A PricewaterhouseCoopers
white paper

Rethinking postretirement benefits*

The FASB's proposal,
its impact on companies
and capital markets,
and the changing pact with
the American worker

*connectedthinking

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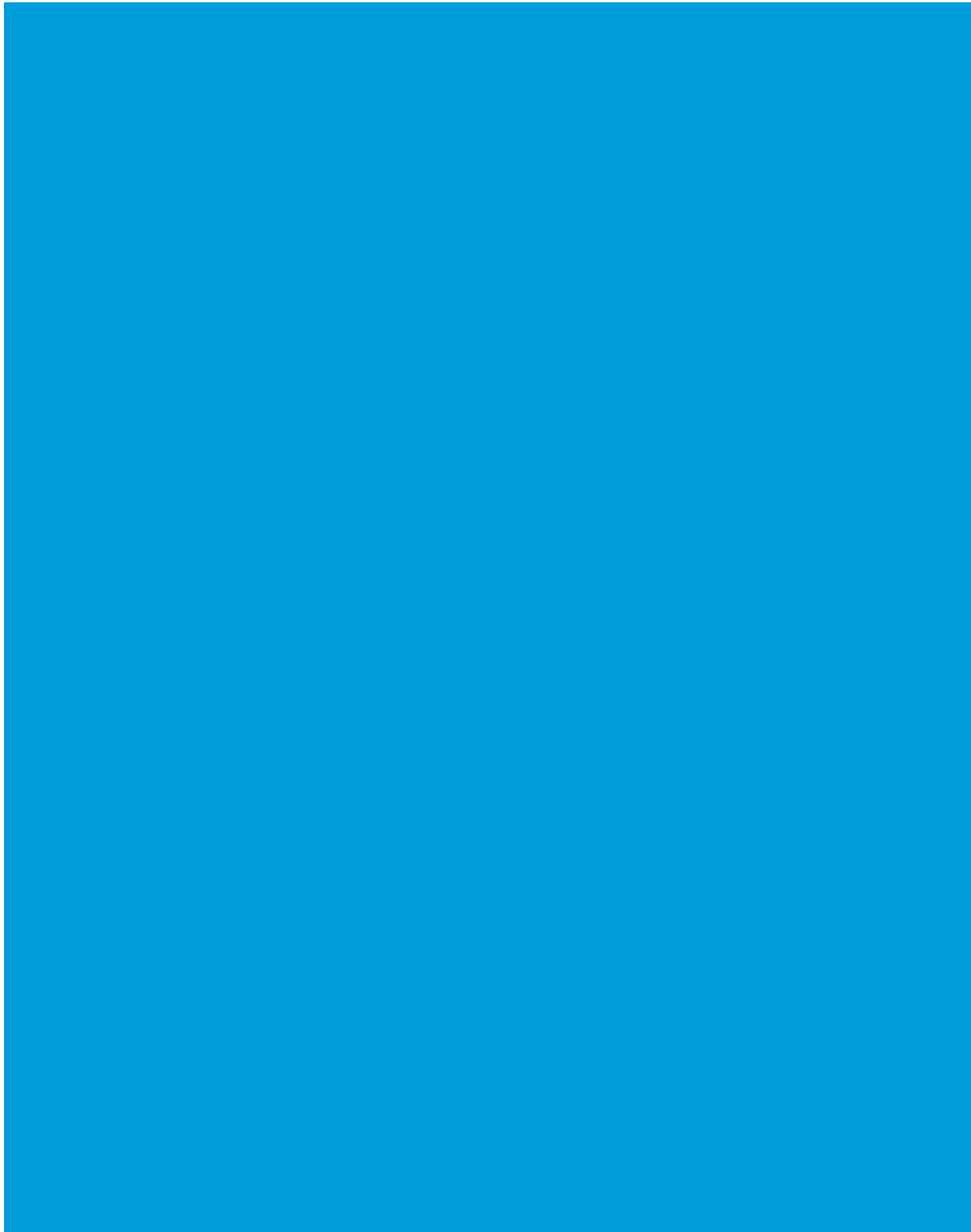

Contents

Executive summary	02
Introducing the issues	04
The business, social, and political context	07
The FASB project	13
Thinking about the issues	18

Executive summary

This publication offers three closely related discussions:

- An overview of the business, social, and political implications of today's changing array of postretirement benefits.
- A technical discussion of the postretirement accounting project on the agenda of the Financial Accounting Standards Board (FASB).
- And a concluding exercise: thinking about these issues from a strategic perspective.

