

REVISED MINUTES



To: Board Members
From: Strange (ext. 442)
Subject: Revised Minutes of the November 10, 2005 Board Meeting: Agenda Decision
Pensions and Postretirement Benefits **Date:** November 30, 2005
Other Than Pensions
cc: FASB: Bielstein, Smith, Petrone, Project Team, Cassel, Carney, Swift, Polley, Gabriele, Mahoney, Sutay, FASB Intranet; GASB: Attmore, Bean; IASB: Leisenring, Upton, McGeachin, Hickey,

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Postretirement Benefit Obligations, Including Pensions—Agenda Decision

Basis for Discussion: Board Memorandum No. 1 dated October 19, 2005

Length of Discussion: 9:10–9:50 a.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schipper, Seidman, Trott, and Young

Board members absent: None

Staff in charge of topic: Proestakes

Other staff at Board table: Bielstein, Cassel, and Strange

Outside participants: None

Summary of Decisions Reached:

The Board considered the staff's analysis of a possible project to reconsider the existing guidance on accounting for postretirement benefits, including pension benefits. The Board decided to add a comprehensive project to its technical agenda and to conduct that project in two phases.

The first phase is targeted for completion by the end of 2006. The Board's objective in undertaking that phase is to address the fact that under current accounting guidance, important information about the financial status of a company's postretirement benefit plans is reported in the notes to the financial statements but not in the statement of financial position. Accordingly, this phase seeks to improve financial reporting by requiring that the funded or unfunded status of postretirement benefit plans, measured as the difference between the fair value of plan assets and the benefit obligation (i.e., the example, projected benefit obligation (PBO) for pensions and the accumulated postretirement benefit obligation (APBO) for other postretirement benefits), be recognized on the balance sheet. This phase of the project is not expected to change the amount of net benefit cost included in the determination of net income.

In the second multi-year phase of the project, the Board expects to comprehensively consider a variety of issues related to the accounting for postretirement benefits, such as (a) how the various elements that affect the cost of postretirement benefits are best recognized and displayed in the statement of earnings and comprehensive income, (b) how to best measure an entity's benefit obligations, including whether more or different guidance should be provided regarding assumptions used in measuring the benefit obligations, and (c) whether postretirement benefit trusts should be consolidated by the plan sponsor. Furthermore, consistent with its efforts toward international convergence, the FASB expects to conduct this comprehensive phase collaboratively with the IASB and other standard setters around the world.

Objective of Meeting:

The objective of the meeting was for the Board to decide whether to add a project to its technical agenda to reconsider the accounting for postretirement benefits and, if so, the objective, scope, and timing of such a project. The objective was met.

Matters Discussed and Decisions Reached:

1. Mr. Proestakes began the discussion by stating that several months ago Board members asked the staff to identify and analyze the issues associated with the accounting for postretirement benefits in order for Board members to assess whether to add a project to the technical agenda. The staff's research included the following:

- a. Review numerous articles in the financial press and other reports, primarily authored by investment analysts
- b. Obtain input from the FASB's Financial Accounting Standards and User Advisory Councils and other financial statement users
- c. Examine recommendations included in the SEC's 2005 Report on Off-Balance Sheet Arrangements
- d. Study the decisions reached by the Boards that promulgated FASB Statements No. 87, *Employers Accounting for Pensions*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

2. Mr. Proestakes stated that the staff found that users of financial statements and other constituents do not believe the current accounting model results in financial statements that are understandable or that reflect the costs and economic status of defined benefit postretirement plans. The specific issues financial statement users, primarily investment analysts, would like the Board to address are quite varied, with emphasis on:

- a. Delayed recognition of economic gains and losses, which results in significant obligations not being recognized in the balance sheet,
- b. Individual components of cost and how they should be classified in earnings; the current model is viewed by some as incorrectly classifying financing gains and losses within the operating section of the income statement,
- c. Measurement of benefit obligations, including the need for more guidance on how assumptions should be derived, the measurement of cash balance plans and other plans containing lump-sum settlement features, the accounting for multiemployer plans, and quarterly measurement updates, and

