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Response to FASB Exposure Draft, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans: An Amendment of FASB Statements No. 87, 88, 106, and 132(R)"

American Accounting Association's Financial Accounting Standards Committee
Hollis A. Skaife (chair); Mark T. Bradshaw (principal co-author); Paquita Y. Davis-Friday (principal co-author); Elizabeth D. Gordon (principal co-author); Patrick E. Hopkins; Robert Laux; Karen K. Nelson; Shiva Rajgopal; K. Ramesh; Robert Uhl; George Vrana

INTRODUCTION AND OVERVIEW OF THE EXPOSURE DRAFT

The Financial Accounting Standards Committee of the American Accounting Association (the Committee) is charged with responding to requests for comment from standard-setters on issues related to financial reporting. This paper summarizes the Committee's response to the Financial Accounting Standards Board's Exposure Draft, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans: An Amendment of FASB Statements No. 87, 88, 106, and 132(R)" (hereafter, the ED). The comments in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

The ED addresses recognition and disclosure requirements for defined benefit pension and other postretirement plans in connection with employee services. The ED takes the position that employers' financial statements are incomplete with respect to those plans, despite footnote disclosures regarding the funded status of the plans. The Board is sympathetic to arguments that current guidance on the accounting for pensions makes it difficult for users of financial statements to clearly understand how pension and other postretirement liabilities affect a company's financial position or ability to meet its plan obligations.

The ED, which primarily addresses the reporting of periodic costs and balance sheet reporting under existing measurement rules, is the result of the first phase of an intended two-phase project. In the second phase, the Board will reexamine issues of measurement and recognition of pension and other postretirement obligations. The following is a summary of the primary changes required by the ED:

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- Funded status is defined as the difference between the fair value of plan assets and the benefit obligation where the benefit obligation is measured as the projected benefit obligation (PBO) for pension plans and as the accumulated postretirement benefit obligation (APBO) for any other postretirement benefit plan. Companies would be required to recognize the funded status of such plans on the balance sheet rather than disclose this information in the footnotes.
- Changes in the funded status not recognized as components of net periodic benefit cost would be included as a component of other comprehensive income, net of tax.
- Amortization of any transition asset or obligation that resulted from the initial adoption of Statement Nos. 87 and 106 would be eliminated by adjusting beginning-of-year retained earnings.
- The measurement date of defined benefit plan assets and obligations would be required to coincide with the company's fiscal year-end.

The primary effect of the ED is to recognize the funded status of defined benefit postretirement plans in the statement of financial position. As a result, actuarial gains and losses and prior service costs that have not yet been included in income would be recognized on the balance sheet. As a consequence, the necessity to report a minimum liability as well as a prepaid pension asset would be eliminated. Further, the proposed Statement would amend Statement Nos. 87, 88, 106, and 132(R) (FASB 1985a, 1985b, 1990, 2003) without substantially altering their measurement and disclosure guidance.

In brief, our general position on the ED is that it is a significant improvement over current reporting. Recognizing the funded status of the plans in the balance sheet will lead to financial statements that better reflect the underlying economics of the plans as of the date of the statement of financial position. Additionally, this will eliminate the need to provide reconciliations in the notes to the financial statements that many users may not see or understand.

Some users have expressed concern that such a significant project should be addressed in a comprehensive manner, rather than in phases. The decision to proceed in phases seems largely driven by the complexity of determining a subset of measurement issues, which otherwise ideally would be addressed comprehensively. The FASB has not yet detailed the full extent of phase two of this project. However, the basis for conclusions in SFAS No. 158 (FASB 2006) highlights several issues likely to be addressed in the second phase. The FASB intends to readdress all measurement issues, including:

- Recognition of components of postretirement benefits cost and presentation in earnings and comprehensive income, including interim period measurement issues and disclosures of sensitivity information;
- Measurement of postretirement benefit obligations and guidance regarding underlying assumptions, with separate consideration of not-for-profit entities;
- Recommendation as to whether plan sponsors of postretirement benefit trusts should consolidate the trusts' assets and liabilities.

