EMPLOYER'S ACCOUNTING FOR PENSIONS

An Honors Thesis (ID 499)

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This paper will deal with the issue of accounting for pensions by employers. After beginning with an introduction and update of pensions, the paper will concentrate on the FASB's proposed new policies for the accounting of pensions by employers and will then outline the good and not so good points of these proposals. The paper will also outline other views on the subject and indicate the possible effects of these proposals.

A pension can be defined as periodic payments to an individual who retires because of age, disability, or completion of a time span previously agreed upon by the involved parties. The provision of pensions by non-government employers for aged or disabled employees originated in Europe in the nineteenth century. They are now nearly universally viewed as an integral part of compensation for employees. Employers who participate in setting up pension plans are seen as socially responsible individuals.

A pension plan is usually a written document stating the rules of eligibility, conditions for the receipt of the pension, a formula for determining the pension amount, the source of funds, and regulations covering benefits due in view of death, termination, or other possibilities.

In recent times, there has been a move towards requiring formalization and guaranteeing of pensions. Correspondingly, there has been a trend towards the funding of pension obli-

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1 FASB: Financial Accounting Standards Board
gations as the pensions are earned as opposed to the original method of pay-as-you-go financing. Greatly enhancing this trend is the fact that contributions towards the funding of pensions are deductible as a business expense for income tax purposes. Further underscoring the importance of advance provision for meeting pension obligations is the official position of the accounting profession in the United States. The position taken involves the current reflection of the value of pension accruals in the employer's financial statements.

For the purpose of funding pensions, there are two commonly used methods. One of these is to make payments into a pension trust fund and the other is to purchase annuities from an insurance company. The determination of the amounts of the contributions to be made to a pension fund or paid as an annuity consideration and the valuation of pension liabilities are tasks left to an actuary employed for that purpose.

Private pension plans have increased from a few hundred in the 1930's to over 150,000 presently. Court decisions in the late 1940's formalized the right of employees, through unions, to bargain collectively for pensions. Due to these newly established rights, there has been the creation of pattern plans. These are separate but similar pension plans designed by a union with different employers within an industry. Also, the United States has witnessed the creation of multi-employer plans. These are single plans with pooled assets, usually established by a group of employers and a union which has bargaining power for the employees it represents.

The establishment of such plans has greatly complicated
the accounting of pensions. In addition, if an employer wishes to claim tax deductions for the funding payments and not subject his employees to tax until the pension is received while also avoiding taxation of the investment income of the pension trust fund or insurance company, he must allow for certain conditions set forth by tax law and regulation.

1). Contributions must be irrevocable.

2). Contributions must not exceed specified actuarial limits.

3). The plan must be bona fide and permanent.

4). The benefits must be reasonable.

5). Coverage and benefits must be non-discriminatory.

6). There must be communication of the plan to employees.

Although some guidelines have been set for the accounting of pension funds, they have been viewed as insufficient. There are still many methods being used leading to a great deal of confusion and mayhem.

In order to combat this confusion, the FASB issued a discussion memorandum dealing with the subject entitled "Employers' Accounting for Pensions and Other Post-Employment Benefits". The memorandum deals largely with single-employer, non-insured, defined benefit pension plans. The FASB outlined several issues for discussion and invited comment from interested parties. Some of the main issues included were:

1). Should pension benefit obligation be measured as of the date of the financial statements?

2). What guidance should the Board provide as to the actuarial assumptions to be used for accounting purposes?
3). Should an employer who sponsors more than one defined benefit pension plan report net pension liabilities and net pension assets separately?

4). Should the amortization of the measurement valuation allowance be computed based on the beginning of the year balance rather than the end of the year balance?

8). How should an employer account for events of termination or curtailment of a defined benefit pension plan including: a) plan termination without replacement, b) plan suspension without replacement, c) plan suspension or termination without replacement, and d) plan curtailment?

10). What information about defined contribution plans should be disclosed?

11). Does an employer participating in a multi-employer plan that provides defined benefits have a recognizable liability for: a) a share of the plans unfunded obligation for benefits promised to participants under the terms of the plan, b) contributions due and unpaid plus the balance of the potential withdraw liability (if any), c) only contributions due and unpaid?

