9-1979

Erisa and The Accountant

Gregory Honl

ERISA AND THE ACCOUNTANT

by

Gregory J. Honl

Bachelor of Science

North Dakota State University 1971

An Independent Study

Submitted to the Faculty

of the

Department of Accounting and Business Law

of the

University of North Dakota

in partial fulfillment of the requirements

for the degree of

Master of Science

Grand Forks, North Dakota

September
1979

TABLE OF CONTENTS

INTRODUCTION

Over the last twenty years, accounting for pension plans has received considerable attention from the accounting profession. The Financial Accounting Standards Board (FASB) is currently studying the problems involved with accounting and reporting for pension costs. The accounting profession has not made an authoritative pronouncement on the subject since the Accounting Principles Board (APB) released Opinion No. 8, "Accounting for the Cost of Pension Plans" in 1966. Since then, the number of plans, plan participants, and benefits provided have grown significantly.

The Employee Retirement Income Security Act (ERISA) was signed into law by President Gerald Ford on Labor Day, 1974. Since its passage,

> . . . the entire area of accounting, auditing and financial reporting for pension plans has become the subject of much discussion and uncertainty. Accountants, auditors, plan trustees, sponsors, administrators, and others involved with pension plans are raising questions regarding implications of the Act for generally accepted accounting principles, reporting and disclosure requirements, generally accepted auditing standards, and various aspects of plan management.[1]

ERISA was the result of a decade of work by various

---

[1]Felix Pomeranz, Gordon P. Ramsey, and Richard M. Steinberg, Pensions: An Accounting and Management Guide (New York: Ronald Press Co., 1976), p. v.

INTRODUCTION

Over the last twenty years, accounting for pension plans has received considerable attention from the accounting profession. The Financial Accounting Standards Board (FASB) is currently studying the problems involved with accounting and reporting for pension costs. The accounting profession has not made an authoritative pronouncement on the subject since the Accounting Principles Board (APB) released Opinion No. 8, "Accounting for the Cost of Pension Plans" in 1966. Since then, the number of plans, plan participants, and benefits provided have grown significantly.

The Employee Retirement Income Security Act (ERISA) was signed into law by President Gerald Ford on Labor Day, 1974. Since its passage,

> . . the entire area of accounting, auditing and financial reporting for pension plans has become the subject of much discussion and uncertainty. Accountants, auditors, plan trustees, sponsors, administrators, and others involved with pension plans are raising questions regarding implications of the Act for generally accepted accounting principles, reporting and disclosure requirements, generally accepted auditing standards, and various aspects of plan management.[1]

ERISA was the result of a decade of work by various

---

[1]Felix Pomeranz, Gordon P. Ramsey, and Richard M. Steinberg, Pensions: An Accounting and Management Guide (New York: Ronald Press Co., 1976), p. v.

government bodies. The Act changes the way in which employers and pension funds must operate the plan. ERISA made vesting mandatory; established or increased minimum requirements; increased the report and disclosure requirements; restricts the manner in which pension fund assets may be invested; requires payment of insurance premiums to the newly established Pension Benefits Guaranty Corporation; and requires the fund's financial statements to be audited by independent public accountants.[2]

The Financial Accounting Standards Board and the government must solve many problems involving the accounting for pension plans. Included in the problems is whether to record a liability for unfunded benefits; which basis should be used to measure the value of fund assets; whether to reduce the excessive paperwork involved in reporting a plan to various government agencies.

This paper is designed to highlight the major accounting, auditing, and reporting issues relating to pension plans as they are affected by ERISA. It will attempt to relay the solutions offered by many accountants and authors, and where there are no solutions, to discuss all the aspects of the problem.

[2]William D. Hall and David L. Landsittel, A New Look at Accounting for Pension Costs (Homewood, Ill.: Richard D. Irwin for the Pension Research Council, 1977), pp. 3-4.

