ACCOUNTING TRANSPARENCY FOR POST RETIREMENT BENEFITS: COULD THE NEW FASB STANDARD RESULT IN NEGATIVE EQUITY?

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ABSTRACT

The Financial Accounting Standards Board (FASB) issued a new standard, Statement of Financial Accounting Standards (SFAS) No. 158, Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, on September 29, 2006, which is an amendment of FASB Statements No. 87, 88, 106, and 132R. This new standard may drastically impact stockholders' equity for many companies and possibly even cause it to be negative.

INTRODUCTION

SFAS 158 is the first phase of the Board's comprehensive project to improve the reporting and accounting for defined benefit plans and other postretirement benefits. Phase 2 of FASB's project will address the measurement and recognition issues that will affect the amount of pension expense on a company's income statement. This new standard requires companies to account for their pensions and other postemployment benefits (OPEB) in a way that could potentially change the equation as we know it for some companies. SFAS 158 requires that a company recognize, as an asset or liability, the full underfunded or overfunded status of its benefit plan in its 2006 year-end balance sheet. For most companies this new treatment will cause an increase in liabilities. The offset to any increase in pension liability will be to an equity account, accumulated other comprehensive income (AOCI) rather than to the income statement under this new standard. Hence, for some large companies, the decrease in equity will exceed the current balance, resulting in a negative equity balance. Thus, the impact of pension reform could be more profound than expected.

Pension reform has been the subject of lively debate in Washington, which led to the Pension Protection Act of 2006 on August 17. The pension/healthcare crisis is twofold: the *first issue* is the actual funding of postemployment benefits and the *second issue* is the reporting of such benefits in the financial statements. The magnitude of the actual underfunding of pensions and OPEB is evidenced by the fact that the Pension Benefit Guaranty Corporation (PBGC), which was created in 1974 to help guarantee companies' pension plans, has a deficit for 2005 of $22.8 billion (Adams 2005). In recent years, the PBGC has had to assume the pension obligations of several large, insolvent companies. Furthermore, the Government Accountability Office estimates that the country's pension plans total $600 billion in the red (Cheney 2006). Moreover, this figure does not include the cost of other post employment benefits such as healthcare. Underfunded pension plans did not truly come into the limelight until the stock market fell at the end of 1999, and interest rates also declined. Companies were then caught in a situation where the actual return on plan assets was dramatically less than their actuarial assumptions.

The second issue is the financial *reporting* implications of pensions and OPEB. Historically, FASB has attempted to address postemployment benefit issues in the corporate financial statements. Unfortunately, compromises were made that resulted in minimal inclusion in the balance sheet with mainly footnote disclosures. This treatment does not appear to be a huge problem for a sophisticated financial statement reader. However, the Securities and Exchange Commission (SEC) conducted a study in 2005 and concluded that transparency and comparability are an issue in the accounting for pensions and OPEB

(Milliman, 2005). As a result the FASB has issued SFAS 158. Even though it is Phase one of FASB's project and typically affects only the balance sheet, it could have a dramatic impact for some companies.

LITERATURE REVIEW

For financial information to be useful, it must be understandable to reasonably informed users. Prior to SFAS 158 it was fairly difficult for average users to look at a company's balance sheet and be able to know the full extent of its liability for its pension plan and OPEB. Generally accepted accounting principles did not require companies to disclose the funded status of the plan (the difference between the projected benefit obligation and the fair value of the plan assets at the end of the year) in the corporate financial statements. In accordance with Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pension Plans* (SFAS 87) and Statement of Financial Accounting Standards No.106, *Employers' Accounting for Postretirement Benefits Other than Pensions* (SFAS 106), companies are allowed to use smoothing techniques that have the effect of delaying the recognition of certain retirement benefit costs such as changes in actuarial assumptions and plan amendments. In addition, the balance sheet reflected "net" reporting prior to SFAS 158's implementation. If the contributions to the pension plan for the year exceeded pension expense, then a "prepaid" pension asset was reflected on the balance sheet even though the pension plan may in fact have been underfunded. Moreover, as indicated in the Wall Street Journal (Schultz, 2004) analysts were concerned that some companies may have used unrealistically high discount rates, which underreported the present value of their future pension obligations.

Under SFAS 87, companies can reduce pension expense for the *expected* return on plan assets (even if their assumptions are unrealistic) rather than the *actual* return on those assets (one of the smoothing techniques noted earlier under the current accounting for pensions). When actual returns diminish as they did after 1999 and prior to 2004, companies could conceivably record a pension profit (reduce the expense) based on their expected return even if their actual return on plan asset declined during the period. Although plan assets have recorded actual gains in 2004 and 2005, the gains have not been large enough to prevent the increase in pension expense that companies are incurring. Because of perceived abuses by some companies, the SEC began to aggressively question management's assumptions with regard to their expected returns on plan assets. As a result, companies have had to use more realistic discount rates in recent years, which have also increased pension liabilities.

