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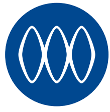

Milliman USA
Consultants and Actuaries

Benefits Perspectives
Current Issues in Employee Benefits

FALL 2003

- Renewed Employee Interest in Defined Benefit Plans
- The Convergence of International Accounting Standards for Employee Benefits

How Fit is Your Funding Policy?

by Glenn Bowen

Many defined benefit pension plan sponsors are currently faced with significant contribution requirements, after enjoying extended "contribution holidays." While legislative and market developments will ultimately determine how long these conditions last, of more immediate concern to plan sponsors are accelerated funding requirements, additional pension insurance premiums, underfunding notices to participants, and financial statement effects.

This article suggests strategic actions for plan sponsors in today's environment, and examines pending regulatory issues that may affect plan sponsors in the years ahead. Boldfaced terms are defined in the accompanying sidebar on page 2.

While You Were Out

In "normal" times, a pension plan sponsor contributes an amount sufficient to cover the value of benefits accruing in the current year, i.e., the **normal cost.** These annual contributions, together with expected future investment returns, fund the future benefits promised to employees upon retirement.

However, the unusually large investment returns of the mid-to-late 1990s fulfilled both the expected return and the normal cost components. As a result, many plan sponsors were not required to make contributions for several years. In some cases, those that wanted to contribute were prohibited from doing so by the tax code's maximum funding provisions. On the accounting side, plan sponsors recognized pension income on their income statements, leading to a **prepaid pension cost** on the balance sheet.

Where Have All the Good Times Gone?

March 2000 marked the bursting of the Internet-fueled market bubble. As of January 1, 2003, the NASDAQ Composite Index was off by over two-thirds from its high, having plunged back to 1997 levels. One major difference between now and then is the interest rate environment. The yield on the benchmark 30-year Treasury bond (which underlies several important pension liability measures) was nearly 7% in early 1997, whereas it was under 5% at the beginning of this year. Thus, plan sponsors are confronting both underperforming assets and increased liabilities.

Other factors also increased pension cost and/or liability in recent years. The 2001 Economic Growth and Tax Relief Reconciliation Act (EGTRRA) permitted qualified plans to use higher compensation for calculating benefits and to pay larger benefits. Plans that offer lump-sum payments must use a new mortality table to determine the minimum value for lump sums paid on or after December 31, 2002.

What Do We Do Now?

Because decisions made about plan funding may affect the employer's balance sheet, and vice versa, issues raised on both sides should be assessed carefully. The discussion below assumes a single-employer final average pay plan with both plan and employer fiscal years coincident with the calendar year.

DEFINITIONS

Accumulated Benefit Obligation (ABO)–the present value of future benefit payments attributable to past service and salary levels. For use in the plan sponsor's accounting (analogous to the current liability for the funding valuation). A current market discount rate assumption is developed by the plan sponsor.

Actuarial Value of Assets (AVA)–a market-related value of assets, where asset gains and losses are recognized over time. If no smoothing method is used, the actuarial value simply equals the fair value, plus any receivable contributions on account of prior plan years.

Current Liability (CL)–the present value of future benefit payments attributable to past service and salary levels. The mortality table is mandated, as is an allowable range of interest rates, which is based on historical government bond yields.

Fair Value of Assets (FV)–market value of the assets in the trust as of the valuation date.

Full Funding Limit (FFL)–the contribution amount that would be expected to cover the cost of benefits accruing in the current year as well as clear any unfunded liability.

Normal Cost (NC)–the value of benefits accruing during the current plan year.

Pension Benefit Guaranty Corporation (PBGC)–a quasi-government corporation chartered by ERISA that provides certain guarantees to participants in qualified defined benefit pension plans. Funded by premiums paid by plan sponsors.

Prepaid Pension Cost/Accrued Pension Cost–the total contributions made by the plan sponsor over time, less the total annual expenses recognized in the income statement. If positive, it is a prepaid pension cost, which is an asset in the plan sponsor's balance sheet; if negative, it is an accrued pension cost, which is a liability in the balance sheet.

- *Additional Funding Charge*—If a plan's **actuarial value of assets (AVA)** sinks far enough below the **current liability (CL)**, an additional funding charge (AFC) over and above the regular contribution applies. The AFC is not required for plans with fewer than 100 participants; plans with between 100 and 150 participants pay a portion of the AFC.