CHAPTER I

THE DEVELOPMENT OF PENSION PLANS

IN THE AMERICAN SOCIETY

The size of the problem that accountants are now facing with regard to pension plans is immense. The pension funds are so large that these funds now control most of American business. One author has said:

> Through their pension funds, employees of American business today own at least 25 percent of its equity capital, which is more than enough for control. . . . By 1985 (probably sooner), they will own at least 50 - if not 60 - percent of equity capital. . . .
> . . . . the largest employee pension funds, those of the 1,000-1,300 biggest companies plus the 35 industry-wide funds (those of the college teachers and the teamsters for instance) already own control of practically every single one of the 1,000 largest industrial corporations in America.[3]

Pension plans in the United States have grown dramatically since the inauguaration of the first pension plans in the late 1800's. Undoubtedly, some type of retirement payments to former employees have been made every since industry began. Almost all plans began with informal payments to retired employees based on the goodwill of the employer.

---

[3]Peter F. Drucker, The Unseen Revolution: How Pension Fund Socialism Came to America (New York: Harper & Row, 1976), pp. 1-2.

The employers granted these payments to retired employees in recognition of past employee loyalty.[4]

In the early part of this century, the first formal plans commenced in the government, railroad, and utility industries. These first formal plans did not provide for advance funding, that is, the projected retirement benefits were not satisfied at any time before the actual liability was due. Rather, a pay-as-you-go method was used. Under this method, a pension plan was funded and expensed when the cash was awarded to the former employee.

Later in the twentieth century pension plans became a permanent part of the employment policy of many businesses. Retirement payments continue throughout the employees retirement. A most noticable change occurred when the employing business started to make advance payments to a pension fund. Many such advance payments were made to insurance companies who guaranteed the retirement payments. When the Internal Revenue Service allowed contributions to a qualified pension plan fund as a deductible expense, funded plans grew quickly.[5]

Before World War II most pension plans were still informal. Most of the retirement payments were still being made on a sporadic and discretionary basis. During World War II the government instituted wage and price controls. Many pension plans were improved during this time as a way to

---

[4]Pomeranz, Ramsey, and Steinberg, p. 4.

[5]Ibid., pp. 4-5.

increase the total compensation to employees without violating the wage guidelines. Since then, the number of formal plans has increased dramatically until now the cost of providing benefits makes up a large percentage of the total compensation of employees. It is very evident to the businesses that they have a substantive ongoing obligation.[6]

In April, 1950, Charles Wilson, the president of General Motors, offered a new type of pension plan to the GM workers. This new idea was a pension fund which would invest in the free enterprise system of the American economy. The union accepted the proposal because the older workers, who wanted the largest pension payments possible, outnumbered the younger workers, who wanted the extra cash in their paychecks.

In 1959, Bell Telephone System had the largest pension plan of the over two thousand in existence at the time. Before Wilson proposed his plan to the GM workers, the Supreme Court, in the Inland Steel Company case,[7] ruled that employers had to bargain about pensions with their unions. By this time the Internal Revenue Service had decided to treat pension contributions as deductible expenses. Therefore, the stage was set for retirement plans to soar.

In <u>The Unseen Revolution,</u> Peter F. Drucker described

---

[6]Hall and Landsittel, pp. 1-2.

[7]Inland Steel Co. v. Lebold, 62 SCT. (U.S.), 1045.

Wilson's plan:

> The GM plan was to be an 'investment trust'; it was to invest in the capital market, and especially in equities. Practically all earlier plans had been 'annuity plans', to be invested in standard life-insurance investments such as government bonds, mortgages, and other fixed-interest-bearing instruments.[8]

Wilson rejected the idea that pension assets should be invested into the stock of the employing company. He reasoned that to use employee pension money would make sure that few employees would ever get a pension. He based this belief on the observation that a great majority of existing companies and industries go downhill after a period of thirty to forty years, which is the time needed to build a decent pension fund.

The GM plan had a major impact on the style of today's pension plans. Within one year after the GM plan was implemented, eight thousand new plans were written. This represented four times as many pension plans that were commenced in the previous centruy. Each one of the new plans copied Wilson's new idea to invest into the stocks and bonds of other enterprises.[9]

In 1974 the Employee Retirement Income Security Act wrote into law the four basic rules that Wilson provided for the GM plan. Namely, the corporate pension fund will

[8]Drucker, p. 7.

