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New Standards: Implications for EAs

THE ACADEMY BOARD OF DIRECTORS has approved revised Qualification Standards, which will take effect Jan. 1, 2008. With broadened scope and strengthened continuing education (CE) requirements, they are expected to affect most practicing actuaries in the United States.

The revised Qualification Standards apply to all actuaries who are members of one of the U.S.-based actuarial organizations and who issue Statements of Actuarial Opinion (SAOs) in the United States, as well as members of any actuarial organization that is not U.S.-based but requires its members to meet the standards when practicing in the United States.

Under the revised Qualification Standards, an SAO is an opinion expressed by an actuary in the course of performing actuarial services (as defined in the Code of Professional Conduct) and intended by that actuary to be relied upon by the person or organization to which the opinion is



addressed. (The code defines actuarial services as “professional services provided to a Principal [client or employer] by an individual acting in the capacity of an actuary. Such

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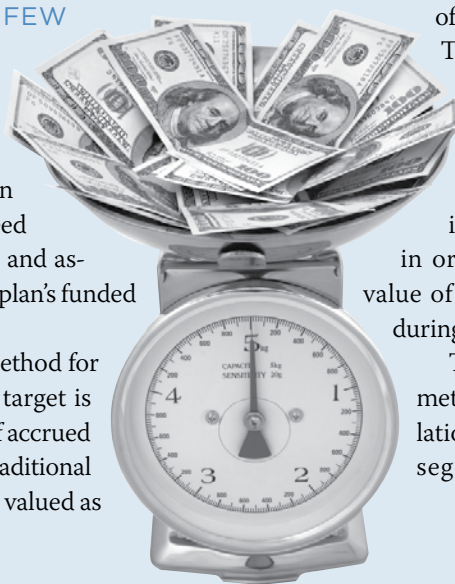
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GREGORY REARDON

Measuring Assets and Liabilities Under PPA

ONE OF THE FEW SIMILARITIES between pension provisions under the old law and under the Pension Protection Act of 2006 (PPA) is the need to measure plan liabilities and assets in order to calculate a plan’s funded status.

Under the PPA, the method for determining the funding target is based on a present value of accrued benefits calculation (i.e., traditional unit credit method) and is valued as



of the beginning of the plan year. The target normal cost is developed in the same manner and takes into account applicable salary increases or collectively bargained benefit increases during the plan year in order to calculate the present value of benefits expected to accrue during the plan year.

The prescribed interest rate method used in the liability calculation is based on either a three-segment discount rate model

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OPEB Liabilities Under GASB

GOVERNMENT ACCOUNTING STANDARDS BOARD (GASB) statements 43 and 45, issued in June 2004, may significantly affect the financial statements of employers sponsoring other post-employment benefits (OPEB) since they require accrual-basis accounting measurement and disclosure for OPEB plans. That they have an OPEB liability will come as a surprise to many sponsors because the underlying benefit is part of an implicit subsidy of retirees contained within their group insurance program. (No GASB 45 cost determination is needed if beneficiaries and retirees pay 100 percent of their own actuarially determined costs.)

OPEB reporting requirements are phased in based on the governmental entity’s annual revenues as shown below:

Annual revenue	Fiscal years beginning after
At least \$100 million	12/15/06
\$10 million to \$100 million	12/15/07
Under \$10 million	12/15/08

The disclosure requirements are very similar to pension reporting requirements—GASB 43 is similar to GASB 25, and GASB 45 is

similar to GASB 27. Among the requirements is a schedule showing funding progress over a multi-year period. Plans that are exempt from the disclosure requirements are cost-sharing multiple-employer plans, insured benefit plans, and defined contribution plans.

The chart below compares Financial Accounting Standards Board (FASB) Statement of Accounting Standard (SFAS) 106 and GASB 45.

The actuarial aspects of OPEB work blend elements of both pension and health practice. In doing this work, the actuary should take into account Precept 2 of the Code of Professional Conduct regarding when the actuary is qualified. The actuary should also remember that this area of practice will require continuing education in the health, pension, and investment areas.