  Plan sponsors may avoid the AFC if the AVA exceeds 90% of the CL or if the AVA exceeds 80% of the CL in the current year and the AVA exceeded 90% of the CL in two consecutive years during the prior three-year period. Thus, maintaining an AVA in excess of 90% of CL eliminates the AFC. There's not much a sponsor can do to decrease CL, but one option for plan sponsors that have not made a change to actuarial methods in the past five years is to introduce an asset smoothing method to phase in recent asset losses, thereby increasing the AVA.

- *Quarterly Contributions*—If a plan is sufficiently funded, the 2003 plan year contribution is not due until September 15, 2004. However, if the January 1, 2002 AVA was less than 100% of the CL, the 2003 plan year contribution is payable in quarterly installments throughout 2003 and early 2004, with any remaining contribution then payable by September 15, 2004. In general, allocating any contribution to the earliest possible plan year is advantageous. Plan sponsors that pay the 2002 minimum contribution early enough in 2003 (instead of waiting until September 15) may allocate some of the required 2003 quarterly payments to the 2002 plan year, thus increasing the January 1, 2003 AVA, which could prove beneficial in a number of ways.

- *PBGC Variable Premium*—If a sponsor of a plan that is less than fully funded according to standards established by the Pension Benefit Guaranty Corporation (PBGC) contributes an amount at least equal to the full funding limit (FFL) for 2002 (by September 15, 2003), no variable premium is due for 2003. In the event that a variable premium is due, the plan sponsor should ensure that the vested current liability (VCL) calculation is minimized by not including contingent benefits that do not vest. In addition, there are two permissible methods

for determining the premium: (1) the general method, which uses the January 1, 2003 valuation results; and (2) the alternate method, which uses the January 1, 2002 valuation results. Thus, having the 2003 valuation completed in time might allow for a lower premium.

- *Participant Notices of Underfunding*—Plans that are subject to the PBGC variable premium in 2003 and that have an AFC in both 2002 and 2003 are required to notify participants about the plan's funded status and the extent of the PBGC's guarantee. Due to a quirk in the law, sponsors may also find themselves in a position in which they are not required to pay a variable premium for 2003 but nevertheless must provide the notices.

- *Lump-Sum Payment Restrictions*—Plans that offer a lump-sum payment option to terminating/retiring employees may face restrictions in paying lump sums to any of the "top 25" current or former highly compensated employees (HCEs) (i.e., those who earned over $90,000 in 2002). To pay an unrestricted lump sum to a top 25 HCE, the AVA must be greater than 110% of the CL *after* the lump-sum payment is made, or the lump sum must be less than 1% of the CL.

  Plans that do not meet the 1% of CL exemption but want to avoid the restrictions should ensure sufficient contributions to satisfy the 110% of CL exemption. In some instances, however, the contribution required to achieve this exemption may be greater than the maximum allowable in a given year. Plan sponsors should review the top 25 HCEs who will be eligible for retirement in the upcoming years so that any desired additional funding may be spread over time.

  If the above requirements are not met, a lump-sum payment is still possible, but the HCE must post security to the plan to guarantee repayment of the lump sum in the event of insolvency (and the plan document must provide for this). While theoretically possible, administering this security arrangement may be difficult in practice.

- *Charge to Equity*—On the accounting side, plan sponsors must recognize a minimum liability if the accumulated benefit obligation (ABO) exceeds the fair value of assets (FV). To the extent that the unfunded ABO is not already reflected through an accrued pension cost or other unrecognized past service liability, a reduction in equity results. Additionally, plan sponsors that had built up a prepaid pension asset will see the entire prepaid asset reversed, significantly affecting the debt-to-equity ratio. The bottom line is that it may be worthwhile to consider making additional contributions to avoid having an unfunded ABO.

  The ABO is compared to the FV in determining minimum liability, so an unfunded ABO cannot be rectified by making additional contributions after the balance sheet date. Thus, asset performance should be reviewed prior to the end of the year to determine if additional contributions would be advantageous. Note that additional contributions of less than the amount of the unfunded ABO have no effect on the existence or magnitude of the reduction in equity.

