

New Pension Accounting Rules: Defusing The Retirement Time Bomb

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NOVEMBER 2006 - The SEC and FASB have recently directed their attention to improving the rules for pension accounting. On October 18, 2004, the SEC announced that it was investigating whether six large companies had manipulated earnings when calculating their costs for pensions and retiree health benefits. (The companies were not identified by name.) In particular, the SEC intended to focus on assumptions companies use to calculate current pension expenses. The SEC also planned to examine how companies can use qualified retirement plans to create “cookie jar” reserves that could boost future earnings.

On November 10, 2005, FASB voted to add a project to its agenda that revised SFAS 87, *Employers' Accounting for Pensions*, and SFAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. In its statement, FASB said that it had received many requests to make information about pension obligations and assets more useful and transparent for investors. FASB expects to conduct the project in two phases. The first phase will seek to address the concern that, under current accounting standards, important information about the funded status of a company's plan is reported in the footnotes but not in the body of the financial statements. The second, more comprehensive phase would address the following issues:

- How to best recognize and display in earnings and other comprehensive income the various elements that affect the cost of providing postretirement benefits;
- How to best measure the obligation; in particular, plans with lump-sum settlement options;
- Whether more, or different, guidance should be provided regarding measurement assumptions; and
- Whether postretirement benefit trusts should be consolidated by the plan sponsor.

FASB has addressed the first phase by issuing SFAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, an amendment of SFASs 87, 88, 106, and 132(R). This statement requires employers to recognize the overfunded or underfunded positions of defined benefit postretirement plans, including pension plans, in their balance sheets. Previously, this information was recognized only in the footnotes. Calendar-year public companies will have to apply this requirement when preparing their balance sheet as of December 31, 2006.

The statement requires employers to measure plan assets and obligations as of the date of the financial statements. Companies previously measured benefit obligations as of the balance sheet date or three months earlier. However, the new measurement date requirement will not be effective until fiscal years ending after December 15, 2008.

This article reviews the current rules governing pension accounting and reporting. Because the rules have the overriding goal of minimizing volatility in the periodic measure of pension expense, pension accounting has been strongly pervaded by estimates, a result that has significant consequences for financial statement users. The authors also present a sample of large companies to illustrate how the funded status of a plan was not disclosed in the financial statements and could be determined only by reference to the footnotes.

Qualified plans can be divided into two broad categories: defined contribution plans and defined benefit plans. Defined contribution plans specify the amount of money an employer puts into the plan for the benefit of employees. No explicit promise is made about the periodic payments the employee will receive upon

retirement. Once an employer has paid the defined contribution, there is no additional liability to provide pension benefits. The amount ultimately paid out is determined by the accumulated value at retirement of the total contributed by the employer and by the employee over the term of employment. When employees retire, they receive their share of the accumulated balance from the investments. Accounting for such plans is simple. Each year, the employer records pension expense equal to the amount of the annual contribution.

Defined Benefit Plans

In a defined benefit plan, the formula for determining pension payouts is specified. The risk in these benefit plans is borne by the employer, who must accurately estimate the amount that must be contributed to fund the plan and make future payouts. Defined benefit plans raise many financial reporting complications. The primary difficulty is determining how much should be charged to pension expense each year while covered employees are working. Additional complications result because only the benefit formula is specified, not the benefit amount. Determining the periodic pension expense to be assigned requires the estimation of these factors:

What proportion of the workforce will qualify for benefits under the plan? This forecast requires actuarial assumptions regarding personnel turnover, mortality rates, and disability.

- What is the rate of salary increases until retirement?
- Over what length of time will the benefits be paid?
- What rate of return will be earned by the investments made using the assets of the pension fund?
- What discount rate should be used to reflect the present value of future benefits?

The required disclosure rules are designed to minimize volatility in the recognition of pension expense. Financial managers have traditionally been extremely reluctant to have pension expense affected by the vagaries of investment markets. This objective is achieved through numerous smoothing devices and deferrals when computing pension expense. The resulting rules are some of the most technically challenging and confusing in the accounting literature.

Pension Expense

Accounting for pension plans requires the measurement of pension cost and then the allocation of such cost to appropriate time periods. The determination of pension cost is a complicated task because it is calculated by netting five factors:

- Service cost;
- Interest on the projected benefit obligation;
- Expected return on plan assets;
- Amortization of prior service cost; and
- Effects of gains and losses.

The income statement reports the net amount as pension expense. Each of the components is disclosed in the footnotes accompanying the financial statements.

Service cost. Service cost is defined as the actuarial present value of projected benefits earned by employees in the current accounting period. In other words, it is the increase in pension benefits payable to employees because of services performed during the current year. Future salary levels must be taken into consideration when calculating service cost. The measurement of service cost depends upon the assumptions made in estimating the increases in future pension benefits, such as turnover, early retirement, salary increases, and promotion. Revisions in these assumptions can substantially affect the valuation of service cost.