- d. Additional disclosures about plan assets, delayed recognition, and sensitivity information.
3. Mr. Proestakes stated that the FASB's Financial Accounting Standards and User Advisory Councils have in the past urged the Board to add similar issues. The Financial Accounting Standards Advisory Council ranked postretirement benefits as one of the highest priorities the Board should address. In its report on off-balance sheet arrangements, the SEC ranked postretirement benefits as the Board's highest priority among the SEC's specific standards-setting recommendations. The SEC also recommended the Board jointly address postretirement benefit accounting with the IASB.
4. Mr. Proestakes reported that on November 7, 2005, the Pension Benefit Guaranty Corporation submitted a letter to the FASB acknowledging the problems with the current accounting, stating that it is vitally important that plan participants, equity owners, bondholders, and others have relevant and timely information regarding the funded status of a company's pension plan. The letter strongly encouraged the Board to undertake a project.
5. In reviewing the Board's decisions described in the basis for conclusions of Statements 87 and 106, Mr. Proestakes noted that the staff observes a difference between what the Board believed would be the most relevant, conceptually-based accounting and what was promulgated based on certain pragmatic compromises. For example, the Board believed the projected benefit obligation was the most relevant measure of the pension obligation and that it would be conceptually appropriate and preferable to recognize a net liability or asset measured as the difference between the obligation and plan assets, either with no delay in recognition of gains and losses, or perhaps with gains and losses reported currently in comprehensive income but not in earnings (Statement 87 paragraph 107). Mr. Proestakes stated that instead the Board compromised, departing from that fundamental belief in order to reduce earnings volatility. Compromises resulted in recognition of expected long-term returns rather than actual returns on plan assets and amortization of actuarial gains and losses only if the accumulated gain or loss exceeds 10 percent of plan assets or the benefit obligations (10 percent corridor).

6. Mr. Proestakes stated that as a result of the staff's research and analysis, including the availability of feasible solutions, the Board could consider addressing the issues and concerns of financial statement users. He continued that the staff recommends adding a comprehensive project to the Board's technical agenda.

7. Mr. Proestakes noted that there are diverse opinions about what aspects of the current accounting model need to be addressed and revised, and the accounting issues do not lend themselves to simple or quick resolutions. Addressing the concerns of financial statement users would entail revisiting many of the questions deliberated when Statements 87 and 106 were active projects, in addition to other issues that have arisen more recently. Mr. Proestakes stated that these factors require a comprehensive multi-year project; however, in lieu of waiting years before the comprehensive project is completed, the staff considered a phased approach in which improvements could be made incrementally.

8. Mr. Proestakes outlined that the first phase of the staff's proposed project would improve the understandability and representational faithfulness of the amounts reported in the balance sheet by recognizing the economic status of postretirement benefit plans, which could be accomplished by recognizing in the financial statements amounts that are presently disclosed in the footnotes. Actuarial gains and losses that were previously deferred pursuant to the delayed recognition (smoothing) devices of the existing accounting model could be recognized either in earnings or other comprehensive income when those gains and losses arise. The staff believes that initially those actuarial gains and losses should be recognized in other comprehensive income.

9. Mr. Proestakes stated that in the first phase, Board members would be asked to consider whether to require that the funded or unfunded status of defined benefit plans, measured as the difference between the fair value of plan assets and the benefit obligation, be recognized in the balance sheet. (There would be no change in reported earnings.) Mr. Proestakes explained that this proposed change would significantly improve financial reporting as compared to the present state in which significant

obligations are not recognized, including those for retiree healthcare plans, which for the most part are not funded. The staff discussed its proposed approach with certain financial statement users who agreed that the proposed approach represents a significant and worthwhile improvement in financial reporting. Each of them identified additional changes they would like the Board to consider in the initial phase; however, there was little commonality between the additional changes they suggested.

10. Mr. Proestakes stated the staff believes that the scope of the initial phase should not be expanded beyond what has been recommended because it would be difficult to reach a consensus as to which additional issues should be added and because addressing additional issues would delay the significant improvements in balance sheet reporting that could otherwise be achieved. The proposed improvements would be similar to IAS Statement No. 19, *Employee Benefits* which allows reporting entities to immediately recognize actuarial gains and losses outside of profit or loss in a statement of changes in equity. The goal would be to have an amendment of Statements 87 and 106 issued by the end of 2006.

