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LETTER OF COMMENT NO. 187

Re: File Reference No. 1025-300 (March 31, 2006) – Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans: an amendment of FASB Statements No. 87, 88, 106, and 132(R)

Dear FASB:

I am an accounting professor at the University of Idaho and I’ve taught pension accounting since the pre-FASB Statement No. 87 days. Due to a concurrent role with the National Association of College and University Business Officers (NACUBO), I dug into this exposure draft with the hopes of understanding the changes well enough to be prepared to teach the new rules as well as warn next semester’s students of the changes coming soon. My comments on the Exposure Draft (ED) are primarily related to the technicalities of the proposed standard – I can offer little insight into the more practical implementation issues (e.g., impact on bond covenants or problems with changing employer’s measurement date). However, both my experiences as a practitioner and my academic research interests have been related to not-for-profit entities – another area where I believe I’m well qualified to comment. Please note that I have participated with comment letters from both NACUBO and the Government & Nonprofit Section of the American Accounting Association and, accordingly, some of these comments duplicate or reiterate what was said there. However, I will try to limit myself primarily to other issues not emphasized or included in those letters.

First of all, I’d like to thank the Board on behalf of my future students for getting rid of the minimum liability requirement – a natural effect of the proposed changes. My students have always struggled with that particular concept. I believe that teaching the “new rules” without bothering students with retroactive application and the like will be relatively straight-forward although intermediate accounting text books will need to be putting more emphasis on the relatively neglected statement of comprehensive income.

Issue 1 – Cost of Implementation

In general, I agree that the cost related to the recognition of the unfunded postretirement obligation should be relatively minor given that almost all necessary information is available from prior years' footnote disclosures.

However, I personally had to spend an unreasonable amount of time and effort to fully understand the examples provided. Since I have earned a PhD in accounting and have been teaching pensions for years, this is not a good sign. Initially, I concentrated on the Company A with retroactive implementation example. One of the problems I had was the incompleteness of the example which led to misconceptions that the net actuarial loss (an even \$10,000 per year) was amortization which it is not. I finally had to create most of the pension note (consistent with facts provided) and working papers to go with the Company A example. It would have been helpful to actually HAVE the two reconciliation schedules (plan assets and postretirement benefit obligation) as well as the schedule of components of pension/post-retirement benefit expense provided. An example with actual journal entries would certainly help others achieve understanding of how the retroactive adjustments really work but I realize that this level of detail has rarely been provided in the past. Each of the piecemeal computations was correct but most of us are more familiar with the debits equal the credits approach.

As an aside, I was concerned that the “least preferred” presentation of the statement of comprehensive income was the one used in the examples for Companies A, B and C. A combined statement of net income and comprehensive income (the FASB preferred style) would make more sense and serve to reinforce the Board's preference! As a professor, I always try to encourage my students to follow the preferred methods rather than the less preferred methods. Change will be slow if the FASB itself provides illustrations solely using the methods it labels as less desirable.

After finally succeeding in understanding the intent and results of the changes in accounting for postretirement benefits, I believe that the required implementation is no more onerous than any other retroactive presentation of a change in accounting principle. Unfortunately, retroactive applications are always tricky to implement.

Issue 3 – Effective Dates and Transition

Based on my research in the not-for-profit sector, I've observed that many not-for-profit entities have fiscal years that do not coincide with the calendar year. In many cases, the fiscal years were selected to obtain “off season” audits at reduced cost. On behalf of these organizations, I strongly recommend that the implementation date for recognition of a plan's funded status by public companies be fiscal years ENDING after December 15, 2006 for all entities or postpone the effective date for not-for-profit and nonpublic companies to fiscal years beginning after December 15, 2007. It is not uncommon for large not-for-profit entities, particularly in the health care and education arenas, to carry publicly-traded debt. I've also noted a small but increasing number of other not-for-profit organizations getting bond ratings through Standard & Poor's and its competitors. These not-for-profit entities are considered “non-issuers” by the SEC and are therefore of lesser concern for the Board – a year's delay for non-issuer public entities (not-for-profit organizations) should not be a serious impediment to achieving the Board's goals. At a minimum, I do not believe that these entities should be forced to implement

the provisions of the proposed standard before the majority of large publicly-traded for-profit entities – as will be the case if the ED's effective date remains unchanged.

Issue 5 – Provisions for Not-for-Profit Organizations

Recognition of Funded Status

In the past, the Board has been able to implement certain desired standards for not-for-profit entities that were politically impossible in the for-profit sector. In particular, SFAS No. 124 requires fair value accounting for all investments as compared to the pieced-together compromises embodied in SFAS No. 115. When I first read the ED, I was thinking that maybe the same could be done in this situation – the accounting would certainly be more straightforward and we could avoid all the awkward decisions about how to present the unrecognized postretirement obligations on the statement of activities! While the amortization of prior service cost is a fairly minor issue, the recognition of the gains and losses that result from changes in the assumptions used to measure postretirement obligations could cause substantial volatility in reported expenses. I do not believe that users of NFP financial statements would understand that such increases and decreases actually had little if any immediate impact on the level of charitable services the NFP was able to provide. After reflection, I think that the approach used in the ED is the only viable solution. To saddle not-for-profit entities with volatility avoided by for-profit entities (through off-income statement presentation) would be an unreasonable burden that would provide no benefit to financial statement users.