The Board has indicated that their plan to readdress these issues does not necessarily guarantee that current practices will change. The scope of the second phase is expected to be determined in early 2007, factoring in other projects in process and continuing coordination with the International Accounting Standards Board (IASB).

The Committee recognizes that this ED is the first step in a comprehensive project aimed at providing more sufficient guidance for reporting an employer's financial condition and results of operations. The Committee commends the Board on its efforts and looks forward to the reexamination of the recognition and measurement provisions of Statement Nos. 87 and 106.

In the next section, we elaborate on several issues in the ED for which research provides relevant findings and discuss other issues that remain to be addressed. Then we provide a brief discussion of each of the specific issues raised in the ED. The final section concludes.

ACADEMIC RESEARCH RELEVANT TO ED ISSUES

Market-Related Value

One primary improvement in financial reporting from the ED is that the current funded status of the postretirement plan would be reported in the financial statements, rather than disclosed in the footnotes. The calculation of funded status rests on the difference between the benefit obligation and the fair value of plan assets. The ED does not change the measurement of plan assets, benefit obligations, or net periodic costs.

It is important to note, however, that paragraph 30 of SFAS No. 87 includes a provision that provides for a smoothing of market values in determining actuarial components of periodic pension cost. Expected return on plan assets is defined as the expected long-term rate of return on plan assets times the "market-related value" of plan assets. Market-related value can be either fair value or a smoothed value calculated in a manner determined by the reporting entity. As stated in paragraph 30, "The market-related value of plan assets shall be either fair value or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years."

In calculating gains or losses on plan assets, the use of market-related value results in a moving "error" in the quantification of plan asset fair value (i.e., fair value of plan assets minus the market-related value). This "error" escapes the financial statements under both SFAS No. 87 and the ED. Moreover, users of financial statements have limited ability to understand the magnitude of this discrepancy due to nonexistent disclosures related to market-related values, the reporting of which continues to be reinforced in the ED. Paragraph B49 of the ED states that the Board concluded that "disclosure of the market-related value of plan assets might not add sufficient benefits to justify the additional costs of compliance." This directly contrasts with the Board's stated beliefs that changes required by the ED would not result in significant costs because information required is already determined and previously available (e.g., see Benefits and Costs in the Summary of the ED and paragraph B80). Clearly, the discrepancy between actual fair value and market-related value will be most important exactly in situations of most interest to financial statement users (i.e., where plan assets are composed of assets with volatile prices).

The problem is that *no* disclosures regarding market-related values exist. Indeed, based on informal discussions with various investors, practitioners, and academics, we find it apparent that users of financial statements are largely unaware that the measurement of fair values in the computation of pension cost under SFAS No. 87 does not necessarily measure fair value per se. Presumably, this is due in part to the lack of disclosures regarding the specific calculation methods employed.

Because the ED does not change the measurement of the components of assets, liabilities, or costs, the use of market-related value in determining the expected return on plan assets will continue. Accordingly, objections raised by Arthur Wyatt in the original SFAS No. 87 are still applicable under the ED. We sympathize with these objections particularly because the embracing of fair values in financial statements is obfuscated to the extent that a significant component of net period pension cost (i.e., the expected return on plan assets) is based on a measure of fair value that may not necessarily be the fair value of plan assets on the measurement date.

Basing the expected return on plan assets on market-related values that might differ from actual fair values is a reasonable, albeit arbitrary, way of mitigating volatility of asset fair values, which follows from the overall spirit of the smoothing mechanisms underlying SFAS No. 87. However, whereas the ED shifts much of the volatility in calculated net periodic pension costs to "other comprehensive income," it appears inconsistent to retain a smoothing mechanism as part of the computation of expected return on plan assets. Even allowing for the reasonableness of the use of market-related values in the computation of expected return on plan assets, the complete lack of disclosure regarding this convention is unacceptable. At a minimum, firms should be required to affirm whether their calculations are based on fair values or market-related values. Additionally, specific assumptions regarding the time period averaging convention and the grouping of asset classes subject to market-related value would be helpful to investors wanting to fully understand pension costs.

