PENSION PLAN BOOKKEEPING METHODS

HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE FRINGE BENEFITS

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-FIFTH CONGRESS

SECOND SESSION

ON

S. 2992

A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE UNIFORM ACCOUNTING OF PENSION LIABILITIES OF TAX-EXEMPT PENSION FUNDS

JUNE 14, 1978

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PENSION PLAN BOOKKEEPING METHODS

WEDNESDAY, JUNE 14, 1978

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE PENSION PLANS AND EMPLOYEE
FRINGE BENEFITS OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m. in room 2221, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senators Bentsen, Curtis, and Packwood.

[The committee press release announcing this hearing and the bill S. 2992 follow:]

[Committee on Finance—Press Release]

SENATOR BENTSEN ANNOUNCES HEARING ON PENSION PLAN BOOKKEEPING METHODS—SAYS LIABILITIES UNDERSTATED FOR MANY PLANS

Senator Lloyd Bentsen (D.-Tex.), Chairman of the Finance Subcommittee on Private Pension Plans, announced Tuesday that hearings have been scheduled for Wednesday, June 14, 1978, into bookkeeping methods that may not reflect the true condition of pension plans.

The hearings will be held in Room 2221 Dirksen Senate Office Building and will begin at 10 A.M.

Witnesses will include spokesmen for the Treasury and Labor Departments, pension actuaries and pension consultants.

"Some observers report that a potentially disastrous pension situation is developing with regard to unfunded liabilities—those pension benefits owed by a company that it hasn't set aside assets to pay for," Bentsen said.

"It is a matter of concern that, because of the differing accounting procedures that can be used, the size of these unfunded liabilities may be greatly understated."

According to one recent published account, Senator Bentsen said, corporations themselves report that unfunded liabilities for their pension plans now exceed $50 billion. However, the article concluded that the liabilities might actually amount to several hundred billion dollars.

He noted that Caterpillar Tractor, for example, negotiated a pension increase with the United Auto Workers in 1976 but, using generally accepted accounting procedures, reported a decrease in unfunded liabilities from $440 million to $270 million.

"Pension plans for government workers are the prime offenders and the Federal Government is at the top of the list," Bentsen said.

"The Civil Service system reports unfunded liabilities for its pension plan of $107 billion but admits that the true liabilities are more than twice as big as that."

"During these hearings, we will take a look at the advisability of setting standard accounting procedures for pension plans, both public and private. As things now stand, one plan's assets may be another's liabilities and we can't have that," Senator Bentsen said.

The Subcommittee will receive comments on the following accounting and actuarial issues which relate to the safety of pension benefits for senior citizens:

1. What methods should be used to determine the amount of pension expense to be charged to the operations of the sponsoring employer for each accounting period? Are different methods needed for multiemployer plans?

2. Should the unfunded liability of a pension plan be shown as a liability on the balance sheet of the sponsoring employer?

3. How should plan assets be valued? Should they be valued at market, acquisition cost, or some basis in between these two values?

4. For purposes of symmetry or for some other reason, should pension costs and liabilities be computed on the same basis for the pension plan and for the sponsoring employer's corporate statement?

5. How to insure that actuarial assumptions are not manipulated to the detriment of plan participants and retirees?

6. Do these or similar accounting and actuarial problems exist with respect to public retirement systems?

Legislative Reorganization Act.—Senator Bentsen stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

1. A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

2. All witnesses must include with their written statement a summary of the principal points included in the statement.

3. The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

4. Witnesses are not to read their written statements to the Committee, but are to confine their fifteen minute oral presentations to a summary of the points included in the statement.

5. No more than 15 minutes will be allowed for oral presentations.

Written testimony.—Senator Bentsen stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by July 14, 1978, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

95TH CONGRESS
2D SESSION

S. 2992

IN THE SENATE OF THE UNITED STATES

APRIL 26 (legislative day, APRIL 24), 1978

MR. BENTSEN introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amend the Internal Revenue Code of 1954 to provide uniform accounting of pension liabilities of tax-exempt pension funds.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That section 412 of the Internal Revenue Code of 1954 is
4 amended by adding the following new subsection (j):
5 "(j) UNIFORM ACCOUNTING.—Within 90 days of
6 the date of enactment of this subsection, the Secretary shall
7 promulgate uniform standards for calculating and reporting
8 the assets and liabilities of pension plans and for disclosing
9 the actuarial assumptions used in such calculations.".

Senator BENTSEN. This hearing will come to order. May we have quiet in the back of the room, please?

This morning, the Pension Subcommittee of the Finance Committee of the Senate is holding hearings on the adequacy of funding pension plans and, in particular, on the adequacy of accounting and actuarial methods that are currently being used. Several aspects of this issue were brought to public attention, and to my personal attention, when I read last November an excellent article in Fortune magazine which, in turn, was applauded by the New York Times in an editorial.

The purpose of this hearing is to determine the extent of the problem and to develop appropriate remedies.

First, it was reported that a potentially disastrous pension situation was developing with regard to unfunded liabilities, those pension benefits owed by a company that it has not set aside the assets to pay for. It is a matter of concern that, because of differing accounting procedures that can be used, the size of these unfunded liabilities may be greatly understated.

According to Fortune magazine, corporations themselves report that unfunded liabilities for their pension plans now exceed $54 billion. However, the article concluded that the liabilities might actually amount to several hundred billion dollars.

Second, the potential for manipulation of actuarial assumptions must be prevented to protect plan participants and senior citizens across the Nation.

Caterpillar Tractor, for example, negotiated a pension increase with United Auto Workers in 1976, but reported a decrease in unfunded liabilities from $440 million to $270 million.

One of the problems that you run into in labor management negotiations is that management can decide, well, we are going to cut down the contributions to the funding of the pension fund by changing the actuarial assumptions. So they bring in the actuary and they say, we are going to get a bigger return on these assets. So we are going to forecast a higher return and therefore we have to spend less to fund. And, in turn, we do not affect the profits of the company. What they do not say is that that increased funding will be needed down the road someplace. The current management and the current labor negotiators will not have to face that decision. It will be somebody else that has replaced them in future years.

Third, the presentation of actuarial and accounting information is often so confusing that the information is almost worthless. There is so much latitude in the way that pension calculations are performed that the companies can come up with virtually any level of contributions and liabilities that they choose. There is an abundance of misleading pension data, and Congress recently learned this the hard way.

When ERISA was formulated in 1973 and 1974, we were assured that the prospects for financial failure of the multiemployer pension plans were virtually nonexistent. In fact, they said we ought to cut the contributions down substantially, they were so safe.

However, we learned last fall that the PBGC was faced with the prospects of a multibillion dollar liability. PBGC was about to go bankrupt because the multiemployer plans, the ones we were told were so sound, had enormous liabilities. And this situation now threatens the entire ERISA termination insurance program.

It is essential that this kind of misinformation be eliminated.

During these hearings we will look at the advisability of setting standard accounting procedures for pension plans, both public and private. I recently introduced S. 2992, and that would direct the Secretary of the Treasury to promote uniform standards for reporting and calculating the assets and liabilities of pension plans, and for disclosing the actuarial assumptions used in such calculations.

This hearing will also look at the actuarial and accounting problems with respect to State and local plans. The House pension task force recently prepared an extensive report on public plans. The task force concluded that "there is a compelling need for uniform actuarial measures, terminology and standards to enable plan participants,

plan sponsors and taxpayers to assess the present funding status and future funding needs of their system."

Today, pension plans receive several billion dollars of tax benefits from Congress each year. Investment earnings of most plans are tax-exempt. Employer contributions are tax deductible.

Pension contributions are not taxable to employees currently. Qualified plans receive special estate tax and lump sum distribution treatment.

I think it is the responsibility of the tax committees of the Congress to insure that these billions of dollars of annual tax incentives are not abused to the detriment of pension plan participants and their beneficiaries. Money in these plans belongs to the participants and to the beneficiaries and to no one else.

In response to the Fortune magazine article, the Labor Department began a thorough review of these problems in coordination with the accounting and actuarial professions, and I certainly commend Mr. Lanoff and Mr. Woodruff of the Labor Department for their constructive efforts to formulate a solution to these problems.

I urge the private sector to cooperate with the Labor Department and the Treasury Department on this matter. I am very pleased that the pension officials of the Labor Department are going to be our first witnesses this morning.

Senator Curtis?

Senator CURTIS. I have no statement to make. I concur with what the chairman said.

Senator BENTSEN. At this point in the hearing record I will insert a copy of the November 1977 Fortune article as well as a New York Times editorial and article.

[The material referred to follows:]

[From Fortune, November 1977]

THOSE PENSION PLANS ARE EVEN WEAKER THAN YOU THINK

(By A. F. Ehrbar)

MANAGERS AND ACTUARIES ARE VASTLY UNDERESTIMATING THE COSTS OF RETIREMENT BENEFITS. WHEN COMPANIES FINALLY HAVE TO PAY THE BILLS, THERE MAY NOT BE MUCH LEFT OVER FOR STOCKHOLDERS

Fans of "*Pumping Iron*" will surely recognize that fellow flexing his muscles on the opposite page. Rather than pumping iron himself, though, our Mr. Pension Fund has been pumped up with a lot of hot air. His condition, leaks and all, does not grotesquely exaggerate the condition of the private pension system in the U.S. today. The figure discloses in the footnotes to annual reports make most pension plans look considerably more robust than they actually are.

The most obvious measure of a pension plan's strength is the degree to which assets have been set aside to cover retirement benefits. "Unfunded liabilities," as uncovered benefits are called, have been growing apace, and now exceed $50 billion, according to corporations' own reported figures. To be sure, corporate America could pile up that much money by funneling off pretax profits for four or five months. But the bulk of the unfunded liabilities are concentrated among a relative handful of companies that would be hard pressed to pay them off in a few years, let alone months.

There is reason to believe, moreover, that the reported figures are ridiculously understated. Unfunded liabilities might actually come to several hundred billion dollars. If that is true, even the "fully funded" strong men of the pension world may turn out to be ninety-seven-pound weaklings.

In a few extreme cases, employees' pension claims against a company have grown nearly as large as the total assets employed in the business. Lockheed's obligations, for instance, are so great that the company might be thought of as

a pension plan that happens to make some missiles and aircraft on the side. At the end of last year, Lockheed reported total liabilities for vested pension benefits of $1.3 billion, an amount equal to 82 percent of the assets used in the business. The unfunded portion of those liabilities alone came to $276 million—66 percent more than the company's net worth and 46 percent more than the market value of its stock.

Dozens of other corporations aren't in much better shape when it comes to unfunded liabilities. Ten of the top 100 companies in the Fortune 500 have unfunded vested liabilities equal to a third or more of their net worth. In seven of those cases, these uncovered pension claims exceed the value of the companies' stock (for the companies, see page 107). The winner in the unfunded-liabilities derby, however, has to be Wheeling-Pittsburgh Steel, No. 243 on the Fortune 500. Wheeling's unfunded vested liabilities of $274 million come to more than seven times its recent stock-market value.

WHO BETTER WATCH OUT

The immediate question that comes to mind about these tremendous unfunded liabilities is whether retiring employees will get their pensions. Actually, the employees have little to fear. The pension laws, as tightened up by the Employee Retirement Income Security Act of 1974 (ERISA), have effectively lifted the risk from the employees' backs. ERISA requires all companies with defined-benefit pension plans to pick up the tab if one of their number defaults. (Defined-benefit plans—which make up the vast majority of all plans—specify the dollar-amounts employees will receive; the other variety, defined-contribution plans, promises only that the company will put a certain amount into a pension fund each year.)

Now it is the shareholders who had better watch out. From their point of view, the disquieting question is whether the companies whose pension funds are deeply in arrears will be able to pay off their obligations and still have much of anything left over for profits. All those past, uncovered pension claims, after all, must be met out of funds that would otherwise flow down to the bottom line. The unfunded liabilities of some companies are so large—and rising so rapidly—that they will inevitably put a drag on profits like lead in a racehorse's saddlebags. Wheeling-Pittsburgh, for instance, has amassed unfunded liabilities totaling eight times its average pretax profits over the last three years. Uniroyal's unfunded liabilities come to the equivalent of 12 years of profits, and Chrysler's to a staggering 27 years.

Even in this era of all-pervasive regulation and strict disclosure requirements, there is ordinarily no way for an investor to get a decent line on the pension-fund risks and unfunded liabilities he's buying into. The accounting and actuarial treatment of pension liabilities is a masterpiece of obfuscation. There is so much latitude in the way pension calculations are performed that companies can come up with virtually any level of contributions and liabilities they choose. Various actuarial methods, all of them legitimate, produce wildly divergent results, as the chart illustrates. And no matter which actuarial method is used, seemingly minor variations in the company's assumptions about the growth of wages and the return on pension-fund investments can yield substantially different costs and unfunded liabilities.

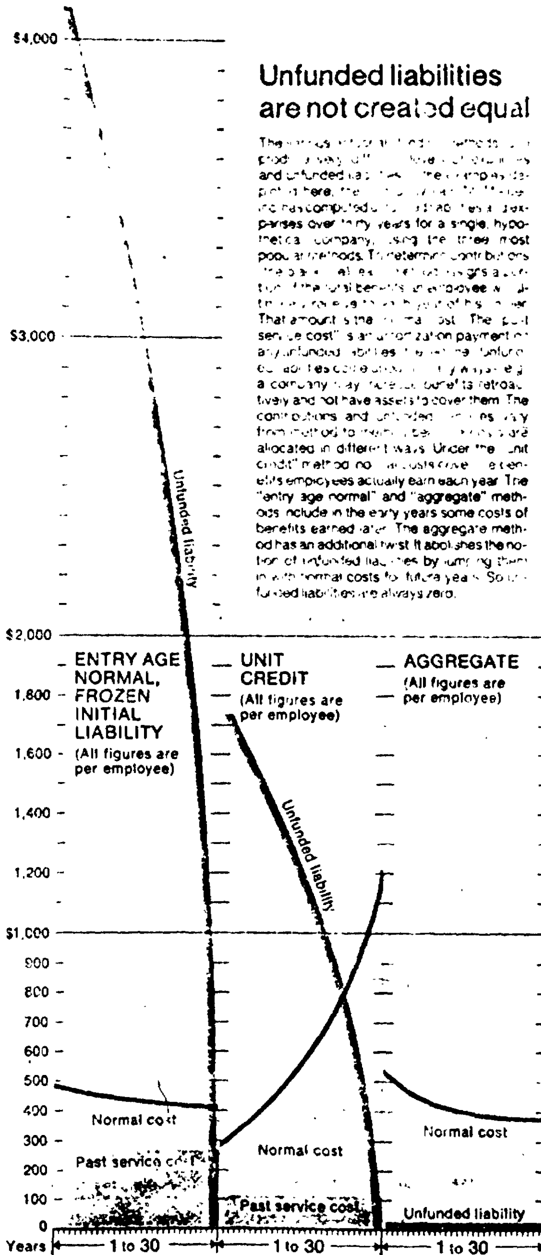
When it comes to comparing one company with another, the only pension figure universally available on a vaguely comparable basis is "unfunded vested benefits." (In fact, for many companies, this is the only figure available.) Vested benefits are those a company would have to pay employees if its pension plan were terminated immediately. They are always smaller than total liabilities, because they include no allowance for the higher future salaries on which benefits ultimately will be paid, or for benefits that will be paid to current employees who will become vested.

That they are "vaguely comparable" is the best that can be said for unfunded vested benefits. All companies use essentially the same actuarial method to compute them, but minor differences in assumptions can throw the figures off by astonishing amounts. Unfortunately, few companies routinely disclose the assumptions they use.

THE "THREE-MARTINI" EFFECT

Nor do many companies disclose anything about the full dimensions of their pension plans—the total assets and liabilities—even though these data are critical in assessing the massive, but largely unrecognized, component of leverage that pensions have added to corporate financial structures. All the gains and losses on

pension-fund portfolios untimately affect profits by raising or lowering future pension contributions. For some companies, the pension fund's performance is actually more important to shareholders than operating results. Swings in Lockheed's $1.04-billion pension fund, for example, usually exceed operating profits or losses. And in years of great stock-market fluctuations, the returns on A.T. & T.'s $17-billion pension fund could conceivably double or wipe out even that company's reported profits.



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What figures are reported show that pension expenses have been exploding. During the Seventies, annual corporate contributions to pension funds have bounded upward at a rate of 15 percent a year, while funds available for contributions (i.e., profits before taxes and pension expenses) have risen less than 7 percent a year. Even this torrid rate of spending hasn't kept pace with the need. It seems remarkable in our statistics-crazed age that no one has compiled precise aggregate data on either total or unfunded liabilities. But the few samplings of reported pension figures all show a widening gap between pension liabilities and assets.

The liabilities have been bloated by what might be called the "linebacker effect" and the "three-martini effect." Most employees earn benefits based on their incomes in the years immediately before retirement. So inflation in wages creeps up on a pension plan like that infamous third martini. And companies also increase retirement benefits, most often retroactively. The new liabilities created by such an increase can suddenly hit the pension fund with the jolt of Dick Butkus chopping down a running back.

In the investment climate of the Seventies, pension portfolios have been unable to keep up with the huge growth of liabilities. Unfunded liabilities naturally increased during 1973–74, when momentous stock-market losses pared the value of pension-fund assets. But, incredible as it may seem, unfunded liabilities had climbed even higher by the end of last year. Wage inflation was so great, and benefit increases so munificent, that they more than offset the boost pension funds got from the best two-year stock-market rally since the mid-Fifties. With stocks down again, pension funds are certain to be deeper in the red at the end of this year.

THEY LOOK CONSERVATIVE BUT . . .

Getting a focus on just how large a drag pension costs will put on future profits requires a look beyond the reported numbers and into the arcane realm of the actuary. At first blush, it would appear that actuaries have been conservatively overstating costs and liabilities, and that the future burden will not be as bad as it looks. Using one of six "funding methods," actuaries spread pension costs over a period of years. Most of the methods distribute the cost fairly evenly, often as a constant amount each year or as a constant percentage of payroll. This approach tends to be conservative, for pension costs do not really follow a smooth pattern. They start low and increase during an employee's career, both in dollar terms and as a percentage of compensation. The methods that smooth out the costs increase pension contributions in the early years and lighten the burden later on.

10 WEAKLINGS AT THE TOP OF AMERICAN INDUSTRY[1]

Fortune 500 rank	Unfunded vested benefits (millions)	Recent market value of common stock (millions)	Pension-fund assets (millions)	Unfunded vested benefits as a percentage of net worth	Unfunded vested benefits per employee
10—Chrysler	$1,095	$965	$1,354	39	$4,472
22—Westinghouse Electric	751	1,530	1,163	35	4,666
27—International Harvester	676	772	751	43	9,243
33—Bethlehem Steel	1,284	813	1,119	48	12,229
39—LTV	447	92	631	108	7,870
61—Lockheed Aircraft	276	189	1,042	166	5,009
76—National Steel	468	599	413	37	12,945
86—Republic Steel	497	364	530	38	12,553
94—American Motors	185	121	171	59	5,922
95—Uniroyal	560	226	200	89	10,367

[1] Sizing up a company's unfunded liabilities can be a tricky matter. When their unfunded vested liabilities are examined as a proportion of net worth, these corporations are the 10 worst among the top 100 companies on the Fortune 500. They are in trouble no matter how you look at them, but concentrating on just 1 measure can be somewhat misleading. Lockheed, for instance, appears to be the worst off, with unfunded liabilities exceeding net worth by 66 percent. But if a rise in the stock market increased the value of Lockheed's pension assets 27 percent, it would wipe out unfunded vested benefits. Uniroyal's assets, in contrast, would have to nearly quadruple to erase unfunded liabilities. In addition, the interest rates used to discount liabilities affect appearances. If Lockheed were to raise its 5.5 percent interest assumption to the 7 percent that Bethlehem uses, its total vested liabilities would probably drop to less than its pension assets, and Lockheed would become "fully funded." (Figures for unfunded liabilities and assets are the latest available, in most cases as of Dec. 31, 1976.)

Unfortunately, this actuarial conservatism is vitiated by a couple of crucial assumptions that corporate managers and their actuaries make about what will happen in the future. The two most critical assumptions concern the rate of return at which pension-fund assets will be invested (the "interest assumption") and the rate at which wages will grow (the "wage assumption").

Obviously, if the interest assumption is overly optimistic, a company won't put up enough money to cover benefits. And since corporations also use the assumption to discount those benefits back to a present value, a high rate will tend to understate pension liabilities. The wage assumption is important because most companies operate plans that scale retirement benefits to the worker's income in later years. If a company underestimates the growth of wages, its contributions will also fall short of what will be needed.

As it turns out, the assumptions made about interest and wages are so far out of line with reality that most companies contribute too little to cover future benefits. Even small errors in the interest and wage assumptions have a powerful effect on the actuaries' calculations. One pension specialist, Professor Howard E. Winklevoss of the Wharton School, says an increase of 1 percentage point in the interest assumption will, on average, reduce pension expenses and liabilities by 25 percent. And a reduction of one percentage point in the wage assumption, he says, will cut expenses and liabilities by 13 percent or so.

Superficially, most companies' interest assumptions would appear to be quite conservative. The average interest rate used is only 6 to 6.5 percent (they range as high as 10 percent and as low as 3.5 percent). At a time when 30-year government bonds pay more than 7.5 percent, a 6-percent assumption would seem to be pretty modest. However, the interest assumptions are being pitted against wage assumptions of only 3.5 to 4 percent. That is, companies are increasing future wages at, say, 3.5 percent to estimate the costs of benefits, and then discounting the costs back at 6 percent to arrive at a present value of liabilities.

The question of the proper wage and interest assumptions is a matter of some contention, and it is complicated by the uncertain impact inflation will have on both wages and investment returns. But a strong case can be made that the wage assumption should be higher than the interest assumption, not lower, as is now the case.

The best way to understand this is to strip inflation out of the figures and look at the relationship between "real" wage increases and "real" rates of interest. The wage assumption, first of all, should include an allowance for the longrun real increase in wages for the work force as a whole. Average weekly wages in manufacturing have increased at a real rate of 1.5 percent over the last 30 years. In addition, some allowance should be made for the "merit" raises that individual workers get as they move through their careers. Winklevoss estimates that, in real terms, merit increases average 1 percent to 2 percent a year. Adding the two, we come up with a real wage increase of 2.5 to 3.5 percent a year.

THE IMPORTANCE OF THE "RISKLESS" RATE

The interest assumption, on the other hand, should be the "riskless" rate of interest—i.e., the rate that would be earned on an investment that carries no possibility of default. The riskless rate—rather than the expected return on risky pension-fund assets—is appropriate for computing the present value of liabilities because the obligations must be paid if the company remains in business.

Until very recently, it has generally been assumed that the real riskless rate is about 3 percent, which would suggest that the interest and wage assumptions should be about equal. However, several recent studies have produced startling evidence that the riskless rate actually is at most 1 percent. The real rate of return on government securities over the last fifty years has been only 1 percent, and the rate has actually been negative since the end of World War II.

If this thinking is correct—and it seems clearly to be the best available—wage assumptions should exceed interest assumptions by at least 1.5 to 2.5 percentage points. But, as we have seen, companies now use wage assumptions that fall short of interest assumptions by an average of 2.5 percentage points (an interest assumption of 6 percent versus a wage assumption of 3.5 percent). The swing of four or five percentage points between the way companies now run their calculations and the way they should run them has a fantastic impact on estimated

pension liabilities. Using Winklevoss's rule of thumb, the adoption of proper interest and wage assumptions would nearly double reported corporate pension liabilities and expenses.

It is difficult to sort out the countervailing effects of the understatement caused by improper assumptions and the overstatement caused by the use of conservative actuarial methods. It appears, though, that actual pension expenses and liabilities should be, on balance, about 50 percent higher than the figures now being reported. Unfunded liabilities are understated by an even greater amount. For example, a company that now estimates it has $100 million in liabilities and $80 million of pension-fund assets would report unfunded liabilities of $20 million. If actual liabilities were $150 million (an increase of 50 percent), unfunded liabilities would come to $70 million (an increase of 250 percent).

The practice of using interest assumptions that are higher than wage assumptions is commonly defended on the grounds that long-run returns on pension funds are likely to exceed long-run wage inflation, since the average fund has 65 percent of its assets in common stocks. That logic has been roundly criticized by several financial economists, including Professor William Sharpe of Stanford and Jack Treynor, editor of the *Financial Analysts Journal*. They point out, quite simply, that the value of pension liabilities is independent of the type of pension-fund assets a company holds.

In other words, corporate managers are gambling when they invest pension assets in common stocks. By assuming that pension-fund assets will grow at the expected rate of return on risky investments, they are taking it for granted that they will win the gamble. There is always a chance, however, that they will lose. That possibility of losing constitutes a real claim against future profits—it just doesn't show up on the books. The only way a corporation can be certain of having sufficient funds to cover future benefits is to invest in riskless assets. And that would of course raise the level of pension-fund contributions above what it is today.

In a complex matter such as this, it is hard to determine the degree to which corporations are endangering their futures. An important question is whether they will in fact win the gamble. If the real rate of return on pension-fund portfolios turns out to be 5 percent or more, the use of the present optimistic interest and wage assumptions would be justified to determine funding levels.

One of the more intriguing studies of what future rates of return will be was done by Roger Ibbotson of the University of Chicago and Rex Sinquefield of the American National Bank. They simulated future returns on several kinds of securities through the year 2000 by using the distribution of past rates of return over the last fifty years. Based on the simulations, Ibbotson has concluded that there is a 60 percent chance that the real rate of return on pension-fund portfolios will be 5 percent or more. This means there is a 40 percent chance that the rate will fall short of 5 percent. In that unhappy event, companies will have to dip into future profits to pay benefits that they now report as having been funded.

THE ODDS ARE LONGER FOR AMC

Although the odds appear to favor the pension funds, three to two is cutting it pretty close. Plenty of odds-on favorites have lost the Kentucky Derby. What's more, those odds apply only to companies whose interest assumptions exceed wage assumptions by the average 2.5-percentage-point spread. The spreads can be a lot higher and the odds a lot worse. Goodyear and American Motors, for instance, have 6-percent interest assumptions and zero wage assumptions.

These two companies have a partial defense for such unbridled optimism. Their union contracts call for pensions of specified amounts for each year of service, rather than basing payments on final salaries. Since pension contributions are tax deductible and in this case aren't formally tied to wage inflation, the Internal Revenue Service doesn't allow companies using the years-of-service formula to assume any future increases. Of course, this doesn't alter the economic realities: unions will demand that pensions keep pace with wages. And nothing prevents the companies from better reflecting true conditions by lowering interest assumptions to partly offset the unrealistic wage assumptions.

Unfortunately, the adjustments most companies make are of a different kind. From what can be ascertained about them, it appears that they have had a conspicuously self-serving quality. Even though wages have been shooting up faster than the actuaries have assumed, and pension portfolios have barely stayed above water, the actuaries have seen fit in recent years to raise interest assumptions

more than wage assumptions. This holds down pension costs and lowers unfunded liabilities. The trend toward higher spreads between the two assumptions means, of course, that actual pension costs have been rising even faster than the 15 percent rate companies have reported.

A WAY TO "PAY" THE UNIONS

Actuaries, who are required by ERISA to certify the assumptions, insist that their adjustments are "reasonable." Curiously, though, a lot of the adjustments are made around the time new labor contracts are negotiated. With an adjustment or two in its assumptions, a company can "pay" for a benefit increase by pushing the costs into the future; in the meantime, reported profits are maintained and unfunded liabilities are held in check.

Caterpillar Tractor, for example, negotiated a pension increase with the United Auto Workers last year, but its pension expenses dropped (from $106.9 million to $100.3 million), and its unfunded vested liabilities declined (from $440 million to $270 million). The principal reason was that Caterpillar raised both the interest and wage assumptions, and the higher interest assumption predominated. The company will not disclose the figures for either assumption.

Goodyear improved the looks of its financial statements by making similar adjustments last year. It agreed to a thumping increase in pension benefits for its United Rubber Workers employees, and then raised its interest assumption from 5.5 percent to 6 percent. Unlike Caterpillar, it reported the changes quite plainly. With a few extra calculations, and investor could figure out from the footnotes to Goodyear's annual report that the new benefits will cost 30 percent more, and that the actuarial change reduced pension expenses by 14 percent from what they would have been had the assumption remained unchanged.

Goodyear's executives are also a lot more candid about how actuarial changes come about. As Bennett Shaver, an assistant treasurer, puts it, "It's always good to look at [assumptions] at the same time you have a benefit increase." He adds, though, that the looking comes after labor negotiations. "Otherwise, the union could say, 'Go ahead, raise the interest rate to 10 percent. It [a pension-benefit increase] is not going to cost you anything.' "

Investors clearly would be better able to assess a company's profit prospects if they had a more objective measure of pension costs and liabilities. Jack Treynor, viewing the issue from the perspective of the security analyst, asserts that "what is needed from the pension actuary is something much more straightforward than he now provides—namely, the present value of benefits discounted at the riskless rate."

Accountants also recognize the deficiencies of pension reporting, and many of them have been arguing for greater consistency and disclosure. Shareholders aren't likely to get a closer look at the actuarial sinews of the pension strong men anytime soon, though. The actuaries have staked out pensions as their turf, and they aren't granting easements. Some actuaries are so riled about all the attention unfunded liabilities have been getting that they want to stop using the term altogether. Instead, they prefer calling them "supplemental present values," a euphemism worthy of an undertaker.

A STRANGE KIND OF INSURANCE

Before the advent of ERISA, most pension agreements limited a company's liability to pension-fund assets; in the event a company went bankrupt or terminated its pension plan for some other reason, employees couldn't collect anything beyond what was in the pension fund. Hence, employees were always "at risk" for any unfunded vested liabilities.

ERISA relieved employees of those risks by guaranteeing pension benefits up to a specified limit, currently $937.50 a month. It accomplished this by transferring the risks to shareholders. The law holds a corporation liable for its own unfunded guaranteed benefits up to 30 percent of the company's net worth. Any guaranteed benefits left over must be picked up by all other companies under a scheme called "plan-termination insurance." The "insurance" is administered by the Pension Benefit Guaranty Corporation (PBGC), a government agency that raises the money by levying a per-employee tax on all companies that have defined-benefit pension plans. Thus shareholders are now "at risk" not only for the guaranteed benefits of the companies in which they own stock but also for those of all other corporations.

The PBGC spreads the tax equally across all companies. Weak companies that are likely to default pay the same "premium" per employee as strong companies whose risk of default is minimal. Strong companies are therefore subsidizing the weak ones.

Plan-termination insurance tends to warp the way businessmen make decisions. It raises the value of pension promises by assuring that the benefits will be paid. This encourages weak companies to offer, and their employees to accept, overly generous pension promises in lieu of additional wages. Promised benefits have the advantage of not immediately increasing costs, as higher wages would. And a weak company has little to lose by making pension promises: if it goes broke, the extra liabilities will cost the shareholders little if anything. And if the company thrives, profits will be available to pay the benefits when the employees actually retire.

The insurance scheme has operated successfully for the last three years, but some pension experts believe it is fatally flawed. The architects of ERISA overlooked a special aspect of pension-fund risk when they decided to insure benefits. They really aren't insurable. The concept of insurance is based on the law of large numbers, which describes what happens when events are essentially independent of one another (e.g., everyone will die sometime, but everyone will not die at the same time). Pension assets are invested largely in common stocks, and the law of large numbers doesn't apply in the stock market—all stocks can go down, and they can all go down at the same time.

The chances of a catastrophic stock-market decline are slight, to be sure, but prices, in real terms, have been cut in half twice during the last fifty years. Should that happen again, it is apt to coincide with a major economic decline, when the PBGC's resources are likely to be strained by a surge of pension-plan defaults. The defaulting companies' unfunded liabilities would be swollen by stock-market losses, forcing the PBGC to jack up the taxes on other companies to make up the huge deficits. These companies, meanwhile, would be struggling to make up losses in their own portfolios. The added levies from the PBGC could persuade them to abandon their plans. And the PBGC, swamped by claims, would have to cut off benefits or turn to Congress for help.

It is possible that, even without an economic disaster, claims against the PBGC could force its "premiums" to go so high that many companies with solid defined-benefit pension plans would abandon them in favor of defined-contribution plans (e.g., profit sharing). Unfunded vested liabilities now total at least $25 billion, and the great bulk of them are concentrated in several dozen large companies, many of which are less than robust. Should the PBGC sail into a line squall of major bankruptcies, the tax per employee could easily jump from its current level of $1 to $10, $20, or even $50 a year. The PBGC is already looking for a "premium" increase to $2.25, and it has yet to come up against its first truly large claim. If Bethlehem Steel were to go bankrupt, for instance, other companies would get stuck for an additional per-employee "premium" of about $4 a year for 15 years. That, in turn, would cost General Motors alone $3 million annually.

SADDLED WITH THE HATTERS

Industries in which all employers are covered by one labor contract and pay into a common pension plan appear to be particularly dicey propositions. Many of those multi-employer plans, which cover about 7.7 million workers, are in deep trouble. A lot of them cover present and former employees in anthracite coal, hats, and other declining industries. As an industry shrinks, surviving companies end up paying the obligations of their defunct competitors.

Although the PBGC doesn't have to cover multi-employer plans until January, it has voluntarily taken over four of them already. It has also identified eight others—with $350 million in unfunded liabilities—that it believes will terminate soon. In contrast, losses on single-employer plans, which cover some 26 million employees, have totaled about $100 million over the last three years.

Some special aspects of the insurance program increase the likelihood that well-funded companies will opt out of the system. One of them is that provision in ERISA making corporations liable for any unfunded benefits up to 30 percent of the company's net worth. The provision was included in the law in order to discourage weak companies from terminating their plans and dumping all the liabilities on the PBGC—in effect, on other companies.

As the law reads now, though, a company with huge unfunded liabilities could still terminate its plan and get off the hook by paying the PBGC 30 percent of its

net worth. The PBGC says it calculates net worth by judging what a company's assets could be sold for and deducting all liabilities. In Wheeling-Pittsburgh's case, the company could clear its books of $274 million in unfunded vested liabilities, while paying the PBGC a maximum of $110 million (30 percent of its balance-sheet net worth) and perhaps as little as $11 million (30 percent of its stock value). Harrison Givens, a vice president of the Equitable Life Assurance Society who has been an adviser to the PBGC, contends that the 30-percent limit constitutes "bribery to terminate."

HOW TO GET OFF THE HOOK FOR LESS

There is no evidence that companies are in fact planning to terminate in order to dump liabilities, but they may simply be waiting for a big uncertainty about government regulations to be resolved. The PBGC's claims against a company have the status of a tax lien. Bankers have naturally become uneasy about the PBGC getting a lien against a company's assets, because that claim could be senior to theirs. Aroused by nightmares of subordinated status, the American Bankers Association induced Congress to require the PBGC to offer corporations "contingent employer liability insurance" covering the agency's claim against a company. If a company could buy this insurance, it could discontinue its pension plan and wipe out all of its unfunded liabilities—without having to fork over that 30 percent of net worth.

The PBGC began shopping around for an underwriter to supply the insurance back in 1974 but, unsurprisingly, private insurers weren't lining up for the opportunity. Even Lloyds, which has insured everything from robots to Marlene Dietrich's legs, turned down the proposition, observing that underwriting unfunded pension liabilities amounts to "insuring the profitability of the American economy."