The first topic concerns the cost structure and competitiveness of businesses and the long-term welfare of employees. Statistics show that defined-benefit plans have been receding for more than a decade, while defined-contribution plans, which assign much more responsibility and risk to employees, have increasingly become the norm. This shift may represent a substantial, long-term cost saving for companies that face global competition, often from rivals that have no comparable legacy obligations to their employees.

The conflict between achieving a lean, competitive, non-volatile cost structure and providing adequate retirement benefits would exist with or without the FASB's postretirement accounting project. But the new FASB project is likely to force companies to account for postretirement benefits in a much more transparent way. This accounting change will not, in and of itself, alter the financial condition of a company, but it will change the balance sheet presentation. Some companies, including celebrated industry giants, will face the possibility of recording a negative net worth. Our discussion underscores that postretirement benefits are not just an accounting or business issue. Rather, this is an issue that stands to impact a significant number of Americans directly and indirectly as they prepare for retirement. Concern among policymakers and other constituencies about the impact on this significant segment of the population is growing.

The second topic, of particular concern to senior executives, boards, investors, analysts, and auditors, relates to the substance of the FASB project, which is to be carried out in two phases—the first now progressing, the second to begin in 2007. The recently issued Phase I exposure draft proposes putting a company's full pension and other postretirement benefit liability less the fair value of plan assets on the balance sheet rather than in a footnote as required today, which typically proves difficult to decipher for investors and others who lack a trained analyst's skills. The FASB believes that this proposal can be completed and effective by year-end 2006, primarily because the Board expects that most of its constituents will rally around this decision to eliminate an off-balance sheet item.

In our discussion of Phase I, we show how the new accounting would alter the balance sheet presentation and explore the implications of that change. The second phase of the FASB project will revisit all of the key remaining accounting issues in the accounting for pensions and other post-employment benefits, and there are many.

The third topic in this white paper concerns strategy. The accounting changes under consideration support increased transparency and clarity—undisputed values in today's business and accounting culture. But the changes affect both the balance sheet and the workforce in far-reaching ways. Our discussion offers simple principles that can be useful to management teams and boards searching for an optimal strategy as the United States adjusts its approach to postretirement benefits.

Introducing the issues

In the post-Enron era, there is acute discomfort when investors must resort to the footnotes to obtain information that is not, by any stretch of the imagination, unimportant.

In November 2005, guided by a request from the U.S. Securities and Exchange Commission (SEC)[1] and its own sense of agenda, the Financial Accounting Standards Board (FASB or the Board) decided to reconsider the standards that govern accounting for pensions and other postretirement benefits. This area of accounting had remained unvisited for quite some time. The existing guidance[2] was widely recognized, when it came into force in 1985 and 1990, as a set of compromise solutions, reasonable but imperfect.

The FASB of that era acknowledged that the statements provided what it termed "worthwhile improvements" and looked forward to "future change to occur in the gradual, evolutionary way that has characterized past change."[3] It was a tactful way of saying that the Board had done its best for the moment in an exceptionally complex and sometimes controversial area of accounting. The accounting treatments were not as transparent and straightforward as they could be, but there was little pressure to advance further. The accounting served companies satisfactorily, and employees received the benefits they earned and expected. A plan's funded status,[4] which is the most important information about pension and other postretirement benefit plans, was to be found only in the footnotes to financial statements. On the other hand, diligent investors could learn to navigate those footnotes to assemble a whole picture of a company's pension and other postretirement benefit obligations.

Today, conditions are quite different. In the post-Enron era, there is acute discomfort in Congress, among regulators, and in the accounting profession when investors must resort to footnotes to obtain information that is not, by any stretch of the imagination, unimportant. Enron and the other massive corporate failures led to the Sarbanes-Oxley Act of 2002 and to more rigorous, explicit definitions of responsibilities in the executive suite, the boardroom, and the audit process. The effort to achieve substantially greater transparency in corporate reporting and disclosures is deliberative, and the technical content of accounting standards is such that rushing them makes no sense. But the FASB is now focusing again on pension and other postretirement benefits issues. Robert H. Herz, chairman of the FASB, has made clear that he is "not a fan"[5] of FAS 87 and has reported that "more and more people started telling us this accounting just isn't right."[6]

1 *SEC Special Report: Report and Recommendations Pursuant to Section 4019(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers*, dated June 16, 2005.

2 Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions*, 1985; Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*, 1990

3 Source: Summary section of FASB Statement No. 87, *Employers' Accounting for Pensions*

4 The funded status is measured as the difference between the fair value of a plan's assets and its benefit obligation.

5 *Financial Times*, January 24, 2005

6 *Wall Street Journal*, December 19, 2005

The net asset or liability can be expected to move up from a complex and detailed footnote to the balance sheet, where it will be stated with clarity.

