

CLIENT REPORT

VOLUME 1, ISSUE 2

NOVEMBER 21, 2006

STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 158

The Financial Accounting Standards Board (FASB) recently completed Phase I of their multi-year project of revising the accounting requirements of defined benefit pension plans and other post-employment benefit plans (OPEBs), like retiree health care. On September 29, FASB issued Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans". This statement makes significant changes to the balance sheet entries for companies sponsoring defined benefit plans and/or OPEBs. However, there were no changes made to the calculation of annual expense as recorded on the income statement. Under Phase II of this project, FASB intends to examine carefully the annual expense calculation. Statement 158 amends prior FAS Statements 87, 88, 106, and 132R.

Balance Sheet Liability

FASB's primary goal in Phase I was to require plan sponsors to clearly illustrate the current funded status of retirement plans directly on their balance sheet. Thus, for fiscal years ending after 12/15/2006 for companies with publicly traded securities (and ending after 6/15/2007 for all others), plan sponsors must include a liability equal to the excess of their retirement plans' benefit obligations over their plan assets, or include an asset if plan assets exceed obligations. This change makes retirement plan liabilities more understandable and visible for

investors, creditors, employees, and retirees. However, it creates significant volatility for plan sponsors to manage. The demand for transparency erased the smoothing and deferral methods designed in FAS 87 two decades ago specifically to dampen that volatility.

Prior to FAS 158, the difference between obligations and plan assets was shown in the footnotes to the financial statements. On the balance sheet, the plan's shortfall was reduced by the obligations that had not yet been expensed on

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the income statement due to the deferral techniques allowed under FAS 87, often resulting in a net prepaid asset on the balance sheet. However, if a plan's accumulated benefit obligation exceeded the plan's assets, a liability at least as large as that shortfall had to be shown on the balance sheet. FAS 158 simplifies the process – the difference between obligations and assets is recorded. But FAS 158 takes it a step further by defining the obligations to be

the projected benefit obligations (PBO) instead of the accumulated benefit obligations (ABO). A plan's PBO reflects benefits based on expected future pay and can be substantially larger than a plan's ABO, especially for plans that provide benefits based on highest average pay. The switch to PBO from ABO has been highly questioned by many employers and actuaries, but FASB ultimately concluded that PBO was the appropriate measure. For OPEB plans, the difference between the accumulated postretirement benefit obligations (APBO) and plan assets must be shown. This liability could be significant since many retiree health care plans are not pre-funded meaning that the entire APBO will show up as a liability.

Since the annual expense calculation will continue to utilize smoothing and deferral techniques, changes in the plan's funded status that are not recognized in the annual expense will be captured as an adjustment to other comprehensive income in order to make the balance sheet position reconcile from year to year. As liabilities are subsequently amortized as annual expense, they will be offset by a reversal of other comprehensive income. Not-for-profit organizations will capture the change under their unrestricted net assets.

Measurement Dates

Historically, plan sponsors have been allowed to measure plan obligations and assets up to three

ALLIANCE BENEFIT GROUP
OF INDIANA

9320 Priority Way West Drive
Indianapolis, IN 46240-1468

P. O. Box 80883
Indianapolis, IN 46280-0883

Phone: 888-290-1206

Fax: 317-254-4480

www.abgindiana.com

months prior to the end of their fiscal year. FAS 158 requires the measurement date to be the last day of the fiscal year for all fiscal years ending after 12/15/2008. This change will put added pressure on plan sponsors to pick year-end assumptions, actuaries to measure liabilities, and investment managers to finalize asset values. In addition, for those currently using an early measurement date, the extra months of expense for the time between the last early measurement date and the fiscal year-end will reduce the retained earnings on the balance sheet, but will not hit the income statement like normal pension expense does.

Conclusion

While the measurement date change is primarily a nuisance, the balance sheet changes could have huge implications for a company's net equity position. The impact on employers will vary greatly based on their plan's current situation. For some, the change could be large enough to affect loan covenants and other arrangements that hinge on the equity position shown in the financial statements. Please contact your Alliance Benefit Group consultant to see how your organization may be affected.