The Road Ahead

While no one can say with any certainty what the future holds, the following issues are likely to be at the forefront of pension activity in the upcoming years.

- *JCWAA Interest Rate Relief*—The Job Creation and Worker Assistance Act of 2002 (JCWAA) provided temporary interest rate relief for 2002 and 2003, increasing the allowable interest rates for determining if a plan is subject to quarterly contributions and AFC requirements, and for calculating PBGC variable premiums. Although there have been calls for an extension of this relief while a permanent replacement for the 30-year Treasury rate is sought, the outcome is uncertain.

- *PBGC Activity*—The PBGC's funded position has fallen from a surplus of $9.7 billion in the 2000 fiscal year, to a deficit of $5.7 billion as of the end of July 2003. The PBGC is currently investigating alternatives to strengthen minimum funding requirements, for chronically underfunded plans in particular.

- *EGTRRA Sunset*—EGTRRA contains a "sunset" clause that will cause the law's retirement-related provisions to

expire in 2011 unless extended or made permanent by Congress. Since its enactment, there have been legislative proposals to extend or make permanent EGTRRA's pension-related provisions.

- *Other Legislation*—Extensive pension reforms have been proposed by the authors of EGTRRA's pension provisions. One significant provision is the replacement of the 30-year Treasury rate with a rate based on conservatively invested high-quality long-term corporate bonds. In addition, cash balance and 401(k) plans continue to receive attention in Congress. Owing to federal budgetary concerns, an aging population, and plan solvency issues, considerable legislative activity with regard to private pension plans and Social Security can be expected in the upcoming years.

- *Market Environment*—On the asset side, the uptick in the equity markets since the beginning of the year is not reflected in January 1, 2003 funding valuations. However, strong asset performance over the remainder of the year would help with end-of-year accounting disclosures and January 1, 2004 funding valuations. On the liability side, significant increases in market interest rates do not seem likely in the near term. Thus, the largest variable is potential regulatory changes surrounding how market rates are reflected in the actuarial valuation.

- *FASB Pension Accounting Project*—In September 2003, the Financial Accounting Standards Board proposed expanded single-employer pension disclosure requirements, with a target effective date at the end of 2003. Proposed changes include additional detail in the areas of expected returns for asset classes, near-term contribution requirements, and projected benefit payments. (See also Carl Hansen's article on page 8 of this issue for a discussion of the convergence of international accounting standards.)

  Separately, the Securities and Exchange Commission (SEC) has recently increased its scrutiny of pension plan assumptions, asking some plan sponsors to justify their assumptions. The SEC has long held that a yield-curve approach is preferable to a single rate for determining a plan's liabilities. This concept may ultimately catch on in the funding arena. Such an approach would result in a lower weighted-average rate for plans with a large proportion of retirees, and thus an increased liability.

- *Demographics*—Lifespans continue to increase while retirement ages have not, leading pension plans to pay annuities over more years to retirees or to pay larger lump sums at retirement. Liabilities are also increasing due to the demographic wave of baby boomers that is approaching retirement age.

Conclusion

Change in the pension arena is certain, but forewarned is forearmed. Plan sponsors should review these issues with their actuary and other benefit plan advisors to determine what strategic funding or other actions to take. Plan sponsors should also take advantage of the channels available for offering public commentary to legislators, regulators, and policy-making bodies regarding pending changes.

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Renewed Employee Interest in Defined Benefit Plans

by John B. Wukitsch

Employers typically provide retirement benefits through either a defined benefit plan or a defined contribution plan, often a 401(k) plan. Some employers offer both. Until recently, many employees covered by only a defined benefit plan felt they were missing a golden opportunity to build a retirement nest egg. In contrast, many employees covered by a defined contribution plan believed they were accumulating abundant retirement resources and would be able to retire earlier than they previously anticipated. The perception of defined contribution plan participants was primarily due to years of favorable investment returns, which some employees believed would continue into the foreseeable future.

This article looks at the shift in employee attitudes about retirement income security issues, examines the growing appreciation for defined benefit plans, and discusses the implications for employers.

Change in Attitudes and Trends

With the recent downturn in the financial markets, many employees have become less confident in their ability to manage their retirement investments. Employees increasingly are focusing on retirement security, not just retirement income adequacy. Improved mortality rates due to advances in healthcare and longer life expectancy have added to the cost of retirement. As a result, employees in increasing numbers have come to value the risk-free aspect of retirement income provided through a defined benefit plan.