Healthcare Assumptions

Healthcare assumptions for fully insured plans will require adjusting the premium for factors such as age, sex, pre-Medicare and post-Medicare (but only when the plan is secondary to Medicare), employment status, the mix of plan options expected to be elected, cross subsidies within the plan options, cross subsidies between

	SFAS 106	GASB 45
Cost method	Projected unit credit cost method	Six permitted cost methods
Conceptual basis	Comparability	Funding
Attribution	Date of hire to full eligibility	Date of hire to date of term
Basis for cost determination	Substantive plan	Same
Actuarial assumptions	Explicit	Same
Transition issues—initial unfunded OPEB liability	Recognize over time or initial one-time charge	Recognize over time
Valuation frequency	Not explicitly specified, but most frequently annual	Based on sponsor size; alternative option
Discount rate	Set based on effective yield of high-quality bonds that match expected plan benefit disbursements	Long-term expected yield on investments to be used to pay plan benefits
Federal reimbursements under Medicare (Part D)—i.e., 28 percent subsidy	Reflect anticipated cost savings via lower net per capita costs	No anticipated cost savings; treat as inter-government transfer payment

Academy Reaffirms Position on GASB 45

As accounting treatment for retiree health obligations in public plans faces scrutiny by state legislatures, the Academy's Joint Committee on Retiree Health has been busy setting the record straight. In June, the joint committee sent a letter to Texas Governor Rick Perry and other state officials to correct a mischaracterization of a 2006 comment letter and to reiterate its support of accrual accounting for other post-employment benefits (OPEBs) in public plans.

During hearings to advance Texas legislation that would

impede the implementation of Governmental Accounting Standards Board (GASB) statement 45, which requires disclosure of the long-term unfunded obligation of OPEBs for public plans, it was asserted that the Academy believed that giving the current accumulated post-retirement benefit obligation balance sheet status would most likely diminish the credibility of a balance sheet and add unwarranted volatility.

The assertion arose from the joint committee's 2006 comments to the Financial Accounting Standards Board

(FASB) regarding proposed changes to accounting standards for OPEBs. While the 2006 letter suggested that FASB consider revising the measurement process before assigning the existing measure of obligation to the balance sheet, it did not advocate that the obligation be zero.

The letter to the governor discusses in more detail the differences between accounting for public- and private-sector plans, specifically noting that GASB standards deal with governmental entities, which often offer stronger benefit guaran-

tees than private-sector plans under FASB jurisdiction.

In addition to the letter to Governor Perry, the committee wrote a similar letter to the editor responding to a widely circulated opinion piece by Susan Combs, Texas' comptroller of public accounts, Sen. Robert Duncan, and Rep. Vicki Truitt. The op-ed advanced the same misperceptions introduced during the Texas legislature hearings.

To read the joint committee's letter to the governor, go to www.actuary.org/pdf/health/opeb_june07.pdf

—HEATHER JERBI

employees and dependents, extraordinary loss ratios, benefit types, and other less common factors. Self-insured plans will require the same adjustments, after establishing the gross per capita costs that are expected.

Valuation Discount Rate

Selection of the valuation discount rate first involves an analysis of whether the plan is funded, unfunded, mixed funded, or partially funded. Funded plans provide benefits through a trust or similar arrangement, where the funding policy is to consistently pay an amount equal to or greater than the annual required contribution (ARC) and where plan assets are expected to be the sole source for the payment of benefits. In unfunded plans, there is no trust, and employer assets are the only source for the payment of benefits. Mixed funded plans of various types operate in between. Understanding the funded nature of the plan is crucial for a GASB valuation since the estimated long-term investment yield is likely to be

greater for plans that are funded.

Once the nature of the plan's funding is understood, the valuation discount rate can be determined. For unfunded plans, the actuary must look solely to the employer's investment policy (written and in practice) for unrestricted assets, especially in regard to maturity/duration and credit quality. For funded plans, the actuary must look solely at the trust's investment policy (written and in practice). The asset allocation specified by the investment policy will have great influence on the determination of the discount rate. Guidance is provided in Actuarial Standard of Practice No. 27, *Selection of Economic Assumptions for Measuring Pension Obligations*, in relation to determination of expected returns.

Employer Contributions

As with private pension plans, payments from the sponsor to the benefit trust are considered contributions. In addition, payments made by a sponsor directly to or on behalf of a beneficiary or a retiree are a contribution that meets the ARC.

As a further trust requirement, the payments must be made to a trust that meets four standards: The trust must be a legally separate entity under the stewardship of trustees; it must be irrevocable; it must be dedicated to providing the benefits being valued for retirees (not actives); and it must be legally protected from the employer's and administrator's creditors. In practice, this means a tight legal document that is similar to a pension trust.

