-assets assumption and the delayed recognition of the actual return on assets, the remedy for that complaint is a change in the fundamental accounting model, not a disproportionately expanded disclosure.

In addition, the proposed disclosures illustrated in appendix C of the Exposure Draft bring to light several practical and computational problems that would render the proposed calculation virtually meaningless:

- The weighted-average “building block” approach outlined in the Exposure Draft is only one method of estimating an expected return on assets assumption. In our experience, this method is not used by most large employers. Most companies use portfolio-based approaches, which include both historical and forward-looking methods and take into account the benefits of diversification and rebalancing.

Diversification and rebalancing typically add 30 to 70 basis points to the total portfolio return; the effect increases with the number of different asset categories and when the returns of the various asset categories are less correlated with each other. This effect is illustrated by the following example:

A \$1 million portfolio is invested 50% in equities and 50% in Treasury bonds that yield 4%. On its own, the \$500,000 equity portion returns 100% in the first year, increasing to \$1 million, but loses 50% in the second year, falling back to \$500,000, resulting in a compound average return of 0%. On its own, the Treasury bond portion would increase to \$520,000 at the end of the first year and \$540,800 at the end of the second year, an average of 4% per year. Using the method proposed in the exposure draft, the expected return for the portfolio would be $50\% \times 0\%$ (long-term equity return) + $50\% \times 4\%$ (long-term Treasury return), or 2%.

However, if the sponsor rebalances the \$1,520,000 in assets at the end of the first year to maintain the 50/50 diversification (\$760,000 each in equities and Treasuries), the equity portion of the portfolio at the end of year two would be \$380,000 and the Treasury portion would be \$790,400, for a total of \$1,170,400. The compound average portfolio rate of return over the period would be 8.19%.

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- The buildup of the expected return in the Exposure Draft is applied on an arithmetic (*i.e.*, one-year or short-term) basis. FAS 87 describes the selection of the expected long-term rate of return as follows: “In estimating that rate, appropriate consideration should be given to the returns being earned by the plan assets in the fund and the rates of return expected to be available for reinvestment.” Therefore, we believe that it is more appropriate to base the selection of the expected long-term rate of return on geometric (compound average, multi-year) rates of return.

As illustrated below, arithmetic returns are always higher than compound returns, and the greater the volatility of returns (as measured by the standard deviation), the larger the difference (*i.e.*, arithmetic and compound returns are equal only if there is no volatility). For a typical US common stock portfolio, the difference is about 200 basis points. Because the compound average takes return volatility into account, it is the more appropriate measure.³

Example. A \$1 million portfolio is invested 100% in equities. The portfolio returns 100% in the first year, increasing to \$2 million, but loses 40% in the second year, falling back to \$1.2 million. The simple or arithmetic rate of return for the period would be 30% per year, determined as $\frac{100\% - 40\%}{2 \text{ years}}$.

The compound or geometric return would be 9.5%, determined as

$$\left(\frac{\$1.2 \text{ million}}{\$1 \text{ million}} \right)^{1/2} - 1.$$

Actuaries and the investment community generally expect disclosures of compound rates of return. However, the weighted-average “building block” approach outlined in the Exposure Draft illustrations applies only to simple, or arithmetic, returns. The resulting mismatch between the form of the disclosure

³ The much larger issue is the necessity for choosing, for accounting purposes, a *single* estimate of pension or postretirement benefit cost from amongst a *range* of estimates with varying degrees of probability. Addressing this question would require a change in the fundamental accounting model, and is beyond the scope of a disclosure project. Although providing information on the full probability distribution of potential outcomes might yield interesting information, that information would be available only at substantial cost.

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and user expectations creates the potential for confusing or misleading investors, and does not achieve the objective of providing useful information.

- The portfolio rate of return may also take into account taxes and expenses, which are assessed only at the portfolio level and are not available for individual asset classes.
- Aggregating plans with different currency, investment, and tax characteristics may produce assumptions that are not meaningful to investors, and could mislead them into drawing erroneous conclusions.

d. Range and weighted-average maturity of debt securities.

We do not support the required disclosure of the range and weighted-average period to maturity for all debt securities.