The PBGC is now required to offer the insurance itself. It hasn't been eager to get into this business either and is now preparing an alternative proposal for Congress. The agency wants to limit the coverage to $5 million or so, and require that a company be in bankruptcy before it can escape without any liability for unfunded benefits.

These recommendations are a step in the right direction, but they aren't nearly radical enough to wipe out the perverse incentives built into the pension system. To make sure companies shoulder the risks they create for themselves, Congress would be wise to dump the idea of contingent employee liability insurance altogether and eliminate the 30 percent ceiling. Corporations should also be required to report pension liabilities on a uniform basis so that investors and regulators can assay the true condition of the enterprise. And the PBGC should base its "premiums" on the amount of risk a company contributes to the system—i.e., its unfunded guaranteed liabilities. So long as companies can reap the benefits that accompany higher risks while avoiding the costs, they are certain to impose all the risks on the system that they can get away with.

It would also be a good idea to re-examine the entire issue of whether the government should guarantee a fixed level of future income to any particular group in society—in this case retired employees. Shifting the risk of pension-fund defaults from employees to shareholders in general is merely a form of transferring wealth, not an insurance program. What's more, no amount of funding will eliminate the possibility that the pension system may collapse: in the final analysis, all corporations, as investors in each other's stock, are dependent on one another's profits to meet their pension obligations. In terms of the system as a whole, virtually all pension liabilities are essentially "unfunded." So long as they are guaranteed, the liabilities constitute an overhanging burden not only on future profits, but on the future living standards of all but the 35 million or so workers who are covered by defined-benefit pension plans.

[From Fortune, November 1977]

IT MAKES SOCIAL SECURITY LOOK SOLVENT

The pension bills facing shareholders pale before those that taxpayers will eventually have to pay to provide retirement benefits for public employees. Congressmen, governors, and mayors have run up gargantuan tabs for pensions that are frequently more lavish than anything found in business, and they have left the

liabilities largely unfunded. As a result, the unfunded liabilities of public pension plans dwarf the total liabilities of corporate plans—even though public pensions cover fewer workers.

When it comes to actuarial and disclosure practices, public pension plans are even worse than their corporate counterparts. The meager figures available chillingly illustrate the politician's unwillingness to look beyond the next election and reveal an astonishing propensity for fiscal irresponsibility.

A BIG BILL IN BOSTON

New York City's pension dilemma has achieved the status of a contemporary legend. Less widely noted is the fact that many other cities and states aren't far behind. Based on the latest reported data, Boston, Detroit, Los Angeles, and even Jacksonville, Florida, have unfunded pension liabilities that exceed their net municipal debt. Boston had unfunded liabilities of $1.1 billion a year ago, and Massachusetts had unfunded liabilities of $12.8 billion.

In Los Angeles, retirees who are struggling to get by on fixed incomes have complained that soaring property taxes are forcing them out of their homes. Half of those taxes go for the pensions of city employees. And, despite the high tax levies, Los Angeles had unfunded liabilities of $1.6 billion at the beginning of 1975 (the latest reported figures).

As in everything else, the federal government leads the pack when it comes to piling up pension deficits. Congress, which labored for 7 years to force corporations to treat their pension obligations more responsibly, presides over a system of its own that is so far in arrears that it makes Social Security look positively solvent. By some estimates, the unfunded liabilities for federal-employee pensions will soon reach the trillion-dollar mark.

In a scathing report last summer, the General Accounting Office concluded that federal pension costs and liabilities are perilously understated. Many of the federal plans give no consideration to the effects of future pay increases and the impact of inflation on pension annuities, many of which are tied to the consumer price index. The reported unfunded liabilities of the civil-service system (which includes about half of all federal employees) came to $107 billion at the end of fiscal 1976. Based on calculations made by the system's board of actuaries, the true unfunded liabilities—after adjustment for future inflation—are more than twice that amount.

WHEN THE BILL ARRIVES

The underestimation of pension liabilities and costs means, of course, that the federal budget deficit is even bigger than reported. The GAO estimates that pension costs for federal civil-service employees were understated by $7.1 billion in fiscal 1976. Moreover, the unfunded liabilities have been growing geometrically, despite an increase in contributions in 1969 that was designed to stem the rise. Between fiscal 1970 and fiscal 1976, the reported unfunded liabilities of the civil-service system more than doubled, and payments to retired employees more than tripled, to $8.3 billion. Assuming government wages rise 6 percent a year, payments will hit $29 billion by 1985.

If Congress were to restate unfunded liabilities along the lines advocated by the GAO, and then pay them off over thirty years, as it requires corporations to do, taxpayers would have to cough up $15 billion or more a year just to amortize the unfunded obligations of the civil-service system. Regardless of how Congress treats the liabilities, though, the benefits ultimately must be cut or paid. If it doesn't cut the benefits, the government will have to raise taxes, reduce services, or print more money.

[From the New York Times, Jan. 21, 1978]

PENSIONS: A $100 BILLION MISUNDERSTANDING

The only line that concerns most of us about pensions from a private business is the bottom line. It takes a whiff of scandal—insider shenanigans, or dealings with gangsters—to tranform the arcane world of other people's pensions into headline news. But the pension issue with the greatest potential impact on Americans has little to do with improper conduct by pension managers. In the view of many experts, private pension funds—representing retirement security for tens of mil-

lions—could have great difficulty delivering on their promises. Corporation stockholders, and perhaps taxpayers, may get stuck with the bill.

According to Fortune magazine, the collective obligations of corporate pension plans may exceed their current assets by as much as $100 billion. The "unfunded" pension liabilities of at least two major corporations are actually greater than the companies' net worth. Government-sponsored insurance makes it unlikely that workers belonging to even the weakest pension programs will ever go hungry. But the questionable financial underpinning of the nation's private pension system suggests that serious reforms are in order.

A pension, offered as an employment fringe benefit, typically promises a specific monthly payment to a retiring employee, based on salary and the number of years of service. Money is then set aside by the company and invested to cover this liability for 10, 20, or 30 years into the future. The amount that should be set aside, however, is extremely difficult to compute. Trustees cannot be sure how much the invested funds will earn; they thus cannot be sure how much will be available for pension checks decades ahead. Moreover, since benefits are often calculated on wages paid during the last few years of service, future obligations of the fund cannot be determined until those wages are actually set.

What is known, however, is that the dismal performance of pension-fund investments in recent years has left hundreds of funds with much less cash than their managers expected. For the most part, these shortfalls can be covered by drawing on current corporate revenues that would otherwise have gone toward profits. Nothing, however, prevents corporations from repeating their honest mistakes, overestimating investment earnings or underestimating future obligations. And that is precisely what a growing group of actuaries and economists believe is happening today. Corporate stockholders may have some unpleasant surprises in store.

Tomorrow's pensioners have two lines of defense. First, pension benefits are obligations of contract. If the funds prove inadequate, pensioners must be paid off before stockholders receive a nickel. Second, benefits up to $11,250 a year are insured by a Government agency, the Pension Benefit Guaranty Corporation (PMGC). If a company goes broke, the PBGC collects money from all other corporate pension funds to keep the benefit checks moving. So far, the PBGC has had to pick up the pieces of bankrupt funds on only a few occasions. But if pension fund investments turn sour in the 1980's or 1990's, as they did in the early 1970's, PBGC could face an annual multibillion-dollar deficit that would represent a massive drain on corporate earnings.

At that point the only alternative to saddling business with the pension debt would be to bail out the funds with Federal tax revenues. Neither alternative is very attractive. Hence the need for some cautionary reforms to put the pension system back on track.

Uniform Accounting Standards.—Pension trustees are legally required to exercise prudence, but prudence is hard to define. Rather than adding another layer of Government regulation to a field already overwhelmed by regualtions, it probably makes sense only to insist that trustees publish liability estimates based on uniform, conservative criteria. This would give warning of trouble ahead to regulators, employees and stockholders—and deter corporate managers from sweeping tomorrow's pension problems under the rug.

Conservative Financial Incentives.—Unlike most insurance premiums, those charged by FBGC bear no relation to the risks run by the insured. All companies chip in a fixed amount per employee, regardless of how likely the chances of default. If companies with large unfunded liabilities were charged higher premiums, the insurance costs would be spread more equitably and those that take the biggest chances would have an incentive to take less.

Defined Contribution Pensions.—The root of the pension fund problem is the guarantee of fixed benefits in an indefinite future. Funds in which the size of the company's contribution, rather than the promised benefits, is fixed cannot go broke. Such "defined-contribution" plans already cover millions, and in cases where employees are willing, could be substituted or added to "defined-benefit" plans. This approach admittedly shifts risk from the company to its workers. But some companies might be willing to pay a premium pension benefit to achieve that shift.

Private pensioners aren't begging on the streets, nor are they remotely likely to face that prospect. It surely makes sense, however, to encourage more conservative pension practices by letting future pensioners and those who will ultimately be forced to pay those pensions know exactly where their interests lie.

[From the N.Y. Times, Jan. 8, 1978]

WORRYING ABOUT THE PENSION GAP

(By Deborah Rankin)

Many financial analysts and bankers are in a cold sweat over whether the nation's largest corporations have set aside enough assets to cover the pensions they have guaranteed their employees. In the past the workers carried much of the risk. But the Employee Retirement Income Security Act of 1974 transformed pensions from gratuities—payable to employees at a company's discretion—to liabilities with a potential claim on up to 30 percent of a company's net worth. Such pension claims have the status of tax liens, which makes them senior to the claims of other creditors, such as banks.

Now that the workers' pensions are protected, the risks of shaky retirement plans have been transferred to investors, who must consider whether a company whose stock they are purchasing has a hidden time bomb. The trap is an underfunded pension plan that could wipe out future profits if the assets it has invested in the stock market do poorly or, even worse, devour corporate assets if the plan is terminated.

By one estimate, there is a $23 billion gap between the pensions that workers have been guaranteed and the assets that have been set aside to pay for these obligations. When the costs of contingent pension benefits that will come due are added, the gap widens to a staggering shortfall of almost $50 billion.

The problem for investors examining the footnotes of corporate annual reports, where pension-plan information is given, is to find a common denominator that will allow them to compare on a uniform basis the pension figures of one company to the pension figures reported by another. Critics contend that the law allows actuaries so much latitude in making pension-cost determinations that the same numbers can have widely different meanings from company to company.

"The trouble is that nobody knows what pension costs are," said Jack L. Treynor, editor of the Financial Analysts Journal and co-author with Patrick J. Regan and William W. Priest, Jr., of a book, "The Financial Reality of Pension Funding Under ERISA."

Andrew J. Cappelli and S. Thomas Moser of the accounting firm of Peat, Marwick, Mitchell & Company recently complained in a trade periodical that complex accounting rules for pensions have made meaningful comparisons from company to company "all but impossible."

Pension cost figures are actuarially derived numbers whose size can vary dramatically, depending upon what assumptions the actuary feeds into the calculations. Basically, they represent the amount of money a company must set aside today to meet its pension obligations years from now. Minute changes in two key assumptions can make pension cost figures grow or shrink by millions of dollars.

The first important assumption, known as the "interest assumption," concerns the rate of return a company expects to earn on its contributions to the pension fund. An increase of one percentage point in the interest assumption will, on average, pare pension costs by 20 or 25 percent.

The second key assumption, known as the "wage assumption," concerns the rate at which wages will grow and take into account such factors as inflation and special industry trends. This rate is crucial because most pension benefits are tied up to the wages employees earn in their final years of work. A cut of one percentage point in the wage assumption will reduce pension liabilities by 13 percent or so.

Currently there are no limitations on the numbers that companies can crank into these critical assumptions. Although a typical interest rate assumption is in the neighborhood of 6 to 6.5 percent, the numbers can rise as high as 9 percent and sink as low as 4 percent. Similarly, although wage assumptions tend to cluster around the 3 or 4 percent level, the range goes from zero to 8.5 percent. All are considered legitimate, at least by the companies and actuaries that use them.

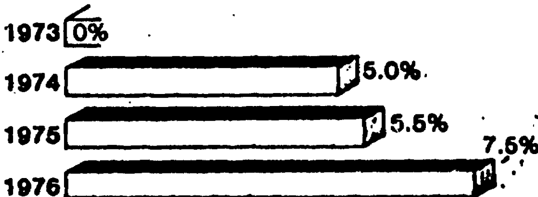
Pension Fund Liability

Company	1976 pension expense in millions	Pension expense as % of payroll
Western Union	$33.4	16.2%
Bethlehem Steel	261.2	11.3
Union Carbide	130.3	11.1
Uniroyal	79.4	10.4
Lockheed	96.0	9.3
Republic Steel	83.8	9.2
Armco Steel	82.9	8.5
General Motors	1,071.2	8.2
DuPont	212.8	8.2
Chrysler	277.1	7.8
Dow Chemical	82.7	7.7
Ford	505.5	7.6
Eastman Kodak	164.3	7.1
B.F. Goodrich	40.7	6.8
Monsanto	70.7	6.8
Caterpillar Tractor	100.3	6.4
American Motors	37.0	6.3
U.S. Steel	221.0	6.2
Goodyear	87.7	5.9
General Foods	41.1	5.9
Firestone	60.1	5.0
Kraft	30.8	4.6
Borden	19.2	4.2
Johnson & Johnson	28.9	3.7
K Mart	24.3	2.0
Amer. Home Products	9.8	1.8

Note: Figures from company reports. Pension amounts generally cover only domestic plans, although some corporate payrolls include foreign operations

Unfunded vested benefits as a percent of net worth.

(Medians of a 40-company sample)



Source: SEA Associates Inc.

Under the pension law, however, actuaries must certify that the assumptions are "reasonable" in the aggregate. "For example, the wage rate assumption might be understated by two percentage points, which by itself would produce an understatement of costs," said Lawrence N. Bader, vice president and actuary with William M. Mercer Inc., an employee-benefits consulting firm. "And the interest assumption might be understated by one percentage point, which by itself would produce an overstatement of costs." The result, he said, might be to state costs correctly. "This is permissible under ERISA," Mr. Bader said, "but it is debatable whether it is sound actuarial practice."

It is not unusual for companies to periodically alter their interest and wage assumptions. Indeed, many companies increased their interest assumptions after the bull stock market of the 1960's from a level of 3 to 4 percent to the current level of 6 to 6.5 percent. The market's precipitous decline since then has made some of the more optimistic assumptions suspect.

Most analysts' attention is focused on the size of the "unfounded vested benefits" of American business. This is a net figure that represents the difference between the benefits a company is legally obligated to pay to workers, even if they quit tomorrow, and the amount of assets, such as stocks and bonds, it has on hand to pay for these future obligations.

Even this number can be tricky, however. Just as companies can fiddle with the assumptions (such as interest-rate growth) that are used to compute the liability side of the equation, they also can—and do—use different methods to arrive at the asset side.

A recent study of 40 large industrial corporations by BEA Associates, a New York-based investment counseling firm, found that even though the aggregate pension assets of the sample rose by 27 percent in 1976, to $39.3 billion, the total unfunded vested benefits rose by 8 percent, to $12.3 billion. Furthermore, unfunded vested benefits as a percentage of the average company's net worth increased from zero in 1973 (which meant the average company was fully covered) to 7.5 percent of net worth in 1976.

"These numbers are incredible," said Mr. Regan, the co-author of the book on pensions and a vice president of BEA. "Even though pension assets were growing, the plans wound up worse funded than they had been. What would have happened if the company and the stock market collapsed?

There is growing pressure to standardize the way companies account for their pension costs and disclose the actuarial assumptions underlying them. While most of the pressure has come from the pension law, which requires pension plans to submit financial statements annually to the Department of Labor and the Internal Revenue Service, other supporters of uniformity are accountants and bankers. As creditors, the bankers are especially concerned because of their precarious position should a company pension plan fail and the Government go after some of the corporation's assets.

The Financial Accounting Standards Board, the private sector's top authority on accounting procedures, had tentatively recommended that major pension plans standardize their financial reports to plan participants. This could have laid the groundwork for standardizing the reporting of pension costs.

But the intense opposition from actuaries, who resented the accountants' intrusion and contended that the rule would increase actuarial costs without helping beneficiaries, made the board delay. So it will probably be years before the board gets around to debating the proper accounting method for pension costs.

STATEMENT OF IAN D. LANOFF, ADMINISTRATOR, PENSION AND WELFARE BENEFIT PROGRAMS, U.S. DEPARTMENT OF LABOR

Mr. LANOFF. Thank you, Mr. Chairman, Senator Curtis, I would like to thank you for inviting me to speak to this subcommittee today on accounting and actuarial disclosure practices in pension funds.

With me, to my left, is my special assistant, Dr. Thomas C. Woodruff who, since December, has been coordinating a review of these disclosure practices, particularly as they relate to the reporting and disclosure of pension fund benefit liabilities.

To my right is Larry Long, who is with the Department's legislative office.

In my remarks today, I will primarily address the Department of Labor's efforts toward improving the disclosure of private pension fund liabilities in pension fund financial reports.

While we believe that the results of our efforts on pension fund disclosure may have implications for corporate financial disclosure, we are not prepared to speak on that subject today.

Mr. Chairman, during the past year, a number of articles have appeared in newspapers and business magazines regarding pension plan liabilities and how those liabilities are to be calculated. These articles have made two general claims: First, that the size of pension fund benefit liabilities threatens the financial security of many companies, and second, that the lack of uniform accounting and actuarial data on pension plans makes it difficult for beneficiaries, corporate shareholders, the public, parties involved in collective bargaining and the Government to know what the real benefit liabilities of the plans are.

At this time, Mr. Chairman, I would like to submit for the record two speeches which I delivered during the late winter and early spring of this year. In the first speech, entitled, "Are Pension Funds Really Jinxed," I analyzed and then proceeded to take strong exception to the claim made in the media that the financial security of many companies is threatened by their pension liabilities.

The problem is that the media relies, all too often, upon inaccurate or inappropriate liability figures. However, in that same speech, I agreed with the complaint that inadequate accounting and actuarial data is available for disclosure purposes because of actuarial assumptions and methods used in calculating pension plan liabilities.

My concern over the lack of data regarding calculation of benefit liability figures led me to initiate a review of the Department's reporting and disclosure requirements for annual and actuarial accounting data for pension plans on schedule B, the actuarial reports portion of the 5500 annual financial report to the Department of Labor and the Internal Revenue Service.

In the second speech, delivered on May 22, 1978 before the ERISA workshop group at Cornell University, I announced that we had largely completed that review and expected to soon request public comment on a series of changes in schedule B incorporating the following four principles:

No. 1, the annual reporting of accrued vesting and nonvested benefits for all defined benefit pension plans with over 100 participants.

No. 2, the requirement that all plans use a single actuarial cost method, the accrued benefit unit credit cost method for calculating these accrued benefits figures.

No. 3, disclosure on the form of major actuarial assumptions.

No. 4, guidelines indicating that the assumptions selected should reflect the anticipated experience of an ongoing, rather than terminated, plan.

This morning, Mr. Chairman, I will elaborate briefly upon my earlier announcement of these basic principles. I will briefly describe the basis of the principles and explain the proposed changes to schedule B.

Our proposed changes to schedule B resulted from a long series of meetings with various groups over the past several months, including

meetings with representatives of the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, the American Academy of Actuaries, the ERISA Advisory Committee, the Pension Benefit Guarantee Commission, and the Internal Revenue Service.

These meetings all confirmed the need to make changes in the reporting of these important data. An important consideration underlying our expected proposals is their cost and the degree of burden they impose upon plans. I am advised that the costs for plans in reporting this information in the form we expect to propose is nominal and significantly less than the alternatives we have projected.

This is consistent with the Department's approach to reporting that we demonstrated during this past year when we reduced paperwork requirements contained in the 5500 annual report form in five significant ways. The key, we believe, is to require the reporting of only necessary information in the least burdensome way. It is also our hope, and expectation, based on discussion with representatives of FASB, that our proposals for the annual reporting forms will be accepted by FASB when it sets standards for the financial statements on which the accountant signs off, thereby avoiding unnecessary double work for accountants and higher plan costs.

It is my hope that the changes we now have under consideration will lessen the uncertainty and confusion that currently surround disclosure of private pension plan benefit liabilities. In the end, the elimination of much of this uncertainty should have a positive impact on the growth of these plans.

Pursuant to the requirements of section 103(d) (1) and (5) of ERISA, defined benefit pension plans disclose accrued benefits, value of assets, unfunded accrued benefits on schedule B of the 5500 annual report to the Department of Labor and IRS.

The value of vested benefits is only required to be reported if calculated and therefore, already available.

In footnotes to corporate financial statements, the SEC requires disclosure of unfunded accrued benefits and the Financial Accounting Standards Board requires disclosure of unfunded vested benefits.

In addition, section 103(d)(6) of ERISA calls for a display of the present value of pension plan liabilities for nonforfeitable benefits allocated by ERISA section 4044, termination priority categories. This requirement has been waived by the Department for plan years 1975, 1976, and 1977.

Both the disclosure of accrued benefits under ERISA section 103 (d)(1) and the display of plan nonforfeitable benefits under section 103(d)(6) were intended to provide plan beneficiaries, Federal agencies and investors in private corporations supporting the pension plans with some measure of the adequacy of pension plan assets to meet benefit payout obligations.

The figures on all of these reports, however, including those required by the SEC and FASB are calculated using a number of accepted actuarial methods and assumptions. The choice of methods and assumptions can, however, significantly change the value of the figures, as you mentioned this morning, Mr. Chairman.

This freedom of choice for plan actuaries has led to questioning among accountants and investors about the adequacy of these figures for disclosure of pension plan assets and liabilities.

The work of the three ERISA agencies—Labor, Treasury and PBGC—has been hampered by this lack of uniformity and full disclosure.

In our first proposal, we expect to recommend waiver of section 103 (d)(6) requirements. Section 4044 priority categories require elaborate calculation of each individual's benefit priority status. Our analysis indicates, for example, that one beneficiary might fit into any or all of section 4044's six priority categories.

Performing such annual calculations on each individual participant could be expensive and burdensome to plans.

The authors of section 103(d)(6) apparently believed that beneficiaries could look to allocation categories to assess their likelihood of receiving future benefits. PBGC's experience to date, however, indicates that the financial condition of the companies or industries contributing to the plan may be a better indicator of whether the plan may terminate or otherwise in funding problems in the future.

In other words, unless we also require corporate financial disclosure alongside the pension fund data, we probably cannot adequately meet the intent of 103(d)(6) to inform beneficiaries of the probability of the pension fund's likelihood of meeting pension payments. At the present time, however, we do not have either the specific statutory authority or the desire to require such reporting.

Our efforts, instead, have been focused on improving the reporting of the pension funds. Participants in pension plans have an interest in knowing whether their pension fund will be able to pay for benefits during the benefit payout period and, if not, how much the PBGC will guarantee upon plan termination. Most plan participants are enrolled in ongoing pension plans that will not terminate.

We believe that to require all plans to disclose 103(d)(6) figures that are relevant to less than 1 percent of pension plan participants is unduly burdensome. For that reason, we expect to continue to waive the requirements of section 103(d)(6).

Section 3 of ERISA defines acceptable actuarial cost methods that may be used by pension plan actuaries for funding standard account calculations. Unfortunately, the use of some of these methods which are appropriate for funding calculations may result in misleading numbers for statements of accrued benefits.

When these misleading figures are then compared to pension plan assets, misleading figures for unfunded liabilities are created. It is our belief that the accrued benefit cost unit credit method is the proper method for calculating the accrued benefit figures. This method, unlike the others, allocates benefit accruals to periods of time that are related to actual service performed by the employees covered by the pension plan.

Furthermore, we believe that the assumptions used by the plan actuary should explicitly reflect the expected experience of an ongoing plan.

In addition to the choice of assumptions, we expect to propose that the accrued benefits statements reflect the pension obligations current

to the end of the plan year. This is necessary in order that these figures be current to the same day as other financial data reported on the 5500 annual report, particularly the current value of plan assets.

Many plan actuaries currently calculate the value of vested benefits because their plan sponsors are subject to the guidelines of APB opinion No. 8. Common practice is to use the accrued benefits cost method for calculating this figure.

However, there still exists some degree of variation in the practice of calculating this figure.

Our expected proposals on the choice of methods, guidelines as to assumptions and the timing of the calculations would alleviate most of this variation.

In order to represent fairly the accrued benefit obligations for an ongoing plan, it is necessary to include a statement of accrued nonvested benefits.

In calculating the value of accrued nonvested benefits we again expect to propose that the plan actuary use the accrued benefit cost method. Currently, the greatest distortion in the calculation of accrued benefit liabilities due to the choice of actuarial cost methods occurs in the calculation of nonvested benefits.

We believe that a requirement to use the accrued benefit cost method for calculating accrued nonvested benefits would eliminate these distortions.

Depending upon the provisions of the particular pension plan, the present value of accrued nonvested benefits may also be subject to assumptions about future services. For example, in a pension plan where the level of pension benefits is based on final salary prior to retirement, the value of accrued benefits based on service to date is subject to the assumption of the level of final salary.

Therefore, for plans that have provisions such as final salary that may change the value of accrued benefits contingent on future events, two nonvested benefit figures would be required.

No. 1, accrued nonvested benefits historical, based upon current compensation levels and current entitlements, and two, additional accrued nonvested benefits projected, based upon anticipated changes in the value of accrued benefits due to future events.

If the above-proposed changes in schedule B were adopted, the following calculations could be performed: Figure 1, unfunded vested benefits equal accrued vested benefits minus current value of assets,

Figure 2, unfunded total accrued benefits historical equal accrued vested benefits plus accrued unvested benefits historical minus current value of assets.

Finally, figure 3, unfunded total accrued benefits projected equal accrued vested benefits plus accrued nonvested benefits historical plus additional accrued nonvested benefits projected minus current value of assets.

We believe that the above three calculations will reveal an accrued benefit liability figure that is more meaningful than those that are currently available.

Figure 1 represents a fair comparison between the entitlements of participants to pension benefits and current assets. Figures 2 and 3, however, should not be used in isolation. They will be most useful for

analysis on a multiyear basis as measures of the changing characteristics on ongoing plans.

The fact that 2 and 3 may be greater than zero in any particular year need not necessarily be alarming to either plan participants or to plan sponsors. What would be important, it seems to me, are changes in these figures over a number of years.

In addition, trends in the individual items in accrued benefits would be useful in analyzing changes in the structure of benefits in the various plans.

In conclusion, Mr. Chairman and members of the subcommittee, we believe that these proposals on the disclosure of accrued benefits in schedule B on defined pension benefit plans, if adopted, would disspell the current confusion that has been generated by lack of uniformity. These proposals would help plan participants, plan sponsors, investors, the ERISA agencies and the public determine the ongoing obligations of these private pension plans.

We do not know whether all of these proposals are applicable to disclosure of public plan benefit obligations. We currently, however, are supporting a research project that may help us make this determination.

We hope that ourd concern with these issues will ultimately result in greater income security for the American workers participating in the private pension system.

Thank you. I am prepared to answer any questions you may have.

Senator BENTSEN. I think we will interrupt the presentation of the rest of the witnesses at this point to comment on what you have done here.

I am pleased with some of the simplification that has taken place. We have passed a bill out of this committee for a substantial amount of pension simplification, to try to ease the burden for the participants, and particularly for small pension plans.

I am all for trying to achieve some kind of standardization here so that participants really know what they are going to receive and have greater confidence in the system, but the one thing I want to be sure of is that there are not further burdens on some of the small pension plans.

Now, as I understand what you are proposing, you are talking about new rules for plans with over 100 participants. Under ERISA these plans are required to obtain an outside audit anyway. Is that not correct?

Mr. LANOFF. Yes, Mr. Chairman, although I believe we have waived the requirement for——

Senator BENTSEN. What, in here, will make it any more burdensome for some of these small pension plans. Will it, in any way?

Mr. LANOFF. We do not believe so, Mr. Chairman, since the computation of the figures that we are seeking will not be required of the smaller plans.

Senator BENTSEN. Of those with under 100 participants; is that not right?

Mr. LANOFF. That is right. We believe that the turnover rate in most of these smaller plans would make the information provided under this approach virtually meaningless to participants anyway and, meas-

ured against the cost and potential burden for small plans, we just decided to exempt them from these particular requirements.

Senator BENTSEN. Even for those over 100 participants. I want to be sure we are not putting on another layer of regulations. I do not believe we are, from what I see of your proposal. Again, we are talking about a standardization.

What are the objections you are getting to it? What do some of the plans tell you, other than the fact that it gives them greater flexibiliy in their assumptions so they continue to show whatever profits they want in their company and ease the pain of any negotiations on wages?

Mr. LANOFF. Well, according to reports I have received, most plans over 100 already have this type of work performed for them and the additilonal costs would be nominal. But perhaps Dr. Woodruff would like to speak to this, since he is the one who has personally met with some of these plans and some of these groups.

Mr. WOODRUFF. Yes. Mr. Chairman, from our discussions with plan actuaries and other representatives of plans, this requirement would basically make the plan actuary perform a set of parallel calculations when he performs his normal actuarial evaluation.

We believe, after having had discussion with these actuaries, that the incremental costs of performing these parallel calculations really will be nominal. It basically will mean that they will perform a separate program in their actuarial evaluation for the accrued benefit statement, but we have taken care, in the timing of the calculation, to insure that this will not require an additional actuarial evaluation which we think might be burdensome to some plans.

Senator BENTSEN. Well, public confidence is absolutely essential, I think, for us to have these pension plans, the continuation of them. And it seems to me that standardization of the actuarial procedures used and accounting procedures would give you more public confidence.

What do you think about symmetry between the pension fund accounting and that of the employer?

Mr. LANOFF. Well, as I mentioned in my testimony, we are not really prepared to deal with the issue of employer disclosure today, although we feel that our proposals for pension fund disclosure may have impact on what is required for employer disclosure.

Senator BENTSEN. Senator Curtis?

Senator CURTIS. Thank you, Mr. Chairman.

There is nothing about your paper that leaves any doubt in my mind as to your capability, but, just for the record, tell me a little bit about your background from the standpoint of accounting training and experience.

Mr. LANOFF. Well, perhaps Dr. Woodruff, who I have assigned to direct this project, should respond. I have really nothing in my background that would——

Senator CURTIS. You are not an accountant?

Mr. LANOFF. That is right. I am a lawyer.

Senator CURTIS. Mr. Woodruff, let's have the background of your training.

Mr. WOODRUFF. Yes. One of the problems that we faced was that, for this particular disclosure, there was a need not only for accounting

background but also for actuarial and other backgrounds. My own training is in economics.

Senator CURTIS. You are not an accountant nor an actuary?

Mr. WOODRUFF. No.

But we have, on our staff at the Labor Department, actuaries. We also have consultants who are actuaries and accountants whom we have consulted as we progressed on the development of this proposal.

Senator CURTIS. Now, does your office accountancy expertise come from outside advisors, or can you give me the names of qualified accountants that are in your section?

Mr. WOODRUFF. We have the head of our Office of Regulatory Standards and Exceptions, Fred Stuckwisch, who is a certified public accountant.

Senator CURTIS. Has he had experience in non-Government work?

Mr. LANOFF. Yes, Mr. Curtis. I believe he was a CPA with the Peat, Marevick, Mitchell & Co. before coming to Government.

Senator CURTIS. How many people do you have on your advisory panel?

Senator BENTSEN. This is a side comment, and not directly on what you are saying, but we will have two witnesses who are partners in Arthur Anderson, accountants, of course, and we will have the president of the American Academy of Actuaries appearing.

Senator CURTIS. Now, this advisory group, how many are on that?

Mr. WOODRUFF. We have what is called a reporting and disclosure work group and, on that, the reporting and disclosure work group, whom we have met with on this issue on several occasions, we have a representative of the American Institute of Certified Public Accountants, the American Academy of Actuaries, as well as several representatives of industry and plans who have accounting and banking investment backgrounds.

Senator CURTIS. And how large is this group?

Mr. WOODRUFF. It is, I believe, about seven.

Senator CURTIS. Seven, or 70?

Mr. WOODRUFF. Seven.

Senator CURTIS. Seven.

Do any of those seven accountants handle pension reporting for smaller companies; companies that have 200 employees or less?

Mr. WOODRUFF. Some of the firms do handle small plans, though they also handle large plans.

Senator CURTIS. Now, by "firms," what kind of firms are you talking about? Are you talking about the company which operates the pension or a firm that they employ?

Mr. WOODRUFF. On the advisory council, the members are primarily from a larger accounting and actuarial firm, as well as large corporations.

Senator CURTIS. Are they the larger accounting firms?

Mr. WOODRUFF. That is right, but some of the larger accounting firms handle the accounts of small pension plans.

Senator CURTIS. I understand.

Mr. Lanoff, do you agree that it should be the policy of Government to encourage the creation of private pension plans?

Mr. LANOFF. Oh, definitely, Senator Curtis.

Senator CURTIS. That has been reversed since the passage of ERISA, has it not? The number of pension plans created has slowed down almost to a trickle and the number of pension plans that have been discontinued has increased several fold. Is that not right?

Mr. LANOFF. As far as I am aware, Senator Curtis, there is no study at this point which we accept as being valid which indicates precisely the number of plans that have terminated since ERISA's passage. The closest study to accomplishing that that I am aware of is the recently issued report of the General Accounting Office and, in that report, the GAO, based on its study of some of the plans that terminated since the passage of ERISA, found that, for the most part, it was not ERISA requirements that led these plans to terminate. That, for those that did terminate primarily because of ERISA, the cause was attributed to the disinclination of these plans to meet the minimum standards requirements, the vesting participation and the funding standards, of ERISA.

And finally, that, not withstanding the number of terminations since the enactment of ERISA, all in all, participants in the private pension plan system because of ERISA were now more likely than prior to ERISA to receive earned benefits.

So, for the most part, those of us who believe strongly in this law and the reforms it contains, were very pleased with the results of that study.

I also understand——

Senator CURTIS. I am sure you would be, but I think the cold facts show that there has been a great speed-up in the termination rate.

Now, as I understand you, your reply was not totally responsive to my question. My question was not whether or not the reporting procedures or the accounting procedures caused plans to terminate, but whether ERISA in its total impact caused more plans to terminate and I believe here we should keep in mind also that the private pension plans had been reporting to only one Government agency before ERISA.

Then I think the Congress went pretty far in some of the other areas strictly by fixing the funding and participation requirements and subjecting pension managers and owners of companies to fines for noncompliance.

It was my privilege to attend the all-day panel session on ERISA a couple of years after it had been enacted. It was sponsored by the Bar Association, the accountants, the insurance companies, the banks and trust companies, and we had some very able speakers in there. And I was around there all day. There was not a single individual who held up his hand or, in private conversation, said how do you start a pension plan. But the whole tenor of the feeling of the people in the audience was, how do you terminate one?

So it may be that everything you have recommended here is all right, but in addition to having representatives of large accounting firms who happen to have some work for smaller companies with their pension plans, I think you ought to reach down and have some actual owners of companies and some actual local CPA's who handle plans for small companies, look over the recommendations before this committee takes any action.

Large accounting firms are very important to our economy and they have some exceedingly able people and oftentimes have people who make recommendations to the Congress that are very valuable. On the other hand, they seem to see only the problems that affect the largest plans and they may be unaware of the problems that affect the smaller plans. I am interested in doing what should be done, but not making it any more burdensome for the local industry which has a couple of hundred employees or less and uses a local accountant who is well-qualified, but is unaffiliated with the major firms. That accountant would know the problems ERISA is causing for the small plans.

