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Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

FASB Issues Statement 158

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Introduction

As soon as the end of this year, many balance sheets will change — some quite dramatically — when companies adopt FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans — an amendment of FASB Statements No. 87, 88, 106, and 132(R)*.¹ Released last week, Statement 158 requires most public companies, as defined in the Statement, to **fully recognize an asset or liability for the overfunded or underfunded status of their benefit plans** in financial statements for years ending after December 15, 2006. The pension asset or liability equals the difference between the fair value of the plan's assets and its benefit obligation.

The decision by the Financial Accounting Standards Board ("FASB" or "Board") to defer (until Phase 2 of the postretirement benefit project) reconsideration of how benefit plans should be measured means that Statement 158 retains the Exposure Draft's approach: the benefit obligation is measured as the projected benefit obligation (PBO) for pension plans and as the accumulated postretirement benefit obligation (APBO) for other postretirement benefit plans. **Accordingly, Statement 158 does not affect how an entity computes its benefit expense recognized in the income statement.**

But the Statement differs from the Exposure Draft in two important ways:

- Transition for the recognition provisions are now entirely prospective. In recognizing the plan asset or liability, the Exposure Draft required certain elements to be recorded as a cumulative-effect adjustment back to the earliest year presented (retrospective application); and
- Statement 158 postpones until 2008 the requirement, carried forward from the Exposure Draft, that **the measurement date for plan assets and liabilities must coincide with the sponsor's year end**. The standard provides two ways for companies to make the measurement-date transition. Today, the measurement date may differ by up to three months.

¹ FASB Statements No. 87, *Employers' Accounting for Pensions*; No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*; No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*; and No. 132(R), *Employers' Disclosures About Pensions and Other Postretirement Benefits*.

Recognizing a Plan's Funded Status on the Balance Sheet

How does a company recognize a plan's funded status on its balance sheet? The asset or liability is the offset to an entry posted to other comprehensive income (OCI), consisting of previously unrecognized amounts, namely (1) prior service costs and credits, (2) gains or losses, and (3) transition obligations and assets. In subsequent periods, these amounts are reclassified from OCI and recognized in income as components of net periodic benefit cost pursuant to Statements 87, 88, and 106. Stated another way, Statement 158 does not change how these amounts are recognized in an entity's income statement

Editor's Note: Recording the unrecognized transition obligations and assets as a component of OCI is a change from the Exposure Draft, which had required an adjustment to opening retained earnings. Under Statement 158, these items will continue to affect future earnings.

See [Appendix B](#) of this *Heads Up* for an example of the impact of the recognition provisions of Statement 158 on a company's financial statements.

Presentation and Classification

When presenting the asset or liability in the balance sheet, employers cannot aggregate plan assets and benefit obligations of overfunded plans with the plan assets and benefit obligations of underfunded plans. Instead, the standard requires (1) **assets derived from all overfunded plans to be aggregated** and recognized as an asset and (2) **liabilities derived from all underfunded plans to be aggregated** and recognized as a liability.

How are current and noncurrent assets and liabilities determined? If an entity presents a classified balance sheet, Statement 158 requires that the current and noncurrent portions of any postretirement benefit asset and/or liability be reported separately and determined on a plan-by-plan basis.

A postretirement liability should be classified as noncurrent unless the fair value of the plan's assets is insufficient to cover the benefit payments expected to be made over the next 12 months or, if longer, the operating cycle. When such a deficit exists, a current liability equal to the current expected benefit payments in excess of the fair value of the plan's assets should be recognized.

Example 1

A company, with a classified balance sheet, sponsors a defined benefit postretirement plan with a funded status resulting in a \$200 postretirement liability. The fair value of the plan's assets is \$100 and the plan's expected benefit payments are \$50 over the next 12 months. The company classifies the entire \$200 liability as a noncurrent liability since the fair value of the plan's assets is sufficient to cover its expected benefit payments over the next 12 months.

Example 2

Assume the same facts as above except that the fair value of the plan's assets is only \$40. The company should record a current liability of \$10 and a noncurrent liability of \$190.

Statement 158 concludes that postretirement assets should be presented as noncurrent in a classified balance sheet.

When to Measure Plan Assets and Benefit Obligations

Annually, entities must measure the fair value of plan assets and benefit obligations **as of the date of their year-end balance sheet**. No longer will an entity have months to measure the funded status of its plan(s) by being able to choose a measurement date up to three months prior to year end. Compared to the Exposure Draft,

the timing for adoption of this provision has been significantly extended; it will be effective for all entities in fiscal years ending after December 15, 2008. The Board provided this extension to allow preparers and their service providers (i.e., actuaries and plan trustees) sufficient time to implement necessary reporting changes.

