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Keeping Pension Promises

The Financial Accounting Standards Board (FASB) has approved a project to overhaul accounting for pension plans and other employee-retirement benefits. The accounting and reporting issues involved touch on the measurement of assets and liabilities, consolidation, and reporting of financial performance.

In a unanimous vote in mid-November, the accounting standards setter said it will tackle the project in two parts. The first phase will require public companies to move the financial status of their defined-benefit plan and other postretirement benefit plans from the footnotes of their financial statements to their balance sheet. Under those rules, the balance sheet will show the funded or unfunded status of the retirement benefit plans measured as the difference between the fair value of plan assets and the company's obligation.

But the Board likely won't change the way those numbers are calculated, at least initially. For the time being, companies will be allowed to continue using "smoothing" mechanisms. These techniques obscure the values of companies' financial obligations. They also mask the volatility of their retirement plans' holdings by spreading large swings in the plans' values over long periods of time. Nor would companies initially be required to add their plans' total assets and liabilities to their balance sheets, only the net difference. Even so, the initial revisions likely would add hundreds of billions of dollars to U.S. corporate balance sheets, FASB officials said. Additionally, changes in the values of the plans wouldn't be included in net income, though they would be included in shareholder equity and other comprehensive income.

FASB's new pension-accounting project will likely add hundreds of billions of dollars to U.S. corporate balance sheets.

David Zion, an analyst who specializes in accounting and taxation for Credit Suisse First Boston, found that if hypothetical pension returns and other nonmarket pension values were removed from earnings of companies in the S&P 500 in 2001 and 2002, the aggregate earnings would have fallen by 67% in each of those two years. In 2003, on the other hand, replacing the smoothed pension numbers with current market values would have made aggregate earnings rise by about 3%. Smoothing also makes it difficult for any user of financial reports to discern how well funded a pension plan is or how much risk it exposes retirees and shareholders to, critics argue.

In the second, broader phase of the FASB's project, which is expected to take three years or longer, the Board will address most, if not all, aspects of the existing standards of accounting for postretirement benefits. They will seek to determine how best to recognize and display in earnings and other comprehensive income the various elements that affect the cost of providing postretirement benefits as well as how to best measure the obligation.

In June 2005, the Securities & Exchange Commission (SEC) formally asked the FASB to take on the pension accounting project. An SEC report found that the quality of financial accounting had generally improved after Enron's collapse in 2001 but that there were still problem areas, among them pension accounting.

Underfunded pension obligations of S&P 500 companies are estimated to be $218 billion by the end of this year, up from $165 billion last year and the fourth year in a row of plan deficits, according to a report from Credit Suisse First Boston. The Pension Benefit Guaranty Corporation (PBGC), the federal agency that guarantees private pension benefits, figures the pension deficit of all U.S. companies is $450 billion. That has helped prompt the SEC to investigate the assumptions companies use to project pension obligations, such as the discount rate to determine the present value of future obligations, the risk profile of pension assets compared to liabilities, and retirees' life expectancy.

Even more worrisome to many observers is the solvency of the PBGC. As high-profile bankruptcies mount, some people fear the prospect of another taxpayer bailout akin to the 1980s S&L crisis looms.

Back then, the federal government bailed out the Federal Savings & Loan Insurance Corporation, the government-sponsored insurance fund for the thrift industry, for $223 billion (in today's dollars). The banking insurer succumbed to a rash of S&L bankruptcies because of skyrocketing interest rates, lax oversight, imprudent lending, and outright fraud.

The PBGC was created by Congress in 1974 after several high-profile corporate bankruptcies left retirees without pensions. Its mission is to guarantee the remaining defined-benefit pension plans—those that provide workers with a set amount each month, based on wages and number of years on the job, typically for life. The insurer currently has $79.3 billion in obligations and $56.5 billion in assets—a gap of $22.8 billion, roughly equal to the deficit last year but double that of the prior year. Its growing liabilities stem from the decline of the steel industry as well as troubles among airlines, which burdened the agency with pension plans that were underfunded by billions of dollars.

For example, if Northwest Airlines and Delta Airlines shed their pension plans in bankruptcy court, as US Airways Group and UAL Corp.'s United Airlines have done, it could saddle the PBGC with an estimated $11.2 billion in new unfunded liabilities. Ninety percent of the PBGC's exposure to probable plan failures comes from companies in the transportation, communication, and utilities sectors. The Congressional Budget Office estimates that the PBGC's current shortfall will grow to $86.7 billion by 2015 and $141.9 billion by 2025. That prospect has spurred the White House to propose a pension reform plan.

U.S. Secretary of Labor Elaine Chao introduced the administration's plan in January 2005 to replace with a new formula what she called the current "outdated and ineffective" rules for funding pension plans. To shore up the PBGC's financial condition, the administration proposed a hike in PBGC premiums to $30 per worker from the current $19 that companies must pay, with automatic increases imposed each year pegged to average wage increases of U.S. workers. The current basic premium level has been in place since 1991. Companies with troubled plans would pay even higher premiums, based on the extent that their obligations are underfunded.

To provide more simplicity and consistency, the administration wants to eliminate today's mix of funding rules and use a single corporate-bond interest rate to provide current snapshots of pension liabilities based on the age of a company's workforce. In addition, the administration proposes giving companies between seven and 10 years to make up shortfalls in their defined-benefit pension plan. That's less time than the 20 years that some industries, including airlines, have said is needed.

Congress debated a similar proposal last year but, influenced by election-year politics, instead passed a temporary rule change that eased pension-funding requirements. Congress must now replace that stopgap measure by the end of the year, but it hasn't been easy going. While some Republican leaders have pushed for a broad overhaul such as that proposed by the Bush administration, business groups and labor unions have raised concerns about how far the changes should go. Employer groups and unions say that imposing higher premiums or stiffer rules could prompt some companies to freeze or eliminate pension plans.

By mid-November, a bill in the U.S. House of Representatives containing similar or modified elements of the administration's proposals had been approved in committee as had a related bill in the U.S. Senate. ■