

# Defining Issues<sup>®</sup>

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## More Pension Obligations To Be Recognized on Balance Sheets

New Statement 158 requires employers to recognize on their balance sheets the funded status of pension and other postretirement benefit plans—as of December 31, 2006 for calendar-year public companies.<sup>1</sup> Employers will recognize actuarial gains and losses, prior service cost, and any remaining transition amounts from the initial application of Statements 87 and 106 when recognizing a plan's funded status, with the offset to accumulated other comprehensive income.<sup>2</sup> Many employers that sponsor defined benefit plans could therefore report significantly increased liabilities, with corresponding reductions in equity.

Statement 158 will also require fiscal-year-end measurements of plan assets and benefit obligations, eliminating the use of earlier measurement dates currently permissible. But the new measurement-date requirement will not be effective until fiscal years ending after December 15, 2008.

The new Statement amends Statements 87, 88, 106, and 132R, but retains most of their measurement and disclosure guidance and will not change the amounts recognized in the income statement as net periodic benefit cost.<sup>3</sup> However, Statement 158 represents only the first phase of the Board's project on postretirement benefits. The next phase will consider potential changes in determining net periodic benefit cost and measuring plan assets and obligations.

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### Funded Status

Statement 158 requires the net amount by which the defined-benefit-postretirement obligation is over- or underfunded to be reported on the balance sheet. The new requirement will apply to both pension and other postretirement benefit plans. It replaces Statement 87's requirement to report at least a minimum pension liability measured as the excess of the *accumulated* benefit obligation over the fair value of the plan assets. If no minimum pension liability had to be reported on the balance sheet, neither did any portion of the actuarial gains and losses, prior service cost, or transition amounts that had not yet been included in net peri-

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<sup>1</sup> FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, September 2006, available at [www.fasb.org](http://www.fasb.org).

<sup>2</sup> FASB Statement Nos. 87, *Employers' Accounting for Pensions*, December 1985, and 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, December 1990, both available at [www.fasb.org](http://www.fasb.org).

<sup>3</sup> FASB Statement Nos. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, December 1985, and 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits*, December 2003, both available at [www.fasb.org](http://www.fasb.org).

<b>Terminology</b>	
Projected Benefit Obligation	The actuarial present value of pension benefits attributed to service already rendered, measured using assumptions as to future compensation levels.
Accumulated Benefit Obligation	The actuarial present value of pension benefits attributed to service already rendered, measured using current compensation levels.
Accumulated Postretirement Benefit Obligation	The actuarial present value of postretirement benefits attributed to employee service already rendered.
Prior Service Cost	The cost of benefit improvements attributable to plan participants' prior service pursuant to plan amendments or plan initiation.

odic benefit cost. Instead, these amounts were reported in the financial-statement notes.

The funded-status amount will be measured as the difference between the fair value of plan assets and the benefit obligation, with the benefit obligation including all actuarial gains and losses, prior service cost, and any remaining transition amounts. If the benefit obligation is larger than the fair value of plan assets, the plan would be underfunded, and a net liability would be reported. Conversely, if the fair value of the plan assets is larger, the plan would be overfunded, and a net asset would be reported on the balance sheet.

A pension plan's benefit obligation will be measured using the *projected* benefit obligation. The benefit obligation of a postretirement benefit plan other than a pension will be measured as the accumulated postretirement benefit obligation. These and other key terms are described in the accompanying table.

Statement 158 will not change the components of net periodic benefit cost. All items previously deferred when applying Statements 87 and 106 will now be recognized as a component of accumulated other comprehensive income, net of applicable tax effects. Amounts recognized in accumulated

other comprehensive income will be adjusted or "recycled" out of accumulated other comprehensive income when they are subsequently recognized as components of net periodic benefit cost. The accompanying table illustrates the differences between the requirements for a pension plan under Statements 87 and 158.

Statement 158's requirements for other postretirement benefit plans are similar to those illustrated in the table. However, in most cases, those plans are unfunded, in which case the funded status is the same as the accumulated postretirement benefit obligation.

