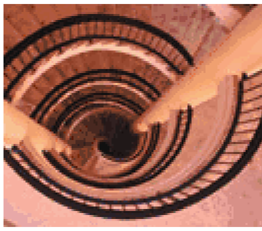

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DataLine

DATALINE 2006-09:
UNDERSTANDING THE BALANCE SHEET IMPACT OF CHANGES THAT WILL ARISE FROM THE FASB'S PENSION PROJECT

Background

.1 The Financial Accounting Standards Board (FASB or Board) is reconsidering the accounting for pensions and other postretirement benefits (collectively "pensions") in a two-phase project. Phase I primarily addresses balance sheet recognition of the difference between a plan's funded status[1] and the amount recognized in the balance sheet. Phase II, a comprehensive reconsideration of all elements of pension accounting, is expected to take several years to complete and will begin once Phase I is completed. Phase I is expected to generate a final standard in the course of 2006.

.2 This DataLine explains the FASB's most significant tentative decisions to date in Phase I. It looks closely at the implications for companies, offers our observations, and encourages companies with defined benefit plans to begin assessing how their financial statements will be affected if the Board's tentative decisions become part of a final standard. The FASB expects to issue an exposure draft for public comment on or about March 31, 2006.

.3 The aggregate impact of Phase I tentative decisions on companies' balance sheets is expected to be significant. The Securities and Exchange Commission's (SEC) June 16, 2005 off-balance sheet report[2] suggests that approximately $414 billion in net pension liabilities and $121 billion in other postretirement benefit liabilities remain off-balance sheet. Collectively, this amounts to a staggering $535 billion in off-balance sheet liabilities, which, based on the FASB's tentative decisions to date, companies will have to recognize in their balance sheets.

.4 To achieve the intended result, the FASB has tentatively decided that companies must fully recognize a plan's over- or under-funded status on the balance sheet by recording heretofore unrecognized gains and losses, unrecognized prior-service costs and credits, and the remaining transition obligation or asset, all with a corresponding offset to stockholder's equity.

Balance Sheet Impact

.5 For a majority of companies, recognizing unrecognized gains and losses, unrecognized prior-service costs and credits, and the remaining transition obligation or asset will increase their reported pension obligations and some companies that previously reported a prepaid pension asset will now recognize a pension liability. The corresponding adjustment to stockholders' equity may also cause some companies to report an accumulated deficit.

.6 The pension obligation will be offset against the fair value of plan assets on a plan-by-plan basis, and the resulting amount will be presented in the balance sheet either as a net pension asset or obligation. Companies will not be permitted to offset one plan's net pension assets with another plan's net pension liabilities.

Income Statement Impact

.7 The impact on companies' income statements will depend on whether they have any remaining unrecognized transition assets or obligations. Companies with unrecognized transition assets or obligations will recognize those amounts in the balance sheet through an adjustment to retained earnings, thereby eliminating the impact that future amortization of those amounts would have had on the income statement. As the transition provisions will require retrospective application, companies will adjust prior-period income statements and earnings per share amounts to eliminate the amortization impact in those periods.

Measurement Date

.8 The FASB has also tentatively decided to eliminate the choice afforded to companies under the current accounting rules of selecting a measurement date. All companies will be required to measure plan assets and benefit obligations as of the date of the financial statements. This change may be most significant for public companies because it will compress the timeframe they will have available in which to finalize their actuarial computations and file their financial statements.

Actions to Consider

.9 Companies with defined benefit plans should now start assessing the impact of these tentative decisions on their balance sheets, income statements, earnings per share computations, and debt covenant agreements, and they should begin planning to address these changes.

Significant FASB Tentative Decisions – Phase I

.10 **Full Recognition of a Pension Plan's Funded Status**: Previously unrecognized items and new items that would have been recognized on a delayed basis will be fully recognized in the balance sheet as part of the net pension asset or liability. These items include unrecognized net gains and losses, unrecognized prior-service costs and credits, and unrecognized net transition assets/obligations.