Employer contributions for an unfunded plan using a fully insured underlying health plan are the age-sex adjusted premiums less retiree contributions, for retirees and their dependents for the time they were retirees. In addition, employer contributions for an unfunded plan with a self-insured underlying health plan are the actual un-reimbursed claims and other expenses incurred for retirees and their dependents for the time they were retirees.

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Modeling Equity Compensation

SINCE FINANCIAL Accounting Standard 123R came on the scene over a year ago, the need for companies to accurately value the share-based incentives they award their employees has exploded. The standard, which requires expensing the grant date fair value of awards, sets the groundwork for valuations, but its complexity often presents companies with complicated choices.

Companies can value their equity compensation using the Black-Scholes model, a lattice (typically a binomial) model, or a simulation model. Each offers various advantages and disadvantages, and often a trade-off must be made between ease of use and flexibility.

Of the three, the Black-Scholes model is the easiest to use and most widely available. However, it can't accommodate interest rates, volatility, or dividend yields that change over time. It also doesn't factor stock appreciation into exercise behavior and makes the sweeping assumption that all exercises and cancellations occur at one point in time. However, it's

the most commonly used valuation model and can provide reasonably accurate valuations for basic award designs.

A multiple-point Black-Scholes model can be used to avoid some of the drawbacks of the traditional model. Essentially, the multiple-point version creates a distribution of exercises by incorporating actual experience at an individual option level. This removes any distortion created by assuming that all exercises occur at one point in time. It also lowers the overall fair value of the award.

Binomial models provide much more flexibility as they can incorporate term structures of interest rates, volatility, and dividend yields, as well as probabilities of exercise, termination, and retirement. However, along with this added flexibility comes far more complexity when calibrating the model and the likelihood of a much more expensive audit. In addition, under FAS 123R, once a company chooses to use a binomial model, it cannot change to a Black-Scholes model.

While binomial models can assume

various forms, they generally can be classified as either a barrier model or an exercise probability model. Barrier models assume that awards are exercised when the stock price reaches a certain level or when a specified amount of time has passed. Exercise probability models can incorporate various drivers of exercise. For example, they can be calibrated by specifying rates of exercise for different levels of stock price appreciation, volatility, time after vesting, or time since grant. Binomial models have been gaining in popularity over the past few years. As of January 2007, 356 companies (80 of them listed in the Standard & Poor's 500) have publicly disclosed using a binomial model.

Simulation models are the most flexible models, but they also tend to be the most time-consuming and costly to build. They also can take a considerable amount of computing time to run. Simulation models, which simulate stock price movements over the term of an award, are used primarily to value exotic options that cannot be valued with a Black-Scholes or binomial

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or a full yield curve approach. Under a three-segment approach, interest rates are based on a 24-month average of high-quality corporate bond yields that remain constant within each segment. Each segment is used to discount benefits based on when they are expected to be paid—the first segment is applied to the discounting period if benefits are expected to be paid within five years of the valuation date; the second segment is tied to benefits expected to be paid 15 years out from the end of the first segment; and the third segment is applied to benefits expected to be paid at

any point after the second segment. Also, plan sponsors have an option of selecting which month's segments to utilize. They may elect the valuation month or any month up to four months preceding the valuation date.

The second interest rate option is to value the plan's liabilities under a full yield curve approach, in which interest rates are based on current yields and vary based on each year a benefit payment is expected to occur.

Under both interest rate methods, the Treasury Department and Internal Revenue

Service (IRS) will publish applicable rates monthly with further guidance to come.

The prescribed mortality table is expected to be similar to the mandated 2007 Retirement Protection Act (RPA) current liability table, adjusted to take into account whether or not a participant's benefit has commenced. The new mortality table is also expected to have a projection period built in and updated annually. In certain situations, there is the option to use a full generational or plan-specific mortality table.

Under the PPA, plan assets are based

model. They commonly are used to value performance-based awards because they can incorporate the correlation between various stocks and the path dependency often inherent in the awards.

FAS 123R requires that all valuation models use six assumptions to calculate the grant date fair value of equity awards. These are the grant price, exercise price, stock price volatility, risk-free rate of return, expected dividend yield, and expected life (employee behavior). The most challenging to develop are valuation assumptions focused on volatility and employee behavior.