The declines in discount rates and investment returns over the past several years have caused many employers to disclose material amounts of unrecognized net benefit obligations. Under Statement 158, these net obligations will be recognized on the balance sheet with the offsetting reduction to equity. The reduction in equity could affect an employer's ability to comply with debt-covenant provisions, such as debt-to-equity ratios and other contractual requirements. Employers may want to discuss these changes with their lenders and suppliers.

### Classification

Employers with more than one postretirement benefit plan will be required to aggregate all

<b>Example Comparing Statement 158's Requirements for a Defined Benefit Pension Plan to Statement 87's</b>			
Assumed Facts		Statement 87	Statement 158
Projected benefit obligation	\$ (1,000)	Note disclosure	No change
Fair value of plan assets	600	Note disclosure	No change
Funded status (net obligation)	\$ (400)	Note disclosure	Recognized on employer's balance sheet
Unrecognized actuarial loss	\$ 325	Note disclosure	Recognized as a component of accumulated other comprehensive income
Unrecognized prior service cost	100	Note disclosure	Recognized as a component of accumulated other comprehensive income
Unrecognized transition amount	50	Note disclosure	Recognized as a component of accumulated other comprehensive income
Prepaid pension asset	\$ 75	Recognized on employer's balance sheet	Not separately recognized or disclosed
The employer will be required to adjust its financial statements to eliminate the \$75 prepaid pension asset that was recognized under Statement 87, record a pension liability of \$400, and charge accumulated other comprehensive income (or reduction equity) by \$475 (reported net of any related tax effect).			

overfunded plans and report one net asset amount and to aggregate all underfunded plans and report one net liability amount. The current and noncurrent portions of the liability will be reported separately in a classified balance sheet.

A current liability will be reported for the amount by which the fair value of plan assets is exceeded by the expected benefits to be paid over the next 12 months or over the operating cycle if it is longer. This is determined on a plan-by-plan basis. To illustrate this requirement, assume an employer with a classified balance sheet has one pension plan that is underfunded by \$10,000 and expects to pay pension benefits of \$1,000 in the next fiscal year. The fair value of the plan's assets is \$800 at the balance-sheet date. The employer will separately classify a current liability of \$200, the excess of the expected benefit payment over the fair value of plan assets, and a noncurrent liability of \$9,800.

The entire amount of expected benefits to be paid over the next 12 months or operating cycle will be classified as current for plans with no plan assets, such as many supplemental executive-retirement and postretirement medical plans. Net postretirement benefit assets will always be classified as noncurrent.

### Tax Effects

Employers will have to measure the tax effects of the amounts reported in accumulated other comprehensive income. Recognizing a liability related to previously unrecognized amounts (i.e., actuarial and experience losses, prior service cost, remaining transition obligation from initial adoption of Statements 87 and 106) will result in an associated deferred tax asset that will have to be evaluated for realizability in accordance with Statement 109.<sup>4</sup>

Employers evaluating whether realizability is more-likely-than-not will need to consider all the relevant facts and circumstances, including the length of the period during which the deferred tax asset is expected to reverse and whether valuation allowances have been established for other deferred tax assets. Changes in the assessed need for a valuation allowance for previously recognized deferred tax assets are reported in the current-period tax provision under Statement 109, not in accumulated other comprehensive income.

For example, assume that a company reports a pre-tax charge to accumulated other comprehensive income of \$1,000 and has a 40 percent tax rate. It recognizes a deferred tax asset of \$400 and assesses the deferred tax asset for recoverability. The company concludes that realizability is not more-likely-than-not and therefore establishes a valuation allowance equal to the deferred tax asset of \$400. As a result, no tax effect is reported for the charge to equity because the valuation allowance offsets the deferred tax benefit at its initial recognition. The company's facts and circumstances change in a later period, and in that subsequent period the realizability of the deferred tax asset is more-likely-than-not. The company therefore eliminates the valuation allowance and recognizes a tax benefit of \$400 in current-period income from continuing operations.

