Deloitte & Touche

2003 Survey of Economic Assumptions Used for SFAS No. 87 and SFAS No.106 Purposes

Human Capital

Introduction

Statement of Financial Accounting Standards No. 87 (SFAS 87) requires the sponsor of a defined benefit pension plan to measure the plan's obligations and annual expense using assumptions that (1) individually reflect best estimates (paragraph 43) and (2) are "consistent [with each other] to the extent that each reflects expectations of the same future economic conditions" (paragraph 46). In general, liabilities are most sensitive to the discount rate assumption; for example, a relatively small change in the discount rate (of say, 25 basis points) could result in a more visible change in the liabilities (perhaps as much as 5 percent).

The Financial Accounting Standards Board (FASB) describes the methodology to select the discount rate (SFAS 87 paragraph 44). The discount rate should reflect the rates at which the pension benefits could be settled effectively.

The staff of the Securities and Exchange Commission (SEC) has interpreted this requirement to mean that the discount rate should reflect the yield of a portfolio of high-quality fixed-income instruments that has the same duration as the plan's liabilities (see Emerging Issue Task Force Topic D-36). Because the duration of the plan's liabilities is affected by certain demographic characteristics of the plan population (e.g., average age, average service, proportion of retirees), actuaries generally expect that plans with similar demographics would use similar discount rates.

Statement of Financial Accounting Standards No. 106 (SFAS 106) contains similar requirements for the selection of assumptions for Other Postretirement Employee Benefit plans (paragraphs 29 and 42). Similar guidance is also provided for the selection of discount rate (paragraph 31).

Companies also disclose other economic assumptions: the expected rate of return on plan assets, the expected rate of salary increases, and the expected increase in health care costs.

Plan sponsors, as well as regulators, often compare their discount rate and other assumptions to those of others.

In this survey, the Human Capital practice has compiled information disclosed by many of the *Fortune* 500 companies in their most recent annual reports. We have focused on approximately 287 companies with defined benefit plans that disclosed as of December 31, 2002; 244 of these companies disclosed Other Postretirement Employee Benefit plans (subject to SFAS 106). This disclosure information also included assumptions used as of the prior year, thereby enabling us to compare changes in the assumptions from one year to the next.

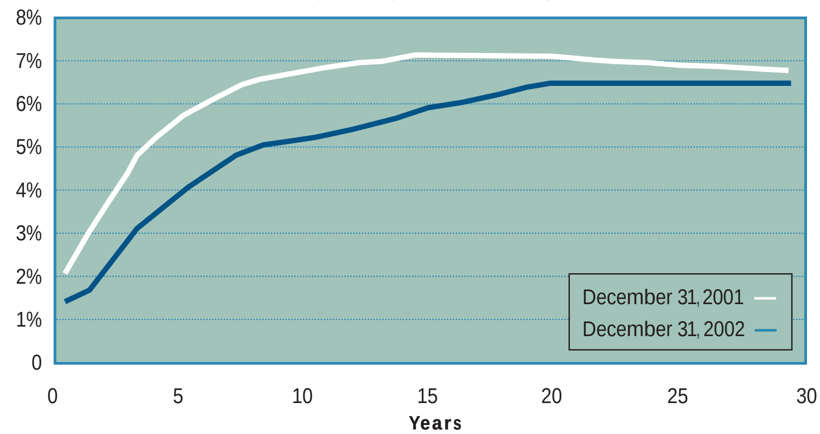
A useful summary of prior years' rates can be found under Pension Plans in the Income Statement section of the Accounting Trends and Techniques annual survey, published annually by the American Institute of Certified Public Accountants.

Background

The SEC staff has indicated that it believes the term "high-quality" refers to those fixed-income instruments with at least an Aa3 rating from Moody's (or its equivalent from another rating service). Exhibit 1 shows the yield curve on the Bloomberg Composite Aa3 bonds at both December 31, 2001, and December 31, 2002.

Taken together, these two yield curves indicate that the slope of the yield curve has steepened slightly and that yields have decreased over the year. The decrease ranges from about 100-150 basis points at the first half of the curve down to about 30-50 basis points at the longer end of the curve.

