



# Financial Accounting Standards Board

## Board Meeting Handout

### ACCOUNTING FOR PENSIONS AND POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

November 10, 2005

#### **PURPOSE**

At the November 10, 2005 meeting, the Board will discuss whether to add to its technical agenda a project to reconsider the present accounting for pensions and other postretirement benefits.

#### **STAFF RECOMMENDATION**

The staff will recommend that the Board add a comprehensive project to its agenda to reconsider the accounting for postretirement benefits pursuant to FASB Statement No. 87, *Employers' Accounting for Pensions*, and FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*. Such a project would provide the best opportunity for achieving a conceptually sound result, and provide, to the extent conducted jointly with the IASB, international convergence through development of one or more common, high-quality accounting standards.

Because of the breadth and complexity of the issues in this area of accounting, the staff believes that a project to improve and converge the accounting for postretirement benefits would take years to complete.

Thus, in order to provide a timely and substantial improvement to postretirement benefit accounting, the staff recommends that the Board address the project in phases.

#### Initial Improvements Phase

The staff recommends an initial improvements phase directed at delivering a substantial improvement in the transparency, understandability, and representational faithfulness of the sponsoring employer's balance sheet. With the goal of a final standard issued by the

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end of 2006, the staff recommends the scope of the initial phase be limited to addressing whether the funded status of postretirement plans as presently disclosed in the footnotes should be recognized in the employer's statement of financial position.

The staff recommends the Board consider amending Statements 87 and 106 to require the following:

1. That a reporting entity recognize in its balance sheet a net postretirement benefit asset or a net postretirement benefit obligation for each sponsored defined benefit plan equal to the difference between plan assets measured at their fair value and the projected benefit liability (pensions) and accumulated postretirement benefits obligation (other postretirement benefits), measured as of the measurement date. That would ensure an employer reports in the balance sheet the economic funded or unfunded status of its defined benefit postretirement plans.
2. That there would be no change to the amount of net benefits cost included in the determination of net income. Rather, changes in the fair value of plan assets and the benefit obligation that are not currently required to be recognized in earnings (unrecognized gains and losses) would be reported as credits or charges through other comprehensive income (OCI).
3. That an intangible asset related to any unrecognized prior service costs be recognized consistent with the current requirements in Statement 87 when an additional minimum liability is recognized.

The staff believes that improving the balance sheet would be convergent with international reporting standards, because IFRS allows entities the option of immediately recognizing actuarial gains and losses outside of profit or loss in a statement of changes in equity.

#### Comprehensive Reconsideration

The second phase of the project would reconsider comprehensively most, if not all, aspects of the existing standards of accounting for postretirement benefits. The staff recommends that a goal of this phase be the development of one or more high-quality

common standards that apply internationally. That goal would be achieved by undertaking this effort jointly with the IASB.

The Board could issue a single standard after all deliberations are completed or issue more than one standard after groups of issues are addressed. The staff also notes that other matters presently on the Board's technical agenda, such as work on the conceptual framework, financial performance reporting, and consolidations, as well as research being conducted by others in the international accounting community, could affect the conduct of subsequent phases of the postretirement benefits project.

The appendix to this handout describes many of the significant issues that would be addressed in this phase of the project.

## **Appendix A: Discussion of the Major Issues Associated with the Accounting for Pensions and Other Postretirement Benefits**

### **Summary**

This appendix discusses the current accounting for postretirement benefits, the Board's original rationale for that accounting, and current issues with, and concerns about, that accounting. The appendix contains a more thorough analysis of the issues that financial statement users find to be more problematic or more complex or both. Although much of the discussion concentrates on pension accounting rather than other postretirement benefits (OPEBs) accounting for OPEBs is similar to, although not the same as, pension accounting.

The following issues included in this appendix represent major issues, but are not a complete list:

#### 1. Definition and Scope

- a. Whether or not the scope of Statements 87 and 106 should be written as plans, constructive obligations, or substantive obligations
- b. Whether or not the criteria for assessing when individual employee contracts (otherwise subject to the requirements of APB Opinion 12, *Omnibus Opinion—1967*) would be subject to the requirements of Statements 87 and 106.

