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Short history of the economic development and accounting treatment of pension plans

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A SHORT HISTORY OF THE ECONOMIC DEVELOPMENT AND ACCOUNTING TREATMENT OF PENSION PLANS

Pension plans have recently received considerable publicity in financial and accounting periodicals, and in general circulation magazines and newspapers. Comments about Social Security and the taxation of private pension plans, as well as comments on accounting for the cost of pensions, have appeared on a regular basis. Considering this frequent discussion about pension plans, one might wonder about the economic conditions which have laid the groundwork for the current interest in pensions. The purpose of this paper is to provide a short history of the economic conditions which have led to the development and expansion of pension plans. Accounting for the cost of pension plans is also considered from a historical perspective.

Providing for Old Age Before the Industrial Revolution

Before the Industrial Revolution, most people provided for old age through their own initiative. Agriculture was the main occupation. If a person's health was good, he continued to work until he died. If he became incapacitated, his children provided for him. If there was need for aid outside the family unit, the Church was the provider of the last resort. Public aid to the needy aged did not become generally available until the sixteenth century when the first English Poor Law was enacted. Under the Poor Law, the old age poor were granted limited help but only when there were no relatives capable of providing support.

Economic Changes Caused by the Industrial Revolution

The Industrial Revolution changed employment opportunities available to workers. The demand for agricultural workers lessened; thus, an increasing supply of laborers became available for industrial positions. The occupational shift away from agriculture caused a movement of population from rural to urban areas. This population movement brought changes in the basic family structure. Children, searching for employment opportunities, moved from their parent's home and were no longer available to care for them during old age.

In many instances, the new industrial workers could not depend on their own efforts to provide them with an acceptable income. Continued employment often depended on market forces over which they had no control. Saving for retirement was almost an impossibility. Government intervention in the economic process would have been one way of increasing old age security but such intervention was vigorously opposed by economists.

Economic Thought During the Late Eighteenth and Nineteenth Centuries

The dominant economic thought during the late eighteenth and nineteenth centuries was the concept of the self-regulating market. This concept advocated a *laissez-faire* policy for government. Adam Smith, one of the first economists to support *laissez-faire,* stated that "every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way, and to bring both his industry and capital into competition with those of any other man, or group of men. The sovereign is completely discharged from a duty . . . of superintending the industry of private people. . . ."[1]

David Ricardo, another prominent economist during this period, developed an economic model of a self-regulating market which became the norm for governmental policy in the nineteenth century. Within this model, there was the assumption that economic growth would eventually deteriorate into a stationary state with an accompanying decline in the rate of profits. The law of diminishing returns was inevitable. There was little room in this model for government or business to adopt long range programs to improve the economic security of the aged.

Increasing Worker Unrest During the Second Half of the Nineteenth Century

During the second half of the nineteenth century, the continuing movement of people from rural to urban areas accentuated economic problems. There was a growing sense of concern that the number of workers living in poverty was increasing while at the same time the society in which they were living was getting wealthier. Better communication between workers about their impoverished state led to worker unrest. This unrest helped workers gain political power. Most national governments responded to the increasing political power of workers by enacting various forms of social legislation including old age pensions.

Public Pensions in Germany, England, and the United States

In 1889, Germany became the first country to adopt a comprehensive plan of public pensions. Otto von Bismarck, the German Chancellor, favored pensions and other social reforms for political rather than social reasons. Bismarck was concerned with the growing popularity of socialism. In a message to the Reichstag, Bismarck stated that "I will consider it a great advantage when we have 700,000 small pensioners drawing their annuities from the state, especially if they belong to those classes who otherwise do not have much to lose by an upheaval and erroneously believe they can actually gain by it."[2]

In England, a system of public pensions was adopted in 1908 following a period of tremendous social concern about the increasing number of people living in poverty. Some of the social concern during this period resulted in violence. A historian notes that "in the Trafalgar Square riot of February 8, 1886, the old humanitarianism died in a spasm of terror. The poor were no longer to be pitied and to be helped from Christian generosity. They were a menace to be bought off."[3]

At the start of the twentieth century, many Americans regarded poverty as being due to the weakness of poverty-afflicted individuals rather than to weaknesses in the economic system. Because of this prevailing attitude, the only public pensions in America up until 1935 were state pensions of very limited amounts.

During the 1930's, the depression caused widespread poverty and lessened confidence in the American economic system. The collapse of financial markets, the closing of banks, and mass unemployment convinced many Americans that it was possible for a person to be poor through no fault of his own. This change in national attitude during the 1930's resulted in many social reforms including the enactment of the Social Security Act in 1935.

Private Pensions in the United States

In 1875, the American Express Company became one of the first American companies to adopt a formal pension plan. By 1900, approximately five to seven more companies introduced formal plans. Some companies during this period had informal pension programs where payments were made at the discretion of the company owners. These payments, however, were usually looked upon as gifts to retired workers rather than required pension expenditures since they could be adjusted or discontinued at anytime. Approximately 250 additional companies established formal pension plans between 1900 and 1925. Thereafter, the number of companies with formal plans expanded considerably.

