



Financial Reporting

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Accounting Year In Review: 2006

BDO Seidman, LLP prepared this *Financial Reporting* letter to help clients anticipate and respond to questions that may arise in connection with financial statements for 2006 and 2007.

Underfunded pension plans, a frenzy of deal-making, soaring stock prices, and a breathtaking boom in private equity – those were the top business stories of the year in 2006. Many of these same trends also affect the application of new accounting standards and add to the challenges of financial reporting. The key challenges for this year include:

- Moving the funded status of retirement plans out of the footnotes and onto the face of the financial statements.
- Adopting “how-to” guidance for measuring the fair values of assets and liabilities, including goodwill acquired in business combinations.
- Coping with the complexities of accounting for private investments in public equity transactions (PIPEs) and other transactions involving convertible securities and equity derivatives.

But the biggest change confronting companies – and the one for which many appear least prepared – is the adoption of a new accounting interpretation designed to reduce earnings management by making tax contingencies (sometimes loosely referred to as “tax cushion”) more transparent. The risks to avoid and potential consequences of all these changes are discussed in this *Financial Reporting* letter. We hope you find the summaries useful in preparing your 2006 financial statements and in the months to come.

Accounting for Uncertain Tax Positions

Because of its effects on balance sheets, controls, and risk management, FASB Interpretation No. 48 will demand lots of attention from management and audit committees.

FASB Interpretation No. 48 on *Accounting for Uncertainty in Income Taxes* is likely the accounting change for which many companies are least prepared this year. The interpretation was released in July 2006. By January 2007, the FASB had received hundreds of requests from companies and trade associations for a deferral of the effective date. Many requests for deferral were based on a self-assessed lack of readiness combined with an awareness of the Interpretation's potentially significant effects on both financial reporting statements and processes.

OVERVIEW

To help companies come to grips with this complex and controversial new standard, this letter provides answers to questions about the accounting changes and the steps needed to implement them, along with the risks and possible consequences facing companies in the months to come.

What is a tax position?

The issuance of Interpretation 48 adds the everyday term *tax position* to the technical accounting dictionary. It is defined as any position taken (or not taken) in a tax return (either previously filed or future) that affects the accounting for income tax assets and liabilities (either current or deferred). Here are some examples:

- Decisions to take deductions and claim tax credits.
- Decisions to treat income or entities as not taxable, including a decision to exclude reporting taxable income in a tax return or a decision not to file a tax return.

- Allocations or shifts of income between jurisdictions, (e.g., through royalties or licensing agreements with related parties).

Importantly, the tax positions governed by Interpretation 48 apply only to income taxes. The Interpretation does not apply to uncertainty in other types of taxes, such as sales taxes, gross receipts taxes, and property taxes. Uncertainties regarding other types of taxes continue to be guided by FASB Statement No. 5, *Accounting for Contingencies*.

What causes uncertainty in income taxes?

Contrary to the proverbial wisdom that “nothing is certain but death and taxes,” companies can experience considerable uncertainty in income tax positions. The reason is because the body of statutory, regulatory and interpretive guidance on income taxes is voluminous, complex, sometimes ambiguous or internally inconsistent, and constantly changing. As a result, there may be times when the company is not sure that a position taken in good faith will ultimately be sustained upon audit by the taxing authority. In those cases, the position is considered an uncertain tax position, and companies must apply the new model of accounting.

How has the accounting model changed?

Interpretation 48 introduces a new way of thinking about uncertain tax positions. Below is a comparison with past practice.

- *Past practice.* In the past, uncertain tax positions were treated as loss contingencies under Statement 5. Companies recorded accruals (sometimes loosely referred to as “tax cushion”) for tax positions that they thought they would probably lose upon challenge by the taxing authorities. As one FASB member summed up, Interpretation 48 is a new approach to solving the age-old questions of, “When do I set up a tax cushion,” “How much should that cushion be,” and “Do I have to tell anybody I have a tax cushion?”
- *Interpretation 48.* Interpretation 48 rephrases the questions to address the tax benefits associated with an uncertain tax position. The questions become, “When should I recognize a tax benefit,” “How much should I recognize,” and “Do I have to disclose my unrecognized tax benefits?”