To alleviate timing constraints, the Statement provides (see paragraph B95) that certain information can be prepared earlier than the balance sheet date and projected forward to account for subsequent events. However, the Board appears to have intended to limit these estimates to plan participant demographic data and employee service and not to the measurement of most plan assets or the determination of appropriate discount rates.

There are instances when it is appropriate not to align measurement and year-end dates. Statement 158 provides that (1) if a subsidiary is the plan sponsor and is consolidated using a different fiscal period from its parent's, the parent should measure the subsidiary's postretirement benefit plan assets and benefit obligations as of the same date used to consolidate the subsidiary; or (2) if the plan is sponsored by an equity method investee and the financial statements of the equity method investee are not available timely for the investor to apply the equity method currently, the investor should measure the investee's plan assets and benefit obligations as of the date of the investee's financial statements that were used to apply the equity method. **This may require the equity method investee to perform multiple measurements of its plan assets and benefit obligations.** For example, an equity method investee and its investor each have a calendar year end. Based on the timing of the availability of the equity method investee's financial statements, the investor accounts for its equity method investment on a one-month lag (i.e., the investor uses the equity method investee's November 30 financial statements to record its equity pick-up in its December 31 financial statements). Under paragraph 5 of Statement 158, the equity method investee is required to measure its plan assets and benefit obligations as of November 30 for purposes of the investor's financial statements and again as of December 31 for its own stand-alone financial statements.

Transition for the Change in Measurement Date

Statement 158 provides two transition alternatives related to the change in measurement date provisions. The first alternative, which was included in the Exposure Draft, requires that an entity that uses a measurement date earlier than its year end perform two separate measurements within a few months of each other. In response to constituent concerns, the Board developed the second alternative (the "15-month" alternative)² to help reduce the costs associated with transition.

Example

In preparing for the adoption of the change in measurement date provisions of Statement 158, a calendar year-end company that currently uses a September 30 measurement date will measure its plan assets and benefit obligations as of September 30, 2007, for its annual financial statements.

Dual Measurement Approach (Paragraph 18 Transition Guidance)

The company performs another measurement on January 1, 2008, to determine the net periodic benefit cost for 2008. On January 1, 2008, the company recognizes the net periodic benefit cost³ for the period between September 30, 2007, and January 1, 2008, net of tax, as a separate adjustment to the **opening balance of retained earnings**. Any change in the fair value of plan assets and benefit obligations for the period between September 30, 2007, and January 1, 2008, should be recognized, net of tax, as a separate adjustment to the **opening balance of accumulated OCI** on January 1, 2008. Note that any gains and losses resulting from a settlement or curtailment that occurs in the fourth quarter of 2007 or later should be recognized in earnings in the period it was incurred and not as an adjustment to retained earnings.

² The "15-month" alternative refers to the fact that a company may take up to 15 months before performing a second measurement upon adoption of the change in measurement date provisions of Statement 158 (e.g., a calendar year company that has a September 30 measurement date performs a measurement on September 30, 2007, and not again until December 31, 2008).

³ The cost is exclusive of any gain or loss from a curtailment or settlement incurred in that period.

15-Month Alternative (Paragraph 19 Transition Guidance)

The September 30, 2007, measurement is used to determine the net periodic benefit cost for the next 15 months (i.e., from October 1, 2007, through December 31, 2008). The net periodic benefit cost⁴ should be proportionately allocated between amounts to be recognized as an adjustment to retained earnings and net periodic benefit cost for 2008. In this example, three-fifteenths of net periodic benefit cost determined for the 15-month period should be allocated as an adjustment to retained earnings and the remaining twelve-fifteenths should be recognized as net periodic benefit cost for 2008. The company's next measurement date is December 31, 2008. That measurement would be used to record the funded status of its plan for the December 31, 2008, financial statements and to determine the net periodic benefit cost for fiscal year 2009. In addition, any change in the fair value of plan assets and benefit obligations for the period between the September 30, 2007, and December 31, 2008, is recognized in OCI on December 31, 2008. Note that any gains and losses resulting from a settlement or curtailment that occurs in the fourth quarter of 2007 or later should be recognized in earnings in the period it was incurred and not as an adjustment to retained earnings.