In 1975, one hundred years after the first private pension plan—a defined benefit plan—was established in the US, there were over 100,000 defined benefit plans. During the 1980s and 1990s, revisions to the tax and benefit laws, along with a change in employer and employee attitudes, produced a significant shift away from defined benefit plans to 401(k) and other defined contribution plans. Many large employers added defined contribution plans as a supplement to their primary defined benefit plans. Others modified their defined benefit plan to a "hybrid" pension plan, which displays both defined benefit and defined contribution plan characteristics. By 2002, private employers sponsored about 42,000 defined benefit plans and 700,000 defined contribution plans, each type covering approximately 42 million workers.

A number of factors contributed to the trend toward defined contribution plans, including:

- Employee investment education programs promoting the positive attributes of defined contribution plans;
- Technological advancements such as daily valuations, voice response systems, and internet account access;
- An extended bull market during most of the 1990s;
- A perception that the workforce was more mobile than in the past and the resulting impetus to create "portability" in retirement plans;
- Increased employee demand to manage their retirement account assets;
- Tax deferral advantages for employee contributions under 401(k) plans;
- Easier understandability over defined benefit plans;
- Regulatory and accounting requirements that are less burdensome than those applicable to defined benefit plans; and
- Employers' desire to shift investment risk and costs to employees.

Defined Benefit Plans' Appeal to Employees

Recent economic conditions have increased employee awareness about the positive aspects of defined benefit plans, which in turn is producing greater employee appreciation of these plans. For example, defined benefit plans offer:

- *Predictability*—Because defined benefit plans specify the amount that will be paid upon retirement, workers know how much they will receive, regardless of how long they live or whether there are any disruptions in financial markets.

- *Security*—Federal government insurance from the Pension Benefit Guaranty Corporation covers most defined benefit plans, guaranteeing that benefits up to certain limits will be paid if the plan sponsor is unable to do so (due to employer bankruptcy, for example).

- *Financial familiarity*—Because employees generally have developed budgeting strategies for paying expenses on the basis of earning wages with regularity, they are able to continue applying the same concepts during retirement.

- *No employee cost*—Most private employers shoulder the entire cost of defined benefit plans and require no employee contributions.

Implications for Employers

With the renewed employee interest in defined benefit plans, employers should consider the implications of maintaining or adopting such retirement vehicles. Among the key issues are:

- *Investment Risk.* Employers bear all of the investment risk in a defined benefit plan. The cumulative effect of the poor investment market of the last three years, along with a continued low interest rate environment, has had a dramatic effect on pension plan funding and pension expense accounting. Many plans face a decreased funded ratio as assets have dropped due to poor investment returns, and liabilities have increased due to low interest rates. This is leading to: increased minimum required contributions to the plans for 2002, 2003, and beyond; increased pension expense on the company's accounting statements; and additional financial liability attributable to the plan, resulting in a significant charge to shareholder equity.

  Although no one likes to bear all the risk, employers are better able to manage this risk because they are able to hire professional investment advisors to manage the plans' portfolio.

- *Predictability and Volatility.* Under a defined benefit retirement plan, employer contributions and accounting cost may fluctuate substantially as a percent of pay from year to year. However, actuarial projection models can help plan sponsors prepare and budget for future funding levels and pension expenses.

- *Design.* A defined benefit retirement plan is designed to provide a suitable level of pension income to employees who retire under the plan. There are a number of plan designs that an employer may consider. Traditional retirement plans are typically based on a percent of career compensation or a percent of final average compensation for each year of service. In recent years, hybrid retirement plans—with features of both defined benefit and defined contribution arrangements—have become more widespread. For example, benefits may accrue using a formula like a defined benefit plan but are expressed as an individual account balance like a defined contribution plan.

- *Cost.* For any contribution level, a defined contribution plan will have higher costs and benefits for younger, shorter-service employees and lower costs and benefits for older, longer-service employees as compared with a defined benefit retirement plan.

- *Flexibility.* Under a defined benefit retirement plan, an employer may fund any plan improvements (including for past service) over a period of up to 30 years. Defined benefit retirement plans may also offer periodic ad-hoc post-retirement increases to retirees to offset the effects of inflation.