Before 1900, most companies did not have pension plans since it was assumed that a company could not pay for a pension plan and remain competitive. Several reasons given for increased employer interest in formal pension plans after 1900 were (1) employers became more humanitarian and wanted to improve the living conditions of their workers; (2) employers learned that workers who do not have to worry about financial problems of old age are more productive workers and develop more loyalty to the firm; and (3) some employers started pension plans to lessen the impact of labor unions which were attempting to organize their workers. Pension plans also made it possible to retire older workers when their efficiency declined rather than letting them continue to work or firing them. Retirements also opened up promotion lanes for younger workers and increased their incentive to succeed.

Continuing Growth of Public and Private Pension Plans

Public pension programs are viewed by most economists as a necessity in wage societies. Without some old age income security program, social peace would be threatened. All of the industrialized countries in the world currently have public pension programs.

Many large and small companies in the United States and elsewhere now also have private pension plans for their employees. Most people no longer view private pension benefits as gifts from employers to employees but rather as deferred wages earned by an employee during his working years and payable to him after he retires.

Accounting Treatment of Pension Plans

Before 1900, many companies did not retire older workers but retained them on their payroll until they became disabled or died. The wages paid to the older workers were considered as compensation expense even though the productivity of the older workers may have been much less than that of younger workers. Any informal payments to persons after they were no longer capable of working were not considered as an expense of doing business unless the payments were contractual or compulsory in nature. It was assumed that labor had already received its subsistence. Any additional distribution to labor such as an old age pension which was not contractual was a share in profits given to labor.[4] With the advent of the federal income tax in 1916, pension payments became allowable deductions for tax purposes; the deductible amount usually being the amount of pension payments made during the year.

During the early to mid-1900's, most companies with pension plans accounted for pension costs on either a pay-as-you-go basis or on a funding basis. Under the pay-as-you-go method, pension payments to retired workers were recognized as expense when the payments were made. No accounting recognition was given to the expense during the years when the pension benefits were being accumulated. Under the funding method, the yearly amount paid to a pension trust or other funding agency was considered to be the pension expense for the period. Use of either of these two methods of determining pension expense was considered to be sound policy since most companies reserved the right to cancel their pension plan at any time and, thereby, eliminate any additional pension liability. If a company made a payment to a pension trust to partially or fully fund past service costs (pension cost assigned to years prior to the inception of a pension plan) the payment could either be considered as a current operating expense or as a charge against retained earnings. There was a diversity of opinion in this respect.

In November 1948, the American Institute of Accountants (now the American Institute of Certified Public Accountants) issued Accounting Research Bulletin No. 36 to help tighten accounting practices in the pension area. The Bulletin, entitled "Pension Plans—Accounting for Annuity Costs Based on Past Services," stated that past service costs should not be charged to retained earnings but should be allocated to expense over current and future periods. The rationale for this approach was that companies adopt pension plans to achieve present and future benefits, therefore all pension costs should be allocated to present and future periods.

In September 1956, another Accounting Research Bulletin (No. 7) was issued which dealt with accounting for the cost of pensions. The ideal position as stated in the bulletin was that the accrual of costs under a pension plan should not necessarily be dependent on the funding arrangements provided for in the plan or be governed by a strict legal interpretation of the obligations under the plan. Costs based on current and future services should be systematically accrued during the expected period of active service of the covered employees. Costs based on past services should be charged off over some reasonable future period. Since many companies were not adhering to this ideal position at the time the bulletin was issued, it was recommended in the bulletin that pension expense, as a minimum, should equal the present worth of pension commitments to employees to the extent that the rights have vested (benefits that are not contingent on the employee's continuing in the service of the employer) reduced by any accumulated pension funds.

A third statement on accounting for the cost of pension plans was issued in November 1966 when the Accounting Principles Board released Opinion No. 8. This opinion considered the pay-as-you-go basis of accounting for pension costs as unacceptable and again stated that pension expense in any one year should not necessarily be dependent on the funding arrangements provided for in the plan. The opinion also defined minimum and maximum limitations on the amount of pension expense that can be recognized in any one year. The opinion was, however, somewhat transitional in nature and the topic of accounting for the cost of pension plans is again being reviewed by the Financial Accounting Standards Board.

Conclusion

A review of history indicates that changing economic conditions have necessitated the development and expansion of pension plans. Today, pensions have become an integral part of our economic system. Recent publicity given to changes in public and private pensions indicates the importance of pensions in our daily lives.

Accounting for pension costs has also followed an evolutionary path from a highly flexible beginning to a more narrowly defined present. Chances are that the future will hold even more uniformity in accounting for pension costs.

FOOTNOTES

[1]Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations,* Modern Library, Inc., 1937, p. 651.

[2]Bismarck, *Gesammelte Werke,* Wilhelm Schuessler, ed., Otto Stollberg Verlag, 1929, Vol. XII, pp. 186-187, as quoted in Gaston V. Rimlinger, "Social Security and Industrialization: The Western Experience, With Possible Lessons for the Less Developed Nations," article included in *The Role of Social Security in Economic De-*

velopment, Research Report No. 27, Social Security Administration, U.S. Government Printing Office, 1968, p. 137.

[3]Bentley Gilbert, *The Evolution of National Insurance in Great Britain,* Michael Joseph, 1966, p. 32, as quoted in Rimlinger, *Ibid.,* p. 143.

[4]Sir Arthur Lowes Dickinson, *Accounting Practice and Procedure,* Ronald Press Co., 1913, pp. 210-211.

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