12). What disclosures should be required in the financial reports of an employer participating in a multi-employer pension plan?

18). To the extent that contracts with insurance companies are included in plan assets, how should they be measured?

Some elaboration on these issues is necessary. Issue 1 should ideally be reported as of the date of the statement for timeliness and representational faithfulness. There are two possible methods: A). Project the obligation as of the date from earlier measurements. Basically, increase the cost. B). Use the obligation of an earlier date because the first
alternative is too expensive and too much of a change. In evaluating the two possibilities, the first seems representational but in reality it may not be. The measurement of pension benefit obligation at any time is speculative due to the time span involved between the setting aside of funds and payment of such funds to the recipient. Inflation and loss of value are factors which cannot be accurately predicted. Considering that the amount is debateable at any time, the adviseability of projecting such a figure to arrive at an amount for the financial statements is at best shaky and probably not worth the extra cost involved.

Issue 2 involves two possibilities also. One is to use the guidance from statement #35 which indicates the impossibility to prescribe a method that will fit all plans. The other is to have a more specific regulation which would enhance comparability. With this issue one should consider that the figures arrived at by the actuary are only estimations. Therefore, the numbers themselves do not mean a great deal. In view of this, it would seem that comparability of the figures would be more important. To achieve comparability, a specific set of regulations governing actuarial assumptions would appear adviseable.

Concerning Issue 3, there are three possibilities: A). report separately on the statement of financial position in which case excess assets of one plan are not used to cover the obligations of others, B). Group the amounts with footnote disclosures, or C). Group the amounts but with no disclosure. In the case of B or C, the obligation is relevant
only if the plan is terminated.

The first possibility would allow the reader to have exact, detailed information but would also clutter the face of the financial statements. The second would provide the same information without the cluttering of the statements. The third possibility does not appear to provide enough information for the statement user. The second possibility appears to be a good compromise.

With Issue 4, use of the beginning balance would be consistent, systematic and prospective. Use of the ending balance indicates the annual amount is the important consideration. The first would seem to be more consistent with accounting practice.

There are three possibilities for Issue 8. One is to recognize the change as a gain or loss at the date of the event. A second possibility involves writing off some or all of the unamortized measurement valuation allowance existing at the date of the event and recognize the gain or loss. The third possibility is to write off the allowance or some of the unamortized intangible assets or deferred credit existing at the date of the event and recognize the gain or loss.

The first possibility does not recognize that the amount was used in the measurement valuation allowance but simply recognizes the gain or loss. Although probably being the least complicated method, it does not consider the measurement valuation allowance. The second does recognize the allowance change while not getting into the intangible asset accounts. Possibility two would seem the most appropriate.

Several different things have been suggested for disclosure.
They include: a). the existence of a plan and an identification and description of its substance, b). a general description of the employer's policy for funding, c). the amount of cost received for cost paid, d). the nature and effect of significant matters affecting comparability for all periods, e). information about plan assets and there performance, and f). other information. A strong case can be built for disclosing all of these pieces of information. However, one must consider what information is important enough to allow its presence on the financial statements. If all the information were disclosed, cluttering the face of the statements would become a problem. The first two items listed above would appear to be the basic information necessary. This information along with anything highly significant and unusual might be a fair compromise.

Issues 11 and 12 deal with multi-employer plans. ERISA, which stands for Employee Retirement Income Security Act, and MEPPA, which is Multi-employer Pension Plan Amendments Act of 1980, are both significant here. Under Issue 11, the possibilities include: a). A share of the plans unfunded obligation for benefits promised to participants under terms of the plan, b). contributions due and unpaid plus the balance of potential withdrawal liability, and c). only contributions due and unpaid. Of these three possibilities, the first would appear to be the most thorough and complete method. Being that this issue involves a liability, the first possibility would seem most consistent with accounting theory.

In considering Issue 12, it would appear very similar to Issue 10 and it would seem appropriate to use the same guide-
Issue 18 can be solved by using a). Fair market value, b). the Contract value, c). either of these, or d). some other measure. Both a) and b) have good and bad points. However, once again, comparability of statements is an important aspect to consider. Although either one would be a fine measurement, it seems that one or the other should be used consistently.