As you might expect, Interpretation 48 changes the answers as well as the questions, making significant changes in the requirements for recognition, measurement, and disclosures.

How have the accounting requirements changed?

Interpretation 48 is a principles-based standard. This means judgment is required in applying the standard. Highlights of the changes in requirements, along with the types of judgment required in each of the three areas, are as follows:

1. *Recognition.* Interpretation 48 takes a more disciplined approach to the question of when to recognize an uncertain tax position. Prior to Interpretation 48, the test for setting up a tax accrual typically rested on an evaluation of how much a company would lose upon challenge by a taxing authority. Interpretation 48 refocuses the evaluation by shifting the probability threshold from “probable

loss” to “more likely than not to prevail.” The new approach requires that companies use their judgment to organize tax positions into meaningful components or “units of account” and to identify whether material tax positions are more likely than not of being sustained. If the more-likely-than-not test is met, the tax benefit is recognized.

2. *Measurement.* Interpretation 48 introduces a more complex approach to measurement. This approach requires judgment to assess the possible outcomes and their respective probabilities. For example, if a company identifies a tax credit for research and experimentation as an uncertain tax position that is more likely than not of being sustained by a taxing authority having full knowledge of all relevant information, the next step is for the company to assess the probabilities that the entire amount of the credit will be sustained, or 80% of it, or 50% of it, or some other percentage.
3. *Disclosure.* Interpretation 48 expands the disclosure requirements and calls for judgment in assessing the likelihood and timing of future events. For example, companies are required to discuss reasonably possible changes that might occur in the recognized tax benefits over the coming year. Other disclosure requirements include a description of open tax years by major jurisdiction, a roll-forward of all unrecognized tax benefits (in effect a reconciliation of the beginning and ending balances of the unrecognized tax benefits), the total amount of interest and penalties recognized in the balance sheet and income statement, and the accounting policy for the classification of interest and penalties, (i.e., in the provision for income taxes or as interest and other expense, respectively).

All these requirements are effective starting in 2007.

What factors determine that a position is more-likely-than-not?

The determination of more likely than not is based on technical merits. Key factors to consider:

- A tax position is more likely than not of being sustained on its technical merits, if it has more than a 50% likelihood of being upheld when challenged and considered by the highest court in the relevant jurisdiction.
- The more-likely-than-not threshold is less ambiguous than the “probable” threshold used for loss contingencies. While the FASB says that “probable” is a different (higher) threshold than more-likely-than-not, it has never defined probable in percentages, and practice varies.
- To evaluate technical merits, companies consider relevant tax law, case law, and regulations, as well as external tax opinions. Administrative practices and precedent may also be considered in cases where a position might be considered a technical violation of the tax law, but the tax authority has demonstrated through its administrative practices that it will accept the position.

Importantly, the determination of more likely than not should *not* take into account the probability of a settlement with the taxing authority as a result of negotiations. If a tax position meets the more likely than not threshold on its merits, then the probability of a settlement would be factored into the measurement of the benefit.

What factors determine the unit of account?

There are two key factors for determining the unit of account: (1) the manner in which the company prepares and supports its tax return, and (2) the anticipated level at which the tax authority will address issues during an examination.

In applying these factors, companies should consider their past experience with the tax authorities and the materiality of the tax position within the context of the overall tax reported on the return and compared with other companies in the same industry or with similar business operations. Once determined, the unit of account should be applied consistently from year to year.

The determination of more likely than not is based on technical merits.

How are tax benefits measured for a range of outcomes?

Under Interpretation 48, tax positions are measured individually, rather than in the aggregate. Some have only two possible outcomes, (e.g., either 100% tax-deductible or not deductible at all). Others may have a range of reasonable outcomes.