#### 2. Measurement

- a. The measurement attribute for benefit obligations (for example, accumulated benefit obligations (ABO), projected benefit obligation (PBO), or some other measure of fair value, including use of a discount rate that considers the credit quality of the plan sponsor)
- b. The employer's measurement of the obligation or disclosures or both for defined benefit plans with lump-sum settlement features

- c. The measurement date for all postretirement benefits. Statements 87 and 106 permit use of a measurement date that is up to three months prior to the fiscal year-end.

### 3. Recognition

- a. Recognition of expected long-term, rather than actual, returns on plan assets
- b. Deferred recognition of actuarial gains and losses subject to a 10 percent corridor
- c. Use of a calculated value of plan assets (recognize changes in fair value over not more than five years) for determining the expected return on plan assets and 10 percent corridor
- d. Immediate recognition of the amortization period for prior service costs associated with plan amendments (active employees and retirees)
- e. Depending on other issues included in this potential project (for example, immediate recognition of the funded status measured as the difference between the fair value of plan assets and the PBO), reconsider Statement 87's requirement to recognize an additional minimum liability when the ABO is greater than the fair value of plan assets
- f. Measurement and recognition of multiemployer-defined benefit plans.

### 4. Classification

- a. Income statement classification of the components of net benefits cost, which either are operating, financing, or investing gains and losses
- b. Balance sheet recognition of plan assets and benefit obligations, or the net funded surplus or deficit

- c. Cash flow statement presentation of cash flows associated with postretirement benefits, and possibly benefit payments from dedicated plan assets. (The staff notes that unless dedicated plan assets are consolidated it may not be appropriate to present benefit payments made out of those assets in the statement of cash flows.)

## ***Definition and Scope***

### Current Accounting and Board Rationale

The Board, in Statement 87, concluded that accounting for postretirement benefits should apply to any arrangement that is in substance a plan, whether written or implied. Paragraph 7 of Statement 87 states that it applies:

...to any arrangement that is similar in substance to a pension plan regardless of the form or means of financing. This Statement applies to a written plan and to a plan whose existence may be implied from a well-defined, although perhaps unwritten, practice of paying postretirement benefits.

Future amendments resulting from negotiations, such as collective bargaining agreements, are not assumed to be a part of the substantive plan (that is, they should not be anticipated). Under Statement 106, the substantive plan establishes the expected future outflows that determine the benefit obligation, and amendments to the written plan are anticipated as part of determining the substantive terms of the plan.

Paragraph 9 of Statement 106 states that it applies:

...to deferred compensation contracts with individual employees if those contracts, taken together, are equivalent to a plan that provides postretirement benefits. It does not apply to an employer's practice of providing postretirement benefits to selected employees under individual contracts with specific terms determined on an individual-by-individual basis. Those contracts shall be accounted for individually, following the terms of the contract.

## Current Issues

There are two issues: first, whether a benefit arrangement with an individual, or group of employees, should be accounted for as a plan pursuant to Statements 87 and 106 or as an individual agreement pursuant to Opinion 12; and second, whether the scope of arrangements included in Statements 87 and 106 should be legal or implied obligations.

Different interpretations of what constitutes a plan that is subject to the provisions of Statements 87 and 106 may reduce comparability of financial statements when similar economic transactions are accounted for differently. For example, many reporting entities provide deferred compensation for selected groups of employees through individual contracts. Certain reporting entities treat insurance products and deferred compensation agreements as individual contracts not subject to the requirements of Statements 87 or 106 or both. Judgment is needed to determine whether Statements 87 and 106 apply or whether the contract should be accounted for under Opinion 12.

The second issue is broader because it relates to whether liability recognition should be limited to legally enforceable obligations or whether it should include additional implied obligations, an issue not unique to postretirement benefits. Some might suggest that benefit obligations should be limited to promises that are legally enforceable; others may believe that substantive promises also should be included because legal obligations do not represent all of an entity's probable future economic sacrifice.

Limiting obligations to those that are subject to a written plan or those that are legally enforceable may understate the current costs of employee service and benefit obligations. Specifically, recognizing only legally enforceable obligations would exclude many obligations for retiree healthcare. Including additional costs and obligations that may be implied by past actions of providing benefits better represents future outflows that can be reasonably expected; however, doing so would introduce subjective judgments regarding when past practices rise to the level of a substantive plan that must be anticipated in measuring costs and obligations.

