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More Prominent Pensions

FASB Amends Employers' Accounting for Pensions and Other Postretirement Benefits

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Last week, the FASB issued its Exposure Draft, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* — an amendment of FASB Statements No. 87, 88, 106, and 132(R).[1] The proposed Statement would require, for example, a calendar year-end company that sponsors a postretirement benefit plan to **fully recognize, as an asset or liability, the over-funded or under-funded status of its benefit plan** in its 2006 year-end balance sheet. Here's a hint of the potential impact that a final standard might have on corporate balance sheets — the total estimated under-funded obligation for defined benefit pension plans of the S&P 500 in 2005 was approximately $213 billion, according to a recent Bear Stearns study.[2]

This important development is designed to partially tackle certain important deficiencies the FASB finds in today's pension accounting:

- Changes in a plan's assets and its benefit obligation are not recognized as they occur.
- Important information about postretirement plans is relegated to the footnotes rather than being recognized in the financial statements.

Note that the proposed Statement does not address the measurement and recognition issues related to changes in the fair value of plan assets and benefit obligations — these, as well as other issues, will be the primary focus of a multi-year Phase II project. Likewise, if finalized, the proposed Statement will not have an impact on a company's computation of its benefit expense recognized in the income statement.[3]

Recognition of the Funded Status of a Defined Benefit Postretirement Plan

The proposed Statement requires the recognition of a plan's over-funded or under-funded status as an asset or liability in the balance sheet — but how is this measured? It depends.

- Pension plans — the asset or liability is the difference between the fair value of the plan's assets and the projected value of the pension liability.

[1] FASB Statements No. 87, *Employers' Accounting for Pensions*; No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*; No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*; and No. 132 (R), *Employers' Disclosures About Pensions and Other Postretirement Benefits*.
[2] *Bear, Stearns & Co., Inc.,* Equity Research — Accounting Issues (January 2006), *"Pension Tension: Hurricane Watch."*
[3] Except to the extent that a company had previously been amortizing its unrecognized transition obligation/asset as a component of net periodic benefit cost, such amortization would be eliminated under the proposed Statement.

- Other postretirement benefit plans — the asset or liability is the difference between the fair value of the plan's assets and the value of the benefits promised.

This will result in the immediate recognition (on the balance sheet) of amounts that would have been recognized in subsequent years (off-balance sheet). One might ask, how will this work in a double entry accounting world? *Unrecognized prior service costs and credits*[4] *and unrecognized net actuarial gains or losses* (the consequences of pension "smoothing") will now be recorded as components of other comprehensive income (OCI). Further, any *unrecognized transition obligation or asset* is recorded as an adjustment to the opening balance of retained earnings upon initial adoption of the Statement.

A basic example of the impact on a company's financial statements is provided below:

Example

Assume under Statement 87 that an employer has recorded a *prepaid pension cost asset* of $50 million, which represents contributions made in excess of *net periodic benefit cost* accrued for its defined benefit pension plan. However, the plan is currently under-funded by $500 million. The plan's unrecognized prior service costs and net actuarial losses amount to $525 million and its unrecognized transition obligation is $25 million. Income taxes are ignored. Upon adoption of the provisions of this proposed Statement, the following entry is recorded (increase to liability shown in bold):

Other comprehensive income	$525	
Retained earnings	25	
Accrued pension cost (liability)		**$500**
Prepaid pension cost		50

As you can see from the above example, the proposed Statement will improve the transparency of an entity's financial statements by requiring immediate recognition of previously unrecognized amounts. For those seasoned in pension accounting, note that this approach also eliminates current complexities related to the recognition of *additional minimum liabilities* and intangible assets.

Editor's Note: Some potential consequences to keep in mind:

- Effect on debt covenant ratios.
- Impact on compensation arrangements that are indexed to net assets or return on equity.
- Costs involved in renegotiating agreements to avoid these consequences.

Presentation and Classification

When presenting the asset or liability in the balance sheet, the proposed Statement prohibits employers from aggregating plan assets and benefit obligations of *over-funded plans* with the plan assets and benefit obligations of *under-funded plans*. Instead, it requires (1) **assets derived from all over-funded plans to be aggregated** and recognized as an asset, and (2) **liabilities derived from all under-funded plans to be aggregated** and recognized as a liability. The proposed Statement requires that the current and non-current portions of any postretirement benefit asset and/or liability be reported separately on the balance sheet.

4 Phrases in italics are defined in Appendix B: Glossary of Terms.

Measurement Date of Plan Assets and Benefit Obligations

Don't overlook this potential sleeper. The proposed Statement **eliminates the use of a measurement date that is different than the date of the entity's year-end financial statements**.[5] The current accounting model requires that the fair value of plan assets and benefit obligations be measured annually as of the date of the financial statements or as of a date not more than three months earlier. Now that companies will be required to determine the fair values of their plan's assets, as of year-end, company books will need to remain open until the fair values have been determined.