Communication Strategies

Employers that are experiencing renewed employee interest in their defined benefit plans are paying closer attention to communications. A successful communication program increases an employee's understanding and appreciation of the retirement program while effectively promoting the value of the benefit. It also should emphasize the importance of planning for retirement.

Because defined benefit plans may involve complex formulas, the employer must carefully weigh the amount and type of information to communicate. Too much precision may confuse workers or over-value estimates. Too little information could lead to misunderstanding and a lack of appreciation of the plan.

There are a number of strategies a defined benefit plan sponsor can undertake to accomplish the objectives of an education program, including:

- *Written periodic communications* focusing on individual topics, such as benefit security, the cost to the employer, death benefits, retirement income needs, Social Security benefits, domestic relations orders, and comparisons to a defined contribution plan.

- *Customized employee statements* that are mailed directly to plan participants. Employees should be encouraged to review the statements for accuracy about compensation. The statements also should communicate the retirement benefit amount earned to date the amount projected at retirement, the normal form of payment, available payment options, and where to get additional information. If multiple retirement benefits are offered, one statement combining all the information will provide a comprehensive picture.

- *A hotline or website* could provide additional resources about the plan to participants. Hotlines can offer experts outside of the employer who can answer specific questions and provide additional plan information, while websites can be designed for ongoing education and provide interactive tools to respond to employees' "what if" scenarios.

- *Participant meetings* can help maintain employee interest in the plan. One key area to emphasize is retirement planning education. The earlier in their careers that employees begin planning for retirement, the greater the chance they will accumulate sufficient financial resources for retirement. Employees also will want information on managing their personal retirement assets or defined contribution accounts.

Conclusion

Defined benefit plans have served the needs of millions of employees for more than 100 years. While defined contribution plans remain popular, recent economic conditions have helped employees appreciate the retirement security provided through defined benefit plans. And although there are challenges to defined benefit plan sponsorship, employers that sponsor such plans along with an effective communications program will find that workers increasingly value the benefits. This may give employers that sponsor defined benefit plans a competitive advantage over those that do not.

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The Convergence of International Accounting Standards for Employee Benefits

by Carl I. Hansen

Over the last few years, accounting standards for employee benefits around the world have begun to look similar. In many ways, the US *Statement of Financial Accounting Standard 87* (*SFAS 87*) and its related statements (numbers *88, 106, 112, 132*) are no longer the trendsetters for employers' accounting for employee benefits. Newer standards outside the US resemble the SFAS family but attempt to address SFAS shortcomings. Governing bodies for accounting standards in several countries have a review of benefits accounting high on their agendas. All the above factors may be leading to one approach or standard for employee benefits accounting, regardless of where in the world an organization has its headquarters or operates.

This article explores the convergence of international accounting standards for employee benefits, including the history, recent developments, and what the future may hold.

The History of Employers' Accounting for Employee Benefits

Historically, organizations took a simplified approach to benefits accounting, with no liabilities disclosed on the balance sheet or in related footnotes. The charge to profits (or expense) for a period was generally equal to the cash contributions to a fund or insurance policies, the amount directly paid to participants, or the amount set aside as an internal reserve if benefits were unfunded. Accounting bodies concluded that there was a need to disclose liabilities on the organization's balance sheet (or in financial statement footnotes), since they could be quite significant in some cases. Also, actuarial methods and assumptions for determining cash contributions to a benefits fund could vary considerably from one organization to another. Under certain circumstances, a country's tax regime may allow no contributions in some years, even though benefits continue to accrue. As a result, expense amounts were not always comparable and could be subject to manipulation.

Financial Accounting Standards in the US

In December 1985, the Financial Accounting Standards Board (FASB) in the US issued *SFAS 87*. At the same time, it issued *SFAS 88,* covering employers' accounting for settlements and curtailments in defined benefit pension plans, as well as termination benefits. A few years later, *SFAS 106* and *112* were released, covering employers' accounting for post-employment benefits other than pensions. For most US employers, this primarily means retiree medical and retiree life insurance coverage. The disclosure and expense requirements under these standards set the trend for most ensuing accounting statements for employee benefits around the world. The basic principles of disclosing the market value of assets and a current interest rate measure of liabilities in the footnotes to the balance sheet, and a prescribed method for calculating expense for the period have withstood the test of time.