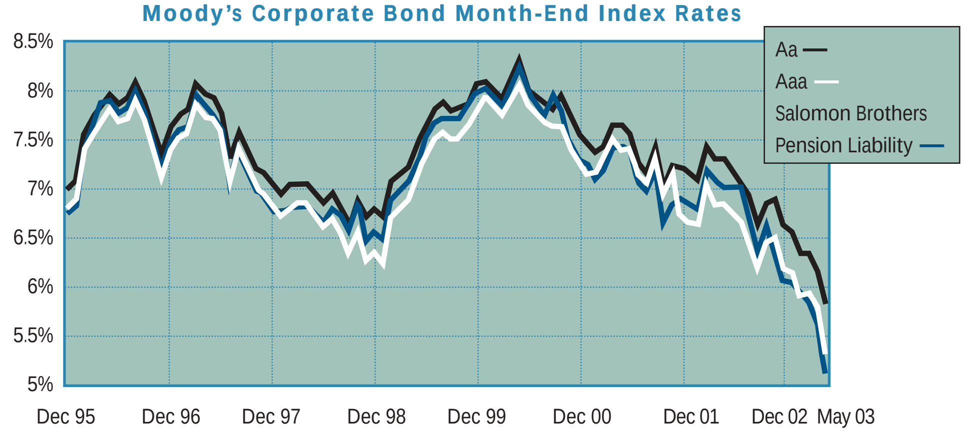
Exhibit 1
Bloomberg Composite Aa3 Spot Yields



Based on material published by Bloomberg; current information is available through Bloomberg Services.

Over the past several years, the rates available on corporate bonds (i.e., Moody's Aaa and Aa Long-Term Corporate Bond Indices, as well as Salomon's Pension Liability Index) have varied considerably. The historic yields over the past several years for the Moody's Aaa and Aa Long-Term Corporate Bond Indices, as well as the Salomon's Pension Liability Index, are plotted in Exhibit 2.

Exhibit 2
Moody's Corporate Bond Month-End Index Rates



As published by Moody's Investor Services; current information is available at www.moodys.com.
Salomon Brothers Pension Liability Index historical data received from Salomon Brothers Asset Management.

This exhibit indicates that rates, after an initial increase, declined throughout 2002 — ultimately ending the year approximately 50 to 100 basis points lower than at the end of 2001.

Furthermore, Exhibit 2 indicates that rates are currently (as of the end of May 2003) down about 75 basis points since the end of 2002.

Discount Rate

Exhibit 3 summarizes the discount rate disclosures as of December 31, 2001, and December 31, 2002. The median discount rate disclosed at December 31, 2002, was 6.70 percent, about 50 basis points below that disclosed at the end of 2001. Eighty-seven percent of the companies surveyed were between 6.50 percent and 7.00 percent.

No information was provided with regard to the measurement date used to determine the disclosure information. The measurement date can precede the disclosure date by up to three months (see paragraph 52 of SFAS 87; paragraph 72 of SFAS 106). Accordingly, some of the variation in discount rate shown may be attributable to the use of a measurement date other than December 31. However, as indicated by Moody's Aa yield for 2002, rates were approximately the same level on September 30 and December 31.

Most of the companies disclosed a discount rate within a narrow range at both December 2001 and December 2002; in each year, fewer than 5 percent disclosed at a discount rate that was more than 50 basis points about the average.

The SEC staff has indicated that it expects discount rates to move with general economic trends. Exhibit 4 presents the change in discount rate from December 31, 2001, to December 31, 2002.

Exhibit 3
Discount Rate Disclosures

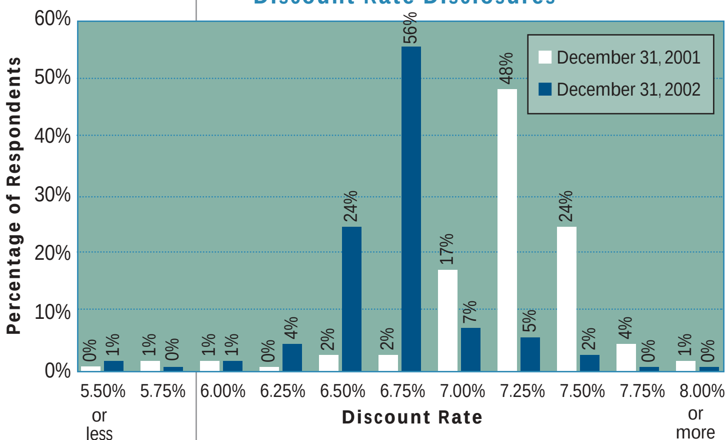
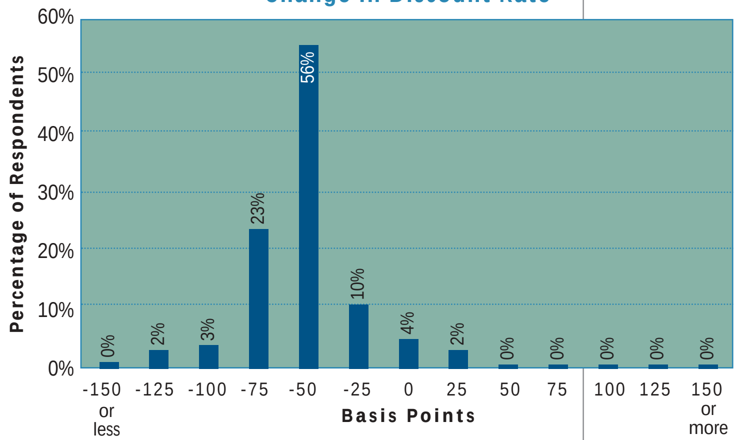