> **Editor's Note:** Points to consider when thinking about the *measurement date* requirement:
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> - Consider the time it takes to measure a plan's assets. For plans that only hold investments with readily determinable fair values (e.g., publicly traded securities), measurement of the fair value is relatively easy. Other investments might take more time.
> - Properly designed and effective internal controls need to be in place to ensure that the fair values of plan assets and benefit obligations are properly measured.
> - Increased demand placed on and capacity of the actuaries.

As with the requirement to recognize the funded status of postretirement benefit plans, moving the measurement date also reduces some of the complexities in the current accounting.

- The delay when recognizing net periodic benefit cost and the effects of *curtailments* and *settlements* will be eliminated.
- Questions regarding the treatment of other transactions (e.g., contributions) that occur after a plan's measurement date, but before the date of the financial statements, will no longer be applicable.

Additionally, reported financial information will be improved as pension and other postretirement benefit assets and liabilities will be measured on the same date as other assets and liabilities in the financial statements.

Disclosure Requirements

The proposed Statement requires entities to separately disclose the following:

- The amounts of prior service cost or credit and net actuarial gain or loss recognized during the period in OCI.
- The cumulative amounts of prior service cost or credit and net actuarial gain or loss included in accumulated OCI.
- The amounts subsequently reclassified out of OCI into earnings as components of net periodic benefit cost during the period.
- The portion of prior service cost or credit and net actuarial gain or loss included in accumulated OCI that will be reclassified to earnings as a component of net periodic benefit cost over the next fiscal year.

As you might expect, the proposed Statement also eliminates or revises some of the disclosures currently required under Statement 132(R); amounts previously displayed in the footnotes now will be recognized on the balance sheet.

Applicability to Not-For-Profit Entities

The scope of the proposed Statement extends to all entities, including not-for-profit entities. Since there is no notion of OCI in the not-for-profit world, the proposed Statement modifies certain of the provisions discussed above. The modifications depend on whether the not-for-profit entity utilizes a performance indicator.

[5] Sometimes a subsidiary has a different fiscal period than its parent and is consolidated as of that date. According to the proposal, the parent should measure a subsidiary's postretirement benefit plan assets and benefit obligations as of the same date used to consolidate the subsidiary.

Effective Date and Transition

The effective dates are as follows:

	Recognition of Asset or Liability Related to the Funded Status of a Plan	Change in the Measurement Date
Public Companies	Fiscal years ending after December 15, 2006.	Fiscal years beginning after December 15, 2006.
All Others	Fiscal years ending after December 15, 2006.	Fiscal years beginning after December 15, 2007.

Early application is encouraged.

The requirement to recognize the funded status of defined benefit postretirement plans should be applied retrospectively for all periods in which financial statements are presented, unless the impracticability exception outlined in the proposed Statement applies. In such cases, the requirement should be applied retrospectively to the earliest year practicable.

Editor's Note: As a result of applying the proposed Statement, entities may need to record additional deferred tax assets. The realizability of any incremental deferred tax assets will need to be assessed to determine the need for a valuation allowance. The impracticability exception only applies to (1) an entity's inability to assess the realizability of any incremental deferred tax assets recognized in a particular prior period, and (2) an entity's inability to assess the ongoing need for a deferred tax asset valuation allowance in any subsequent period for which retrospective application otherwise would apply. The FASB considers these situations to be the **only impediments to retrospective application**.

Retrospective application is prohibited related to the requirement to measure plan assets and benefit obligations as of the annual balance sheet date. Detailed transition guidance of the proposed Statement is included in tabular format in Appendix A.

Comment Letters

The FASB is soliciting comments on the proposed Statement, and is also seeking responses to a number of specific questions. Comment letters are due by May 31, 2006.

Appendix A: Transition Guidance

Recognition of the Funded Status	Transition
Unrecognized prior service costs and credits and unrecognized actuarial gains and losses	• Recognize as a component of OCI, net of applicable income taxes, amounts that were not included in net periodic benefit cost for each year for which an income statement is presented. • Recognize as an adjustment to the opening balance of accumulated OCI, amounts not yet included in net periodic benefit cost as of the beginning of the period in which the proposed Statement is initially applied, net of applicable income taxes.
Unrecognized transition asset or transition obligation	• Recognize as an adjustment to the opening balance of retained earnings, the amount not yet included in net periodic benefit cost as of the beginning of the period in which the proposed Statement is initially applied, net of applicable income taxes. • Any previous amortization of the transition asset or transition obligation would be removed from net periodic benefit cost for all periods presented. • The effect of eliminating the amortization would be recognized without affecting any net periodic benefit cost that may have been capitalized as inventory or other productive assets.

