Pension and Accounting, Transpare

Introduction

Pension and other post-retirement employee benefit (OPEB) plans are now under extensive scrutiny by lawmakers, regulators, and standard-setters as many companies are failing to contribute sufficient funds to worker retirement plans. Pension benefits are becoming too expensive, and many employees have switched from traditional pensions to so-called defined contribution plans like 401(k). The application of existing accounting standards for pension and OPEB plans has created misleading and meaningless financial statements that often overstate reported total assets. For example, in 2004, the S&P 500 companies reported $99.0 billion in net pension assets on their balance sheets, while their pension plans were underfunded by $165.0 billion, indicating a total overstatement of $264.0 billion.[1] This article's purpose is to examine the funding status and accounting of both pension and OPEB plans and make suggestions for their transparency and compliance.

[1] D. Zion and B. Carcache, "Let the Games Begin: FASB to Tackle Pension and OPEB," *CSFB's Research and Analysis*, November 11, 2005.

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OPEB Plans:

ency, and Compliance

by
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Funding Status of Pension and OPEB Plans

The two sources for funding retirement are lifetime corporate pensions and private 401(k) employee contribution plans, which are both in crisis as baby-boomers live longer and their income shrinks.[2] Recently it was found that about half of the nation's workforce is not covered by a private-sector retirement plan: 30.0 percent invest in employee contribution plans like 401(k), 10.0 percent have lifetime corporate pensions, and the remaining 10.0 percent have a combination of 401(k) and pension plans.[3] Americans with 401(k) and pension plans need to save 15.0-18.0 percent of their annual salary for 30 years by accumulating at least six to ten times their annual pay before retirement in order to be able to maintain their standard of living.[4] In the past several decades, there also has been a significant shift in the cost and responsibility for retirement saving from corporations to employees.

[2] Press Release, "Baby Boomers Face Retirement Crisis as Lifetime Pensions Wither and 401(k)s Falter," May 8, 2006. Available at: http:/www.pbs.org/frontline/retirement

[3] *Ibid.*

[4] *Ibid.*

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At the turn of the century (2000-2001), public pension plans held an average of 100.0 percent of the fund required to meet obligations to workers. However, many public pension plans lost money when the stock market dropped. By 2004, the average funding level of these plans had decreased to 87.8 percent, and for some plans to as low as about 50.0 percent funded.[5] Several prominent companies have announced that they will go out of business unless they are allowed to terminate their pension plans. One example is Pittsburgh Brewing, which informed the Federal Pension Benefit Guaranty Corporation (PBGC) that unless its pension plan is terminated, it will not be able to continue in business.[6] On January 23, 2006, Sprint Nextel reported its decision to freeze pension plans for almost half of its 80,000 employees by not offering a fixed retirement benefit to new workers in order to be able to compete with other wireless carriers.[7]

A report issued by the Government Accountability Office (GAO) reveals that more than half of the 29,000 private pension plans insured by the U.S. PBGC are underfunded. This suggests that companies' obligations to their retirees exceed the assets of their defined-benefit plans, and the underfunded pension and OPEB plans have been keeping the off-balance-sheet.[8]

Pensions and OPEB Accounting

Post-retirement benefits, including pensions and their accounting, have been a challenge for public companies and are now becoming a struggle to survive as:

1. Some companies have eliminated, frozen, or amended their plans (e.g., Sprint, Nextel, Verizon, and IBM);
2. Other financially-distressed companies (e.g. United Airlines, Pittsburgh Brewing) have shifted their pension obligations to the PBGC; and
3. The Financial Accounting Standards Board (FASB) has initiated its two-phase project of improving accounting practices by requiring recognition of unfunded pension and OPEB obligations.

Many of the OPEB and pension plans were developed several decades ago with observable costs and obligations for companies, and now fulfilling OPEB and pension obligations diverts companies' operating capital intended for growth, expansion, and operating purposes. To effectively compete in the global market and particularly with companies in countries where labor is cheap and pension and OPEB plans are practically non-existent, U.S. companies may have to reduce employees' retirement benefits and freeze or terminate their defined-benefit plans.