## ***Measurement***

### **Summary**

Current footnote disclosures include information about plan assets, obligations, and costs, based on the measurement attributes selected by the Board when it issued Statements 87 and 106. One criticism of existing measurement is that amounts disclosed in the footnotes for benefit obligations are not a faithful representation of the underlying economic phenomena (described under the benefit obligations section below). Some constituents argue that the PBO, which includes assumed future increases in compensation, is not a present obligation that meets the definition of a liability. Some of those constituents believe the ABO more faithfully represents the benefit obligation than the PBO. Others believe that neither the ABO nor the PBO faithfully represents the benefit obligation because neither represents the amount the obligation could be settled for with an independent third party. The individual issues related to measurement follow.

### **Plan Assets**

#### Current Accounting & Board Rationale

The Board concluded that plan assets should be measured and disclosed in the footnotes at their aggregate fair value. A calculated value may be used for recognition of investment returns and recognition of actuarial gains and losses (discussed under the recognition section below). Paragraph 117 of Statement 87 states:

The Board concluded that plan investments should be measured at fair value for purposes of this Statement...Fair value provides the most relevant information that can be provided for assessing both the plan's ability to pay benefits as they come due without further contributions from the employer and the future contributions necessary to provide for benefits already promised to employees.

#### Current Issues

The fair value measurement attribute for plan assets has not been a controversial decision even though fair values may not be readily available for some investments, for example, private equity.

## **Benefit Obligations**

The PBO represents the present value of pension benefits earned to date. The PBO includes anticipation of future increases in compensation when the benefit formula incorporates pay. The main issues related to measurement of the benefit obligation are whether the PBO, ABO, or some other measure of the benefit obligation is the most relevant measure, and the factors to be included in the measurement of the ABO and PBO (for example, discount rate, inclusion of future salary levels (PBO only), plans with lump-sum settlement features, and measurement date).

### ***Determination of the Discount Rate***

#### Current Accounting & Board Rationale

Expected cash outflows associated with pensions are long-term in nature and must be discounted to derive the present value as of the measurement date. Statements 87 and 106 provide that the discount rate is intended to represent the rate inherent in the price at which the plan's obligations could be effectively settled (that is, a defeasance notion) at the measurement date either by looking at the prices of annuity contracts or high-quality fixed income investments. In 1993, the EITF issued EITF Topic D-36, "Selection of Discount Rates Used for Measuring Defined Benefit Pension Obligations and Obligations of Postretirement Benefit Plans Other Than Pensions," which clarifies that fixed-income debt securities that receive one of the two highest ratings given by a recognized ratings agency should be considered high quality (for example, a rating of Aa or higher from Moody's Investors Service, Inc.).

#### Current Issues

Some financial statement users believe discounting at the high-quality fixed income rate fails to achieve the Board's objective of measuring the obligation at a settlement amount because the discount rate does not represent what the obligation could be settled for with an independent third party. A discount rate appropriate for an actual settlement with a third party would be risk-adjusted and include a profit factor. In addition, inquiries concerning the selection of an appropriate discount rate continue to be received, some of which deal with narrow questions based on specific facts and circumstances.

## ***Inclusion of Future Salary Levels***

### Current Accounting & Board Rationale

There are two measures of the benefit obligation disclosed in the footnotes: the ABO and the PBO. The difference between the two is that the PBO includes the effect of estimated future increases in compensation when the benefit formula defines the benefit in terms of pay.

### Current Issues

Some believe that future increases in compensation should not be anticipated; they explain that a plan sponsor has the option to terminate or freeze a plan and, therefore, not incur the cost of benefits that would arise due to future increases in compensation. Others believe that benefit obligations defined in terms of pay are similar to postretirement healthcare obligations that reflect future medical inflation in determining those obligations and that considering future increases in compensation is consistent with the going-concern concept and that obligations should be based on expectations that the plan will continue as it presently is. The basis for conclusions of Statement 87 states that “among those respondents who argued that obligations dependent on future compensation increases are excluded by the definition of a liability, very few were prepared to accept a measure of net periodic pension cost that was based only on compensation to date.”

