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Theory and Practice

Accounting for Pensions

The Complexity Continues

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The FASB has reached the end of its project dealing with accounting standards for defined-benefit pension plans. The Board has been working on this issue since 1974 and completion of the project is a major accomplishment, regardless of the popularity of the final outcome. Since 1980 two discussion memorandums, a Preliminary Views document, two exposure drafts and the final statement have been issued. Each publication has included changes, many of them significant, from previous documents. Between 1980 and the end of 1985 the FASB witnessed 151 presentations over 13 days of public hearings on pensions.[1] The length of time this project required indicates that accounting for pensions is an important and controversial topic.

What Issues Are of Greatest Concern?

The FASB is requiring various changes, most of which emphasize more uniformity of methods and greater disclosure. From the beginning of the project the FASB was committed to a serious revamping of pension accounting from the methods acceptable under APB Opinion No. 8. Statement of Financial Accounting Standards No. 36, "Disclosure of Pension Information," was a first major step because it moved information about the pension plan assets and liabilities into the sponsoring employer's financial statement footnotes. At that time, the FASB clearly stated that it perceived SFAS No. 36 as merely an interim step. Now, the FASB states that some information, notoriously a calculated liability for future benefits to be paid from the plan, should be shown as a liability on the employer's balance sheet. Further, pension cost should be calculated using a uniform method, and the effects of actuarial gains and losses should more realistically affect the employer's calculation of pension expense.

The disclosure, cost calculations and liability presentation, deemed important by the FASB in 1985, are also important to the business community—as indicated by the responses at public hearings. After publication of the Preliminary Views, dissenting opinions were heard which stressed that the FASB was out of touch. Publication of the two exposure drafts instigated dissenting opinions voicing concern that the then-proposed balance sheet liability was "not real," that pension-expense impact on the income statement would be too volatile, and that the increased disclosure would be a hardship, especially for smaller businesses. Perhaps the FASB was trying to make concessions on these issues, in both the exposure draft and final statement as FASB No. 87, "Employer's Accounting for Pensions," requires fewer disclosures for some small companies and a delayed implementation date of fiscal years beginning after 12/15/88 for the recording of any additional liability.

What Are the Changes?

The Liability. The December, 1985 statement of Financial Accounting Standards No. 87, "Employer's Accounting for Pensions," states that a sponsoring employer will show a liability on its balance sheet equal to the amount by which the pension plan's "accumulated benefit obligation" exceeds the fair value of pension plan assets. The accumulated benefit obligation is the actuarial present value of benefits, based on employee service rendered prior to that date. It is calculated using the pension plan's benefit formula and is based on current and past compensation levels. The calculation includes benefits that are both vested and nonvested at the specified date. Fair value of pension assets are calculated using an averaging technique. The credit entry to the balance sheet pension account will be for the amount required to bring the total liability equal to the unfunded accumulated benefit obligation. The total liability will be redetermined and adjusted annually at the balance sheet date.

What does this mean to the sponsoring employer? From a simplistic point of view, under APB 8 if a company has been funding its pension plan in an amount equal to its pension expense it does not show any pension liability on its balance sheet. Under the new FASB statement that will change if assets currently in the plan are not sufficient to meet the calculated amount of future retirement claims of employees. Effectively, if a company wishes to avoid showing this balance sheet liability it has until 1989 to sufficiently fund its pension plan to equal the plan's accumulated benefit obligation.

Criticism has developed for at least two reasons. One, if the fair value of

the plan assets exceeds the accumulated benefit obligation an asset is not shown on the sponsoring employer's balance sheet. Two, since the accumulated benefit obligation is based on vested and nonvested benefits a liability is shown that is contingent on future events. Hence, the liability may not be a "true liability," as defined in the Conceptual Framework.

The Cost. Pension cost is to be calculated independently of the pension liability. FASB No. 87 calls primarily for the use of the benefit/years of service approach, also called the projected unit credit method, to calculate pension cost. The benefits/years of service approach is appropriate for most plans because it reflects benefits defined similarly for all years of service. If a particular pension plan provides for benefits based on final pay or on some average of compensation over an entire work life, then pension expense should reflect future compensation levels. This uniformity is a major departure from the range of actuarial methods acceptable for calculating expense under APB 8. As explained below amortization of a related intangible asset and recognition of some component of actuarial gains and losses, if appropriate, are also a part of pension cost.

In some circumstances an "unusual" debit may result from the independent calculations of the pension liability and pension cost, if the credit to the liability is greater than the debit to expense. The debit is shown as an intangible asset to the extent of any unrecognized prior service cost and amortized as a part of pension cost. The remaining portion of the debit is shown as a separate component of the equity section of the employer's balance sheet. Offsetting

The liability shall equal the amount by which the accumulated obligation exceeds the fair value of the pension plan assets.

any unfunded accumulated benefit obligation resulting from unrecognized prior service cost with an intangible asset is conceptually sound. An employer would not grant pension benefits for service prior to a plan's origination or amendment unless some future benefit were expected. Thus, it is reasonable to assume that an asset related to that portion of the pension liability does exist, and will be depleted in the future.

Actuarial gains and losses will be amortized when they exceed a defined amount, known as a corridor. The corridor, as defined by FASB No. 87, is 10 percent of the greater of the projected benefit obligation or the fair value of plan assets. The projected benefit obligation differs from the accumulated benefit obligation by inclusion of assumptions about future compensation levels. The usual minimum amortization is to be over the average remaining work years of active employees who are expected to receive benefits under the plan. In certain circumstances this method of recognizing actuarial gains and losses may create unexpected fluctuations in total pension cost.

The Disclosure. The new FASB statement adds considerably to the disclosure which was required under APB Opinion No. 8. New disclosures include: components of net periodic pension costs, ratio of net periodic pension costs to covered payroll, changes in the fair value of plan assets during the period with itemization of certain components, and a reconciliation of the funded status of the plan to the information reported in the sponsoring employer's balance sheet.

FASB No. 87 provides some relief from the disclosure requirements for nonpublic companies sponsoring pension plans with 100 or fewer participants. The disclosures from which these companies are exempted are not extensive. Exempt information includes the breakdown of the components of net periodic pension cost and changes in the fair value of plan assets during the period. Since these companies must perform all the calculations and entries that generally apply, the limited amount of disclosure exemptions may hardly be noticed. In light of the increase in overall disclosure requirements for pensions these small-business concessions can hardly be

Under FASB No. 87 pension cost shall be calculated by the benefit/years of services approach (aka projected unit credit method.)

perceived as aiding the standards overload problem.

Conclusion

Pensions has to be a difficult accounting issue; it is impossible to assess it in any other manner. The problem is one of currently accounting for a cash outflow which will occur many years in the future. The cash outflow will be of uncertain amounts, to an uncertain number of people, for uncertain periods of time. Further, appropriate rates for discounting future amounts back to the present are good estimates, at best, and bad guesses, at worst. Controversy surrounds even the nature of the pension liability. Some perceive a pension plan to be a moral obligation of the sponsoring company; others perceive it to be a legal relationship between the pension fund and the participants. Controversy has surrounded accounting for pensions for many years. At the very least, the FASB should be commended for coming to grips with the problem and presenting a workable solution.Ω

NOTES

[1]Donald J. Kirk, "Controversy Apparent at FASB Pension Hearing," *The CPA Letter*, August, 1985, p. 1.