Davis-Friday et al. (2006) attempt to back into market-related values from pension footnote disclosures as the result of the implementation of SFAS No. 132 (FASB 1998a). They compute market-related values based on the dollar value expected return divided by the percent expected return. Their results indicate that more than 75 percent of firm-years use market-related values that differ from fair values of plan assets. Moreover, the use of market-related values to calculate expected return on plan assets resulted in understatements of net income (via understatement of expected returns and hence overstatement of pension costs) that range from 4 to 10 percent of net income for firm-years in the upper quartile of differences between market-related values and fair values of plan assets. Based on these results, at least a minimum of disclosure regarding market-related values seems prudent.

This discussion will probably be even more relevant when the Board progresses with the second phase of this project (i.e., measurement), but we note it here because the ED includes specific language regarding market-related value. Further, because the ED addresses issues of presentation, it seems appropriate to highlight any easily adaptable presentation changes in this first phase of the project.

General Findings on Recognition versus Disclosure

Considerable research and practitioner literature indicates that users incorporate information provided in financial statement footnotes (e.g., Aboody 1996; Davis-Friday et al. 1999; Gordon and Joos 2004). Analysts and credit rating agencies are aware of off-balance-sheet items and maintain that they adjust for such items in their analyses (AAA FASC 2005). Studies examining the valuation implications of footnote disclosures about pensions and postretirement benefit obligations demonstrate the usefulness of such disclosures in the valuation of recognized amounts in the financial statements (e.g., Barth 1991; Choi et al. 1997). Similarly, academic research suggests that market values of equity appear to reflect market values of estimated liabilities generated using footnote disclosures of operating lease obligations (Ely 1995; Imhoff et al. 1993; Imhoff 1995).

It is important to note that some research examining the valuation implications of footnote disclosures implicitly assumes market efficiency, which means all publicly disclosed information is priced. However, numerous studies in the accounting and finance literature are consistent with market inefficiency with respect to both accounting and non-accounting information. Footnote disclosure may have the effect of creating or enhancing opportunities for subsets of users to identify and exploit market inefficiencies. For example, Fairfield and Whisenant (2001) report that analysts from the Center for Financial Research and Analysis successfully identify overvalued firms by interpreting the full set of disclosures provided in firms' SEC filings.

Hirst and Hopkins (1998) find that professional analysts are more likely to discover earnings management when earnings components are clearly reported in an income statement than when further analysis is required. Aboody (1996) shows that stock market participants react differently to asset write-downs that are recognized in the financial statements by oil and gas firms adopting the full cost method than to firms using the successful efforts method where footnote disclosure is sufficient. These findings can be interpreted as evidence that capital markets value disclosure and recognition differently. As such, some argue that disclosure does not adequately substitute for recognition and that the benefits of footnote disclosure are limited. Any recommendations for recognition as opposed to disclosure involve trade-offs between costs and benefits to various user groups, as well as the preparers.

Two studies examine the implications of recognition versus disclosure for market participants specifically in the context of other postretirement benefits. Davis-Friday et al. (1999) examine whether the market weights other postretirement benefit (PRB) obligations differently before and after formal recognition in the financial statements. The authors exploit the SFAS No. 106 transition period, during which firms provided estimates of their PRB obligations in the footnotes to their financial statements prior to recognizing the obligations in the balance sheet. The results support the contention that the market attaches less weight to disclosed PRB liabilities than to those subsequently recognized in the balance sheet.

Davis-Friday et al. (2004) investigate whether the market's perception of the measurement error contained in the obligations might drive the results in Choi et al. (1997) relating to differences between pension and postretirement benefit obligations, and those in Davis-Friday et al. (1999) relating to recognized versus disclosed PRB obligations. They provide evidence that the reliability (i.e., the more measurement error, the less reliable), and therefore the usefulness of postretirement benefit disclosures provided to comply with SAB No. 74 may have been enhanced if more supporting details had been disclosed. They argue that this may also be an issue in the case of other complex disclosures such as those associated with pensions.

In another recent study, Hirst et al. (2004) examine how disclosure versus recognition of fair value estimates affects equity analysts' risk and value judgments. Using an experimental research design, they compare a model where all fair value changes are included in net income with a model where some fair value changes flow through the income statement, and the rest are disclosed in footnotes. They find that equity analysts' risk and value judgments distinguish differences in interest rate risk only under full fair value measurement. If fair value accounting is appropriate, then Hirst et al. (2004) suggest that recognition is more likely to enable equity analysts to reach the appropriate risk and value judgments.

