Article from:

International News

November 2007 – Issue No. 43

Pension Accounting Changes

by Catherine Robertson

Standards for accounting for pension and post-retirement plans around the world are changing. The ultimate goal is a global standard which will replace International Accounting Standard 19 (IAS 19), which is used in many European countries, as well as in other countries around the world. The first steps in convergence are underway. This first in a series of articles will concentrate on the changes in the United States under their Statements of Financial Accounting Standards (SFAS).

Adapting to a New Reality

At the end of 2006, employers following U.S. accounting standards were faced with a new set of reporting rules for defined benefit pension plans and other post-retirement benefits. The most significant change was a new requirement to recognize immediately the entire funded position of the defined benefit plans directly on the employer's balance sheet, whether the plans are in a surplus or a deficit position.

The U.S. Financial Accounting Standards Board (FASB) issued its Statement of Financial Accounting Standards No. 158 Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans in September 2006. The standard is applicable to financial statements of public companies and not-for-profit organizations sponsoring single-employer pension and other post-retirement benefits plans. It amends parts of FASB Statements Nos. 87, 88, 106 and 132 (R). The changes do not apply to employer financial statements related to multi-employer pension or benefit plans.

What is Different about SFAS 158?

This accounting standard introduces the following new requirements:

- Recognition of a plan's funded status in the balance sheet;
- Immediate recognition of changes in funded status in the balance sheet;
- Footnote disclosure modifications; and
- Measurement of assets and obligations at the end of the employer's fiscal year.

Although the funded position of pension and benefit plans has been part of the disclosure notes in financial statements for a number of years, the recognition of these surpluses and deficits on the employer's balance sheet has generally emerged on a delayed basis under US GAAP, due to the amortization methods applied to past service costs and to experience gains and losses. For certain pension plans in a deficit position relative to the “accumulated benefit obligation,” there has been only limited recognition of the deficit on the employer's balance sheet through the “minimum liability” reporting process.

continued on page 16

Recognition of Funded Status

The new standard now requires employers to recognize the full funded status of benefit plans in the statement of financial position. The funded status of a benefit plan is the difference between the fair value of plan assets and the benefit obligation. For a pension plan, the benefit obligation is the "projected benefit obligation" (i.e., incorporating future salary increases on accrued benefits), and for an Other Post-Employment Benefits (OPEB) is the accumulated post-retirement benefit obligation.

The prior standards allow an employer to recognize in its statement of financial position an asset or a liability arising from benefit plans which in most cases differs from the funded position of the plan as it allows for delayed recognition of actuarial gains or losses and costs of benefit changes. In some cases, an employer could recognize an asset for a plan which was underfunded. In the prior standards, information on the funded status of a plan is provided only in the notes to the financial statements.

Under the new standards, the difference between a plan's funded status and the current balance sheet amount, i.e., any existing unamortized actuarial gains and losses, prior service costs and/or transitional balances will be recognized as a credit or charge through accumulated other comprehensive income (AOCI) without passing through the company's income statement. Essentially, this results in a direct increase or decrease to shareholder equity. For companies with underfunded plans, the reduction could be significant, especially in the first year of reporting under the new rules. A recent evaluation of the financial status of companies sponsoring pension and OPEBs within the S&P500 group indicates that about 25 percent of them will have a material charge to shareholder equity resulting from the implementation of FASB No.158.

For not-for-profit organizations or other entities that do not report other comprehensive income (OCI), the adjustment from recognizing the plan's funding status is reflected in unrestricted net assets.

The status of all overfunded plans shall be aggregated and recognized as an asset on the balance sheet. Similarly, underfunded plans shall be aggregated and recognized as a liability.

This first stage of the project to amend pension accounting standards does not modify the calculation of the net periodic benefit cost (NPBC). Any existing actuarial gains/losses, prior service costs and remaining transitional balances continue to be amortized as under the prior standards, with an appropriate adjustment to OCI as they are amortized.