## ***Plans with Lump-sum Settlement Features***

### Current Accounting & Board Rationale

Some plans (for example, plans with lump-sum settlement features) define the employee’s benefit in terms of a cash balance. Such plans increase the balance annually with additional notional employer contributions and interest based on variable- or fixed-interest rates. The lump-sum amount at any given date may be more or less than the amount determined for the PBO according to Statement 87 (that is, by projecting the timing of future cash outflows and discounting at rates other than those used to grow the cash balances).

### Current Issues

Some believe that the obligation for plans with lump-sum settlement features should be based on the amount an employee would be entitled to receive as of the measurement date; others believe the benefit obligation should be based on discounted future cash outflows that assume a separation of employment in the future. One view tends to favor a payable-on-demand liability, the other an expected outcomes approach. The issue for cash balance plans is similar to measuring the obligation for demand deposits for a financial institution.

### *Measurement Date*

#### Current Accounting & Board Rationale

In Statements 87 and 106, the Board departed from the usual requirement that financial information should be as of the balance sheet date. This accommodation was given because of the actuarial nature of pension and other postretirement benefit computations. As a result, Statements 87 and 106 allow measurements and disclosures to be as of a date that is up to three months earlier than the fiscal year-end.

Furthermore, measurements of net periodic benefits cost for both interim and annual financial statements are based on the assumptions used for the previous year-end unless more recent measurements are available or a significant event (such as a plan amendment) occurs, in which case a more recent measurement would be required.

### Current Issues

While using a measurement date that is up to three month earlier than the fiscal year-end may have been necessary in the past to give reporting entities and their actuaries time to compile reports and projections in time for year-end reporting, with the evolution of systems and processes since Statements 87 and 106 were issued, that length of time may no longer be necessary. Amounts disclosed in the footnotes may not faithfully represent the true assets and obligations of benefit plans as of the balance sheet date because market changes between the measurement date and fiscal year-end may not be reflected. The up to three-month gap could have a significant impact on the measurement of plan assets and benefit obligations and, therefore, also impact the reported funded status.

## ***Recognition***

The most common criticisms of the accounting for postretirement benefits have been about delayed recognition. Most financial statement users believe that gains and losses represent economic events and transactions that should be attributed to income and expensed in the reporting period in which they are earned or incurred.

### ***Expected Long-term Rate of Return versus Actual Returns***

#### Current Accounting and Board Rationale

The amount of earnings from investments of plan assets recognized in each accounting period is based on the rate of return that the reporting entity expects to earn over the period that plan assets are invested. Therefore, amounts recognized represent long-term expectations, not actual performance during the current accounting period.

Using the expected long-term rate of return typically results in either an overstatement or understatement of income each period compared to actual results, and sometimes produces recognition of expected income when, in reality, net losses were incurred. The exhibit below illustrates this information in the aggregate for companies in the S&P 500.

#### **Exhibit–5 Year Expected vs. Actual Return on Assets for Companies in the S&P 500 (\$ in Billions)<sup>1</sup>**

<b>Year</b>	<b>Expected gain recognized</b>	<b>Actual gain (loss)</b>	<b>Overstatement (understatement) of income</b>
2000	98	58	40
2001	103	(87)	190
2002	102	(91)	193
2003	95	179	(84)
2004	100	138	(38)
<b>5 Year Total</b>	<b>498</b>	<b>197</b>	<b>301</b>

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<sup>1</sup>“The Analyst’s Accounting Observer, Pondering Pensions: How They Affected the S&P 500 in 2004,” May 27, 2005 (Revised June 27, 2005).

As demonstrated above, there can be large differences between the earnings that are recognized based on assumed and actual investment returns. In addition, some financial statement users believe the current accounting requirements are not neutral because they provide an incentive to invest in higher risk equity securities to justify a higher than expected long-term rate of return because (a) the real consequences of investment decisions do not appear in current earnings and (b) a small change in the expected long-term rate of return can have a significant effect on reported earnings. One of the qualitative characteristics of accounting described in the glossary of terms in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, is neutrality. Neutrality is defined as the “absence in reported information of bias intended to attain a predetermined result or to induce a particular mode of behavior.”

During the deliberations of Statement 87, in paragraph 120 some constituents commented that:

...volatility is meaningless or even misleading, particularly in view of the long-run nature of the pension commitment and the fact that pension investments are often held for long periods, thus providing the opportunity for some gains or losses to reverse.

