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Decision Rule Approach to Minimum Pension Liability Recognition Under SFAS No. 87

Wanda G. Spruill

Sharon E. Bossung

A Decision Rule Approach to Minimum Pension Liability Recognition Under SFAS No. 87

By Wanda G.Spruill and Sharon E. Bossung

Introduction

Statement of Financial Accounting Standards No. 87 (SFAS 87), *Employers' Accounting for Pensions,* requires a company with a defined benefit plan to report a balance sheet minimum pension liability (ML) when the accumulated benefit obligation (ABO) is underfunded. Balance sheets published after 1989 must reflect the ML requirement. A company recognizes the required ML by creating or adjusting balance sheet accounts. The decision rule approach in this article facilitates the calculations required for adjusting these accounts.

Required Minimum Liability

The ML is the excess of the ABO over the fair value of plan assets (FVA) at measurement date, which is the date of the financial statements or an alternate allowed date. This is strictly a liability recognition requirement since SFAS 87 does not provide for recognition of a minimum asset if the FVA exceeds the ABO. The first proposition in the Step 1 decision rule below embodies the requirement that no minimum asset be recognized in ML accounting. The second proposition in the Step 1 decision rule assists with the calculation of the ML when ABO is greater than FVA.

Step 1. Determine if there is a Minimum Liability

Compare ABO and FVA. Do not recognize a minimum asset when ABO is less than FVA. Recognize ML when the ABO is greater than FVA.

Step 1 Decision Rule
If ABO ≤ FVA, then, ML = 0.
If ABO > FVA, then, ML = ABO - FVA.

If an employer has more than one defined benefit pension plan, the minimum pension liability (ML) determination must be made independently for each plan. If the accumulated benefit obligation (ABO) exceeds plan assets in one plan and plan assets exceed ABO in another plan, the two cannot be netted. Even if total plan assets are greater than total obligations for all employer plans, an ML must be recognized for any one plan in which the ABO exceeds that plan's assets.

Additional Pension Liability

ML accounting considers the balance of the Prepaid pension cost/Accrued pension liability (PPC/APL) account to determine whether an additional pension liability (ADL) should be recognized in order to comply with the ML requirement. A balance in PPC/APL results from cumulative differences between pension expense recognized and cumulative cash disbursed for funding pension expense.

A credit (APL) balance in PPC/APL decreases the amount of the ML that must be recognized as the ending balance (EB) of ADL. A debit balance (PPC) in the PPC/APL account is added to the ML amount to determine the EB ADL. Step 2 decision rules below encompass these conditions.

Step 2. Determine Ending Balance of the Additional Pension Liability

Compare ML as determined in Step 1, with the ending balance of the PPC/APL account to determine the desired EB ADL.

Step 2 Decision Rules:
When EB PPC/APL = 0, then, EB ADL = ML
When EB PPC/APL is a Credit Balance (APL):
If ML ≤ APL, then, EB ADL = 0
If ML > APL, then, EB ADL = ML - APL.
When EB PPC/APL is a Debit Balance (PPC):
If ML = 0, then, EB ADL = 0
If ML > 0, then, EB ADL = ML + PPC.

Adjusting the Ending Balance of ADL

The balance in the additional pension liability (ADL) account must be adjusted to the amount that was determined in Step 2. The Step 3 decision rules take into

Exhibit I

Legend

ABO	Accumulated benefit oblication
ADL	Additional pension liability
APL	Cedit balance in PPC/APL
BB	Unadjusted beginning balance
CE	Contra-equity
EB	Adjusted ending blaance
FVA	Fair value of plan assets
IA	Intangible asset
ML	Minimim pension liability
PBO	Projected benefit obligation
PPC	Debit balance in PPC/APL
PPC/APL	Prepaid pension cost/Accrued pension liability
SFAS 87	Statement of Financial Accounting Standards No. 87
UPSC	Unrecognized prior service cost

account the possibilities encountered in creating or adjusting the balance of ADL.

Step 3. Determine Adjustment to the Balance Sheet Additional Liability Account

Compare BB ADL with the desired EB ADL (from Step 2). Debit/credit ADL as necessary to achieve the EB.

Step 3 Decision Rules
Adjustment to ADL:

If BB ADL = EB ADL, then,
no adjustment to ADL.