The Financial Accounting Standards Board (FASB) has issued two Statements of Financial Accounting Standards (SFAS), Nos. 87 and 106, to address accounting for pensions and OPEB, including healthcare and related retiree benefits. Both SFAS Nos. 87 and 106, while providing guidance for entities to measure, recognize, and report their pension and OPEB costs, do not require entities to recognize unfunded pensions and OPEB assets and liabilities. Prior to the adoption of SFAS 87, there was little, if any, comparability or consistency among companies and industries regarding reported pension costs. SFAS 87 increased the comparability and understandability of pension accounting by requiring a standardized method for measuring net periodic pension cost and an immediate recognition of a liability when the accumulated benefit obligation exceeds the fair value of plan assets.[9]

SFAS 106 significantly changed the manner in which companies were allowed to account for OPEB. Prior to its implementation, such benefits were accounted for by the "pay-as-you-go" or cash basis method of accounting. SFAS 106 requires that the expected cost of providing post-retirement benefits to an employee and the employee's beneficiaries and covered dependents is to be accrued during the years that the employee renders the necessary service. The FASB promoted the change to enhance the under-

[5] A. Geller, "Walkout Points to More Tension on Public Pensions," Associated Press, December 29, 2005.

[6] L. Boselovic, "Pittsburgh Brewing Says It's in Deep Trouble," *Pittsburgh Post Gazette*, June 29, 2005.

[7] B. Eckert, "Sprint Nextel Freezes Pensions for Half Its Workforce," *Washington Business Journal*, January 23, 2006. Available at: http://www.bizjournals.com/washington/stories/2006/01/23daily6.html

[8] "PRIVATE PENSIONS: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules," United States Government Accountability Office: Report to Congressional Committees, 2005. Available at: http://www.gao.gov/new.items/d05294.pdf

[9] Financial Accounting Standards Board, "Employer's Accounting for Pensions: Statement of Financial Accounting Standards No. 87," 1985. Available at: http://www.fasb.org/pdf/fas87.pdf

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standability, comparability, and usefulness of the disclosed information in the financial statements.[10]

Dissatisfaction with financial reporting for defined-benefit pensions and OPEB has been growing during the past decade primarily because pensions and OPEB obligations are not fully recognized on the balance sheet. The FASB has recently responded to concerns regarding accounting for pensions and OPEB by undertaking a two-phase project to improve the transparency of overfunded or unfunded pension and OPEB plans. Phase I of the FASB's project would adjust assets (liabilities) for the amount of overfunded (underfunded) pensions without addressing the impact of pension and OPEB costs on the income statement. The second phase is intended to be a complete overhaul of accounting for pension and OPEB plans, which would minimize smoothing mechanisms from pension and OPEB accounting.

In September 2006, the FASB issued its "Statement of Financial Accounting Standards (SFAS) No. 158, Employer's Accounting for Defined Benefit Pension and other Postretirement Plans," which requires companies to recognize on their balance sheet the funded status of their pension and OPEB Plans as of December 31, 2006 for calendar-year companies.[11] SFAS No. 158 will also require fiscal year-end measurements of plan assets and benefit obligations, which will be effective for fiscal years ending on or after December 15, 2008. SFAS No. 158 completes the first phase of FASB's project on Pension and OPEB Plans. The next phase will provide accounting standards concerning measuring plan assets and obligations and the determination of net periodic benefit cost. The FASB is planning to move forward with Phase II of its OPEB and pension project that could result in a comprehensive overhaul of accounting standards for pension and OPEB plans. The proposal is intended to improve the accuracy, completeness, and transparency of financial statements to all users of financial reports including shareholders, creditors, employees, donors, and retirees by encouraging the balance sheet to better reflect the economics of the entity's pension and OPEB plans.