Presentation of Other Comprehensive Income

The basic accounting model for not-for-profit entities (SFAS No. 117) did not even hint that then existing “off income statement” items like the deferred pension cost that sometimes arose from booking the required minimum pension liability could impact the statement of activities. The minimum liability requirement already existed but was not included in any of the not-for-profit examples. At that time, there was of course no requirement for a statement of *comprehensive income* by *for-profit* entities. Subsequent to SFAS No. 130, SFAS No. 133 expanded the number of items treated as “other comprehensive income” (OCI). Perhaps it is time for the Board to give more attention to just how not-for-profit entities (NFPs) should handle OCI items on their financial statements. I have seen that some not-for-profit entities (NFPs) treat deferred pension cost (currently an OCI item) as a “nonoperating” reduction of net assets on their statements of activities. There is no rule, as far as I know, that this additional debit could not be allocated among functional expense categories for program services, fund raising and general administration. Universities commonly (about 60% according to my own research) include an intermediate operating measure but such an intermediate performance indicator is less common among the environmental and human services organizations I've studied.

According to the ED, the Board does not intend to change accounting for expenses and has therefore specified that NFPs should present the prior service cost amortization reversal and the recognition of actuarial loss as separate items on the statement of activities. Would it not make sense to generalize this treatment to other existing and future OCI items? In addition, the Board should make it very clear that these OCI items should NOT be allocated to functional or natural expense categories and, further, should not be included in the line labeled “total expenses” on the statement of activities. Clearly, these special items are not really part of

mission-directed “service efforts and accomplishments” information the financial statements are intended to provide. The non-directive language that exists in SFAS No. 117 and is reiterated in paragraphs 7-11 of the ED should be clarified.

There are many NFPs that rely on “less than professional” accounting staff. As an example, I’m pretty certain that most NFP accountants are not going to understand exactly what is meant by the language in paragraph 11a – the “amounts arising during the period” versus “amounts reclassified as components of net periodic benefit cost during the period.” With what’s being called “SOX creep,” auditors are increasingly unwilling to assist their clients in implementing new accounting standards due to the potential independence concerns. This means that all the clarity that can be provided by the Board should be provided!

As part of this clarity, I hope that the Board will include the subsequently issued NFP examples within the final standard AND revise the examples currently available in paragraph 159 of SFAS No. 117. I note that all of the ED’s examples follow the Format A Statement of Activities while, in practice, I’ve found that the multi-column Format B to be far more common. Therefore, it wouldn’t hurt to include a Format B example for at least the NFP Organization C example, perhaps in place of the Format A example. Along the lines of the old proverb that a picture is worth more than words, I suggest that a statement of functional expense be added to the NFP Organization C example to further confirm that changes in the unrecognized portion of postretirement obligations are also separate items on that statement. In fact, I question whether they should appear on a statement of functional expense at all! To include them would be to imply that they are 100% related to “management and general” since they cannot be allocated – but that would clearly be unpopular as it would change overhead ratios and make program expense to total expense ratios deteriorate (at least if actuarial losses exceeds prior service amortization). If these new items that would be OCI in a for-profit entity are included on the statement of functional expense, they should presumably appear in the total column only (although I hope the Board will clarify that they should not appear there at all!). Again, an illustration would be very helpful.

Distinguishing Between Nonpublic and Not-for-Profit

As stated earlier, some not-for-profit entities meet the definition of “public entities” (paragraph 14 in the ED). In many places in the ED, there are statements regarding not-for-profit entities that presume that they would be “nonpublic entities.” For example, the Board needs to clarify whether not-for-profit entities that are “public” when it comes to the expanded disclosure requirements of SFAS No. 132R use the public or the “nonpublic entity, including a not-for-profit organization” effective dates (paragraph 18 vs. 21 for measurement date provisions).