Interest on the projected benefit obligation. The interest on the projected benefit obligation is the increase in the amount of the projected benefit obligation due to the passage of time. A liability results because pensions are a deferred compensation arrangement. Because a liability is not eliminated until the benefits are paid during retirement, it is recorded on a discounted basis. The discount rate chosen is determined by market interest rates on high-quality investments or the implicit rate of return on retirement annuities. Each year, the plan's obligation increases by the amount of interest that accrues based upon the selected discount rate.

Expected return on plan assets. Pension plan assets usually consist of stocks, bonds, and other investments. The expected rate of return on plan assets is the anticipated increase in the plan assets due to investment activities. The expected return is calculated by multiplying the fair value of the plan assets at the beginning of the period by the expected long-term rate of return on plan assets. This number is subtracted in the computation of pension expense.

Amortization of prior service cost. When pension plans are adopted or amended, credit is often given to employees for service performed prior to adoption or amendment. The cost of this service is called prior service cost. FASB requires the allocation of this cost to be expensed over the remaining service lives of the covered employees. The amount of the prior service cost is measured by the increase in the projected benefit obligation due to the adoption or amendment of the plan. The rationale for delaying recognition of prior service cost is the assumption that the adoption or amendment was made with the expectation of receiving benefits in the future.

Effects of gains and losses. FASB was concerned about how pension expense can be affected by large changes in the market value of plan assets and by changes in the actuarial assumptions that affect the calculation of the projected benefit obligation. Wide fluctuations in pension expense would, of course, enhance the volatility of reported net income. As a result, FASB introduced several provisions intended to reduce the likelihood of significant variation in pension expense from period to period.

One of the most volatile components of pension expense is the actual return on plan assets. Fluctuations in the securities markets create volatility. To dampen its effects, FASB requires the expected return on plan assets to be included as a component of pension expense. This amount is computed by multiplying the expected rate of return (developed by an actuary) by the fair value or the market-related asset value of the plan assets. The market-related asset value of plan assets can be either fair market value or any calculated value that recognizes changes in fair value in a rational and systematic manner over not more than five years. This procedure reduces the volatility of the return on plan assets because it can employ both an expected rate of return and a market-related asset value.

Differences between expected returns and actual returns are called "asset gains and losses" by FASB. Asset gains (actual returns exceed expected returns) and asset losses (actual returns are less than expected returns) are combined with liability gains and losses, discussed below.

In a similar vein, the projected benefit obligation is based upon actuarial assumptions about such items as mortality rates, future salary levels, and employee turnover. Changes in these actuarial assumptions change the projected benefit obligation. Because the expectation for the projected benefit obligation will seldom equal actual experience, unexpected gains and losses result from changes in the projected benefit obligation and are called "liability gains and losses" by FASB. Liability gains (unexpected decreases in the liability balance) and liability losses (unexpected increases in the liability balance) are combined with asset gains and losses to calculate the net gain or loss.

To summarize, the last component of pension cost, net gain or loss, is defined as the change in the amount of the projected benefit obligation, as well as the change in the value of plan assets, changes which occur when

experience differs from expectations. Pension expenses are determined by summing these five components that affect the overall amount:

Component of Impact on Pension Expense	Pension Expense
Service cost	Increases
Interest on the obligation	Increases
Expected return on plan assets	Generally decreases
Prior service cost	Generally increases
Gain or loss	Decreases or increases

Financial Statement Disclosures

A corporation with a pension plan (the plan sponsor) recognizes on its books only the pension expense and the cash paid out when funding the pension. Nevertheless, a company is not required to fund the full amount of the pension expense recognized each period. The amount funded is dependent upon legislation, income tax rules, and working capital needs. A plan sponsor is required to fund at least the annual service cost computed under the plan. If the amount funded exceeds the pension expense recognized on the income statement, the difference is an asset called “prepaid pension cost.” If the amount funded is less than the expense recognized, this difference is a liability called “accrued pension cost.” A company may choose to pay more than the calculated pension expense to pay down an accrued pension liability, or it may pay less to take advantage of prepaid pension costs.

The assets and liabilities of a pension plan are not included in the plan sponsor’s financial statements. The plan trustee receives the contributions to the pension plan and pays out the pension benefits. Pension plans are separate legal entities, which present their own financial statements and file their own tax returns (Form 5500).

The off–balance sheet pension assets and liabilities will usually differ. When pension assets are larger than liabilities, a plan is overfunded. If pension liabilities exceed pension assets, a plan is underfunded.

Survey of Pension Disclosures

After a declining stock market (2000–2002) and with interest rates at an all-time low, many companies had pension plans that were underfunded. Major debt agencies began lowering their bond ratings on companies with the most severe problems. General Motors and Ford both had their bond ratings reduced. *Fortune*, in its December 9, 2002, issue, expressed alarm over the deteriorating finances of many companies, likening it to a horror movie. More recent advances in the stock market have calmed some of the concerns (the S&P 500 Stock Index gained 26% in 2003, 9% in 2004, and 3% in 2005), but many of the country’s largest corporations face serious problems funding their pension commitments.

