

MEMORANDUM

TO: Members of the Financial Accounting Standards Board (FASB)

FROM: Susan W. Eldridge, Ph.D., CPA
Assistant Professor at the University of Nebraska at Omaha

DATE: May 31, 2006

RE: File Reference 1025-300
Comments on Exposure Draft, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

Thank you for the opportunity to comment on the proposed standard amending existing accounting for defined benefit pension and other postretirement plans. My comments in this memorandum focus on defined benefit pension plans only. Overall, I believe that the proposed changes will improve existing reporting for defined benefit pension plans by requiring balance sheet recognition of plans' funded status and thereby eliminating the minimum pension liability recognition rules and the need for footnote reconciliation of the funded status and amounts recognized in the balance sheet. I also encourage the FASB to move forward with the second phase of this project on postretirement benefits accounting so that it can address important conceptual issues such as delayed recognition of items in net income, measurement of the liability, and net or gross presentation in the balance sheet and income statement.

My comments below are based on preliminary data analysis using data obtained from Standard & Poor's Compustat database and from Forms 10-K filed with the Securities and Exchange Commission (SEC). The initial data analysis evaluates pension accounting for 1,652 firms for which Compustat reports non-zero values for projected benefits obligation (PBO) and numeric values for fair value of plan assets (FVPA) and prepaid or accrued pension costs for fiscal year 2004. The second data analysis looks more closely

at recognition by firms in the S&P 500, in particular, at amounts recognized because of the *minimum pension liability* rules.

Measurement Date

Par. 5 of the Exposure Draft requires firms to measure plan assets and benefit obligations as of the firm's balance sheet date, and *Issue 2* requests comments on this requirement. Compustat includes a data item (A247, PBID) that represents the measurement date reported in a company's pension footnote. Of the 1,652 firms in my initial data set from Compustat, 1,579 have an available measurement date for fiscal year 2004. Even though existing standards permit companies to use a measurement date up to three months earlier than their balance sheet date, only 283 of these 1,579 companies (18%) did so. These data indicate that the new measurement date requirement will affect a limited number of companies with existing defined benefit pension plans.

2004 Funded Status and Amounts Recognized

Statement of Financial Accounting Standards No. 132(R) (FAS132(R)), par. 5c currently requires disclosure of funded status, amounts not recognized, and amounts recognized in the balance sheet. Most companies present these data in a table in their financial statement footnotes. Table 1 below summarizes descriptive statistics for these items reported by Compustat for the 1,652 firms with non-zero PBO and numeric values for FVPA and prepaid/accrued costs for fiscal year 2004.

TABLE 1 – Descriptive statistics for defined benefit pension plan disclosures, fiscal year 2004. Set includes 1,652 firms reported by Compustat. (Dollars in millions)

| | <u>Mean</u> | <u>Median</u> | <u>Maximum</u> | <u>Minimum</u> |
|--------------------------------|-------------|---------------|----------------|----------------|
| PBO | \$1,109.27 | \$113.62 | \$107,440.00 | \$0.17 |
| FVPA | 969.02 | 86.67 | 99,909.00 | 0.00 |
| Funded status (PBO-FVPA) | (140.25) | (18.37) | 6,696.00 | (12,306.00) |
| Unrecognized losses or (gains) | 288.45 | 21.29 | 42,348.00 | (631.00) |
| Net amount recognized | 148.20 | 0.44 | 34,817.00 | (3,319.00) |

Approximately 90 percent (1,480) of these firms had under-funded defined benefit pension plans at the end of 2004, and 92 percent (1,519) had unrecognized losses due to the delayed recognition rules for prior service costs, actuarial gains and losses, and unexpected returns on plan assets. As a result of these unrecognized losses (mean of \$288.45 million), many companies appear to be reporting prepaid pension assets (mean of \$148.20 million) when their pension plans are under-funded (mean excess PBO of \$140.25 million). In fact, the “net amount recognized,” which Compustat refers to as prepaid/accrued cost (A290, PCPPAO), is positive (negative) for 888 (757) of the 1,652 firms analyzed. The total unrecognized losses for this set of firms as of year-end 2004 is \$476.5 billion, and the Exposure Draft requires these losses to show up on the balance sheet as liabilities and negative equity (pre-tax debit balances in accumulated other comprehensive income).

For pension plans, however, some of these losses have actually already been recognized, even though the reconciliation required by FAS132(R) calls them unrecognized. *Statement of Financial Accounting Standards No. 87 (FAS87)*, pars. 36 – 38 require recognition of unfunded accumulated benefit obligations (ABO). When companies record these minimum pension liabilities because of ABO in excess of FVPA, they also recognize intangible pension assets (up to the amount of unrecognized prior service costs) and accumulated other comprehensive income (AOCI) on their balance sheet. As a result, the “net amount recognized,” which may appear to be a prepaid asset, actually includes intangible pension assets (IPAs) and minimum pension liability losses (MPLs) recognized in AOCI. Most companies follow FASB’s illustration for disclosing where on the balance sheet the “net amount recognized” is recognized (see FAS132(R), par. C3), but financial statement users must carefully read this disclosure to make sure that they understand the “net amount recognized” is often not the same as the net asset or net liability recognized on the balance sheet. This somewhat confusing disclosure focusing on the “net amount recognized” is a weakness of existing generally accepted accounting principles (GAAP) that will be eliminated with the recognition requirements of par. 4 of the Exposure Draft. However, because the Exposure Draft requires the use of other comprehensive income and AOCI recognition for prior service costs and gains and losses

from actuarial assumption changes and unexpected returns on plan assets, the disclosure requirement in par. 6b of the Exposure Draft is essential to enable financial statement users to identify the amount of the recognized pension liability or asset (from par. 4 of the Exposure Draft) that has not yet been included in net income and retained earnings.

