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Alert

Accounting for Pension and Other Postretirement Benefits

Requirements to report the funded status of pension and other postretirement plans on the balance sheet may be adopted by the end of 2006 as a consequence of a new FASB project. New requirements to measure and report the costs of pension and other postretirement benefits in earnings may follow some time later when the FASB completes the comprehensive second phase of the project jointly with the IASB and other standard setters. Meanwhile, additional disclosures by public companies about accounting for pension and other postretirement benefits may be necessary to address the expectations described by the SEC staff earlier this year.

The FASB's decision responds to calls to revisit this subject from the SEC staff, the Financial Accounting Standards Advisory Council, and the FASB's User Advisory Council.

Phase One

The first phase of the FASB's project is expected to conclude by the end of 2006 with a Statement that would require employer sponsors of defined benefit pension and other postretirement plans to reflect the plans' funded status as an asset or liability on the balance sheet. A plan's funded status is the difference between:

- The fair value of the plan assets and
- The benefit obligation—an actuarially computed amount representing the present value of the benefits earned to date based on the employees' current service.

Under Statements 87 and 106, this information is reported in the financial-statement notes, and a different amount is often reported on the balance sheet.[1] If so, a note presents a reconciliation of the two amounts.

[1] FASB Statements No. 87, Employers' Accounting for Pensions, December 1985, and No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, December 1990, both available at www.fasb.org.

Reporting the funded status amount on the balance sheet could significantly affect net equity. The Board will determine how changes in the net funded status should be reported, but it seems likely that they would be reported in other comprehensive income until the second phase of the project is completed.

Phase Two

The second phase of the project will evaluate all aspects of accounting for pensions and other postretirement benefits and will be undertaken in conjunction with other standard setters in order to improve the compatibility of international and national accounting requirements. The following topics were identified by the FASB as among those that will be covered.

- How to recognize and display in earnings and other comprehensive income the various elements that affect the cost of pensions and postretirement benefits, including service cost, interest cost, return on plan assets, plan amendments, and actuarial and experience gains and losses.
- How to measure the obligation, including the measurement of obligations for plans with lump-sum settlement options.
- Whether to provide more guidance on measurement assumptions.
- Whether pension and postretirement benefit trusts should be consolidated by the plan sponsor.

These subjects are responsive to the SEC staff's concern that current requirements allow companies to smooth earnings.[2] Statements 87 and 106 permit policy elections to defer actuarial and experience gains and losses unless they exceed a "corridor" (or threshold) amount. In addition, the effects of plan amendments are amortized over employees' future service periods. It seems likely that the outcome of the new project will be requirements that result in more volatility in reported earnings.

Public Companies' Disclosures

All companies that follow GAAP must disclose in their financial statements the information specified in Statement 132R.[3] Public companies will also have to ensure that their disclosures in the notes to the financial statements and in MD&A meet the expectations articulated earlier this year by the SEC staff.[4] The type of information expected by the staff may in some respects exceed the requirements of Statement 132R. However, the staff emphasized that registrants should minimize repeating in MD&A information that has been reported in the notes to the financial statements. The disclosures in MD&A should build on the information disclosed in the notes.

The staff expects registrants with material defined benefit plans to disclose how they determine the assumed discount rate, including the specific source data used to support that rate. If the registrant benchmarks its assumption from published long-term bond indices, it should explain how it determined that the timing and amount of cash outflows related to the bonds included in the indices matches its estimated defined-benefit payments. Registrants are expected to explain how they adjusted for differences between the terms of the bonds and the terms of the benefit obligation. The staff noted that increases in benchmark rates should not be made unless the registrant has a detailed analysis that supports the specific amount of the increase.

The SEC staff also provided guidance on disclosures in the financial statements and MD&A about the nature of the defined benefit plans and the development of critical assumptions related to the plans. The guidance includes the following matters.

- Assumptions and estimates and changes to those assumptions and estimates that have a material effect on financial condition and operating performance. Changes in assumptions and estimates that may need to be addressed in disclosures include changes in long-term rates of return on plan assets, discount rates used for measuring the benefit obligations, methods of deriving market-related value, average remaining service period and life expectancy, and methods used in amortizing gains and losses.
- Comparison of actual and expected results. Material deviations between results based on the assumptions used by the registrant and actual plan performance, and known material trends and uncertainties relating to plans (including

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[2] SEC, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, June 15, 2005, available at www.sec.gov.

[3] FASB Statement No. 132 (revised 2003), Employers' Disclosures about Pensions and Other Postretirement Benefits, December 2003, available at www.fasb.org.

[4] SEC Division of Corporation Finance, Current Accounting and Disclosure Issues in the Division of Corporation Finance, March 4, 2005, available at www.sec.gov.

those caused by the material deviations) should be disclosed. A sensitivity analysis showing the effects of changes in assumptions about long-term rates of return and actuarial assumptions on the unrecognized gains and losses may also be necessary to sufficiently convey the degree of uncertainty.

- Funding obligations. Material known trends or uncertainties relating to meeting funding obligations, the impact of future payments on future cash flows, and any material uncertainty in the funding obligation should be addressed.

The descriptive and summary statements above are not intended to substitute for the text of FASB Statements 87, 106, and 132R; SEC guidance on disclosures; or any other cited, actual, or potential accounting requirements or studies. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. Those accounting for pensions and other postretirement benefits should refer to the texts of the applicable documents that set out requirements and consult their accounting and legal advisors.

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