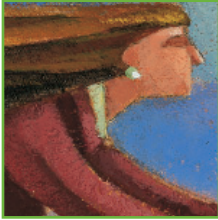


Memo opinions



FASB ruling affects plans with lump sum options

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On October 13, the Financial Accounting Standards Board (FASB) reached tentative agreement on decisions that could dramatically affect the balance sheets of employers who sponsor retirement plans with lump sum options – including all types of cash balance plans.

Previously, the FASB had limited its discussions to only certain types of cash balance plans – those with a variable interest credit rate. But its latest approach would apply to a much broader range of defined benefit plans. In a significant change in direction, the FASB decided that the value of a plan's liabilities must be at least as large as the lump sum that participants could receive were they to leave employment immediately on the measurement date.

At this point, the FASB decision is broad on direction and policy. Its timing and technical details remain to be worked out and will be discussed at one or more future Board meetings. For companies that wish to provide comments to FASB or influence the final outcome, it is important to take the time now to understand the implications of these recent decisions and how they might affect the bottom line.

Context for latest position

Over the past two years, the FASB has been debating the proper accounting for cash balance plans. In May 2003, the Emerging Issues Task Force (EITF) clarified the accounting for cash balance plans that provided a fixed interest credit (for example, a flat 4 percent per year) with a ruling that slightly reduced the expense and obligation for some sponsors of these plans.

Last spring, the FASB turned to cash balance plans that tied interest credits to a variable rate (for example, the yield on 30-year Treasury securities) and reached a number of tentative decisions that would have had a significant effect on the balance sheet and pension expense of sponsors of variable-interest-credit cash balance plans. Employers and the actuarial community (including Mercer Human Resource Consulting) submitted comments to the FASB, noting the theoretical and practical problems of implementing the tentative approach.

[On a separate track, the International Accounting Standards Board and its interpretations arm, the International Financial Reporting Interpretations Committee (IFRIC), issued a similar proposal over the summer that would have applied to cash balance plans subject to international accounting standards. They received more than 40 comment letters, many of which pointed out the poor alignment with typical US cash balance plans. We expect those comments to be debated and the proposal refined or finalized over the coming months.]

Two weeks ago, the FASB again took up the matter, deciding to change direction and broaden the scope of its review. It dropped the idea that certain types of cash balance plans should be singled out for special treatment, instead focusing on plans that offer participants a lump sum. Any type of plan could potentially provide lump sums and be affected by the newly expanded scope, including:

- traditional final average pay plans,
- fixed-interest-credit cash balance plans (for which we had thought the accounting rules were settled in 2003),
- variable-interest-credit cash balance plans, and
- other hybrid plan types.

Proposal specifics

At its October 13 meeting, the FASB made the following tentative broad policy decisions:

- Its eventual guidance should take the form of a revision to Statement of Financial Accounting Standards No. 87 (the previous cash balance proposal was going to be an interpretation of Statement 87). The key difference will be a potentially longer exposure period and a final document that may include a dissenting opinion.
- For any plan that offers a lump sum, the benefit obligation would be measured as the greater of:
 - the payout as determined under current rules, or
 - the lump sum available to plan participants if they were to terminate employment on the measurement date – the so-called “walkaway” amount.

Plans that fall under the new mandate would likely see higher liabilities, may incur higher expense, and will have an increased likelihood of a charge to Other Comprehensive Income or higher funding to avoid the charge to equity. In addition, plan sponsors may experience more volatile expense as they try to balance movements in two discount rates – the traditional FAS 87 rate as well as the actual lump sum rate.

What's next?

The FASB has not yet presented a timeline for issuing an exposure draft or adopting this proposed amendment. None of the details of how employers would transition to the new standard or how the increased liability would flow through pension expense has been worked out. Although a majority of the board voted to proceed with the amendment, some members voiced concerns about the proposal, including the desire to coordinate this amendment with international standards.

Until further information becomes available, plan sponsors should evaluate the effect of the tentative decision on their FAS 87 pension expense and minimum liability. They and other interested parties are encouraged to submit comment letters either now or during the official comment period following the issuance of the exposure draft.