Ahmed et al. (2006) examine if investors' valuation of derivative financial instruments depends on whether the fair value of these instruments is recognized or disclosed. Using a sample of banks that simultaneously held recognized and disclosed derivatives prior to SFAS No. 133 (FASB 1998b), the study finds that recognized derivative fair values are value relevant (i.e., associated with stock prices), whereas the disclosed fair values are not. Additionally, Ahmed et al. (2006) find no evidence of value relevance for the fair value of derivatives in the pre-SFAS No. 133 period (when they were disclosed in footnotes), but find consistent evidence of an association between stock prices and derivative fair values for the same set of firms in the post-SFAS No. 133 period (when they were recognized in financial statements).

Finally, Libby et al. (2006) provide a potential explanation for the differential treatment of recognized and disclosed information by market participants. They examine whether information in footnotes lacks reliability because auditors permit more misstatement in disclosures than in recognized amounts. They find that in both stock-compensation and lease settings, audit partners require greater correction of misstatements in recognized amounts than in equivalent disclosed amounts. Their results suggest the actual choice to disclose versus recognize can also reduce information reliability.

Taken together, the above studies suggest that financial statement recognition and footnote disclosure are not substitutes. Overall, the ED's push toward reporting the underlying economic status of defined benefit pension and other postretirement benefit plans is consistent with conclusions in academic research on the saliency of recognized items compared with that of disclosed items.

Specific Findings on Valuation of Pension and Postretirement Benefit Disclosures

Davis-Friday et al. (2006, 10–12) provide a comprehensive review of the relevant literature regarding the market's valuation of pension and other postretirement benefit information. For example, research generally suggests that the market uses pension or postretirement benefit information in establishing equity prices (e.g., Landsman 1986; Barth 1991; Barth et al. 1992; Amir 1996). Some results suggest, however, that pension and postretirement benefits information is not fully valued. Landsman and Ohlson (1990) examine whether the market fully values net pension assets (liabilities) disclosed in notes under SFAS No. 36 (FASB 1980) from 1979 to 1982. The authors form a zero-net-investment portfolio based on the relative funding level after controlling for market-to-book and earnings-to-price ratios. They find that this investment strategy leads to abnormal returns over a five-year period, suggesting that the market underreacts to the pension information.

Barth et al. (1992) study SFAS No. 87 pension cost component disclosures from 1986 to 1988. They model firm market value as a function of income, disaggregated into non-pension and pension components. Their results suggest the market can separate value-relevant components of pension expense, such as actual return and interest cost, from other components, such as transition asset (liability) amortization. The results also show, however, that (1) the market values early-adopter pension components less than it values on-time adopters, (2) the service cost component coefficient does not have the appropriate relation with market values, and (3) the market does not consistently view the difference between the expected and actual returns as transitory.

Amir and Gordon (1996) conclude that equity values are consistent with the stock market's taking reported postretirement benefit liabilities at face value without adjusting for differences in assumptions. More recently, Coronado and Sharpe (2003) suggest that when the underlying economic status of the pension obligation is ambiguous, the market values components of pension expense instead of funded status. They attribute the problem to investors' inabilities to distinguish pension gains from core operating earnings, and suggest that because the Board requires companies to smooth changes in the value of pension plan assets into earnings over time, investors may value pension earnings in the same way as more persistent operating earnings (partially because it is difficult to disentangle the two). The authors suggest that naively valuing pension earnings, rather than taking into account pension net asset positions, could lead to nontrivial valuation errors.

Hand et al. (1997) examine whether funding status of pension and postretirement benefit plans is associated with market values. They find little evidence that differences in valuation multiples exist based on the funding status of plans. Evidence indicates, however, that valuation multiples vary across alternative measures of the benefit obligation.