Pension and OPEB information contained in financial statements prior to SFAS 158 implementation was neither complete nor transparent. Some postretirement benefit accounts were maintained "off balance sheet". The funded status of a company's benefit plan was buried in the footnotes to the financial statements, and without very carefully reviewing the notes to the financial statements, users may not recognize a continually growing pension liability. Furthermore, SFAS 87 and SFAS 106 include many compromises to eliminate volatility and require overly complex computations. Since SFAS 158 does not affect the income statement, it will not affect most financial ratios. Published debt to equity ratios, called the leverage ratio, typically includes debt and excludes other liabilities including retirement obligations. However, lenders in their loan covenants also include the more typical definition of total liabilities divided by total stockholders' equity, which is sometimes called the debt to book value ratio. This ratio would be affected by this new accounting standard.

Recording the full liability for pensions and OPEB may require resetting some financial ratios including the debt-to-book value ratio, which lenders, investment bankers and investors use to evaluate companies.
Although these additional liabilities may impact existing loan covenants, the reality is that lenders will probably agree to modify the covenants so that companies are still in compliance based on the argument that these liabilities have already been previously disclosed in the footnotes. Lenders may initially downplay the impact of this accounting change because to do otherwise would be an admission on their

part that they may not have fully understood the implications of the retirement footnote. However, it is safe to assume that lenders will subsequently have much greater concern in lending to companies that show a diminished or negative stockholders' equity.

The new Pension Protection Act of 2006 and SFAS 158 have added to the momentum of declining defined benefit pension plans and the movement towards defined contribution plans such as 401(k)s, particularly with the currently mobile workforce. "These findings are a wake-up call," said John Morrow, Vice President of the AICPA's division for CPAs in business and industry. "The traditional system of rewarding employees with pensions after long years of service is on its way out, because companies simply cannot bear the cost. Therefore, employees will have to find alternate methods of funding their retirement."

FASB ADDRESSES PENSION AND HEALTH CARE COSTS

In response to demands for more relevant and complete information regarding pension plan obligations, the FASB issued SFAS 158 on September 29, 2006, which amends Statements of Financial Accounting Standards Nos. 87, 88, 106, and 132R. (The complexities of this new standard, such as the treatment of transition obligations, are beyond the scope of this article.) As stated by the FASB, "The Board has issued this Statement to address the concern that existing standards … fail to produce representationally faithful and understandable financial statements". The objective of the statement is to make postemployment benefit information more complete, useful, understandable, and transparent for investors, creditors, retirees, donors and others. This statement will require companies to report the "current economic status" as to whether a plan is overfunded or underfunded in its balance sheet rather than a footnote reconciliation of pensions and OPEB. SFAS 158 is effective as of the end of the fiscal year ending after December 15, 2006, for entities with publicly traded equity securities, and at the end of the fiscal year ending after June 15, 2007, for all other entities.

As mentioned, FASB's plan to make pension accounting reflect reality will be done in *two phases*. Phase No. 1 resulted in SFAS 158. Phase No. 2 beginning in 2006 has an estimated completion date of 2009 or 2010. Phase No.1 does not change how pension plan assets and benefit obligations are measured nor does it change the basic approach for measuring pension expense. Rather, Phase 1 concentrated on the balance sheet implications of fully recognizing the funded status of defined benefit plans and OPEB. Therefore, this new standard has virtually no impact on a company's results of operations or cash flows. Phase No. 2 of the project, which FASB expects to collaborate with the International Accounting Standards Board, will address measurement and recognition issues related to changes in the fair value of plan assets and the benefit obligation.

METHODOLOGY

To estimate our amounts above, the authors followed the guidance provided by Deloitte (2006) per the above illustrative example journal entry. We documented the amounts and sources of the off-balance sheet accounts and then determined whether the unrecognized amounts were from prior service, deferred actuarial gains and losses or from transition obligations. We also totaled the unrecognized amounts by plan source: U.S. pension plans, non-U.S. pension plans, and OPEB. The net pension liability is recorded as a liability on the balance sheet now and previously deferred amounts are charged to AOCI.

IMPACT ON CORPORATE FINANCIAL STATEMENTS

It is important to note that as previous mentioned changes made to the balance sheet under SFAS 158 will not pass through the income statement but rather are recorded as a charge or credit to AOCI, thereby directly impacting shareholders' equity. Typically, companies will see more of an impact on their

shareholders' equity if they have an asset on their books relating to their pension plan which must be eliminated before recording the actual retirement plan liability.