.11 Existing unrecognized net gains and losses and unrecognized prior-service costs and credits, as well as any new gains and losses and new prior-service costs and credits, will be recognized as part of the balance sheet net pension asset or liability, with a corresponding credit or charge to other comprehensive income (OCI). Unrecognized net transition assets or obligations will also be recognized as part of the balance sheet pension asset or liability, but the corresponding adjustment will be to retained earnings.

.12 Gains and losses and prior-service costs and credits recognized in OCI will be recycled out of OCI as a component of net benefit cost, based on the current amortization and recognition requirements in FAS 87, *Employers' Accounting for Pensions* (FAS 87), and FAS 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106).

.13 An over-funded plan will require recognition of a net pension asset, while an under-funded plan will require recognition of a separate net pension liability. The FASB is expected to prohibit companies with multiple pension plans from offsetting in the balance sheet one plan's net pension assets against another plan's net pension liabilities.

.14 **Elimination of the Measurement Date Option:** Companies will be required to measure plan assets and obligations as of the date of their financial statements, thereby eliminating the current provisions in both FAS 87 and FAS 106 that allow plan assets and obligations to be measured as of an earlier date provided that date is not more than three months prior to the balance sheet date.

.15 Companies that currently have measurement dates prior to their balance sheet dates will be required to change their measurement dates to their balance sheet dates. Using a year-end measurement date will mean that those companies will have less time to perform their actuarial calculations to meet year-end reporting deadlines, particularly those that must meet accelerated filing deadlines. Accordingly, they will need to increase their coordination with their actuaries on the selection of key assumptions, the valuation of plan assets, and the finalization of census data.

.16 **Effective Date:** The FASB anticipates that the effective date for the recognition of the funded status will be for fiscal years *ending* after December 15, 2006.

.17 Public companies that currently measure plan assets and obligations as of a date that is earlier than their fiscal year-end dates (e.g., a company with a December 31, 2006 year-end that will measure plan assets and obligations at September 30, 2006) will be required to change to a fiscal year-end measurement date for fiscal years beginning after December 15, 2006 (and, thus, perform a second measurement as of December 31, 2006).

.18 Non-public companies and not-for-profit organizations that currently measure plan assets and obligations as of a date earlier than their fiscal year-end dates would be required to change to a fiscal year-end measurement date for fiscal years beginning after December 15, 2007.

.19 **Transition method:** With the exception of the measurement date amendments, the new requirements will be applied retrospectively to all prior periods presented. Retrospective application would be required unless it is considered impracticable. The impracticable exception will be limited to companies that are unable to assess the realizability of incremental net deferred tax assets that are recognized as a result of recognizing in the balance sheet a plan's funded status.

New Presentations and Disclosures

.20 Certain new presentations and disclosures will be required. Among them are:

- Separate presentation in the balance sheet of the current and noncurrent portions of the net pension assets and liabilities
- Disclosure of the accumulated amounts of changes in plan assets and benefit obligations recognized in OCI that will be recycled into net income in future periods
- Disclosure of the estimated amount of net gains/losses and prior-service costs/credits that will be amortized from accumulated comprehensive income into net income during the next fiscal year

Implications of the Tentative Decisions

.21 The implications of the tentative decisions that companies need to consider are:

- The tentative decisions should not be complicated to implement. However, their impact on the balance sheets of some companies with defined-benefit plans will be significant. Companies with certain debt covenants that will be affected by the balance sheet changes, such as debt-to-equity ratios or return on equity, may need to amend their loan or other financial agreements to provide for measures that take into consideration the increased balance sheet liability.
- The FASB will dispense with the current requirement to record an additional minimum liability for under-funded pension plans because the projected benefit obligation will be fully recognized at all times in a company's financial statements. This will eliminate any intangible asset that was recorded (typically the intangible asset equals the amount of unrecognized prior-service cost) to establish the additional minimum liability.
- For now, the FASB does not intend to change how plan assets and obligations will be measured. Accordingly, the amount of net benefit cost included in net income will change only if a company is still amortizing its unrecognized transition asset or obligation, since that amount will be charged to retained earnings upon adoption of the new standard and will not subsequently be recycled through net income.
- Public companies with fiscal years ending after December 15, 2006 (e.g., December 31, 2006) that typically measure plan assets and obligations at a date that is earlier than the date of their financial statements (e.g., September 30) will perform the measurement on that date one more time in 2006. Those companies will also be required to perform another measurement of plan assets and obligations as of the end of the 2006 fiscal year to determine the net periodic benefit cost for the 2007 fiscal year. For example, a public company with a December 31 year end, which under the current rules would perform its annual measurement on September 30, would do so on September 30, 2006, and perform a second measurement on December 31, 2006 to determine pension expense for its 2007 fiscal year.