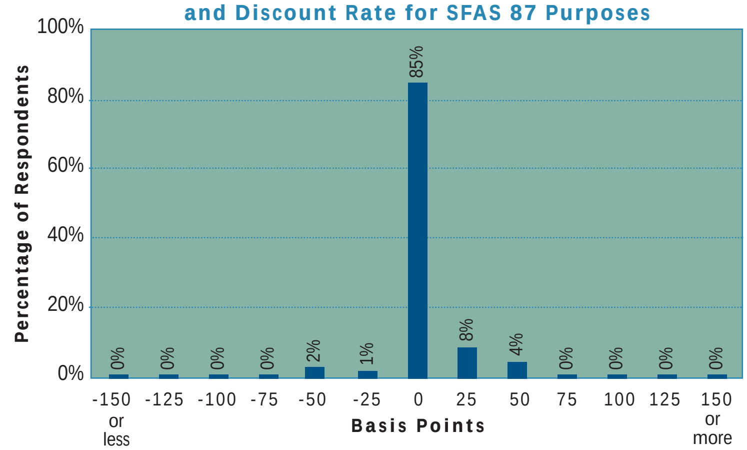
Exhibit 4
Change in Discount Rate



On average, discount rates decreased about 50 basis points from December 31, 2001, to December 31, 2002. While approximately 4 percent of the companies in our survey did not change the discount rate, 89 percent of the companies lowered it by between 25 and 75 basis points. The remaining 7 percent of the companies either decreased the discount rate by more than 75 basis points or increased it.

We also compared the discount rate disclosed for SFAS 106 purposes with that disclosed for measuring pension liabilities in accordance with SFAS 87. As shown in Exhibit 5, 85 percent of the companies surveyed disclosed the same discount rate for both measurements. Twelve percent of companies disclosed a higher discount rate for measuring postretirement benefits than for measuring pension benefits.

Exhibit 5
Difference in Discount Rate for SFAS 106 Purposes and Discount Rate for SFAS 87 Purposes

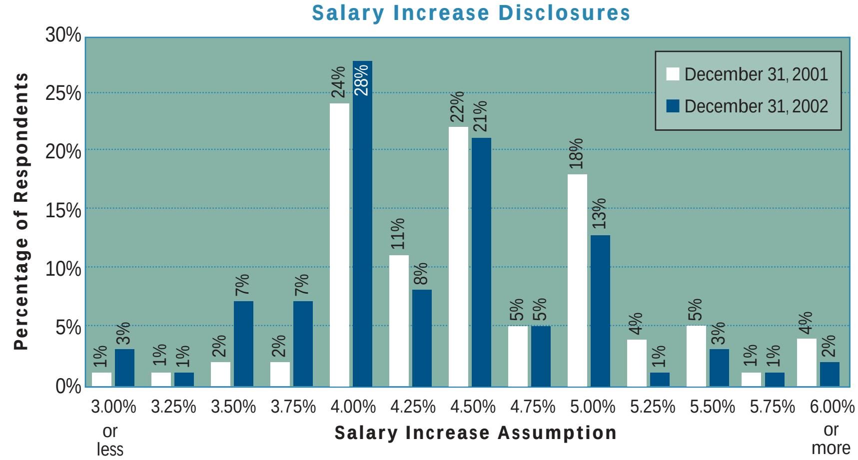


Salary Increase Assumption

Plans that provide pay-related benefits are required to disclose the salary increase assumption underlying the calculations. Almost all of the companies in the survey disclosed a salary increase assumption. SFAS 87 provides relatively little guidance in the selection of the salary increase assumption other than to mention that it should reflect "future changes attributed to general price levels, productivity, seniority, promotion, and other factors" (paragraph 46).