Illustration

Assume under SFAS Nos. 87 and 106, the XYZ Company had the following year end balances related to its pension plan (all previously required footnote disclosures):

Underfunded status of pension plan	$400 Million (*To be Recorded*)
Unrecognized prior service cost	$200 Million (*Off balance sheet account*)
Net actuarial loss	$250 Million (*Off balance sheet account*)
Unrecognized transition obligation	$ 50 Million (*Off balance sheet account*)
Prepaid Accrued Pension Cost	$100 Million (*Asset on Balance Sheet*)

Assuming a 40% tax rate, the journal entry required under the new rules would include:

Deferred Tax Asset	200,000,000 *	
Acc Other Comprehensive Income (AOCI)	300,000,000	
Pension Liability		400,000,000
Prepaid Accrued Pension Cost		100,000,000

**Unrecognized prior service cost of $200 million + $250 million of net actuarial loss + $50 million of unrecognized transition obligation = $500 million * 40% tax rate = $200 million. Guidance provided by Deloitte (2006).*

As indicated by the above entry, stockholders' equity (AOCI component) would decrease by $300 million, which represents the unrecognized prior service cost, actuarial losses and unrecognized transition obligations while liabilities would increase by $400 million and assets would increase by $100 million (net). Note that XYZ Company went from recording a $100 million pension asset to recognizing a $400 million pension liability.

To put this into perspective, according to Milliman's (2005) study of 100 large U.S. corporations that sponsor defined benefit pension plans, if this standard which requires recording a liability for pensions and OPEB had been in effect for 2005, stockholders' equity would have been decreased by $222.2 billion! In addition, the previously unrecorded OPEB liability would also be recorded and further reduce stockholders' equity. It is important to note that as previously stated the adjustment required under the new rules does not directly impact corporate earnings.

This new standard was issued in September 2006. Although the implementation date is December 15, 2006, possible results for some companies are illustrated below. If the following companies were to fully record the liability required for their pension plans and other postretirement obligations (i.e., health care and life insurance), our estimate of the potential impact on stockholders' equity based on the information provided in the 2005 Form 10K footnotes. We have assumed a 40% tax rate (35% corporate and 5% state) for the following companies for illustrative purposes. (Of course, many assumptions could be updated or changed which would lead to different potential results from this SFAS 158 implementation.)

CORPORATE AMERICA RESPONDS

Comment letters received by the FASB while this standard was still an Exposure Draft voiced objections to the proposed standard. One of the strongest objections was the use of the Projected Benefit Obligation, which incorporates future pay raises into the liability calculation, rather than the currently used Accumulated Benefit Obligations which does not and therefore results in a lower liability calculation.

Table 1: Potential SFAS 158 Impact If Implemented for 2005 (Millions of dollars)

Company	2005 Stockholders' Equity *BEFORE* SFAS 158	2005 Stockholders' Equity *AFTER* SFAS 158	Stockholders' Equity % Change in
Ford	12,957	($895)	(107%)
Boeing	11,059	2,997	(73%)
IBM	33,098	18,210	(45%)
Lockheed	7,867	4,599	(42%)
Federal Express	9,588	8,055	(16%)
Raytheon	10,709	9,249	(14%)

As mentioned, the PBGC and the SEC were previously concerned that some companies used overly optimistic assumptions when calculating their expected return on plan assets. With this liability adversely affecting a company's net worth, the possibility remains that if these retirement liabilities are significant, there may be companies who will employ unrealistic assumptions to understate the amount of their liability obligations. There are a number of assumptions including the discount rate that could vary. Changes in assumptions could increase or decrease the impact of implementing SFAS 158. One example might be underestimating future increases in either salary levels or healthcare costs that are used to calculate the costs of defined benefit plans, which would thus reduce a company's retirement liability on the balance sheet. According to Beck 2006, "Investors can see that information in the pension footnote found in the annual report, where companies give the rate of compensation increase for the past few years. It should raise a red flag if that rate differs from the trend seen in the past, or from what competitors show."

As stated earlier, some of the more sophisticated financial statement users are commenting that the change from a footnote disclosure to a recognized liability on the balance sheet should not be an issue. However, the reality is that recording these liabilities on the books now will significantly decrease stockholders' equity and in some cases cause a company's stockholders' equity to actually be negative, which may have an effect on their ratings and investor confidence.

ACTUAL IMPACT ON SPECIFIC COMPANIES AS OF DECEMBER 31, 2006

How does the implementation of SFAS 158 look like for actual companies as of December 31, 2006? A search of the following companies' recent financial disclosures on EDGAR revealed the impact to their stockholders' equity as a result of implementing this new accounting standard.