The FASB project to revise the accounting for pension and other postretirement benefits is likely to be the hard technical core at the center of a spirited debate. Participants in that debate will come from all over the map: business leaders, employee interest groups, unions, legislators, accounting firms, regulators, capital markets professionals, and the media. Though not at length, President Bush has already entered the fray, and his administration can be expected to participate in the social and political aspects of the debate.

One outcome of this period of technical work surrounded by debate is reasonably predictable: at some point in 2006 (or possibly early 2007), the net asset or liability for pension and other post-employment benefits can be expected to move up from a complex and detailed footnote to the balance sheet, where it will be stated with clarity. But that will only be the beginning of the process, not its conclusion. The FASB has committed to a two-phase effort; the first phase will likely be completed this year, while the second will take several years and require the Board to address questions of measurement that it will need time to get right.

The quest for a transparent accounting of pension and other postretirement benefits is not the only force in play. Two distinct lines of development have coincided. The SEC and FASB's desire to achieve greater transparency in financial statements has been increasing for a number of years. But there is something more, which would have required resolution even if regulators and standard-setters were satisfied with the status quo: some U.S. companies find themselves carrying a legacy of heavy pension and other postretirement benefit obligations in a global competitive environment that suggests the need to travel lighter.

Many readers will be aware of U.S. companies with massive unfunded pension liabilities. Several companies with household names, now in bankruptcy proceedings, have turned over billions of dollars in pension liabilities to the federal Pension Benefit Guaranty Corporation. Companies large and small have frozen or closed defined-benefit pension plans, rewritten their defined-contribution benefit plans, and otherwise drawn employees into assuming greater individual responsibility for their retirement plans and assets. As noted just above, the driving force behind this rapidly changing scene is predominantly global competition. On the premise that sustained competitiveness requires a new approach to human resources and a lean cost structure, many companies are no longer willing to make (or in some cases keep) the retirement benefits promises that were considered business as usual in decades past. The pact with the American worker is being rewritten.

In the pages that follow, we look first at the business, social, and political debates that almost certainly lie ahead as the first phase of the FASB's pension and other postretirement

benefits (hereafter "postretirement benefits") project comes under discussion and receives greater media attention. We then look at the technical content and sequence of the FASB project. In a concluding section, we highlight issues that business leaders and all concerned parties will want to consider.

For the sake of clarity, it makes sense to record here the FASB's core agenda for this project. The objective of Phase I is to improve the understandability, transparency, and representational faithfulness of amounts reported in companies' balance sheets by recognizing the overfunded or underfunded status of defined-benefit postretirement plans. This change will remedy what the FASB views as one of the lingering compromises in current accounting guidance, which permits important information about the financial status (funded or unfunded) of a company's postretirement benefit plans to be reported in the notes to the financial statements rather than in the balance sheet. Phase I is of limited scope: the Board does not expect in Phase I to change the basic approach to determining the amount of net benefit cost included in the determination of net income. This phase is targeted for completion by the end of 2006. In the second, multi-year phase of the project, the Board will comprehensively reconsider the measurement and accounting for postretirement benefit obligations.

The business, social, and political context

The FASB is not working for or against employers or employees; it is resolutely setting the accounting right.

Amending the postretirement benefits accounting model is likely to gain more attention and to be more controversial than the discussions, loud at times, that accompanied development of the new accounting for share-based payment. The expensing of stock options under FAS 123(R)[7] mattered for the most part to the technology sector. In virtually all sectors, many more entities (both public and privately held) offer defined-benefit pension and/or retiree medical benefits to their employees and retirees. Tens of millions of employees covered by these plans have huge amounts of capital tied up in them, and additional tens of millions participate through union plans. Union leadership will speak up, and the first skirmishes have occurred—witness the recent strike of transit workers in New York City, very largely over pension issues (unrelated, we should add, to the FASB project).

Just as some companies used FAS 123(R) to justify altering stock-based compensation to their employees, the outcome of the FASB's postretirement benefits project may prompt some companies to freeze or reduce postretirement benefits. For this reason, it's important to recognize that the FASB is not working for or against employers or employees; it is resolutely setting the accounting right. The accounting changes will not affect the economics of the employer's promise to employees. Nonetheless, the changes likely to be proposed cannot help but have far-reaching consequences.