I think their reactions to the proposals would be invaluable to the Congress. I think that is very much in the spirit of the questions raised by our chairman as to what this does to small people.

I am not criticizing what you said. I just do not know the merits of these proposals.

Mr. LANOFF. I agree with what you are saying, Senator Curtis, about us consulting with all types of representatives of these plans, including those, of course, who either run or service smaller plans, and we do intend to propose what we have talked about today for public comment. But, in addition, based on what you are saying, I will agree, of course, to actively solicit comments from representatives of, or those who service, the smaller plans.

Also, I believe Mr. Woodruff wanted to add that he has met with some of the representatives of smaller plans in this process.

Mr. WOODRUFF. Yes, Senator. We, in developing these proposals, in addition to the recordkeeping work group that we mentioned in our testimony, met with the small plans work group of our public advisory committee, and based in part on the results of those meetings, we decided to exempt from this requirement small plans.

They mentioned to us the two points that we made in the testimony, one being that we determine that, on a per participant basis, the cost of this being too burdensome, at least given current practice in the actuarial industry; and that secondly, we felt that the benefits that we derived from these figures in small life plans where the variation could be substantial from year to year because of employee turnover, was minimal so we decided to waive this requirement for small plans.

We continued to meet with that work group to develop other alternatives to this or other reporting requirements that we would have.

Senator CURTIS. Just one other brief question. Does the Treasury and the IRS concur in your presentation this morning?

Mr. LANOFF. We have met with the Chief Actuary at the Internal Revenue Service and believe that we have their concurrence on our approach. We have been working, and the reason that we are not, at this point, proposing the form for publication, we now have a group that is working with the forms people at the Internal Revenue Service to develop the actual form, and that, at that time, we will know exactly where they stand, completely.

Senator BENTSEN. The Treasury will prepare a detailed statement on this.

Senator CURTIS. My question is, whether Treasury and IRS are together in what they are recommending.

Mr. LANOFF. We believe we are on the basic principles.

Senator BENTSEN. I have looked at the General Accounting Office study, and scanned that, and then, in turn, statements from Treasury and IRS on what was happening in the plans. And I think there is general agreement that there are a number of reasons, not just one, for small plan terminations.

One reason is paperwork, but another one is funding and some plans not desiring to fund at the minimum levels as set forth in ERISA.

Were there any further comments or statements to be presented?

Thank you very much, gentlemen.

Mr. LANOFF. Thank you, Mr. Chairman.

[The prepared statement of Mr. Lanoff follows:]

STATEMENT OF IAN D. LANOFF, ADMINISTRATOR, PENSION AND WELFARE BENEFIT PROGRAMS, U.S. DEPARTMENT OF LABOR

Mr. Chairman and Members of the Subcommittee:

I would like to thank you for inviting me to speak to this subcommittee today on accounting and actuarial disclosure practices in pension funds. With me is my Special Assistant Dr. Thomas C. Woodruff who since December, has been coordinating a review of these disclosure practices—particularly as they relate to the reporting of pension fund benefit liabilities.

In my remarks today, I will primarily address the Department of Labor's efforts directed toward improving the disclosure of private pension fund benefit liabilities in pension fund financial reports. While we believe that the results of our efforts on pension fund disclosure may have implications for corporate financial disclosure, we are not prepared to speak on that subject today.

Mr. Chairman, during the past year, a number of articles have appeared in newspapers and business magazines regarding pension plans liabilities and how those liabilities are to be calculated. These articles have made two general claims: First, that the size of pension fund benefit liabilities threatens the financial security of many companies. And, second, that the lack of clear and uniform accounting and actuarial data on pension plans make it difficult for beneficiaries, corporate shareholders, the public, parties involved in collective bargaining, and the Government to know what the real benefit liabilities of the plans are.

At this time, Mr. Chairman, I would like to submit for the record two speeches which I delivered during late winter and early spring of this year. In the first speech, entitled, "Are Pension Funds Really Jinxed?", I analyzed and then proceeded to take strong exception to the claim made in the media that the financial security of many companies is threatened by their pension liabilities. The problem is that the media relies upon inaccurate or inappropriate liability figures. However, in that same speech I agreed with the complaint that inadequate accounting and actuarial data is available for disclosure purposes because of actuarial assumptions and methods used in calculating pension plan liabilities.

My concern over the lack of data regarding calculation of benefit liability figures led me to initiate a review of the Department's reporting and disclosure requirements for annual actuarial and accounting data from pension plans on Schedule B, the actuarial report portion of the 5500 annual financial report to the Department of Labor and the Internal Revenue Service.

In the second speech delivered on May 22, 1978, before the ERISA Workshop Group at Cornell University, I announced that we had largely completed that review and expect to soon request public comment on a series of changes to Schedule B, incorporating the following four principles:

(1) The annual reporting of accrued vested and nonvested benefits for all defined benefit pension plans with over 100 participants;

(2) The requirement that all plans use a single actuarial cost method, the accrued benefit (unit credit) cost method for calculating these accrued benefit figures;

(3) Disclosure on the form of major actuarial assumptions; and

(4) Guidelines indicating that the assumptions selected should reflect the anticipated experience of an ongoing—rather than terminating—plan.

This morning, Mr. Chairman, I will elaborate upon my earlier announcement of these basic principles. I will briefly describe the basis of the principles and explain the proposed changes to Schedule B.

Our proposed changes to Schedule B resulted from a long series of meetings with various groups over the past several months, including meetings with representatives of the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), the American Academy of Actuaries (AAA), the ERISA Advisory Committee, the Pension Benefit Guaranty Corporation, and the Internal Revenue Service. These meetings all confirmed the need to make changes in the reporting of this important data.

It is my hope that the changes we now have under consideration will lessen the uncertainty and confusion that currently surround disclosure of private pension plan benefit liabilities. In the end, the elimination of much of this uncertainty should have a positive impact on the growth of these plans.

THE PROPOSALS

Pursuant to the requirements of section 103(d)(1) and (5) of ERISA, defined benefit pension plans disclose accrued benefits, (also known as accrued liabilities), value of assets, unfunded accrued benefits and value of vested benefits (if calculated) on Schedule B of the 5500 Annual Report to the Department of Labor and IRS. In footnotes to corporate financial statements, the SEC requires disclosure of unfunded accrued benefits, (also known as unfunded accrued liabilities), and the Financial Accounting Standards Board (through APB Opinion No. 8) requires disclosure of unfunded vested benefits.

The calculations for all of these figures are currently performed by the pension plan actuaries at the time that they perform their funding standard account (FSA) actuarial evaluation. In general, the actuary uses the FSA-derived figures for these disclosure requirements.

In addition, section 103(d)(6) of ERISA calls for a display of the present value of pension plan liabilities for "nonforfeitable" benefits allocated by ERISA section 4044 termination priority categories.

This requirement has been waived for plan years 1975, 1976, and 1977.

Both the disclosure of accrued benefits under ERISA section 103(d)(1) and the display of plan unforfeitable benefits under section 103(d)(6) were intended to provide plan beneficiaries, interested Federal agencies, and investors in the private corporations supporting the pension plans with some measure of the adequacy of pension plan assets to meet benefit payout obligations.

The accrued benefit figures are calculated using a number of acceptable actuarial methods and assumptions. The choice of methods and assumptions can, however, significantly change the value of the figures. This had led to questioning among accountants and investors of the adequacy of these figures for disclosure of pension plan assets and liabilities. The work of the three ERISA agencies—the Department of Labor, the Department of Treasury (IRS), and the Pension Benefit Guaranty Corporation (PBGC)—has also been hampered by this lack of uniformity and full disclosure.

Last year in its exposure draft on defined benefit pension plan accounting, the Financial Accounting Standards Board called for uniformity in calculating these figures.

As I mentioned earlier, we began a review of the Schedule B requirements last December. The purpose of the review was to reevaluate the Department's position on section 103(d)(6) and to explore whether uniformity in the presentation of accrued benefits is desirable from the standpoint of the needs of pension plan beneficiaries as well as the three ERISA agencies.

WAIVER OF SECTION 103(D)(6)

Section 4044 priority categories require elaborate calculations of each individual's benefit priority status. Our analysis indicates that one beneficiary might fit into any or all of section 4044's six priority categories. Performing such annual calculations on each individual participant could be expensive and burdensome to plans.

The American Academy of Actuaries and the ERISA Recordkeeping, Reporting and Disclosure Work Group have recommended that this requirement of section 103(d)(6) be waived.

In the event, however, DOL should deem some estimate of priority categories desirable, this group also suggested an alternate method of displaying the categories. While the suggested alternative would be much less expensive to calculate, it could vary substantially from the true calculations, thus misleading an individual seeking information about his/her benefit security by such a display.

The authors of section 103(d)(6) apparently believed that beneficiaries could look to allocation categories to assess their likelihood of receiving future benefits. PBGC's experience to date indicates that the financial condition of the company, companies, or industry contributing to the pension fund may be a better indicator of whether the plan may terminate or otherwise incur funding problems in the future.

In other words, unless we also require corporate financial disclosure alongside pension fund data, we probably cannot adequately meet the intent of section 103(d)(6) to inform beneficiaries of the probability of a pension plan's likelihood of meeting pension payments.

At the present time, however, we do not have either the specific statutory authority or the desire to require such reporting. Our efforts have been focused on improving the reporting of the pension funds.

The ultimate measure of benefit security for pension plan participants in a terminating plan rests with the level of guarantees provided by the Pension Benefit Guaranty Corporation. Should a pension plan terminate, the plan participants' entitlements to benefits are determined by section 4022 of ERISA.

In general terms, pension guarantees of vested benefits are limited by a maximum amount (currently about $1,000 per month) as well as phase-in rules for plan benefit increases.

Therefore, participants in such plans have more of an interest in knowing whether their pension fund will be able to pay for benefits during the benefit payout period and, if not, how much the PBGC will guarantee upon plan termination. Most plan participants are enrolled in ongoing pension plans that will not terminate. We believe that to require all plans to disclose section 103(d)(6) figures that are relevant to less than 1 percent of pension plan participants is unduly burdensome. Therefore we are concentrating on improvements to benefit disclosure for ongoing plans and are considering recommending that this requirement of section 103(d)(6) continue to be waived.

THE CHOICE OF ACTUARIAL COST METHOD FOR CALCULATING ACCRUED BENEFITS

Section 3 of ERISA defines acceptable actuarial cost methods that may be used by pension plan actuaries for funding standard account calculations. Unfortunately, the use of some of these methods—which are appropriate for funding calculations—may result in misleading numbers for statements of accrued benefits. The accrued benefit figures derived from some of these methods do not necessarily reflect benefits earned by employees' past services, but rather the portion of total pension costs which the actuarial cost method allocates to past or accrued services.

When these misleading figures are then compared to pension plan assets, misleading figures for "unfunded" liabilities are created.

It is our belief that the accrued benefit cost (unit credit) method is the proper method for calculating the accrued benefit figures. (Actuaries may still use the other methods for funding purposes). This method—unlike the others—allocates benefit accruals to periods of time that are related to actual service performed by the employees covered by the pension plan.

Furthermore, we believe that the assumptions used by the plan actuary should explicitly reflect the expected experience of an ongoing plan.

For example, the choice of the interest rate for discounting the value of benefits on the present should reflect the anticipated earnings experience of the pension plan's assets over the benefit payout period.

In addition to the choice of assumptions, we expect to propose that the accrued benefit statements reflect the pension plan's obligations current to the end of the plan year. This is necessary in order that these figures be current to the same date as other financial data reported on the 5500 Annual Report—particularly the current value of plan assets.

We do understand that many actuarial firms currently perform their normal actuarial evaluations during—rather than at end of—the plan year. We would not be asking them to change this procedure. Instead, plan actuaries would be permitted to project their calculations to the end of year as long as they believe that those projections reasonably reflect the condition of the plan at that time.

STATEMENT OF ACCRUED VESTED BENEFITS

Many plan actuaries currently calculate the value of vested benefits because their plan sponsors are subject to the guidelines of A.P.B. Opinion Number 8.

Common practice is to use the accrued benefit cost method for calculating this figure.

However, there still exists some degree of variation in the practice of calculating this figure. Our expected proposals on the choice of methods, guidelines as to assumptions, and the timing of the calculations would alleviate most of this variation.

STATEMENT OF ACCRUED NONVESTED BENEFITS

In order to represent fairly the accrued benefit obligations for an ongoing plan, it is necessary to include a statement of accrued nonvested benefits. Nonvested benefits should not be thought of as current liabilities of the pension plan. Rather, nonvested benefits are liabilities that are contingent on future service by the plan participant.

In calculating the present value of accrued nonvested benefits, we expect to propose that the plan actuary use the accrued benefit cost method. Currently the greatest distortion in the calculation of accrued benefit liabilities due to the choice of actuarial cost method occurs in the calculation of nonvested benefits. We believe that a requirement to use the accrued benefit cost method for calculating accrued nonvested benefits would eliminate these distortions.

Depending upon the provisions of the particular pension plan, the present value of accrued nonvested benefits may also be subject to assumptions about future services. For example, in a pension plan where the level of pension benefits is based on final salary prior to retirement, the value of accrued benefits based on service to date is subject to the assumption of the level of final salary. Therefore, for plans that have provisions (such as final salary, death benefits, subsidized early retirement, disability benefits, etc.) that may change the value of accrued benefits either vested or nonvested) contingent on future events, two nonvested benefit figures would be required:

(1) Accrued non vested benefits (historical) based on current compensation levels and current entitlements; and

(2) Additional accrued nonvested benefits (projected) based on anticipated changes in the value of accrued benefits due to future events.

For many plans, disclosure of only the first figure would be necessary. We do believe, however, that disclosure of additional contingent obligations is important for plans with such provisions.

THE CURRENT VALUE OF PLAN ASSETS

The Department of Labor continues to take the position that pension plan assets should be disclosed at current rather than book value in the 5500 Annual Report. The plan actuary, however, may continue to calculate a separate actuarial value of assets for funding standard account purposes.

CALCULATIONS OF UNFUNDED BENEFITS

If the above proposed changes in Schedule B were adopted, the following calculations could be performed.

Figure. 1. Unfunded Vested Benefits equals (Accrued vested benefits)—(current value of assets).

Figure 2. Unfunded Total Accrued Benefits (Historical) equals ((accrued vested benefits) plus (accrued nonvested benefits (Historical))) minus (current value of assets).

Figure 3. Unfunded Total Accrued Benefits (Projected) equals (accrued vested benefits plus accrued nonvested benefits (historical) plus additional accrued nonvested benefits (Projected)) minus (current value of assets).

We believe that the above calculations will reveal accrued benefit liability figures that are more meaningful than those that are currently available. Nevertheless, care would still be required in the use of these figures. Figure 1 represents a fair comparison between the entitlements of participants to pension benefits and current assets. Figures 2 and 3, however, should not be used in isloation. They will be most useful for analysis on a multi-year basis as measures of the changing characteristics of ongoing plans. The fact that 2 and 3 may be greater than zero in any particular year should not necessarily be alarming to either plan participants or the plan sponsors. What would be important, it seems to me, are changes in these figures over a number of years. In addition, trends in the individual items of accrued benefits would be useful in analyzing changes in the structure of benefits in the various plans.

DISCLOSURE OF ACTUARIAL ASSUMPTIONS AND METHODS ON SCHEDULE B

Computerization and, therefore, analysis of Schedule B is currently hampered by the fact that disclosure of methods and assumptions is currently covered via attachments to the Form. There appears to be no additional cost associated with moving some of this information onto the Form itself.

Therefore, we expect to propose that two questions be added to the Form:

(a) A checklist of actuarial methods used for the actuarial evaluation for funding standard account (only one method can be used for accrued benefits calculation).

(b) A checklist of major actuarial assumptions used for funding *and* accrued benefits calculations. Actuaries would still be required to attach a list of all of their assumptions used.

CONCLUSION

We believe that these proposals on the disclosure of accrued benefits in Schedule B for defined benefit pension plans, if adopted, would dispel the confusion that has been generated by the lack of uniformity in the past. These proposals would help plan participants, plan sponsors, investors, the ERISA agencies, and the public determine the ongoing obligations of these private pension plans.

We do not know whether all of these proposals are applicable to disclosure of public plan benefit obligations. We currently, however, are supporting a research project that may help us make this determination.

We hope that our concern with these issues will ultimately result in greater income security for the American workers participating in the private pension system.

Senator BENTSEN. Our next witness will be Mr. A. F. Ehrbar, member of the Board of Editors of Fortune magazine, and author of the article that helped get me stirred up for these hearings.

Mr. Ehrbar, if you would come forward, please?

STATEMENT OF AL F. EHRBAR, BOARD OF EDITORS, FORTUNE MAGAZINE, AND AUTHOR OF "THOSE PENSION PLANS ARE EVEN WEAKER THAN YOU THINK," FORTUNE MAGAZINE, NOVEMBER 1977

Mr. EHRBAR. I appreciate the opportunity to offer my views at this hearing, and I will try to keep my remarks as brief as possible while covering the six questions put by the subcommittee.

As a preface, I would like to say that I do not evaluate this issue from the perspective of an accountant or an actuary, but rather from the standpoint of a user of accounting statements and acturial statements, and I think that is the light in which they should be viewed, rather than the technical aspects.

Senator BENTSEN. I know there are those in the audience who would also like to hear you, so if you would pull your mike up, and speak into it.

Mr. EHRBAR. The issue of pension costs and liabilities is one that, unsurprisingly, was virtually ignored until the past few years, because the magnitude of the pension burden used to be trivial relative to the earning power of corporations.

That has been changed by increases in real benefit levels, inflation, and the dismal stock market performance of the past dozen years. Corporations have now set aside, by the estimate of the Department of Labor, some $250 billion to meet their pension obligations, yet even that amount is, by our estimates at Fortune, at least $50 billion less than the present value of existing obligations for vested benefits, and the shortfall could be $200 billion or more.

To be sure, most corporations have funded their obligations extremely well and are carrying unfunded liabilities that are insignificant relative to their net worth and earning power. A handful of companies, however, have unfunded obligations that exceed what I would consider a prudent level of their net worth. Moreover, the companies——

Senator BENTSEN. Let me ask you one thing, as I read your article, that I did not really quite understand. Net worth, I understand the reason for that. But, if I remember, you also put the market value of stock, in one example, as related to that.

Why is that significant?

Mr. EHRBAR. It gives a good indication of the magnitude of the obligations versus the value that the marketplace puts on the corporation itself, or the residual assets of the corporation. And I view pension obligations as a form of leverage in the same way as long-term debt.

It is common to look at things like debt-to-equity ratios to assess the relative magnitude of the debt.

I was trained as a financial economist, and I try to ignore the book values of debt and equity, and look at the market values of debt and equity. That is why I focused on the market values of the corporation, as well as the net worth.

Does that make it clear, or clearer?

Senator BENTSEN. If you say so. All right. Please proceed with your statement.

Mr. EHRBAR. While only a handful of companies would appear to be in trouble, the companies with the largest unfunded liabilities relative to their ability to discharge them tend to be the largest corporations in the country.

At the end of 1976, 10 of the 100 largest corporations had unfunded liabilities in excess of 30 percent of net worth. An even larger number had unfunded liabilities for vested benefits that were greater than their long-term debt.

With unfunded liabilities of that magnitude, it is natural that investors, lenders, security analysts, and rating agencies have begun to focus on pensions, but when they try to get a fix on pensions, most simply throw up their hands. They know that pensions matter, but the area is so arcane that they cannot find out just how or why.

That outsiders feel lost when they try to deal with pension data is the inevitable result of the way that data is computed and presented. Corporations can use any one of six different actuarial methods to determine their pension costs and liabilities. Within each of those methods, they make numerous assumptions about such things as quit rates, early retirement rates, life expectancies, future rate of wage increases, and the rate of return on the pension fund portfolio. Differing assumptions naturally compound the effects of the different methods, so that it is literally impossible to compare one corporation's pension costs or liabilities with another's.

Moreover, few corporations routinely disclose the methods or assumptions they use and some—Caterpillar is an example—will not even disclose them when asked.

The information is available in 5500, but the 5500's normally are not available.

In sum, pension reporting from the perspective of investors and lenders is astonishingly inadequate. Detailed schedules of long-term debt, complete with interest rates and maturities, are included in the annual 10K report to the Securities and Exchange Commission. Virtually nothing is readily available about pension costs and liabilities even though the magnitude is often greater.

The only figures that most companies report to shareholders and security analysts are their pension expenses for the year and their so-called unfunded vested benefits.

There are several problems with the latter figure. It is generally computed under the unit credit method, which provides a modicum of uniformity, but it normally excludes liabilities for the proportion of currently nonvested employees who will become vested and who will be paid benefits for work they have already performed.

More important, unfunded vested benefits are normally calculated on the basis of current wages, even though most plans base benefits on a final pay formula. The result is that vested benefits are grossly understated, at least in the context of an ongoing plan.

The treatment of using current salary could be called the termination valuation of vested benefits. That treatment is perfectly adequate if one's perspective is that of the employee or the Pension Benefit Guarantee Corporation. Should a plan terminate, benefits will be based on current salaries.

So long as a company keeps up with its liabilities computed on a termination basis, it imposes little or no risk on employees or the PBGC.

Senator BENTSEN. That puts you in agreement with the Labor Department's recommendation that it be an ongoing plan that therefore will factor in some idea of what inflation is and what wages might be on termination.

Mr. EHRBAR. Yes.

Investors and lenders necessarily have a different view. They are evaluating corporations as going concerns, assuming that the company does not terminate its pension plans, an event usually occasioned by bankruptcy.

The meaningful figure for them is the higher one, and also it is a more meaningful one to the company, a point that is obvious from the fact that the future salary estimates are included to compute the pension expenses and funding schedules.

Several actuaries have complained to me that my view amounts to the same things as carrying future salaries, utility bills, or other costs as current liabilities. Corporations, they say, do not have a current liability for higher benefits that result from future wage increases.

However, I am talking about the ultimate costs, based upon existing agreements of benefits that have already been earned by employees, and not about the future costs of future labor services.

Another problem with the unfunded vested benefit figures currently being reported is the disparity in interest rate assumptions used to discount future benefits to present value. An increase of 1 percentage point in the interest assumption will reduce total liabilities by about 25 percent. A company with $400 million in vested benefits and $300 million in pension fund assets would report unfunded vested benefits of $100 million.

A company in identical circumstances could, with a slightly higher interest assumption, report that it had no unfunded vested benefits.

I have been told by members of several large actuarial firms that interest assumptions currently range from about 3.5 percent to as high as 10 percent.

Senator BENTSEN. Interest assumptions of 10 percent?

Mr. EHRBAR. I have been told that those exist. I do not know the specific instance, but I was told that there are companies using interest assumptions as high as 10 percent.

Senator BENTSEN. A 10-percent interest assumption. They either have a genius managing that portfolio, or they are extremely extravagant in their assumptions.

Mr. EHRBAR. Well, there are circumstances under which 10 percent, I think, would be quite reasonable for funding purposes, providing that the wage assumption was commensurately high. But I am not certain that that is the case.

A final, critical point about the unfunded vested benefit figure. The number is a residual obtained by deducting pension fund assets from the total vested benefits. Few companies report total liabilities for vested benefits or pension fund assets.

Those numbers are more important than the unfunded vested benefits. That is so because shareholders bear the risks and reap the rewards of returns to the pension assets.

The trust fund arrangements, are, as far as I am concerned, a facade. If the performance pension portfolio falls short of the assumed rate, the interest assumption, the deficit must be made up out of what otherwise would show up as profits. Conversely, shareholders get the benefit of any greater than assumed returns in the form of reduced funding expenses.

Stockholders thus own a share of the profits from operations plus or minus a share of the excess returns and losses on the pension funds.

In some cases, the returns on a pension fund are more important than a company's operating results, because of the size of the pension fund relative to the size of the company.

I will now address the six specific questions posed by the subcommittee.

First, the selection of a specific actuarial method is essentially a cash budgeting decision. The various methods are mathematical artifices that allocate cash contributions to the pension fund over time. As such, they have nothing to do with measuring expenses or liabilities in any economic sense of the term.

Nonetheless, the cash contribution dictated by the method shows up on a company's income statement as pension expense, and the difference between what should have been accumulated to date and the actual pension fund assets often is reported as the prior service cost, a sort of second cousin of the unfunded vested benefits.

The only actuarial method that measures expenses as they occur in an economic sense, that is, the value of future benefits that an employee earns in the current year, is the unit credit method. That is the method I believe should be used for determining pension expenses and liabilities for public reporting purposes.

In addition, any shortfalls or excesses in the return on the pension portfolio which increase or decrease unfunded liabilities should be charged to earnings in the year that they occur.

For example, if the company has $100 million of pension assets and uses a 7-percent interest assumption, it is assuming that the portfolio will earn $7 million. If, in fact, the portfolio falls by $10 million, the $17 million shortfall from what was assumed should be charged to earnings.

Lastly, the amortization of unfunded liabilities should not be charged as a pension expense, because all liabilities should be charged as incurred rather than as funded.

Senator BENTSEN. Let me ask you what we are talking about here, now. Are you not talking about the market value of the portfolio, are you?

Mr. EHRBAR. Yes.

Senator BENTSEN. You are?

Mr. EHRBAR. Yes.

Senator BENTSEN. Not just the return, but the market value?

Mr. EHRBAR. Well, a change in the market value is the return for a given year, plus dividends or interest payments on bonds.

I will elaborate on that a bit, if you would like.

Senator BENTSEN. I think you should.

Mr. EHRBAR. There is a large body of data which has been compiled over the last 15 years which has come to be known as the efficient market theory of capital asset pricing which holds that the current market price of capital assets such as a share of stock or a corporate bond is the best estimate of its true worth.

If the market value of the asset rises by 10 percent or falls by 10 percent, the corporation, the sponsor of the pension plan, has made or lost 10 percent. I would agree with actuaries that it is not proper to react year to year in funding to those fluctuations. However, the shareholder and the lender want to know at a point in time that the security or the earning power is that he is putting his money up for, and the only estimate for that that is material is the current market value. What was paid for as asset was immaterial. The moving average of market value is immaterial. If a stock is worth *x* number of dollars today, that is what matters, not if it was purchased for *x* plus 10 a year ago.

Senator BENTSEN. Let's go at it another way, and let me follow this through.

Suppose we had nothing but bonds in this portfolio and the market value goes down substantially on these bonds, but we did not change any of the investments and we held them right to their maturity and there was no question about the security of those bonds.

The reason the market value went down was because yields on other types of investments went up, but the actuarial assumptions were based on these yields of these bonds, and you held them until maturity.

Do you not then take care of the funding of the——

Mr. EHRBAR. No. In that situation——

Senator BENTSEN. You get your principal back.

Mr. EHRBAAR. Well, assume that bond coupons were at 6 percent and you were assuming a rate of return of 6 percent which reflects a given expectation about inflation over the next 20 or 30 years. Your wage assumption would also reflect, then, inflation.

Senator BENTSEN. OK. I see where you are. You are talking about an ongoing plan that the wages are going to go up, and therefore——

Mr. EHRBAR. Yes. If the bond drops, that means there is going to be more inflation and wage rates are going to rise at even higher rates, and you are not as far ahead in funding as you were, because you are tied into that fixed coupon.

Senator BENTSEN. I am with you. I see.

My argument would have to be if wages would stay flat, which we know they are not going to.

Mr. EHRBAR. Yes.

Senator BENTSEN. All right.

Mr. EHRBAR. Several specific cases should be mentioned here in the context of the method to use. The unit credit method should, of course, include an assumption about future wage increases as labor has put forth, but some companies, notably those with major union contracts such as auto and tire, pay benefits of so many dollars per year of service. Instead of tying benefits to wages, the dollar figure is renegotiated each contract.

Obviously, those companies cannot assume the outcome of future negotiations. They should, however, charge benefit increases for past service to earnings in the year they are granted, rather than amortizing the retroactive increases as they do now. The motivation for the current treatment is to smooth out the impact of the retroactive grants on earnings. That may look nicer, but it does not change the underlying reality that management has granted a new claim against the company for service that has already been performed.

Multiemployer plans, which you raised, present another problem. The plans frequently promise workers specific benefits, but assess employers fixed amounts for each active employee. In essence, they are defined benefits plans, funded with defined contributions. In practice, one side of the equation must prove incorrect. The contributions will turn out to have been too large or too small when the benefits come due.

Employers have no way of knowing whether the amounts set aside will cover promised benefits. They may ultimately be forced to make up shortfalls after some competitors have gone out of business, thus paying some of the competitors' obligations.

Indeed, that very situation threat is what threatens multiemployer plans now.

Senator BENTSEN. Mr. Ehrbar, they turned the light on us some while ago, and part of that is my fault because I have interrupted you here, but I find what you are saying very interesting and I want it as complete as we can get it for the record, but I am going to have to ask you to summarize because of the number of witnesses we have to hear this morning and we will take your entire statement for the record.

Mr. EHRBAR. All right.

The second point, it is immaterial whether unfunded liabilities are carried on or off the balance sheet. What should be reported are total accrued liabilities by the unit credit method, and total pension fund assets; whether they are on the balance sheet or in a footnote to financial statements I don't think makes much difference.

Plan assets should be valued for reporting purposes, as I said, at market value, although it may make sense to use a moving average for funding purposes.

The computation of costs and liabilities should be the same for corporate reporting and pension plan reporting. What is true for one statement is true for the other. In addition, the existence of two sets of figures would foster undue worry about the veracity of sponsors and the security of benefits.

At the same time, it would be entirely proper to use a second method of computation for funding purposes. It is worth noting here that a principal argument against enforced uniform pension reporting is that different actuarial methods are appropriate for different companies.

I disagree with that assertion, but even if correct, it applies to funding or cash budgeting and not on the measurement of expenses and liabilities. To the fifth question, there is no way to insure against the manipulation of assumptions in order to understate pension expenses and liabilities. There always will be venal people and you cannot regulate them out of existence.

Senator BENTSEN. Let me ask you this. You have raised questions with this.

The investor is trying to evaluate management's performance, and let's say the pension plan is not the responsibility of the management insofar as managing the assets. That has been given to an investment management firm to do.

Is that a fair way, then, to evaluate how the management is doing on the job of running a manufacturing company?

Mr. EHRBAR. It is not a fair way to evaluate management's performance in running the operating assets of the corporation. There would be nothing to preclude a broken-out income statement which would segregate out the facts of the pension portfolio.

The important thing here is that the investors are told all that has happened over the course of the year which affects their claims against the corporation and their claims on the future revenues of the corporation.

While I say that there is no way to insure against manipulation, I believe that there should be outside control over the interest and wage assumptions in order to insure that they are within reasonable bounds and to foster uniformity and comparability among companies.

The best method of setting the limits on those assumptions probably would be a legislated formula, which would be computed and promulgated by Labor and/or Treasury.

I will skip over my discussion of assumptions which pretty well mirrors my article of last November.

Finally, I have not done a detailed study of public pension plans, but a cursory review that I have made leads me to believe that problems in the public sector are even worse than those in the private sector.

The funding of public pensions is immaterial, since governments have the taxing power to meet their obligations—although the California vote suggests that there may be a limit to that power—but irrespective of whether public pensions are funded, they should be fully costed and included in budgets. Taxpayers need to know the total cost of government if the representative system is to provide anything close to the optimum level of public services.

As you pointed out earlier, it is tempting for a manager to grant pension promises instead of raises, knowing that he can adjust the assumptions, hold down costs and keep reported profits up and leave

the bill for his successor. It is even more tempting, as we in New York have discovered, to get the garbage off the streets of Queens and let the next administration worry about how to pay for it.

Senator BENTSEN. There is a lot of competition between actuaries and accountants on whose turf is involved in these things. Some have suggested that the measurement of benefit liabilities should be left to actuaries and that all actuarial cost methods acceptable under ERISA should be acceptable for reporting to plan participants. In their book on pension accounting, William Hall and David Landsittal state:

The accountant is not an actuary, has no expertise in how pension plans should be funded or in identifying and measuring turnover and other factors involved in actuarial determinations. He has the responsibility for specifying the broad criteria for measuring assets, liabilities, revenues and expenses for financial reporting purposes. The obligation to pay pension benefits does not change because of a change from one actuarial method to another.

What are your thoughts on the respective roles of accountants and actuaries?

Mr. EHRBAR. I agree, in large part, with Messrs. Hall and Landsittal. As I said, I do not feel that the actuarial methods which are used for funding, to determine funding schedules, really have anything to do with expenses or liabilities as they are reported in the financial statements of corporations, and that methods such as entry-age normal or aggregate should not be used to measure expenses reported on an income statement or to arrive at an unfunded prior service cost reported in a footnote.

Those should be done in as close approximation as possible of economic reality, which is, in my belief, the accrued benefit method, and none other. It is the accrued liability for benefits that have been earned, with best estimates of what those nominal values will be, discounted to a present value.

I don't think that is a particularly difficult calculation, once the actuaries have supplied the computations on turnover and mortality, early retirement rates.

Senator BENTSEN. Mr. Ehrbar, we will take your entire statement for the record and I want again to congratulate you on writing your article where it was understandable.

I was listening to some of the testimony of the Labor Department and I was following it very carefully and I am going to go back and read it again, and I look at the folks in the press over there and wonder how in the world they are going to report it so lay people can understand it. And yet we are talking about hundreds of billions of dollars. We are talking about an incredible number of people and an issue of very substantial magnitude.

But it is difficult to get it understood.

Thank you very much.

[The prepared statement of Mr. Ehrbar follows:]

STATEMENT OF AL F. EHRBAR, BOARD OF EDITORS, FORTUNE MAGAZINE

I appreciate the opportunity to offer my views at this hearing. I will try to keep my remarks as brief as possible while covering the six questions put by the Subcommittee.

The issue of pension costs and liabilities is one that, unsurprisingly, was virtually ignored until the past few years. The magnitude of the pension burden used to be trivial. But inflation, increases in real benefit levels and the poor

stock market performance of the last dozen years radically altered that situation. Corporations now have, by the estimate of the Department of Labor, set aside some $250 billion to meet their pension obligations. Yet even that huge amount is, by our estimates at Fortune, at least $50 billion less than the present value of existing obligations, and the shortfall could be $200 billion or more.

To be sure, most corporations have funded their obligations extremely well, and are carrying unfunded liabilities that are insignificant relative to their net worth and earning power. A handful of companies, however, have unfunded obligations that exceed 30 percent of their net worth. Moreover, the companies with proportionately large unfunded liabilities tend to be among the largest corporations in the country. At the end of 1976, ten of the 100 largest corporations had unfunded liabilities in excess of 30 percent of net worth; an even larger number had unfunded liabilities that exceeded their long term debt.

With unfunded liabilities of that magnitude, it is natural that investors, lenders, security analysts and rating agencies have begun to focus on pensions. After all, pension obligations must be met with monies that otherwise would be available for dividends, debt retirement or new investment, and there obviously are at least some instances where unfunded liabilities threaten the ability of corporations to reward shareholders or repay lenders. When shareholders, analysts and lenders try to get a fix on pensions, however, most simply throw up their hands. They know that pensions matter, but the area is so arcane that they cannot find out just how or why.