Picconi (2006) examines whether analysts and investors fully incorporate the information contained in pension footnotes. He investigates the effect of changes in pension plan parameters on analysts' forecasts and future earnings and returns. His results indicate that analysts do not explicitly incorporate the information from pension plan parameter changes into their initial forecasts so that these changes predict future earnings surprises. He also finds that pension plan parameter changes predict returns in the year following the information release so that a hedge portfolio constructed based on these changes would earn significant abnormal returns. Additionally, he provides evidence that the stock market does not adjust for all firms' aggressive discount rate and rate of return assumptions.

Overall, prior studies provide mixed results regarding how investors value pension and postretirement benefit information. Some of the mixed results could be due to the form of the parameters of the estimation model or the form of the pension and postretirement benefit variables included in models across studies. For example, the pension variables in the Barth et al. (1992) study are highly correlated and may contribute to the "wrong sign" on service cost. In the Coronado and Sharpe (2003) study, funded status and pension earnings per share are highly correlated, and both variables are never significant in the same model (see Tables 3 and 5). Choi et al. (1997) and Davis-Friday et al. (1999) provide detailed discussions of problems with collinearity when combining pension and postretirement benefit information.

Evidence on Alternative Measures of Postretirement Obligations

In recognizing the funded status, the measurements of the obligations and plan assets are based on the existing requirements in Statement Nos. 87 and 106. Barth (1991) examines the relation between market values and measures of alternative measures of pension plan obligations and assets used in Statement No. 87, including the projected benefit obligation (PBO), accumulated benefit obligation (ABO), vested benefit obligation (VBO), and the fair value of plan assets. She finds that the fair value of plan assets and the ABO both exhibit less measurement error than other alternatives for the entire sample. Although the ABO exhibits less measurement error than the PBO overall, the PBO has less measurement error for subsamples in which salary rate increases include the expected inflation and productivity changes. This finding suggests that the PBO is an appropriate, although noisy, measure of the obligation as investors include expectations about future salary progression in assessing pension liabilities. Therefore, continued use of the existing measurements of the obligations under Statement Nos. 87 and 106 appears reasonable, pending the second phase of the project that will reexamine measurement issues.

This discussion will probably be even more relevant when the Board progresses with the second phase of this project (i.e., measurement), but we note it here because the ED includes specific language regarding the measurement of the pension and postretirement benefit obligations.

Other Comprehensive Income and Unrecognized Prior Service Costs and Unrecognized Actuarial Gains/Losses

Under the current proposal, any unrecognized prior service costs and unrecognized actuarial gains/losses will be included as part of equity in accumulated other comprehensive income. The approach to recognize these as components of net periodic benefit cost remains based on the existing amortization requirements in Statement Nos. 87 and 106. Any new amounts that are initially recognized in other comprehensive income for the period and those that are adjusted as they are recognized as components of net periodic benefit cost are required to be disclosed separately. The ED also requires footnote disclosures about accumulated amounts recognized in other comprehensive income.

Research indicates that market participants process information in comprehensive income in some contexts. For instance, Hodder et al. (2006) find that the volatility in comprehensive income relates more closely to capital market pricing risk indicators than net income volatility in a sample of banks. However, with the exception of financial firms, Dhaliwal et al. (1999) find no evidence that comprehensive income is more strongly associated with returns or market value or that it leads to improved prediction of future cash flows or earnings than earnings before comprehensive income components. Studies using experimental research designs consistently find that presentation format is a key determinant of the effectiveness of information processing (Hirst and Hopkins 1998; Maines and McDaniel 2000).

Both experimental and empirical studies provide evidence that companies will selectively manage items depending on where comprehensive income is reported (Lee et al. 2006; Hunton et al. 2006). While this literature speaks more directly to the presentation format, it suggests that concerns about earnings management using assumptions and estimates in pensions and other postretirement benefits will continue to exist even though changes in unrecognized prior service costs and unrecognized actuarial gains/losses will flow through comprehensive income.

The Committee supports the ED provisions to classify unrecognized prior service costs and unrecognized actuarial gains/losses as accumulated other comprehensive income, including showing the gross effect of changes in these accounts during a reporting period. Reporting the gross effect of changes will make more transparent the reasons for changes and reclassifications of amounts from comprehensive income to net income. As noted in previous commentaries by this Committee (e.g., AAA FASC 1997, 118), the only reason for reclassification adjustments between comprehensive income and net income is the commitment to current net income reporting. We encourage the Board to revisit the need for such reclassification adjustments in this and other areas within the context of a broader scope project on recognition and measurement of comprehensive net income, possibly in conjunction with the project on financial statement presentation.