If BB ADL > EB ADL, then,
Dr. to ADL = difference between EB ADL and BB ADL.

If BB ADL < EB ADL, then,
CR. to ADL = difference between EB ADL and BB ADL.

Intangible Asset and Contra Equity Accounts

When an ADL must be recognized, an equal amount is recognized as an intangible asset (IA) with the constraint that the IA may not exceed unrecognized prior service cost (UPSC). Any excess of ADL over UPSC is treated as a noncurrent deferred expense which is reflected, net of income tax effect, in the balance sheet equity section. This contra equity (CE) does not affect the current period income statement.

For the purpose of limiting the IA balance, UPSC includes both unrecognized prior service cost related to retroactive features of plan amendments adopted after implementation of SFAS 87 and unrecognized transition gain or loss. Unrecognized transition gain or loss is the difference between the balance of the projected benefit obligation (PBO) and the FVA when SFAS 87 is first implemented by a company.

The IA account is adjusted annually but is never directly amortized. Since UPSC is amortized to pension expense, amortization of the IA would result in double recognition of the same expense element.

The Step 4 adjustments take into account the various possibilities for creating and adjusting the IA and CE accounts. Step 4(a) rules deal with adjustments when UPSC is equal to or greater than EB ADL and, therefore, no CE account is required. Step 4(b) rules deal with adjustments when UPSC is less than the EB ADL and, therefore, balances in both IA and CE are required.

Steps 3 and 4 decision rules imply the required order of adjustment. The ADL account is adjusted first (per Step 3); then, the IA is adjusted; and finally, the CE is adjusted.

Step 4. Determine Adjustments to the Balance Sheet Intangible Asset and Contra Equity Accounts

When an ADL must be recognized (Step 2 above), and UPSC is equal to or greater than EB ADL, adjust IA to equal EB ADL. In this case, no CE balance is required.

Step 4 (a) Decision Rules

Adjustment to IA when
UPSC ≥ EB ADL:

Adjust IA so that EB IA = EB ADL.
Adj. Amt. = EB ADL - BB IA.

If BB IA < EB ADL, then,
Dr. Adj. Amt. to IA.

If BB IA > EB ADL, then,
Cr. Adj. Amt. to IA.

Adjustment to CE when
UPSC ≥ EB ADL:
Reverse any balance in the CE account.

When an ADL must be recognized (Step 2 above) and UPSC is less than EB ADL, adjust IA to equal UPSC, and adjust CE to equal the excess of EB ADL over UPSC.

Step 4(b) Decision Rules

Adjustment to IA when
UPSC < EB ADL:

Adjust IA so that EB IA = UPSC.
Adj. Amt. = UPSC - BB IA.

If BB IA < UPSC, then,
Dr. Adj. Amt. to IA.

If BB IA ≥ UPSC, then,
Cr. Adj. Amt. to IA.

Adjustment to CE when
UPSC < EB ADL:

If BB CE ≥ 0, then, adjust CE so that
EB CE = EB ADL - EB IA.
Adj. Amt. = EB ADL - EB IA - BB CE.

If BB CE < EB ADL - EB IA,
then, Dr. Adj. Amt. to CE.

If BB CE > EB ADL - EB IA,
then, Cr. Adj. Amt. to CE

Conclusion

The calculations associated with reporting ML are complicated. The decision rule approach in this article simplifies these calculations. An example illustrating the decision rules is presented in the appendix to this article.

The full balance sheet impact of the SFAS 87 minimum pension liability requirement is not yet clear. Balance sheet volatility caused by the ML requirement is a subject for future investigation.

Wanda G. Spruill, *CPA is an Assistant Professor and Coordinator of Accounting at the John Wiley Jones School of Business at the State University of New York, College at Geneseo. She is a member of the AICPA, Accounting Research Association of the AICPA, NYS Society of CPAs, Arkansas Society of CPAs, American Women's Society of CPAs, American Society of Women Accountants, American Accounting Association, the Administrators of Accounting Programs Group of the American Accounting Association, and Delta Kappa Gamma Society International.*

Sharon E. Bossung, *CPA, is an Assistant Professor in the John Wiley Jones School of Business at the State University of New York, College at Geneseo. Professor Bossung is a member of the AICPA, NYSSCPAs, Institute of Internal Auditors, American Accounting Association, and Women's Business and Professional Association.*