That outsiders feel lost when they try to deal with reported pension data is the inevitable result of the way that data is computed and presented. Corporations can use any one of six different actuarial methods to determine their pension costs and liabilities. Within each of those methods, they make numerous assumptions about such things as quit rates, early retirement rates, life expectancies, the future rate of wage increases and the rate of return on the pension fund portfolio. Differing assumptions naturally compound the effects of the different methods, so that it is literally impossible to compare one corporation's pension costs or liabilities with another's.

Moreover, few corporations routinely disclose the methods or assumptions they use, and some will not even disclose them when asked. The information is contained in the form 5500s, of course, but the Department of Labor necessarily has long delays in making forms accessible to the public.

In sum, pension reporting—from the perspective of investors and lenders—is astonishingly inadequate. Detailed schedules of long term debt, complete with interest rates and maturities, are included in the annual 10K report to the Securities and Exchange Commission. Virtually nothing is readily available about pension costs and liabilities, even though the magnitude is often greater.

The only pension figures that most companies report to shareholders and security analysts are their pension expenses for the year and their so-called "unfunded vested benefis." There are several problems with the latter figure. It is computed under the unit credit method—which provides a modicum of uniformity—but it normally excludes liabilities for the proportion of currently non-vested employees who will become vested, and who will be paid benefits for work they have already performed.

More important, unfunded vested benefits normally are calculated on the basis of current wages, even though most plans base benefits on a final pay formula. The result is that vested benefits are grossly understated, at least in the context of an ongoing plan. For instance, consider the case of a 45-year-old employee, earning $25,000 a year, with a pension plan that pays 1.5 percent of final salary for each year of service. If we assume 5 percent inflation, and that his wages keep pace with living costs, the employee will be earning $66,332 a year in twenty years. This year's service will entitle him to an annual stipend of 1.5 percent of $66,332, or $995 a year. If we assume, on the other hand, that the plan terminates now, the pension paid twenty years from now for this year's service will be 1.5 percent of $25,000, or $375 a year. The annuity value of the lower figure, discounted to a present value, is the one that companies use when computing unfunded vested benefits.

That treatment is perfectly adequate if one's perspective is that of the employee or the Pension Benefit Guaranty Corp. Should a plan terminate, benefits will be based on current salaries. So long as a company keeps up with its liabilities, computed on a termination basis, it imposes little or no risk on employees or the PBGC.

Investors and lenders have a different view. They are evaluating corporations as going concerns, assuming that the company does not terminate its pension plan (an event usually occasioned by bankruptcy). The meaningful figure for them is the higher one, also discounted to a present value. It also is the more meaningful one for the company, a point that is obvious in the fact that it is the one used to compute pension expenses and funding schedules.

Several actuaries have complained to me that my view amounts to the same thing as carrying future salaries, utility bills or other costs as current liabilities. Corporations, they say, do not have a current liability for higher benefits that result from future wage increases. However, I am talking about the ultimate cost—based on existing agreements—of benefits that have already been earned by employees, and not about the future costs of future labor services.

Another problem with the unfunded vested benefit figures currently being reported is the disparity in interest assumptions used to discount future benefits to a present value. An increase of one percentage point in the interest assumption will reduce total liabilities by about 25 percent. A company with $400 million of vested benefits and $300 million of pension fund assets would report unfunded vested benefits of $100 million. A company in identical circumstances could, with a slightly higher interest assumption, report that it had no unfunded vested benefits. I have been told by members of large actuarial firms that interest assumptions currently range from about 3.5 percent to as high as 10 percent.

A final, critical point about the unfunded vested benefit figure. The number is a residual obtained by deducting pension fund assets from total vested benefits. Few companies report total liabilities for vested benefits or pension fund assets. But those numbers are more important than the unfunded benefits. That is so because shareholders bear the risk and reap the rewards of returns to pension assets. If the performance of the pension portfolio falls short of the assumed rate (the interest assumption), the deficit must be made up out of profits. Conversely, shareholders get the benefit of any greater-than-assumed returns, in the form of reduced funding expenses.

Stockholders thus own a share of the profits from operations, plus or minus a share of the excess returns or losses on the pension fund. In some cases, the returns to the pension fund are more important than the company's operating results. An extreme example is Lockheed. At the end of 1976, it had a net worth of $166 million and a pension fund portfolio of $1.026 billion. A 17 percent change in the value of that portfolio—a fairly frequent occurance in recent years—would amount to more than the net worth of the company. Admittedly, few companies are in that situation, but many have pension assets equal to net worth.

I shall now address the six specific questions posed by the Subcommittee, which I believe go to the heart of what should be done to correct the gross inadequacies in pension reporting.

(1) The selection of a specific actuarial method is essentially a cash budgeting decision. The various methods are mathematical artifices that allocate cash contributions to the pension fund over time. As such, they have nothing to do with measuring expenses or liabilities in any economic sense of the term. Nonetheless, the cash contribution dictated by the method shows up on the company's income statement as pension expense, and the difference between what should have been accumulated to date and actual pension fund assets often is reported as the "prior service costs," a sort of second cousin of the unfunded vested benefit figure.

The only actuarial method that measures expenses as they occur in an economic sense—that is, the value of future benefits that an employee earns in the current year—is the unit credit method. That is the method which I believe should be used for determining pension expenses and liabilities for public reporting purposes. In addition, any shortfalls or excesses in the return on the pension portfolio—which increase or decrease unfunded liabilities—should be charged to earnings in the year that they occur. For example, if a company has $100 million of pension assets and uses a 7 percent interest assumption, it is assuming that the portfolio will earn $7 million. If, in fact, the portfolio falls by $10 million, the $17 million shortfall should be charged to earnings. Lastly, the amortization of unfunded liabilities would not be charged as a pension expense because all liabilities would be charged as incurred, rather than as funded.

Several special cases should be mentioned here. The unit credit method should, of course, include an assumption about future wage increases if the benefits are based on final pay. But some companies—notably those with major union contracts, such as auto and tire—pay benefits of so many dollars per year of service.

Instead of tying benefits to wages, the dollar figure is renegotiated at each contract. Obviously, those companies cannot assume the outcome of future negotiations. They should, however, charge benefit increases for past service to earnings in the year they are granted, rather than amortizing the retroactive increases as they do now. The motivation for the current treatment is to smooth out the impact of the retroactive grants on earnings. That may look nicer, but it doesn't change the undelying reality that management has granted a new claim aginst the company for service that has already been performed.

Multiemployer plans present another problem. The plans frequently promise workers specific benefits, but assess employers fixed amounts for each active employee. In essence, they are defined benefit plans funded with defined contributions. In practice, one side of the equation must prove incorrect: the contributions will turn out to have been too large or too small when the benefits come due. Employers have no way of knowing whether the amounts set aside will cover promised benefits. They may ultimately be forced to make up shortfalls after some competitors have gone out of business, thus paying some of the competitors' obligations. Indeed, that very situation threatens the existence of some multiemployer plans now. The best solution would be to shift to straight defined contribution plans for multiemployer contracts. The only other way to obtain equity would be to limit an employer's liability to benefits payable to its own employees, a horrendous bookkeeping chore.

(2) It is immaterial whether unfunded liabilities are carried on or off the balance sheet. In fact, the relevant figures, as I mentioned before, are total liabilities and pension fund assets. Since a shareholder's stake in a company is the remainder after all liabilities have been discharged, he should base his evaluation on total operating assets and pension assets, and total operating liabilities and pension liabilities. Similarly, beneficiaries and the PBGC should be concerned with the total economic unit and its ability to meet pension obligations. Any given level of pension liabilities or unfunded liabilities is meaningful only in the context of the ability of the corporation to meet it, whether out of pension assets or operating assets. In sum, corporations should report total pension liabilities and pension assets, either on the balance sheet or as a footnote to the financial statements.

(3) Plan assets should be valued—for reporting purposes—at market value. If the stock market is up or down 20 percent, that is a gain or loss to shareholders, and an increase or reduction in the security of a lender's claim. From the perspective of a shareholder, lender or the PBGC, the only thing that matters is what an asset is worth now, not what it was worth at the time of purchase. It makes no more sense to value a pension asset at something other than market value than it would to value a mutual fund at, say, cost or amortized cost.

It does make sense, however, to use a moving average of market values for funding purposes. Market values do fluctuate. Incorporating the fluctuations in funding levels immediately can cause unnecessary uncertainty in corporate cash flows. A three-year moving average of market prices will smooth the fluctuations and make cash budgeting easier, while ultimately reflecting large market increases or decreases.

Critics of using market value for reporting purposes and fluctuations in market value for measuring pension costs—argue that pension funds are so large that changes can swamp operating results and are thus misleading. To the contrary, it is because they can swamp operating results that they should be included. It may be unpleasant for managers to report that pension funds have grown so large and important, but that is the reality of the situation. Obfuscating it merely impedes the efficiency of the capital allocation process. If managers are worried that pension fund results will obscure their operating performance, they can report the pension data as extraordinary items, with a breakout of ordinary pension expense, retroactive benefit increases and pension fund fluctuations.

(4) The computation of costs and liabilities should be the same for corporate and pension plan reporting. What is true for one statement is true for the other. In addition, the existence of two sets of figures would foster undue worry about the veracity of sponsors and the security of benefits.

At the same time, it would be entirely proper to use a second method of computation for funding purposes. As I stated before, the various actuarial methods are artifices to budget cash contributions, and are well suited to that purpose.

They become unacceptable only when used to determine the reported costs and liabilities of an ongoing plan. I see nothing undesirable in continued diversity of funding practices, provided that companies do not put undue risks on the PBGC—and, in turn, on other corporations.

It is worth noting here that the principal argument against enforced uniform pension reporting is that different actuarial methods are appropriate for different companies (e.g., companies with new plans versus those with mature plans, rapidly growing companies versus stable ones). I disagree with that assertion, but even if correct, it applies only to funding and not to the measurement of pension expenses and liabilities.

(5) There is no way to insure against the manipulation of assumptions in order to understate pension expenses and liabilities. The pension universe is too large to police on an individual plan basis in that kind of detail. And while I would hope that most actuaries are honest men, there always will be some disreputable practitioners of every profession. The certification of public accountants has not prevented creative accounting, and the "enrollment" of actuaries under ERISA will not end creative assumptions.

Just the same, I believe there should be outside control over the interest and wage assumptions, in order to insure that they are within reasonable bounds and to foster uniformity and comparability among companies. The best method of setting the limits on those assumptions probably would be a legislated formula, which would be computed and promulgated by Labor and/or Treasury. Accountant and actuaries would prefer that any such guidelines be set by the professions, but I am skeptical of their ability to come to an agreement on the precise numbers.

I would like to briefly explain what interest and wage assumption formulae I believe would be optimal. The interest assumption—used to discount future benefits back to a present value—should be the riskless rate of interest coincident with the term structure of the benefit liabilities. If, for example, a benefit is payable in 30 years, it should be discounted to the present at the current rate of interest on government bonds; if it is payable in five years, the rate on government notes should be used.

The riskless rate is appropriate for valuing liabilities because—in the context of an ongoing plan—they are certain obligations which must be paid if the company remains in business. It is important to note here that I am speaking in terms of valuing liabilities, not in terms of deciding how much a company should have in its pension fund. Also, I do not mean to imply that fund assets should be invested in riskless securities.

The current practice is, ostensibly, to discount liabilities at the expected rate of return on fund assets. But those are risky assets, and discounting at the expected return on risky assets is the same as placing a bet and assuming it has been won—the same as valuing a $2 ticket on a 15-to-1 horse at $30. Viewed another way, discounting at the expected return on fund assets means that, in the peculiar arithmetic of the actuaries, a dollar's worth of Treasury bills is worth less than a dollar's worth of Exxon stock. The expected return on fund assets may be appropriate for determining funding levels, but it has nothing to do with the value of the liabilities.

Under the present system, corporations are assuming, in effect, that they will win the gamble, and telling shareholders that their pension obligations are fully funded. That implies that the obligation has been fully offset. What the company should be saying is that we have pension liabilities of $X, we have invested $Y in the stock market, and we believe the investments will grow fast enough to pay benefits when they come due.

The need for outside control of interest assumptions is particularly apparent in the subjective, haphazard way in which they seem to be selected. If actuaries are basing their assumptions on expected returns, the assumptions should bear some relationship to the riskiness of a portfolio—e.g., a fund invested entirely in bonds should have a lower assumption than one invested in stocks. Surveys by Greenwich Research Associates, however, have found that there is no correlation between the riskiness of a pension portfolio and the plan's interest assumption. Risky funds often have relatively low interest assumptions, and conservative ones often have high assumptions.

I believe that wage assumptions—currently in the 3.5 to 5.5 percent range, should be much higher. They should, first of all, reflect expected inflation. In addition, they should include a component for real increases in average wages,

which have risen at a rate of just under 2 percent a year in the postwar period. Finally, they should include an allowance for the merit or seniority increases that workers earn over their careers—about 1 percent a year. Recent studies have established that the best estimate of long run future inflation is one percent less than the yield on government bonds. That is, government bonds provide a real return of about 1 percent. With bonds now at more than 8 percent, wage assumptions should be on the order of 10 percent—7 percent for inflation, 2 percent for real increases and 1 percent for merit or seniority.

If interest assumptions were adjusted to the yields on government securities, and wage assumptions set as I describe, total liabilities would roughly double. Aggregate unfunded liabilities could turn out to be $200 billion or even $300 billion. Those are frightening numbers, but ignoring or obfuscating them is no solution. The obligations may well turn out to be handily within the means of corporations, particularly if the economy returns to its historic growth rates. Whatever the case, shareholders, lenders and regulators should be aware of the true dimension of the claims that employees have against the future revenues of corporations since those are, after all, claims against the output of the economy. Perhaps most important, managers who are granting pension benefits should be aware of the true costs of the promises they make. Otherwise, private pensions could turn out to be a time bomb.

(6) I have not done a detailed study of public pension plans, but the cursory review that I have made leads me to believe that problems in the public sector are even worse than those in the private sector. The funding of public pensions is immaterial since governments have the taxing power to meet their obligations—though the California vote suggests that there may be a limit to that power. Irrespective of whether public pensions are funded, they should be fully costed and included in budgets. Taxpayers need to know the total cost of government if the representative system is to provide anything close to the optimum level of public services.

It seems clear that some type of guidelines are necessary for public pension accounting. It is tempting for a manager to grant pension promises instead of raises, knowing he can adjust the assumptions, hold costs down and reported profits up, and leave the bill for his successor. It is even more tempting, as we in New York have discovered, to get the garbage off the streets of Queens and let the next administration worry about how to pay for it.

Senator BENTSEN. Our next witnesses will be Mr. William D. Hall and Mr. David Landsittel, partners of Arthur Andersen and Co. and authors of the book, "A New Look at Accounting for Pension Costs."

Gentlemen, we are pleased to have you. If you will proceed with your testimony.

Mr. HALL. Thank you, Mr. Chairman.

STATEMENT OF WILLIAM D. HALL AND DAVID LANDSITTEL, PARTNERS, ARTHUR ANDERSEN & CO., AND AUTHORS OF "A NEW LOOK AT ACCOUNTING FOR PENSION COSTS"

Mr. HALL. My name is William D. Hall. I am a certified public accountant and a partner in Arthur Andersen & Co., where my present capacity is managing director, accounting principles and auditing procedures, for the firm at our headquarters in Chicago, Ill. I am accompanied by my partner, David L. Landsittel, who is also located in our Chicago office.

Because you have a copy, I am not going to read the detailed résumé of our qualifications, but with respect to pension accounting, as you noted, Mr. Landsittel and I are coauthors of a recent book, "A New Look at Accounting for Pension Costs," which was published for the Pension Research Council that is affiliated with the Wharton School at the University of Pennsylvania.

Because we understand that the subcommittee staff has a copy of this book, we have, accordingly, kept our comments that we are going to give here, brief.

The thrust of our testimony is twofold. First, we believe that present accounting for pension plans and pension costs requires improvement, particularly in eliminating the alternatives that are now available and that produce widely differing results in determining pension obligations to be reflected in the financial statements of plans and companies.

Second, we believe that the Financing Accounting Standards Board, the FASB, is the most appropriate and most qualified body to establish generally accepted accounting principles with respect to pension plans and pension costs.

I want to point out that we are giving our testimony from the perspective of accountants, not that of an actuary, attorney, securities analyst, or investment banker. We believe it is important to point out the difference between pension accounting and pension funding, something that the previous witnesses have also alluded to.

The accountant is concerned with the presentation of accrual basis financial statements that communicate the economic effects of transactions and events as they occur independent of whether cash concurrently changes hands as a result of such transactions. On the other hand, pension funding relates to the segregation of cash and other assets to meet pension obligations as they mature.

In developing the accounting principles that most accurately communicate the economic substance of pension-related transactions, the objectives of financial statements must be differentiated from the objectives of pension funding.

In our book, we identified four specific deficiencies that we believe are significant in presently existing generally accepted accounting principles governing pension costs and related measurement of the pension obligation, as follows:

One, actuarial cost methods that are equally acceptable under generally accepted accounting principles result in widely differing patterns of cost and liability recognition under similar economic circumstances. Differing methods and periods available for the amortization of the unfunded past service costs compound this problem.

Two, the unfunded obligation for accrued pension benefits is not recognized as a liability.

Three, varying spreading and amortization techniques result in the artificial leveling of pension expense, even in cases where the economic facts are to the contrary.

And fourth and last, there is too great a latitude in the application of actuarial assumptions.

I wish to particularly stress the first of these. Although most accountants and investment analysts recognize that various alternative actuarial cost methods are available to account for similar pension transactions under Accounting Principles Board Opinion No. 8, the present authoritative pronouncement on pension cost accounting, few users of financial statements recognize the magnitude of the differences that these equally acceptable alternatives yield.

The objectives of pension funding may best be served by providing for the use of any one of several acceptable alternative actuarial meth-

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ods, but the objectives of financial reporting are not effectively served when several alternatives are available for accounting for obligations that arise out of similar economic transactions.

The obligation for plan benefits should be recorded in the employer's financial statements as such benefits are earned by the employees; that is, as the employee's performance, measured by service rendered to date, has been completed.

Our view is that the recording of such pension obligations should preferably—and I might say this is a strong preference on our part—be correlated with direct compensation costs using an actuarial present value approach. We would, however, consider any actuarially sound measure of the obligation that is consistently applied in all cases under similar circumstances to be a step in the right direction.

Stated another way, although we have a strong preference for a certain method of measuring pension plan obligations—and I might mention that our view is quite close to those that have been presented by the previous witnesses this morning—we recognize that there are differences of opinions in this respect, and consider consistency among plans and companies and the basis upon which their financial statements are prepared in this respect to be even more important than the question of what methods should be followed.

We believe that accounting standards should be established in the private sector rather than by Congress or an agency of the Federal Government. The present standard-setting organization in the private sector is the FASB, and we believe that that organization is in the best position to establish sound and uniform accounting standards for the benefit of the public, business enterprises, and the accounting profession.

The FASB has on its agenda, and has done substantial work, on a project that deals with pension accounting and pension costs. The issues, as we can see from the discussion this morning, are exceedingly complex and, I might add, controversial.

In an appendix of our book, a number of members of the Pension Research Council, individuals knowledgeable about these issues, present statements that, in many cases, raise questions about our approach and present alternative positions. This is but one indication of the complexities involved and the controversy that exist.

I make this point to stress our view that the FASB, a highly qualified standards-setting body that has already devoted substantial productive time to this project and its presently, we understand, holding discussions with the Department of Labor representatives, should establish any required standards.

Further, the complexities are far too great for a sound solution within the 90-day time limitation for the promulgation of uniform accounting standards set forth in S. 2992. We respectfully submit that the Congress should convey its sense of urgency and can properly apply pressure to insure appropriate results within a reasonable time, but that it would be ill advised to seek immediate, and possibly undesirable, solutions to a complex problem by imposing unrealistic deadlines.

Now, Mr. Chairman, this testimony was prepared before we had received the communication from you office setting forth the six ques-

tions to be addressed specifically at these hearings, and so it does not address all of these questions. I think it does cover the first two questions, and I would like to just briefly respond to the other four.

Starting with the third question, How should plan assets be valued? We believe that they should be valued at current market.

The fourth question: For purposes of symmetry or for some other reason, should pension costs and liabilities be computed on the same basis for the pension plan and for the sponsoring employer's corporate statement?

Our answer is yes.

As to the fifth question, How to assure that actuarial assumptions are not manipulated to the detriment of plan participants and retirees. I am afraid, since this is primarily an actuarial question, I will have to yield to the expertise of actuaries and not attempt to answer it definitively. I believe it would be unfortunate to put into law or regulations rigid requirements. We know that different plans have different earnings rates, and we would not want to try to make dissimilar situations look the same. On the other hand, I am satisfied that there must be some way to narrow the alternatives, to establish parameters that will make the results more consistent.

The sixth question: Do these and similar accounting and actuarial problems, exist with respect to public retirement systems? The answer is, they certainly do.

And that, Mr. Chairman, concludes our prepared testimony.

Senator BENTSEN. Well, I think that is very helpful.

Let me state that, first, I, too, believe that the private sector is in a better position to set forth these standards, but they have not done it.

Mr. HALL. That is right.

Senator BENTSEN. And I will bet you they do not do it if we do not keep the pressure on and if we do not decide we will do it by legislation. We may have to resolve some of those differences, and I frankly think the 90 days is too short also. But I can tell you that I am going to push just as hard as I can, and if you do not do it, I am going to try to pass the legislation, and force it. So you can put your members on notice on that.

I do not want to further complicate the problems with additional paperwork. I want to avoid that to the extent I can. But I think that investors ought to know what they are buying when they buy a stock, and I think plan participants ought to know how sound the plan is. And I think the shenanigans should be narrowed, certainly, the opportunity for it, in some of these assumptions.

I do not want great rigidity on those assumptions, because I know that there are some differences in investment objectives for different types of plans. When I was told previously that there was a 10-percent assumption, sure, I can show you pension assets that have been able to have a 10-percent return or more over some short period of time. But when we are talking about pension plans that extend out 25 or 30 or 40 years, we have to be reasonably prudent on such assumptions.

Now, you talk about the variance. Apparently, you do think that some guidelines should be in there for actuarial assumptions?

Mr. HALL. Yes, sir.

Senator BENTSEN. I think so, too. I do not know what they are, and I am looking forward to listening to some of the actuaries in that regard.

But I think that the Congress has an obligation if you fellows do not do it. We give substantial tax benefiits to the creation of these plans. We have an obligation to the people and to the plan participants, and I think we will pass something, if we do not see the actuaries and the accountants try to come up with standards and bring about as much uniformity as is practicable in this regard.

Mr. HALL. I might say, Mr. Chairman, that I think hearings such as this are helpful to accomplish that end, to convey the Congress sense of urgency on this, and to make the private sector react promptly and responsibly.

Senator BENTSEN. Well, it will help if you will knock some heads together, if you tell them that they will have to contend with some of these arbitrary and opinionated Senators up here, and if they do not do it, we are going to do it.

I am just back from a debate in the GATT negotiations in Geneva, and I was trying to buttress our negotiator by wearing the black hat to show the negotiators of some of these foreign countries what our negotiator was up against in having to deal with the Senators.

I though I was making quite a point until the Brazilian negotiator, who was seated next to me, said, you know, I am not so impressed with Mr. McDonald's saying he has to deal with you Senators. He said, I have to go home and deal with the generals. He said, I'm not so sure that is any easier.

Well, thank you very much. I think that is helpful. We will now hear from the actuaries, and listen to their side of the story.

[The prepared statement of Messrs. Hall and Landsittel follows:]

PREPARED TESTIMONY OF WILLIAM D. HALL AND DAVID L. LANDSITTEL

My name is William D. Hall. I am a certified public acountant and a partner in the international public accounting firm of Arthur Andersen & Co. My present capacity is Managing Director, Accounting Principles and Auditing Procedures in the firm's World Headquarters, 69 West Washington Street, Chicago, Illinois. I am accompanied by David L. Landsittel, also a certified public accountant and a partner in Arthur Andersen & Co. in the firm's World Headquarters.

I shall not read the detailed resumes of our qualifications which are attached to a copy of this testimony. With respect to pension accounting, Mr. Landsittel and I are coauthors of a recent book, "A New Look at Accounting for Pension Costs," published for The Pension Research Council which is affiliated with The Wharton School, University of Pennsylvania. We understand that the Subcommittee staff has a copy of this book.

The thrust of our testimony today is twofold:

1. We believe that present accounting for pension plans and pension costs requires improvement, particularly in eliminating the alternatives that are now available—and that produce widely differing results—in determining pension obligations to be reflected in the financial statements of plans and companies.

2. We believe that the Financial Accounting Standards Board (FASB) is the most apropriate and most qualified body to establish generally accepted accounting principles with respect to pension plans and pension costs.

PERSPECTIVE FROM WHICH TESTIMONY IS GIVEN

The testimony we are giving is from the perspective of an accountant, not that of an actuary, attorney, securities analyst or investment banker. In this regard, we believe that it is important to point out the difference between pension accounting and pension funding.

The accountant is concerned with the presentation of accrual-basis financial statements that communicate the economic effects of transactions and events (including pension-related transactions) as they occur independent of whether cash concurrently changes hands as a result of such transactions. On the other hand, pension funding relates to the segregation of cash or other assets to meet pension obligations as they mature.

In developing the accounting principles that most accurately communicate the economic substance of pension-related transactions, the objectives of financial statements must be differentiated from the objectives of pension funding. Confusion arises when the differing objectives of pension accounting and pension funding are not recognized. Specifically, in the case of S. 2992, this confusion is illustrated by the fact that the bill proposes an amendment to Section 412 of the Internal Revenue Code of 1954, which amendment deals with uniform *accounting* standards, whereas Section 412 (as added by ERISA) deals with pension funding—that is, the minimum cash amount required to be deposited in trust to achieve reasonable security in meeting pension obligations.

DEFICIENCIES IN PRESENTLY EXISTING ACCOUNTING STANDARDS

In our book, we identified four specific deficiencies that we believe are significant in presently existing generally accepted accounting principles governing pension costs and related obligation measurement, as follows:

1. Actuarial cost methods that are equally acceptable under generally accepted accounting principles result in widely differing patterns of cost and liability recognition under similar economic circumstances. Differing methods and periods available for the amortization of unfunded past service costs compound this problem.
2. The unfunded obligation for accrued pension benefits is not recognized as a liability.
3. Varying spreading and amortization techniques result in the artificial leveling of pension expense even in cases where the economic facts are to the contrary.
4. There is too great a latitude in the application of actuarial assumptions.

I wish to stress the first of these. Although most accountants and investment analysts recognize that various alternative actuarial cost methods are available to account for similar pension transactions under Accounting Principles Board Opinion No. 8, the present authoritative pronouncement on pension cost accounting, few users of financial statements recognize the magnitude of the differences that these equally acceptable alternatives yield. The objectives of pension funding may best be served by providing for the use of any one of several acceptable alternative actuarial methods, but the objectives of financial reporting are not effectively served when several alternatives are available for accounting for obligations that arise out of similar economic transactions.

The obligation for plan benefits should be recorded in employee benefit plan financial statements as such benefits are earned by the employees—that is, as the employees' performance, measured by service rendered to date, has been completed. Our view is that the recording of such pension obligation should preferably be correlated with direct compensation cost, using an actuarial present-value approach. We would, however, consider any actuarially sound measure of the obligation that is consistently applied in all cases under similar circumstances to be acceptable. Stated another way, although we have a preference for a certain method of measuring pension plan obligations, we recognize that there are differences in opinions in this respect and consider consistency among plans and companies in the basis on which their financial statements are prepared in this respect to be more important today than the question of what method should be followed.

MECHANISM FOR THE ESTABLISHMENT OF UNIFORM ACCOUNTING STANDARDS

We believe that accounting standards should be established in the private sector rather than by Congress or an agency of the Federal government. The present standard-setting organization in the private sector is the FASB, and we believe that organization is in the best position to establish sound and uniform accounting standards for the benefit of the public, business enterprises, and the accounting profession.

The FASB has on its agenda and has done substantial work on a project that deals with accounting for pension plans and pension costs. The issues are

exceedingly complex—and, I might add, controversial. In an appendix to our book, a number of members of the Pension Research Council—individuals knowledgeable about these issues—present statements that in many cases raise questions about our approach and present alternative positions. This is but one indication of the complexities involved and the controversy that exists.

I make this point to stress our view that the FASB, a highly qualified standard-setting body that has already devoted substantial productive time to this project and is presently, we understand, holding discussions with Department of Labor representatives, should establish any required standards. Further, the complexities are far too great for a sound solution within the 90-day time limitation for the promulgation of uniform accounting standards set for in S. 2992. We respectfully submit that the Congress can properly apply pressure to ensure appropriate results within a reasonable time but that it would be ill advised to seek immediate and possibly undesirable solutions to a complex problem by imposing unrealistic deadlines.

SUMMARY

In summary, we agree that accounting standards covering pension-related transactions are deficient. We have developed our views to the changes that might be made, which views constitute only one approach to a difficult problem of accounting for pension costs.

We believe that the private sector, and specifically the FASB, is the body that is most capable of dealing with the problem of promulgating uniform accounting standards for pension costs. That organization has the necessary capabilities and resources to develop proper standards that meet the objectives of financial reporting. Following this approach also results in the best means to ensure that a mechanism exists to provide for subsequent changes in such standards in later periods responsive to future changes in the economic environment.

WILLIAM D. HALL

Birth: June 16, 1922; Kansas City, Missouri.
Education: University of Illinois: B.S. in Accountancy, 1947; M.S. in Accountancy, 1948.
Present position with Arthur Anderson & Co.
  Partner
  Managing Director—Accounting Principles and Auditing Procedures.
Prior experience with Arthur Andersen & Co.
  Commenced, Chicago, 1948.
  Promoted to audit manager, 1954.
  Transferred to Detroit, 1957.
  Admitted to partnership. 1958.
  Transferred to Home Office, Chicago, as member of Firm's Committee on Accounting Principles and Auditing Procedures with primary responsibility for SEC matters, 1962
  Transferred to London as Accounting and Auditing Practice Director for Europe and South Africa, 1970
  Transferred to Chicago as Vice Chairman of Firm's Committee on Accounting Principles and Auditing Procedures, 1973
  Named Managing Director—Accounting Principles and Auditing Procedures, 1975
  Elected to Firm's Committee on Accounting and Auditing Standards (successor to Committee on Accounting Principles and Auditing Procedures) and Executive Subcommittee thereof, 1975
CPA Qualifications and date:
  Illinois (original), Mar. 25, 1948:

CPA	3467.
PA	3557.
Iowa, Sept. 25, 1958	656.
Louisiana, Mar. 27, 1961	B-2015.
Michigan, Feb. 11, 1958	2918.
North Carolina, Sept. 22, 1959	1576.
Virginia (PA), Sept. 12, 1958	1020.
Wisconsin,[1] Nov. 22, 1958	2255.

[1] Certificate in good standing, but not licensed to practice.

Professional Organizations:

Membership—American Institute of Certified Public Accountants; National Association of Accountants; American Accounting Association; Illinois CPA Society; Michigan Association of Certified Public Accountants

Current Committee Assignments: American Institute of Certified Public Accountants, Task Force on Pension Costs; Financial Accounting Standards Board, Chairman—Task Force, Effects of Price or Rate Regulation on Accounting for Regulated Enterprises

Former Committee Assignments: American Institute of Certified Public Accountants: Member, Committee on Auditing Procedure; Member, International Practice Executive Committee; Member, Committee on Relations with SEC and Stock Exchanges; Member, Committee on Statistical Sampling; Member, Task Force on Conceptual Framework for Accounting and Reporting; Chairman, Advisory Task Force on Comfort Letters; Member, Project Advisory Committee on Depreciation Research Study; Illinois CPA Society; Member, Committee on Relations with Stock Exchanges; Michigan Association of Certified Public Accountants; Chairman, Committee on Accounting and Auditing Procedures.

Publications:

The Michigan CPA, "The Need for Uniform Accounting Standards," June 1963.

Business Lawyer, "Accounting Aspects—Securities Acts Amendments of 1964," January 1965 (coauthored with Ralph E. Lee); reprinted in *Selected Articles on Federal Securities Law*, American Bar Association, 1968.

Financial Analysts Journal, "Balance Sheet Classification of Deferred Income Taxes Arising from Installment Sales," September–October 1966.

The Journal of Accountancy, "Inventory Determinations by Means of Statistical Sampling Where Clients Have Perpetual Records," March 1967.

The Journal of Accountancy, "Current Problems in Accounting for Leases," November 1967; reprinted in *Selected Studies in Modern Accounting*, American Institute of Certified Public Accountants, 1968, and *Accounting Concepts*, Cassell Australia Ltd., 1972.

Sixth International Investment Symposium, "European Accounting Harmonisation," P. N. Kemp-Gee & Co., London, 1972.

Managerial Planning, "What Will Statements Look Like in Three Years?" July–August 1976.

A New Look at Accounting for Pension Costs (Homewood, Ill.: Richard D. Irwin, Inc., 1977) (coauthored with David L. Landsittel).

The Virginia Accountant, "A New Look at Accounting for Pension Costs," March 1978 (coauthored with David L. Landsittel).

Expert Testimony:

Before Michigan Public Service Commission on several occasions from 1957 to 1963 on behalf of Consumers Power Company, Michigan Consolidated Gas Company, Michigan Gas and Electric Company and a group of Michigan utility companies in cases involving:

Accounting for cost of discontinued facilities.
Cost of service.
Working capital requirements.
Allowances for doubtful accounts.
Deferred income taxes.

Before Federal Power Commission on cost of service effect of abandonment of sales by Panhandle Eastern Pipeline Company to Michigan Consolidated Gas Company.

Before U.S. District Court and U.S. Tax Court on matters relating to accounting principles and practices.

Before U.S. House of Representatives Committee on the District of Columbia, Subcommittee on Fiscal and Government Affairs, in connection with its consideration of H.R. 2465, "a bill to establish an actuarially sound basis for financing retirement benefits for policemen, firemen, teachers, and judges of the District of Columbia and to make certain changes in such benefits."

DAVID L. LANDSITTEL

Birth: March 15, 1940; Delware, Ohio

Education: DePauw University, Greencastle, Indiana: A.B., 1962; University of Chicago: M.B.A., 1963.

Present Position with Arthur Andersen & Co.: Audit Partner-Accounting Principles and Auditing Procedures Group with Firmwide responsibilities for SEC Policies.

Prior experience with Arthur Andersen & Co.:

Commenced: Chicago, 1963.

Promoted to manager: Manufacturing division, 1969.

Admitted to partnership: 1975.

Transferred to World Headquarters as member of Firm's Accounting Principles and Auditing Procedures Group: 1975.

C.P.A. qualifications, State and date of certificate:

	Number
Illinois—CPA (original), Mar. 18, 1964	9194
Illinois—PA, Dec. 1975	9780
Louisiana, Jan. 30, 1976	B-10571
North Carolina, Jan. 29, 1976	9048
Virginia, PA, Jan. 9, 1976	4175

Professional Organizations:

Membership: American Institute of Certified Public Accountants; Illinois CPA Society.

Current Committee Assignments:

American Institute of Certified Public Accountants; Committee on SEC Regulations; Accounting Standards Division Task Force on Refunding of Debt;

Illinois CPA Society: Chairman—Committee on Promotion of Continuing Professional Education; CPE Council.