Continued decline in benefits and the number of plans

Before the FASB added this project to its agenda, companies were already amending their plans to reduce the impact of postretirement benefits on earnings and cash flows. Some actions taken have been the following:

1. Companies have either amended their final-average-pay plans to career–average plans, such as cash-balance plans, or frozen their pension plans and replaced them with defined-contribution plans. The result is reduced pension costs and transfer of the investment risk to plan participants, with the added feature of portability for today's mobile workforce.

2. Some companies that once provided unlimited retiree medical benefits, or paid or subsidized retirees' premiums, have amended their plans to cap the amounts that retirees are eligible to receive as medical benefits or premium subsidies. Other companies have gone as far as to close such plans to all new employees.

   Companies, many of which are household names and industry leaders, have closed their defined-benefit plans to all new employees and in some instances replaced those benefits with an increased 401(k) employer match and a decreased vesting period. The marketplace has perceived these plan changes as efforts to reduce expenses

7 Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, 2004

Defined-benefit plans are increasingly a thing of the past. Defined-contribution plans are becoming the primary retirement plan in the United States.

and, therefore, increase earnings in an increasingly competitive global environment. Advocates of the changes emphasize additional factors—for example, today's mobile workforce, which values portable benefits. Taking their lead from the first movers, other companies are exploring similar plan change strategies.

Statistics overwhelmingly demonstrate that defined-benefit pension plans are losing ground. From 1985 to 2000, the number of single-employer defined-benefit plans decreased by 76 percent from 167,911 to 40,000. In the same period, the number of multi-employer defined-benefit plans (typically managed by unions) decreased by 20 percent from 2,261 to 1,800. Meanwhile, the number of single-employer *defined-contribution* plans increased by 52 percent from 461,158 to 700,000, and the number of multi-employer defined-contribution plans increased by 86 percent from 805 to 1,500.[8] The trend is clear and noticeably long-term, stretching back over two decades: defined-benefit plans are increasingly a thing of the past, while defined-contribution plans are becoming the primary retirement plan in the United States. Reports from the United Kingdom and elsewhere reflect similar trends.

Notwithstanding the trend away from defined-benefit plans, many companies continue to offer these types of benefits to their employees, thus justifying the FASB's project. As the project moves forward, some companies may use the new accounting as a pretext or further reason to reduce or eliminate retiree benefits. As noted earlier, the project isn't about that. Two developments are now running parallel—the move to sounder accounting and the trend toward shifting some of the burden and risk of postretirement benefits onto employees. The FASB's objective is to require companies to recognize in their financial statements the true economics of promises made to their employees and retirees, rather than reflect the economic substance of those promises in complex footnotes that are easily overlooked and often difficult to grasp. That objective represents the height of good sense and professional judgment.

Volatility, the capital markets, the possible shift from equities to bonds

One of the more significant issues to be addressed in Phase II of the FASB project will be to consider eliminating the smoothing mechanisms under the current accounting guidance, which companies can and generally do adopt. Smoothing allows companies to minimize the differences between the actual and expected performance of postretirement

8 Source: U.S. Department of Labor

Elimination of the smoothing mechanisms is likely to have a significant impact on the capital markets and on companies' reported financial results.

benefit fund assets and estimates of the obligation. While many analysts and investors would prefer a transparent method that reflects the financial status of a plan and deters overly optimistic assumptions that favorably impact operating income, other stakeholders argue in good faith that smoothing mechanisms appropriately reflect the long-term nature of postretirement benefit plans. They argue, in effect, that it's more important to indicate where a road goes than to record every pothole along the way.

The more transparent method likely to emerge in Phase II should offer a clear picture of the financial and economic realities of a plan. The practice of smoothing reflects the accounting culture of an earlier day before Sarbanes-Oxley ushered in a new focus on transparency at the possible expense of predictability.

If the FASB so decides, elimination of the smoothing mechanisms is likely to have a significant impact on the capital markets and on companies' reported financial results. For example, reporting actual pension asset returns under a mark-to-market standard would introduce into corporate earnings a new and noticeable source of volatility. Corporate earnings would be directly impacted by the performance of pension fund assets—by what the company earns or fails to earn in the equity and bond markets. Would there be some impact on capital allocation decisions? Almost certainly, pension fund assets would progressively flow from equities to fixed-income securities as companies sought to limit the risk (and related volatility) of their investments.

The numbers involved have already been estimated. The Committee on Investment of Employee Benefit Assets[9] estimates that approximately $290 billion would shift from equities to bonds if mark-to-market accounting was approved. It's worth noting that this shift would cause an increase in net pension cost because bond returns are typically lower than returns on equity, and those returns, however earned, would remain a dominant component of net pension cost. One can hardly avoid the observation that this forecast appears to be bad news for stock markets and valuations of companies. Valuations would be affected not by the changes contemplated in Phase I of the FASB but rather by two factors. First, the elimination of smoothing may generate volatility in earnings and share price for some companies, hence changes in valuation. Second, employees may become savers rather than spenders, with measurable impact over time on the revenues of many kinds of companies (on this topic, see the discussion below).