[9]Ibid., pp. 7-8.

be managed by professional independent personnel; the fund will have minimal or no investment in the stocks or bonds of the company that set up the plan; the total investment in any one company shall not exceed more than five percent of the company's total worth; and the total investment in any one company shall not exceed more than ten percent of the total assets of the pension fund.[10]

In the 1960's and early 1970's a problem within the pension plans of America came to light. Many people who thought they had vested rights in retirement payments found out differently. Shutdowns, layoffs, and bankruptcies often resulted in the loss of benefits to many employees. In 1963, forty-five hundred employees lost all future interests in pension benefits when the Studebaker was put of production. A television documentary about this dilemma was telecast on NBC in 1972. The program began, "This is a story about ordinary people with the modest hope to finish their working careers with enough money to live in dignity. . . . but it's one that is all too often not realized."[11] In 1973, Ralph Nader, a consumer advocate, predicted that over half of the thirty-four million Americans expecting pension benefits would collect nothing.[12]

---

[10]Ibid., p. 10.

[11]Andrew J. Capelli and S. Thomas Moser, "The Pension Plight: Major Challenges for Financial Accounting and Reporting," Journal of Financial Planning 1 (Fall 1977): 294-95.

[12]Ralph Nader and Kate Blackwell, You and Your Pension (New York: Grossman Publishers, 1973), p. 5.

In 1974, President Ford signed into law the Employee Retirement Income Security Act. This Act was the direct result of the lost pension benefits in the preceding decade. The Act brought to light many areas of confusion and misunderstanding about how to correctly account for pension plan expenses and pension funds. There are as many variations of accounting principles and auditing standards as there are accountants working on pension plans. Accountants naturally form different principles and standards when there are not industry-wide principles and standards due to the fact that they experience different problems with their respective plans. The accounting profession has to develop generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) concurrently without worrying which should theoretically come first.[13] The Financial Accounting Standards Board must approach the difficult issues surrounding pension plans. The Board needs to state its position on pensions clearly and with force. Until the FASB acts on this issue, almost any method of accounting for pensions that a practitioner chooses is compatible with present principles and standards.[14]

---

[13]Gilbert K. Reeves, "Generally Accepted Auditing Standards for Employee Benefit Plans: What Does ERISA Say?" Fund Advisors Institute, Proceedings (White Sulphur Springs, W. Va.: n.p., 1976), p. 13

[14]Sheldon P. Lewis, "Generally Accepted Accounting Principles for Employee Benefit Plans: What the Future May Hold," Fund Advisors Institute, Proceedings (White Sulphur Springs, W.VA.: n.p., 1976), p. 19.

One of the results of the accounting profession's failure to develop GAAP and GAAS regarding pensions is the lack of clear and meaningful financial statements. Workers need this information so they can adequately determine whether their retirement plans have the capability to pay the benefits they are counting on. Many have been taken by surprise when promises failed to materialize.[15] As a result of the great flexibility in accounting for pension costs and the lack of required standards of plan reporting, management of pensions has decreased in quality and time. This results in a greater likelihood that the fund will falter in the future.

For many years, accountants and actuaries have not been able to formulate accounting rules for pensions. The most confusing concept of pension costs is the use of actuarial methods. Comparisons among companies' pension plans is almost impossible because there are many actuarial and accounting methods which are available for use. Even after the arrival of ERISA, the users of the plans financial statements cannot determine the extent of sponsor companies' assets that may have to be used to make up for pension fund deficiencies.

The topic of pension accounting is very complex and confusing due to three reasons. First, the terminology used by accountants and actuaries is not understood by others. Secondly, there are two entities involved, the sponsoring

---

[15]Capelli and Moser, pp. 293-94.

business and the pension fund. Also, there are many actuarial methods of determining sponsor's costs. Each of the methods include some actuarial assumptions such as the interest rate of return on fund investments, the mortality rate, future wages, retirement age, and vesting developments. When combining the uncertainities of the various methods and the range of assumptions used in these methods, analysis of pension costs becomes almost impossible. Trying to pull apart the relationships between the sponsoring company and the pension fund in regards to pension expense, contributions, benefits paid, pension assets, and pension accruals can become very confusing.[16]

The Daniel v. International Brotherhood of Teamsters[17] case brought out the fact that many aspects of a pension plan are not being disclosed properly. In 1955, Daniel learned about the Local's pension fund through the Teamsters Union. After completing twenty years of service with his employer, Daniel was told he would be eligible to receive pension benefits at the age of sixty. In June 1971, and other times thereafter, he received word from the penion fund that he would be entitled to a pension of four hundred dollars per month upon retirement. In 1973, after he had retired, he was told that an involuntary four-month layoff caused the

---

[16]Jack L. Smith, "Needed: Improved Pension Accounting and Reporting," Management Accounting 59 (May 1978):43.