What Companies Should Do Now

.22 Companies should consider the following now:

- Identify and assess the impact of the potential balance sheet changes on covenants contained in loan and other financial agreements, and examine the need or ability to renegotiate those agreements with lenders.
- Consider managing the balance sheet liability through changes in benefit arrangements.
- Develop a communication strategy to meet the needs of financial statement users such as analysts, investors, credit agencies, and lending institutions.
- Open discussions with auditors and actuaries to prepare for implementation.
- Monitor the progress of FASB activities (refer to the timeline at the end of this document).
- Take time between now and the proposed effective date of the expected final standard to adequately prepare for implementation, which will require retrospective application to prior-period balance sheets, including a determination of the deferred tax implications in those prior periods.

Frequently Asked Questions

.23 The remainder of the DataLine provides an answer guide to frequently asked questions.

1. *Q*—Why did the FASB decide to reconsider the accounting for pensions?

   A—The FASB undertook this project for the following reasons: (i) the SEC recommended that attention be focused on this issue in its June 16, 2005 Special Report on off-balance sheet arrangements; (ii) the Financial Accounting Standards Advisory Council, the FASB's User Advisory Council, and the Pension Benefit Guaranty Corporation encouraged the FASB to undertake this project; (iii) in the past several years, the business press and various FASB constituents, including certain analysts and ratings agencies, have called for a reconsideration of the current accounting because, among other things, it can produce results that are counterintuitive. For example, many questioned the accounting results when, during a down period in the stock market, companies reported pension income largely attributable to expected earnings on pension assets that failed to reflect the sizeable actual losses being incurred by most investors; and (iv) Robert H. Herz, chairman of the FASB, has made clear that he is "not a fan" of FAS 87 and has reported that "more and more people started telling the FASB that this accounting just isn't right."

2. *Q*—Why did the FASB decide to perform the project in phases?

   A—The FASB recognizes that a comprehensive review of all aspects of accounting for pensions could take several years to complete, due to the number and complexity of issues to be addressed. Undertaking a joint project with the International Accounting Standards Board (IASB), which is contemplated, would add time to the project because both boards would need to deliberate and agree on the issues. Rather than waiting many years for new rules to be issued, the FASB decided on a phased approach in which improvements could be made incrementally, with the easier changes occurring first.

3. *Q*—How did the FASB decide on the scope of Phase I?

   A—The FASB believes that recognizing in the balance sheet the funded status of defined-benefit plans will be a significant and worthwhile improvement in financial reporting that requires no new measurements or computations and can be accomplished relatively quickly. Additionally, the issues to be addressed in Phase II are related to, and could be impacted by, decisions that will be made in other major FASB initiatives, such as the conceptual framework, consolidations, and financial performance reporting projects. Accordingly, those issues needed to be excluded from Phase I.

4. *Q*—What issues will be addressed in Phase II?

   A—Phase II will be a comprehensive reconsideration of all elements of pension accounting. Some of the more significant issues to be addressed include:

   - Whether to consolidate the separate trusts that are used to fund pension plans. This issue could include not only whether to present plan assets and benefit obligations at their gross amounts in the balance sheet, but also how to account for plan assets, including changes in the values of those assets, if a trust is consolidated.
   - How best to recognize and display in earnings and OCI the various elements that comprise the cost of pension benefits?
   - How best to measure the benefit obligation?

- Whether more or different guidance should be provided regarding measurement assumptions, such as the development of discount rates and the use of mortality tables.

5. *Q*—Is it possible that decisions reached in Phase I could be amended in Phase II?