To illustrate pension disclosures, the authors examined eight large companies with defined benefit plans, along with Berkshire-Hathaway, for purposes of comparison. The results are presented in the [Exhibit](#). IBM and Verizon were included even though both recently announced their intention to freeze their defined benefit pension plans and increase their contributions to their workers’ defined contribution plans. These freezes are emblematic of the trend among U.S. corporations to switch from defined benefit plans to defined contribution plans. The percentage of companies offering defined benefit plans has dropped from 83% in 1990 to 45% as of 2005.

The current funded status of a pension plan as of a given date is the difference between the fair value of the plan assets at that date and the discounted present value of the expected liability. This liability is the

previously mentioned projected benefit obligation (PBO), and is computed using future compensation levels.

For example, Ford's pension plan had a PBO of \$74.595 billion as of December 31, 2005. Meanwhile, the fair value of its plan assets on the same date was \$63.784 billion. Therefore, Ford's pension plan was underfunded to the tune of \$10.811 billion (\$74.595 -- \$63.784). This \$10.811 billion deficit represents the current funded status of the pension plan on December 31, 2005. Nowhere is this important number reflected on the balance sheet. Only by reading the footnotes can this huge amount be determined.

An interesting disclosure in the Exhibit is the expected rate of return that each company expects to earn on its pension plan investments. This number can be used as a simple measure of how aggressive a company is in its pension accounting. Recall the expected—not the actual—rate of return is used in calculating pension expense on the income statement. This calculation is another example of the effort to insulate pension expense from the vagaries of the stock market.

The companies surveyed used expected returns anywhere from 6.40% to 9.00%. Warren Buffett lowered Berkshire-Hathaway's rate of return from 8.3% to 6.5% in 2001, and that assumed rate of return was lowered slightly to 6.4% in 2005. Buffett has repeatedly stated that investors should expect rates of return significantly lower in this decade as compared to the previous two decades. In response, companies cite the long-term rate of return on common stock of 10%, on corporate bonds of 6%, and on government bonds of 5.5% as justification for their high expected rate of return. Return rates have fallen since 2002, with General Motors lowering its expected rate of return from 10% in 2002 to 9% in 2005, Ford lowering its rate from 9.5% to 8.75%, and IBM lowering its rate from 9.5% to 8.0%. However, with interest rates trending upward, budget deficits soaring, and the economy softening, a strong case can be made that expected return rates are still too high. Incidentally, Standard & Poor's 500 Stock Index returned 3.0% in 2005.

The Exhibit also includes the discount rate that companies use to calculate their pension benefit obligation. When the discount rate declines, the pension obligation rises, and conversely, if the discount rate rises, the pension obligation drops. Companies do not have as much flexibility in choosing the discount rate as in choosing the expected return rate, but investors should pay attention. In 2003, the SEC was pressured by corporations to allow them to use a higher discount rate that would reduce their pension obligations. Fortunately, the SEC stood fast. On March 4, 2005, the SEC issued a pronouncement that included a discussion of its position on pension accounting (search for "pension accounting" on www.sec.gov).

The Uncertainty of Estimates

The accounting for pensions involves the estimation of a number of factors that are highly uncertain. The computation of pension expense requires estimates of future discount rates, expected return on plan assets, and future events such as employee turnover and employee mortality. Pension accounting is replete with estimates. When the estimates do not conform to reality, adjustments have to be made. Recording these adjustments in a single year was unacceptable to FASB, which chose to defer their effect and allocate the difference between expected and actual amounts over a series of future years. The goal of smoothing the effect of expensing pension on income is producing financial statements that seriously understate the cost of pensions and exclude the bulk of pension assets and liabilities. The only way to truly understand pension costs and the extent of over- or underfunding is to examine the pension footnotes in a company's Form 10-K. The issuance of SFAS 158 will require that the funded status of a pension plan be reflected on a company's balance sheet as of December 31, 2006. SFAS 158 does not, however, change how pensions are accounted for and reported in the income statement.

The Pension Benefit Guaranty Corporation (PBGC), the federal agency responsible for insuring private-sector pension plans, reported a deficit of \$22.8 billion as of September 30, 2005. Executive Director Bradley D. Belt stated that "the money available to pay benefits is eventually going to run out unless Congress enacts comprehensive pension reform to get plans better funded and provide the insurance

program with additional resources.” The pension insurance program’s exposure to future losses was estimated to be a staggering \$108 billion in 2005, up from \$96 billion in 2004 and \$82 billion in 2003. In its 2004 fiscal year, the agency took over 192 pension plans, up from 155 the previous year. Problems are particularly acute in the airline industry and the manufacturing sector, especially the steel industry. Experts expect the problem to worsen as companies with defined benefit plans attempt to reduce or even eliminate their pension obligations.

The PBGC’s looming funding crisis was one of the reasons behind the Pension Protection Act of 2006, signed into law by President Bush on August 17, 2006. This legislation will give most companies seven years to fully fund their pension plans and will require accelerated payments from those companies whose plans are seriously underfunded. But the compromises made to get support for the bill will likely limit its effectiveness. The rules don’t become effective until 2008, meaning that most companies won’t be required to fully cover their liabilities until 2015. The longer it might take for companies to fully fund their pension plans, the more important it is for investors to become familiar with how these liabilities are calculated and accounted for.

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