Functional Equivalent of Income from Continuing Operations

Just how “functionally equivalent” does an NFP’s optionally provided intermediate performance measure need to be? From the hospital example (a field in which I have done no research) I infer that it is intended to be pretty close: the hospital presents as nonoperating the unrealized investment gains of only those securities that do not function as trading securities. Obviously, most nonprofits have not needed to make distinctions between trading, held-to-maturity, and available-for-sale securities. These categories are not even mentioned in SFAS

No. 124 and the average NFP accountant has no need to be familiar with both NFP and for-profit rules. Accordingly, I suggest the following changes to the ED:

1. Clarify specifically what is meant by “functionally equivalent” in light of the fact that terminology often differs between the Board’s rules for for-profit and not-for-profit entities. A useful “functionally equivalent” intermediate operating measure should not demand expertise in both sets of accounting rules.
2. Add language to paragraph 9 to require that use of ANY intermediate measure voluntarily reported (not just one that is the functional equivalent to income from continuing operations) should follow the paragraph 8 rules. In other words, changes in the unrecognized portion of the postretirement obligation included in unrestricted net assets but not yet recognized in expense should be reported in the section of the statement of activities that does not include the functional expenses (program fund-raising, and management & general).
3. For those entities that do not report an intermediate measure on the statement of activities, add language to paragraph 9 (and related amendments to other standards) to specify that a separate total for expenses shall not include the prior service and actuarial loss line items. In other words, make the presentation illustrated for NFP Organization C mandatory.

Pension Disclosures

The examples for amended provisions of SFAS No. 132(Revised 2003) are misleading when they imply that all not-for-profit entities are also “nonpublic entities” for the purpose of applying the disclosure requirements. See the examples provided starting on page 81 and related to {ED paragraph E1(p) which amends SFAS No. 132R, para. C3 (begins page 81 of the ED)}. Since people often rely on the picture rather than the words, having language that contradicts the standard must be avoided. The notations that “Nonpublic entities, including not-for-profit organizations, are not required to provide information in the above tables...” should be changed back to the original wording.

Other Issues

Defining current liability

Defer the disclosure of current and noncurrent portions of postretirement assets and obligations until the next phase of the project. I don’t believe the Board had given the issue sufficient thought. This is clearly a measurement issue rather than merely one of presentation.

I can find no guidance in current GAAP for the measurement or disclosure of the current portion of a pension liability. EITF 90-3 implies that the proposed measure (next year’s planned contribution to pension plan) is not a liability but that is in the context of multi-employer plans. In addition, SFAS Nos. 87 & 106 only discussed the measurement of prepaid postretirement cost or accrued postretirement benefit costs in total with the assumption that both would be classified as long-term since the computation was based on a complicated set of offsetting memorandum

amounts. As the Board has found in other areas, defining a liability (let alone the current portion) is a challenge. The proposed language added to Para. 36 of SFAS No. 87 (ED para. C2(1)), is really no guidance at all in this complicated setting where obligations may be offset by assets and portions of obligations remain unrecognized.

From teaching the economics of pension plans, it seems to me that the current portion of a pension obligation should be only the portion related to existing obligations. Accordingly, it would not include future service costs. With the potential existence of assets from which benefits can be paid, it is not clear that the anticipated payments to or on behalf of retirees within the next 12 months (or operating cycle) is a current obligation of the employer. The only component of postretirement benefit expense for the coming year that is clearly related to past services is the interest cost on end-of-the-year obligation. This amount must be provided whether or not employees provide any additional services. However, the obligation itself includes projected future salary increases so only the interest cost on the accumulated benefit obligation (or the other postretirement benefit equivalent) is required with certainty. From this projected interest cost (based on either PBO or ABO), estimated benefits to be paid might be deducted since they are payments for services previously rendered and included in the end-of-year obligation. However, if benefits are being paid out of plan assets, then they should NOT be deducted from interest cost since there is no net change in funded status of the obligation. Prior service costs and amortization of actuarial gain/loss do not enter into the measurement of “funded status” under the proposed rules.

The ED’s proposed inclusion of next year’s contribution to the plan as a current liability is flawed on at least two accounts: (1) It is redundant information. Next year’s planned contribution is disclosed under the expanded requirements already part of the revised version of SFAS No. 132. (2) Planned contributions are presumably a discretionary amount and therefore not objectively determined. Management could improve its current ratio or meet other debt covenant provisions by simply planning smaller (or even zero) contributions to the plans.

Revised disclosures (amendments to FAS132R)

Should there not be a provision for amortization of actuarial loss or gain in the table required under amended paragraphs 5(i) and 8(h)? On page 83 of the ED, there are two lines for prior service cost. One would presumably be needed for plan amendments, curtailments, or the like. Presumably that was what was intended by the line “Prior service cost (credit)” which, by the way, seems unnecessarily opaque. It would likewise make sense to break out the components of the net change in actuarial loss. As I understand it, there are three common components: (1) difference between expected and actual return on plan assets, (2) amortization of accumulated unrecognized gain/loss in excess of corridor, and (3) change in benefit obligation due to revised assumptions regarding inflation, life expectancy, interest rates, future salary increases, retirement dates, etc. While items (1) and (3) could be combined, separate disclosure of item (2) would be helpful since that is the portion of the actuarial loss recognized as a component of postretirement benefit expense. It is also the reclassification amount needed on the statement of comprehensive income.