- It does not provide information that is relevant to the question of whether or not trust assets will be sufficient to pay pension benefits. Bond maturities are only one source of funds to pay benefits. Contributions and asset sales also are important — and for some plans, primary — sources of funds to pay benefits.
- It may not be representationally faithful to the pattern of cash flows provided by the bond portion of the portfolio. For example, a 10-year coupon-paying bond and a 10-year zero-coupon bond will have the same maturity, but totally different cash flows and durations.
- It omits creditworthiness, an important aspect of assessing plan risk.
- For companies that have many large diversified trusts in numerous countries, this information may not be readily available from the trustees; compiling this information for all of an employer's plans and calculating the weighted average will increase the cost and effort of preparing the year-end disclosures.

Issue 2 – Defined Benefit Pension Plan Accumulated Benefit Obligation

We support this disclosure. This information is readily available and will help users of financial statements to monitor the funded status of the plans and anticipate changes in minimum liability.

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We note, however, that the disclosure of the accumulated benefit obligation may be somewhat less useful than anticipated, particularly when funded and unfunded plans are aggregated.

Issue 3 – Cash Flow Information

a. Estimated future benefit payments.

We do not support the requirement to disclose a schedule of the estimated future benefit payments included in the determination of the benefit obligation.

- The proposed benefit payment projection does not achieve the stated objective of enabling users to assess the amounts, timing, and pattern of cash flows and how well asset maturities align with benefit payments. Projecting only the portion of expected future benefits that is included in the obligations (PBO/APBO) understates the total cash flows for an ongoing plan. Combining funded and unfunded plans in the disclosure, together with the shortcomings of the bond maturity information discussed above, makes it impossible to draw conclusions about the alignment of asset maturities and benefit payments.
- Disclosure of undiscounted benefit payments after five years would serve only to include meaningless, out-of-context large numbers in the disclosure footnote. Showing large, undiscounted future payments in a footnote that is otherwise focused on present value calculations does not aid anyone's understanding. Even if perfectly accurate, the results would be completely useless.
- As the Board noted in the Exposure Draft, the inclusion of direct payments for unfunded plans significantly dilutes the ability of the user to compare this information with the asset information.
- The required benefit payment projections are not readily available at this time. Most actuarial valuation systems, including ours, determine liabilities by applying annuity factors to projected benefits at assumed retirement or other exit from the active population. (Annuity factors combine, in a single computational step, a discount for interest and a declining pattern of cash flows to reflect the mortality of the plan's population). Unbundling the discount and cash flow components of the annuity factors will require significant time and expense to reprogram valuation systems in order to

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extract the cash flow projection information required by the Exposure Draft. The difficulties with extracting appropriate cash flows are further compounded when benefit obligations as of the measurement date are projected forward from an earlier valuation, as permitted by Q&A 65 of *A Guide to Implementation on Employers' Accounting for Pensions*. If the final statement is effective as proposed, our actuaries will have to perform special additional work for each plan, at substantial additional costs to employers, before our system can be reprogrammed.

For multinational companies, the situation is even worse: projected benefit payment information may be more difficult, costly, and time-consuming to obtain than for US plans.

- Valuation assumptions are currently selected for the purpose of calculating reasonable benefit obligations, not for accurately predicting future cash flows. More refined assumptions regarding retirement rates for both active and terminated participants, the form of payment elected, and other factors that are relevant to the benefit cash flows — but are not relevant to the value of the total obligation because they are actuarially equivalent — will be needed to produce reasonable benefit payment projections. The use of more refined assumptions will materially increase the annual cost to prepare valuations for FAS 87 and 106 purposes.
- For large employers (where one or two individuals are not likely to drive the total), an analyst could reasonably estimate the near-term annual benefit payments from the last two years' actual benefit payments. This information is readily available from the current disclosure at far less cost than the proposed projections. For smaller employers, or those for whom only a few participants each year elect an unlimited lump-sum option, the projected benefit payments will be very unreliable, as the payment stream will be heavily dependent on the timing of actual retirements or lump-sum elections.

b. Expected contributions during the next fiscal year.

We would support the disclosure of expected contributions if the Exposure Draft were modified to permit disclosure of an expected range of total contributions. To the extent that non-cash contributions are known and available, we support their disclosure as well.

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Segregating contributions between “required” and “discretionary” is computationally difficult, depends on an arbitrary distinction between the two, and may even be misleading to users of financial statements.