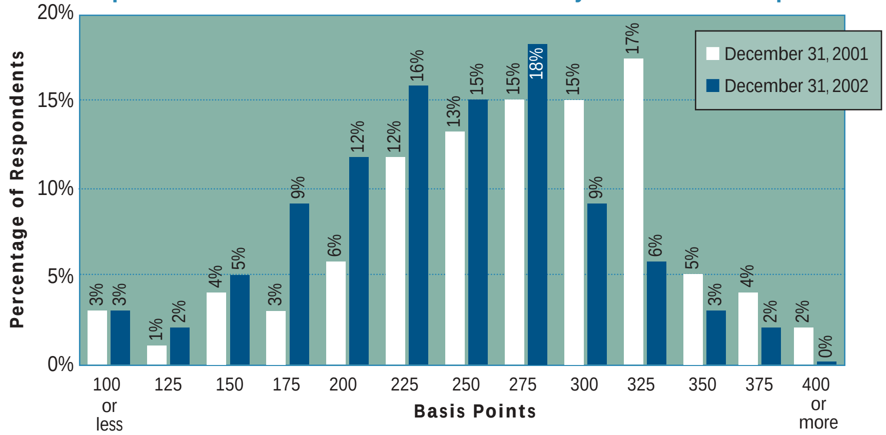
There is a fairly wide range of assumed salary increase as summarized in Exhibit 6. The average salary increase assumption disclosed as of December 31, 2002, was roughly 4.35 percent. Seventy-five percent of the companies surveyed used an assumption between 4.0 and 5.0 percent. Ten percent of the respondents were 100 or more basis points away from the average. The rates disclosed at December 31, 2001, show a similar pattern of dispersion around the average.

Exhibit 6
Salary Increase Disclosures



This range of expected salary increase assumption is also seen in the spread between the discount rate and the salary increase assumptions. Exhibit 7 shows this difference as of December 31, 2001, and December 31, 2002. While the average spread decreased by roughly 35 basis points, the respondents are dispersed over the range.

Exhibit 7
Spread Between Discount Rate and Salary Increase Assumption

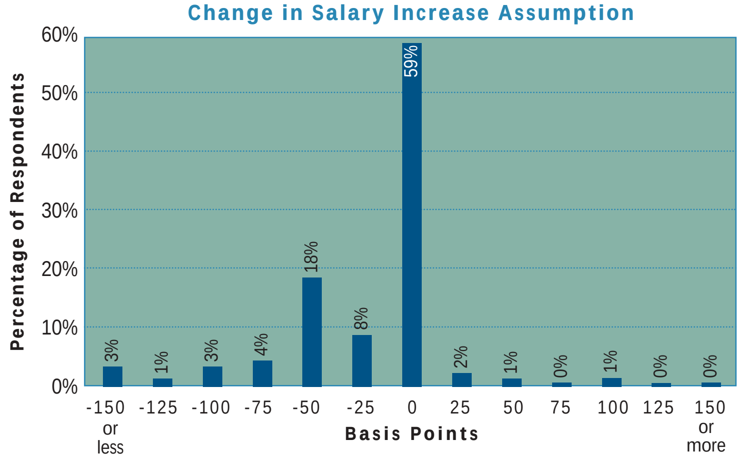


There is an ongoing discussion among practitioners regarding the frequency of changes in the salary increase assumption. Some believe that changes in this assumption should occur infrequently, only as significant changes in the economy warrant and not in lock step with changes in the discount rate. Others believe that real rates of return for high-quality fixed-income investments move slowly and, therefore, when discount rates change, the change is largely attributable to changes in inflation expectations. It should be noted that inflation as measured by changes in the Consumer Price Index has been fairly stable during the last ten years.

Noting the consistency requirement (paragraph 46, SFAS 87), the latter group believes that salary increase assumptions should change when the discount rates change and should move in the same direction as discount rates, due to the noted inflation expectations.

Exhibit 8 shows the change in the salary increase assumption from December 31, 2001, to December 31, 2002.

Exhibit 8
Change in Salary Increase Assumption



Between these two measurement dates, 59 percent of the respondents reported no change in the salary increase assumption, down from 71 percent between December 2000 and 2001; roughly 25 percent of the respondents lowered this assumption by 25 or 50 basis points.