Disclosures

Statement 158 prescribes certain disclosures in an entity's annual financial statements. Entities will be required to **separately disclose** the following:

- The amount of net gain or loss and prior service cost or credit recognized in OCI, separated into two categories: amounts arising during the period and recognized in OCI and amounts subsequently recognized as adjustments to OCI as they are recognized as components of net periodic benefit cost.
- The amount of any net transition asset or obligation, recognized as an adjustment to OCI, as that amount is recognized as a component of net periodic benefit cost.
- The amount of net gain or loss, prior service cost or credit, and net transition asset or obligation included in accumulated OCI.
- The estimated portion of (1) the net gain or loss, (2) prior service cost or credit, and (3) net transition asset or obligation that will be recognized as a component of net periodic benefit cost over the next fiscal year.
- The amount and timing of any plan assets expected to be returned to the entity during the next fiscal year.
- The incremental effect of applying Statement 158 on individual line items in the year-end balance sheet. This disclosure is only required in the initial year in which the recognition provisions of Statement 158 are adopted.
- The adjustments to retained earnings and accumulated OCI from applying Statement 158. This disclosure is only required in the initial year in which the change in measurement date provisions of Statement 158 are adopted.

Entities that issue year-end financial statements, but have not yet adopted the recognition provisions of Statement 158, must disclose a brief description of its provisions and the date they plan to adopt the recognition provisions.

Example

A calendar year-end entity that does not have publicly traded equity securities is required to adopt the recognition provisions of Statement 158 in its 2007 financial statements (see below). Unless it early adopts the provisions of Statement 158, the entity must make this disclosure in its December 31, 2006, financial statements.

⁴ See Footnote 3.

Not-For-Profit Organizations

What's different for not-for-profits? Very little, except for guidance related to the placement of amounts that would otherwise be recorded in OCI. The Statement 158 guidance for not-for-profit organizations related to the change in measurement date, recognition of net periodic benefit costs, and disclosures is similar to that for for-profit business enterprises, as described above.

Effective Date and Transition

The effective dates for the various provisions of Statement 158 are as follows:

	Recognition of Asset or Liability Related to the Funded Status of a Plan and Disclosures	Change in Measurement Date
Entities With Publicly Traded Equity Securities⁵	Fiscal years ending after December 15, 2006.	Fiscal years ending after December 15, 2008.
All Other Entities	Fiscal years ending after June 15, 2007.	Fiscal years ending after December 15, 2008.

Earlier application is encouraged.

Statement 158 must be applied prospectively. Detailed transition guidance for business entities is included in tabular format in [Appendix A](#) of this *Heads Up*.

⁵ Under Statement 158, an entity with publicly traded equity securities is defined as (1) an entity that has issued equity securities that trade in a public market, which may be either a stock exchange (domestic or foreign) or an over-the-counter market, including securities quoted only locally or regionally; (2) an entity that has made a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market; or (3) an entity that is controlled by an entity covered by (1) or (2). It does not include obligors for conduit debt securities as described in proposed FASB Staff Position No. FAS 126-a, "Revision to the Definition of a Public Entity to Include an Obligor for Conduit Debt Securities."

Appendix A: Transition Guidance Applicable to Business Entities⁶

Recognition of Funded Status	Transition
Unrecognized prior service costs and credits, unrecognized gains and losses, and unrecognized transition obligations and assets	Recognize as an adjustment to the ending balance of accumulated OCI, net of tax, those amounts that have not been included in net periodic benefit cost as of the end of the fiscal year that the recognition provisions are initially adopted.
Change in Measurement Date	Transition
Net periodic benefit cost	<p><i>Paragraph 18 Guidance</i></p> <p>Net periodic benefit cost, exclusive of any curtailment or settlement gain or loss, for the period between the measurement date that is used for the immediately preceding fiscal year end and the beginning of the fiscal year ending after December 15, 2008 (i.e., the period between September 30, 2007, and January 1, 2008, for a calendar year-end entity that uses a September 30 measurement date), shall be recognized, net of tax, as a separate adjustment to the opening balance of retained earnings (i.e., adjustment is recorded on January 1, 2008, for a calendar year-end entity).</p> <p><i>Paragraph 19 Guidance</i></p> <p>Net periodic benefit cost for the period between the earlier measurement date and the end of the fiscal year ending after December 15, 2008 (i.e., the period between September 30, 2007, and December 31, 2008, for a calendar year-end entity that uses a September 30 measurement date), exclusive of any gain or loss from a curtailment or settlement in the last quarter of the preceding fiscal year (i.e., the fourth quarter of 2007 for a calendar year-end entity), shall be allocated proportionately between amounts to be recognized as an adjustment of retained earnings and net periodic benefit cost for the fiscal year ending after December 15, 2008 (i.e., three months of net periodic benefit cost should be recorded directly to retained earnings for a calendar year-end entity that used a September 30 measurement date).</p>

⁶ The transition guidance in Statement 158 for a not-for-profit entity is similar to the guidance for a business entity. The primary difference is that adjustments that would normally be recorded directly to retained earnings and accumulated OCI for a business entity are recorded as separate line item or items within changes in unrestricted net assets, apart from expenses, for a not-for-profit entity.