[17]561 F.2d 1223 (7th Cir. 1977).

total forfeiture of his pension.[18]

Daniel filed suit on the grounds that the Union misrepresented material facts by making misleading statements as to the length and continuity requirements of the pension plan's vesting provisions. Daniel was required to show that the Teamsters defrauded him and that his damages were a result of the fraud.

Rule 10b-5 of the Securities Act of 1933 makes it unlawful in a sale of a security to make untrue statements of material fact or to omit a material fact which would make the statements misleading. The 1933 Act defines a security to include an investment contract and a profit sharing agreement. The Circuit Court in the Daniel case decided that a pension plan could be determined to be a security under this definition. The court also found that there was a sale under the 1933 Act. For a sale to occur in this situation, two things are required. First, 'value' must be given. Second, there must be an investment decision by the employees.[19] The court felt that an employee gave value for the pension benefits when he rendered services to the company. As the result of collective bargaining negotiations, an investment decision was made by the employee when the pension plan was approved by the Union.

---

[18]David J. Cartano, "Rule 10b-5 and ERISA After the Daniel Case," Journal of Pension Planning and Compliance 4 (May 1978): 183.

[19]Ibid., pp. 184-85.

Based on the results of the Daniel case, Rule 10b-5 and other antifraud provisions of the federal securities apply to pension plans. The question that was opened in this case is what has to be disclosed to the participants of a plan. By providing some guidelines of what must be disclosed to the participants of a plan, the court made it clear that compliance with the disclosure requirements of ERISA and the Internal Revenue Code does not completely satisfy the disclosure required by the Securities Acts. The Court of Appeals wrote:

> The effect of the opinion (of the District Court) is to require defendants, when offering a defined pension plan to a member, to disclose the actuarial probability . . . that a member actually will receive a pension benefit, and factors such as risk of loss, breaks in service, death before retirement age, and plan termination, that can cause this member to be deprived of his benefits, or otherwise defendants must face fraud liability under the Securities Act.[20]

ERISA requires disclosure in many of these topics such as death before retirement, break in service, and plan termination which will result in the employee losing his retirement benefits. The main areas that are not required to be disclosed in ERISA are the risk that the employee will lose his benefits and the actuarial probability that an employee will receive a retirement benefit.[21]

[20] 561 F.2d 1223 (7th Cir. 1977).

[21] Cartano, p. 188

CHAPTER II

TERMS AND EXPRESSIONS RELATING TO PENSION PLANS

Pension payments have been made to retired employees for over a century. Before a detailed discussion about the current methods of accounting for pension costs can be developed, a knowledge of the terms and expressions relating to this subject is required. Terms such as pension fund, qualified plans, defined benefits and defined contribution plans, contributory plans, vesting, actuarial cost methods, actuarial assumptions, and actuarial gains and losses will be defined and described.

There are two entities involved in accounting for pension costs. The sponsoring company is the entity which sets up the pension plan and actually provides the monies for the retirement payments. Financial statements must be prepared by the sponsoring company and on these statements are located the pension expense of the company and any balance sheet accrual or prepayment. A balance sheet accrual occurs when the company charges a greater expense to income than the amount of cash it contributed to the pension fund. A balance sheet prepayment occurs when more cash is contributed than expense is recognized. The accrual is

CHAPTER II

TERMS AND EXPRESSIONS RELATING TO PENSION PLANS

Pension payments have been made to retired employees for over a century. Before a detailed discussion about the current methods of accounting for pension costs can be developed, a knowledge of the terms and expressions relating to this subject is required. Terms such as pension fund, qualified plans, defined benefits and defined contribution plans, contributory plans, vesting, actuarial cost methods, actuarial assumptions, and actuarial gains and losses will be defined and described.