The Board stated in paragraph 120 that “...measuring investments at fair value could introduce volatility into the financial statements as a result of short-term changes in fair values.” Further, the Board recognized that:

...some changes in the fair value of investments are related to some changes in the measurement of the pension liability because they are affected by the same economic factors. For example, a change in the level of interest rates would be expected to affect the liability by changing the discount rates and would also affect the fair value of at least some types of investments (such as bonds). In many cases such fluctuations in the pension benefit obligation and in the fair value of plan investments would tend to offset each other.

Reporting entities, while not precluded from recognizing actual gains and losses as they occur, are only required to recognize those gains and losses on a delayed basis. As a result, the smoothing devices originally intended to reduce earnings volatility have resulted in financial statements that do not depict the economic conditions and results in the reporting period in which they occur. CSFB’s report dated February 7, 2005, “The

Magic of Pensions, Part III,” states that in 2003, for the companies in the S&P 500, delayed recognition of gains and losses caused assets to be understated by \$887 billion and liabilities to be understated by \$1,137 billion. If assets and liabilities were fully recognized, equity would be reduced by \$163 billion (after tax).

### Current Issues

Some financial statement users believe that the current accounting model, which requires recognition of expected rather than actual return on investments, (a) fails to recognize economic resources that meet the definition of assets, (b) fails to recognize relevant information that enhances predictive value associated with resources available to pay benefits and the need for additional contributions by the plan sponsor, and (c) is not representationally faithful because it does not reflect the economic gains and losses taking place in the marketplace.

### ***Value of Plan Assets Used to Determine Return on Assets May Be a Calculated Value, Not Fair Value***

#### Current Accounting and Board Rationale

The asset value used to calculate the expected investment return is the market-related value of plan assets. Market-related value may be either fair value or a calculated value that recognizes changes in fair value over a period of five year or less.

The decision in Statement 87 to permit the use of a calculated value instead of fair value to compute the expected return on plan assets was reached to further reduce volatility.

The Board stated in paragraph 177:

...that the effects of changes in the fair value of plan assets, including the indirect effect of those changes on the return-on-assets component of net periodic pension costs, should be recognized on a basis that reduces the volatility more effectively than that proposed in the Exposure Draft.<sup>2</sup> The Board believes that both the extent of volatility reduction

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<sup>2</sup> The Exposure Draft would have required use of the discount rate and the fair value of assets as the basis for calculating the return-on-assets component of net periodic pension cost.

and the mechanism adopted to effect it are essentially practical issues without conceptual basis. The Board does not believe that the market-related value of assets used in this Statement as a device to reduce the volatility of net periodic pension cost is as relevant as the fair value required for other purposes. [Footnote added.]

In that same paragraph, the Board concluded that "...the approach required by this Statement represents the best pragmatic solution."

### Current Issues

Reporting entities that use a calculated value to determine the expected return on assets may not be using the value of assets that is available to invest during the current accounting period. In some cases, the differences can be significant. Applying an expected rate of return to a calculated value of plan assets can cause expected returns to be over- or under-stated and also can result in an increase in year-over-year expected returns when year-over-year actual returns are decreasing, and vice versa. As a result, not only do the expected returns not represent the underlying economic gains earned or losses incurred for the period, but the year-over-year trend may also be incorrect. This phenomenon can be observed in the exhibit above for the S&P 500 companies in the aggregate. As indicated in that exhibit, the year-over-year trends for 2001-over-2000, 2003-over-2002, and 2004-over-2003 for expected and actual investment returns did not display the same trends. When this occurs for an individual company with a large amount of plan assets, it can distort the overall trends in the company's reported earnings.

### ***Actuarial Gains and Losses and the 10 Percent Corridor***

#### Current Accounting and Board Rationale

Actuarial gains and losses are changes in the value of either the benefit obligation or plan assets because of experience that is different from that which was assumed, or from a change in an actuarial assumption. Specifically, actuarial gains and losses arise from differences between the expected and actual return on plans assets, changes in the benefit obligation due to changes in the rate of expected future compensation increases, discount rate, expected retirement date, mortality rate, employee turnover rate, and healthcare cost trend rate. Under Statements 87 and 106, actuarial gains and losses are not required to be

recognized in the period in which they arise unless the accumulated gain or loss exceeds 10 percent of the greater of the benefit obligation or the market-related value of plan assets (that is, the 10 percent corridor).