2004 Minimum Pension Liability Recognition

To further evaluate the impact of minimum pension liability recognition on reducing the amount of unrecognized losses and prior service costs, I am in the process of analyzing pension recognition and disclosures for firms in the S&P 500. Because Compustat does not capture IPAs and MPLs, this analysis requires hand-collected data from companies' annual reports (10-Ks or proxies). So far, I have reviewed annual reports for fiscal years 2002 through 2004 for 305 of the 500 sample firms. Of these 305 firms, 135 either have no defined benefit pension plans or have immaterial plans for which only limited disclosure is provided. The analysis that follows includes the 170 firms for which I have collected data.

The 170 firms in this sample reported total PBO at year-end 2004 of \$761.8 billion. This is approximately 42 percent of the total PBO (\$1.8 trillion) for the previous data set of 1,652 firms. The descriptive statistics in Table 2 below are for the disclosures required by FAS132(R), par. 5c.

Approximately 83 percent (141) of the sample firms had under-funded defined benefit pension plans at the end of 2004, and all 170 had net unrecognized losses due to the delayed recognition rules for prior service costs, actuarial gains and losses, and unexpected returns on plan assets. *Seventy firms reported non-zero net transition obligations totaling \$83 million. This amount will be a prior period adjustment (decrease) to retained earnings under the transition rules of the Exposure Draft and is approximately 10 percent of the total PBO for these firms at year-end 2004. All but eleven firms reported prior service costs or credits totaling \$16.6 billion. One firm reported unrecognized gains and the remaining 169 firms reported unrecognized losses totaling \$203.6 billion net losses for the sample. The "net amount recognized" is positive*

(negative) for 131 (39) of the 170 sample firms, but only 15 of the 170 firms avoided recognition of minimum pension liabilities. One hundred eighteen firms reported IPAs, and 155 firms recognized losses in AOCI. As a result of the IPA and MPL recognition, these firms on average recognized an additional liability of \$402.98 million or approximately 31% of the originally unrecognized funded status. Once the IPAs and MPLs were recognized, 79 sample firms recognized net pension assets and 91 recognized net pension liabilities.

TABLE 2 – Descriptive statistics for defined benefit pension plan disclosures, fiscal year 2004. Sample includes 170 S&P 500 firms. (Dollars in millions)

| | <u>Mean</u> | <u>Median</u> | <u>Maximum</u> | <u>Minimum</u> |
|---|-------------|---------------|----------------|----------------|
| PBO | \$4,481.07 | \$1,237.50 | \$107,440.00 | \$40.40 |
| FVPA | 3,979.42 | 978.16 | 99,909.00 | 17.17 |
| Funded status (PBO-FVPA) | (501.65) | (137.94) | 3,887.00 | (12,306.00) |
| Unrecognized losses or (gains) | 1,197.68 | 320.50 | 35,639.00 | (0.46) |
| Unrecognized prior service costs or (credits) | 97.89 | 5.13 | 6,670.00 | (362.00) |
| Unrecognized transition obligation or (asset) | 0.49 | 0.00 | 39.00 | (11.00) |
| Net amount recognized | 794.42 | 87.98 | 34,817.00 | (1,401.00) |
| Net pension asset or (liability) recognized | 391.44 | (13.10) | 29,464.00 | (3,981.00) |
| IPA recognized | 42.28 | 3.78 | 3,043.00 | 0.00 |
| Pre-tax MPL recognized in AOCI | 360.70 | 79.25 | 7,893.00 | 0.00 |

This analysis highlights the facts that many large companies had under-funded defined benefit pension plans at the end of 2004 and that most of them were required to recognize part of their net unrecognized losses because of the minimum pension liability rules in FAS87. The new Exposure Draft recognition requirement will completely eliminate the off-balance sheet treatment of significant actuarial losses and unexpected losses on plan assets so that the entire funded status is reflected in the balance sheet and all gains and losses are reflected in comprehensive income when they occur.

Summary

In conclusion, I support the FASB's decisions reflected in the Exposure Draft with regard to defined benefit pension plans. The measurement date requirement in par. 5 should affect only a small number of companies. The funded status recognition requirements in par. 4 will result in balance sheets that are more faithfully represent assets and liabilities of employers' defined benefit pension plans and will eliminate the somewhat confusing reconciliation disclosures currently required by FAS132(R). The disclosure requirements in par. 6 will provide additional information that is relevant in the analysis of gains and losses and service costs that have been recognized in comprehensive income but not yet recognized in net income. I encourage you to adopted this Proposed Standard and move quickly to the next phase of your postretirement benefits project to address important issues that were excluded from the scope of the initial phase of the project.

Thank you again for the opportunity to provide my opinion to you regarding the *Exposure Draft on defined benefit pension and other postretirement plans*. Please feel free to contact me with any questions you may have. My e-mail address is seldridge@mail.unomaha.edu.