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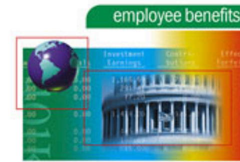

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FASB Considers Changes to Pensions and Benefits Accounting

Phase 1 Will Place Plans' Funded Status on Corporate Balance Sheets

The Financial Accounting Standards Board (FASB) has launched a project to revise private sector employers' accounting for pensions and other postemployment benefits. Under the first phase of the project, unfunded projected benefit obligations for a defined benefit pension plan would be reported on a company's balance sheet, rather than merely being disclosed in the footnotes to the financial statements. Comparable rules would apply to other postemployment benefits (OPEBs), such as retiree healthcare.

FASB anticipates release of a draft accounting standard for the first project phase near the beginning of 2006, with an effective date as early as the end of 2006. The second phase of FASB's project, encompassing a comprehensive review of all accounting rules applicable to pensions and OPEBs, is expected to take two to three years beyond the completion of the first project phase.

This *Benefits Information Bulletin* presents an overview of the current accounting rules for private sector pensions and OPEBs, explains FASB's recent decisions to launch a two-part project to revise the rules and their implications for pension and OPEB plan sponsors, and considers the future areas of concern that the revised accounting rules could raise.

Background

Controversy over pension and OPEB accounting has increased during recent years, as volatile markets, benefits funding practices, and other trends have produced results that have been perceived as anomalies, such as net pension income (rather than a pension expense) despite pension fund losses, or expected rates of return on assets that seem to be inconsistent with recent experience. Adding to the emerging pressure to reconsider the accounting rules referred to as SFAS 87 and SFAS 106 is the movement by international accounting rules toward the general direction of United Kingdom standards, which do not permit "smoothing" or delayed, spread recognition of prior-service costs and gains or losses.

Some believe that the current accounting standards have encouraged plan sponsors to take more risks in the investment of plan assets by allowing for the immediate recognition of expected returns on assets, while permitting the amortization of increased liabilities over a longer period of time, thus resulting in a perceived mismatch of asset and liability valuations.

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This summer, the Securities and Exchange Commission (SEC) moved the controversy a critical step further with a study, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*. Among other corporate transactions and arrangements addressed, the SEC study expressed concern about the transparency of pension and OPEB accounting by companies subject to SEC filing requirements, as well as comparability with accounting for similar items in other areas. The SEC report recommended reconsideration of SFAS 87 and SFAS 106, particularly with respect to smoothing of asset values and deferred recognition of gains and losses.

On a separate but closely related track, Congress is currently advancing legislation that would significantly revamp the rules for pension funding requirements. If enacted, the new funding rules will emphasize greater transparency and address concerns related to the perceived worsening financial condition of the Pension Benefit Guaranty Corporation. For many pension plan sponsors, the new rules will accelerate funding requirements and make contributions more volatile by shortening smoothing periods and changing the basis for measuring pension obligations.

Current Standard for Pension and Benefits Accounting under Scrutiny

U.S. corporations that sponsor defined benefit pension plans or other postretirement benefits, such as retiree healthcare, report those benefits on the corporate financial statements according to accounting standards published by FASB:

- Statement of Financial Accounting Standards No. 87 (SFAS 87), *Employers' Accounting for Pensions*, prescribes rules for the measurement of pension plan assets and obligations, the determination of costs reported on the employer's income statement, and the determination of net assets or liabilities reported on the employer's balance sheet.

- Statement of Financial Accounting Standards No. 88 (SFAS 88), *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, prescribes rules for accelerating the recognition of previously unrecognized balances upon plan termination and other special events.

- Statement of Financial Accounting Standards No. 106 (SFAS 106), *Employers' Accounting for Postretirement Benefits Other Than Pensions*, prescribes rules for OPEBs that are comparable to the pension rules under SFAS 87 and SFAS 88.

- Statement of Financial Accounting Standards No. 132R (SFAS 132R), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, prescribes rules for financial statement footnote disclosures about pensions and OPEBs.

The underlying basis for determining pension costs under SFAS 87 is a projected unit credit cost method. Pension costs are spread over periods of employee service, based on the plan's projected benefit obligation (PBO), a measure that incorporates future projected salary levels. The accounting methodology involves deferred recognition of past-service costs relating to plan amendments and of gains or losses from asset experience, demographic experience, and remeasurement of obligations. Deferred amounts that have not yet been recognized in pension costs are disclosed in financial statement footnotes.

Pension plan contribution requirements are determined under a separate set of guidelines, the rules of which are being reconsidered by Congress. The accumulated difference between costs and contributions is then carried on the employer's balance sheet as a prepaid pension cost (asset) or an accrued pension cost (liability). Furthermore, if the market value of plan assets is less than the value of the plan's accumulated benefit obligation (ABO), a measure that does not take future salary levels into account, then a minimum liability must be recognized, possibly involving a charge to shareholder equity as a component of other comprehensive income (OCI). Similar rules are prescribed for OPEBs under SFAS 106, except that a minimum liability is not currently required for OPEBs.