For uncertain tax positions that meet the more-likely-than-not recognition hurdle and have a range of reasonable outcomes, Interpretation 48 prescribes the use of cumulative probabilities to determine the largest amount that has a greater than 50% probability of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information.

This approach is shown in Exhibit 1. In this example, the company would recognize a tax benefit of \$60 because

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that represents the largest amount of benefit that is more than 50% likely to reflect the ultimate outcome.

In some situations, there might be an almost infinite number of possible outcomes, (e.g., when measuring tax benefits associated with transfer pricing). These situations can require considerable judgment and should be discussed with the external auditors.

How are interest and penalties handled?

Interest and penalties on uncertain tax positions are accrued as follows:

- *Interest.* Interest is accrued on liabilities for tax positions that are not recognized because they do not meet the more-likely-than-not recognition threshold or the measurement guidance.
- *Penalties.* Penalties are accrued on all tax positions that do not meet the statutory threshold to avoid penalties.

The Interpretation gives public companies an unusual opportunity to change their accounting policies on the classification of interest and penalties upon adoption without the classification being considered an accounting change that triggers a need to demonstrate the preferability of the new policy.

What are the requirements for subsequent years?

The Interpretation requires monitoring of tax positions and ongoing evaluations to determine the proper recording of changes in judgments about uncertain tax positions. Subsequent changes may occur only if the changes are based on new information. Specifically:

- *Tax positions that subsequently pass the recognition threshold.* Some tax positions that failed initially to meet the recognition threshold may subsequently pass the more-likely-than-not test. This can happen when an issue is resolved through negotiation or litigation or when the statute of limitations expires. In these cases, the tax benefits should be recognized in the first subsequent financial reporting period in which the test is met.
- *Tax positions that no longer meet the recognition threshold.* A previously recognized tax position may no longer meet the more-likely-than-not recognition threshold. If this happens, the tax benefit should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

- *Tax positions that continue to meet the recognition threshold.* If a previously recognized tax position continues to meet the recognition threshold, the company should reevaluate the recorded amount and adjust it as necessary to reflect new information available as of the reporting date about the amounts likely to be accepted by the tax authorities.

What documentation is needed?

Some general guidelines regarding documentation:

- Each step in the accounting process needs to be documented.
- This includes the identification of all uncertain tax positions, assessments of whether the recognition threshold is met, decisions related to units of account, probabilities of expected outcomes, measurements of the benefits, calculations of interest and penalties, and certain classifications and disclosures, such as whether the Interpretation 48 liability is current or noncurrent and whether expected settlements need to be disclosed.
- At a minimum, companies should document their conclusions, the information and factors considered, and the relative weights assigned to the various factors.

Good controls over documentation are critical. If these controls are not already in place at the time of adopting Interpretation 48, they can be established as phase III of a systematic implementation plan as illustrated in Exhibit 2.

Must all tax positions be documented?

No. Most tax positions have clear support in the tax law or regulations. Interpretation 48 deals only with uncertain tax positions.

**Exhibit 1. FASB Interpretation No. 48
Illustrative Measurement of Uncertain Tax Benefit**

Possible Outcome		Probability	Cumulative
Description	Amount	Percent	Percent
Complete acceptance	\$ 100	10%	10%
Very favorable compromise	\$ 80	20%	30%
Fair compromise	\$ 60	25%	55%
Unfavorable compromise	\$ 40	30%	85%
Total rejection	\$ 0	15%	100%

RISKS TO AVOID

Interpretation 48 is a short standard. It weighs in at a mere 58 pages as published by the FASB. Yet it can present significant challenges. Here are eight key risks to avoid.

1. Lack of preparedness

Interpretation 48 had a relatively brief incubation period. It took effect only

months after its issuance date. Although it is effective for fiscal years beginning after December 15, 2006, it must be applied to all outstanding tax positions as of the beginning of the year of adoption, (i.e., January 1, 2007 for calendar year companies).