11. Mr. Proestakes stated that the goal of the comprehensive phase would be to achieve a high-quality standard that is convergent internationally. The comprehensive phase of the project would address a variety of issues including:

- a. How best to recognize and display in earnings and other comprehensive income the various elements that affect the cost of providing postretirement benefits
- b. How best to measure the benefit obligation, including how to measure for plans with lump-sum settlement options
- c. Whether more or different guidance should be provided regarding measurement assumptions
- d. Whether postretirement benefit plans should be consolidated.

Issues would be grouped so that they could be broadly and thoroughly considered before changes in accounting are promulgated. Mr. Proestakes noted that as an example, the Board recently discussed how obligations associated with cash balance and defined benefit pension plans containing lump-sum settlement features should be measured. The

questions related to that issue are complex. Under the staff's proposal, those measurement issues would be considered together with the broader question of whether more or different guidance should be provided regarding measurement assumptions. In the comprehensive phase, the Board would be asked to consider each issue and decide whether to retain or change the existing accounting guidance. Deliberations would be sequenced to provide the Board with the flexibility to promulgate standards after groups of issues are addressed in order to leverage the Board's progress on the conceptual framework, financial performance reporting, and consolidations projects.

13. Mr. Trott clarified that the staff's proposed first phase would be to take information currently disclosed in the footnotes (the funded status of the plan calculated based on the existing standards) and move that number into the balance sheet. He emphasized that the initial phase would not require any different measurements and that the staff believes this approach is the most efficient way to quickly get to the more comprehensive deliberations in the second phase.

14. Mr. Cassel emphasized that the staff's proposal for the initial phase would not deal with the question of plan consolidation. Funding status information from the footnotes would be presented net in the balance sheet for each plan, not gross (for example, a company with an under-funded plan and a larger over-funded plan would report a net asset on the balance sheet for the over funded plan and a liability for the under-funded plan). No new measurements would be prescribed during the initial phase of the project. Mr. Herz clarified that the first phase would put the full benefit obligation on the balance sheet net of plan assets.

15. In response to Mr. Crooch's question regarding the similarities of the initial phase to the IASB's accounting standards, Mr. Proestakes stated that IAS 19 permits immediate recognition of actuarial gains and losses outside of profit or loss in a statement of changes in equity, an approach that is similar to the change proposed by the staff for the initial phase. Mr. Cassel explained that U.S. accounting standards "recycle" the amounts included in other comprehensive income back through earnings to the extent that those

amounts are permitted to be recognized. Under IAS 19, the amounts in the statement of changes in equity are not permitted to be “recycled” back into earnings.

16. Mr. Batavick stated that he supports the staff’s recommendation. He noted that this issue is one constituents are greatly interested in and it has been widely acknowledged that the current accounting for postretirement benefits needs to be changed to improve employers’ financial reporting of postretirement benefit obligations. While he supports the staff’s phased approach, he admitted that his first reaction was to try to include more in the first phase; however, the staff persuaded him that picking and choosing other items to include would not be effective. Mr. Batavick stated that if the Board tried to add items to the initial phase, it would hamper the short-term goal of improving the understandability and representational faithfulness of the amount related to postretirement benefits recognized in the balance sheet. He agreed with Mr. Proestakes’ previous statement that work completed in the conceptual framework and financial performance reporting projects would assist the Board in the later phase.

17. Mr. Crooch also supported the staff’s recommendation. He noted that one of the questions the Board receives is about the funded status of postretirement plans, which confirms the importance of moving this information into the balance sheet from the footnotes. He also noted that the initial phase would provide the opportunity for the FASB and the IASB to begin the convergence process. He acknowledged that adding any additional items would delay the initial phase and emphasized the importance of moving quickly. Mr. Crooch also recognized that the Board will likely be criticized for not doing enough in the initial phase but that the Board would be criticized regardless.

18. Ms. Schipper also supported the staff’s recommendation. Ms. Schipper noted that there would be no new calculations, no change regarding classification, and no resolution of contentious measurement issues (such as measurement of cash balance plans and use of the accumulated benefit obligation versus the projected benefit obligation) in the initial phase. Regardless, she stressed that simply moving the amounts from the footnotes into the balance sheet represents a major improvement in financial reporting because it eliminates the implicit presumption that disclosure of the net funded status is an adequate

substitution for its recognition. Ms. Schipper believes the Board did not consider disclosure adequate substitute for recognition when it issued Statements 87 and 106. In fact, she said Board members acknowledged they had made pragmatic compromises intending “evolutionary” change. Ms. Schipper stated that disclosure as a substitute for recognition not only violates the conceptual framework’s qualitative characteristic of completeness, but there is also no evidence in academic literature that such substitution is adequate.