Companies can use historical, implied, or peer group volatility (or a combination of all three) to set stock price volatility assumptions. Historical volatility, the annualized standard deviation of the log change in stock price, is easy to calculate and understand. However, it's not a viable alternative for nonpublic companies or companies with little stock price history because it's sensitive to unusual events and might be inconsistent with market

beliefs regarding volatility. Implied volatility, which is calculated using market-traded option prices, is consistent with the market's volatility estimate and can be used for companies with little stock price history. Yet, in order for implied volatility to be used, the options must be actively traded, be trading at or near the money, have an exercise price close to the award's exercise price, and have a remaining maturity of at least six months. The volatility of a peer group of companies, while not a viable alternative for companies with extensive stock price history, is sometimes the only available method for a private company or a recent initial public offering to develop a stock price volatility assumption.

Employee behavior assumptions are built into different valuation models in different ways. The expected life assumption used in the Black-Scholes model encompasses all employee behavior. Therefore, it should reflect an assumption for not only awards that have been exercised or canceled but also for the vested and un-

vested options that remain outstanding. Employee behavior can be built into binomial and simulation models using a series of exercise and post-vesting termination rates. Exercise rates can vary with stock return, time, or other variables to incorporate expected employee behavior.

Regardless of the valuation model used, various factors should be considered when developing employee behavior assumptions. If behavior is expected to differ significantly between groups of employees (perhaps by age or job title), developing different assumptions for each group may be a reasonable strategy. The influence of plan provisions, including vesting and retirement provisions, on employee behavior is important to consider as well. Mergers, acquisitions, and other company events also can affect employee behavior and should be analyzed when setting assumptions.

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The prescribed mortality table is expected to be similar to the mandated 2007 Retirement Protection Act (RPA) current liability table, adjusted to take into account whether or not a participant's benefit has commenced.

on market value as of the valuation date with an averaging period permitted up to 24 months. Further IRS guidance is expected to be released related to this averaging process. Plan contributions deposited after the end of the plan year, on behalf of the prior plan year, are counted as contributions receivable for the cur-

rent plan year asset value. However, they are discounted back to the valuation date based on the prior plan year's effective interest rate. The effective interest rate is the single interest rate that would yield the funding target under the interest rate method elected.

Although the rules appear to be fairly

clear on how to calculate plan liabilities and assets, this isn't the case. The statements above are valid only for a well-funded plan and don't take into consideration possible relief during the transition period (2008 to 2010). There are numerous exceptions to the general statements provided that will be triggered by the size of a plan's population, its funded status, and any applicable transition rule.

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New Rules for Minimum and Maximum Funding

AS A RESULT of the Pension Protection Act of 2006 (PPA), all of the rules for minimum required contributions and maximum deductible contributions have changed. Beginning in 2008, say goodbye to the Section 412 funding standard account, additional funding charges, and full funding limits. Under Section 430, we meet funding targets, funding shortfalls, target normal costs, and shortfall amortization bases, installments, and charges.

In concurrent sessions at the 2007 Enrolled Actuaries Meeting, Bruce Cadenhead, a principal with Mercer Human Resource Consulting in New York; Michael Pisula, an actuary with the Phoenix Benefits Group in Pittsburgh; and Michael Schachet, a senior vice president with Aon Consulting in Chicago, discussed minimum and maximum funding issues under the new law.

A plan's funding target is the present value of accrued benefits at the beginning of the plan year using the unit-credit-funding method and mortality

and interest rates prescribed by Section 430. The target normal cost is the present value of benefits accruing during the plan year using the unit-credit-funding method and salary increases for pay-related formulas.

Under the simplest circumstances, companies will compare their assets to their funding target plus target normal cost. If a company's assets are greater or equal, no contribution is required. If its assets are less than the funding target, a funding shortfall exists, and the company will contribute the target normal cost plus an amortization (or amortizations after the first year) of the funding shortfall. If the assets lie somewhere between these two amounts, then the company will contribute the amount of uncovered target normal cost ($FT + TNC - \text{assets}$).

Complicating the matters above are the ideas of carryover balances (the old credit balance left at the end of the last year of the Section 412 funding standard account) and pre-funding balances

(amounts contributed and elected over the minimum required contribution under Section 430). These amounts are used as offsets to the assets for various calculations, can and/or must be "burned" in order to achieve certain benchmarks, and can be used to offset a year's minimum required contribution unless plan funding limits are too low. Other complications include at-risk status (which wasn't covered in the sessions), shortfall base exemptions, and various transition rules.

Other new items under PPA that were discussed in the sessions include the effective interest rate (used to discount contributions made after the valuation date and receivable contributions), how to project credit balances from the beginning of the year to the end of the year, contribution timing (including quarterlies), and, finally, calculation of the maximum deductible contribution under Section 404.