Recognition of Changes in the Plan Funding Status

Any new actuarial gains and losses and/or prior service costs that arise during a future fiscal period are immediately recognized in the balance sheet. These new amounts can continue to be amortized under the current standards. To the extent that these amounts are not recognized as a component of NPBC in the period that they arise, they are recognized as a component of OCI, with an appropriate adjustment as they are amortized through the NPBC in future periods. For not-for-profit organizations, the reclassified amounts must be shown separately on the statement of activities for the reporting period.

This change results in immediate recognition on the balance sheet of the cost of any future benefit improvements, although the recognition on the income statement continues to be delayed. This could have a significant impact on future changes to plan design.

Disclosures Related to the Recognition

The notes to financial statements have to be changed. Along with the recognition of the plan funded status and its changes during the reporting period in the statement of financial position, the new standard introduces new disclosure requirements and removes the redundant ones. In particular, a footnote reconciliation of AOCI status is now required while a footnote reconciliation of funded status is removed.

The disclosure requirements in respect of reconciliation of the fair value of assets, accrued benefit obligations, cash payments, and assets portfolio remain unchanged.

Effective Dates for Recognition and Related Disclosure

The effective date for recognition of the plan funded status on the balance sheet and for the related disclosures is the end of fiscal year after Dec. 15, 2006 for public companies and six months later, i.e. ,the end of the fiscal year after June 15, 2007, for non-public companies. Application as of the end of an earlier fiscal period is encouraged in both cases, but must be applied to all of an employer's benefit plans. Retrospective application is not permitted, so financial statements for previous reporting periods will not change. The methodology prescribed under FASB Nos. 87, 88, and 106 for measurement of plan assets and benefit obligations, as well as determination of the net periodic benefit cost, continues to apply.

Change of Measurement Date

Plan assets and obligations are to be measured as of the fiscal year end. The new rules no longer permit measurement of assets and obligations up to three months before the fiscal year end.

The effective date of this change is delayed to the fiscal year ending after Dec. 15, 2008, in order to give companies enough time to change their valuation and budgeting processes. Earlier application is encouraged but not required.

The transition from an advanced measurement date to a fiscal year-end date must be accounted for by an adjustment to the retained earnings. The new standard allows for two calculation methods of the adjustment.

The first method is to re-measure the assets and obligations at the beginning of the fiscal year of the new measurement date and to adjust the opening balance of retained earnings by the amount of the NPBC corresponding to the period between two measurement dates.

The second method is to use the earlier measurement and to adjust the retained earnings for the year of transition by the amount of NPBC proportional to the period between the two measurement dates.

Under both methods, any gain and loss arising from a settlement or curtailment during the transition period is recognized in earnings in the period and not as an adjustment to retained earnings. Any gains and losses other than from settlements or curtailments are recognized as a separate adjustment to the opening balance of accumulated OCI.

Future Changes

These changes are the first phase of a two-phase comprehensive review by FASB of all the accounting rules applicable to pensions and OPEBs. The aim of the project is to have a set of rules that are consistent with the international accounting standards.

The first phase of the project focuses on balance sheet recognition. FASB feels these changes will improve financial reporting by providing more complete financial information with the reporting of the plan funded-status, that the statements will be more understandable, by eliminating the need to reconcile with the information currently provided in the notes to the financial statements and that the statements will be more timely by requiring immediate recognition of all transactions in the year.

The second phase of the project is expected to take several years and result in an extensive overhaul of the pension and OPEB accounting rules to improve consistency with international accounting rules as well as address numerous concerns with the current standards. Issues expected to be addressed include measurement of assets, smoothing, recognition of gains and losses, past service costs as well as multi-employer plans. The two-phase approach is also being followed by the International Accounting Standards Board to revise and improve International Accounting Standard IAS 19 (Employee Benefits). No timing has yet been confirmed for the expected completion of phase 2 of the project. ☐

Catherine Robertson, FFA, FCIA, is a consulting actuary with Eckler Partners, Ltd. in Toronto, Ontario. She can be reached at crobertson@eckler.ca.