Former Committee Assignments: American Institute of Certified Public Accountants; Accounting Standards Division Task Force on Current Value Disclosures.

Publications:

A New Look at Accounting for Pension Costs (Homewood, Ill.: Richard D. Irwin, Inc., 1977) (coauthored with William D. Hall).

CPA Journal, "New Developments in Comfort Letters to Underwriters," SEC Commentary Section, February 1978.

The Virginia Accountant, "A New Look at Accounting for Pension Costs," March 1978 (coauthored with William D. Hall).

Mr. Hall. Thank you, Mr. Chairman.

Senator Bentsen. Mr. Boynton, the president of the American Academy of Actuaries will be our witness. And will you introduce for the record those who accompany you?

Mr. Boynton. Thank you, Mr. Chairman. I am sorry the witness list did not include the two people accompanying me.

On my right is Mr. Preston Bassett, who is the vice president of the American Academy and on my left is Steve Kellison who is the executive director of the academy.

Senator Bentsen. And whom I have known for some time. I had to listen to his actuarial assumptions for years, as an associate of mine.

Mr. Boynton. Mr. Bassett and I are, you might say, volunteers in these positions. We have both spent most of our careers consulting on pension plans.

STATEMENT OF EDWIN F. BOYNTON, PRESIDENT, AMERICAN ACADEMY OF ACTUARIES, ACCOMPANIED BY: PRESTON BASSETT, VICE PRESIDENT, AMERICAN ACADEMY OF ACTUARIES, AND STEVE KELLISON, EXECUTIVE DIRECTOR, AMERICAN ACADEMY OF ACTUARIES

Mr. Boynton. We do appreciate the opportunity to present this statement since it has a significant impact upon enrolled actuaries under ERISA.

We understand the record will remain open for a few weeks so that we can prepare a more comprehensive statement. We are particularly anxious about that because the academy has, in fact, underway a project very pertinent to this bill which is the study of the manner in which actuarial liability should be presented, and we will attach the completed copy of that study to our final statement.

I might also add that the American Society of Pension Actuaries is another organization which represents a significant number of pension actuaries who are not members of the academy. The two organizations, combined, represent approximately 93 percent of the enrolled actuaries.

The representatives of ASPA have reviewed this statement and advise us that they fully agree with the position taken by the academy on this bill, and although the academy representatives cannot speak for ASPA, the statement can be taken as representing the common position of both organizations.

In general, we support what we believe was the intent of the bill. We believe further clarification is needed to be sure this intent is carried out, and it might require certain changes in other parts of ERISA and in the Internal Revenue Code. However, and I would underscore this, we believe the apparent intent of the bill may, in fact, be accomplished without specific legislation.

We are obviously aware of the adverse publicity given to private pension plans recently in the press. The stories in Fortune, New York Times, U.S. News & World Report, Forbes magazine, for example.

Much of this information in these articles appears to be based on misinformation and lack of understanding on the part of the authors as to the nature and purpose of various actuarial and funding methods. We would acknowledge that there is a variation of actuarial and funding methods available to pension plans to be used for different purposes, and this has compounded the problem and led to confusion and misunderstanding on the part of plan participants, the press, as well as legislators and regulators.

I would add, however, that a lot of the confusion is due to the fact that it is a very complex problem. It is not an effort by the actuaries or plan sponsors to confuse people, or mislead people. It is a very complex issue.

Actuarial liabilities are calculated for three general purposes and the particular purpose intended will dictate the kind of actuarial methodology to be used. These three purposes, as outlined on paper, are to determine the annual contributions to the plan, to measure the funding project on an ongoing plan basis and to measure the liabilities that would emerge in the event of plan termination.

There are a number of funding methods available which are used for the purpose of determining the annual contributions and that will be discussed later. For the purposes of measuring the funding progress on an ongoing plan basis, or as a measurement of the termination liabilities of plans, we believe there is considerable merit in having consistent methodology to be used in developing its values.

Adoption of uniform methodology would go a long way to reducing some of the misunderstandings which have occurred in the past through the use of incorrect types of figures to represent plan liabilities. In the prepared statement we point out that often these numbers are taken from form 10-K of SEC and that number may be calculated a number

of different ways and it is for a different purpose but often has been misused in some of the articles which have appeared.

We believe that uniform methodology would be highly desirable for the purpose of reporting the value of accrued benefits or the termination values. For example, the development of the value of the crude benefits on a going plan concept would serve several different purposes which we have outlined here to substitute for the present section 103(d)(6) of ERISA; for the footnotes of a company's annual financial statement; for the purposes of protecting individuals in the event of mergers and terminations and spinoffs of plans; and for the purpose of any actuarial statement that should be attached to the financial statement prepared by the accountant.

We believe that one single methodology could be developed with enough flexibility to handle varying plan conditions for all of these purposes.

The bill would provide the Secretary of the Treasury to promulgate standards for evaluation of both assets and liabilities. We do not believe the value of assets used in the presentation of these measurements should be standardized, such as at market value, but rather should be the value of assets used by the actuaries. We have no quarrel with the idea that the market value of assets be used for the presentation of the financial statement prepared by the administrator, pursuant to 103(b), but when the actuarial value of liabilities is presented, the value of assets should be prepared on a consistent basis.

That is, when the actuary sets forth the actuarial status of the plan for any of the purposes mentioned above, he is considering the projection of these actuarial values on a long-range basis averaging out potential future variations in experience both in investment returns and in other actuarial factors.

It would be misleading for plan participants and others who read such statements to be required to match these actuarial values with, say, the market value of assets which can exhibit wide variations over the short term.

Since the pension plan obligation is a long-range one with an orderly cash flow out of the fund in the form of benefit payments, a more stable asset value is desirable to match up more properly with the determination of the actuarial values.

As I have mentioned, the Academy Committee on Actuarial Principles and Practices of Pension Plans is in the process of preparing an interpretation of the Academy's actuarial principles of pension plans which basically set forth a recommended methodology to be used in determining the value of accrued benefits in connection with the actuarial values to be associated with the financial statement required by 103(b) of ERISA.

This has been prepared, really, at the request of the FASB. We do not believe it is necessary or appropriate to include this as part of the financial statement, but that is the FASB's decisions and we are merely complying with their request that a reasonable method be developed by the actuarial profession.

As soon as the paper is finalized, we will present a copy to the subcommittee.

We have also indicated in here that if legislation is passed, we do believe there are some other sections of ERISA which should be

amended to be consistent for all purposes, because we have the Labor Department's sections, 103 particularly, and other areas that should be made consistent.

Now, we do support the concept of establishing uniform methodology for the presentation of the value of accrued benefits, but we do question the need for this specific legislation at this time. We believe that many of the problems created by different methods of reporting unfunded liabilities can be resolved under existing regulatory authority.

There are several current developments that would lead us to believe that the objective of more uniform reporting of actual liabilities will be accomplished in the relatively near future without additional legislation—but perhaps with your prodding. Among these are the revised schedule B, which we have not seen yet, but which was discussed this morning by the Labor Department; the exposure draft which the Academy is almost ready to release—I mean, pardon me, the final is almost ready to be released; the view of the FASB that actuarial liabilities attached to a plan's financial statement be calculated by a uniform methodology; the section 6059 of the code which provides for periodic reports by the actuary would appear to give the Secretary of the Treasury the authority to issue such regulations it deemed necessary right now.

Additionally, and this would be out of a different area, but the SEC would also have the authority to prescribe a uniform methodology, hopefully the same as Treasury and Labor, for reporting the unfunded actuarial liabilities which now appear in such things as form 10-K.

Accordingly, the Academy does not believe legislation of this type is needed now in order to accomplish the desired goals.

Now, the support for the concept in this proposed bill is based on the assumption that the development of any uniform standards for actuarial methodology would be limited to those kinds of situations described earlier which call for a display of the statements for the value of accrued benefits under the plan, either on an ongoing basis or in the event of plan termination, so as to fairly present the actuarial position of the plan.

We would not support the adoption of uniform standards of actuarial methodology with a calculation of minimum or maximum funding requirements of ERISA. The actuarial methods to be used to develop minimum contribution requirements to provide for a sound and orderly funding of a plan are often different than those used for the purposes described above, and we hope that there is no intention to prescribe a standard methodology for the purposes of determining minimum funding requirements of ERISA.

The present structure of ERISA and the background committee report certainly supports the concept that there should be flexibility in funding methods and assumptions. It leaves the actuarial basis of funding levels to the discretion of the enrolled actuary to select the method and assumptions that are most appropriate for the particular plan and, as indicated, ERISA specifically requires this. The actuary must also make a certification for this purpose.

We recognize the differences in funding methods to determine that the contribution can lead to differences in annual contributions and in

unfunded liabilities. It is for this reason that we support the concept in the bill that whenever unfunded liabilities are to be displayed to participants, the public, in financial statements, et cetera, they should be calculated in accordance with uniform methodology.

As a matter of related interest, we will be submitting as part of our more complete statement a pension discussion document prepared by a research accounting group in the United Kingdom very recently dealing with financial reports of pension funds. One of the major conclusions of this accounting research group is that a part of the comprehensive report which a trustee should provide to participants in the plan should be prepared by the actuary regarding the overall funding position of the plan. It notes particularly that this should be presented in parallel with rather than part of, the financial statement prepared by the accountant. We certainly endorse this approach with regard to the preparation of statements under ERISA and we would be pleased to review further proposals regarding the manner in which this might be implemented.

We appreciate the opportunity to present this statement and I would like to ask Mr. Bassett if he has any other comments to add at this point.

Mr. BASSETT. I have nothing further to add to that statement but would be pleased to answer questions, and fortunately, after hearing the other witnesses, I have several comments regarding some of the statements they have made, if you would like them.

Senator BENTSEN. Fine. Let's have them.

Mr. BASSETT. I think it is important to keep in mind that the law, ERISA, requires that the enrolled actuary give his best estimate of the long-range cost of this plan based on past and expected future experience. These enrolled actuaries are enrolled by the Internal Revenue Service and are subject to disqualification by the Internal Revenue.

So I think extravagant statements about actuarial assumptions and methods, that they are unreasonable or are unsound, I think is hardly justified today. I do not know where Mr. Ehrbar got his figures of 3.5-percent and 10-percent interest. I highly suspect that they go back historically and are not current. There may be in the wide United States a plan fund that justifies today currently in percent that the actuary decree was signed to, but I think we fail to recognize sometimes that the actuary now is under a much more extreme obligation to do a sound job or he will lose his certificate, and I want that on the record.

Senator BENTSEN. I understand that, but I also believe that most actuaries are competent, have integrity and are capable, but I think they have a few goats in the crowd and I think that is true of lawyers and doctors and Congressmen and on down the list. And that is why I think you have to have some standards that are in force.

I look at a situation like Caterpillar. We see a lot of new actuarial assumptions that all of a sudden come about the time of the labor negotiations. I do not think that is just accidental.

In the Caterpillar situation, they negotiated a pension increase in 1976 with the United Automobile Workers. Their pension expenses dropped and its unfunded vested liabilities declined from $440 million to $270 million. Now, Catepillar raised both its interest and its wage

assumptions, but the interest rate presumption is what prevailed. And they would not disclose the figures that they used in that assumption. What are your thoughts on that?

Mr. BASSETT. Well, No. 1, at that time the welfare and pension plan disclosure act was in effect and the actuarial assumptions and methods had to be filed with the Labor Department, so they were disclosed somewhere. But my first comment is I cannot understand how they say they were not disclosed, because it was required by law that they be disclosed, and I assume Caterpillar complied with the law.

The second comment, we do not normally, in actuarial practice, review actuarial assumptions every year. We feel it is unnecessary to modify the assumptions on year to year changes, but normally wait until an appropriate time to review the assumptions and changes. This may be 3 years, or 5 years, depending on economic conditions.

Now, when you come up to union negotiations, you are reviewing the whole plan document. You are reviewing all the provisions, you are reviewing what you are going to be negotiating. And it is a very logical time, at that time, to review actuarial assumptions, and they may or may not be changed at that time, depending on conditions. But in the past several years, with increasing rates of interest each year, it is very likely that each time that a Caterpillar Tractor actuary reviewed the assumptions, he increased the interest rates probably one-half of 1 percent or one-quarter of 1 percent. For the last 20 years, it has been going up.

And so, to me, yeah, he did it at the time of the negotiations, but he was looking at it on an ongoing basis. It was time to review the assumptions. It was convenient, because we were reviewing the whole plan document. You can call it coincidence, you can call it manipulation; I do not think it is the latter.

Senator BENTSEN. I hope you are right.

Now, in their book on accounting, Mr. Hall and Mr. Landsittel stated:

> In the past when pension costs typically represented no more than 5 percent or 10 percent of the pretax income, perhaps the alternative actuarial practices did not significantly distort the financial statements of the business enterprise. However, pension costs now typically exceed 10 or 20 percent of pretax income and the flexibility of such accounting alternatives must be eliminated.

Now, the obligation to pay pension benefits does not change because we have changed from one actuarial method to another. What are your comments on that?

Mr. BASSETT. My comments are this, that there has been a lot of confusion about whether we are talking about the development of the cost of a plan on an ongoing basis to record the contributions to be made to the fund as distinct to the financial status of the plan. We believe that, in determining the ongoing costs of the plan, there is need for different actuarial methods.

A plan, for example, that is insured, may buy policies from an insurance company and pay a premium each year in the future. That is one funding method.

Another company may decide to fund it through a trust fund where they go back and develop a past service cost and use some other method. But all of these methods are budgeting methods to determine

the best way to fund this plan for future years and we believe it is necessary to have flexibility in determining future company costs.

Now, when you talk about the financial status of the plan, we are talking about another item, and here we do agree, as our testimony we presented indicated, we believe that the uniform method for determining the financial status for the plan should be used, and we support it.

Senator BENTSEN. I frankly would like to see some guidelines on actuarial assumptions. I do not quite know how they should be drafted. It is a complex subject, and I know that. But I do think there are abuses, and I do not agree with you when you say it is a routine thing, at wage negotiation times, to look at all of the assumptions and therefore it is, in effect, you state it is a natural result. I think that the results are sometimes skewed to achieve a management objective on profits and to try to get out of a tough bargaining situation over wages with labor.

The same kind of thing happens. You talk about actuarial assumptions to set the rates on an insurance policy, and you have a sales manager who is pushing very hard for the most liberal of assumptions. You can have a chief executive of a company pushing very hard to get that. He wants to increase sales, he wants to be more competitive, and at the same time, he wants to show profits.

And you end up sometimes in assumptions that result in companies that just have losers.

Mr. BASSETT. Well, I hope that the enrolled actuaries in compliance with ERISA are using their best judgment and are not influenced, but I cannot deny that possibility.

Senator BENTSEN. I think they are also fallible, as other people are, and I think they are subject to pressures as others are, and that they sometimes bend, as others do.

Mr. BOYNTON. I do think, Senator, that the requirement for giving opinions subject of being deprived of your making a livelihood has had a very good influence in this area. I think, in the past few years, it is made clear now that the actuary has a responsibility under the law, and I know from personal experience, it improves your posture with clients in dealing with the problem. There is no question that clients do bring pressure on actuaries in this area, and the actuary is in a much stronger position now because he can say I've got to sign off on this and I do not agree, and we have gone through those experiences already.

I have looked at it in the marketplace, where we had competition that I knew there was no way they could come up on an insurance policy, that the actuarial assumptions just had to be beyond the realm of what was practicable. And I could see nothing else except pressure on the actuary, making assumptions for that policy.

Do you want to talk about that?

Mr. KELLISON. I agree that some of the policies you are referring to had to predict losses.

Mr. BASSETT. I would like also to comment on Ian Lanoff's proposal, if I may.

I am a member of the Advisory Council to the Labor Department and, as such, submitted to the Labor Department a proposal in regard

to financial statements to include in schedule B that they are talking about. It was prepared on behalf of the American Academy of Actuaries.

We believe that this would produce the kind of figures you are looking for. We believe it would satisfy the accountants and it is referred to in our testimony.

We did make the statement that we did not feel that this would be a significant increase in cost for most employers for their actuaries to produce this information.

However, in reading over and listening to Mr. Lanoff's statement today, I believe he has changed it in two or three significant ways which may significantly increase the cost of the actuarial work. I was particularly delighted to hear Senator Curtis question the increased costs' effect on plans termination because I think this is vitally important.

Senator BENTSEN. I share that concern. I am deeply concerned about any increase in costs, either accounting or actuarial costs that we bring on the participants or the company, and trying to hold those down.

Mr. BASSETT. Well, I can give you an illustration. We increased our actuarial staff one-third since ERISA, so I can tell you that there has been a heck of a lot of increase in cost because of ERISA. There is no question about it.

Senator BENTSEN. Let me say I heard the Labor Department talk about how strong they felt about ERISA. I used to talk about being one of the original authors of ERISA; I do not do that anymore.

Mr. BASSETT. Now, I am afraid that some of the proposals that I heard this morning are going to significantly increase the costs. I am not looking for additional actuarial business. We have plenty and I am sure that Ed Boynton and the Wyatt Co. also have plenty of actuarial work. We do not need it. But the idea—to give you an illustration, they propose that the value of vested benefits be projected to the end of the year.

In projecting to the end of the year, what they are saying is that we want you, as an actuary, to look at the ceiling, or whatever it is, and value that benefit 8, 9 months ahead. We have to select an interest rate.

I do not know if I can tell you what interest rates are going to be at the end of December of this year. I really do not think I can. And Mr. Ehrbar stated that a 1-percent difference in interest rates makes a 25-percent difference in costs and you are asking the actuaries to forecast what it is going to be at the end of the year, to measure against market value of the fund.

I have a problem, and I think all actuaries will.

I hope that whatever is put together is not asking us to stick our necks out too far. We are willing to make forecasts and projections, but——

Senator BENTSEN. Oh, you stick your necks out 25 years and more on these assumptions.

Mr. BASSETT. Yes, but now they are saying we have got to use market value of the fund to compare with the liability and the market value of the fund, I cannot predict it for the end of the year.

Mr. BOYNTON. Just to add to that, in terms of the additional expense, in the course of doing the regular actuarial evaluation to deter-

mine the contribution to the plan, you can, almost as a byproduct, produce the kind of accrued liability figure that was described this morning and that we have in mind in our statement. But when you change it so that you must, in effect, make an advance projection of that liability, you have added another step to the process. You must now do it—you will probably do it at some other time of the year. You will do it in order to have the figure ready by yearend, and you are just adding another step to the normal work of the actuary. It is no longer a byproduct evaluation.

The comments made earlier that were not, by the actuaries, that this approach would not increase costs was related to the idea that it will be a byproduct of the evaluation.

Senator BENTSEN. Well, gentlemen, as we stated, you will be given time. We will not close the record for your more complete statement, and we will be very pleased to have it.

I told Mr. Hall that I did not think 90 days was long enough, and I agree with that. I want you to understand, though, that the clock is running now, not from the date of enactment.

Mr. BOYNTON. We get the message.

Senator BENTSEN. All right. Thank you very much.

Mr. BOYNTON. Thank you, sir.

[The prepared statement of Mr. Boynton follows:]

STATEMENT OF THE AMERICAN ACADEMY OF ACTUARIES, EDWIN F. BOYNTON, PRESIDENT, PRESTON C. BASSETT, VICE PRESIDENT, STEPHEN G. KELLISON, EXECUTIVE DIRECTOR

The Academy appreciates the opportunity to present this statement to the Subcommittee on S. 2992, a bill which would have a significant impact on the work of Enrolled Actuaries under ERISA. It provides that the Secretary of the Treasury shall promulgate uniform standards for the calculating and reporting the assets and liabilities of pension plans and for disclosing actuarial assumptions used in such calculations.

Because of the short time period between the date when the hearings were first announced and today's hearing, our statement today will be fairly brief and only outline the major points to be made by the Academy. We understand that the record will remain open for a few weeks so as to permit a more comprehensive statement to be submitted, including some pertinent exhibits. In particular, the Academy has under way a study on presentation of actuarial liabilities which is very pertinent to this particular bill and which will be completed within the next few weeks. We plan to attach this special study by the Academy to our more complete written statement to be filed later.

As the Committee is aware, the American Society of Pension Actuaries (ASPA) represents a significant number of pension actuaries who are not members of the Academy. The two organizations combined represent approximately 93 percent of Enrolled Actuaries. Representatives of ASPA have reviewed this statement and have advised us that they fully agree with the position taken by the Academy on S. 2992. Accordingly, although the Academy representatives cannot speak for ASPA, this statement can be taken as representing the common position of both organizations.

In general, the Academy supports what we believe is the intent of the bill. However, we believe that further clarification is needed to be sure that this intent is properly carried out. We also believe that to do so would require certain changes in other parts of ERISA and in the Internal Revenue Code. We would add further that we believe that the apparent intent of the bill may, in fact, be accomplished without this specific legislation.

We are obviously aware of the adverse publicity given to private pension plans recently in the press. The most recent of these stories which reflect adversely on private pensions generally have appeared in such publications as Fortune, the New York Times, U.S. News and World Report, and Forbes magazine. Unfortunately, much of the information in these articles appears to be based on mis-

information and lack of understanding on the part of the authors as to the nature and purpose of various actuarial funding methods. On the other hand, we would acknowledge that the variation of actuarial funding methods available to pension plans, to be used for different purposes, has compounded the problem and led to press, as well as legislators and regulators. Certainly one of the most misunderstood items appearing in pension plan reports is what is often called the "unfunded liability". It is this item in particular which has given rise to so much misunderstanding because there are admittedly a wide range of interpretations of the "unfunded liability" item.

Actuarial liabilities are calculated for three general purposes, and the particular purpose intended will dictate the kind of actuarial methodology which is used. The three general purposes for the development of these actuarial liabilities are as follows:

(1) As a means of determining the annual contributions to be made to the plan so as to provide for orderly funding of the benefits;

(2) As a measurement of the funding progress of an ongoing plan based upon the benefits which have been credited to participants up to any particular date (this might contemplate either the value of accrued benefits for all persons who are vested or retired, or for all accrued benefits of the plan, whether or not vested);

(3) As a measurement of liabilities that would emerge for the plan in the event of plan termination. (This measurement is significantly affected by the termination insurance program established under ERISA which sets up priority allocations in the events of termination.)

There are several funding methods available for the first purpose defined above, that of determining annual contributions for proper funding of the plan. This is necessary and will be discussed later. For the purpose described in the second and third items above—that of measurement of funding progress on an "ongoing plan" basis, or as a measurement of the termination liabilities of the plan, the Academy believes there is considerable merit in having consistent methodology to be used in development of such values. Adoption of a uniform methodology would go a long way toward reducing some of the misunderstandings which have occurred in the past through the use of incorrect types of figures to represent plan liabilities.

For example, many of the articles appearing in the press over the years have called attention to the wide variations in unfunded liabilities among companies in the same industry and even from year to year in the same company. This is often due to focusing on the wrong kind of actuarial values. Although we are not familiar with the source of information which has been used in some of the recent articles, we understand that often the unfunded liability figures used in such articles were taken from the reports filed with the SEC pursuant to Regulation S-X. This information is provided pursuant to SEC regulations which request "the estimated amount that would be necessary to fund . . . the past service cost of the plan". This rather vague description leads to rather wide variations in the values reported to the SEC. We believe the amounts reported often come directly from actuarial values prepared by the actuary for the purpose of determining annual contribution levels to provide for the long range funding of the plan, and not for the purpose of measuring the value of accrued benefits. The figures derived from actuarial values used for determining annual contribution levels may be totally misleading in terms of suggesting that this represents a true unfunded liability of the company. Such values are often only actuarial or mathematical tools used to derive a funding level which will remain reasonably constant as a percentage of payroll over a long period of time. In other words, the so-called "unfunded liability" developed by the actuary for the purpose of determining annual contribution levels is often not a true unfunded liability at all. It does not represent the value of benefits accrued to date or the value of benefits that will be payable if the plan terminated. For reasons that will be discussed later, we do believe that flexibility in the funding methods used for determining the contribution is a highly desirable and necessary tool of the actuary to provide advice on the proper funding of pension plans.

Returning to the bill itself and the desirability of having uniform standards for the purpose of reporting the value of accrued benefits or the termination values of plans, we believe that uniform methodology would be a highly desirable feature so as to avoid misunderstanding by plan participants, the press, legislators, etc. For example, the development of the value of accrued benefits on a "going plan" concept could have the following useful purposes.

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(1) It could be used as a statement of the actuarial condition of the plan as a substitute for the present Section 103(d)(6) of ERISA, which is so complicated to administer that the Labor Department has continued to waive the requirements that such information be reported.

(2) It could be used for the purpose of reporting, on a uniform basis among various companies, the amount of unfunded actuarial liabilities to be used in the footnotes of the financial statements of the Company, as required by the SEC.

(3) It could be used for the purpose of meeting the test required in Section 414(1) in the Code and in Section 208 of ERISA in the event of mergers, terminations, or spin-off of plans. (i.e. this measurement, which is established to protect the rights of participants in the event of plan mergers or spin-offs, could be simplified considerably without diminishing the protection to participants).

(4) If the Financial Accounting Standards Board (FASB) continues to hold the view that the financial statement called for by Section 103(b) of ERISA should include actuarial values, this type of measurement would be appropriate for that purpose.

We believe that one single methodology could be developed with enough flexibility to handle varying plan conditions for all four purposes.

We are pleased to see the bill acknowledge the importance of not requiring the Secretary to prescribe a single set of actuarial assumptions, since such assumptions must of necessity be varied to meet varying plan conditions. For example, turn-over rates, rates of retirement, disability rates, assumed return on investments, rates of pay increases and other factors vary widely among companies. Therefore, the actuary must have the flexibility to select assumptions appropriate not only to the features of the plan itself, but to these other conditions. ERISA recognizes this by requiring that the Enrolled Actuary select actuarial assumptions and methods which, in the aggregate, are reasonable and offer the actuary's best estimate of anticipated experience under the plan.

The bill would provide for the Secretary of Treasury to promulgate standards for the valuation of both assets and actuarial liabilities. We do not believe that the value of assets to be used in the presentation of these measurements should be standardized, such as at market value, but rather should be the value of assets used by the actuary. We have no quarrel with the idea that the market value of assets be used in the presentation of the financial statement prepared by the Administrator pursuant to Section 103(b), but when the actuarial value of liabilities is presented, the value of assets should be prepared on a consistent basis. That is, when the actuary sets forth the actuarial status of the plan for any of the purposes mentioned above, he is considering the projection of these actuarial values on a long range basis, averaging out potential future variations in experience, both in the investment returns and in other actuarial factors. Accordingly, it would be misleading, to plan participants and others who would read such actuarial statements, to be required to match these actuarial values with, say, the market value of the assets, which can exhibit wide variations over the short term. Since pension plan obligation is a long range one with an orderly cash flow out of the fund in the form of benefit payments, a more stable asset value is desirable to match up more properly with the determination of the actuarial values.

As mentioned earlier, an Academy Committee is currently at work on a project which is quite consistent with the intent of this bill as we see it. The Committee on Actuarial Principles and Practices for Pension Plans, after discussion with the Financial Accounting Standards Board, has prepared an interpretation of the Academy's actuarial principles for pension plans which basically sets forth a recommended methodology to be used in determining the value of accrued benefits in connection with the actuarial values to be associated with the financial statement required by Section 103(b) of ERISA. While the Academy does not believe it is necessary or appropriate to include this actuarial value as part of the ERISA financial statement, that decision is the prerogative of the FASB and we are merely complying with their request that a reasonable method of determining such liability be developed by the actuarial profession. This particular paper is in the final stages, and at this point we do not know whether the FASB will accept the recommendations or not. In any event, as soon as the paper is finalized we will see that the Subcommittee is provided with a copy of it.

As indicated, we question whether legislation is currently needed to provide for the desired uniformity in the presentation of actuarial values. However, if Congress should decide the legislation is necessary, we believe the bill, as drafted, needs some clarification and expansion. For example, from the stand-

point of the Internal Revenue Code, the requirement for uniform standards could be linked specifically to Section 414(l) where this kind of standardized methodology would be very appropriate. In addition, it should be recognized that there is a problem of dual responsibility between the Finance Committee and the Labor Committee, since this problem also encompasses the reporting requirements of Section 103 of ERISA. Therefore, certain other sections of ERISA should be likewise amended to adopt consistent language and provide for this uniform methodology to be applicable for other purposes. For example, Section 103(d) of ERISA, which calls for the presentation of certain actuarial values in accordance with the termination priorities of Section 4044 of ERISA, could be amended to call for presentation of the actuarial values in accordance with the uniform methodology prescribed in this bill. As noted earlier, Section 103(d)(6) has been so difficult to administer that the Secretary of Labor has waived the requirements for the past two years and now is proposing an alternative presentation consistent with the ideas expressed by the Academy. If legislation is to be enacted in this area, we would be happy to discuss with the staff the specifics of the language and any other changes which might be required for consistency.

While we support the concept of establishing a uniform methodology for the presentation of the value of accrued benefits, we do question the need for this specific legislation at this time. We believe that many of the problems created by different methods of reporting "unfunded liabilities" can be resolved under existing regulatory authority. In fact, there are several current developments that would lead us to believe that the objective of more uniform reporting of actuarial liabilities will be accomplished in the relatively near future without additional legislation. Among these are:

(1) The revised Schedule B proposed by the administration for joint reporting to the Internal Revenue Service and the Department of Labor which incorporates the ideas proposed by the Academy in this area and substitutes more reasonable requirements for the burdensome actuarial reporting requirements of Section 103(d)(6);

(2) The exposure draft prepared by the Academy Committee on Actuarial Principles and Practices for Pension Plans which does set forth recommended standards for the presentation of the actuarial liabilities of a pension plan;

(3) The view of the FASB that the actuarial liabilities attached to the plan's financial statement be calculated by a uniform methodology;

(4) Section 6059 of the Internal Revenue Code, which provides for periodic reports by the Actuary, appears to give the Secretary of the Treasury the authority to issue such regulations, if deemed necessary;

(5) The Securities and Exchange Commission, we believe, also has authority under existing law to prescribe uniform methodology for the reporting of unfunded actuarial liabilities (such as the Academy's recommendation).

Accordingly, the Academy does not believe that legislation of this type is needed at this time in order to accomplish the desired goals that we believe is the intent of this bill.

The Academy support for the concepts in the proposed bill is based on the assumption that the development of any uniform standards for actuarial methodology would be limited to those kinds of situations described earlier which call for a display of the statement of the value of accrued benefits under the plan, either on an on-going basis or in the event of plan termination, so as to fairly present the actuarial position of the plan. We would not support the adoption of uniform standards of actuarial methodology for the calculation of the minimum or maximum funding requirements of ERISA. That is, the actuarial methods to be used to develop the minimum contribution requirements to provide for sound and orderly funding of the plan are often different than those used for the purposes described before, and we would hope that there is no intention to prescribe a standard methodology for purposes of determining the minimum funding requirements of ERISA. The present structure of ERISA and the background committee report certainly support the concept that there should be flexibility in funding methods and assumptions. It leaves the actuarial basis for funding levels to the discretion of the Enrolled Actuary to select the method and assumptions that are most appropriate for the particular plan, and as indicated earlier, ERISA specifically requires this.

The selection of the funding method for the purpose of determining annual contribution levels should reflect the variations in plan provisions as well as variations in the potential economic conditions of the employer. With respect

to this latter point, certain industries, such as utilities, have a very stable cash flow and therefor less flexibility is needed in the funding program designed for such a company than would be in the case of, say, a steel company which is subject to substantial fluctuations in its cash flow patterns over the years. Similarly, the type of plan has an influence on the selection of an appropriate funding method. A typical career-average pension plan financed by a deferred group annuity contract of a life insurance company has traditionally been funded by the unit purchase funding method; this has proven to be a very sound method for this situation. On the other hand, in selecting the funding method for a final average pay plan, the actuary will often want to use one of the "projected benefit" family of methods, since it provides for more flexibility in the establishment of an orderly funding program to recognize the significant elements in the pension formula.

We recognize that these differences in funding methods can lead to differences in annual contributions and in "unfunded liabilities." It is for this reason that we support the concept in the bill that whenever the "unfunded liabilities" are to be displayed (to participants, the public, in financial statements, etc.) they should be calculated in accordance with a uniform methodology.

As a matter of related interest, we will be submitting as part of our more complete statement a pension discussion document prepared by a research accounting group in the United Kingdom dealing with financial reports for pension funds. One of the major conclusions of this accounting research group is that a part of the comprehensive report which the Trustees should provide to participants in the plan should be prepared by the actuary regarding the overall funded position of the plan. It notes particularly that this should be presented in parallel with, rather than part of, the financial statement prepared by the accountant. We would certainly endorse this approach with regard to the preparation of statements under ERISA and would be very pleased to review further proposals regarding the manner in which this might be implemented.

We thank you very much for the opportunity to present this statement and, as indicated, we will file a supplemental statement within a few weeks when some additional source material becomes available.

[Whereupon, at 11:50 a.m., the subcommittee recessed, to reconvene at the call of the Chair.]

[By direction of the chairman, the following communications were made a part of the record:]

AMERICAN ACADEMY OF ACTUARIES,
Washington, D.C., July 14, 1978.

Senator LLOYD M. BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR BENTSEN: The American Academy of Actuaries was pleased to present a written statement at the public hearing on S. 2992 on June 14, 1978. We understand that this statement will become part of the official record of the hearing and are enclosing another copy for your convenience.

The last paragraph of our June 14 statement indicated that the Academy planned to ". . . file a supplemental statement written a few weeks when some additional source material becomes available". We understand from the Subcommittee staff that the record is remaining open through July 14, 1978.

The additional source material mentioned above is now available and is enclosed with this letter for the record. This material consists of two documents.

The first is Interpretation 2 released on June 30, 1978 by the Academy Committee on Actuarial Principles and Practices in Connection with Pension Plans. This committee is the group officially charged by the Board of Directors of the Academy to examine and develop actuarial principles and practices for actuarial calculations with respect to pension plans. The context of this Interpretation and its relevance to S. 2992 was described on pp. 7–8 of our June 14 statement as follows:

"As mentioned earlier, an Academy Committee is currently at work on a project which is quite consistent with the intent of this bill as we see it. The Committee on Actuarial Principles and Practices for Pension Plans, after discussion with the Financial Accounting Standards Board, has prepared an interpretation of the Academy's actuarial principles for pension plans which basically sets forth a recommended methodology to be used in determining the value of accrued benefits in connection with the actuarial values to be associated with the financial state-

ment required by Section 103(b) of ERISA. While the Academy does not believe it is necessary or appropriate to include this actuarial value as part of the ERISA financial statement, that decision is the prerogative of the FASB and we are merely complying with their request that a reasonable method of determining such liability be developed by the actuarial profession. This particular paper is in the final stages, and at this point we do not know whether the FASB will accept the recommendations or not. In any event, as soon as the paper is finalized we will see that the Subcommittee is provided with a copy of it".