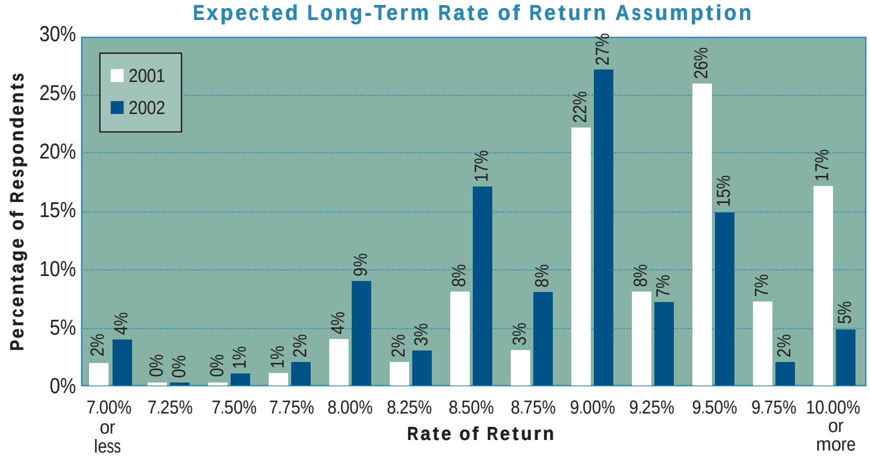
Expected Return Assumption

Paragraph 45 of SFAS 87 specifies that the Expected Long-Term Rate of Return Assumption should "reflect the average rate of earnings expected on the funds invested or to be invested to provide for the benefits. . . ." This provision is generally understood to require the plan sponsors to reflect the composition of the plan's actual investment policy as well as the expected return for various categories of investment vehicles.

Exhibit 9 shows the range of the Expected Long-Term Rate of Return Assumption used in calculating pension expense for 2001 and 2002. While SFAS 106 has a similar requirement (paragraph 32), most Other Postretirement Employee Benefit plans are unfunded and so this assumption would not be used in that situation.

The average Expected Long-Term Rate of Return was 8.75 percent for 2002 (roughly 50 basis points lower than was used for 2001), with 59 percent of the respondents using between 8.50 and 9.25 percent. However, 16 percent of the respondents reported an Expected Return of 8 percent or less, and 22 percent reported an Expected Return of 9.50 percent or more.

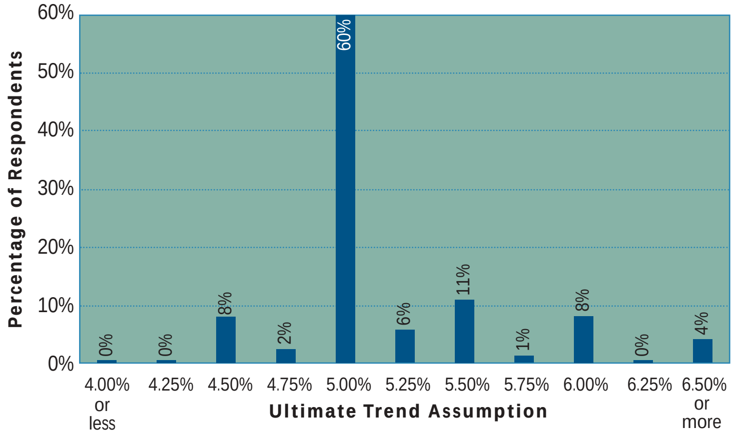
Exhibit 9
Expected Long-Term Rate of Return Assumption



Health Care Cost Trend

Paragraph 39 of SFAS 106 describes the Health Care Cost Trend assumption as representing "the annual change in the cost of health care benefits . . . for each year from the measurement date until the end of the period in which benefits are expected to be paid." This paragraph also makes the observation that "health care cost trend rates may be assumed to continue at the present level for the near term, or increase for a period of time, and then grade down over time to an estimated health care cost trend rate ultimately expected to prevail. Exhibit 10 summarizes this ultimate health care cost trend disclosed as of December 31, 2002.

Exhibit 10
Ultimate Trend for Medical Claims



At the end of 2002, the median health care trend cost rate was roughly 5.20 percent, with three quarters of the respondents between 5.00 percent and 5.50 percent.

About the Survey

A number of factors influence each company as it selects the appropriate assumptions to measure its pension and benefits liabilities. This survey is intended to provide information regarding the assumptions disclosed by a wide range of companies and, as such, can provide an indication of the trends in the marketplace.

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