   A—Yes. For example, the FASB may decide in Phase II to give companies an option to perform the annual measurement as of a date that is earlier than the balance sheet date, if the FASB can be convinced that companies need more time to complete their year-end actuarial valuations. This might be the case if, for example, the FASB decides to require use of a measurement methodology other than the projected unit credit method that requires additional time to properly perform. Additionally, the FASB could adopt an approach that disallows deferrals of some or all gains and losses or prior-service costs and credits. This would change how much of those items would be charged to OCI. However, we do not expect the FASB to reverse its proposal to fully recognize the funded status of pension plans.

6. *Q*—Will Phase II result in more than one statement being issued?

   A—It may. Phase II is expected to take several years to complete, owing to the number and complexity of the issues, some of which we expect to be debated at length. For example, is the projected benefit obligation or the accumulated benefit obligation—or some other measure of the benefit promise—the proper measurement of the pension obligation, and should some or all of the actuarial gains and losses that are presently eligible for deferral be recognized? The FASB staff has stated that it will structure Phase II deliberations to provide the FASB with flexibility, if needed, to issue statements after groups of issues are addressed.

7. *Q*—Will the FASB's project be performed jointly with the IASB?

   A—Phase I will be performed solely by the FASB because the more significant issues to be addressed in this phase have already been addressed by the IASB in IAS 19, *Employee Benefits* (IAS 19). However, it is expected that Phase II will be performed jointly with the IASB.

8. *Q*—Are the FASB's tentative decisions in Phase I consistent with the provisions of IAS 19?

   A—The FASB's tentative decision to recognize the funded status differs from IAS 19 in that IAS 19 allows companies to recognize all gains and losses in the period they occur (outside the income statement) in a statement of changes in equity, entitled Statement of Recognized Income and Expense. These gains and losses are not recycled into income in future periods.

   The tentative decision to measure plan assets and benefit obligations as of the balance sheet date is generally consistent with IAS 19, which requires plan assets and obligations to be determined with sufficient regularity that the amounts recognized in the financial statements do not differ materially from those that would be determined at the date of the financial statements.

9. *Q*—When is the FASB expected to issue its Phase I Exposure Document?

   A—That document is expected to be issued on or about March 31, 2006 and will have a 60-day comment period.

10. *Q*—When would a Phase I final standard be effective?

    A—It is expected to be effective for fiscal years ending after December 15, 2006, and 2006 calendar-year-end companies would be required to adopt the guidance for 2006 year-end reporting.

11. *Q*—Can a company with a fiscal year that will end prior to the effective date of the new statement (e.g., a company with an October 31, 2006 year-end) adopt its provisions early?

    A—We expect the FASB to provide such companies with the option to early adopt, if they so desire. However, because a final standard is not expected until the fourth quarter of 2006, those companies may not have sufficient time to apply the provisions of a final standard and meet their filing requirements. Accordingly, these companies will need to closely monitor the FASB's re-deliberations and take action as appropriate to get an early start on implementation.

12. *Q*—What are the measurement date implications for public companies with a December 31 year-end and a measurement date prior to that date—for example, September 30?

    A—These companies would:

    1. Perform a measurement of plan assets and benefit obligations on a date consistent with prior years—in this scenario, September 30, 2006.
    2. Perform a remeasurement of plan assets and benefit obligations on December 31, 2006.
    3. Adjust January 1, 2007 opening retained earnings and other comprehensive income for the change in a plan's funded status from October 1st to December 31st. The adjustment to opening retained earnings is for the net periodic benefit cost for the period October 1, 2006 to December 31, 2006, which is developed from the measurement at September 30, 2006, because this is the amount that otherwise would have been recognized on a delayed basis during the first quarter of 2007.

    Curtailment gains and losses occurring between the 2006 early measurement date and December 31, 2006 would be recorded in the period of occurrence.

13. *Q*—What are the tax implications of the tentative decisions?

    A—Most companies will record an incremental net deferred tax asset for the temporary difference between the book and tax bases of the increased balance sheet liability (a tax deduction is taken when a plan contribution is made). The realizability of that asset will need to be assessed, based on a company's tax profile and the provisions of FAS 109, *Accounting for Income Taxes*.