### Measurement Date

Statement 158 will require plan assets and benefit obligations to be measured as of the balance-sheet date except for plans sponsored by a subsidiary or equity-method investee that are consolidated or included in the financial statements using a fiscal period different

from that of the parent or investor. The new Statement eliminates the provisions in Statements 87 and 106 that permit employers to measure plan assets and benefit obligations as of a date not more than three months prior to the balance-sheet date. Companies that currently use a lagged measurement approach will need to develop processes to measure the asset and obligation as of the balance-sheet date when Statement 158's provisions become effective.

### Not-For-Profit Organizations

Some not-for-profit organizations report a measure of activity for the period instead of net income and comprehensive income. The Statement provides reporting guidance for not-for-profit organizations that report a measure of activity. These not-for-profit organizations should also refer to existing guidance.<sup>5</sup>

### Transition

Public companies, defined as entities whose equity securities trade in a public market, are required to recognize on the balance sheet the funded status of their defined-benefit postretirement plans in fiscal years ending after December 15, 2006 (December 31, 2006 for calendar-year companies). All other employers are required to adopt these provisions in fiscal years ending after June 15, 2007. Financial statements for previous periods will not be adjusted.

### *Transition for Changes in Measurement*

**Date.** The Statement requires plan assets and benefit obligations to be measured as of the balance-sheet date for fiscal years ending after December 15, 2008. Earlier application is encouraged, but the Statement prohibits applying the measurement-date requirement

<sup>4</sup> FASB Statement No. 109, *Accounting for Income Taxes*, February 1992, available at [www.fasb.org](http://www.fasb.org).

<sup>5</sup> FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, June 1993, available at [www.fasb.org](http://www.fasb.org); and AICPA Audit and Accounting Guide, *Health Care Organizations*, May 2005.



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retrospectively to prior periods for which financial statements have previously been issued. Employers may choose one of two transition methods to adopt this requirement.

Under the first method, in the year that the measurement date is changed, the employer makes an additional measurement of the plan assets and obligations as of the beginning of the year of adoption. The net periodic benefit cost is determined using a beginning-of-the-year measurement date. Net periodic benefit cost for the period between the previous lagged measurement date and the beginning of the current year is recognized as an adjustment of the opening balance of retained earnings.

Under the second method, the employer determines the net periodic benefit cost for the period between the lagged measurement date and the end of its year ending after December 15, 2008 (a period that could be up to 15 months). The amount determined is then proportionately allocated to current-period benefit cost and to ending retained earnings. This approach will not require an additional measurement of plan assets and benefit obligations at the beginning of the fiscal year that the measurement-date provisions become effective.

To illustrate the second method, assume a calendar-year-end company had measured its plan assets and benefit obligations using a September 30 measurement date. The company measures these plan assets and benefit obligations on September 30, 2007 based on its previous measurement policy and will make its next measurement of plan assets and benefit obligations at December 31, 2008. The September 30, 2007 measurement will be used to determine net periodic benefit cost for 2008, which is the same amount that would have been recognized in 2008 if the Statement's measurement-date provisions had not been adopted. The company would estimate the benefit cost for 15 months. If that amount is \$15 million (\$1 million per month), the company would record \$12 million of net periodic benefit cost for 2008 and \$3 million as an adjustment to the ending balance of retained earnings at December 31, 2008—representing the net periodic benefit cost (\$1 million per month) attributed to the 3 months that was not recorded in the income statement.

Under either transition method, any gains or losses from plan settlements or curtailments that occur during the change in measurement period (September 30, 2007 to December 31, 2007 in the previous example) will be recognized in earnings in that fiscal year.



With the publication of Statement 158, the FASB can move on to the second phase of its project on pension and other postretirement benefit obligations. It will be undertaken jointly with the IASB and will evaluate all aspects of accounting for pension and postretirement benefit obligations, including the measurement of plan assets and obligations and the option to delay income-statement recognition of actuarial gains and losses and prior service cost.

The descriptive and summary statements above are not intended to be a substitute for the text of Statement 158 or for the text of any other cited or potential requirements. Reporting entities complying with adopted requirements or complying with SEC filing requirements should consult the texts of the applicable documents that set out GAAP and SEC requirements, the particular circumstances to which the requirements are to be applied, and their accounting and legal advisors.