If the accumulated gain or loss exceeds the 10 percent corridor, thereby requiring amortization, the excess must be amortized over the remaining service period of active employees (except in instances in which the plan covers primarily retirees, in which case the estimated remaining life expectancy is used). The 10 percent corridor is used to establish a minimum amortization; reporting entities are permitted to use any systematic method of amortization of unrecognized gains and losses as long as the minimum is used in periods in which the minimum is greater, the method is applied consistently from period-to-period and to gains and losses, and the method used is disclosed. Reporting entities also may choose to immediately recognize gains and losses on a consistent basis.

Preceding Statement 87, the *Preliminary Views—A Field Test: Employers' Accounting for Pensions and Other Postemployment Benefits*, proposed a simple amortization based on the average remaining service period of active plan participants. Under this approach, the amortization would have been equal to the net unrecognized gain or loss divided by the estimated average remaining period of service. Constituents argued that the proposed amortization method did not sufficiently reduce volatility. The Board concluded that once a decision is made to delay recognition of gains and losses, no demonstrably correct period is identifiable over which those items should be amortized and, therefore, as a practical matter, decided that a less rapid amortization could be allowed but that some limit should be retained.

Paragraph 187 of Statement 87 states:

The Board was attracted to the “corridor” approach required by this Statement as a minimum amortization approach in part because it allows a reasonable opportunity for gains and losses to offset each other without affecting net periodic pension cost. The Board also noted that the corridor approach is similar in some respect to methods used by some to deal with gains and losses on plan assets for funding purposes.

## Current Issues

The SEC, in its Off-Balance Sheet Report, pointed out that changes in assumptions that affect other long-term obligations are reflected currently in financial statements. Some financial statement users believe that actuarial gains and losses should be recognized immediately, thereby reflecting current values of plan assets and the most current estimates of benefit obligations in the balance sheet.

## ***Plan Amendments***

### Current Accounting and Board Rationale

Amendments to a pension plan may provide additional benefits to employees for past service. In Statement 87, the Board concluded that, fundamentally, such amendments are made with the expectation that the employer will realize economic benefits in future periods because such amendments encourage employees to continue working and to require that the full amount of prior service cost attributable to a plan amendment be expensed in the year the amendment is made would be too great a change from past practice. Therefore, Statement 87 allows the cost of those additional benefits (prior service costs) to be amortized over the future service periods of those employees active at the date of the amendment who are expected to receive benefits under the benefit plan rather than immediately in the year of amendment (the accounting for prior service costs associated with OPEB obligations is similar to the accounting for prior service costs associated with pension obligations).

Paragraph 159 states:

The Board believes that a future economic benefit exists, that the cost of acquiring that benefit can be determined, and that amortization of that cost over future periods is consistent with accounting practice in other areas. The Board also believes that a requirement to charge the cost of a retroactive plan amendment immediately to net periodic pension cost would not be representationally faithful and would represent an unacceptably radical change from current practice. The Board concluded that the increase in the projected benefit obligation resulting from a plan change should be recognized as a component of net

periodic pension cost over a number of future periods as the anticipated benefit to the employer is expected to be realized.

There may also be instances in which a plan amendment increases the benefits to retirees. Such amendments clearly cannot be recognized over those individuals' remaining service periods. Some believe that because those individuals are retired, additional benefits to them do not give rise to a future economic benefit, and therefore the entire cost of the amendment should be included as an expense in the current period. Although the Board agreed with that view to a certain extent, it concluded in paragraph 171 that there were some future benefits to increasing the benefits for retirees because in some cases, such as in collective bargaining agreements, those benefits may be viewed as being exchanged for services of active employees. In addition, amendments that increase benefits to retirees encourage current employees to continue working and it is "simpler and more practical to recognize the cost of all plan amendments similarly, that is, on a delayed basis."

#### Current Issues

Some financial statement users believe that additional costs of plan amendments that are associated with periods of service already rendered (prior service costs) should be expensed immediately. Other users may ascribe to the view that the plan sponsor incurs the costs of plan amendments in anticipation of future economic benefits and that those costs should be recognized over the period of expected future service or the period of vesting. For the most part, financial statement users believe that prior service costs associated with retired employees should be expensed immediately.

