AUDIT COMMITTEE LEADERSHIP NETWORK
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Pension obligations: a deep dive into one area of risk

Introduction

On June 29, 2006, members of the Audit Committee Leadership Network (ACLN) met for the network's 13th meeting. Members began by considering information technology (IT) governance and the associated technology risks;[1] the network then explored in depth another particular source of risk: pension obligations. During the discussion, attention focused on:

- **The forthcoming Financial Accounting Standards Board (FASB) rule changes on pension accounting**
- **Increasing the audit committee's comfort with actuarial assumptions**

Members also discussed how the audit committee agenda is evolving in the post-Section 404 environment. Changes noted included increased attention to more long-term strategic matters, such as enterprise-wide risk, and a focus on more controversial and topical items, such as executive compensation.

Audit chairs participating in the meeting included:

- Gene Fife, Audit Committee Chair, Caterpillar
- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Chuck Noski, Audit Committee Chair, Microsoft and Morgan Stanley
- Sandy Warner, Audit Committee Chair, General Electric Company
- Steve West, Audit Committee Chair, Cisco Systems

Audit chairs who participated in individual discussions before the meeting were:

- John Clendenin, Audit Committee Chair, The Home Depot
- Marie Knowles, Audit Committee Chair, McKesson
- Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company
- Doug Yearley, Audit Committee Chair, Lockheed Martin

The members listed above sit on the boards of nearly 50 large-, mid-, and small-cap public companies between them. Other members participating in the meeting included:

- John Ferraro, Vice Chairman, Ernst & Young
- Tom Flannery, Partner and Director, Audit Committee Communications, Ernst & Young

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made before and during meetings are not attributed to individuals or corporations.

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[1] See Audit Committee Leadership Network, "IT risks and governance," *ViewPoints*, July 19, 2006. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_July06_View13.pdf

Executive summary

Pension obligations often appear on board and audit committee agendas as items having to do with investment performance, accounting treatments, and actuarial assumptions. However, pensions – and related health care obligations – also represent financial and reputation risks to companies. As audit committee chairs, members were interested in the accounting aspects of pension obligations; as board directors, they were interested in the broader social implications surrounding pension obligations.

Members also make a distinction between the *"social issue of post-employment health and retirement,"* which is a matter for government and perhaps for the board, and the pension accounting issues that arise in audit committee discussions.

- **Forthcoming FASB rule changes on pension accounting** *(Page 2)*

  Most members are skeptical that anything will really change during the first phase of the FASB's rule changes, although balance sheets may look weaker due to charges to shareholder equity. However, they feel that phase two, which may eliminate smoothing, will be more *"exciting."*

  Audit chairs consider pension obligations not from a moral or social perspective, but from an accounting perspective. They admit that pension accounting is a difficult topic for boards and audit committees as it requires more technical knowledge than many other risk items. Consequently, board discussions often start with a primer on the subject. For a summary of the FASB exposure draft, see boxes on pages 3 (phase one) and 4 (phase two).

- **Increasing the audit committee's comfort with actuarial assumptions** *(Page 5)*

  Audit committees are concerned about the robustness of the actuarial assumptions behind their companies' pension and retiree health care obligations. For pensions, it is the rate of return on investment that concerns them; for health care, the potential future cost. Audit chairs question how actuarial assumptions are developed and are worried about opportunities to manipulate data to impact earnings. Members recommended a number of methods for ensuring that actuarial assumptions are reasonable, including asking for a sensitivity analysis of the financial statement impact of changes in the assumptions, seeking the external auditor's perspective, and studying peer-group benchmarks. To see how companies typically provide oversight of pension obligations, see page 5.

Forthcoming FASB rule changes on pension accounting

Pension accounting is a difficult, technical topic for boards and audit committees. As one member revealed, *"When we have a board discussion, we have to start with a primer … If it's like that for us, what's it like for someone who has to read [the disclosures in securities documents]?"*

In its *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2003 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers,* the Securities and Exchange Commission (SEC) staff concluded that pension accounting must be revised to improve the quality and transparency of financial statements and to eliminate inconsistent accounting treatment for pensions.[2]

Responding to the SEC's challenge, the FASB proposed requiring companies to reflect the current over-funded or under-funded positions of post-retirement benefit plans in their balance sheets in order to make their basic financial statements more complete, useful, and transparent. One pension expert interviewed before the meeting said that in phase one of the likely rule change, "most companies are going to put liabilities on their balance sheets that were previously netted down into footnotes and off their balance sheets. When they put them on, the offset goes to shareholders' equity." One member agreed: *"Companies will have charges to equity and will look weaker."*