As many companies have already learned, the computation of the required cumulative effect adjustment as of the beginning of the period of adop-

tion can take a considerable amount of effort. And that is just the start. Because of the need for continual monitoring, Interpretation 48 will continue to demand attention from management and directors throughout 2007.

To avoid unpleasant surprises, companies should approach this standard with an orderly and systematic implementation plan similar to the one illustrated in Exhibit 2.

**Exhibit 2. FASB Interpretation No. 48
Illustrative Company Implementation Plan**

Phase I	Phase II	Phase III
<p>Identify and investigate positions.</p> <ol style="list-style-type: none"> Gain an understanding of the requirements and timeline for adopting Interpretation 48. Develop an implementation plan. Begin SAB 74 disclosures. Identify uncertain tax positions, list all material potentially uncertain tax positions, and inventory the existing documentation. <ul style="list-style-type: none"> <i>Lay out the pieces.</i> Identify relevant tax transactions, jurisdictions, and open years. Include all evidence that would help assess the potential for exposure. Set a threshold for materiality. Put together a team with in-house expertise as well as outside consultants, if needed. <i>Do a "top down" investigation.</i> Analyze federal and state income tax provisions and accruals. Review audit activity. Probe exposures in complex areas, (e.g., transfer pricing or R&D tax credits). <i>Add a "bottoms-up" analysis.</i> Search for latent issues by reviewing legal entities, transaction-level details, source documents, contracts and agreements, such as intercompany pricing with related parties. 	<p>Analyze, document and report.</p> <ol style="list-style-type: none"> Cull through the phase I findings. Explore any potential gaps in documentation. Analyze and document potentially significant uncertain tax positions. <ul style="list-style-type: none"> <i>Prioritize the significant issues.</i> Assess the potential effects of any gaps on the company's financial reporting. <i>Reach agreement with auditors.</i> Discuss the level of tax analysis to be performed and the nature of the documentation requested. <i>Assess the likelihood that the position would be sustained.</i> Determine the unit of account for each tax position. Do "more-likely-than-not" assessment. <i>Measure the tax benefits.</i> Determine the proper measurement for recognized tax benefits. Prepare appropriate documentation. Reflect results in financial reports. Prepare cumulative effect adjustment. Identify reasonably possible changes in next 12 months. Prepare tabular roll-forward. Calculate and record interest and penalties. Prepare MD&A. Monitor subsequent events for possible changes in judgment. 	<p>Build or strengthen controls.</p> <p>Possible areas of weakness:</p> <ol style="list-style-type: none"> Does the company have controls over the authorization of aggressive tax strategies and the taking of uncertain tax positions? Does the company's audit committee review the analysis of uncertain tax positions and the key judgments and estimates involved in reporting of these positions? Does the company have controls in place to ensure the identification of material uncertain tax positions? Does the company have controls in place to ensure the appropriate determination of the unit of account for each tax position? Do the company's documentation procedures show evidence that all relevant tax laws and precedents are being considered? Does the company have procedures in place to monitor new developments in tax laws, regulations, court decisions, etc.? Does the company have controls in place to ensure full disclosure of interest and penalties, expected changes, and unrecognized tax benefits that, if recognized, would affect the effective tax rate?

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2. Insufficient investigations and analysis

The first step in the plan is generally a thorough search for uncertain tax positions. This will involve a “top-down” review of past tax returns and supporting documents, an analysis of disclosures made on tax returns, such as Schedule M-3’s reconciliation of book and tax income, and a review of the results from past tax audits.

It will also typically include looking through tax opinions and other reviews by outside experts, and reviewing the

company’s schedule of tax contingencies that was prepared in prior years in accordance with FASB Statement No. 5.

For best results, companies should add a “bottom-up” review of the company’s legal structure, accounting policies, outstanding SEC comment letters, general ledger, and source documents for transactions.

The findings of all these steps should be discussed with the company’s independent accountants and other external advisors as appropriate.