Did the Board intend to let nonpublic entities omit disclosure of the total amount of postretirement benefit costs included in expense? Paragraph 8(g) in FAS132R implies such a

disclosure but the change in ED paragraph E1(h) appears to remove any requirement. Clearly, the Board intended to simplify nonpublic entities' disclosures by omitting the need to disclose the components of expense [FAS132R paragraph 5(h)]. However, the expense recognized is surely a minimal disclosure given the current volume of information required from even the nonpublic entities. Without adding a requirement (possibly to paragraph 8(a) of FAS132R), it will be impossible to ascertain pension and other postretirement benefit expense since they are normally combined with other fringe benefits when reported on a statement of functional expense or on the face of the statement of activities. Sufficiently detailed income statements are probably not common among nonpublic for-profit entities either.

Studying the impact on existing standards is a bit confusing given the length of the ED. To the best I can tell, FASB Statement No. 132R paragraph 8 needs to be modified to delete paragraph 5(c) from the disclosures from which nonpublic entities are exempt. Revised paragraph 8(g) [FAS132R, ED para. E1(h)] calls for the current/noncurrent breakdown for assets and liabilities reported in the balance sheet. Existing paragraph 8(a) in FAS132R calls for reporting the funded status consistent with the revised paragraph 5(c) [FAS132R, ED para. E1(b)]. Between the requirements of paragraphs 8(a) and 8(h) it would appear that all of the disclosures of 5(c) are being required of nonpublic entities.

FASB 130 amendments

Again, along the lines of "a picture is worth a thousand words," please consider revising all of the examples of the statement of comprehensive income to "add back" amortization of actuarial gain/loss. In other words, there should also be a line for:

Less: amortization of previously unrecognized actuarial loss/(gain) included in net income.

So far, I've generally been teaching preparation of the statement of comprehensive income primarily at the graduate level. This seems to be a challenge for almost all of my students probably because they only learned to prepare the basic statements in previous classes since the OCI items tend to be related to more advanced topics in accounting. I encourage the Board to take the opportunity to make the SFAS No. 130 examples as complete as possible because we professors tend to use the examples to teach the preparation of this statement. Accordingly, it would help to clarify the "prior service cost arising during the period" line by maybe changing it (in the examples) to "Prior service costs arising during the period due to plan (amendments)/curtailments."

Amendments to SFAS No. 87

The amendments to SFAS No. 87 do not appear to include any definition of a public entity. Without such a definition, the amended glossary entry for "nonpublic entity" is useless (see Para. C2(u) in ED which amends para. 264 in SFAS No. 87). Obviously, the one from page 84 in the ED would work just fine [ED paragraph E1(r)].

Improving the Examples

As discussed earlier under Issue 1, the examples provided in the ED (and the NFP examples issued later) are hard to follow. The pension portion of the Company A example was

applied to three types of not-for-profit entities. I worked primarily with the University B example. I found it very hard to trace the “with tax” adjustments for Company A to the University B “without tax” financial statements. It was impossible to see the link between the impact on balance sheet and statement of activities because there was no balance sheet for the not-for-profit examples. In addition, only the most recent balance sheet is adjusted for Company A and that makes the changes in net assets unclear in the “prior year” University B example.

The Company A example would be more understandable if it included all the components of postretirement benefit costs and the complete schedules for changes in projected benefit obligations and plan assets. This would let the reader figure out that the constant \$10,000 change in actuarial loss is NOT the result of amortization but (presumably) the difference between expected and actual return on plan assets. I spent hours re-creating an entire pension and postretirement benefit note and resulting work paper equivalents before I could successfully make the required adjustments.

Oversimplification of the examples is really a disservice to those trying to understand the accounting standard. To make the example more useful, I suggest making it more realistic by including the following changes: (1) The unrecognized actuarial loss should be larger so that amortization of the excess over the corridor amount would be included in expense. (2) Include an actuarial gain/loss in addition to the difference between actual and expected return on plan assets. (3) Add a minimum liability with related intangible asset and deferred pension cost. The elimination is straight-forward but many companies present the accrued pension cost liability as a single amount that includes the “additional” liability offset in the intangible assets.

As mentioned earlier, please add a statement of functional expense to the NFP Organization C example and consider using the more common Format B presentation.

It would also be helpful if the SFAS No. 132(F) disclosure examples were based on the same numbers as used in the Company A example. That would clarify the board’s intention on what was to be included in certain vaguely described lines like the “Prior service cost (credit)” on page 83. While I’m looking at page 83, it would also help to have an example of the equivalent wording that would be used by a not-for-profit entity - see paragraph that begins “The estimated net actuarial loss and prior...” since an NFP does not have accumulated other comprehensive income.

I hope the Board finds these comments and suggestions constructive and useful.

Sincerely,

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