    Upon adoption of a final standard and for periods thereafter, companies will need to assess whether a valuation allowance or additional valuation allowance is required on any deferred tax assets recognized. The deferred tax assets (and related valuation allowances) will be established by jurisdiction and by plan. It is important that companies perform a robust and rigorous deferred tax asset realizability assessment at the date of adoption because valuation allowances established at that date for the incremental net deferred tax asset will be established through OCI, whereas valuation allowances established subsequent to the date of adoption will be recognized as an adjustment to the tax provision in the income statement.

Previously unrecognized gains and losses and prior-service costs and credits recorded in OCI upon adoption will be amortized out of OCI into income in future periods, based on the current recognition requirements in FAS 87 and FAS 106. The effects of such amortization on the expected tax rate are complex and highly situation-dependent, and may result in additional income statement volatility.

14. *Q*—What are the implications of Phase I for not-for-profit organizations (NFPs)?

    A—NFPs that have remaining transition assets or obligations will recognize those assets or obligations as an adjustment to the opening balance of unrestricted net assets, thereby eliminating the impact that future amortization of those amounts would have had on the statement of activities. Because the transition provisions will require retrospective application, NFPs will adjust prior-period statements of activities to eliminate the amortization recognized in those periods.

    FAS 117, *Financial Statements of Not-for-Profit Organizations,* does not require NFPs to report an earnings measure, nor does FAS 117 have a concept of OCI. Therefore, NFPs, such as health care organizations, that present an intermediate measure of operations in their statements of activities, which is equivalent to income from continuing operations, will report in separate line items outside this measure any actuarial gains and losses and prior-service costs and credits that are subsequently recognized. NFPs that do not present an intermediate measure of operations in their statements of activities will report those recognized actuarial gains and losses and prior-service costs and credits in separate line items, apart from functional expenses.

15. *Q*—Where does PwC expect the debate during Phase I to focus?

    A—Recognizing the projected benefit obligation (PBO) as the pension liability will be questioned by some. The PBO includes a component that is based on future salaries, which some may consider to be inconsistent with the definition of a liability in the FASB's Concepts Statement No. 6 (pars. 35 and 36) and result in an overstatement of the liability.

    To a lesser extent, we expect that requiring plan assets and benefit obligations to be measured as of the balance sheet date will be questioned by plan sponsors and others because information, such as some asset values, may not be readily available as of that date. The result could be delayed filing of financial statements.

16. *Q*—What is the likelihood of a final standard being issued and effective in 2006?

    A—It is difficult to predict with certainty when a final standard will be issued, and the effective date of the standard depends on when it is issued. We do know that the FASB has given this project its highest priority, put it on an accelerated timeline for completion, and publicized that it fully expects Phase I to be completed and effective in 2006. Because the proposed changes generally require no new information to be gathered or processed and no new measurement techniques, it is reasonably likely that a final standard will be issued and effective in 2006.

17. *Q*—Where can I find more information?

    A—A project summary and FASB meeting minutes are available at the FASB's website: http://www.fasb.org/project/postretirement_benefits.shtml

PwC publications will provide further details and insights as the FASB's work proceeds.

18. *Q*—How can PwC help?

    A—PwC has the expertise in accounting, taxation, and actuarial services to assist in your assessment of the implications of these tentative decisions. PwC clients who desire that assistance should contact their engagement partner(s).

Phase I Timeline

November 10, 2005: FASB adds pension and other postretirement benefits project to its agenda
November 10, 2005 – March 2006: FASB deliberations

Tentative Dates
March 31, 2006: FASB issues proposed rules, comments due by May 30
May 30, 2006: Comment period ends
June 2006: Public roundtable(s) to be held
July-August 2006: FASB resumes redeliberations
September/October 2006: Final standard to be issued
December 2006: Final standard goes into effect, beginning with years ending after December 15, 2006.

Q4 2006: Phase II deliberations commence

1 The fund status is to be measured as 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, while for other postretirement benefit plans' the benefit obligation is the accumulated postretirement benefit obligation.

2 SEC Special Report: *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*. This report is available on line at http://www.sec.gov/news/studies/soxoffbalancerpt.pdf.