Table 2: SFAS 158 Impact for 2006: Stockholders' Equity Decrease *

Company	2006 Change in Stockholders' Equity from SFAS 158 Implementation (Millions of dollars)
Boeing	($6,509)
IBM	($9,498)
Lockheed	($3,069)
Raytheon	($1,338)

** Actual implementation results for Ford and Federal Express were not available. SFAS 158 is effective for FedEx and FedEx Express as of May 31, 2007.*

An examination of the percentage decrease in stockholders equity (AOCI) for the above companies resulting solely from the actual implementation of SFAS 158 is more revealing.

Table 3: SFAS 158 Impact for 2006: Stockholders' Equity Percentage Change (Millions of $)

Company	Stockholders' Equity BEFORE SFAS 158**	Stockholders' Equity AFTER SFAS 158	Stockholders' Equity % Change
Boeing	11,248	4,739	(58%)
IBM	38,004	28,506	(25%)
Lockheed	9,953	6,884	(31%)
Raytheon	12,439	11,101	(11%)

*** Methodology: Stockholders' Equity as of December 31, 2006 adding back SFAS 158 implementation adjustment.*

IMPLICATIONS OF ASSUMPTIONS USED BY COMPANIES

Actuarial firms are typically used to compute expense and income for a company's benefit plans. Many actuarial assumptions are used in estimating pension expense or income. These assumptions include the discount rate, the long-term rate of return on plan assets, rates of increase in future compensation levels and mortality rates. Each company determines their own rate of compensation increases, based upon its long-term plans for such increases. Mortality rates are updated periodically based on the actual experience of a company, and assumptions are based on life expectancy and death rates for different types of participants. The amount and timing of expected contributions to plans and benefit payments to plan participants can also make a difference in a company's calculations. Since assumptions can have a material impact on the valuations, investors need to carefully read the pension footnotes for any changes in assumptions to understand their impact on financial statements.

A partial explanation for the fact that 2006 SFAS 158 implementation results for Lockheed might look a bit different from projected results for the previous year includes but is not limited to the fact that Lockheed increased their discount rate assumption to 5.875% at December 31, 2006, compared to 5.625% used at the end of 2005. This change, together with other factors such as the effects of the actual return on plan assets over the past few years, resulted in Lockheed's projecting that the amount of pension expense for 2007 will decrease by approximately 25% as compared to 2006 expense. Lockheed indicated that "In 2006, the minimum pension liability decreased from the balance recorded at December 31, 2005, primarily due to a higher than expected return on benefit plan assets in 2006 and the increase in the discount rate assumption..."

A review of IBM's 2006 10K indicates that they changed their mortality rate assumption thereby increasing 2006 income by approximately $55 million. Changes to the rate of compensation increases reduced IBM's 2006 net periodic pension cost, which therefore increased income by approximately $32 million. Furthermore, IBM stated in their most recent annual report that they assume that the healthcare cost trend rate for 2007 will be 8 percent. In addition, the company assumes that the same trend rate will decrease to 5 percent over the next four years. One wonders what the true healthcare cost trend is and what assumptions have been made or changed by various companies. This is an issue that FASB will take into consideration during Phase 2 of their Pension reform project.

CONCLUSION

Milliman's (2006) study of 100 large U.S. corporations that sponsor defined benefit pension plans indicated that although the aggregate pension deficit decreased by $14.8 billion in 2005, the aggregate pension deficit for these 100 companies was still $96 billion. If interest rates continue to rise, it will enhance funding to the extent that actual returns on pension assets will exceed expected returns. Thus, inflation can save investors as it has during 2005 and 2006. However, offsetting this is the fact that many pensions have cost of living increases. Furthermore, healthcare costs are significant and have been increasing at a rate of approximately 10% a year. Further complicating this issue is the fact that approximately 75 million baby boomers will become eligible for benefits in the very near future and retirees are also living longer.

Thus, FASB has taken an important step with this new standard to help average financial statement users understand the magnitude of a company's retirement obligations by recording them on the balance sheet. It is interesting to note that although pension liabilities get the most publicity and employers have anticipated their pension liabilities with some prefunding, it is actually the almost entirely unfunded retiree healthcare costs that will be the big surprise. Healthcare costs are difficult to predict and unlike pension obligations cannot be easily hedged. Actuaries have estimated that it costs about 20% of wages.

Healthcare premiums and expenses have experienced double digit increases in recent years. OPEB has even been described by some as a financial tsunami.

The more human aspect of the impact of this new standard could be to hasten the demise of the defined benefit plan as we know it and the curtailment of postemployment benefits for new employees. Another unintended consequence may be a renewed interest in the establishment of a national healthcare system which could take corporate America off the hook for retiree healthcare coverage thereby eliminating or reducing their OPEB liability.

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