An increase in income statement volatility coupled with an increase in net pension cost may well be viewed by some U.S. companies as a crippling competitive disadvantage. Many

9 The Committee on Investment of Employee Benefit Assets represents nearly 140 of the largest corporate pension funds in the United States. Its membership consists of corporate financial officers who administer and manage, as fiduciaries, the investment of over $1 trillion in retirement plan assets on behalf of more than 15 million plan participants and beneficiaries.

new and established competitors in the global marketplace will not have such legacy costs to face because postretirement benefits are funded through a national system or do not exist. Taking the competitive facts into account, some U.S. companies will perceive yet another reason to freeze defined-benefit plans and emphasize defined-contribution plans, which are less expensive for employers and have more predictable costs. Their disadvantage is that they are generally more expensive and riskier for employees.

Washington weighs in

The House and Senate both passed pension reform bills in fall 2005, respectively H.R. 2830, The Pension Protection Act of 2005, and S. 1783, The Pension Security and Transparency Act. Joint conferences are expected to generate final legislation in the current year.

Both pieces of legislation, which have differences that will need to be bridged, aim to strengthen and secure corporate pension plans and relieve some of the financial pressure on the Pension Benefit Guaranty Corporation (PBGC), which has been overburdened in recent years. The bills require companies to implement a new 100-percent funding target for their pension plans and close funding shortfalls in their plans over a period of seven years (although the Senate bill offers a break to financially ailing major airlines, which would have 20 years to close funding gaps). These funding rules for single-employer defined-benefit plans are intended to induce employers to fully fund their pension plans. They also require an increase in the premiums paid to the PBGC for plan termination insurance and mandate greater disclosure to participants and the government concerning a plan's funding status.

Requiring employers to fully fund their pension obligations is likely to divert operating capital from other uses. For example, in some instances, dividends may no longer be paid or may be reduced. Some companies will find in the legislation yet another reason to reduce employee retirement benefits and freeze or terminate defined-benefit plans. Higher PBGC premiums—some substantially higher, owing to the new measurement of underfunding applicable to PBGC risk-based premiums—are likely to further accentuate these trends.

Shifting risk and cost to employees

Freezing benefits or closing defined-benefit plans to new employees shifts the cost and risk of providing retirement income from the employer to the employee. While some companies are partially compensating employees after freezing their defined-benefit plans by increasing the company match on 401(k) contributions, they have nonetheless transferred the investment risk and management of that risk because employees are solely responsible for investing those funds. Looking at this circumstance, unions and other employee advocate groups will surely argue in the coming debate that employees in general have neither the sophistication nor the capital to sufficiently diversify their portfolios to weather market volatility. As a consequence, their retirement income will be subject to stock market swings: retire in an up market and you may be secure, retire in a down market and perhaps suffer the consequences for years to come. When a defined-benefit pension plan doesn't perform as a company expects, the employer is still legally responsible to provide employees their accumulated retirement benefits. When a defined-contribution plan does not perform as expected, the employee is the loser. If, owing to adverse market conditions, employees lose very significantly, the federal government may find it necessary to offer a safety net—and so public policy issues probably cannot be excluded from the debate on how best to ensure satisfactory retirements for American workers.

Will defined-contribution plans provide enough savings to last through retirement? As companies continue to freeze defined-benefit plans, employees will turn to wealth management consultants for advice, and they will be more likely to invest in so-called lifestyle funds, which target a constant investment style, or in lifecycle funds, which shift from aggressive to conservative investments as investors near retirement. In brief, knowledgeable or knowledgeably advised employees will do what they can to ensure sufficient funds for their retirement years, but they will act at their own risk. Employees who are neither knowledgeable nor well-advised will be at much greater risk.

If Americans gradually became savers—far from our strongest point in the past, implications for goods, services, and the capital markets would be huge.

A nation of savers?

Quite apart from mortgage obligations, the average American is in debt. Recent research documents that the average American has debts of approximately $10,000 and little, if any, savings. Combine these facts with others: people live longer, defined-benefit plans are being phased out, plan benefits are being frozen, postretirement health care benefits are under pressure, and the future of the Social Security system remains unresolved. From all of this, one could rationally conclude that the average American will not have the means to retire at 65—or at any age, for that matter. Will he and she have to continue working well beyond the age of 65? Or accept support from younger family members? Or, alternatively, begin a program of reduced consumption, lower spending, and greater savings from an early age?