- It does not make sense that direct payments to participants (which may be required by contract or common law), contributions to non-US plans that are set by trust agreement, and contributions that are required by collective bargaining agreements are treated as “discretionary” rather than “required” contributions. This split would seem to go against one of the central tenets of Statement 87, namely that the accounting for the employer obligation should be independent of the funding mechanism.
- Because of the complexity and flexibility of the ERISA funding rules in the US, an employer may not know until 8½ months into the year whether or not a particular contribution was “required” or “discretionary.” For US qualified pension plans, discretionary contributions made for one plan year (up to 8½ months after the end of the year) can prepay, reduce, or, in some cases, eliminate required contributions for a subsequent year. A plan sponsor has until the end of the 8½ month period to decide whether a particular contribution is discretionary for the prior year or required for the current year. For example:

Two employers maintain identical US calendar-year qualified pension plans covering identical populations with the same benefit obligations, assets, net benefit cost, and expected benefit cash flows. If no additional discretionary contributions were made for 2003, the 2004 ERISA minimum required contribution for each plan would be \$10 million. Both employers expect to contribute \$10 million on September 1, 2004. Because this contribution is made within 8½ months of plan year-end, it may be allocated to either the 2003 plan year or the 2004 plan year.

Employer A allocates the contribution to the 2004 plan year and, in accordance with the proposed statement, discloses that “the entire \$10 million expected to be contributed to the pension plans during 2004 is estimated to be needed to satisfy minimum funding requirements.”

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Employer B allocates the contribution to the 2003 plan year, prepaying and reducing the 2004 minimum required contribution to \$0. In accordance with the proposed statement, Employer B discloses that, “of the \$10 million expected to be contributed to the pension plans during 2004, the entire contribution is discretionary, as the plans’ ERISA minimum funding requirement is \$0.”

In even more extreme cases, the year to which an employer decides — after the fact — to allocate a contribution can actually affect the total *amount* of contribution required during the fiscal year (whether required or discretionary).

Users of Employer A’s and Employer B’s financial statements would be likely to draw different, and therefore erroneous, conclusions about future cash flows between these two plan sponsors and their plans.

- A range of contributions appropriately conveys the uncertainty of the contribution decision. For example, in cases where the employer wishes to maintain a fully funded accumulated benefit obligation (ABO) to avoid an additional minimum liability, a contribution amount might not be known until late in the fiscal year, limiting the usefulness of advance disclosure.
- Although it does not provide information about timing, we note that the unfunded benefit obligation is the present value of cash required to fund the accrued benefits of the plan. We would expect that a financial analyst who was trying to ascertain the present value of future cash flows of an enterprise would take this into account in his or her valuation.

Issue 4 – Assumptions

We agree that separately identifying the key assumptions used to measure the benefit obligation and the key assumptions used to measure net benefit cost will help to avoid confusion. We recommend that the final statement provide additional guidance about the appropriate disclosures to be made when assumptions used to measure net benefit cost are changed during the year. This occurs whenever mid-year remeasurements are required — for example, because of a curtailment or significant plan amendment.

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Issue 5 – Nonpublic Entities

We have no comment regarding this issue. We note, however, that in practice there does not seem to be a great deal of difference between what is required for a non-public company and what is required for a public company. In our experience, auditors generally ask us to prepare the full public company material as supporting documentation, regardless of what is included in the final disclosure.

Issue 6 – Sensitivity Information about Changes in Certain Assumptions

We agree that additional disclosure of sensitivity information about hypothetical changes in certain assumptions should not be required. Providing sensitivity information would substantially increase the cost to prepare year-end disclosures. The limited value of this information does not justify incurring the additional cost to provide it.

Issue 7 – Measurement Date(s)

Disclosure of the measurement date should be required annually in all cases, and the requirement to disclose “significant” economic events or changes in economic conditions between the measurement date and fiscal year-end should be eliminated. For any measurement, the “as of” date is an integral part of the measurement; its disclosure allows users to form their own opinions about reasonableness and subsequent economic events. For companies that have multiple measurement dates, we would support a table indicating the total benefit obligations and assets associated with each measurement date.