#### ***Additional Minimum Liability***

#### Current Accounting & Board Rationale

Statement 87 requires immediate recognition of a liability (the additional minimum liability) when the ABO (the obligation measured without estimating future increases in compensation for plans that base the benefit on compensation) exceeds the fair value of plan assets. However, if the ABO is less than the fair value of plan assets, the plan

sponsor may not recognize a minimum net asset. Statement 106 does not contain a parallel requirement to recognize an additional minimum liability.

### Current Issues

Financial statement users have not criticized the requirement to recognize an additional minimum liability. In fact, because they are generally opposed to delayed recognition, they tend to view the additional minimal liability as a necessary device that partly compensates for delayed recognition. Most criticisms related to balance sheet recognition emphasize delayed recognition. Financial statement users are more apt to support the notion of an additional minimum liability merely because it makes the financial statements better reflect the funded or unfunded status of the benefit plan, although they might say that using two different measures of the obligation adds complexity.

### **Multiemployer Plans<sup>3</sup> are Accounted for on a Contribution Basis**

The accounting for multiemployer plans is not the same as for single-employer plans. Multiemployer plans are accounted for based on contributions made or due. The Board's conclusions in Statement 87 were influenced by the fact that an employer's obligation can be changed by events affecting other participating employers and their employees and by the lack of availability of information sufficiently reliable for accounting recognition. IAS 19, *Employee Benefits*, requires defined benefit accounting, at least when information is available. Specifically, IAS 19 provides an exemption from defined benefit accounting for multiemployer plans when sufficient information is not available, for example when:

1. The entity does not have access to the information about the plan that satisfies the requirements of the standard; or
2. The plan exposes the participating entities to actuarial risks associated with the current and former employees of other entities, with the result that there is no consistent and reliable basis for allocating the obligation, plan assets, and cost to individual entities participating in the plan.

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<sup>3</sup>A plan to which two or more unrelated employers contribute, usually pursuant to one or more collective bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers.

The following information provides some evidence of the size of multiemployer defined benefit pension plans. The U.S. Chamber of Commerce recently commented in an issue summary on its website entitled *Retirement Security: Funding Reform* (May 11, 2005), that multiemployer plans “cover 25 percent of all participants in defined benefit plans.” In the June 28, 2005, *Congressional Budget Office’s (CBO) Testimony* before the Subcommittee on Select Revenue Measures, Committee on Ways and Means of the U.S. House of Representatives, CBO Director Douglas Holtz-Eakin stated that there were approximately 9.8 million participants in 1,600 multiemployer plans, representing approximately 20 percent (less than the U.S. Chamber of Commerce’s 25 percent referred to above) of all participants in defined benefit plan whose pension is protected under the Employee Retirement Income Security Act (ERISA).

The actuarial firm, the Segal Company, analyzed in the December 2003 *Employee Benefits Journal* 455 client multiemployer plans (for plan years ending in 2000 and 2001) with combined assets of \$140 billion covering 3.9 million participants. The Segal Company’s analysis indicated that this represented approximately 45 percent of the multiemployer participant universe. The Segal Company found that the average funded ratio was 95 percent, combining the data for both over- and under-funded plans; therefore, the staff is able to quantify the aggregate benefit obligations at \$147 billion.

### ***Classification***

The following discussion addresses the way information is classified in the income statement, balance sheet, and cash flow statement. Income statement display of net benefits cost is one of the more common criticisms about the current accounting model.

### ***Income Statement Classification Presentation of Net Periodic Pension Cost***

#### **Current Accounting & Board Rationale**

Fundamentally, net benefits cost includes the following possible elements:

1. Service cost for the period
2. Interest cost
3. Expected return on the plan assets if the plan is funded

4. Amortization of unrecognized prior service cost if the plan has had amendments, the cost of which have yet to be included
5. Required amortization of any deferred gain or loss, changes in assumptions and experiences that are different from that which was estimated
6. Amortization of the unrecognized net asset or obligation that existed as of the date of adoption of Statement 87
7. Settlement and curtailment gains and losses.