If Americans gradually became savers—far from our strongest point in the past, implications for goods, services, and the capital markets would be huge. There would likely be more funds for current investment but lower rates of consumption, and lower corporate profits could have a negative impact on share prices and the capital markets. As noted earlier in another connection, it is difficult to imagine that these dynamics would leave the government's resources untouched. The reduction or elimination of employer-sponsored retirement benefits could bring about the need for bailouts by the federal government. Would there also be tax increases to ensure that the Social Security system can continue to offer a safety net for retired Americans? The question is more open than it might seem.

The FASB project

The FASB's objective is to improve the reporting of postretirement benefit arrangements in an employer's financial statements by identifying and mandating information that investors, creditors, employees, retirees, and other users will find suitably transparent and useful. Owing to the breadth and complexity of the issues to be considered and attempting to converge its solutions with international accounting standards, the Board will conduct the project in two phases. The recently issued exposure draft (Phase I) intends to put the company's postretirement benefit obligation on the balance sheet, net of plan assets. The FASB believes that this proposal can be completed and effective by year-end 2006, primarily because it expects that most of its constituents will rally around this decision to eliminate another off-balance sheet item. The second phase will revisit all of the remaining key issues in the accounting for postretirement benefits. Because of the number of complex decisions that must be made, the FASB expects this phase to take several years to complete (more on Phase II below).

Balance-sheet impact: in some instances, enormous

The FASB proposes that the balance sheet fully reflect the funded status of defined-benefit plans. The funded status is the difference between the plan's assets at fair value and the postretirement benefit obligation.[10] Under existing standards, as noted earlier, the funded status is currently disclosed only in the footnotes. The FASB also proposes that companies record the difference between the funded status and the amount currently recognized in the balance sheet as an adjustment to equity.

This proposal would bring significant amounts of liabilities onto many companies' balance sheets. A major SEC publication of June 16, 2005, *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*, suggests that approximately $414 billion in net pension liabilities may remain off-balance sheet and $121 billion in other postretirement benefit liabilities may remain off-balance sheet (these numbers are extrapolations based on a sample of U.S. issuers). This amounts to a staggering pre-tax amount of $535 billion that the FASB in Phase I recommends be fully recognized in issuers' financial statements. Recent studies performed by Credit Suisse[11] and Towers Perrin[12] substantiate further the magnitude of the off-balance sheet liabilities. The Credit Suisse study estimates that implementing Phase I would decrease the equity of the S&P 500 by $248 billion or 6 percent while the Towers Perrin study on the U.S. *Fortune 100* companies' pension plans estimates that shareholders' equity would decrease by $180 billion or 9.3 percent.

10 The projected benefit obligation (PBO) is the liability for pensions and the accumulated postretirement benefit obligation (APBO) for other postretirement benefits. The PBO and APBO are the actuarial present value of benefits attributed by the benefit formula.

11 Credit Suisse, May 5, 2006, *The Hit to Equity*

12 Towers Perrin, January 2006, *Assessing the Impact of the Planned Changes in Accounting for Pensions and Other Postretirement Benefits*

Companies will need to consider how to mitigate the effect of this change on their balance sheets; some companies will face a significant reduction in their reported equity. Companies with debt covenants will need to consider the impact of the proposed change on defined terms and ratios and other balance sheet metrics, potentially requiring amendments to covenant agreements. Companies should assess their unique circumstances and develop a plan to deal with this newly recorded postretirement benefit liability, which could range from relying on equity offerings or even shifting investment strategies in their investment portfolios. Whatever solutions companies adopt, they will need to communicate the rationale for their decisions to investors and analysts.

The investor community and credit rating agencies already include in their valuation models the difference between the funded status and the amount recognized in companies' balance sheets. For this reason, we do not anticipate significant adjustments to valuations upon implementation of the FASB's proposal. Nevertheless, we believe that the proposal, if instituted, will give analysts and users a more transparent view of companies' benefit obligations.

The FASB project: Phase I

To put the balance-sheet issue in context, a simple example of the current disclosure requirements for a pension plan, placed alongside the FASB's proposed treatment, will be helpful.