SPECIFIC ISSUES LISTED IN THE ED

Issue 1: Do you agree that implementation of this proposed Statement would not require information (other than that related to income tax effects) that is not already available, and, therefore, the costs of implementation would not be significant?

The Committee believes that it is unlikely that the implementation of the ED would require any significant additional information not already available. As noted in our response to Issues 2 and 4 below, however, companies may incur significant additional costs in implementing the ED. In addition, empirical evidence on the economic consequences of accounting standards suggests that managers sometimes respond to mandatory accounting changes by changing their behavior (see e.g., Watts and Zimmerman [1986] for an overview).

For example, Amir (1993) found that prior to the discussions on SFAS No. 106 (1984–1986) firms underestimated the full effect of the postretirement benefit liability on firm value, even though the information to calculate the economic consequence was disclosed in the footnotes to financial statements. Another study attempted to measure the direct impact of the mandatory accounting change by investigating managements' reaction to the new rules. Mittelstaedt et al. (1995) document benefit reductions in employer-sponsored retiree health care plans following the approval of SFAS No. 106. These studies and others demonstrate that accounting rule changes have economic consequences.

Issues 2 and 4: Are any specific implementation issues associated with the requirement that plan assets and benefit obligations be measured as of the date of the employer's statement of financial position that differ significantly from the issues that apply to other assets and liabilities that are recognized as of the date of the statement of financial position?

Further, the ED includes a provision that companies that settle or curtail pension or postretirement obligations during the last quarter of the fiscal year ending after December 15, 2006, must recognize any associated gain or loss in that quarter (with periodic costs for that year being based on assumptions in place as of the beginning of that year). Are there impediments to implementation [by the proposed effective date] that would make implementation impracticable?

Because of the complex actuarial computations, the measurement of postretirement benefit obligations and assets may be more time-consuming than the measurement of other assets and liabilities. Therefore, fiscal year-end reporting may be substantially more difficult, as is the case for consolidating subsidiaries with fiscal year-ends different from that of the parent. Constraints might also exist with regard to the availability of actuarial resources. However, the benefits to investors of aligning the measurement of a significant liability with the measurement of other assets and liabilities are likely to justify any initial or ongoing additional efforts required to simultaneously measure benefit obligations and prepare periodic financial statements.

As we discussed in our response to Issue 1, adopting a new accounting standard has economic consequences. With regard to defined benefit pension plans, Mittelstaedt et al. (1995) document benefit reductions in employer-sponsored retiree health care plans following the approval of SFAS No. 106. More recently, Choudhary et al. (2006) find that several firms accelerated the vesting of employee stock options to avoid recognizing fair-value-based expense in future financial statements under SFAS No. 123(R) (FASB 2004).

Issue 3(a): The ED proposes that an entity would be exempt from retrospective application only if the entity determines that it is impracticable to assess the realizability of deferred tax assets that would be recognized in prior periods as a result of applying the proposed new standard. Should the Board provide an impracticability exemption related to the assessment of realizability of deferred tax assets?

The ED's provision for the exception of retrospective application is consistent with the impracticability provision in Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections—a Replacement of APB Opinion No. 20 and FASB Statement No. 3* (para. 11). SFAS No. 154 allows such an exception under certain circumstances when it would be impracticable for an entity to determine the period-specific effects of an accounting change on all prior periods presented (para. B11). Here, the ED limits this exception to the realizability of deferred tax assets. Conceivably, other difficulties may arise in estimating the retrospective application of this proposed standard including plan changes, on which the preparer community is in a better position to comment. Generally we believe that it is appropriate to allow the impracticability exemption for taxes and other areas where estimates or management's intent is difficult to assess retrospectively.

Issue 3(b): Some entities may have contracts other than debt contracts that reference metrics based on financial statement amounts that would be affected by the ED. The Board is interested in understanding what types of contracts might be affected, how those contracts treat pension and other postretirement obligations, and how minimum liability provisions, if at all, are treated in such contracts.

