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Director of Technical Application and
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Financial Accounting Standards Board
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Dear Board Members:

The purpose of this letter is to comment on the Exposure Draft entitled, "Employers' Disclosures about Pensions and Other Postretirement Benefits — an amendment of FASB Statements No. 87, 88, and 106 and a replacement of FASB Statement No. 132." I have conducted research on pensions and other retiree benefits for more than fifteen years, and I have research in progress that relates directly to some of the issues identified in the Exposure Draft (ED). My comments deal primarily with the non-disclosure of market-related values and the elimination of the reconciliations of beginning to ending balances of plan assets and benefit obligation.

Market-related value

Par. A4 of the ED states that one aim of the ED is to improve information about net benefit costs. Consequently, the ED calls for considerable information about a firm's rate of return assumption. However, little attention is given to the asset amount multiplied by the rate of return assumption. SFAS No. 87 par. 30 and SFAS No. 106 par. 32 allow the expected return to be computed with a market-related value instead of the fair value of plan assets. Depending on the magnitude of investment returns, the use of market-related values can distort the expected return as much as assuming an unreasonable rate of return.

Two other University of Notre Dame professors (Paquita Davis-Friday and Jeffrey Miller) and I have been examining data from 1998 to 2001 for approximately 220 U.S. firms with the largest defined benefit pension or postretirement benefit plans. I describe briefly some of our findings regarding market-related values in the next few paragraphs.

We compute the market-related value used for computing expected return by dividing the reported expected return by the rate of return assumption. We then compute the *adjusted fair value* of plan assets by adjusting the beginning fair value of pension assets for contributions, benefits paid, divestitures, acquisitions, and settlements. Because of the substantial increase in the stock market from 1995 to 1999, we expect that the adjusted fair values will exceed market-related values computed with three to five-year moving averages.

To examine the effects of using moving averages on the calculation of expected return, we evaluate a subsample of firms where the average adjusted fair value to market-related value ratio exceeds 1.1 from 1998 to 2000. In constructing this sample, we eliminate firms with acquisitions, divestitures, or settlements representing more than 25% of beginning plan assets. We also require the firms to have complete data for all four years. These procedures yield a sample of 54 firms, or approximately 30 percent of the firms with complete data. We then compute a new after-tax expected return using each firm's rate of return assumption and the adjusted fair value instead of the market-related value. The following table presents

descriptive statistics by year for the reported expected return per share and the percentage difference in expected return from using the adjusted fair value instead of the market-related value (moving average).

Year	Reported After-tax Expected Return per Share Mean (5 th , 50 th , and 95 th percentiles)	Difference from Using Adjusted Fair Value (as a % of Reported Expected Return) Mean (5 th , 50 th , and 95 th percentiles)
1998	0.85 (0.08, 0.53, 2.58)	17.2% (6.2%, 16.1%, 33.0%)
1999	0.92 (0.06, 0.56, 2.75)	13.8% (1.8%, 13.9%, 27.5%)
2000	0.96 (0.06, 0.52, 2.75)	15.0% (4.4%, 15.2%, 25.4%)
2001	0.99 (0.06, 0.56, 2.86)	5.8% (-1.0%, 5.1%, 14.8%)

The above table shows that the expected return can be a substantial component of earnings per share for most of the subsample. For each year, the median after-tax expected return exceeds \$0.50 per share and the 95th percentile exceeds \$2.50. The median increases in expected returns from using adjusted fair values instead of market-related values were 16.1% in 1998, 13.9% in 1999, 15.2% in 2000, and 5.8% in 2001. The 95th percentiles exceed 25% from 1998 to 2000 and 14% in 2001. The effect of using moving averages diminishes in 2001 because of the stock market declines in 2000. One might argue that the moving averages would be preferred in 1998 through 2000 because they result in more conservative expected returns. However, with the continued decline in the stock market in 2001 and 2002, market-related values could exceed adjusted fair values, thereby leading to higher instead of lower earnings.