The second is "The Report of the Pensions Research Accountants Group on Financial Reports for Pension Funds" released jointly by the National Association of Pension Funds and the Pensions Research Accountants Group in Great Britain. This document was mentioned on p. 12 of our June 14 statement as follows:

"As a matter of related interest, we will be submitting as part of our more complete statement a pension discussion document prepared by a research accounting group in the United Kingdom dealing with financial reports for pension funds. One of the major conclusions of this accounting research group is that a part of the comprehensive report which the Trustees should provide to participants in the plan should be prepared by the actuary regarding the overall funded position of the plan. It notes particularly that this should be presented in parallel with, rather than part of, the financial statement prepared by the accountant. We would certainly endorse this approach with regard to the preparation of statements under ERISA and would be very pleased to review further proposals regarding the manner in which this might be implemented."

In closing, we are pleased that we are able to provide these two additional documents to the Subcommittee in time for inclusion in the record. The Academy stands ready to participate in further deliberations on S. 2992 and related legislation. Thank you for your consideraiton of these materials.

Respectfully yours,

STEPHEN G. KELLISON.

INTERPRETATION 2: INTERPRETATION OF RECOMMENDATIONS CONCERNING THE CALCULATION OF THE ACTUARIAL PRESENT VALUE OF ACCRUED BENEFITS UNDER AN ACTIVE PLAN

I. Recommendation A(7) allows flexibility to the actuary in determining the actuarial present value of accrued benefits under an active plan within the scope of this Recommendation. This Interpretation provides for consistent practice in the determination of the actuarial present value of accrued (or accumulated) benefits which might be disclosed in Schedule B of Form 5500, where required, or in a statement accompanying a plan's financial statements. A comparison of such actuarial present value of accrued benefits with the actuarial value of assets will provide a measure under an active plan of the progress which is being made toward the funding of the benefits which are accruing, according to measurement methods reasonably consistent for all plans. Other actuarial calculations ordinarily are necessary to measure the progress made in meeting the long range funding objectives of the plan sponsor, to ascertain the status of the plan if it were terminated or to determine statutory funding requirements.

(a) The present value of accrued benefits represents the present value, at the date of determination, of (i) the benefits expected to be paid with respect to former employes who have retired or who have terminated service with vested rights; (ii) the benefits expected to be paid to beneficiaries of employees who have died; and (iii) the accrued benefits based on service rendered and compensation earned prior to the date of determination, which are expected to become payable with respect to present employees; taking into account the regular valuation assumptions as to mortality and, in the case of present employees, such other matters as withdrawal, retirement, disability and future service accrual for benefit eligibility.

(b) The accrued benefit related to one contingency may differ from the accrued benefit related to another, e.g., retirement, termination from service and death. The following are guidelines for determining the amounts of accrued benefit.

(i) If the accrued benefit is specifically defined in the plan document or is clearly implied by the plan's provisions, that definition will be followed for the contingencies to which it is applicable.

(ii) If (i) does not apply and the benefit type is includible in the present value of vested benefits, the benefit will be considered to accrue in proportion to the ratio of completed years of benefit service to projected years of benefit service when it first became fully vested. Therefore, if an employee has satisfied the

requirements for full vesting, the accrued benefit will be computed as in Interpretation 1.

(iii) Any other benefit will be assumed to accrue in proportion to the ratio of completed years of benefit service to projected years of benefit service upon anticipated separation from covered employment.

(c) In the regular valuation of a plan, the actuary may be using an implicit approach to the choice of actuarial assumptions in the selection of the salary increase and investment return assumption. Inasmuch as the calculations to be performed within the scope of this Interpretation do not involve the anticipation of future salary increases, the actuary should use an explicit approach in his consideration of an appropriate investment return assumption.

The degree of conservatism, if any, which the actuary chooses to reflect in his consideration of an appropriate investment return assumption for the purposes of this Interpretation need not be the same as that reflected in the regular valuation investment return assumption.

(d) Automatic cost-of-living or similar benefit increases specified by the plan and expected to occur after retirement, death or other termination should be recognized, using an inflation assumption which is consistent with assumed rate of investment return.

(e) Increases in the level of benefits which become effective in the future need not be recognized even though they have already been adopted.

(f) In the determination of Social Security benefits the employee's compensation as of the date of termination should be assumed to continue unchanged during his assumed future service, i.e., until his termination, retirement, etc., according to the actuarial assumptions. Calculations related to the Social Security law should not take into account any changes in the law or increases in the wage base or Consumer Price Index subsequent to the date of determination.

(g) In determining an appropriate actuarial value of assets which may be compared to the actuarial present value of accrued benefits. Recommendation A(10) should be followed.

(h) The actuary may be required, or may feel it is appropriate, to distinguish between the portion of the actuarial present value of accrued benefits which is vested and the portion which is not vested. Interpretation 1 defines acceptable practice for calculating the actuarial present value of vested benefits of an active plan, as required, for example, by APB Opinion No. 8 and should be applied in determining the portion of the actuarial present value of accrued benefits which is vested.

Because a breakdown of the present value of accrued benefits among the plan termination categories under ERISA generally is of little significance for an active plan, it is not intended that such a breakdown will be made in the usual case.

(i) In all cases approximations consistent with Recommendation A(11) may be utilized.

(j) Benefits to be provided under an insurance company contract which are not fully guaranteed by the insurance company should be taken into account in determining the actuarial present value of accrued benefits. Fully guaranteed benefits should be included in or excluded from this calculation, depending on whether or not the assets standing behind these benefits are included in the asset value with which the actuarial present value of accrued benefits is being compared.

(k) The actuary should indicate that the determination of the actuarial present value of accrued benefits has been made in accordance with generally accepted actuarial principles and practices. The sources of the data used in the calculations, as well as the investment return assumption and the other assumptions used should be disclosed. In addition, the actuary should identify any limitation on the use of the calculations for various purposes which he feels are appropriate. Although comparative figures for the current year and prior year should be shown (after the first year the statement is prepared), a complete reconciliation of the actuarial present value of accrued benefits from year to year is not required. However, the impact of significant changes in the actuarial assumptions, plan provisions and Social Security legislation should be disclosed. A sample Statement of Actuarial Present Value of Accrued Benefits and a sample Actuary's Opinion are attached.

II. The application of this Interpretation for determining the actuarial present value of accrued benefits under an active plan is illustrated by the following Examples A and B.

EXAMPLE A

It is assumed that the actuary uses a table incorporating decrements for termination at ages below 55, as well as for death at all ages. Further, all surviving active employees are assumed to retire at age 63 (or attained age, if greater) with unreduced benefits.

(a) Given:

(i) Benefit rate of $10 per month per year of service.

(ii) Normal retirement at age 65, irrespective of service. Retirement not compulsory.

(iii) Unreduced immediate benefit upon early retirement from active employment at age 62 or over.

(iv) Reduced immediate benefit upon early retirement from active employment after age 55 and before age 62 with 20 years of service. Reduction is 4 percent for each year by which retirement precedes age 62.

(v) Deferred vested benefit, commencing at age 65, upon termination with 10 years of service. Benefit payments (at full actuarially reduced value) may also be elected to commerce as early as age 55 if 20 more years of service have been completed.

(vi) Spouse's benefit upon death in active service after meeting eligibility requirements for early or normal retirement equal to $5 per month per year of service.

(b) The following calculations are intended:

Type of benefit	Payable upon separation from service at ages	Amount of benefit	Benefit starts at—	Duration of benefit
Age 25 and 5 yr of service:				
(1) Deferred vested	30–54	$50	Age 65	Life.
(2) Unreduced early	63	50	Age 63	Do.
(3) Spouse	55–62	25	Death in service	Life of spouse.
Age 40 and 5 yr of service:				
(1) Deferred vested	45–54	50	Age 65	Life.
(2) Unreduced early	63	50	Age 63	Do.
(3) Spouse	55–62	25	Death in service	Life of spouse.
Age 45 and 10 yr of service:				
(1) Deferred vested	45–54	100	Age 65	Life.
(2) Unreduced early	63	100	Age 63	Do.
(3) Spouse	55–62	50	Death in service	Life of spouse.
Age 50 and 20 yr of service:				
(1) Deferred vested	50–54	200	Age 65	Life.
(2) Unreduced early	63	200	Age 63	Do.
(3) Spouse	55–62	100	Death in service	Life of spouse.
Age 60 and 10 yr of service:				
(1) Unreduced early	63	100	Age 63	Life.
(2) Spouse	60–62	50	Death in service	Life of spouse.

EXAMPLE B

It is assumed that the actuary uses a full range of decrements including termination rates and disablement rates at ages below age 65, early retirement rates at ages when eligible below age 65, and normal retirement rates at ages 65 and over.

(a) Given:

(i) Benefit rate of $10 per month per year of service.

(ii) Normal retirement at age 65, irrespective of service. Retirement not compulsory.

(iii) Unreduced immediate benefit upon early retirement from active employment at age 62 with 20 years of service.

(iv) Unreduced immediate benefit upon early retirement from active employment before age 62 with 30 years of service. Social Security make-up benefit of $200 per month payable until age 62.

(v) Reduced immediate benefit upon early retirement from active employment after age 55 and before age 62 with 20 years of service. Reduction is 4 percent for each year by which retirement precedes age 62.

(vi) Unreduced immediate benefit upon total and permanent disability before age 65 with 10 years of service.

(vii) Deferred vested benefit, commencing at age 65, upon termination with 10 years of service. Benefit payments (at full actuarially reduced value) may

also be elected to commence as early as age 55 if 20 or more years of service haev been completed.

(viii) Spouse's benefit upon death in service after meeting eligibility requirements for early or normal retirement (30 years of service, age 55 and 20 years of service, or age 65) equal to $5 per month per year of service.

(b) The following calculations are intented:

Type of benefit	Payable upon separation from service at ages	Amount of benefit	Benefit starts at—	Duration of benefit
Age 25 and 5 yr of service:				
(1) Deferred vested	30 to 49	$50	Age 65	Life.
(2) Unreduced early	50 to 64	50	Retirement	Do.
(3) Social security makeup	50 to 61	[1] 33	do	To age 62.
(4) Normal	65 and over	50	do	Life.
(5) Spouse	50 and over	25	Death in service	Life of spouse.
(6) Disability	30 to 64	50	Disablement	Life.
Age 40 and 5 yr of service:				
(1) Deferred vested	45 to 54	60	Age 65	Do.
(2) Reduced early	55 to 61	[2]	Retirement	Do.
(3) Unreduced early	62 to 64	50	do	Do.
(4) Normal	65 and over	50	do	Do.
(5) Spouse	55 and over	25	Death in service	Life of spouse.
(6) Disability	45 to 64	50	Disablement	Life.
Age 45 and 10 yr of service:				
(1) Deferred vested	45 to 54	100	Age 65	Do.
(2) Reduced early	55 to 61	[3]	Retirement	Do.
(3) Unreduced early	62 to 64	100	do	Do.
(4) Normal	65 and over	100	do	Do.
(5) Spouse	55 and over	50	Death in service	Life of spouse.
(6) Disability	45 to 64	100	Disablement	Life.
Age 50 and 20 yr of service:				
(1) Deferred vested	50 to 54	200	Age 65	Do.
(2) Reduced early	55 to 59	[4]	Retirement	Do.
(3) Unreduced early	60 to 64	200	do	Do.
(4) Social security makeup	60 to 61	[1] 133	do	To age 62.
(5) Normal	65 and over	200	do	Life.
(6) Spouse	55 and over	100	Death in service	Life of spouse.
(7) Disability	50 to 64	200	Disablement	Life.
Age 50 and 30 yr of service:				
(1) Unreduced early	50 to 64	300	Retirement	Do.
(2) Social security makeup	50 to 61	[1] 200	do	To age 62.
(3) Normal	65 and over	300	do	Life.
(4) Spouse	50 and over	150	Death in service	Life of spouse.
(5) Disability	50 to 64	300	Disablement	Life.
Age 60 and 10 yr of service:				
(1) Deferred vested	60 to 64	100	Age 65	Do.
(2) Normal	65 and over	100	Retirement	Do.
(3) Spouse	65 and over	50	Death in service	Life of spouse.
(4) Disability	60 to 64	100	Disablement	Life.

[1] Because this benefit type is one which is includible in the computation of the present value of vested benefits, the $200 monthly benefit is assumed to accrue uniformly over the 1st 30 yr of service (see I(b)(ii)). If, on the other hand, there had been specified a benefit which never is includible in the computation of the present value of vested benefits, such as a $200 monthly benefit payable in the event of the employee's death after 30 yr of service, the accrued death benefit to be valued in the age 25 and 5 yr of service example would have been $33 (5/30 of $200) for death at age 50, $32 (5/31 of $200) for death at age 51, etc.

[2] $36 at age 55 increasing $2 a year to age 61.

[3] $72 at age 55 increasing $4 a year to age 61.

[4] $144 at age 55 increasing $8 a year to age 59.

(c) If, in the example, there were a maximum service limit of 30 years applicable at normal or early retirement or disablement, with a pro-rata portion of the expected normal retirement benefit payable on vested termination, the only changes in the amount of benefit would be for the deferred vested benefit:

Age 25 and 5 Years of Service .... $ 33 (5/45 of $300)
Age 50 and 20 Years of Service .... $171 (20/35 of $300)

SAMPLE STATEMENT OF ACTUARIAL PRESENT VALUE OF ACCRUED BENEFITS

XYZ CORPORATION PENSION PLAN

Actuarial present value of accrued benefits	Jan. 1, 1980	Jan. 1, 1979
Retired participants and beneficiaries of deceased participants		
Terminated participants with vested interests		
Active participants		
Total		

Note:

1. The actuarial value of assets, corresponding to the total actuarial present values of accrued benefits, was $xxx at January 1, 1980 and $xxx at January 1, 1979, respectively. The actuarial value of assets is equal to the average market value of assets of the plan as of the computation date and the four preceding January 1's with an adjustment to reflect the cash flow during this period. This formula is used to smooth out fluctuations in the market value of assets, which was $xxx at January 1, 1980 and $xxx at January 1, 1979.

2. A comparison of the actuarial present value of accrued benefits with the actuarial value of assets provides a measure under an active plan of the progress which is being made toward the funding of the benefits which are accruing, according to measurement methods reasonably consistent for all plans. Other actuarial calculations ordinarily are made to determine year-to-year contribution levels.

3. The actuarial values which would apply in the event the plan were terminated would differ from those shown, for many reasons including, but not necessarily limited to, the following:

(a) Certain plan provisions which may apply in the event of partial or complete plan termination are not reflected in the benefits valued nor in the actuarial assumptions employed.

(b) Vested benefits may be limited with reference to the value of the assets of the fund.

(c) Certain vested benefits may be insured by the Pension Benefit Guaranty Corporation.

(d) Actuarial computations under actuarial assumptions other than those specified herein may be required as a basis for determining plan benefits in the event of a partial or complete termination of the plan.

(e) Benefits deemd already earned may not be the same as those underlying the actuarial value shown.

4. The benefits reflected above have been determined on the basis of the plan provisions in effect on the respective dates. No recognition was given at January 1, 1979 to benefit increases which became effective on October 1, 1979; or at January 1, 1979 and January 1, 1980 to benefit increases scheduled to become effective on May 1, 1980 and May 1, 1981. The amendments effective October 1, 1979 caused an increase of approximately $xxx in the actuarial present value of accrued benefits as of January 1, 1980. Benefits under the plan are based on a participant's compensation during his last five years of credited service. The actuarial present values shown above for active participants are based on estimated average compensation during the five years ending on the respective dates of determination. Benefits payable under all circumstances—retirement, death, disability and vested termination of employment—are included, to the extent that they are deemed to have accrued as of the computation dates.

5. The actuarial present value was determined by the actuary on the basis of employee data supplied by the plan administrator (sponsor), the provisions of the plan as supplied by the plan administrator (sponsor), and actuarial assumptions as described in note 6. The plan administrator (sponsor) has stated that, to the best of his knowledge, the employee data is accurate and complete and that the plan provisions provided the actuary are accurate and complete as of the valuation date. The actuarial value of asset was determined by the actuary on the basis of information supplied by the plan administrator (sponsor).

6. There have been no changes in actuarial assumptions since the previous valuation. The principal actuarial assumptions used in determining the actuarial present values shown are as follows: Investment return: X% compounded annually (after deducting expenses). Mortality: The ____________ Mortality Table. Withdrawal: Rates ranging from X% at age 18 to X% at age 55 and over. Retirement: Rates ranging from X% at age 48 to X% at age 62, X% at age 63 and 64, X% at ages 65 through 69 and 100% at age 70. Spouse benefits: X% of men and X% of women married with wife ______ years younger than husband.

SAMPLE ACTUARY'S OPINION

This Statement has been prepared in accordance with generally accepted actuarial principles and practices and, to the best of our knowledge, fairly reflects the actuarial present value of accrued benefits of the (Name of Plan) as of (Date) and (Date).

In preparing this Statement, we have relied upon information provided to us regarding plan provisions, plan participants, plan assets and other matters, as more fully detailed in the notes to the Statement. In particular, we call attention

to the fact that information as to (TYPE) has been certified to by (Name of Certified Public Accountants).

The present values shown herein have been estimated on the basis of actuarial assumptions which, in the opinion of the actuary, are appropriate for the purposes of the Statement, are reasonable in the aggregate (taking into account the experience of the plan and reasonable expectations), and when applied in combination, represent his (her) best estimate of the measure of anticipated experience under the plan.

(Name of firm)
(Date) BY:___________________
(Name of Actuary
(Professional Designation)

FINANCIAL REPORTS FOR PENSION FUNDS

(A Joint NAPF/PRAG Publication)

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FOREWORD

PRAG: A Discussion Document

The NAPF have been delighted to agree with the Committee of PRAG—the Pensions Research Accountants Group—that in order to assist in the circulation of their Report on the preparation of Pension Fund Accounts, it should be included in the Notes on Pensions Series and issued to all members.

Although PRAG includes a number of NAPF members it is independent of the NAPF. Nevertheless we consider this report of such importance that we decided to circulate it to all NAPF members as a Discussion Document.

In this way we hope that the Report will achieve wide circulation amongst the various responsible professional bodies. Hopefully, it may prove possible that a mutually agreed code of practice as to the manner of Pension Fund Accounting can be established, setting out the separate and joint responsibilities of Auditors, Actuaries, Pension Fund Managers and Trustees.

K. G. SMITH,
Chairman.

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SUMMARY OF CONCLUSIONS

1. Occupational pension schemes in the United Kingdom have grown very rapidly to a position of national importance, but their financial reporting methods have not developed correspondingly.

2. The traditional balance sheet produced by accountants is a source of confusion. PRAG suggests that it be replaced by a net assets statement.

3. As part of a comprehensive annual trustees should provide members of the scheme and other interested parties with a suitable report from the fund's actuary on the overall financial situation. This should be presented in parallel with, rather than as part of, the financial accounts.

4. Adopting these proposals would help to solve the present demarcation problems experienced by auditors and actuaries, to the advantage of all concerned.

5. Members of schemes should normally be offered a simplified report, with access to the full version on request.

6. Trade unions recognized by the employer should be provided with full information about the scheme.

7. Where insurance policies form a means of funding, periodical valuations are required in order to provide more satisfactory financial reports on such schemes.

8. An adequate report on the fund's investment objectives and achievements is essential. PRAG's proposed format for the annual accounts provides a good framework for such a report.

INTRODUCTION

1. Pension funds occupy a prominent place of increasing importance in the national economy; almost half the working population is in membership of occupational pension schemes, the benefits and contributions of which are now key features of industrial negotiations. However this increasing social and economic impact has not been matched by work in the field of pension fund reporting and many of those most closely involved have for some time considered this to be an unsatisfactory situation.

2. It was considerations such as these that led to the formation in July 1976 of the Pensions Research Accountants Group ('PRAG'). Those attending the first meeting adequately represented most professional interests likely to have views on how pension fund reporting might be improved. Both public and private sector schemes were represented as well as those with professional involvement in the actuarial valuation and auditing of pension schemes. This nucleus of people quickly agreed that there was much work to be done if a new impetus is to be given to pension fund reporting and the first task should be to publish a study on the annual reports of pension funds.

3. The inaugural meeting was accorded an appropriate degree of publicity in the professional press and enquiries were received from some who were not present but none the less had something to offer the project. As a result five working parties, selected to cross professional boundaries, were formed with clearly defined areas of research; their preliminary findings were subsequently sifted and collated by a drafting committee. The recommendations made in this study therefore represent a consensus emerging from a wide range of professional interests over the past 12 months.

4. This—the first report of PRAG—is addressed primarily to practitioners with responsibility for pension fund reporting and accounting; but the Group hope that its conclusions will be of interest to pension fund trustees, to those with managerial responsibility for pension administration, to trade union representatives (who are paying an increasingly active role in pension fund matters) and, not least, to members and students of those professional bodies which require an understanding of pension fund reporting. The underlying purpose of this research is to influence thinking and the development of accounting for pen-
Paper on the disclosure of information and member participation (Cmnd. 6514).

5. The Group readily acknowledges the support of individual members, and of their employers, in the production of this study; its conclusion and recommendations should not however be regarded as representing their individual views.

HISTORICAL BACKGROUND TO PENSION FUND REPORTING

6. Occupational pension schemes in the United Kingdom have largely been a development of the twentieth century. Prior to this time pension arrangements, if any, were usually on an ad hoc basis, although there were notable exceptions; for example a comprehensive non-contributory Civil Service scheme was established in 1834. Since the 1930's there has been a phenomenal growth in the spread of occupational pension schemes and recently there were estimated to be about 20,000 employers who have schemes with ten or more members.[1]

7. Employee involvement in the running and trusteeship of schemes has traditionally been minimal, particularly in the private sector. However, historically a number of private sector companies have taken a paternalistic attitude and given priority to the welfare of their employees, in particular by looking after their interests long after they have ceased to be in employment.

8. From a legal point of view most schemes are trusts and under trust law trustees are accountable to the beneficiaries of their trusts. In addition pension arrangements are forming an increasingly important part of employees' conditions of employment. Although the practice was normally to prepare audited accounts, it was not usual for copies of these or any form of trustees' report to be available to the beneficiaries. Of course there have always been a significant number of exceptions, particularly where the trustees had a duty under the rules to circulate certain financial and other information to members. (This particu-

[1] Department of Employment Gazette—May 1977.

larly applied to those schemes which were registered under the Superannuation and Other Trust Funds (Validation) Act 1927).

9. The special nature of pension funds has to some extent been recognized by the professional accounting bodies, and the latest advice from the Institute of Chartered Accountants in England and Wales to practitioners, is set out in recommendation N21. However, this recommendation was issued in 1960 and since then the pensions industry has seen substantial development in step with the march of social and economic events.

CURRENT THINKING ON PENSION FUND REPORTING

10. The Occupational Pension Board (OPB) in its report on the question of Solvency, Disclosure of Information and Member Participation in Occupational Pension Schemes (Cmnd. 5904) pointed out the lack of specific legal requirement as to disclosure of financial information and recommended that on resquest each member and beneficiary of a pension scheme (unless fully insured) should be given a copy of an annual report which should contain the annual accounts, the auditors' report, details of the scheme's investments, a certificate prepared by the actuary at the lastest valuation, showing the extent to which accrued benefits would be secured on the immediate discontinuance of the scheme, and a statement by the actuary giving his recommendation, at the most recent valuation, on the rate of contribution to be paid, the bases used in making this recommendation, and the level of funding which this was intended to achieve. It was envisaged that all this information would be presented in a form laid down by the Board.

11. The Government, in accepting these recommendations, also felt that the annual report should indicate, in general terms, the investment policy being followed.[1] They have since indicated that in practice they propose to leave the form and content of the annual accounts to be settled by the professional accounting bodies.

12. The Employment Protection Act, 1975 gave independent trade unions a right to information necessary for collective bargaining. In some circles the present thinking is that the right to receive a pension in retirement from an occupational pension scheme is deferred pay and should fall within the scope of collective bargaining. This is certainly the view of the Trades Union Congress who in their book on occupational pension schemes[2] stated:

"Pensions, in the past, have too frequently been regarded as a gift granted in respect of long and faithful service as an act of benevolence by the employer. This view is unacceptable to trade unionists but pension schemes developed under the influence of such attitudes, and there remains a heavy legacy from the past which at present too often prevents their proper use. This is now changing, largely due to the influence of trade unions but supported by legislation such as the Social Security Pensions Act. Money set aside to provide for future benefits is as much earnings of the worker as the money in his wage packet. Pension schemes therefore should be the result of freely negotiated joint decision by a group of workers to set aside part of the income currently available to them and to save it collectively, for their future use".

This obviously supports the idea that financial information should be available to recognized unions as well as to members.

13. In view of the interest being shown by the various parties already mentioned, the Group set out to ascertain whether the members of schemes generally showed interest in accounting information. A survey among Group members produced remarkably consistent findings which were:

(a) When abbreviated accounts were issued to members with an offer to supply the full version no requests were received;

(b) Members did not understand why, with an apparently large amount in the fund, there could be any difficulty about giving much needed current pension increases.

This seems to bear out a general impression that, as presently constructed, pension schemes report give little satisfaction.

PRINCIPLES GOVERNING PRAG'S APPROACH

14. Before summarising what the Group thinks is good practice, it is right to outline the considerations which have shaped the proposals.

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[1] Command 6514.—Occupational Pension Schemes: The role of members in the running of schemes.

[2] Occupational Pension Schemes.—A TUC Guide.

15. First, it is taken for granted that UK pension schemes are, for the most part funded rather than pay-as-you-go, and will remain so in the forseeable future. Hence it will continue to be important for any financial reporting system to deal with the solvency of the scheme. This means presenting figures derived from two rather different disciplines: accountancy and actuarial, and differing opinions are held as to their relative scope and emphasis.

16. The Group takes as its starting point the relationship between the trustees and the other interested parties (mainly the members and the employer). The trustees are regarded as the principal party; they employ the scheme's officials (at least functionally) and they are effectively the client so far as auditors and actuaries are concerned. Hence, the OPB's suggestions that the framework of the financial report should be a trustees' report, with the other necessary components attaching thereto, is entirely helpful. In the Group's view in each party's relationship to the trustees is clear, there should be no demarcation problems between the various professional advisers.

17. This leads to the conviction that actuarial information should be presented in parallel with, rather than as part of, or subordinate to, the accounting information, and that the auditors' report should not normally refer to the substance of the actuarial report. While emphasizing that this seems the only practical way forward, the Group notes that amongst a number of auditors there is the sincerely held view that despite anything the client (i.e. the trustees) may say, the auditors' own professional standards will compel them to review the actuarial information (and presumably to comment if necessary) on the grounds that their name will be associated with the whole set of financial statements in the minds of members and other users. The Group is bound to acknowledge that the exercise of independent judgment by professional men has been a force for good in the regulation of commerce. In this case, however, the result has been considerable misunderstanding and confusion about the financial affairs of pension funds.

18. The Group believes the focus of confusion has been in the use of the conventional balance sheet, where the reader may be misled into thinking that for a pension scheme the balance sheet describes the "state of affairs". Indeed it has often been the endeavour of the auditors to report whether the balance sheet represents a true and fair view of the state of affairs of the scheme. Such an approach which is derived too slavishly from Companies Act requirements is inappropriate and, in practice, harmful.

19. The annual accounts of a commercial organisation are designed to show how the company has managed its affairs during the review period and whether it has generated a profit or a loss as a result of its activities. Its balance sheet is a "snapshot" of its financial position on a particular date. Accounting practice has focussed on "state of affairs" reporting to shareholders and company auditors have very properly emphasized the importance of this concept in the phrasing of their audit reports.

20. The concepts are meaningless in the management of understanding of pension funds, which occupy a fundamentally different position from commercial organisations. Pension funds are essentially devices for matching long term commitments to pay pensions and other benefits with the assets which will create the financial capacity to meet these long term liabilities. A pension fund's liabilities cannot be determined by conventional accounting practice. nor can the fund be adequately described in accounting terms which pay attention to facts rather than probabilities.

21. The underlying financial position of a pension fund is revealed in the actuarial valuation report which is concerned with the ability of the fund to meet its long term liabilities. As part of this process the report may show that the fund is in "surplus" or "deficit"—but these terms are not used in the normal commercial sense—they indicate a probability rather than an accounting certainty.

22. Since the objectives of pension funds are so fundamentally different from those of commercial organisations it is unrealistic and unfair to expect them to report on a commercial basis. The Group holds the view that the short term financial reporting arrangements for pension funds should be designed to show how the trustees have discharged their responsibility for the stewardship of the money under their control and the way in which the assets of the fund have been managed and deployed. These aspects can be incorporated in accounting comprising an income and expenditure statement together with statements showing net assets movements and net assets, all of which are described in greater detail in the next section. These reports have been designed to show those things which

are most relevant to the particular accounting period and the Group is content to leave the actuarial valuation report to bring out the long term financial position of the fund.

23. While the Group earnestly commends the general approach outline in this report, it does not suggest that a standard presentation is appropriate or desirable. For the present, experiment deserves to be encouraged to discover what the users of financial statements find understandable and helpful.

24. In summary therefore the Group believes the annual report of a pension fund should comprise the following:

(a) Trustees' report
(b) Actuarial report
(c) Accounts
(d) Auditors' report

25. The above documents may well be lengthy and complex. The Group therefore commends the practice of preparing a simplified report for issue to the members of the scheme the aim of which should be to communicate to members in a simple and straightforward manner the financial position of the fund. In particular, it should show how the income of the fund is disbursed, and invested, and reassure the members that the fund is being properly managed. The simplified report should comprise an abbreviated version of the income and expenditure account. together with the net assets movements and net assets statements indicating the split of investments. A brief resumé should be made of the reports of the trustees, the actuaries and the auditor of the fund. Whilst we commend the practice of making a simplified report availbale to all members, this should not preclude any member who so wishes, from obtaining a copy of the detailed annual report.

ANNUAL ACCOUNTS AND AUDIT

26. As already indicated, the stewardship concept of pension fund accounts can be demonstrated by an account which records the income and expenditure during an accounting period together with statements of charges in net assets during the period and of net assets at the end of that period. An example is given in Appendix 1. An advantage of this presentation is that the information disclosed corresponds simply with the investment section of the trustees' report, showing the way in which the assets and money avavilable for investments have been deployed in pursuance of the investment policy.

27. The presentation of the information to be given in the accounts and its completeness are of vital importance. As the accounts may be read by members of pension schemes they should be presented in a form that is readily understandable by them. The terminology should not be capable of misinterpretation and words with a particular accountancy meaning should be explained. The accounts should set out to be informative and care should be taken in deciding the information to be included in annexed explanatory notes.

28. The suggested minimum information to be given in an income and expenditure account is as follows:

(a) Contributions, divided between members and employers; special payments and voluntary contributions to be shown separately.

(b) When charged to the fund, administration costs including professional fees split between operating and investment costs.

(c) Transfers to and from other funds. Because the actuaral basis of computation varies, individual, transfer club payments and bulk transfers to be shown separately.

(d) Benefit payments divided between pensions, lump sum retirement benefits, lump sum death benefits, refunds, etc. so that the utilisation of the funds can be seen.

(e) Investment income divided in the same manner as the investments.

29. The net assets movement statement is a simple document setting out the overall changes in the fund's net assets during the accounting period.

30. The net assets statement presentation recommended in this study does not require any change in the customary manner of recording the transactions of the fund in its books of account. So far as accounting disclosure is concerned the degree to which assets should be detailed in the assets statement is a matter for the trustees to decide; a minimum requirement is likely to be a statement which provides an analysis by different types of investment together with a clear indication of the liquidity of the fund, and Appendix 2 suggests a division

which is likely to be sufficient in such cases. Some trustees may wish to go much further and publish a detailed breakdown of their investment to the point where individual holdings are disclosed.

31. Traditionally, pension funds have tended to use book costs as the basis on which assets should be shown. Whilst book costs are readily available, and can be derived in a very simple manner from the normal accounting records of the trustees, an increasing number of pension fund accounts are showing assets based on market values. It is argued that current market values are more appropriate since they have a direct relevance to the current economic situation, whereas book costs merely display an accident of history which is quite irrelevant to the current financial health of the fund. Although the Group has a preference for a current market value method of presentation, it is mindful of the difficulties in determining market values for some assets such as properties and insurance policies.

32. The Group considers it essential that the consequences of a fund investing in insurance policies should be disclosed in the annual accounts. This may well involve procedures which, hitherto, have not been customary, especially in the establishment of realistic values for the purpose of the net assets statement. The suggested accounting treatment and procedures are given in Appendix 3.

33. In the particular case of leasehold property, adoption of the market value basis for the annual accounts does not invalidate the conventional system of recording cost and amortisation figures in the books of account. However, the amount set aside for amortisation for the year does not appear separately in the accounts, being subsumed in the figure for change in market value.

34. Although it can be expensive to have a valuation of certain assets such as properties and insurance policies, it is recommended that all such assets should be valued at least every three years—the basis used being explained in the accompanying notes to the accounts.

35. Irrespective of the method by which the assets are introduced into the net assets statement, the supporting notes should show, comparatively, both book cost and market values, so far as the figures are available. Where a full schedule of investments is not given, it is desirable to disclose any investment amounting to more than 5% of the total assets of the fund (by market value). If the fund owns more than 5% of a particular business this should also be disclosed.

36. The other net assets of the fund will need adequate disclosure in the notes if not in the net assets statement. A note should disclose balances with the employer and any investments in the employer's business, including property on lease and loans (indicating whether or not secured).[4]

37. The amount of money held on trust by the trustees awaiting the exercise of the discretion (e.g. lump sum death benefits) should be shown as a note to the accounts if not already disclosed separately in sundry creditors.

38. A statement of accounting policies is axiomatic and should be drawn up in simple terms. This statement should follow immediately after the accounts, ideally on the page opposite. The statement should cover those areas that might be accorded differing treatment and where relevant the following information is considered essential:

(a) Whether the accounts are prepared on an accruals or cash basis.

(b) Where asset market values are shown, the method of assessment of these values; for example a mid-market basis of valuation of quoted securities and the basis on which any premium content of overseas stocks has been included.

(c) The method adopted for asset amortisation.

(d) The treatment of foreign currency conversions.

(e) Changes in accounting policies.

39. The Group supports the usual accounting custom of showing in the accounts comparable figures for the previous period. Where, due to a change in circumstances or to a change in accounting policy, a comparison of the figures for the two periods does not provide a fair indication of what has happened, an explanation should be provided by way of note to the accounts. Some funds have made a practice of including in their accounts a historical summary of the figures in the income and expenditure account. The Group is not convinced that, given inflation, such summaries are generally meaningful but would favour experiments in presentation technique whereby the long term trends underlying any fluctuating investment results could be brought out, thereby avoiding over-emphasis on the results for a particular period.

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[4] Occupational Pensions Board Memorandum 43 (paragraph 44).

40. The Group recommends in paragraph 48 the inclusion of a statement of the actuarial position in each annual report. It is essential that a reference to this statement is included in the annual accounts and the following example is suggested:

'These accounts record the transactions of the XYZ Pension Fund during the period ended……and they give details of the net assets at the end of the period. For a statement of the long-term financial position, reference should be made to the actuarial statement on page……

The current practice of includi·g an all too brief summary of the actuarial position as a note to the accounts would not then be necessary.

41. The responsibility for issuing accounts lies clearly with the trustees, and this fact should be formally acknowledged by their signing the net assets statement. Depending on whether the fund has individual or corporate trustees, the statement should be signed by at least two persons, being either directors of the corporate trustee body, or individual trustees of the scheme.