[10]Financial Accounting Standards Board, "Employers' Accounting for Postretirement Benefits Other Than Pensions: Statement of Financial Accounting Standards No. 106," 1990. Available at: http://www.fasb.org/pdf/fas106.pdf

[11]Financial Accounting Standards Board (FASB), "Exposure Draft to Improve Accounting for Postretirement Benefit Plans, Including Pensions," March 31, 2006. Available at: http://www.fasb.org

Transparency and Compliance of Pension and OPEB Funding Status

Credit Suisse estimates that in 2005, S&P 500 companies were underfunded $145 billion for pensions and $327 billion for OPEB that was not recognized in their financial statement. Presenting this nearly half a trillion dollars in underfunded pensions and OPEBs on the balance sheets for the S&P 500 companies would reduce their shareholders' equity by about 6.0 percent, or $248 billion, whereas some companies would experience more than a 25.0 percent decline in their shareholders' equity. This substantial decline in the book value of equity could have several effects on companies' key financial indicators.[12] First, declining book values of equity will increase price-to-book ratios, which makes companies appear more expensive based on a price-to-book ratio and could affect the determination of whether the company's stock is a growth index or a value index. Second, such a decline in book values affects the company's debt-to-equity ratio and, thus, debt/loan covenants, which may result in defaults or covenant renegotiations. Third, the recognition of unfounded pensions and OPEB could generate a substantial deferred tax asset for companies. Finally, many companies may choose to fund their pension and OPEB plans in order to prevent adversarial effects on their equity by either borrowing to fund their plans or using the cash that is on their balance sheet.

In summary, the FASB proposal should encourage entities to better present the economics of their pension and OPEB plans in their financial statements and eventually will improve the transparency of the post-employment benefits and compliance with funding requirements of their pension and OPEB plans. To mitigate the substantial decline in equity resulting from the implementation of the proposed standards by bringing the funded status of the pension and OPEB plans on the balance sheet, companies may take a number of initiatives. First, companies may choose to fund their OPEB and pension plans through either debt financing (borrowing) or by using their excess cash. The Credit Suisse report indicates that 235 of the S&P 500 companies could fully fund their OPEB and pension plans with the cash that is on their balance sheets, whereas 128 companies (that constitute about 70.0 per-

[12]Credit Suisse, "The Hit to Equity: Bringing Pension and OPEB Funded Status on Balance Sheet," *The Credit Suisse Research & Analytics*, May 5, 2006. Available at: http://www.credit-suisse.com/research-andanalytics

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cent of underfunded plans) would have to borrow money to fully fund their pension and OPEB plans.[13] Fully funding of OPEB and pension plans could significantly improve the health, transparency, and compliance for these companies' pension and OPEB plans. Second, companies may attempt to reduce their OPEB and pension-funded status by shrinking their plans' obligations by passing on some costs to their plan participants. Third, companies may attempt to limit the growth in the plans' obligations by closing the OPEB and pension plans to new employees or by freezing these plans. Finally, companies may try to totally shut down or terminate their pension and OPEB plans.[14]

Future of OPEB and Pension Plans

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (PPA), which requires many changes in the way pension funds are designed, administered, documented, funded, and disclosed in regulatory filings.[15] The key provisions of PPA are:

1. The simplification of Form 5500 annual return reporting requirements for certain pension plans with fewer that 25 participants.
2. The requirement that plan Form 5500 annual reports be made available electronically on the company sponsor's web site and the Department of Labor's web site.
3. Actuarial certification as to whether the plan is endangered or in a critical status for multiemployer defined benefits plans.
4. The requirement for quarterly benefit statements for participant-directed defined contribution plans, annual statements for other defined contribution plans, and statements every three years for defined pension plans.
5. The establishment of new minimum funding standards for multi-employer and single-employer defined benefit pension plans.
6. Limitations of benefit increases and accruals for underfunded plans.
7. Allowing companies with up to 500 employees to establish combined defined benefit and automatic enrollment 401(k) plans using a single plan document and trust fund beginning in 2010.
8. Permitting fiduciary advisers of a plan to give investment advice to 401(k) participants or beneficiaries if certain criteria are met (e.g., new independent audit requirement).
9. Increasing the deductions limits for multiemployer and single-employer plans.
10. The establishment of new rules for testing defined benefit plans, including cash balance and other hybrid plans.
11. Allowing annuity contracts and life insurance to include long-term care insurance contacts.[16]