There are two entities involved in accounting for pension costs. The sponsoring company is the entity which sets up the pension plan and actually provides the monies for the retirement payments. Financial statements must be prepared by the sponsoring company and on these statements are located the pension expense of the company and any balance sheet accrual or prepayment. A balance sheet accrual occurs when the company charges a greater expense to income than the amount of cash it contributed to the pension fund. A balance sheet prepayment occurs when more cash is contributed than expense is recognized. The accrual is accomplished by debiting pension expense and crediting liability for expense not funded and cash.[22]

The second entity involved in accounting for pension costs is the pension fund. Financial statements must also be drawn up for the pension fund. One author has described the pension fund as:

> . . . the entity which receives contributions, accumulates assets, makes benefit payments, and performs other functions in accordance with the provisions of a pension plan. ERISA generally requires that assets of a pension fund be held in trust by one or more trustees or held in the form of insurance policies or contracts.[23]

The fund is administered under a written declaration which sets the responsibilities and duties of the trustee.

A pension plan can be defined as "an arrangement whereby an employer can provide retirement benefits for employees in recognition of their service to the company."[24] A plan is called informal if the payments are made to retired employees on a voluntary basis at the goodwill discretion of the employer. For formal plans, the amount of the retirement benefits and the eligibility requirements are stated in a written document. ERISA has forced many informal plans to become subject to federal regulations. All plans adopted after the passage of ERISA must be maintained by a written document. An employer may establish a pension plan volun-

---

[22]Smith, p. 45.

[23]Pomeranz, Ramsey and Steinberg, p. 7.

[24]Ibid., p. 5

tarily or be negotiating with his employees. In many cases, a plan which has been negotiated with a union is used as a model plan by many employers.

If both the employer and the employees contribute funds to the pension fund, it is called a contributory plan. If only the employer provides the funding, it is designated as non-contributory. A major distinction is made between defined benefit and defined contribution plans because all the attention to accounting for pension costs has been directed toward defined benefit plans. As the term indicates, the benefits of a defined benefit plan are established in the plan instrument. The contributions to the pension fund which are needed to provide for the established retirement payments are determined by actuarial calculations. An actuary uses statistical and financial techniques to compute the value of the future benefits, assign costs to periods, and determine unfunded amounts. Under the defined contribution plans, the level of contributions are set by the plan agreement. The function of the actuary is to use actuarial computations to calculate the level of benefits that can be provided with the given amount of contributions.[25]

All pension plans contain provisions for eligibility requirements and retirement dates. The eligibility requirements of a plan determines when an employee may begin

[25] Ibid., p. 15.

to accumulate pension credits. At retirement, the employees level of pension credits is multiplied times a dollar amount to determine his periodic benefit. Some plans provide for eligibility immediately upon employment. Most plans have a combination of age and period of service, such as twenty-five years old and one year of service. The normal retirement date is the age at which the employee will receive full normal pension benefits. Most plans provide for an early retirement age which will result in less than normal benefits.[26]

The amount of retirement benefits is dependent on the terms of the pension agreement. A flat benefit is one in which all participants receive the same payment if they have served the company for a specified period of time. Examples would be four hundred dollars per month for each year of service. Benefits may also be computed in terms of a prescribed percentage of the employees salary. The percentage may be applied to the career average of the employee, or it may be applied to the employees salary during the last three to five years of employment. Social security benefits are usually correlated with pension benefits. A lower rate is applied to the part of the employees earnings covered by social security.

The duration of retirement benefits may be either for the lifetime of the employee or for a longer period if the

[26]Ibid., p. 8.

plan so provides. When the retirement payments continue for the life of the employee only, it is called straight life. In a period certain and life plan, the participant also receives the benefits for the remainder of his life. However, if the participant dies before the prescribed period has passed the named beneficiary will receive the benefits for the remainder of the period. The third most common type of plan is joint and survivorship. In this plan, the employee elects to have the benefits continued to be paid to a named beneficiary if the participant dies before the beneficiary. This election usually results in reduced benefits.[27]

When the employee entitlement to benefits is not contingent on his continuing in the service of the employer, he is said to be vested. Vested benefits must be paid to the employees at retirement even if they have since left the firm. The employee cannot draw out the money until he retires, borrow against it, or assign or sell his interest. But if he reaches retirement age, the employee is assured of payments even if he quits, is laid off, or stops contributing.[28] An employee is fully vested if the amount of his vested interest is equal to the pension credits he has accumulated. Many plans provide for full vesting after ten years of service. Other plans provide for a percentage of vesting for every year of service. The value of vested benefits is computed as follows: Assume an employee, ten years

[27]Ibid., pp. 9-11.