Change in Measurement Date	Transition
Effects of curtailments and settlements	<p>The effects of any gain or loss from a curtailment or settlement that occurs in the last quarter of the preceding fiscal year (i.e., October 1, 2007, through December 31, 2007, for a calendar year-end entity), are recognized in earnings when incurred and not as an adjustment to retained earnings.</p>
Changes in the fair value of plan assets and benefit obligations	<p><i>Paragraph 18 Guidance</i></p> <p>Changes for the period between the measurement date that is used for the immediately preceding fiscal year end and the beginning of the fiscal year ending after December 15, 2008 (i.e., the period between September 30, 2007, and January 1, 2008, for a calendar year-end entity that uses a September 30 measurement date) shall be recognized, net of tax, as a separate adjustment to the opening balance of accumulated OCI (i.e., adjustment is recorded on January 1, 2008, for a calendar year-end entity).</p> <p><i>Paragraph 19 Guidance</i></p> <p>Changes for the period between the earlier measurement date and the end of the fiscal year ending after December 15, 2008 (i.e., changes that occur between September 30, 2007, and December 31, 2008, for a calendar year-end entity that uses a September 30 measurement date), shall be recognized as OCI for the fiscal year ending after December 15, 2008.</p>

Appendix B: Example — Impact of the Recognition Provisions

Prior to the adoption of Statement 158, ABC Company recorded or disclosed the following in its financial statements relating to its defined benefit pension plan:

- Prepaid pension cost asset of \$50 million.
- The plan is underfunded by \$500 million.
- Unrecognized prior service costs, unrecognized losses, and an unrecognized transition obligation total \$550.
- The company's income tax rate is 40 percent.

The following table illustrates the effect that Statement 158's recognition provisions will have on ABC Company's

ABC Company			
Consolidated Balance Sheet			
(amounts in 000s)	Before 158 Adoption	Adjustment	After 158 Adoption
Assets:			
Cash	\$ 100,000		\$ 100,000
Accounts receivable	200,000		200,000
Inventories	100,000		100,000
Prepaid pension costs	50,000	(50,000)	—
Property, plant, and equipment (net)	300,000		300,000
Deferred tax assets⁷	—	220,000⁸	220,000
Other assets	20,000		20,000
Total assets	<u>\$ 770,000</u>		<u>\$ 940,000</u>
Liabilities:			
Accounts payable	\$ 100,000		\$ 100,000
Accrued expenses	50,000		50,000
Accrued pension costs	—	500,000	500,000
Long-term debt	150,000		150,000
Total liabilities	<u>\$ 300,000</u>		<u>\$ 800,000</u>
Shareholders' Equity:			
Common stock	\$ 10,000		\$ 10,000
Paid-in capital	180,000		180,000
Retained earnings	300,000		300,000
Accumulated other comprehensive loss	(20,000)	(330,000)⁹	(350,000)
Total shareholders' equity	<u>\$ 470,000</u>		<u>\$ 140,000</u>
Total liabilities and shareholders' equity	<u>\$ 770,000</u>		<u>\$ 940,000</u>

⁷ This example assumes that a valuation allowance is not necessary for the additional deferred income tax asset recognized upon the adoption of Statement 158. However, entities will need to assess the future realization of the tax benefit of the existing deductible temporary difference based on the expected existence of sufficient taxable income of the appropriate character when determining if a valuation allowance is necessary.

⁸ Calculated as the sum of the unrecognized prior service costs, unrecognized losses, and unrecognized transition obligation multiplied by the company's tax rate ($\$550,000 \times 40\% = \$220,000$).

⁹ Represents the total of the unrecognized prior service costs, unrecognized losses, and unrecognized transition obligation, after tax ($\$550,000 \times (1 - 40\%) = \$330,000$).

The above example demonstrates the potentially significant effect of the Statement, especially on companies with large underfunded plans. Had ABC concluded that a tax valuation allowance was appropriate, the reduction of equity would have been larger.

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