	Current model		FASB proposal
Projected benefit obligation[13]	$46		
Fair value of plan assets	40		
Funded (unfunded) status	(6)	->	liability to be fully recorded
Unrecognized cost of benefits earned in the past	3	->	record as a charge to equity
Unamortized experience losses	5	->	record as a charge to equity
Unrecognized transition obligation	-	->	record to retained earnings
Net amount reported in balance sheet	$2 asset	->	$6 liability

Under the current accounting and reporting model, a company would be required to disclose the information in the above table as part of a footnote, and would record in its balance sheet an asset in the amount of $2 when it actually has an economic liability, representing the unfunded status, of $6.

13 The projected benefit obligation is the actuarial present value of all benefits attributed by the pension benefit formula to employee service rendered. It is measured using assumptions as to future compensation levels if the pension benefit formula is based on those future compensation levels.

Under the FASB proposal, the unrecognized cost of benefits earned in the past ($3) and the unamortized experience losses ($5) would be recognized in the balance sheet with a corresponding charge to equity. No longer would companies' balance sheets reflect "difficult to understand" prepaid postretirement benefit assets when these companies have unfunded off-balance sheet liabilities for such benefits, thus avoiding the confusion that often surrounds this accounting in the marketplace.

The income statement accounting for those amounts would not be impacted and would continue to follow the current accounting guidance (that is, they would be amortized out of equity and run through the income statement) unless that guidance is changed in Phase II.[14]

Few people question whether recording a liability for employee-defined benefits is appropriate, and few support disclosure of the liability only. Where there is debate concerns how to measure the liability. Some question whether recording the projected benefit obligation is the correct measurement of the obligation because it includes a component based on future salaries, which they consider to be inconsistent with the definition of a liability in the FASB's Concepts Statement No. 6. Rather, they believe that the assumption of future salary increases should be ignored. It also can be argued that the measurement issues need to be fully understood before the FASB requires companies to record their full benefit obligations. This issue is expected to receive considerable attention in the Phase I comment letter process. As noted just below, this issue may be the very one that slows the FASB's intended timetable for Phase I.

Another issue addressed by the proposal is, in our view, of secondary importance, although it may have meaningful operational implications for some companies. If passed, it would force companies to measure plan assets and benefit obligations as of the date of the financial statements rather than continuing the existing practice of permitting an alternative measurement date that is no more than three months prior to the date of the financial statements. The existing practice was provided so that companies had sufficient time to gather necessary information and perform actuarial calculations to meet year-end reporting deadlines. The loss of that additional time is likely to be inconvenient for some companies, but the current requirements were written in 1985, and most companies are now accustomed to challenging accounting measurements. With today's sophisticated software programs and the 2007 effective date for this change, some companies will not find this feature of the proposal especially burdensome.

14 Phase II is expected to address, among others, how a pension obligation should be measured and the interrelated issues of balance-sheet and income-statement recognition and classification.

By using a phased approach to the pension project, the FASB can quickly deliver a substantial improvement in the transparency, understandability, and usefulness of a company's balance sheet.

The Phase I timeline is aggressive

The FASB plans to issue a final standard by October 2006, effective for 2006 year-end reporting. This is an aggressive timetable, given that the proposal was issued at the end of March. Companies will have little time to address the impact of the proposal on financial ratios, debt covenants, and capital maintenance agreements and to take actions to obtain waivers and renegotiate contracts. The FASB considered this issue when it formulated the proposed effective date, and we suspect that the Board will hear from companies troubled by this feature of the proposal when redeliberations get under way.

From an accounting standpoint, the FASB's timeline is within reach because the proposal is, generally speaking, neither complicated nor extensive and, as we stated, there will be few who argue that a liability does not exist. Nonetheless, the political and media attention the project has attracted and the pressure the FASB may experience could be significant. If this prediction proves to be accurate, project completion at some point in 2007 would be more likely. By using a phased approach to this project, the FASB can quickly deliver a substantial improvement in the transparency, understandability, and usefulness of a company's balance sheet. But the public debate surrounding Phase I and the technical debate concerning the proper measurement of the obligation have the potential to slow matters down.

Moving closer to convergence

By calling for the funded status of a plan to be reported on the face of the balance sheet, the FASB will move closer to the International Financial Reporting Standards (IFRS) on pension and other postretirement benefits. IFRS currently provides companies with an option of recording their plans' funded status. However, key differences will still need to be harmonized in Phase II of the project. Those differences include different expense recognition treatments of experience gains and losses and the cost of benefits earned in the past, as well as the method for deriving the amount of expected earnings on plan assets.

Phase II

Objectives and scope

The second phase of the project is likely to be a good deal more controversial, and more debate can be expected. The key issues are complex. Here is our inventory of key issues:

1. For plans with benefits that are based on salary levels, should the liability include estimates of future salaries? This debate will center on whether a company can have a liability today that is based in part on future salaries that haven't been earned yet.