The FASB approach to accounting for employee benefits spread quickly around the world because overseas subsidiaries of US companies—as well as non-US companies wishing to do business or raise capital in the US—were required to report on that basis. Over the years, other countries adopted their own accounting standards for employee benefits that looked similar to the SFAS statements. In particular, Canada, Mexico, and Japan followed the lead of the US.

Some observers felt that *SFAS 87* as originally written allowed too much smoothing of changes in asset and liability values due to economic market fluctuations. Under the standard, employers are allowed to systematically recognize asset gains or losses over a period of up to five years when determining the market-related value of assets

used for determining the return on assets component of the net periodic benefits cost. Smoothing is also employed for gains or losses from both assets and liabilities, which must be recognized only to the extent that the net value exceeds 10% of the greater of assets and the projected benefit obligation (PBO). In addition, the net value outside this corridor is further smoothed by gradually recognizing it in pension expense over the average expected working period of the covered employees assumed to benefit under the plan.

Primarily due to the extended bull markets of the 1990s, another criticism of *SFAS 87* has surfaced over the last few years. When pension plans become well funded, an employer may actually have net periodic pension income and build up a prepaid pension cost as an asset on the balance sheet. In the last few years, this created front-page headlines in the US about large companies "inflating" their earnings by using pension income. This increased the pressure for more transparent accounting for benefits in the US.

TABLE 1

Comparison of *SFAS 87* (US), *IAS 19*, and *FRS 17* (UK)

	SFAS 87	IAS 19	FRS 17
Measurement Date	Up to 3 months prior to date of financial statements	As of the date of the financial statements	As of the date of the financial statements
Asset Value	Fair market value for reconciliation of funded status; market-related value (up to 5-year averaging) allowed for expense	Fair market value	Fair market value
Limit on Net Asset on the Balance Sheet	None	Net asset on balance sheet limited to value of refunds or reductions in future contributions due to surplus assets in plan	Net asset on balance sheet limited to value of refunds or reductions in future contributions due to surplus assets in plan
Treatment of Actuarial Gains and Losses	Net gain or loss outside a corridor of up to 10% of the greater of assets or PBO is amortized over expected working lifetime	Net gain or loss outside a corridor of 10% of the greater of assets or PBO is amortized over expected working lifetime	Immediate recognition in STRGL
Treatment of Past Service Costs	Amortized over expected working lifetime	Recognized over period until fully vested	Recognized over period until fully vested
Additional Minimum Liability	Minimum liability on the balance sheet of unfunded ABO	None	None
Additional Disclosure for Underfunded Plans	Must also disclose ABO for underfunded plans	None	None

International Accounting Standard

In 1985, the predecessor to the International Accounting Standards Board (IASB) introduced its version of an accounting standard for employee benefits (*IAS 19*). Some employers in countries with no formal accounting standards now use *IAS 19*. The standard was modified over the years, most significantly in 1998, so that the current version closely resembles the FASB approach, while attempting to address some of the perceived shortcomings of the FASB statements. In particular, the standard places a limit on the buildup of a net pension asset on an organization's balance sheet. Also, prior service costs are recognized over the period until benefits covered by a plan amendment are vested (in many cases, this may mean immediate recognition). Table 1 on page 9 compares the primary provisions of the different standards.

The types of benefits covered by *IAS 19* are quite broad. In general, post-employment benefits are included in the standard, as well as such benefits as vacations and sick leave. Because *IAS 19* is intended to apply internationally, the IASB did a better job of anticipating the variety of benefits typically encountered outside North America.

In *Regulation 1606/2002,* the European Union (EU) has prescribed that International Accounting Standards will be required for the accounts of publicly traded employers in member countries starting in 2005 (2007 in some cases). Other non-publicly traded employers may report under national accounting standards if such standards exist. With much of Western Europe following the IASB standards (and much of Eastern Europe set to join the EU within the next few years), there will likely be strong pressure on North American accounting groups to change local standards to mirror *IAS 19*.