Change in the Measurement Date	Transition
Net periodic benefit cost	• Net periodic benefit cost would be measured as of the beginning of the fiscal year the proposed Statement is applied (e.g., as of January 1, 2007, for calendar year-end public-companies). • Net periodic benefit cost, exclusive of any curtailment or settlement gain or loss for the period between the company's previous measurement date, and the balance sheet date, would be recognized as an adjustment of the opening balance of retained earnings as of the beginning of the fiscal year the change in measurement date is applied, net of applicable income taxes.[6]
Effects of curtailments and settlements	• The effects of any gain or loss from a curtailment or settlement that occurs in the period between the company's previous measurement date and the balance sheet date, would be recognized in earnings when incurred and not as an adjustment to retained earnings.
Changes in prior service costs and credits and actuarial gains and losses	• Changes in the balances of prior service costs and credits and actuarial gains and losses for the period between the company's previous measurement date, and the balance sheet date, would be recognized as an adjustment of the opening balance of accumulated OCI as of the beginning of the fiscal year the change in measurement date is applied, net of applicable income taxes.

[6] A calendar year-end public company with a measurement date of September 30, 2006, would recognize the net periodic benefit cost for the period October 1, 2006, though December 31, 2006, as an adjustment to retained earnings on January 1, 2007.

Appendix B: Glossary of Terms

Accumulated Benefit Obligation (ABO) — The actuarial present value of benefits (whether vested or nonvested), which is based on a pension plan's benefit formula, related to employee service rendered before a specified date and based on employee service and compensation levels (if applicable) prior to that date. The ABO differs from the projected benefit obligation (PBO) in that it includes no assumption about future compensation levels. For plans with flat-benefit or non-pay-related pension benefit formulas, the ABO and the PBO are the same. The term is used in the context of a pension plan.

Accumulated Postretirement Benefit Obligation (APBO) — The actuarial present value of benefits attributed to employee service that has been rendered to date. The term is used in the context of a postretirement benefit plan that is not a pension (for example, a postretirement healthcare plan).

Additional Minimum Liability — Represents the difference between the fair value of a plan's assets and its ABO (see definition of an ABO) that has not already been recorded in the financial statements. An additional minimum liability will only exist in cases when the plan is under-funded.

Curtailment — An event that significantly reduces the expected years of future service of present employees or eliminates, for a significant number of employees, the accrual of defined benefits for some or all of their future services. Examples include:

- The termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a component of an entity.
- The termination or suspension of a plan so that employees do not earn additional defined benefits for future services.

Measurement Date — The date as of which a plan's assets and benefit obligations are measured.

Net Periodic Benefit Cost — The amount recognized in the income statement as the cost of a postretirement benefit plan for a period. Components of net periodic benefit cost include service cost, interest cost, actual return on plan assets, amortization of unrecognized actuarial gain/loss, amortization of unrecognized prior service cost/credit, and amortization of the unrecognized transition obligation or asset.

Over-funded Plan — A plan in which the fair value of its assets exceeds the benefit obligation.

Projected Benefit Obligation (PBO) — Identical to the ABO except that it includes the impact of expected future compensation levels (if applicable) in the measure of the benefit obligation. For plans with flat-benefit or non-pay-related pension benefit formulas, the ABO and the PBO are the same. The term is used in context of a pension plan.

Prepaid Pension Cost Asset — An asset that is measured as cumulative employer contributions to a plan that is in excess of accrued net pension costs.

Settlement — An irrevocable action that relieves the employer of the primary responsibility for a pension benefit obligation and eliminates the significant risks related to the obligation and the assets used to effect the settlement. Examples include:

- Making lump-sum cash payments to plan participants in exchange for their rights to receive specified pension benefits.
- Purchasing nonparticipating annuity contracts to cover vested benefits.

Under-funded Plan — A plan in which the benefit obligation exceeds the fair value of its assets.

Unrecognized Net Actuarial Gain/Loss — The cumulative changes in the value of either the benefit obligation (PBO for pensions and APBO for other postretirement plans) or the plan assets resulting from experience different from that assumed or from a change in an actuarial assumption that have not yet been recognized as a component of net periodic benefit cost.

Unrecognized Prior Service Cost/Credit — The cumulative cost/credit of retroactive benefits that have been granted/eliminated in prior plan amendments that have not yet been recognized as part of net periodic benefit cost.

Unrecognized Transition Asset — The amount of (a) the fair value of a plan's assets plus any recognized accrued benefit cost (a liability) or less any recognized prepaid benefit cost (an asset) in excess of (b) its benefit obligation that existed at the time of adopting Statements 87 and 106 and has not yet been recognized in the financial statements.

Unrecognized Transition Obligation — The amount of (a) a plan's benefit obligation in excess of (b) the fair value of its assets plus any recognized accrued benefit cost (a liability) or less any recognized prepaid benefit cost (an asset) that existed at the time of adopting Statements 87 and 106 and has not yet been recognized in the financial statements.

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