2. Is it appropriate to eliminate the income statement smoothing mechanism and require companies to report directly in the income statement actual asset returns and any experience gains and losses? This debate is likely to acknowledge the lack of a sound conceptual basis for smoothing reported earnings and to address the significant volatility in corporate earnings from non-operating activities that would result if smoothing were eliminated. This should be one of the most closely watched issues in Phase II.
3. For plans that are partially or fully funded, should the company consolidate the pension or postretirement benefit trust in its financial statements? This debate will likely focus on concepts of consolidation and whether it would be more meaningful to present the pension liability and the pension assets separately on the balance sheet, instead of following a net liability/asset presentation as proposed in Phase I.
4. How should companies recognize and display in the income statement the various components of the cost of benefits, such as interest cost and investment earnings on plan assets? This debate will center, in part, on whether those amounts should continue to be reported as part of benefit expense or displayed separately, along with other interest expense and investment earnings.

GASB 45:
The governmental entities' version will soon be effective

We add this brief note about state and local government accounting because GASB 45[15] will serve as a point of reference in the economic, social, and political debates that the FASB project is likely to elicit as the Board's deliberations advance.

The Governmental Accounting Standards Board (GASB) is a participant in the changing treatment of accounting for other postretirement benefits. The GASB recently issued a new standard that requires governmental entities to measure and recognize expenses and liabilities for postretirement benefits. Before this standard was issued, governmental entities recorded those expenses on a pay-as-you-go basis—that is, on a cash basis. The new standard will require state and local governments to recognize approximately $1.0 trillion[16] on their balance sheets. We have already observed financial and political pressures emerging in some state and local governments from the growing awareness of the issue.

15 Governmental Accounting Standards Board, Statement of the Governmental Accounting Standards Board No. 45, *Accounting and Financial Reporting by Employers for Postretirement Benefits Other than Pensions*, 2004

16 *New York Times*, December 11, 2005

Thinking about the issues

We urge all stakeholders to avoid making the accounting a lightning rod for their dissatisfaction or satisfaction.

If all of this were exclusively an accounting issue, there would likely be no sharp or enduring difficulty for companies, their employees, and investors. The accounting would be brought up to date—brought into conformity with new and sensible attitudes about the transparency of corporate disclosures—and companies would adjust and go on, as would their employees. The larger issues have to do with the competitiveness of American companies and the quality of life of American workers. These are issues that reach well past accounting. We urge all stakeholders to avoid making the accounting a lightning rod for their dissatisfaction or satisfaction with the trends in corporate pension and other postretirement benefits offerings.

Senior executives and their advisors, including boards and external auditors, would do well to study this complex of issues very carefully. Multiple, sometimes conflicting perspectives will matter: the company's competitiveness, obligations old and new to employees, treasury concerns, the substance and the "optics" of the company's financial statements, and the impact of changes on tangible facts, such as share price, and on high-value intangibles, such as reputation.

In earlier pages we highlighted many issues that need attention and ultimately, decisions. Here we focus on just a few remaining perspectives and issues.

Companies will take action, insofar as possible, to ensure their competitiveness and sustainability. It is already evident that this involves, for some companies and perhaps many more to come, a reengineering of their postretirement benefit arrangements. In our view, prudent actions to consider include the following:

- Act with great care. Study the issues with a focus on understanding the interactions among the many perspectives that influence benefits offerings, and bear in mind that more than an accounting change is at stake.
- Act in an equitable manner. If benefit reductions are considered necessary, management may find it worthwhile to ensure that reductions are unmistakably perceived to impact all levels of employees, not just those least able to influence outcomes.
- Communicate clearly, honestly, and often with all stakeholders in a company's network, both inside and outside the company. No constituency should have grounds for saying that management acted without due consultation or that the decisions it reached have no proper rationale.

Businesses and the economy are now constantly in the headlines, and ordinary people are keenly aware of breakthrough technologies, new types of businesses, the emergence of global competitors, and the struggles of famous companies and key industries to renew themselves. Today's consumer culture doesn't blindly receive what companies produce and distribute. Consumers look past goods and services to the companies they deal with, and the Internet provides a nearly instantaneous, flexible medium for sharing knowledge and views.

That the FASB has a postretirement benefits project is probably not common knowledge outside of the accounting and human resource communities—but the fact that postretirement benefits are coming under pressure is definitely common knowledge. Given the level of public attention to business in general and to this issue in particular, companies are under some pressure to solve their competitive dilemmas in ways that retain employee, customer, and investor loyalty. So doing, they will build soundly for the future.

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