Summary of the FASB exposure draft – phase one[3]

- Under the proposed Statement, employers who sponsor defined benefit postretirement plans will be required to recognize the funded status of the plans in their statement of financial position. The proposed Statement requires actuarial gains and losses and prior service costs and credits that have not yet been recognized as components of net periodic benefit cost to be recognized in other comprehensive income.
- To more accurately reflect the economic status of defined benefit plans and further improve the understandability of the financial statements, the proposed Statement also requires that the measurement of plan assets and benefit obligations be as of the date of the sponsoring employer's statement of financial position, not up to three months earlier, as had been permitted by Statements 87 and 106.

As one commentator wrote, "According to at least one accounting analyst, David Zion of Credit Suisse First Boston, the plan announced by [FASB] in mid-November to move the funding status of retirement benefits, such as pensions and retiree health care, onto the balance sheet could take a bite out of shareholder equity to the tune of $255 billion for S&P 500 companies that would be affected by the accounting rule change."[4]

The rule change has the potential to affect debt covenants and other covenants and contractual arrangements that contain references to financial metrics that may be impacted by recognition of the funded status of a plan on reported assets, liabilities, and equity. However, one audit chair commented that debt covenants often contain provisions that allow for their renegotiation if there are accounting rule changes.

Members disagreed over the impact of the rule changes. One member said, *"Pensions are a train wreck waiting to happen. Companies have not recognized their liabilities on a realistic basis and have put their heads in the sand. They are looking for 8-9% return on investment. The assumptions are not realistic.*

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[2] U.S. Securities and Exchange Commission, *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2003 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers* (Washington, DC: U.S. Securities and Exchange Commission, 2005), 4. Available at: http://www.sec.gov/news/studies/soxoffbalancerpt.pdf

[3] The summary is paraphrased from Ernst & Young, *Summary of FASB Exposure Draft on* Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R) (New York: Ernst & Young, 2006), 1. Available at: http://www.ey.com/global/download.nsf/US/FASB_Summary_Postretirement_Benefits/$file/FASB_ED_SmryPostretireBenefits.pdf

[4] "Watch out, the FASB has you in its sights again," *Treasury and Risk Management Express* 4, no. 21, November 21, 2005. Available at: http://www.treasuryandrisk.com/eletter/archives/treasuryandrisk/193.html

Stock options have hit the balance sheet, and pensions will, so balance sheets won't look as good as they do [today]." However, most members are skeptical that any impact will be felt. One said, *"Reality doesn't change. The presentation of what reality seems to be changes. The market knows and has incorporated it [into the stock price]. It will be a non-event."*

In response, another member warned, *"Sophisticated investors factor it in, but all you need is one pension fund to go down, or some scandal, and politicians will demand something happen and demand more disclosure."* There was some concern that the accounting changes themselves, while fairly uneventful, may *"…drive some more hysterics. There may be some rust belt issues with people not getting their pensions."*

Summary of the FASB exposure draft – phase two[5]

In the second phase of the multi-year project, the Board will comprehensively reconsider other issues in accounting for postretirement benefits, including, but not limited to:

- How the items that affect the cost of providing postretirement benefits should be recognized and displayed in earnings or other comprehensive income (i.e., how prior service costs and credits related to both retired employees and active employees should be recognized).
- How to measure an employer's benefit obligations, including whether more or different guidance should be provided about measurement assumptions.
- Whether postretirement benefit trusts should be consolidated by the plan sponsor.
- Accounting issues related to plan assets and plan obligations being remeasured each interim reporting period.

The pension expert stated that the changes in phase one "won't have an immediate impact on earnings, so [they] may not be of great concern to management … It shouldn't have any impact on [companies'] market value, but it should affect the reported book value of shareholder equity … The second [phase] could dramatically change pension accounting, in that it may get rid of smoothing. We think people should take it seriously. They need to evaluate the impacts." A member agreed saying, *"Phase two, impacting earnings, will be more exciting, with new ways of thinking about assumptions."*

Bradley Belt, the outgoing executive director of the Pension Benefit Guaranty Corporation, considers smoothing to be "inconsistent with current reality. Asset values from four or five years ago or an interest rate [from then] has no impact on reality. It's like driving down the highway at a high rate of speed and only looking at the rear-view mirror. You shouldn't be surprised if you hit a tree. I'm sure the CFO of an airline would welcome the opportunity to smooth fuel prices, that of an auto maker would smooth rubber prices, and that of an insurance company would smooth interest rates. That should not be the way the world works, or the pension world works."[6]

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[5] The summary is quoted from Ernst & Young, *Summary of FASB Exposure Draft on* Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R), 4.

