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For Your Information

FASB TO PROPOSE RADICAL CHANGE IN ACCOUNTING FOR CASH BALANCE PLANS

The Financial Accounting Standards Board (FASB) has tentatively approved what would amount to a sharp break from current practice in how most employers account for the cost of their cash balance pension plans. For the majority of cash balance plans – those that credit "interest" based on a varying index such as the yield rate on one-year Treasury bills – the change could materially increase a plan sponsor's reported obligations and costs. FASB anticipates that this new guidance will be adopted in time to affect 2004 year-end disclosures and 2005 financial results. Concerned parties will have an opportunity to comment on the proposal when an exposure draft is issued, probably in May.

BACKGROUND

It has been universal practice to determine benefit obligations and costs under cash balance plans consistently with the approach used for other defined benefit plans under Statement of Financial Accounting Standards No. 87 (FAS 87). That is, account balances are projected with interest to potential retirement ages, converted to annuities if appropriate, and discounted back to the valuation date using an appropriate discount rate. The interest rate used to project participants' account balances is based on the plan's interest crediting rate. The discount rate is determined based on current yields on high quality corporate bonds, as it is for all other defined benefit plans. If the interest crediting rate is variable, an assumption about future rates is made under the "best estimate" requirements of FAS 87.

Since interest crediting rates typically are lower than corporate bond rates, benefit obligations for cash balance plans can be much less than account balances.

FASB TENTATIVE DECISIONS

In March, FASB tentatively decided that the projected benefit obligation (PBO) for a variable rate cash balance plan should be set equal to the account balances (with a downward adjustment to reflect the possibility

that employees could terminate employment before becoming vested). Thus, it would no longer be possible to have a PBO less than account balances merely because the interest crediting rate is expected to be lower than the discount rate.

The Board also decided that the cost of benefits under all cash balance plans should be allocated to employees' service under the "traditional unit credit" actuarial cost method. Under this method, the PBO and the accumulated benefit obligation (ABO) are equal. This change, by itself, could result in a reduction of the PBO for some plans.

Any net change in the PBO due to these new requirements would be recognized immediately in the income statement as additional expense (or more rarely, income) and prior years' results would not have to be restated. Any increase in the ABO could reduce stockholders' equity due to the special minimum liability provisions of FAS 87 applicable to plans that do not have assets at least equal to the ABO.

These tentative decisions do not apply to other hybrid designs like pension equity plans.

An exposure draft is anticipated in May with a comment period of at least 60 days. FASB is expected to issue final guidance in the form of an Interpretation of FAS 87 in the fourth quarter of 2004, which will become effective for fiscal years beginning after December 15, 2004.

> ***COMMENT.*** *The financial impact of these changes will depend on each plan's benefit provisions and the current assumption made for future interest credits. For cash balance conversions, the cost of the changes will be affected by the existence of transition provisions and minimum benefits under prior benefit formulas. Detailed actuarial calculations will be required to determine the impact.*

FASB RATIONALE FOR CHANGES

The Board appears to have been influenced by the following factors in reaching its conclusions.

- ***Analogy to transactions in the securities markets.*** The Board found suspect the notion of setting a value on an obligation to pay an account balance at some future time that is less than the current account balance, especially if the obligation is credited with interest at a "market" rate.
- ***Convergence with international standards.*** The Board is committed to converging its standards with those of the International Accounting Standards Board (IASB). The IASB has tentatively concluded that the obligation under certain European minimum-guarantee defined contribution plans that resemble cash balance plans should equal the account balances.

- ***Comparability with accounting for unfunded "defined contribution" promises.*** The Board could see little difference between a funded cash balance plan and an unfunded executive retirement program of the defined contribution type where the obligation is usually set equal to the account balances.
- ***Reliability of interest rate projections.*** Some Board members doubted that actuaries or anyone else could predict future interest rates.

ARGUMENTS AGAINST THE PROPOSAL

There are a number of arguments that can be made against the FASB proposal.

- ***Inconsistency with other defined benefit plans.*** The new methodology would, in effect, account for variable rate cash balance plans under the assumption that vested participants terminate employment on the financial reporting date. All other defined benefit plans are accounted for on the assumption that such employees retire at various points in the future. This inconsistency could distort comparisons of financial results among companies.
- ***Inconsistency among cash balance plans.*** Cash balance plans with fixed interest crediting rates (e.g., 4%) would continue to be accounted for under the old rules under which PBOs are likely to be less than account balances. This inconsistency in accounting for different cash balance plans could have unexpected results. For example, a plan that credits the rate on one-year Treasury bills currently would have a PBO higher than a similar plan that credits a fixed 4% rate, despite the fact that Treasury bills are currently yielding far less than 4% and are not likely to earn 4% in the near future.
- The new rule also creates inconsistencies among cash balance plans with different variable rates. For example, a plan which credits the yield rate on one-year Treasury bills apparently would show the same PBO if it were amended to credit the yield rate on one-year Treasury bills plus 1%.
- ***New guidance is being offered as an "Interpretation" of a long-standing Standard.*** FASB plans to offer this guidance as an Interpretation of a Standard (FAS 87) that has existed for 18 years. To our knowledge, cash balance plans have never been accounted for in accordance with FASB's new view of the issue. The economic consequences of the change can be significant to a number of employers but, so far as we know, FASB has not quantified the consequences of its proposed Interpretation.
- ***Need for a more systematic approach to change.*** Major changes in accounting standards should be applied consistently to all defined benefit plans. Thus, a new measurement requirement of this magnitude should not apply only to one class of defined benefit plan.

- ***Projection of future interest rate is required under FAS 87.*** Although the Board thinks that actuaries should not attempt to project future interest crediting rates, existing FASB guidance requires just such projections when developing discount rates and other economic assumptions.

CONCLUSION

FASB's new position on cash balance accounting could have a significant financial impact on many cash balance plan sponsors, and Mellon intends to comment to FASB. Your Mellon HR&IS consultant will be glad to discuss the issues with you, estimate the financial impact of the change, and assist you in responding to this FASB initiative.

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