Watts and Zimmerman (1986) summarize contracting issues that are affected by financial reporting. The nondebt contracts that would perhaps be most affected by the ED are compensation contracts, since many compensation contracts define managers' bonuses based on earnings and/or book values that will be affected by the new reporting requirements in the ED. Generally, research indicates that when given the choice, managers will choose accounting methods that are more favorable to bonus plans (Aboody et al. 2000; Healy et al. 1987). Although the ED does not allow the choice of whether to recognize the net postretirement benefit obligations or to change the measurement of reported periodic benefit costs, it will significantly impact the financial statements of certain firms. Therefore, we expect that managers and compensation committees will be readily sensitive to such effects where compensation parameters include measures of book value, liabilities, or profitability.

Issue 5: The ED would apply to both public and not-for-profit organizations. Specific provisions in the ED speak to how not-for-profit organizations would implement the "other comprehensive income" effects required of public companies. Are these provisions appropriate?

Because there are no equivalents to retained earnings or accumulated other comprehensive income in the financial statements of a not-for-profit organization, the ED provides additional guidance by focusing on the reporting of not-for-profits. Under FASB Statement No. 117 (FASB 1993), not-for-profit organizations have considerable discretion in deciding how to display the results of operations in their statement of activities each year. See Fischer et al. (2003) for an examination of the variation in reporting choices of U.S. colleges and universities.

Essentially, the ED's provisions allow a not-for-profit organization to report the "other comprehensive income" effects within the context of its selected presentation method of its statement of activities. Given the variation in reporting and presentation of not-for-profits statement of activities, the provisions are appropriate. This issue, though, relates to two larger areas of concern. First, the lack of a definition of an operating measure and a defined structure for the statement of activity will require the FASB to continue to explicitly address not-for-profit accounting with specific provisions. Second, this reiterates the importance of a broader scope project on recognition and measurement of comprehensive net income mentioned above.

SUMMARY AND CONCLUSION

The Committee believes that the changes to pension accounting proposed in the ED will improve the accounting for pension and other postretirement obligations. Based on prior research, we expect that investors will find the balance sheet presentation of the funded status of these obligations to be more useful than the pension-related reconciliations currently found in the footnotes. Moreover, with the mandate that the measurement date of these obligations coincides with the balance sheet date, investors will have a clearer picture of a firm's financial position at fiscal year-end.

Nonetheless, we emphasize two key issues for the FASB to address, perhaps in conjunction with measurement issues to be considered in the second phase of the project. First, the prospect of reporting certain components of periodic pension cost as part of other comprehensive income will potentially add more complexity to a growing part of the financial statements, which prior research suggests is receiving only limited attention or understanding by users of financial statements (e.g., Dhaliwal et al. 1999). Second, because the ED does not change the measurement of the components of assets, liabilities, or costs, the use of market-related value in determining the expected return on plan assets will continue. While the reasonableness of the use of market-related values in the computation of expected return on plan assets remains an empirical question, the lack of disclosure regarding this convention is unacceptable. At a minimum, firms should be required to affirm whether their calculations are based on fair values or market-related values.

Finally, to ensure consistent and comparable reporting, the FASB should provide additional implementation guidance. Without clear and sufficient current guidance and updates to prior implementation guidance, practitioners and academics must potentially expend nontrivial resources interpreting the new statement and updating old illustrations.[1] Additionally, the possibility for numerous differing interpretations could result in inconsistent reporting. Given these concerns, the FASB ultimately will need to rewrite SFAS Nos. 87 and 106 to make them consistent with subsequent pronouncements.

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[1] For instance, from ED (para. C5), it is unclear which examples from SFAS No. 87 will be retained, deleted, or modified. In some examples provided in the ED, detailed explanation is lacking or ambiguous. To illustrate, the actuarial gain/loss in Example 1 of Appendix A-Implementation Guidance is the same for both 2005 and 2006, making it look more like amortization instead of new losses. In other areas such as transitioning a firm with a minimum liability or accounting by not-for-profit entities, no guidance is included. The authors thank Fred Mittelstaedt for sharing his evaluation of the ED, which includes a discussion regarding the lack of implementation guidance.

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