Even during the initial formulation of SFAS 87, SFAS 106, and the related accounting standards, numerous key elements of the accounting standard were hotly contested. Among the concerns:

- *Delayed Recognition* — Asset experience and other gains or losses are not recognized in the corporation's financial statements during the year that those amounts occur.
- *Smoothing of Value of Assets* — For determination of costs, investment gains or losses may be spread over a period of up to five years.
- *Spreading of Recognition of Prior-Service Costs and Gains or Losses* — Prior-service costs arising from a plan amendment are recognized over future service of plan participants. Accumulated gains or losses within a corridor are exempt from immediate recognition, and amounts outside the corridor may be spread over average future service.

FASB Review of Accounting for Pensions and Other Postretirement Benefits

Responding to mounting concerns from financial statement users, proposals for "convergence" of U.S. with international accounting standards, and the SEC's recommendations, FASB launched a project to conduct a comprehensive review of SFAS 87 and SFAS 106. The FASB project is to be conducted in two phases:

- *Phase 1 — Unfunded Obligations on Corporate Balance Sheet*. The initial phase will directly address deferred recognition of gains and losses, calling for unfunded

PBO to be recognized on the corporate balance sheet. Also, the measurement date will be required to coincide with the company's financial statement date, eliminating the current rule that permits an earlier measurement. FASB anticipates completing Phase 1 by the end of 2006.

- *Phase 2 — Comprehensive Review of Pension and Benefits Accounting*. After Phase 1, FASB will undertake a complete review of all rules under the existing standards.

FASB Project Phase 1: Unfunded Obligations on Corporate Balance Sheets

Under the new accounting standard, a company would report its pension plan's net assets or net obligations on its balance sheet, rather than merely disclosing the amounts in the footnotes to the financial statements. The amount to report would be directly based on the difference between the defined benefit plan's PBO and the market value of the assets. Changes to the balance sheet that arise under the new rule would be reported as credits or charges through OCI, essentially as direct increases or decreases to shareholder equity, without passing through the company's income statement. The accounting would be similar to the existing rule used for minimum liability, with three major differences:

(1) The new rule would be based on PBO, which includes the effect of future compensation increases on accrued benefits (versus the current rule's reference to ABO, which considers only compensation actually earned to date).

(2) The new rule would require balance sheet recognition of pension assets in excess of PBO (whereas the current rule applies only to unfunded ABO). Removal of the ceiling on the rule has the practical effect of making employer contributions an ineffective strategy for eliminating the charge to OCI. Under the current rule, employer contributions that eliminate unfunded ABO will also eliminate an OCI charge. Under the new rule, the increase in prepaid employer cost (or decrease in accrued pension cost) resulting from additional employer contributions would keep the OCI balance intact.

(3) Under current rules, if an amount is charged to OCI attributable to unfunded ABO, an intangible asset is reported to the extent of the amount of unrecognized prior-service cost and unrecognized transition obligation. Under the new rule, no intangible asset would be reported in conjunction with the charge or credit to OCI.

The initial phase of FASB's project would not modify the calculation of net periodic pension costs. Accordingly, actuarial gains or losses, prior-service costs from plan amendments, and any remaining transition balances would continue to be amortized as required under the current accounting standard. The accumulated difference between a company's contributions and pension costs as determined under existing rules would continue to be reported as a prepaid

pension cost or an unfunded accrued cost. The credit or charge to OCI that would be necessary to reflect the PBO funded status would then essentially have to "reverse out" the prepaid or accrued amount. For example, in the common instance for which a prepaid pension cost is being recognized for a pension plan with underfunded PBO, the base for the determination of the OCI charge would be the amount of PBO underfunding, increased by the amount of the prepaid pension cost.

The overall effect of the new rule is the immediate recognition through a charge or credit to shareholder equity of all currently unrecognized pension gains or losses, including any remaining transition balance and any unrecognized prior-service cost. Although these unrecognized amounts would continue to be amortized under existing rules for determining pension costs, the adjustment to shareholder equity to reflect the new rule can be highly leveraged and significantly volatile from year to year.

Consider the following example, illustrative of numerous plan sponsors (without taking into account tax timing differences):

Components of Balance Sheet Accounting		
Accumulated Benefit Obligation (ABO)	$97,000	Current basis for Other Comprehensive Income (OCI) charge
Projected Benefit Obligation (PBO)	$100,000	New basis for OCI charge
Market Value of Plan Assets	$98,000	
Unrecognized Net Losses	$17,000	Disclosed in footnotes
Unrecognized Prior-Service Cost	$5,000	Disclosed in footnotes
Prepaid Pension Cost (pretax)	$20,000	Excess of contributions over cost
Current Balance Sheet		
Charge to OCI (pretax)	$0	Since asset value exceeds ABO
Prepaid Pension Cost (pretax)	$20,000	
Net Balance Sheet Position (pretax)	$20,000	
New Balance Sheet		
Charge to OCI (pretax)	($22,000)	Unrecognized amounts
Prepaid Pension Cost (pretax)	$20,000	
Net Balance Sheet Position (pretax)	($2,000)	Unfunded PBO