The analysis shows that the use a market-related value can affect expected return calculations as much as altering the rate of return assumption by one to three percent. However, the ED addresses only the rate of return assumption. Under the ED disclosures, investors may be able to identify the firms using market-related values, but it will be difficult for them to predict expected returns for subsequent periods because firms use a variety of methods to compute market-related values. Few firms disclose their market-related values or their computational methods. For these reasons, I encourage the Board to consider requiring firms to disclose the market-related value amount used for expected value calculations and a description of the specific averaging method.

Reconciliations of Beginning and Ending Plan Assets and Obligations

I agree with the three dissenting Board members who believe that the reconciliations of beginning and ending balances of plan assets and benefit obligation should be retained. The proponents of eliminating the reconciliations state that most of the information is provided elsewhere and that "a more focused approach would be more useful to users of financial statements" (par. A33). However, I cannot find the logic for this conclusion in the ED. Under the ED, instead of being in one schedule, the amounts of employer contributions, employee contributions, benefits paid, and actual return are spread throughout the footnote. This form of disclosure unduly increases the length of the disclosure and may actually increase the investor's search time.

Further, under the ED, disclosures about amendments, combinations, divestitures, and other nonroutine events are required only when the events are significant (par. 5). Without the reconciliation requirement, I believe that firms will not report adequately these events, and consequently, investors will not understand how plans changed during the year. The basis for conclusions of SFAS No. 132 (par. 31) implies that under SFAS No. 87 and SFAS No. 106, disclosures about significant events affecting comparability were incomplete. I believe that the ED will take us back to an environment of incomplete reporting.

In our research on market-related values (described above), we collected information on acquisitions, divestitures, curtailments, settlements, and other items affecting comparability. The number of firms used in the analysis was 221 in 1998, 229 in 1999, 219 in 2000, and 212 in 2001. Acquisitions and divestitures are common and can be material. For 1998, 1999, 2000, and 2001, respectively, 66, 61, 70, and 53 of the sample firms disclosed acquisitions or divestitures. The median effect as a percentage of beginning plan assets was 0.8 percent. The 5th, 25th, 75th, and 95th percentiles were -13.0

percent, -1.0 percent, 4.8 percent, and 46.8 percent, respectively. Curtailments and settlements are less common but can still be material. For 1998, 1999, 2000, and 2001, respectively, 24, 21, 26, and 20 of these firms disclosed settlements or curtailments. The median effect as a percentage of beginning plan assets was -0.7 percent. The 5th, 25th, 75th, and 95th percentiles were -15.0 percent, -3.0 percent, -0.3 percent, and -0.1 percent, respectively.

Given the current guidance regarding disclosure materiality, I am pessimistic about the number of the above events that would be reported adequately under the ED. This belief is influenced by prior research where I found evidence that some firms with material retiree medical plans did not report pay-as-you-go cost under SFAS No. 81 (see "Materiality Judgments and Disclosure of Retiree Health Care Costs Under SFAS No. 81," *Review of Accounting Studies* 7, December, 2002: 405-434, with C. Liu).

In summary of this issue, I do not believe that the Board has given adequate justification for eliminating the reconciliations of beginning to ending balances of plan assets and benefit obligation. Further, I present evidence that shows that acquisitions and divestitures are common and that acquisitions, divestitures, settlements, and curtailments can be material. Therefore, I urge the Board to retain the SFAS No. 132 requirement to present reconciliations of beginning to ending balances of plan assets and benefit obligation.

Conclusion

Thank you for the opportunity to comment on the ED. I believe that the reporting of retiree benefits is a very important issue, and I commend the Board for attempting to improve retirement plan disclosure. I have limited my comments to areas where research can provide additional insights. I encourage the Board to require disclosure of market-related value amounts and computational methods and to retain the SFAS No. 132 requirement to present reconciliations of beginning to ending balances of plan assets and benefit obligation. If you would like to discuss these issues further, please do not hesitate to write or telephone.

Sincerely,

H. Fred Mittelstaedt