42. Having considered the accoutning aspects of pension funds we now turn to the role of the auditors whose responsibilities can be summarised as follows:

(a) Reviewing compliance with appropriate legislation, Inland Revenue approval and the requirements of the trust deed and scheme rules.

(b) Reviewing the adequacy of internal control and systems.

(c) Ascertaining that transactions have been duly authorized.

(d) Examining and reporting on the annual accounts.

(e) Examining the data supplied to the actuary as the basis of periodic valuations.

A more detailed summary of the work normally covered in audit programmes is given in Appendix 4. It is of course open to the trustees to request the auditors to perform additional work and to report thereon.

43. The Group believes that the auditors' responsibilities should relate primarily to the stewardship of the assets. With this in mind they recommend that the auditors' report should be broadly as follows:

In our opinion the accounts on pages……to……give a true and fair view of the transactions of the fund for the period ended……and of the disposition of the fund at that date.

44. The auditors should take note of the latest actuarial report and review the extent to which the trustees have adopted the actuary's recommendations arising from both the periodic valuations and other advice given from time to time. Failure to comply, together with the reasons, should be noted in the accounts. If such failure is not disclosed the auditors may be expected to refer to the fact in their report.

ACTUARIAL REPORT

45. In paragraph 24 the Group recommends that the actuary to a pension fund should provide a separate report to the trustees of the fund for inclusion in the annual report. In particular it was concluded that, although the actuary is normally engaged by and reports to the trustees and employer, the beneficiaries of the trust should have the right to a statement of the conclusions and agreed recommendations contained in the actuary's formal report.

46. To prevent any misunderstanding, the actuary's report to members should be phrased in a way which would avoid the use of technical and emotive terms. In particular the actuary should avoid terms as "deficiency" or "surplus" without defining what he means. In making a valuation the actuary has to make a large number of assumptions about the future (such as future rates of investment return and salary increases) and therefore any deficiency or surplus is only meaningful if all the major financial assumptions made are given. An objective test of a fund's solvency is by reference to the position if it were to be wound up and it is thus normally helpful in the report to members to make a reference to the discontinuance position, in addition to the going concern position. In this connection the Group believes that care should be taken not to imply that a fund which can just meet the discontinuance liabilities is fully funded; it is, therefore, considered undesirable to publish a precise percentage figure which purports to show the degree of funding.

47. The actuary's report should state the planned amount of the funding required in order to enable the fund to meet its present and future liabilities. If the employer is not making funding arrangement which are acceptable to the actuary, this should be stated in the report to the beneficiaries, as they are the persons affected.

48. Following a formal valuation and the acceptance of the actuary's formal report and recommendations by the trustees and employer, the actuary should present to the trustees a statement for publication in the fund's next annual report. As a minimum this should contain the following elements:

(a) A valuation was carried out at (date).

(b) A stated rate (or rates) of contributions to the fund which has (have) been recommended by the actuary to meet the fund's liabilities and has (have) been accepted by the employer.

(c) A statement as to whether or not the assets of the fund at the valuation date were adequate to meet the accrued liabilities for benefits incurred by that date and if not what action, if any, was required to meet the shortfall (including a statement as to what is meant by accrued liabilities and how it is assumed they will be secured).

(d) That the next valuation under the rules is due at (date).

49. If required by the trustees, the content of the report could be wider than the minimum described above. It could, for example, include details of the actuarial method and bases used for the valuation and any major events since the previous valuation which have had a significant effect on the financial position of the fund. A summary of the full valuation report might be suitable in some cases.

50. Full actuarial reports are normally prepared triennially unless a major event has occurred which required the trustees (or employer) to commission a full reassessment. For those years where no full valuation is published, it is considered that there should be an up-dated actuarial report, and not merely a statement of the position at the last valuation date without further comment. This report should normally include an approximate indication of the discontinuance position at the year end. For most funds this would only involve the fund's administrator in providing the actuary with a few aggregate statistics. The actuary could then produce a statement similar to that suggested in Appendix 5.

51. The above comments apply in the main to funds providing final pay types of benefit. For other benefit structures, other than fully insured funds, it is recommended that similar considerations should apply.

TRUSTEES' REPORT

52. The Group considers that a trustees' report should provide the facility for disclosure of matters not directly relevant to the annual accounts but yet important enough to be drawn to the members' attention. In addition, the more general information which members would expect to be interested in, such as details of membership, should also be shown. Such a report would accompany the annual accounts in conjunction with the other reports referred to in paragraph 24.

In practice, a "trustees' report" often takes the form of a report by a Committee of Management, or it may be the report by the pensions manager to the trustees according to the practice of the fund concerned. In the opinion of the Group the trustees' report should be addressed to members, beneficiaries and participating companies, since all these parties have a direct interest in the activities of the fund. Whilst a trustees' report will give more detailed information than the average member requires, unions and consultants representing them will expect to be given full information about the fund.

Such a report should therefore be in addition to, and not replace, any simplified versions of annual reports and accounts distributed to members. In the first instance the report should be distributed to the secretary of each participating company and to each recognized trade union. Members and beneficiaries should be advised that copies are available on request.

53. The Group considered whether any exception on account of size or status of the fund should be accepted, but came to the conclusion that regardless of size, trustees should provide the suggested information, although the quality and method of presentation might be varied to suit the circumstances. Likewise, whether the scheme is contributing or non-contributory and whether it is contracted out of the State scheme, is irrelevant, since the parties concerned have the same degree of interest in the activities.

54. The Group considers that every trustees' report should contain information about the financial background of the fund.

The basis of the employer's contributions should be stated, and whether it is a fixed rate or whether the employer pays the balance of the cost. Any changes in contribution rates should be reported. As is indicated in paragraph 36 the annual accounts should disclose any material indebtedness with, and/or investments in,

the employer at the year end. However this may not reflect the situation during the year and if it fails to do so appropriate disclosure should be made in the trustees' report; for example if there is a serious or consistent delay in paying over contributions to the fund by the employer or the lending of money to the employer. Where the employer bears the administration expenses of the fund this fact should be recorded.

55. Because they are matters of general interest to participants of the fund the following should be stated:

(a) The basis of appointment of the trustees and/or the committee of management, with a list of their names. (The same principles would apply in the case of directors of a corporate trustee.) Any changes during the year and the relevant dates should be given. The name and address of the secretary to these bodies should also be shown.

(b) A list of participating employers with changes during the year, if any.

(c) The names of professional advisers, and of all persons to whom the trustees have substantially delegated their investment powers.

56. As the readers of the report need to appreciate the size and activity of the scheme the numbers of members (distinguishing between males and females), pensioners and deferred pensioners should be given, together with changes (deaths, retirements, leavers etc.) during the year.

57. An outline of changes to the rules during the year should be given, split between voluntary changes and those brought about to comply with legislation. For practical reasons these may be covered, as to detail, by referring to the announcements made at the time of the changes. Any discretionary increases in pensions should be stated, with the rates and effective dates.

58. The method of investment should be shown i.e. self administered or insured. If the fund is self administered information on investments should be presented with a description of the investment policy and strategy followed during the year. From the net assets statement exemplified in Appendix I a suitable table can be developed for the trustees' report showing the categories of assets at market value at the commencement of the year, the deployment of new money arising within the fund during the year, and the changes resulting from sales and the fluctuation in market values. An example using figures that link with Appendix 1 is given below and it will be seen that these figures reconcile with the market value of the assets held at the year end.

[In thousands of English pounds]

	Market value, 5.4.76	Deployment of money available, 1976/77	Change in market value	Market value, 5.4.77
Investments at market value:				
Fixed interest securities	8,481	13,705	1,093	23,279
Equities and convertibles	14,494	[1] 3,203	4,792	16,083
Short-term loans and deposits	1,550	[1] 599		951
Freehold and long leaseholds	16,941	1,194	3,519	21,654
Short leasehold property	1,895	446	[1] 258	2,083
Annuity policies	851	47	127	1,025
Uninvested	456	[1] 300		156
Subtotal	44,668	11,290	9,273	65,231
Other net assets	360	[1] 260		100
Total	45,028	11,030	9,273	65,331

[1] Negative.

In addition, if the trustees have appointed external fund managers then each should be asked to submit for publication a separate report on their investment policy and strategy during the year with reference being made to it in the trustees' report. In the case of an "in-house" manager the information could either be treated similarly or incorporated in the trustees' report.

59. The Group is of the opinion that, interpreted correctly, comparative investment performance measurement offers trustees a useful vehicle for discussing the fund's performance with their investment managers. Whilst the trustees' report should state whether such measurement takes place detailed disclosure of the results might be misleading.

THE FUTURE

60. The Group is very conscious of the fact that this study has done no more than scratch the surface of a subject area which is rapidly becoming more involved. It is considering further research into related subject such as:

(a) Comparative investment performance measurement methods.

(b) Standardised terminology in connection with pension fund accounting and reporting.

(c) The provision of information by insurance companies as a basis for placing values on pension contracts.

(d) The consideration of presentation techniques to display more effectively the long term trends underlying fluctuating investment results during inflationary periods.

APPENDIX 1

XYZ PENSION FUND: SPECIMEN ACCOUNTS FOR THE YEAR ENDED APRIL 5, 1977—INCOME AND EXPENDITURE

[In thousands of English pounds]

	1976	1977
Contributions receivable:		
Normal:		
Members	1,832	3,149
Companies	2,840	4,881
Special	54	315
Voluntary scheme	309	347
Transfer values receivable (note 1)	274	807
Subtotal	5,306	9,499
ess—		
Benefits payable:		
Pensions to retired members	711	1,413
Lump sums on retirement	153	631
Pensions and allowances to widows	184	215
Death benefits	274	377
Refunds of contributions	268	302
Transfer values payable (note 1)	139	178
Insurance premiums (term life assurance)	36	47
Subtotal, contributions less benefits	3,541	6,336
Income from invested funds:		
Fixed interest securities	1,089	1,937
Equities and convertibles	894	871
Short-term loans and deposits	271	146
Freehold and long leasehold property	1,336	1,541
Short leasehold property	97	107
Annuity policies	77	92
Money available for investment	7,305	11,030
Net assets movements at Apr. 5, 1976	34,296	45,028
Money available for investment	7,305	11,030
Changes in investment market values during year	3,427	9,273
Subtotal at Apr. 5, 1977	45,028	65,331
Net assets at Apr. 5, 1977:		
Investments at market value:		
Fixed interest securities	8,431	23,279
Equities and convertibles	14,494	16,083
Short-term loans and deposits	1,550	951
Freehold and long leasehold property	16,941	21,654
Short leasehold property	1,895	2,083
Annuity policies	851	1,025
Uninvested	456	156
Subtotal	44,668	65,231
Other net assets (note 2)	360	100
Total	45,028	65,331

NOTES TO THE ACCOUNTS FOR THE YEAR ENDED APRIL 5, 1977[1]

[In thousands of English Pounds]

	1976		Transfer values 1977	
	Receivable	Payable	Receivable	Payable
Note 1—Transfer values:				
Bulk transfers	37		401	26
Under transfer club rules	117	16	193	63
Individual	120	123	213	89
	888	998		
Subtotal	274	139	807	178
Note 2—Other net assets:				
Contributions due from company	298			73
Bank account working balances	25			30
Sundry debtors:				
Transfer values	70			52
Other	15			5
Subtotal	408			160
Less sundry creditors:				
Members' refunds		15		12
Death benefits		27		40
Other		6		8
Total		360		100

[1] The fund pays and receives transfers on a number of different bases.

Note: Accounting policies would be listed in accordance with par. 38 of this report.

Appendix 2

SUGGESTED ANALYSIS OF ASSETS

(a) Fixed interest securities
- UK Government
- Overseas Governments
- Industrial:
  - UK
  - Overseas

(b) Equities and convertibles
- Equities:
  - UK listed
  - Overseas listed
- Convertibles:
  - Unlisted
  - Listed

(c) Short-term loans and deposits
- Loans—UK
- Loans—Overseas
- Deposits—UK
- Deposits—Overseas

(d) Freehold and long leasehold property
- Freehold
- Long leasehold
- Property Unit Trusts

(e) Short leasehold property

(f) Insurance policies
- Annuity
- Other

(g) Uninvested
- Bank balance
- Indebtedness re stockbrokers, agents, etc.

Managed Funds and Units Trusts would be shown under an appropriate heading.

Appendix 3

INSURANCE POLICIES

1. This appendix considers how insurance policies might be treated in the annual accounts.

2. In the past schemes have frequently been categorised as 'insured' or 'self administered'. This distinction is now much less clear because:

(a) Many large self administered funds have taken over funds with insurance policies.

(b) Insurance policies have become much more flexible and truly comprehensive insurance of pension benefits has largely disappeared.

(c) Whilst retaining an insurance base some funds which were formally in the insured camp have increasingly participated in the direct investment market.

(d) The role of the consulting actuary has expanded and extended to many of the former insured schemes, and insurance companies have made their actuarial expertise more readily available to pension funds.

3. Whilst insurance policies form a decreasing proportion of the total assets of the pension funds they are still important and should be reflected in the annual accounts of a fund. In principle the decision to pay a premium to an insurance company is no different from any other investment decision. In general premium payments should be treated as an increase in assets in the net assets statement and if nothing more was done this would result in a gradual build up in the assets statement of the insurance policy at book cost. However, whenever a claim is paid part of this assets is realised and it will therefore be necessary to adjust the asset value downward from time to time. This can be done on some book cost formula by a process of amortisation or by revaluation on a market value/actuarial basis.

4. Attributing a fair value to an insurance policy is no different in principle from the valuation of other fund investments. It is a function the actuary would need to carry out as part of the regular valuation of the fund and in most cases would be done at least every three years. Between formal valuations a simple net payment adjustment would be a satisfactory method of updating the asset value until the completion of the next full valuation.

5. Slightly different considerations apply in the case of short term insurance. For example, many trustees insure lump sum death benefits on a year to year basis and in this case it is entirely appropriate to show annual premiums paid to the insurer and sums received in settlement of claims as transactions within the income and expenditure statement. Sums received from insurers (such as the proceeds of a policy on its maturity) should be treated in the same way as income from any other sort of investment.

6. Some trustees pass the pension liability on retirement legally and irrevocably to an insurance company. In cases where the liability is so transferred any premium paid will appear as expenditure within the income and expenditure statement and no transaction will appear in the statement of assets. No further record is necessary as the pensioner has no subsequent claim to benefit from the fund even if the insurance company defaults.

Appendix 4

AUDIT PROCEDURES—CHECK LIST

The following check list assumes a properly constituted, funded and approved pension scheme, with separate accounting records, giving rise to accurate accounts, prepared on accepted accounting principles. The recommendations are concerned only with principles and are not intended to represent an exhaustive list of detailed audit procedures.

1. Authority

The auditor should examine and note the terms of the Trust Deed, (including all Supplemental Deeds), rules, Inland Revenue approval, minutes of trustees, investment and any other relevant committees and the record of trustees' appointments and resignations. In particular, the following should be checked while performing the various audit procedures:

(a) That the trust deed and rules have been complied with in all material respects.

(b) That contributions and benefits have been calculated and received or paid in accordance with the trust deed and rules.

(c) That all appropriate transactions have been authorized by minute, and all such authorizations have been complied with.

(d) That relevant legislation has been complied with.

(e) That the appointment and resignation of trustees and committee members has been properly actioned and recorded.

2. Internal control

That auditor should investigate and assess the adequacy of systems in operation, noting particularly the following:

(a) Control over calculation, receipt and subsequent recording of contributions receivable, investment income receivable and any other relevant recurring items which should be received.

(b) Control over calculation, payment and recording of all types of benefits payable and any other recurring payments, noting that such items are properly authorized and actioned promptly.

(c) Control over custody and title of scheme's assets and purchases and sales thereof.

(d) Adequacy of the books of account and of various membership records.

Based upon the outcome of this review, the scope of the required audit testing can be determined and the appropriate action taken if weaknesses are identified.

3. Verification

The volume of testing and precise documents to be examined will vary from scheme to scheme; the following procedures are concerned primarily with the principles involved.

(*a*) *Receipts in the year*

Ascertain that members and the company have contributed at the appropriate rates.

Ascertain that the scheme's assets have generated the proper amount of income and that gains and losses on sales of investments have been properly treated.

Ascertain that the appropriate amounts have been received from insurance companies.

Ascertain that any other appropriate receipts which are due have been accounted for.

Ascertain that the above transactions have been properly recorded within the scheme's records, including the members' contribution records.

(*b*) *Payments in the year*

Ascertain that benefits paid were in fact due, have been properly calculated, correctly authorised and paid to the correct person.

Ascertain that benefits payments due have in fact been actioned.

Ascertain that other payments made were proper charges on the scheme or were approved investment transactions, have been correctly authorised and that the correct amounts have been paid to the appropriate persons.

Ascertain that the above transactions have been properly recorded within the scheme's records.

(*c*) *Year end accounts*

Ascertain that investments represent bona fide assets to which the scheme has good title, are properly classified and correctly shown on a reasonable basis, consistent with previous years. Where appropriate, ascertain that adequate provision has been made for permanent diminution of value.

Ascertain that receivables stated in the accounts are correctly calculated, represent bona fide debtors of the scheme, are properly classified and shown on a basis consistent with previous years and that adequate provision has been made for irrecoverable items.

Ascertain that required receivables are disclosed in the accounts.

Ascertain that significant liabilities of the scheme are stated in the accounts and are properly classified and shown on a basis consistent with previous years.

Where appropriate, confirmation should be obtained from third parties and reference should be made to relevant specialist documents (e.g. Stock Exchange data).

Detailed reviews of the income and expenditure, net assets and net assets movements statements are required.

(d) Other procedures

Other relevant procedures must be carried out, depending upon the circumstances. For example, where a scheme holds insurance policies these must be examined, the terms ascertained and scrutinised to ensure that policy requirements have been met.

Ascertain that the operation of the scheme continues to meet Inland Revenue requirements for approval.

4. Actuarial matters

(a) The auditor should be satisfied as to the quality of the membership and other data supplied by the trustees to the actuary as the basis for the periodic valuations.

(b) The auditor should take note of the latest actuarial report and review the extent to which the trustees have complied with the actuary's recommendations and advice.

Appendix 5

REPORT OF THE ACTUARY

1. We made a valuation of the XYZ Pension Fund as at 5 April 1975. As a result of this valuation we have recommended that constributions of x% of pensionable salaries should be paid to the Fund by the Company, in addition to those payable by members, to provide the pensions and other benefits for which the Fund is liable. We have been advised that contributions have been made by the Company at this rate since 6 April 1975.

2. We also considered the position if the Fund had been discontinued as at 5 April 1975. At that date we estimated that the market value of the assets was more than adequate to secure accrued benefits to that date (i.e. pensions in course of payment, deferred pensions in respect of former members and deferred pensions in respect of persons in service based on pensionable salaries and service to the valuation date, without making allowance for any increase to pensions in payment or deferred pensions in deferment other than those guaranteed under the rules).

3. We have not made a detailed examination of the Fund at 5 April 1977, but approximate calculations that we have made indicate that a similar statement to that set out in 2 above could be made as at 5 April 1977.

Appendix 6

CITATIONS AND BIBLIOGRAPHY

	Paragraph
Department of Employment Gazette—May 1977[1]	6
Command 6514—Occupational Pension Schemes[2]: The role of members in the running of schemes	4 and 11
Occupational Pension Schemes—A TUC Guide[3]	12
Occupational Pensions Board Memorandum 48[4] (paragraph 44)	36
Superannuation and other Trust Funds (Validation) Act 1927	8
Recommendation N21 (1960)—Institute of Chartered Accountants in England and Wales	9
Command 5904—Report of the Occupational Pensions Board—Solvency, disclosure of information and member participation in occupational pension schemes	10
Employment Protection Act, 1975	12

PENSIONS RESEARCH ACCOUNTANTS GROUP

Formed in 1976, the Group consists of the accountants or managers of some of the leading UK occupational pension schemes, together with practitioners in the actuarial and auditing professions who are interested in the financial administration and reporting of pension schemes.

The Group exists to sponsor research in fields directly of concern to the members and to act as a forum for discussion of current developments.

Although virtually all the funds represented belong to the National Association of Pension Funds, and many of the individuals concerned are members of the Pensions Management Institute, the activities of PRAG and the views expressed are independent of these bodies.

Details of membership may be obtained from the Hon. Secretary

J. C. Richards, IPFA, APMI
c/o National Water Council
Superannuation Department
St. Peter's House
Hartshead
SHEFFIELD
S1 1EU
Tel. 0742 737831

COMMENTS OF THE FINANCIAL ACCOUNTING STANDARDS BOARD

INTRODUCTION

The Financial Accounting Standards Board ("FASB" or the "Board") welcomes the opportunity to submit these Comments on S. 2992 (the "Bill") to the Subcommittee on Private Pension Plans and Employee Fringe Benefits ("the Subcommittee") of the Committee on Finance of the U.S. Senate.

The Board is aware of and shares the concerns that have resulted in the Bill. In 1974, the Board placed two projects on its technical agenda to improve financial reporting relating to pension plans. (Those projects are more fully described in subsequent paragraphs.) Significant progress has been made by the Board to respond, in a responsible manner, to the need for improved financial reporting. It is the Board's belief that resolution of issues relating to reporting the assets and liabilities of pension plans should remain with the private sector's standard-setting process, which, with the oversight of the Securities and Exchange Commission (the "SEC"), has worked successfully for forty years.

ESTABLISHING FINANCIAL ACCOUNTING STANDARDS

The FASB is the authoritative professional body designated by the American Institute of Certified Public Accountants and recognized by the SEC to establish and improve financial accounting and reporting standards. It is widely endorsed by the accounting profession, the financial and business community, accounting educators, and others. The FASB does not set auditing standards or regulate auditing, which involves examining financial statements for the purpose of expressing an opinion as to whether they are presented fairly in conformity with generally accepted accounting standards.

As the independent, full-time financial accounting standard-setting body, the FASB is primarily concerned with the Bill's provision that the Secretary of the Treasury establish uniform standards for calculating and reporting the assets and liabilities of pension plans. Although the Bill would amend Section 412 of the Internal Revenue Code, which describes the minimum funding standards for plans, the Board presumes that the Bill's use of the word "reporting" is not limited to reporting to the Internal Revenue Service but is also intended to encompass general-purpose external financial reporting. That presumption is based on certain of Senator Bentsen's remarks in introducing the Bill. In those remarks, he referred to "the numbers that are reported in the accounting and actuarial reports of pension plans." The nature of the accompanying articles inserted into the Congressional Record when the Bill was introduced, and the wording of the press release announcing the Subcommittee's June 14 hearings also appear to support a broad interpretation of "reporting."

In the Board's opinion, the private sector's system for setting financial accounting standards, as it has evolved and is evolving, is successfully serving the public interest. The Board is not aware of any evidence that substituting the Secretary of the Treasury for the Board as the authoritative body to set accounting standards for pension plan financial statements would better serve the public interest. The private sector is proceeding to establish accounting standards for financial reporting by defined benefit pension plans. A brief history of the Board's efforts in that regard follows.

FASB PROJECT ON DEFINED BENEFIT PENSION PLANS

In recognition of the financial reporting requirements for most employee plans as a result of the Employee Retirement Income Security Act of 1974 ("ERISA"), the significance of both the assets held by pension plans and the benefits accumu-

lated by participants in those plans, and the diversity of existing accounting and reporting practices of employee benefit plans. the FASB placed on its technical agenda in November 1974 a project on accounting and reporting for employee benefit plans. The Board's due process procedures are similar to those required by the Administrative Procedures Act and include appointment of a task force of experts for each major project,[1] preparation and publication of a neutral and comprehensive Discussion Memorandum ("DM") analyzing issues related to a project, solicitation of written comments on the issues in the DM, and holding a public hearing on the subject. The Board received 104 position papers in response to the DM on employee benefit plans[2] and heard 23 presentations at its public hearing.

An Exposure Draft ("ED") of a proposed Statement on "Accounting and Reporting by Defined Benefit Pension Plans" was issued on April 14, 1977,[3] and comments on its were solicited. In the Board's opinion, the final Statement for this project should satisfy the Bill's requirement for the promulgation of "uniform standards for calculating and reporting the assets and liabilities of pension plans and for disclosing the actuarial assumptions used in such calculations."

To date, the Board has received approximately 700 letters of comment in response to the ED. The Board would be pleased to provide copies of those letters to the Subcommittee, should they be desired.

ERISA requires that private plans annually provide certain financial and actuarial information to the Department of Labor ("DOL") and a summary of that information is to be provided to participants. Because of those requirements, many letters of comment have expressed the view, which the Board shares, that to avoid duplication of efforts on the part of preparers and to avoid confusion on the part of users of the respective information, it would be beneficial if the standards developed by the FASB for general-purpose external financial reporting purposes were acceptable to the DOL for its reporting needs.

From the beginning of the FASB project, the Board has communicated with the DOL. The Board believes that a cooperative effort with the DOL is in the public interest. The Board is also working with the actuarial profession (through the American Academy of Actuaries) to resolve certain concerns expressed by respondents to the ED. With the cooperation of those groups, substantial progress has been made since the ED was issued.

Recently, FASB staff met with a representative of the American Academy of Actuaries ("Academy"), and the Board met with a representative of the DOL. The purpose of each meeting was to discuss informally the current views of the respective organization on certain critical issues related to the project. The Board is encouraged by the results of those meetings and expects to receive within the next month formal statements of the views of those organizations. The substance of those views is described in the written statements those organizations have made to the Subcommittee. After considering the formal statements of the Academy and the DOL, the Board will begin final deliberations this summer on a Statement of accounting standards for reporting by defined benefit pension plans. In preparing for those deliberations, the Board would welcome the views of the Subcommittee regarding any or all of the issues facing the Board. Deliberations of the Board are held in "sunshine," and representatives of the Subcommittee are welcome to observe those deliberations, should they so desire. The Board expects that its deliberations will be completed in time for a final Statement to be applicable to the preparation of plan financial statements for 1979.

FASB PROJECT ON ACCOUNTING BY EMPLOYERS FOR PENSION PLANS

Although the wording of the Bill is unclear as to whether it is intended to encompass the reporting by employers for their pension plans, the issues enu-

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[1] The Board also invites individuals from various governmental agencies to meetings of its task forces. Regarding the projects relating to pensions, those individuals have included representatives from the Department of Labor, the Pension Benefit Guaranty Corporation, the Cost Accounting Standards Board, the Securities and Exchange Commission, and the House Pension Task Force.

[2] The Subcommittee's staff has been provided with a copy of the DM issued on October 6, 1975. Additional copies can be provided, should the Subcommittee so desire.

[3] The Subcommittee's staff has been provided with a copy of the ED. If desired, additional copies can be provided.

merated in the Committee's June 6, 1978 press release announcing the hearing clearly indicate the Subcommittee's interest in the reporting by the employer.

In addition to its project on accounting by the plans themselves, the Board has on its technical agenda a project on accounting *by employers* for pension plans. The objective of that project is to reconsider the requirements of the existing authoritative accounting literature with regard to accounting by employers for the cost of pension plans. The basic existing literature is Opinion No. 8, "Accounting for the Cost of Pension Plans," issued in 1966 by the Accounting Principles Board, the FASB's predecessor. Supplementing that Opinion is *FASB Interpretation No. 3*, "Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974."[4] For companies registered with the SEC, that agency has an additional reporting requirement—namely, the disclosure of unfunded past service costs.

In 1975, the task force for this project considered whether there was a need for any immediate amendments or additional interpretations of Opinion No. 8 (FASB Interpretation No. 3 having been previously issued) as a result of the passage of ERISA. Because many of the proposed areas for possible interpretations or amendments either required reconsideration of the fundamental conclusions expressed in the APB pronouncement or were related to matters that would be addressed in the project on employee benefit plans, it was concluded that the FASB would not proceed with any interpretations or amendments at that time. At a meeting in 1976, the task force considered a preliminary outline of a discussion memorandum with regard to reconsideration of Opinion No. 8. However, following the public hearing on accounting and reporting by employee benefit plans, it was concluded that first priority should be given to establishing standards for defined benefit pension plans, not only because of ERISA's reporting requirements but also because a critical issue in the reconsideration of Option 8 is the nature of the employer's obligation for its pension plans. The possibility of and conditions for a contingent employer liability insurance program under ERISA have not been decided by the Pension Benefit Guaranty Corporation. The nature of an employer's obligation could be significantly affected by such a program. In addition, the Board has on its technical agenda a project that is intended to establish a conceptual framework for financial accounting and reporting. With that project, the Board is addressing the nature of accounting liabilities.

Although top priority has been given by the Board to the defined benefit pension plan project, progress has also been made in resolving issues related to the project on accounting by employers for pension plans. Following and perhaps concurrent with the completion of the defined benefit pension plan project, the Board expects to place a high priority on completing its due process for reconsidering Option No. 8. An initial phase of that process will be the development of a discussion memorandum to address the various issues to be resolved. Those issues will include the issues enumerated in the Subcommittee's press release that pertain to accounting by employers. In addition, the Board will be considering the appropriateness of issuing, following completion of the defined benefit pension plan project, an amendment of the disclosure requirements of Opinion No. 8. The possible amendment would require uniform disclosures based on the financial status of the employer's pension plans as reflected in the plans' financial reports. That amendment would be an interim step that would be withdrawn when a comprehensive final Statement is issued that addresses the accounting and reporting by employers for pension plans.

CONCLUDING COMMENTS

The Board is keenly aware of the need to improve financial reporting relating to pension plans. As highlighted in this submission, the Board is in the midst of two projects aimed at meeting that need. The Board is confident that the issues relating to reporting by pension plans and their sponsors can be effectively resolved by the private sector's standard-setting process in a manner that will best serve the public interest.

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[4] The Subcommittee's staff has been provided with a copy of the Interpretation. If desired, additonal copies can be provided.

WILLIAM M. MERCER, INC.,
June 27, 1978.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I am writing you in accordance with the last paragraph of the Committee on Finance's Immediate Release of June 6, 1978, P.R. No. 36, concerning pension plan liabilities.

William M. Mercer, Incorporated is the nation's largest employee benefit consulting firm. I am a member of the Board of Directors, with specific responsibility for professional standards, and with a strong interest in the accounting and actuarial issues raised at the hearing of June 14, 1978. (A biography indicating published papers, books, etc. is attached.)

Attached are comments related to the major issues presented at the hearing. If you have any questions or wish any additional information, please let me know.

Sincerely,

BOB BERIN.

Attachments.

DEPARTMENT OF LABOR

My field of specialization and my professional work for a good number of years, has been directly related to the appropriateness of actuarial funding methods and to testing for the continued appropriateness of actuarial assumptions. I hope that I might be of service to the Labor Department and to your committee in this connection. Given the opportunity, I would like to contribute to the sharpening of the supporting technical details contained in Mr. Lanoff's statement.

FORTUNE ARTICLE

The views of the writer of the Fortune article of November 1977 are well known from this particular article and from the discussion of March 23, 1978 before the American Pension Conference. The focus of this article, and of his views are contained in the following two quotations:

"In terms of disclosure, and the focus of the piece that I did in November, my emphasis is on shareholders. I am not particularly concerned about the ability of people covered by pension plans to collect their benefits."

"A few people wrote after my article appeared and asked if I was advocating the end of defined benefit plans. Given the current ground rules of ERISA, I am."

While there is much that is inaccurate and misleading, I would only add one comment, by way of explanation, and that is about unfunded liabilities being about one-half of what they should be. This is based on an extremely pessimistic view of the future and lack of sufficient testing of the results of the underlying premise. First, the theory rests on salaries increasing faster than the return on investments over the next 50 to 75 years. Few economists would accept this as possible, certainly without the caveat that this portends an entirely different society, other than the one we have now. (For briefer periods, the scenario is of course possible.) Second, the theory assumes an inflation rate of about 5 percent for the next 50 to 75 years. If you test the proposition by assuming other rates such as no inflation and then assume double digit inflation rather surprising results follow:

No inflation.—Favorable conditions and yet unfunded liabilities became more than three times the present level.

Double digit inflation.—Unfavorable conditions and yet unfunded liabilities become less than they are now.

These results are difficult to accept without seriously questioning the theory underlying the calculation which is suspect by itself.

ACCOUNTING ISSUES

The recognized funding methods specified in ERISA reflect different patterns of funding a pension plan, each chosen to fit the employer's financial forecast. All achieve exactly the same goal. Only the incidence is different. This kind of choice is found in accounting, in the same sense, in the choices available when depreciating fixed assets and also in the methods of valuing inventory. Such choice should be retained.

Some accountants take the position that adding the assets of the pension fund to the asset side of the balance sheet and adding the accrued liabilities of the pension plan to the liability side of the balance sheet should be the preferred approach. This would be unfortunate in several respects:

(i) It would disturb accounting statements significantly. Relationships common to accounting and finance, drawn from the balance sheet, would no longer be valid. Benefit improvements or a change in actuarial assumptions would have roller coaster effects on financial statements. No where alse in the world is this type of adjustment made.

(ii) Actually, plan termination liabilities should be employed above. These are generally much less than ongoing plan liabilities. For many companies this could produce a surplus but the comments in (i) still applies.

(iii) Those who have made these adjustments indicate that financially healthy companies come out about the same as do financially disturbed companies when rankings are examined. This is not a surprise: the private pension plan follows the health of the plan sponsor and not the other way around.

(iv) Pension costs are probability statements. There is no other such item on the balance sheet.

(v) A better approach would be a supporting exhibit on pension costs and a tightening up of APB-8. We would be pleased to discuss both of these further.

Curriculum Vitae Barnet N. Berin

I. Education

City College of New York: Highest second year honors, Phi Beta Kappa, Magna Cum Laude, B.S. 1951.

Columbia University: M.A. 1953.

Fellow of Society of Actuaries, 1960.

II. Professional

Director-Professional Standards, William M. Mercer, Incorporated, the nation's largest employee benefit consulting firm.

A. Society of Actuaries Committees:

1. Education and Examination—prepared study materials and examinations for pension sections, 1963–1969.
2. Committee on Pensions—discussed and recommended solutions for current pension problems, 1969–1973.
3. Committee on Professional Development—discussed changing times and related problems for actuarial profession, 1970–1973.
4. Committee on Review—prepared book reviews of professional material related to pensions, 1975–1977.
5. Committee on Retirement Plans, Chairman—develop continuing education, research activities and seminars, 1977 to date.

B. New York Actuaries Club:

1. Instructor, Pension Mathematics—established and taught first and succeeding classes in pension mathematics to actuaries in the tri-state area, 1971–1976.
2. Pension Committee—arranged speakers and programs on matters of professional interest, 1971–1972.
3. Committee on Student's Education—helped run and monitor actuarial study classes, 1972–1973.
4. Continuing Education Committee—helped run continuing education seminars, 1974.
5. Nomination and Election Committee—recommended actuaries for election to club offices, 1975–1977.

C. Teaching Assignments:

City College of New York: Statistics Lecturer, 1952.

Insurance College of New York: Group Insurance Lecturer, 1962.

New School for Social Research: Member of faculty, taught course on pensions, 1974.

D. Member of the Advisory Board:

1. Actuarial Education and Research Fund—representatives from six actuarial organizations identify issues for study and grant awards to accomplish research, 1974 to date.

2. Bureau of National Affairs—a professional study group related to government matters in the employee benefits field, 1975 to date.