19. Ms. Schipper stated that she understands constituents’ concerns that requiring recognition before solving measurement problems may result in two transitions (one related to recognition and another related to new measurement) but noted that those concerns should not overwhelm the importance of the initial phase. Ms. Schipper acknowledged that although the initial phase will not address glaring measurement problems, aggregation discrepancies, and disclosure issues, they would be addressed in the later phase.

20. Ms. Seidman supported the staff’s recommendation for the same reasons articulated by Ms. Schipper. She added that the phased approach would allow improvements to be made in the near term. The later phase would comprehensively address other related issues in conjunction with the Board’s projects on conceptual framework, consolidations, and financial performance reporting.

21. Mr. Trott supported the staff’s recommendation. He noted that the Pension Benefit Guarantee Corporation and Congress set funding requirements while the IRS sets tax deductions for employers that sponsor plans. Mr. Trott contrasted the role of these entities with the role of the FASB to proscribe financial reporting to ensure good communication between companies and the capital markets. The FASB will need to consider related issues as these other bodies make amended requirements known.

22. Mr. Trott also highlighted the significant flexibility available in Statements 87 and 106 that allows companies to eliminate some smoothing mechanisms (for example, an entity can elect to recognize all actuarial gains and losses when they occur). He

acknowledged that the basic conflict in postretirement benefit accounting lies in the value of information between a short-term and long-term view of the obligation. The long-term view is that given the long-term nature of benefits, it is valuable to have a normalized run rate (smoothed numbers). The short-term view is that economic events should be reflected in financial statements when they occur despite the increase in reported volatility, even if gains and losses might reverse over the life of the plan.

23. Mr. Trott noted his disappointment that the Board's work on cash balance plans will be consumed by the comprehensive project; however, he understands its inclusion in the initial phase would extend the deliberation process for balance sheet improvements thereby delaying robust debate of the many issues to be addressed in the later phase.

24. Mr. Young strongly supported the staff's recommendation as it addresses the number one priority of the User Advisory Council who indicated support for both a short-term improvements project and a comprehensive project. Mr. Young stated that he believes this project is responsive to investors and strikes the right balance between long-term and short-term goals. Mr. Young asked the staff to consider whether more topics could be included in the initial phase, particularly the possibility of adding required disclosures when a company uses a calculated value of plan assets as opposed to fair value and the location of pension expense components by line item on the income statement. He stated that he does not believe it is more important to deliver the initial phase in 12 months than to add additional items to the initial phase. In reference to smoothing and delayed recognition, Mr. Young also noted that options under Statement 87 include the use of actual return on plan assets and fair value of plan assets. He stated he would like the staff to consider ways of reducing the effects of delayed recognition in certain situations when a pension is under funded.

25. Mr. Herz also strongly supported the staff's recommendation for a comprehensive reconsideration of the accounting for postretirement benefits with an initial phase as proposed. While he would like to address transparency by disaggregating components of pension expense on the face of the income statement in the initial phase, he understands it would delay the main accounting benefit of the initial phase. He concurred with the staff

that plans containing lump-sum settlement options are inextricably linked to overall measurement. Mr. Herz stated that he would like to progress as quickly as possible and that deliberations on issues in the later phase should not wait for completion of the initial phase. Given the ongoing study of postretirement benefits by various groups including the UK Accounting Standards Board, the Board should be able when deliberating the second phase to leverage off and consult with interested parties, including parties with other public policy considerations such as the Department of Labor, the IRS, and the Pension Benefit Guaranty Corporation. Mr. Herz stated that it is important the real economic liability be reflected in the financial statements.

26. In summary, the Board unanimously voted to support the staff's recommendation for a comprehensive reconsideration of the accounting for pensions and postretirement benefits with an initial phase targeted to be completed by the end of 2006.

Follow-up Items:

None.

General Announcements:

None.