In addition to the debate surrounding these issues of pension accounting, there is some question as to whether whatever changes are made should be retroactive or prospective. If the changes are retroactive, the accountant would need to return to the beginning figure and reevaluate the accounts with differences being resolved through the retained earnings account. If the changes are prospective, the pension liability amount would remain the same as would the intangible asset account.

There are many effects possible from these FASB proposals. Some of the immediate financial effects would include: a). changes in financial ratios, b). change in tangible net assets, and c). the causation of some companies to be in violation of loan covenants. In addition, pension expense may be effected as well as increased costs involved in separating funding and accounting. The long-run consequences would include changed credit analysis and impaired financing.

There are several individuals who have expressed opposition to the FASB's proposals and have suggested other possibilities. According to the proposals, a pension benefit obligation would be created which would include an accrual
for all benefits earned by employees not yet paid including prior service credits granted when the plan was initiated. Also, an intangible asset would be created by the prior service credit which would have to be amortized. The proposals would "require companies to report unfunded pension benefits as a net pension liability in their balance sheets"\(^2\) rather than disclosed as a footnote as was previously done. Ernst and Whitney have expressed the feeling that it is not needed, not reasonable and not workable. They state, "We strongly disagree with these proposed changes, which would require liability recognition ... a procedure that is neither reasonable or workable. We believe the key issue is expense measurement and that the solution to the so-called 'pension problem' lies in improved disclosure."\(^3\)

Another pair of individuals by the names of Greene and Power stated that these proposals would require the prediction of future salary increases among other highly questionable events. They state, "There's no guarantee that users of the reports will regard the asset, which is supposed to represent a sort of goodwill the company picks up by establishing a pension plan, as a real one. But they are likely to pay a lot of attention to that liability."\(^4\) In addition, they question the FASB's consistency. They state, "The FASB backed away from requiring that oil companies record changes in reserves

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\(^3\)**IBID.**

\(^4\)**"In The Cards?", F**O**R**B**ES, R. Greene and C. Power, vol., 131, p. 126, February 14, 1983."
when they arrive at a basic profit and loss figure but the changes will be in supplements. However, in the case of pension accounting, they did just the opposite. In the case of pensions, it is a soft number that is recorded while in gas and oils, it is a soft number that is not recorded.

Another area under debate is the measurement of pension expense. The proposal is to measure the present value of pension benefit obligation based on terms of the plan and benefits promised.

Another possibility is using annual pension cost which would include the total change in net pension liability and intangible assets excluding decreases from employees contributions. This would mean taking the portion of increase in obligation attributeable to employee service during the period, adding accrual of interest, amortization of the intangible asset and amortization of measurement valuation allowance, and decreasing the amount by the increase in plan assets resulting from earnings on assets.

Ernst and Whitney have expressed the opinion that the first single measurement proposal is to narrow. However, they agree that some restrictions are necessary.

In summary, there are many issues under debate but the main areas of dispute are the requiring of a pension liability figure on the statements and how this figure and the expense figure should be determined.

The necessity of a pension liability figure on the state-
ments is real. The liability is a real one that will eventually have to be paid. The problem lies in arriving at a relevant figure.

The estimating of salaries fifty to sixty years in the future is by necessity a very tenuous prospect. Those who would have estimated salaries for the present in the 1920's could not possibly have imagined the salaries and wages now being paid. Therefore, their estimates would have been far from the actual amounts. This is a legitimate consideration. However, if there were a particular equation for estimating this liability, it would probably not be correct in the final result but it would represent the liability and do so in a manner that would allow comparability. I feel this representation and comparability outweigh the probability of an incorrect figure.

Concerning measurement of pension expense, the first proposal bases the amount on an estimate figure which would not provide a very reliable figure. The second method, although complicated, would provide a more reliable figure for the expense amount. However, the expense amount would no longer have any relation to the liability figure. I feel that the liability figure is already soft and will need to be reevaluated regularly and, therefore, its relation to the expense account does not outweigh the importance of a solid expense figure. The second method would provide a much more relevant figure.

A final concern involves making any changes retroactive or prospective. Being that the pension liability, if included on the statements would change the financial ratios, I feel the changes should be retroactive. This would allow financiers
to compare and to follow trends within a company in making finance decisions.
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