In this example, the value of future compensation adds only $3,000 to ABO to produce the PBO of $100,000. However, employer contributions have exceeded pension costs for previous years, particularly during recent years as the employer sought to minimize unfunded ABO that would have affected shareholder equity under the existing rules. As a result, the balance sheet currently shows only a $20,000 asset, equal to the accumulation of those differences between contributions and costs. For the employer's balance sheet to report the net

unfunded PBO that would be required under the new accounting rules, $22,000 must be charged to OCI, first essentially reversing out the asset for the prepaid pension cost and then reflecting the unfunded PBO. The charge of $22,000 essentially represents recognition through OCI of the unrecognized net losses of $17,000 and unrecognized prior-service cost of $5,000.

The charge or credit to shareholder equity under this rule is likely to be highly volatile, changing with each new financial statement to reflect actual investment return for pension fund assets, the remeasurement of the PBO under new assumptions, employer contributions, and actual net experience gains or losses. Although a company would continue to calculate these amounts using existing smoothing techniques for pension costs, doing so for the determination of the charge or credit to OCI is prohibited.

Similar accounting rules would apply for OPEBs such as retiree healthcare. Although the practical effect of the new rules for such benefits might be lessened because there typically is minimal prefunding of these plans, immediate recognition through OCI of previously unrecognized balances will still introduce significant new balances and volatility to the corporate balance sheet.

Although not yet directly addressed in FASB's materials, the changes to SFAS 87 and SFAS 106 would likely involve changes to SFAS 88 and SFAS 132R to maintain consistency among the set of standards. FASB anticipates publishing an exposure draft of a new accounting standard under Phase 1 by Spring 2006, with implementation of a final standard by the end of 2006. Given the SEC's recommendation and other developments, employers with calendar-year fiscal periods can expect a requirement to determine OCI credits or charges on the new basis for December 31, 2006.

FASB Project Phase 1: Measurement Date at Financial Statement Date

Under Phase 1 of FASB's project, the measurement date will be the financial statement date. Under current rules, an employer is permitted to select a measurement date that is as much as three months prior to the financial statement date. For example, many employers with a calendar fiscal year select September 30 for measurement of pensions and OPEBs. Under the new standard, such employers will have to measure pensions and OPEBs on December 31.

FASB contemplates mandating this change one year after the required changes in balance sheet presentation take effect. If those changes apply to financial statements beginning at the end of 2006, for example, the new measurement date rule would apply to financial statements beginning at the close of 2007.

Comprehensive New Accounting Rules Expected in Phase 2

After the completion of Phase 1, FASB anticipates a follow-up project under which comprehensive new accounting rules might be developed for pensions and OPEBs. Phase 2

would be designed to further improve consistency with international accounting rules, as well as to address the numerous concerns expressed about the current accounting standards. Among the issues anticipated to receive attention are:

- *Scope of SFAS 87 and SFAS 106* — Should executives' deferred compensation arrangements continue to be spread as individual arrangements under Opinion 12, or should the arrangements be subject to SFAS 87? Should the accounting rules apply only to legally enforceable claims, a stance that would significantly reduce the net liabilities reported for many retiree healthcare plans?

- *Measurement of Assets and Obligations* — How should asset values be determined for investments for which the market value is not readily available? Should the settlement basis for selecting the discount rate be modified? Is the PBO basis that incorporates future salary levels appropriate? Should special considerations be taken for the measurement of obligations under plans with lump-sum settlement features, notably for cash balance and other hybrid pension plans? Should the measurement date be restricted to the financial reporting date, instead of permitting measurement up to three months earlier?

- *Recognition of Costs* — Should the actual rate of return during a period be recognized immediately, instead of basing costs on expected return? Should market value of assets be used for cost determination, versus the smoothed market-related value currently permitted? Should all gains and losses be recognized immediately in cost, rather than the current corridor and spreading methodologies? Should prior-service costs be recognized immediately, versus the current delayed spreading methodology? Should the rules for minimum liability be revisited, depending on the decisions made during Phase 1?

- *Other Issues* — Should multiemployer plans continue to be recognized on a basis similar to defined contribution plans (i.e., based on the required contribution) or should net obligations under the plan be allocated to the participating employers? How should costs and other items under new accounting standards be classified for financial reporting?

Completion of Phase 2 of FASB's project could take several years, involving an extensive overhaul of SFAS 87 and SFAS 106, with very significant changes to pension and OPEB costs, net assets or liabilities, and footnote disclosures.

Conclusion

Sponsors of defined benefit pension plans and other postemployment benefits should study the effects that the new rules would have on the financial reporting of their pension and benefit plans. If a measurement date earlier than the financial statement date is being used under

current rules, the company should work with its actuary to prepare for the measurement date change. Companies should consider communicating the results of their assessments to FASB.

For additional information about FASB's proposal to modify the accounting standards for pensions and OPEBs, please contact your Milliman consultant.

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