3. Misperceptions about auditor independence

Some companies may find it difficult to recruit and retain managers with sufficient expertise to handle all phases of Interpretation 48. Companies that lack sufficient in-house expertise will naturally look to their external auditors or other outside advisors for assistance. In so doing, some may be confused by the post-SOX constraints on the provision of tax services by auditors. This can be a complex area, and some of the changes are relatively recent.

Exhibit 3. FASB Interpretation No. 48 Independent Auditor’s Services

Phase	Public Companies	Nonpublic Companies
Phase I: Identify and investigate positions.	<p>The auditor may:</p> <ul style="list-style-type: none"> – Review and provide a reaction to the company’s implementation plan and list of uncertain tax positions. <p>However, the auditor may not draft the implementation plan or perform the identification of uncertain tax positions for the company.</p>	<p>The auditor may:</p> <ul style="list-style-type: none"> – Draft the implementation plan for review by management. – Compile a list of potential uncertain tax positions for review by management to help the company make determinations and decisions about uncertain tax positions.
Phase II: Analyze, document and report.	<p>The auditor may:</p> <ul style="list-style-type: none"> – Provide a reaction to drafts prepared by the company. – Provide technical advice, such as tax opinions on matters that are not precluded by PCAOB rules pertaining to “confidential” or “aggressive” tax positions. <p>However, the auditor may not prepare disclosures or assist in the measurement of tax positions or the cumulative effect adjustment.</p>	<p>The auditor may:</p> <ul style="list-style-type: none"> – Assist in the measurement of tax positions. – Assist in the calculation of the cumulative effect adjustment. – Provide technical advice, such as tax opinions. – Draft disclosures for review by management.
Phase III: Build or strengthen controls.	<p>The auditor may provide reactions, comments and suggestions on proposed controls or modifications. However, the auditor may not design or implement controls for the company.</p>	<p>The auditor may recommend controls and provide examples of best practices for review and implementation by management.</p>

Conditions for compliance

- Audit committees of public companies must pre-approve tax services.
- Conditions for providing tax advice are established in PCAOB rules and IRS Circular 230.
- Tax services to nonpublic companies may be provided if conditions set forth in the AICPA’s ethics rules are met. The client must make all management decisions and perform all management functions. The client must also accept responsibility for the results of the services, designate an appropriate individual to oversee the services, and establish and maintain internal controls, including monitoring activities. BDO clients should ask their engagement partner for more details.

The keys to avoiding troublesome situations are for audit committees of public companies and those charged with governance in nonpublic companies to understand which services are covered by the audit engagement letter, which services are permitted by professional standards, and what precautions the company needs to put in place to ensure compliance with the standards.

For example, technical tax advice is typically not covered in the audit engagement letter. This might include research on tax regulations and court rulings, reviews of open years, transfer pricing studies, nexus studies, or tax opinions for specific tax positions. In public companies, these services must be pre-approved by audit committees.

The permitted services and conditions for compliance with independence standards differ for public and nonpublic companies. The differences are summarized in Exhibit 3.

4. Weak internal controls

Because Interpretation 48 introduces a new model of accounting for uncertain tax positions, many companies will need to modify or strengthen their internal controls over financial reporting.

The risks associated with weak internal controls affect public and private companies in different ways. Companies subject to management reporting on internal controls under Section 404 of the Sarbanes-Oxley Act will want to build and strengthen controls to avoid reporting control deficiencies. Nonpublic companies will want to establish controls to help ensure effective and efficient audits.

5. Inadequate documentation

When considering recognition of specific tax positions, the amount of documentation considered adequate will vary with the position's material-

ity and complexity. As a general rule, adequate documentation should provide evidence that all relevant tax laws and precedents have been considered. Possible sources range from statutes, rulings, and tax treaties to court cases and legislative intent.

Interpretation 48 does not require third-party tax opinions. However, if the documentation consists of a third-party tax opinion, companies should be aware that dated tax opinions may need to be updated.