The United Kingdom

The one notable exception to the FASB/IASB accounting approach was, until recently, the United Kingdom (UK). In 1998, the UK Accounting Standards Committee published a statement of standard accounting practice (*SSAP 24*) covering pension costs. *SSAP 24* allowed more flexibility in the methods and assumptions used to determine the "regular" pension cost and variations during a financial period. Under the standard, it was not necessary for employers' accounting for benefits to reflect the "market value" of liabilities or assets.

Over time, the clamor grew for better disclosure in employers' accounting for employee benefits and more comparability among employers. It also became clear that many UK employers were manipulating the accounting for benefits so that the expense for the period was still roughly equal to the contributions made. As a result, the UK Accounting Standards Board introduced *Financial Reporting Standard 17* (*FRS 17*) in late 2000, bringing a new market value approach to the UK.

FRS 17 breaks new ground in the areas of transparency of reporting and immediate recognition of events in the profit and loss account. A net pension liability or asset (to the extent that the employer can recover a surplus) is to be listed explicitly on the employer's balance sheet instead of being buried in footnotes. Under the standard, most fluctuations in assets or liabilities are recognized immediately. This includes investment gains or losses due to changes in the economic environment, liability gains or losses due to changes in actuarial assumptions, the impact of changes in benefits on liabilities (to the extent vested), and settlements or curtailments resulting from corporate restructuring. Actuarial gains and losses are actually reported in something unique to UK accounting called the Statement of Total Recognised Gains and Losses (STRGL), instead of in operating income. Immediately recognizing all of these items in some type of income account (i.e., not smoothing their impact) may cause significant volatility. Table 1 on page 9 compares *FRS 17* with *SFAS 87* and *IAS 19*.

The *FRS 17* methodology has not been particularly popular with actuaries, employers, or even accountants in the UK. The standard has already been blamed for driving up the accounting cost for employee benefits by forcing employers to invest pension funds conservatively so as to limit volatility in asset values. This effect, along with current market conditions, has been cited by many larger employers in the UK as the principal reason for closing their pension plans to new entrants. Perhaps partly for

this reason, but primarily to coordinate with the EU's schedule for using the IASB standard, full implementation of *FRS 17* has been delayed until 2005.

The Future

Nearly any new accounting standard for employee benefits currently being introduced by the accounting authorities in any country follows a similar approach for valuing assets and liabilities as originally introduced by *SFAS 87*. New standards adopt the best elements of *IAS 19,* often with a few minor revisions to fit the local accounting environment. In fact, major differences between a new standard and *IAS 19* or the FASB standards must be justified to investors and financial analysts, causing more pressure for standards to converge.

The UK Accounting Standards Board believes that it has found the solutions to two criticisms of the FASB standards in the US: delayed recognition of asset or liability fluctuations; and lack of transparency in benefits accounting. However, the price to pay for these answers is that employers are reluctant to offer traditional defined benefit pension plans to employees. This leads to a philosophical question: should benefits accounting drive an employer's decisions on benefits, or should it simply give shareholders and other users of financial statements an accurate picture of the benefits an employer offers its employees and the impact of the cost to the organization?

The IASB is expected to review *IAS 19* before the EU mandates its use in 2005. Since the Chair of the IASB—one of the primary authors of *FRS 17* in the UK—publicly stated a preference for immediate recognition of changes in assets and liabilities, there is an expectation among practitioners that any revision to *IAS 19* will incorporate this element. But other members of the IASB have voiced opposition to the immediate recognition approach. Because all major accounting standards bodies in the world give input to the IASB, the North American contingency will be able to weigh in also.

For now, any planned revisions to the FASB standards in the US focus on increased disclosures and do not address the details of calculations or methodology. Revisions to *IAS 19,* coupled with the recent outcry for better corporate accounting, will likely cause the FASB to do a more comprehensive review of the FASB standards within the next few years. The Chair of the FASB fully supports the convergence of the FASB and IASB standards.

Standards governing employers' accounting for employee benefits will likely continue to converge. A point at which one standard applies in all jurisdictions is possible. In the meantime, those charged with preparing financial statements should be aware of potential changes in the current standards and understand the implications. Preparation now will prevent unpleasant financial surprises later.

Carl Hansen is the Executive Director for Milliman Global. Keith Faulkner, the Head of Milliman Global's International Consulting Practice in London, peer reviewed this article.

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