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Ethical Dilemmas

HAVE YOU EVER BEEN asked to use assumptions that would seem inconsistent with those used for similar clients at your firm? Have you ever taken over work for another actuary and found a mistake? Have you ever completed a published study and later found that key data you relied on was misinterpreted?

At a session on ethical dilemmas at this year's Enrolled Actuaries Meeting, panelists Lauren Bloom, former Academy general counsel and director of profes-

sionalism; David Godofsky, chairperson of the Joint Program Committee for the Enrolled Actuaries Meeting and a partner in the legal firm of Alston & Bird in Washington; and Paul Zeisler, a principal with Mercer Human Resource Consulting in Chicago, explored these questions through the use of three case studies.

The first case concerned a potential conflict of interest. Anxious to be hired by a company, an actuary promises a conservative set of assumptions for FAS 87 calculations. It's discovered later that the

company was spun off from another client of the actuary's firm and that the original firm uses an aggressive set of assumptions for its FAS 87 calculations. While very few believed there was a confidentiality issue, the vast majority of the session's attendees felt it was OK for two enrolled actuaries to use different assumption sets. It was also pointed out that each plan sponsor needs to document the rationale for forward-looking assumptions and that it's quite possible that these two organizations would have different future horizons fol-

services include the rendering of advice, recommendations, findings, or opinions based upon actuarial considerations.”)

While the revised standards apply to all actuaries who issue SAOs in the United States, there are some specific implications for enrolled actuaries in the area of continuing education.

→ EAs are deemed to meet the basic education and experience requirement of the General Qualification Standard in the pension practice area.

→ Beginning in 2009, annual CE requirements are 30 hours per year, of which a minimum of three CE credit hours must cover professionalism topics and a minimum of six must be from organized activities that, as defined in the revised Qualification Standards, involve interaction with actuaries or other professionals working for different organizations. The new CE requirements take effect on Jan. 1, 2008, but are being phased in so that only 24 hours of CE are required in 2008 for actuaries issuing SAOs in 2009.

→ Through 2010, EAs who issue SAOs related to retirement plans to which ERISA applies will be exempt from the new CE requirements if they meet the

CE requirements of the Joint Board for the Enrollment of Actuaries. However, EAs who issue SAOs not covered by this exemption, such as SAOs related to supplemental retirement plans or post-retirement medical benefits, must meet the CE requirements of the revised Qualification Standards.

→ Beginning in 2011, EAs who issue SAOs other than Schedule B (Form 5500) certificates must supplement the Joint Board’s CE requirements with the CE requirements of the Qualification Standards

→ Under the new standards, there is no longer a process for becoming an approved CE provider. It is now up to the individual actuary to determine if attendance and participation in a particular event constitute an organized activity that is directly relevant to the actuary’s practice area relative to the subject matter of any SAO.

To meet the general qualification requirements under the revised Qualification Standards, an actuary must obtain membership in one of the five U.S. actuarial organizations or be a fully qualified member of another actuarial organization

that is a member of the International Actuarial Association; have three years of responsible actuarial experience, defined as work that requires knowledge and skill in solving actuarial problems; and be knowledgeable, through examination or documented professional development, of the laws (as defined in the Code of Professional Conduct) applicable to an SAO.

The revised standards were developed by the Academy’s Committee on Qualifications over the course of several years. Beginning in 2002, the committee began soliciting input from the profession on whether the standards should focus solely on statutory and regulatory work or should be expanded to include all SAOs. A first draft was exposed for comment in May 2004, and a second version was exposed for comment in January 2006. The committee received more than 200 comments on the second exposure draft from various groups and individuals.

Printed copies of the standards were mailed to all Academy members with the August *Actuarial Update*. Copies can also be downloaded from the Academy website, www.actuary.org/qualstandards/qual.pdf.

lowing the spinoff.

In the next case, an actuary takes over an account from her boss and finds a significant error. When notified of the error, her boss takes responsibility for notifying the client but does so in a letter that the actuary later discovers was misleading. Bloom said that the letter violated two precepts and could be considered to border on fraud. This point was challenged by others who preferred giving the boss the benefit of the doubt and suggested that he may have believed he wrote a clearly understandable letter. The importance of peer review and having a solution in place before notifying the client was discussed.

Among other options, the actuary could consult her own attorney or seek guidance from the Actuarial Board for Counseling and Discipline.