Controls over documentation are especially important and should be considered as early as possible. A few helpful techniques:

- Companies should ensure that good documentation practices are a part of the company's normal decision-making process. It helps facilitate timely issuance of financial reports, when companies make their more-likely-than-not assessments and compile their documentation at the time the decision is made to take a tax position.
- One way to incorporate good controls into the documentation process is to build in a step that calls for identification of factors that might be susceptible to change and should therefore be monitored closely in subsequent periods.

6. SAB 74 omissions

Public companies are required to make the disclosures specified in Staff Accounting Bulletin (SAB 74), Topic 11-M. This SAB requires:

- A brief description of Interpretation 48, the date that adoption is required, and the date that the registrant plans to adopt, if earlier.

- A disclosure that Interpretation 48 will be adopted by adjusting tax accounts and retained earnings at the date of adoption.
- A discussion of the impact that adoption of Interpretation 48 is expected to have on the financial statements, unless not known or reasonably estimable.

Because calendar year companies will have adopted the Interpretation as of January 1, 2007, the disclosures in their annual reports are expected to be robust and may include a monetary amount or a range of monetary amounts. Companies should be aware that the FASB intends to issue additional guidance on Interpretation 48. This guidance may not be available until March, and its impact or status may need to be reflected in the SAB 74 disclosure.

7. Misclassification on the balance sheet

The liability for uncertain tax positions and related interest and penalties must be classified separately from deferred tax liabilities, and its classification as short-term or long-term is based on the expected timing of the related cash payments to the taxing authorities. The short-term portion of the liability is the amount for which the company expects to make a payment in the next twelve months. The remainder is long-term.

8. Implementation issues

The FASB is expected to provide implementation guidance for the phrase "the tax matter is ultimately settled through negotiation or litigation" in paragraph 10(b) of Interpretation 48. This phrase has caused confusion when applied to closing agreements of federal and state tax audits, where a matter may be negotiated and presumably settled, but the statute of limitations has not expired.

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In addition, companies typically encounter a host of practical questions when implementing Interpretation 48. Examples of the kinds of questions that can arise:

- Should all companies do both a top-down and bottoms-up analysis of their tax positions?
- Is a transfer pricing study required for companies with international operations?
- What level of documentation is suggested for a company with substantial foreign operations?
- What documentation do auditors expect to see for loss companies that have a full valuation allowance?
- How does a company's settlement strategy affect the measurement of its tax position and unit of account?

9. Not anticipating user reactions.

Many companies have expressed anxiety over the possibility that the Interpretation 48 documentation and disclosure requirements may create a roadmap for the taxing authorities.

Equally important, companies should give some thought to the reactions of other users of the company's financial statements. A well thought out corporate communications program could pay extra dividends this year.

Banks, private equity firms, potential acquirers of the business, investment bankers, shareholders and other investors, and even the general public may have more questions than usual about a company's tax and risk management policies. Companies will want to be prepared with the answers.

POTENTIAL CONSEQUENCES

In addition to wanting to understand the effects of Interpretation 48 on a company's financial statements, the questions on the minds of many will relate to the potential consequences of the new accounting standard on the company's risk management policies and cash tax payments. Here are some examples that may trigger questions and further analysis.

Greater volatility in earnings

Interpretation 48 reduces management's flexibility in managing tax liabilities, and it can result in greater earnings volatility. The increased volatility is caused by the accounting treatment for changes in estimates and judgments about previously filed tax positions. The amounts associated with these changes are treated as discrete adjustments in the period of change if they pertain to a prior year tax position and as adjustments to the estimated annual effective tax rate if they pertain to a current year tax position.

For example, when a tax benefit is no longer considered more likely than not of being sustained, the write-off is taken entirely in the period of the change in judgment. This can have a significant effect on earnings that will need to be carefully explained to the users of the company's financial statements.

Reduced negotiating power with taxing authorities

Some companies have expressed concerns about Interpretation 48's disclosures, saying these disclosures may reduce the company's negotiating power with the tax authorities and result in larger cash outlays for income taxes. For example, this could happen when a company discloses the amount of a significant accrual that is released in anticipation of an expected settlement within the coming year.