3. Public Employees' Retirement Systems Study Group—preparation and organization of a recommendation for a study of Public Employee Retirement Systems, 1976 to date.

4. Bessemer Pension Institute—a group of 50 large companies that regularly meets and discusses pension issues, 1977 to date.

E. Other Professional.—Actuary-in-Residence, The University of Michigan, Academic Year 1977–78.

III. ORGANIZATIONS

Fellow.—Canadian Institute of Actuaries; Conference of Actuaries in Public Practice; Society of Actuaries.

Associate.—Institute of Actuaries (United Kingdom)

Member.—Actuaries Club of New York; American Academy of Actuaries; International Actuarial Association; International Association of Consulting Actuaries.

IV. PUBLICATIONS

A. Books:

"The Fundamentals of Pension Mathematics," 1971, The Society of Actuaries.

"Pensions: A Guide to the Technical Side," 1973, C.D .Spencer and Associates.

B. Periodicals:

1. "Dividend Model For Noncontributory Deposit Administration Group Annuity Contracts," *Society of Actuaries*, 1961.

2. "What Is Your Pension Plan Worth?", *Pension News*, December 1967. (Co-author)

3. "Life Contingencies and Compound Interest — the Connecting Link," *Conference of Actuaries in Public Practice*, 1971.

4. "The BAI Interest Rate," *The Actuary* December 1971.

5. "APB–8 Five Years Later—Strong Influence Felt," *Pension News*, 1972.

6. "Pension Funding: A Nontechnical Explanation," *American Management Association*, 1972.

7. "You and Your Pension," (book review) *The Actuary*, February 1973.

8. "Women's Liberation and the Female Mortality Rate," *The Actuary*, October 1973.

9. "The President's Message," *Pension News*, October 1973.

10. "Pension Mathematics, The Underlying Philosophy," *International Association of Consulting Actuaries*, Amsterdam, March 1973.

11. "Revenue Ruling 71–446 (Social Security Integration): An Assessment And A Proposal For Change," *Conference of Actuaries in Public Practice*, Vol. XXIV, 1974–1975.

12. "BAI: One for Two," *Pension News*, October 1974.

13. "Interest Rates and Salary Scales in Pension Valuations," *The Actuary*, April 1975.

14. "Corraling The Conglomerates," *Pension World*, July 1975.

15. "Pension Plans In Difficult Economic Times," *Society of Actuaries*, April 1976.

16. "The Valuation of Pension Fund Assets," *Employee Benefits Journal*, Fall 1976.

17. "Pension Actuarial Gain and Loss Analysis," *Record, Society of Actuaries*, October 1976.

18. "Actuaries Needn't Be The Only Ones to Understand Valuation Reports," *Pensions & Investments*, August 1977.

19. "From the Pony Express," *across-the-board, The Conference Board Magazine*, June 1978.

STATEMENT OF KWASHA LIPTON

Kwasha Lipton is a firm of actuaries and employee benefit consultants. We welcome this opportunity of submitting our comments on the accounting and actuarial practices of pension plans to the Senate Finance Subcommittee on Private Pension Plans.

Our comments are directed toward a single end: the preservation of the private pension system in the U.S. With our nation's present tax structure, we see the

private pension system as the principal source of future investment capital for our free enterprise economy. We also see it as a desirable means of preserving some individual freedom of choice in supplementing a legislated social security system—a choice exercised by the individual through the employer-employee relationship and colective bargaining.

Without defined benefit pension plans, we believe the private pension system will not survive. Experience has shown that most employees and their collective bargaining representatives will not be content with the vagaries of defined contribution plans to fulfill all of their retirement income needs and objectives; and, in our opinion, they would turn to an expanded social security system.

Any practice or legal requirement which regards or treats the so-called "unfunded liability" of a defined benefit pension plan as a claim against the current assets of a plan sponsor's business inevitably must discourage employers from adopting or improving such plans.

Such implicit characterization of a pension plan's "unfunded liability" is becoming increasingly common. Some sources are as follows:

1. Since 1967, the rules of the American Institute of Certified Public Accounts have required that a pension plan's unfunded value of vested benefits be reported as a footnote to a corporation's financial statement and, since 1970, have required that such amount be treated as a liability when accounting for a business acquisition as a purchase.

2. Since 1974, Title IV of ERISA has established the "unfunded liability" for the PBGC-guaranteed portion of a pension plan's benefits as such a claim, up to a limit of 30% of the plan sponsor's net worth. (Even such limited claim—intended, we believe, to be a necessary anti-selection protective measure for the PBGC plan termination insurance fund and not to be a governmental characterization of a pension plan's "unfunded liability" as an inherent liability of the plan sponsor—nevertheless apparently has deterred many small employers from maintaining their defined benefit pension plans.)

3. We understand that pension plan "unfunded liability" is now included in the determination of the risk classification of a corporation's debt securities by the two major rating agencies.

4. Judging from the exposure draft issued in April 1977, the Financial Accounting Standards Board intends to require that the value of a pension plan's accumulated benefits be reported in the plan's financial statement, which we believe tends to imply a liability beyond the assets of the plan.

5. The Department of Labor has announced that it expects to require the disclosure of the value of accrued benefits (both vested and non-vested) in the Form 5500 annual financial report of a pension plan, along with the plan's assets, which adds to the implication of extended liability in our opinion.

6. The Pension Benefit Guaranty Corporation staff has announced that it hopes to recommend changes in ERISA which would make the unfunded vested liability of a pension plan a legal liability of the plan sponsor, which the employer would have to continue to fund, regardless of business necessity, unless the employer went into bankruptcy.

7. The November 1977 article in Fortune entitled "Those Pension Plans Are Even Weaker Thank You Think" (which has been entered into the Congressional Record) apparently was intended to alert stockholders to the dangers which corporate pension plans hold for them as investors. In our letter to the Editor of Fortune (a copy of which is attached), we stated that ". . . the logical conclusion the reader must reach, in our opinion, is that the private pension system (or, at least, the defined benefit part of it) is an unreasonable burden for stockholders to bear. Hence, we ask you the question: Is Fortune magazine advocating the elimination of the private pension system?" To that question, Mr. Ehrbar (the author of the Article) replied in the January 16, 1978 issue of Fortune, as follows:

"The risk exposure from ERISA's plan-termination insurance makes a defined-benefit pension plan imprudent for any single corporation and, thus, for corporations as a whole. Unless the ERISA insurance scheme is radically reformed, corporations should abandon defined-benefit plans in favor of defined-contribution plans".

Such characterizations of a pension plan's "unfunded liability" as an implied or potentially real claim against the current assets of a plan sponsor's business is contrary to the historical development of pension and other employee benefit plans—which development, as we see it, is expressed in the attached copy of

our March 1976 Newsletter. Had such characterizations existed during the last 40 years, private pension plans would never have developed to the important role they now fulfill in helping to meet the economic and social needs of our nation.

Against such currently developing background, how can one expect an employer who is prepared to add, say, 3 percent of future annual payroll to his labor cost to do so by way of a defined benefit pension plan if he can opt for a defined contribution plan which carries no threat against the business's previously accumulated earnings and invested capital. Some may even question whether the management of a publicly-owned corporation has the right, in such circumstances, to add an element to future compensation which could constitute a substantial direct claim against the corporation's existing assets should the future prospects of the business deteriorate.

Why should the nation encourage employers to use defined contribution-individual account plans which do not recognize the relative needs of individual participants—such as, the fact that an older employee may not have sufficient time left to accumulate an adequate retirement account; the fact that after retirement some persons live longer than others; the fact that some deceased participants have dependents and others do not.

Instead, why not again encourage employers to use defined benefit pension plans by curtailing the potential claim against the employer's existing assets and restoring the perspective under which such plans were adopted in the past—that is, a perspective whereby the same overall future annual contributions which could have been made to a defined contribution plan are instead made to an unallocated asset pool under a defined benefit plan wherein each participant's right to draw upon the pool is fixed by the terms of the plan according to his or her age and years of service, longevity, dependency status, etc.

One past criticism of defined benefit pension plans has been that participants expect the plan to go on forever and the plan's asset pool always to be sufficient to fulfill their benefit expectations, regardless of how recently the plan may have been established or their benefit expectations increased. In those instances where plans have had to be curtailed by business necessity, the participants naturally have been disappointed and often have felt cheated because they did not understand the nature of the plan as a pooling of a portion of their compensation since the plan was established and, hence, having only the remainder of the pool available at the plan's curtailment.

Even if participants fully understand the limited-resource nature of a defined benefit pension plan (as they undoubtedly do in defined contribution plans), one could question the usefulness of private plans in fulfilling their part of the retirement income needs of the nation as a whole if each plan had to stand entirely on its own.

Both of those concerns with defined benefit pension plans have largely been eliminated by the guaranteed benefit provisions of Title IV of ERISA, whereby all such plans must participate in a group arrangement insuring one another against plan survival. Since the plans are private and subject to freedom of choice and should remain so, Title IV must contain reasonable provisions to deter one plan sponsor from unfairly burdening the others. But, as Congress has already recognized, the deterrents must not be so onerous as to defeat the entire purpose of the program by discouraging the maintenance of defined benefit pension plans and their expansion to cover a greater proportion of the population.

In our opinion, the increasing characterization of "unfunded liability" as a potential claim against the employer's existing assets does tend to defeat the program. The PBGC staff proposal to make it a legal liability certainly would do so.

The apparent justification of the Department of Labor and the Financial Accounting Standards Board proposals to disclose the value of accrued or accumulated benefits in comparison to a plan's assets—with the resulting implication of the plan sponsor liability beyond the assets of the plan—is that participants need that comparison to assess the security of their benefit expectations. But, even if such assessment could be made from such disclosure—which it cannot be on an individual basis—do the participants need it when the true measures of their benefit security are the continued strength of the plan sponsor's business and the guaranteed benefit provisions of ERISA.

If not the participants, who needs such disclosure. Investors certainly do but only to the extent that "unfunded liability" represents a real and substantial

claim against the existing assets of the business. Otherwise they need only be concerned that the business is making adequate annual contributions out of current revenues to maintain the pension plan in accordance with the contribution standards of ERISA and generally accepted actuarial principles and practices.

Congress can encourage employers to maintain and adopt defined benefit pension plans, and alleviate the fears which investors, or at least their advisors, seem to have with such plans, by means of the following:

1. Reduce the contingent employer liability under Title IV of ERISA from the present 30 percent of the plan sponsor's net worth to a less onerous percentage such as 10 percent; but be prepared to raise it again if actual plan termination claim experience should reach a level requiring supporting premiums beyond some limit deemed to be a reasonable price for the private pension system to pay to self-insure itself. Perhaps, such a limit would be 5 percent of the aggregate annual contributions required under the minimum contribution provisions of section 412 of the Internal Revenue Code for all defined benefit pension plans as a group. (For example, if such aggregate annual contributions were to average $600 per participant, a premium limit of 5 percent would be $30 per year per participant.)

2. Require PBGC to switch from the present basis of a flat premium per participant to a premium measured by an individual plan's unfunded value of guaranteed benefits, if the necessary overall supporting premium should rise to a level which would justify the expense of calculating the premium on such basis. Perhaps, such level would be one-half of the limit referred in item 1 above—that is, a level of 2½ percent of the aggregate annual minimum funding contributions (which would be $15 per participant in the above example).

3. Specify that the audited financial statement to be attached to the Form 5500 annual financial report is to be a statement of the plan's existing assets and is not to include any statement or footnotes regarding the so-called "unfunded liability" of the plan.

4. Eliminate the requirement that the actuarial statement to be attached to the Form 5500 report should include the value of vested benefits and limit it to a statement of information pertinent to the determination of the plan's minimum annual contribution requirement under section 412 of the Code.

5. Explicitly state that Congress recognizes that the so-called "unfunded liability" of a defined benefit pension plan generally is not a claim against the plan sponsor's existing assets except to the extent of the contingent employer liability under Title IV of ERISA.

Two illustrations, which we believe to be realistic possibilities, of what could result from the PBGC staff proposal to make the so-called "unfunded liability" for vested benefits a legal liability of the plan sponsor are as follows:

1. Employers would become increasingly reluctant to amend a plan to provide the so-called "cost-of-living" type of pension increase to previously retired participants, when such increase would constitute a legal commitment of the current assets of the business to persons no longer rendering any services to the business. (At present, many employers periodically make such amendments on an ad hoc basis, either unilaterally or through collective bargaining.)

2. At plants which are currently operating at a loss (or are only marginally profitable) but which still have prospects of being turned around, employers will resist any proposals to increase accrued benefits when such increase would constitute a legal liability adding to the potential financial loss if the plant subsequently had to be shut down. In industries where collective bargaining could force the same pension increases upon all of the employer's operations, both the profitable and unprofitable ones, the presence of a legal liability for pension increases would leave the employer no alternative but to accelerate the decision of whether or not to shut down an unprofitable location rather than risk an increased financial loss by continuing the endeavors to turn it around.

As to the methods and assumptions used to measure the assets and benefit values of a pension paln and to determine its annual cost, we believe that the rules and guidelines now prescribed by ERISA and by the American Academy of Actuaries adequately cover the varying needs of individual private plans; and, short of dishonesty for which adequate penalties exist, such rules and guidelines preclude manipulation to the detriment of plan participants. One improvement which Congress could make—which would permit greater consistency among the various types of pension plans—would be to specify in section 412 of the Code that, under the so-called "flat dollar" and "career average pay" types of plans,

the effect of future inflation in leading to plan amendments raising accrued benefits may be anticipated in advance to the same extent that the effect of future inflation is anticipated in determining the costs for "final average pay" plans which respond automatically to inflation. At present, such effect of inflation on "flat dollar" and "career average pay" plans may be anticipated only indirectly by understating or overstating other assumptions.

Again, we thank you for the opportunity of submitting our comments and would be pleased to discuss them further with the Committee staff, if desired.

Respectfully submitted by Kwasha Lipton.

JOHN A. CONNORS,
Partner.

[From Kwasha Lipton Inc. Newsletter, March 31, 1976]

PENSION "OBLIGATION"—"WHAT IS IT"?

(This Newsletter presents an excerpt from the comments submitted by our President, John A. Connors, to the Financial Accounting Standards Board (FASB) in response to its "Discussion Memorandum" dealing with the establishment of standards for the "Accounting and Reporting for Employee Benefit Plans." We will be happy to send you a copy of the complete text of Mr. Connors' comments. Please address your request to Mr. Harry F. Bremer, Vice President, Kwasha Lipton Inc.)

In recent months the Financial Accounting Standards Board (FASB) circulated a Discussion Memorandum on the subject "Accounting and Reporting for Employee Benefit Plans." In reference to pension plans this Memorandum frequently uses phrases such as the "obligation for pension benefits" and "a promise by the employer to make benefit payments to the employee after retirement." Among other issues the Memorandum poses the question of how and to what extent should a plan's financial statement report it's "obligation for pension benefits." In effect, what is its "liability"?

The use of such phrases in the FASB Discussion Memorandum suggests to us that perhaps sight has been lost of an employer's intention and purpose when he adopted his pension plan. Did he incur such "obligation" or make such "promise"? Present accounting rules require a footnote to a company's financial statement disclosing the unfunded value of a plan's vested benefits (i.e., the value of expected payments of vested benefits beyond those which can be provided by current plan assets). Moreover, in plant shutdown situations and certain acquisitions accounted as a "purchase," present accounting rules require such unfunded vested value to be included in a company's balance sheet (not as a footnote).

Lest such present and prospective accounting rules create an erroneous impression to the public at large (including plan participants) regarding an employer's "obligation" under a pension plan, we suggest that some of the fundamentals of employee benefit plans in general and pension plans in particular be reexamined. (The following paragraphs are excerpted from our comments to the FASB on its recent Discussion Memorandum.)

POOLING OF RESOURCES

When employee benefit plans are viewed historically, one starts with the time long ago when all of an employee's compensation was paid currently and the employee was left individually to take care of his and his family's needs—needs such as medical care, income during a period of illness or disability, income at and after the employee's death or retirement, and the like. Because such needs are varying and unpredictable, hardships resulted which could be avoided or diminished if employees, with the assistance of their employer, pooled their resources under a group employee benefit plan. Tax laws were structured to encourage the creation of such group plans, which also encouraged the contributions to the pool to be cast in the form of employer contributions rather than in the form of employee contributions which would have to be made out of post-tax compensation.

Regardless of how a particular employee benefit plan started—whether by unilateral employer action or collective bargaining negotiations, and whether with or without employees making post-tax contributions, and whether with defined contributions or defined benefits having an estimated reasonable periodic cost—the employee benefit plan has not lost its historical nature of a pooling, for the good of the group, of amounts which would otherwise be paid as current

compensation, with the terms of the plan specifying the conditions as to time, circumstances and amount at which each participant and/or his beneficiary may draw upon the pool.

EXPECTATIONS

When in the past an employer or plan sponsor, unilaterally or by negotiation, has agreed to the adoption or amendment of an employee benefit plan, he generally has done so with the expectation of making periodic contributions to the plan which, together with all other forms of direct and indirect compensation, represent a reasonable, competitive and manageable total compensation package. Although he almost always reserved the right to curtail, suspend or discontinue such contributions—except during the limited term of certain collective bargaining agreements—he recognized that, realistically, in a competitive labor market he must expect, while he has a going business, to continue such contribtuions and even accept certain effects of inflation on such contributions, so long as his total compensation package allows his business to remain competitive. If ever it shouldn't, or if his business ever ceased, his intention would have been to curtail such contributions just as any other compensation cost.

APPLICATION TO DEFINED BENEFIT (PENSION) PLANS

Employee pension benefit or retirement income plans have the same historical nature as do other employee benefits plans. Some plans—such as profit sharing plans, savings or thrift plans, money purchase plans—are of the defined contribution type in which case each contribution to the plan's asset pool (and the investment earnings thereon) is allocated and credited to an individual account for each participant and his right to draw upon the plan's asset pool is limited to the amount then credited to his account.

Were such defined contribution plans are intended to provide the principal source of retirement income benefits for the employee group, most plan sponsors and collective bargaining representatives have found them to be a less desirable application of the group's resources. Just as other employee benefit needs vary, retirement income needs vary according to an employee's survival to retirement and post-retirement longevity. Inflation, early retirement, permanent disability, surviving spouse needs and other factors have continually increased retirement income needs and objectives. Those participants whose needs are most imminent have the least time in which to build up an adequate individual retirement account under a defined contribution plan. Others who don't survive to retirement have no need for a retirement account.

Consequently, most retirement plans have followed the defined benefit approach which permits each participant to draw upon the plan's asset pool according to the group's definition of an adequate benefit even though the accumulated contributions which may be deemed to have been made on such participant's behalf would not support such benefit. Naturally, the group hopes that the plan will continue indefinitely and that the plan's asset pool will always be sufficient to meet current pension payments. But, while no one likes the thought, most plan documents recognize the possibility that the plan may terminate at some time and provide in such event that the asset pool remaining at that time will be divided among the remaining participants according to the group's specification of priorities.

ROLE OF THE GOVERNMENT

The government has recognized the social desirability of private defined benefit plans vs. defined contribution plans and has sought a means of alleviating the human disappointment and the social economic harm which occurs when a group's defined benefit plan cannot continue. The result is a mandated group insurance arrangement (via the Pension Benefit Guaranty Corporation) to partially insure the benefit expectations of those groups. Since a plan's sponsor plays a major role in deciding whether or not a plan can continue, and it would be socially and economically undersirable to preclude him from making that decision, the plan insurance arrangement needed some protection against the plan sponsor's ability to select against the plan insurance fund. The solution adopted by the government is the imposition of a possible penalty against the plan sponsor (up to 30 percent of net worth) when he elects to terminate a plan. In our opinion such penalty in no way implies that the plan sponsor had an obligation to continue the plan when the participating group could no longer make contributions to it.

CONCLUSIONS

An employee benefit plan, including an employee pension plan, is a group arrangement to accumulate a portion of the group's compensation for services rendered after the installation of the plan and to disburse the accumulated pool of assets in accordance with the terms set down by the group specifying the conditions as to time, circumstances and amount that each participant will have a right to draw upon the pool. The fact that in a defined benefit pension plan a participant's pre-installation (or pre-amendment) service or earnings may be included among the factors used to measure the amount which he may withdraw does not change the nature of the plan from being a group compensation arrangement for services rendered after installation or amendment. Accordingly, the financial liability at any date of an employee benefit plan is the pool of assets accumulated to that date and remaining to be disbursed as benefit payments.

[From Kwasha Lipton Bulletin, November 28, 1977]

IS FORTUNE MAGAZINE ADVOCATING THE ELIMINATION OF THE PRIVATE PENSION SYSTEM?

Probably not—at least, not consciously. But, in its November 1977 issue, Fortune presents a strong indictment of the private pension system under an article entitled: "Those Pension Plans Are Even Weaker Than You Think".

Almost every group or entity connected with pension plans is indicted to some degree—corporations, their managers, their actuaries, the government (which adopted the pension plan termination insurance program under ERISA), and the plan participants (whose pension benefits are now guaranteed for the most part through the ERISA insurance program).

While no one would claim that the private pension system is perfect, we feel that the article presents a distorted picture by dramatizing presumed dangers while ignoring the positive role the system fulfills as a source of social benefit and capital investment. But, more importantly, we think that the article raises a serious question about the viability of the private pension system in the mind of the reflective reader.

At first reading the purpose of the article appears to be to alert stockholders of the dangers which pension plans hold for them—dangers which the authors believe are being hidden from them today, despite the efforts of accountants and security analysts. But, upon further reflection the reader should ask the question:

If the dangers are as the article pictures them to be, and

If the only solutions to those presumed dangers are the solutions the article suggests,

Is the private pension system an unreasonable burden for stockholders to accept?

If so, what is the logical alternative? Will the 35 or so million persons now covered by defined benefit pension plans accept lesser assurances of future retirement income? Or will they pressure the government—a government which has already evidenced its sympathy in seeing that such retirement incomes expectations are fulfilled—to take over the private pension system? Some people already advocate the latter alternative because it would also solve the continuing problem of how to provide social security supplementation to the other half of the working population now covered by private plans.

Would corporate stockholders be better off with an expansion of the social security system to cover 100 percent of the retirement income needs (or expectations) of the entire population of the U.S.? Where would their corporations turn for the investment capital now available from the $240 billion or so in private pension funds and from the expected future additions to such funds?

And further, who are the corporate stockholders? Are they not in large part the workers and other members of the population represented by institutional investors plus many small investors who are also employees or retired employees or beneficiaries of such persons? Would they be acting in their own interest to turn over to the melting pot of a government managed system the retirement income prerogatives which they now exercise through their individual employers and unions? We think not.

Attached is a copy of a letter we have sent to the editors of Fortune, commenting on their article and askng them in light of the questions we pose above to reexamine and clarify their assessment of the dangers of the private pension

system. You and your associates may also wish to express your thoughts to the editors of Fortune. We sincerely urge you to do so.

NOVEMBER 21, 1977.

Mr. ROBERTT LUBAR,

Managing Editor, Fortune, Time and Life Building, Rockefeller Center, New York, N.Y.

DEAR MR. LUBAR: We find Mr. A. F. Ehrbar's article "Those Pension Plans Are Even Weaker Than You Think" (November) very alarming—primarily because we assume that it represents the views and concerns of the editors of Fortune, a publication which we consider to be one of the strongest supporters of the free enterprise system among the media.

Using very dramatic language, chastising almost every group or entity connected with pension plans, and describing doomsday possibilities, the article seems to portray the private pension system as posing a nightmarish danger to stockholders—a danger which can be contained only by the adoption of certain corrective measures which the article either supports or proposes itself.

If the danger and the solution were as the article describes them to be—both of which we disagree with (as discussed further below)—the logical conclusion the reader must reach, in our opinion, is that the private pension system (or, at least, the defined benefit part of it) is an unreasonable burden for stockholders to bear. Hence, we ask you the question: Is Fortune magazine advocating the elimination of the private pension system?

Attached is a copy of a bulletin which we are widely circulating, together with a copy of this letter, to pension plan sponsors and other parties interested in the private pension system. Our purpose is to alert them to the import of your article, as we see it to be; and to ask them to share with you their thoughts on this article and its subject.

Ours is a firm of actuaries and employee benefit consultants. We, therefore, have a personal interest in the preservation of the private pension system. But, more than that, we believe that our nation will be better served in the long term to the extent that it can fulfill its needs through the private sector rather than through governmental systems.

Our analysis of your article indicates that the danger portrayed and the solutions offered are founded in two areas. We contest the article's conclusions in both areas—in the first area because we find the reasoning fallacious and in the second because we believe the result will be harmful to the nation. The two areas are as follows:

1. That corporations—through their managers and actuaries—are understating and underfunding the costs and liabilities of their pension plans. To wit:

"There is reason to believe, moreover, that the reported figures are ridiculously understated."

"The accounting and actuarial treatment of pension liabilities is a masterpiece of obfusation."

"Getting a focus on just how large a drag pension costs will put on future profits requires a look beyond the reported numbers and into the arcane realm of the actuary."

"As it turns out, the asumptions made about interest and wages are so far out of line with reality that most companies contribute too little to cover future benefits."

2. That the pension plan termination insurance provisions of ERISA are fraught with dangers to stockholders. To wit:

"Plan termination insurance tends to warp the way businessmen make decisions" (by encouraging them to substitute "generous pension promises" for current wage increases, promises which the rest of the private sector will have to fulfill through ERISA's insurance pool if the company making the promises fails).

"The architects of ERISA overlooked a special aspect of pension-fund risk when they decided to insure benefits. They really aren't insurable." (viz., pension funds "are invested largely in common stocks"; stock prices "in real terms, have been cut in half twice in the last fifty years"; if it happens again "it is apt to coincide with a major economic decline"; "PBGC's resources are likely to be strained by a surge of pension plan defaults," with unfunded liabilities swollen by stock-market losses; PBGC's levies on continuing plans would have to increase to make up the deficits, possibly causing further plan abandonments; and "the

PBGC, swamped by claims, would have to cut off benefits or turn to Congress for help.")

"So long as they (i.e., the ERISA-insured benefits) are guaranteed, the liabilities constitute an overhanging burden not only on future profits, but on the future living standards of all but the 35 million or so workers who are covered by defined benefit pension plans."

At this point we would like to pause to compliment your author, Mr. Ehrbar, and your research associate, Ms. Morrison, on their apparent awareness and grasp of most of the major factors affecting the measurement of pension plan costs and liabilities. The article evidences the greater knowledge of subject matter which we have admired as a characteristic in most Fortune articles. Unfortunately, in this instance, it only puzzles us more as to how such knowledge could fail to recognize what seems to be the logical result of the article's conclusions. It is because we consider that result to be evident that we have posed the question stated earlier in this letter and in the attached bulletin: Is Fortune magazine advocating the elimination of the private pension system?

UNDERSTATEMENT OF PENSION COSTS AND LIABILITIES

Fortune's justification for all of the disparaging statements the article makes about corporate managers and their actuaries rests almost entirely on Fortune's premise

That pension plan costs and liabilities should be measured and pension plans should be funded on the assumption of a "riskless" rate of investment return from the pension fund's assets whereas

Currently pension plan costs and liabilities are being measured and plans are being funded on the assumption of the probable investment return that corporate managers and their actuaries expect from the investments the pension fund actually makes.

Fortune's premise seems to be stated most clearly in the paragraph of the article (p. 108) which reads:

"In other words, corporate managers are gambling when they invest pension assets in common stocks. By assuming that pension-fund assets will grow at the expected rate of return on risky investments, they are taking it for granted that they will win the gamble. There is always a chance, however, that they will lose. That possibility of losing constitutes a real claim against future profits—it just doesn't show up on the books. The only way a corporation can be certain of having sufficient funds to cover future benefits is to invest in riskless assets. And that would of course raise the level of pension-fund contributions above what it is today."

All future events are uncertain and all future expectations include the risk that actual events may be less favorable or more favorable than the expected events. Does Fortune really believe that it is in the interest of stockholders (i) to increase the charges to the current generation of stockholders in order to protect future generations of stockholders from any risk that the future may be less favorable than expected, and (ii) to reduce the charges to future stockholders at the expense of current stockholders if the future turns out to be as favorable as expected? If so, why stop at the expected investment return? There are other expectations that substantially affect pension costs—two of which are age at retirement and life expectancy. There is the chance that all plan participants will retire when first eligible to do so and, further, that the eligibility requirements for retirement will continue to be reduced. There is the chance that medical science will find cures for the present major diseases and accelerate the rate of increase in life expectancy.

We expect that most corporate managers and actuaries share our belief that it would be wrong to increase the charges to one generation of stockholders in order to eliminate all risk for future generations. In the end, it would not be in the interest of any generation of stockholders if it led to the demise of the private pension system and the loss of the role it fulfills in our free enterprise system. Rather, we think that the great majority accept as correct (and are fulfilling) the direction given in ERISA that pension costs and liabilities be determined on the basis of assumptions which, taking into account the experience of the plan and reasonable expectations, offer the actuary's best estimate of anticipated experience under the plan.

On the other hand, it may be that Fortune is not proposing a shift in pension expense charges merely to remove risks from future generations. Perhaps For-

tune really is advocating that pension funds be invested only in "riskless" assets because it believes that to be the only appropriate funding medium for pension plans under a premise that (quoting from the article) "the obligations must be paid if the company remains in business."

What are "riskless" assets? The article really doesn't say. It defines the "riskless" rate of interest as the rate "on an investment that carries no possibility of default." It uses the real rate of return on government securities in an earlier stage of its analysis but goes on to note that such real rate has been negative since the end of World War II.

Assuming that securities guaranteed by the federal government come closest to what Fortune would regard as "riskless" investments, what would the end result be if private pension plans were to invest only in that medium? Not only would there be an unnecessary doubling or so of pension plan costs, with an inflationary effect on the economy, but there would be a constant and substantial flow of capital out of the private sector and into the government sector. Private industry might soon have to look to the government to finance its capital needs and accept the further regulation which inevitably would accompany government financing.

Within the private pension system, many companies would not be able to absorb the double cost and would have to terminate their pension plans. Many if not most, of the others would begin to cut back on the level of pensions relative to wages and living standards. Employees and their families would turn more to the government to fulfill what they have come to regard as retirement income rights; and the private pension system would eventually be eliminated as a meaningful component of our private enterprise system.

If such limitation on pension fund investments were truly necessary, private industry might have to accept the eventual demise of the private pension system as inevitable. But, for industry and its stockholders to self-impose such limitation—merely because some people might believe that pension funds should be invested without any of the economic risk which is inherent in our economy—would be disastrous.

As a final thought in the understatement-of-pension-cost area, we would like to note that the so-called "gamble" on expected investment return is not won or lost all at once. Under cost pension plans, the difference between actual and expected results—commonly called experience gains and losses—is recorded annually and subsequent costs are adjusted accordingly.

PENSION PLAN TERMINATION INSURANCE

Your article describes certain dangers connected with the insurance provisions of ERISA. Certainly, those dangers are possibilities. But, how significant they may prove to be must remain a conjecture.

As we see it (and whether we like it or not), Congress has responded to its interpretation of the demands of the nation's work force for an assurance of its retirement income expectations. If private industry were now to refuse to accept the burden of self-insuring the private pension system on a defined benefit basis, we believe it must lead to the government replacing the private system with an expanded social security system. In a sense, it is one of the prices private industry and its stockholders must pay if they wish to continue a private pension system.

That is not to say that there cannot be or ought not to be improvements in the plan insurance program. However, of the two improvements proposed in the Fortune article, we regard the first—i.e., the removal of the 30% of net worth limit on the plan sponsor's liability—to be self-defeating for the private pension system; and while in theory we support the second—i.e., the gearing of PBGC premium charges individually to each plan's unfunded value of guaranteed benefits—we think it must be weighed against the increase in the program's administrative cost necessary to determine the premiums individually. For example, if the average premium were $3 per participant and it would cost an additional $2 per participant to determine the premiums individually, the greater equity wouldn't be worth the cost. But, if the average premium were $20 per participant, the additional $2 cost could be justified on a cost/benefit basis.

Removing the 30 percent limit and putting 100 percent of every company's assets at risk in order to deter some managements from making what others might regard as imprudent pension promises is, in our opinion, a self-defeating proposal. It would cause many prudent managements to cut back on pension

levels relative to wage and living standards or to switch from defined benefit to defined contribution plans or to terminate their pension plans, and could lead to the demise of the private pension system.

Just the contrary, unless it can be demonstrated that a significant proportion of managements would make imprudent pension promises—recognizing that under ERISA's minimum funding requirements they must bear the cost of the pension increases for at least 5 years before PBGC fully guarantees the benefits—we think it would enhance the preservation of the private pension system to reduce the 30 percent limit and make it a more acceptable risk for smaller companies to adopt and maintain defined benefit pension plans.

We urge Fortune to reexamine the conclusions reached in its article in light of what we believe to be the end result of those conclusions; and to clarify Fortune's concerns with the present private pension system on the basis of such reexamination, so that Fortune's readers may, with greater understanding, decide whether or not they share those concerns and agree with the proposed corrections.

Sincerely,

KWASHA LIPTON.
JOHN A. CONNORS,
Partner.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS,
New York, N.Y., July 24, 1978.

Hon. LLOYD M. BENTSEN,
Chairman, Subcommittee on Private Pension Plans and Employee Fringe Benefits, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The American Institute of Certified Public Accountants wishes to express its views on the recently introduced Bill S. 2992 which deals with the financial and other disclosure requirements in connection with the Employment Retirement Income Security Act (88 Stat. 829).

It has always been the policy of the AICPA to support and promote full and fair disclosure and the pension fund area is no exception. We are in complete agreement with the objectives of the Bill. However, after careful consideration of its provisions, the views expressed in statements submitted by interested parties and our knowledge of the progress being made in the development of accounting and reporting standards, we have concluded that the proposed legislation is unnecessary. We believe that there is a substantial record of substantive progress being made to resolve the problems relating to financial reporting by pension funds through the cooperative effort of the Financial Accounting Standards Board (FASB), the accounting and actuarial professions, and the responsible government agencies(Department of Labor, Treasury Department, and the Securities and Exchange Commission).

As you know, the FASB was created to set financial accounting and reporting standards. This activity is under the close scrutiny of the Securities and Exchange Commission and has been operating satisfactorily for many years.

The FASB has been working closely with the Department of Labor (DOL) in an effort to develop uniform standards for accounting and reporting by defined benefit pension plans. We agree with the expression of the FASB that finalization of the Board's statement on "Accounting and Reporting by Defined Benefit Pension Plans" will resolve the concern which resulted in the introduction of S. 2992. We have no reason to doubt the FASB's prediction that its deliberations will be completed in time for a final statement to be applicable to the preparation of pension plan financial statements for 1979 and we have been working closely with it to achieve that objective.

A requirement that the Secretary of Treasury be directed to set acccounting standards for pension plan financial statements would therefore disrupt the progress being made without evidence that such a change would accelerate the issurance of uniform standards or enhance the quality of such standards. In addition, we strongly support the principle that the setting of financial accounting and reporting standards should remain in the private sector.

We recommend that the Subcommittee permit the present progress to continue without further legislation. We are confident that the issues addressed by the Bill will be satisfactorily resolved by the actions already underway.

Thank you for the opportunity to comment on this matter.

Sincerely yours,

WALLACE E. OLSON, *President.*

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