The last case involved a situation where a study was performed using data from multiple countries that suggested a new pension law in this country would enable 37 million Americans to retire with a pension. The study findings were touted by a presidential candidate in a national campaign but an actuary later discovered that some of the foreign language translations were wrong and the correct number of pension recipients would be only 3 million. The bulk of the discussion focused

on what the actuary should do if told to keep the information confidential. Session attendees debated whether or not the general public became the actuary’s de facto client once the information was used publicly by a presidential candidate. Attendees also pondered what steps an actuary should take to reasonably ensure that his or her work isn’t used to mislead others. At the end of the session, Zeisler reminded attendees that an actuary who leaves with integrity, leaves with something.

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FASB Reform: Smooth Sailing or Rough Waters?

THERE HAS BEEN widespread dissatisfaction with current financial accounting and disclosure standards in Financial Accounting Standard (FAS) 87 and FAS 106, particularly from investors and other users of financial statements. The Financial Accounting Standards Board (FASB) is in the middle of a two-phase project to reform pension accounting. Phase 1 of this effort resulted in FAS 158, released in 2006. Phase 2 will address a broad range of pension issues and replace FAS 87, 88, 106, 132, and 158. Investors want the best information about cash flows, assets, and liabilities, both for now and in the future. The preservation and social value of pension plans is not their primary focus.

FAS 158

Traditionally, companies have focused on the accounting implications of their plan's net periodic benefit cost. FAS 158 creates the opportunity for companies to think more comprehensively about the long-term cost of their plan. Phase 1 reform has focused on financial transparency, fair values of assets and liabilities, exposing risk, and balancing actuarial calculations with principles of financial economics.

FAS 87 introduced accrual accounting concepts to the income statement but compromised on balance sheet items, as the difference between prior costs and prior contributions is recognized on the balance sheet. FAS 158 leaves the income statement unchanged while requiring market-value accounting of both assets and liabilities on the balance sheet. Each plan's net funded status must appear on the balance sheet under FAS 158. Other changes include the elimination of early measurement dates and revised footnote disclosure requirements.

FAS 158 is estimated to reduce shareholder equity for the *Fortune* 1,000 by



\$3.648 trillion. However, a majority of these companies experienced less than a 5 percent loss in shareholder equity because of its implementation. Since the changes implemented under FAS 158 have typically been previously accounted for by analysts and credit rating agencies, little impact on corporate bond ratings is expected to result.

The United Kingdom experienced similar accounting reform in 2005 with the implementation of Financial Reporting Standard (FRS) 17. There was a subsequent large contraction of defined benefit plans, although notable differences exist compared with the U.S. market. There are more contributory plans in the United Kingdom, a stronger union presence, and smaller social insurance benefits. After the implementation of FRS 17, higher demand from pension funds caused bond shortages, reducing bond yields and, in turn, increasing pension deficits.

Accounting Reform—Phase 2

Phase 2 of FASB pension accounting reform is expected to have greater impact for investors than Phase 1. The Phase 2 project is expected to be intertwined with the International Accounting Standards Board's (IASB) project on post-retirement benefit accounting reform. Although the results of Phase 2 are unpredictable at this time, the issues to be debated are more certain. The project may be divided into

Phases 2A and 2B, focusing initially on areas of smoothing, components of comprehensive income, and multiemployer plan disclosures.

Key issues in Phase 2 may include liability measurement, cost classification, profit and loss recognition, and balance sheet consolidation. Liability measurement reform may address the use of accumulated versus projected benefit obligations in determining plan liabilities, lump sum features, discount rates, and other assumptions. Profit and loss recognition reform may include debate on the appropriateness of smoothing options for the recognition of gains and losses and prior service costs. Cost classification reform would consider the allocation of net periodic benefit cost components into more appropriate sections of the income statement. For example, rather than listing a pension plan's interest cost and expected return on assets in a company's operating costs, FASB may deliberate moving these items to the financing and investing cost sections of the income statement. This particular reform has upside potential for plan sponsors, since operating costs would become smoother under Phase 2. Finally, balance sheet consolidation reform would evaluate separating plan assets and plan obligations to their respective sides of the balance sheet, rather than reporting the post-retirement liability net of plan assets.

The remainder of the FASB pension project is likely to take three to five years. As convergence to international accounting standards remains a priority, the simultaneous progress of IASB accounting reform will very likely influence both the content and timeline of future FASB directives.

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