As currently proposed, the requirement to evaluate whether or not a significant economic event has occurred between measurement date and fiscal year-end needlessly adds cost and delay to completing the year-end disclosures. Additional work would be required every year to identify potential economic events or changes occurring between the measurement date and fiscal year-end and determine whether they are significant. Although the *Frequently Asked Questions* on the proposed statement indicate that the effect of the economic event or change is not required to be quantified in the disclosure, in practice we believe the effect generally will need to be quantified to support the determination of whether or not it is significant.

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Issue 8 – Reconciliations of Beginning and Ending Balances of Plan Assets and Benefit Obligations

The existing reconciliations as required by Statement 132 should be retained. They provide useful information that helps meet the disclosure objectives, they are easy to read and interpret, they provide a complete picture of the operation of the plan, and eliminating them would not reduce costs. From our perspective, we expect that auditors will continue to require the reconciliations as backup for the year-end disclosure.

There is some ambiguity as to whether some disclosures apply to the measurement date or to the fiscal year-end. Therefore, the proposed standard should state that continued disclosure of this reconciliation (from measurement date to measurement date) will satisfy the requirement to disclose benefit payments and contributions for the prior two years.

Issue 9 – Disclosures Considered but Not Proposed

We agree that disclosure of the various items listed under issue 9 should not be required.

a. and b. Description of investment policies; basis for selecting long-term return.

As noted above, both these items are forward-looking items within management's discretion that would not typically be disclosed for other parts of an enterprise's operations.

c. through j. Obligations on alternative bases; allocation of net periodic cost by income statement line item; counts and benefit obligations by participant group; duration; interim disclosure of assets and obligations; multiemployer plans.

We agree with the Board's rationale and conclusions for excluding these items.

Issue 10 – Disclosures in Interim Financial Reports

We do not support the proposed disclosures of net periodic benefit cost by component in interim financial reports. The proposed disclosure would provide disproportionately more detail about a single expense line item than about any other aspect of an enterprise's operations. However, we would support interim disclosure of any **material change** in total net periodic benefit cost, the range of total expected contributions, or actual contribution amounts. We also support interim reporting of material changes in the aggregate amount or description of noncash contributions. As

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stated above, segregating contributions between “required” and “discretionary” is arbitrary and potentially misleading, and should be eliminated.

We are also concerned that reporting other than a range of contributions before those contributions are actually made would needlessly alarm either investors or employees. For example, if a company’s policy were to fund the accumulated benefit obligation to avoid an additional minimum liability, the disclosed amount of funding could go up or down each quarter by significant amounts depending on very small changes in the discount rate. Of course, the final amount would not be determined until the measurement date, and could be vastly different from any of the disclosed amounts. Employees could become unduly concerned if an “expected” contribution in one quarter vanished in the next quarter; conversely, investors and creditors might become needlessly alarmed if a small contribution in one quarter ballooned to a large one the next.

For example, recently we have seen several employers’ “expected” contributions vary between zero and several hundreds of millions of dollars in the space of only a few weeks.

We also note that a financial analyst could easily form an opinion about likely plan funding if he or she were armed with the measurement date and the actual allocation of plan assets.

Issue 11 – Effective Date and Transition

If the Exposure Draft were modified as discussed above, we would support the effective date and transition plan as outlined.

However, in its current state, the proposed effective date – fiscal years ending after December 15, 2003 — is much too aggressive. It is particularly so for businesses that are already under pressure to meet the SEC’s accelerated 10-K filing deadline, which is also first effective for fiscal years ending after December 15, 2003. It is also too aggressive for multinational employers, which must collect information from multiple sources in many countries. Actuaries around the world will need time to become familiar with the new standards and gather the newly required information. To enable employers to arrange for the collection and compilation of the new

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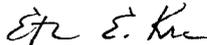
information, a minimum of three months is needed between the publication of the final statement and the earliest measurement date for which it could be effective. Because the measurement date may be as early as three months before fiscal year-end, the statement should be effective no earlier than fiscal years ending six months after the date the final statement is published.

We very much appreciate the opportunity to provide comments and look forward to a continuing dialogue on the issues.

Sincerely,



Asghar Alam, FSA, MAAA, EA
US Retirement Practice Leader



Ethan E. Kra, FSA, MAAA, EA
Chief Actuary, Retirement