The recent rash of pension defaults among industries, including steel, airlines, and car companies, have raised serious concerns about the future of the PBGC. Regarding the seriousness of pension plan problems, Arthur Levitt, former SEC chairman, stated, "It's imperative that we reform the regulatory incentives and accounting rules that encourage employers to make, and employees to accept, promises that can't be kept."[17]

Levitt (2005) makes three recommendations for reforming pensions to prevent the pension crisis that may cripple the economy:[18]

1. **Bring Accuracy, Transparency, and Accountability to Pension Accounting.** There are currently extensive subjectivity and unrealistic estimations involved in pension accounting to the extent that the real economic liability of pension plans and its related actual value of assets are not properly reflected on the balance sheet.
2. **Relevant and Reliable Pension Plan Information.** Investors and pensioners demand and deserve reliable, transparent, and relevant information from pension plans, not just incomprehensible footnote disclosures.

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[13]*Ibid.*

[14]*Ibid.*

[15]Pension Protection Act of 2006. Technical Explanation of H.R. 4 "Pension Protection Act of 2006." (July 28). Available at: www.house.gov/jct/x-38-06.pdf.

[16]*Ibid.*

[17]A. Levitt,, "Pensions Unplugged," *The Wall Street Journal*, November 10, 2005: A16.

[18]*Ibid.*

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3. **Improvements of Public Pensions of State and Local Governments.** Inadequate disclosure rules have failed to accurately reflect the assets and liabilities of the public pensions of state and local governments, and their unfunded liabilities are reaching $1.0 trillion.

Conclusion

Defined-benefit pension plans are coming under closer scrutiny by lawmakers, regulators, and standard-setters because of weaker plans, high profile bankruptcies, pension reform, and the FASB's new pension accounting standards. Several factors have contributed to the perceived crisis in pension and OPEB plans, including the bankruptcy of high-profile companies such as Enron and WorldCom (which legally terminated lifetime pension programs), well-publicized financial restatements of prominent companies such as Xerox, AOL, and Tyco (which caused the underfunding of pensions and OPEB), and companies' decisions to reduce or terminate their pension plans and their unfunded retirement plans to the PBGC (which already has more than a $23 billion deficit). This perceived retirement crisis can be worsened by the fact that the majority of pension and OPEB plans are unfunded and soon will be required to be presented on the balance sheet, which will substantially reduce the shareholder equity of public companies. Pension and OPEB plans will be unsustainable if they are not fundamentally altered over the next few years to create a right balance between corporate pensions and private 401(k) plans and improve accounting, transparency, and compliance for these plans.

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Professor Rezaee has published over 160 articles in a variety of accounting and business journals, such as the *Journal of Accounting and Economics*, *Journal of Business, Finance and Accounting*, *Journal of Accountancy*, *Journal of Accounting, Auditing and Finance*, *Management Accountants*, *Internal Auditor*, *Advances in Accounting*, *Advances in Public Interest and Accounting*, *Journal of Forensic Accounting*, and *Strategic Finance*. Professor Rezaee has published several articles on forensic accounting and financial statement fraud.

Active within the accounting profession and the academic and business communities, Professor Rezaee has made over 120 presentations at conferences and workshops throughout the world. He teaches financial, management and international accounting and auditing, and has been involved in financial and management consulting with national and international organizations, such as the United Nations. Professor Rezaee is the author of *Financial Institutions, Valuations, Mergers and Acquisitions*, John Wiley & Sons, 2001, and has served on the editorial boards of several journals, including the *Forensic Accounting Journal*. He received the 1998 Distinguished Research Award at Middle Tennessee State University and the Lybrand Bronze Medal for Outstanding Article in 1999, selected by the Institute of Management Accountants. In 2002, he published a book entitled *Financial Statement Fraud: Prevention and Detection*, John Wiley & Sons. Dr. Rezaee has recently received the IIA 2003 Outstanding Contributor Award for his article, "The Three Cs of Fraudulent Financial Reporting" from the Institute of Internal Auditors.

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