Although the Board believed that separate reporting for the individual components might be conceptually superior, it decided to retain the model in APB Opinion No. 8, *Accounting for the Cost of Pension Plans*, of combining the separate elements and accounting for that amount as a net number, and instead improved the disclosure requirements related to the individual components.

Paragraph 86 of Statement 87 states that:

The *net* cost feature means that the recognized consequences of events and transactions affecting a pension plan are reported as a single net amount (net periodic pension cost) in the employer's financial statements. That approach aggregates at least three items that might be reported separately for any other part of an employer's operations: the compensation cost of benefits promised, interest cost resulting from deferred payment of those benefits, and the results of investing what are often significant amounts of assets.

Paragraph 91 of Statement 87 states that “the interest cost and return-on-plan-asset components represent financial items rather than employee compensation cost. They can be changed or even eliminated by changes in the employer's financing arrangements.”

### Current Issues

Some financial statement users believe that net recognition of benefits cost incorrectly characterizes financing and investing gains and losses as costs of sales and selling, general, and administrative expenses. For example, gains and losses from investments in plan assets are investing gains and losses. These gains and losses are affected by the plan sponsor's investment strategies and policies. Interest cost on the obligation (that is, the time value of money) is a financing expense. Interest cost could be avoided by settling the benefit obligation. Service cost (the additional cost of benefits earned during the

period) is an operating cost. It represents the compensation cost incurred by the reporting entity during the current accounting period. Amortization of prior service costs also represents compensation. Gains and losses from changes in assumptions may be either financing or investing, if due to changes in the discount rate or return on plan assets, respectively, or operating, if due to changes in assumptions related to increases in future compensation, employee mortality, employee turnover, or the healthcare cost trend rate. Financial statement users believe that the consequences of investment and financing decisions should be presented separately from the consequences of decisions relating to employee compensation.

### ***Recognition of Plan Assets and Benefit Obligations***

#### Current Accounting & Board Rationale

In Statements 87 and 106, the Board believed fundamentally that a plan sponsor with an over-funded obligation has an asset and that a plan sponsor with an under-funded obligation has a liability that should be reflected in the sponsor's statement of financial position. The staff notes that other postretirement benefits are less likely to be pre-funded with dedicated plan assets because there is no regulatory requirement to pre-fund those plans.

The Board did not conclude whether benefit obligations and plan assets held in a separate legal entity (a trust account) should be separately consolidated into the balance sheet of the reporting entity.

#### Current Issues

The SEC stated its belief in its Off-Balance Sheet Report that separate-entity pension plans should be consolidated by the reporting entity that is responsible for the assets and obligation of the plan. The SEC based its conclusion on the employer's continuing involvement with risks and rewards associated with, and control over, the plans.

## *Cash Flow Statement Presentation of Postretirement Benefits*

### Current Accounting and Board Rationale

The Board did not prescribe any specific requirements in Statements 87 and 106 for how entities should classify or present postretirement benefit cash flows in the statement of cash flows. Guidance on the statement of cash flows is presented in FASB Statement No. 95, *Statement of Cash Flows*.

### Current Issues

Some financial statement users say they would like more information in the statement of cash flows, specifically, separate reporting of the operating, investing, and financing cash flows associated with postretirement benefits. The staff reviewed the cash flow statements of several companies and found that postretirement-benefits-related cash flows are:

- (1) Not separately identified in the statement of cash flows and instead are combined within other line items,
- (2) Reflected as a net adjustment in the operating section to adjust net benefits cost included in reported earnings to the net cash used to acquire plan assets, or
- (3) Presented as separate line items:
  - a. First, added back the non cash postretirement-benefits expense to earnings; and
  - b. Second, separately displayed the cash outflow for contributions made to fund the plan.

While the review of cash flow statements was limited, the staff did not observe cash flow statements that treated contributions to fund benefit plans as investing activities.

In addition, some users would like benefit payments made to plan participants to be reported as operating cash outflows, even though payments are funded from dedicated pension trusts. Such presentation is considered by some users to be a more complete picture of cash inflows and outflows and more consistent with how other postretirement

benefits-related cash flows are reported. Statement 95 describes the purpose of a statement of cash flows as providing “relevant information about the cash receipts and cash payments of an enterprise during a period” (paragraph 4). Statement 95 also states that “a statement of cash flows shall explain the change during the period in cash and cash equivalents” (paragraph 7).