[6] David M. Katz, "Q&A: Pensions on the Brink," *CFO.com,* April 4, 2006. Available at: http://www.cfo.com/article.cfm/6767363?f=related

However, members are not convinced the final rules will makes matters any clearer: *"The big issue is the piecemeal march towards mark-to-market balance sheets, asset by asset. Net worth will become hard to understand."*

How companies typically provide oversight of pension obligations

Members broadly agree with the following formula for oversight of pension obligations:

- **Full board:** asset allocation and investment performance
- **Audit committee:** actuarial assumptions and pension accounting
- **Compensation committee:** design and structure of pension plans

Increasing the audit committee's comfort with actuarial assumptions

Audit committees are very concerned about the actuarial assumptions behind the accounting of the company's pension obligations. These assumptions rest on estimates of the discount rate, the rate of return on investment, and the demographic profile of impacted employees (including mortality rates and salary progression). The discount and return rates must be disclosed in securities documents.

The pension expert interviewed before the meeting warned audit chairs about the dangers of management using changes in actuarial assumptions to manage earnings: "That is becoming more and more of a hot button. The SEC has really focused on the assumptions and ensuring that they are reasonable." A member pointed out that the problem is not usually with assumptions about the discount rate, which is directly linked to bond rates, but with assumptions about the rate of return on investment: *"[Companies] can use different periods to create the average and really play games with it."*

The possibility of management manipulation aside, audit chairs still have concerns. Speaking before the meeting, one member said, *"Under the current arithmetic, we are currently funded, but I ask myself: Are the actuarial assumptions behind it really worthy of reliance, and if they aren't, what do we do about it?"* The pension expert said, "The assumptions need to be reviewed and updated annually at a minimum … The biggest thing that we see is that companies do not have adequate documentation [of] the thought process behind their assumptions."

Members recommended a number of ways to ensure that actuarial assumptions are reasonable:

- **Ask for a sensitivity analysis of how particular changes in actuarial assumptions would affect the financial statement.**
- **Listen to the external auditors.** External auditors have an obligation to point out any concerns they have with the assumptions being used. The audit committee should ask if there have been any changes in any assumptions recently. If there have been, what was the impact? One member said, *"The external auditor should highlight any differences between management's idea on the discount rate and [the auditor's] view of history."*
- **Study peer-group benchmarking.** One audit chair said, *"We look at our peers. If we are in the middle of the pack, we take comfort."*

Phase two of the FASB rule changes will also include **retirement health care benefits**. *CNNMoney.com* reported, "Credit rating agency S&P found that among S&P 500 companies, they have a combined under-funded balance of $292 billion for their OPEB (Other Post Employment Benefits) obligations, which include company-paid health insurance premiums and drug coverage plans for retired workers."[7] One member commented that the assumption of future health care costs is the *"big ticking time bomb in many financial statements."* Another said, *"We all got into the health care mess. We didn't fast forward 20 years to see what [it] would cost us. Is that [type of shortsightedness] still going on, or not?"*

Members agreed that audit committees need to look at assumptions around retiree health care, as well as pension obligations. *"It's the same problem, and the numbers are huge."* However, members feel they have even less control over assumptions about long-term health care costs. *"The assumptions [for lower costs in the future] are not very strong; there are no compelling arguments [for them].* Another member agreed: *"People are hopeful [health care] costs will come into line with other costs, and that's a big gamble."*

Conclusion

Members of the Audit Committee Leadership Network are keen to see the performance of audit committees improve. Overloading the audit committee with additional responsibilities is unlikely to help; audit chairs would like to see their committee focus on those areas of risk that fit with their particular competencies, areas in which the committee can make a real difference. As far as pension obligations are concerned, that means a laser-like focus on pension accounting and on actuarial assumptions – not plan design, fund performance, or the social issues surrounding retirement.

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment. *ViewPoint*s is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues.

The views expressed in this document represent those of the Audit Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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[7] Jeanne Sahadi, "S&P 500: Under-funding retiree health," *CNNMoney.com,* December 19, 2005. Available at: http://money.cnn.com/2005/12/19/retirement/health_benefits_retirees/index.htm