As a result, users of financial statements may ask about management's assessment of the risks and how the company is managing them.

Bigger differences between accruals and cash tax payments

Regardless of whether Interpretation 48 creates a roadmap for the taxing authorities, it seems clear that adoption of the Interpretation will cause many companies to report liabilities that are higher than in the past, at least initially. (Other companies will have no immediate effect on their recorded liabilities, and some may even have a decrease).

Where increases in corporate tax liabilities are experienced, the company may also experience bigger differences between its liability and its actual cash tax payments. Users of financial statements may ask about these differences or request an estimate of anticipated cash tax payments.

Changes to risk management

As Interpretation 48 takes hold, companies will need to reevaluate the types of uncertain tax positions that they are willing to take in view of the increased disclosures required by the Interpretation. Some may also reevaluate their use of programs for accelerated dispute resolution. Decisions in these areas form the cornerstones of a company's risk management strategy for taxes.

Users of financial statements will be looking for any indication of a shift toward a more conservative or aggressive risk management strategy. Because of the stakes involved, audit committees and boards of directors may wish to be more involved in managing the risks and determining how aggressive or conservative the company's tax strategy should be. This is becoming a high priority matter for directors, as Interpretation 48 shines a spotlight on the fact that income taxes are both one of a company's greatest costs and one of its greatest risks.

Accounting for Retirement Plans

Pension plan deficits are in the spotlight as FASB Statement 158 moves the funded status out of the footnotes, resulting in lower shareholders' equity for some companies.

Underfunding of retirement plans has been very much in the public spotlight during the past few years. Rising stock prices and interest rates in 2006 have helped to improve the funded status of these plans, and companies will need to report that status on their balance sheets under FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*. Public calendar-year companies must comply with the requirement for this year-end. Private companies and not-for-profit organizations will soon need to comply as well.

OVERVIEW

Statement 158 is an attempt to reflect the economic value of promises made in connection with retirement plans on the balance sheet. When companies adopt this standard, they are likely to experience lower shareholders' equity (or net assets for not-for-profits)

The funded status is one of the most important pieces of information about retirement plans. It represents the difference between the fair value of a plan's assets and its benefit obligation. But prior accounting standards have relegated this measure to the footnotes, reflecting a different amount on the balance sheet.

Under the preceding balance sheet guidance in FASB Statements (No. 87 for defined benefit plans and 106 for other postretirement benefit plans), the prepaid asset or accrued liability on the balance sheet represents the cumulative difference between the expense under generally accepted accounting principles and the cash disbursements for funding a plan or paying benefits.

Because of the way expense is computed under Statements 87 and 106, the difference between the funded status and the amount on the balance sheet is made up of three items that may seem difficult to understand and less important than the funded status. The three items are:

- Unrecognized (deferred) gains and losses from experience different from assumptions and from changes in assumptions.
- Unrecognized prior service cost from plan amendments that give participants retroactive credit for prior years of employee service.
- Unrecognized transition amounts from the adoption of Statement 87 or 106.

Statement 158 requires that these three items be shown instead on the balance sheet as adjustments to shareholders' equity. A summary of the other key provisions and requirements of Statement 158 is provided in Exhibit 4.

The effects of Statement 158 will vary by industry. Companies in all industries have taken actions to shore up retirement plan deficits, such as making larger contributions in the past few years, cutting back benefits and/or switching to plans with more predictable costs, making analysis difficult. Still, the hardest hit industries will likely include heavily unionized industries, such as automotive, steel, telecommunications, aerospace, defense, and airlines. Other companies may be less affected, but they still must be prepared to timely adopt this complex Statement.

RISKS TO AVOID

1. Unexpected reductions in equity or working capital

A key lesson learned from the experiences of the companies that have already adopted the Statement is that early review of the provisions can help avoid unpleasant surprises, including adverse effects on key ratios such as debt-to-equity and return on equity.

Statement 158 is an attempt to reflect the true economic value of promises made to retirees.

The two steps that can reduce equity or working capital are as follows:

- *Recognition of funded status.* The adjustment made to recognize the funded status may be significant, causing key ratios to fall out of line with targets and expectations. Companies with severely underfunded plans can experience negative shareholders' equity. Even companies with fully funded plans or overfunded plans may experience reductions in shareholders' equity because they may need to reduce their balance sheet asset with an offsetting reduction to shareholders' equity.
- *Classification of balance sheets.* The step of breaking down the balance sheet into current and non-current portions can have unexpected effects on a company's working capital. This can occur because all benefit plan net assets are classified as non-current while some portion of a net benefit liability may be classified as current.

**Exhibit 4. FASB Statement No. 158
Key Provisions, Calculations and Disclosure Requirements**

Recognition of funded status	Classification of balance sheets	Additional requirements
<p>Recognition of funded status</p> <p>Statement 158 requires that companies with single-employer defined benefit pension plans or other postretirement benefit plans recognize the funded status of their plans as a net asset or net liability.</p> <ul style="list-style-type: none"> √ The net asset or liability is calculated as the difference between the fair value of the plan's assets and the benefit obligation. √ For pension plans, the benefit obligation used in the calculations is the projected benefit obligation (PBO). This measure includes an allowance for future salary growth in plans where benefits are based on salaries. √ For other postretirement benefit plans, the obligation is the accumulated postretirement benefit obligation (APBO). This measure includes an allowance for future medical cost inflation. <p>Calculated on a plan-by-plan basis</p> <p>Companies with multiple defined benefit pension plans or other postretirement benefit plans will need to calculate their net assets or liabilities on a plan-by-plan basis.</p> <ul style="list-style-type: none"> √ A company cannot offset one plan's net benefit assets against another plan's net benefit liabilities. √ Instead, a single net asset is reported for the aggregate of all overfunded plans, and a single net liability is recorded for the aggregate of all unfunded or underfunded plans. 	<p>Classified balance sheets</p> <p>Companies that present classified balance sheets (current and non-current assets and liabilities) will classify all benefit plan net assets as non-current, but some portion of the benefit plan net liability may be classified as current. To determine the current portion, companies will need to consider their expected benefit payments over the coming year.</p> <ul style="list-style-type: none"> √ For an overfunded plan, the net asset is non-current. A refund anticipated from the plan in the coming year would be disclosed but not classified as a current asset. √ For an unfunded plan, the portion of the liability that represents expected benefit payments over the coming year is classified as a current liability. √ For an underfunded plan, the liability is non-current, unless the company's expected benefit payments over the coming year exceed the plan assets. In that unusual case, the excess is a current liability. <p>Other changes</p> <ul style="list-style-type: none"> √ Companies will need to adjust their deferred income taxes for the effects of the changes required by the Statement. This adjustment can be fraught with complexity. √ There is little or no change in the income statement. 	<p>Added disclosure requirements</p> <p>The transition provisions do not allow retrospective application of the balance sheet requirements. Instead, Statement 158 requires additional disclosures that address the effects on the balance sheet in the year of adoption and provide other supplemental information.</p> <ul style="list-style-type: none"> √ For each period an income statement is presented, companies disclose in their annual financial statements, separately for pension and other postretirement plans, the changes in other comprehensive income (OCI) that resulted from application of the Statement. √ For each period a balance sheet is presented, companies disclose in their annual financial statements the changes in accumulated OCI (AOCI) that resulted from application of the Statement. √ For the most recent balance sheet, companies disclose the amounts in AOCI that will be recognized as a component of benefit expense in the next fiscal year (that is, the amount that will be amortized in the next fiscal year). √ In the unusual case that a company expects to withdraw assets from a retirement benefit plan in the coming year, it should disclose the amount. <p>Additional requirements</p> <ul style="list-style-type: none"> √ Starting no later than 2008 for calendar year companies, the balance sheet date must be used as the measurement date for plan assets and obligations.