[28]Drucker, p. 11.

from retirement, will receive forty-eight hundred dollars for an actuarially determined period of twelve years. Using present value tables, the value of the vested benefits is $16,755. $4,800 times 7.54 (the factor for the present value of an annuity of one dollar for twelve periods at an actuarially assumed interest rate of eight percent) equals $36,192. $36,192 times .46 (the factor for the present value of an annuity of one dollar for ten periods at eight percent) equals the vested benefits of $16,755.[29] Once the amount of vested benefits is determined, the employer can determine the extent of unfunded vested benefits.

A plan which conforms with Internal Revenue Service requirements is called a qualified plan. For a plan to qualify it must meet four requirements. The requirements are listed by one author as:

> A plan must not discriminate in favor of employees who are officers or shareholders or are highly compensated;
> Benefits under the plan must be reasonable in amount when considered with other forms of compensation;
> The plan must be permanent;
> Contributions to the fund must be exclusively for the benefit of participants.[30]

A qualified pension plan has distinct tax advantages. The contributions to the pension fund are deductible by the employer. These contributions are not taxable to the employees until the employee receives the benefits at

---

[29]Smith, p. 45.

[30]Pomeranz, Ramsey, and Steinberg, p. 11.

retirement. The investment income that is generated by the pension fund is exempt from taxation. Certain lump-sum retirement payments are taxed at the more favorable capital gains rate.[31]

The total cost of a pension plan can only be accurately determined when all employees have been paid all their benefits. Therefore, pension costs are based on actuarial assumptions involving future interest rates and life expectancy, and actuarial cost methods. The normal cost is the pension expense assigned to the annual service credits generated by the employees during the year. The normal cost is computed as follows using an assumed interest rate of eight percent: If $950,000 is needed in 25 years to pay for the benefits which were earned during the 25 years, $11,614 must be provided each year ($950,000 divided by 73.1, the factor for the amount of an ordinary annuity of one dollar for twenty-five years at eight percent). $11,614 is the normal cost.[32]

In addition to the provision for normal costs, many plans provide a contribution for past service costs. Past service costs are the funding obligation for the claims of employees who were already employed for a period of time before the pension plan started. To be equitable, these employees deserve to be credited, with service credits

---

[31] Ibid., p. 6

[32] Smith, p. 44

for their prior service.[33] Funding of the past service cost is included to foster equity among younger employees and those in the pension group who were employed much longer before the plan was established.[34]

To proivde an example of the determination of past service costs, assume the normal cost needed to accumulate the required pension payments is $6,453 for a period of thirty years. If it has been decided to credit all past employees with five years of pension credits, the past service cost is $37,857 ($6,453 times 5.87, the factor for the amount of an ordinary annuity of one dollar for five years at eight percent). The past service cost is the amount which would have been accumulated if the payments would have been made each of the five years.[35]

Prior service cost is the term used to designate all the costs assigned to prior years at a valuation date subsequent to the inception of the plan. Prior service cost includes past service cost, normal cost to date, and increases in the plan cost which arose due to an amendment to the plan. As was illustrated in the previous examples, the use of present value is the basis of pension cost. Present value allows any value of a future point in time to be expressed in an equivalent value at the present.[36]

---

[34] J. Cramer and Charles A. Neyhart, "Accounting for Pensions: A Contemporary Perspective," The CPA Journal 46 (June 1976): 20.

[35] Smith, p. 44.

[36] Pomeranz, Ramsey, and Steinberg, p. 16-17.

Actuarial cost methods can be classified into two general categories, the accrued benefit cost method and the projected benefit cost method. The projected benefit category is comprised of four distinct cost methods, whereas there is only one variation of the accrued benefit category. These methods are used to determine the cost of the pension plan and are the basis for the advance funding of benefits. Funding "means building up actuarially adequate reserves, based on actuarial assumptions"[37] about the projected interest rates, life expectancy, and level of benefits.

In the past, most plans used terminal funding or pay-as-you-go funding instead of accumulating funds for the payment of benefits. Under the pay-as-you-go method, the employer paid the benefits to the participant when they were due instead of pre-funding. The benefits were only funded at the retirement of the employee under the terminal method.[38]

When estimating the amount that needs to be funded, the actuary must make certain actuarial assumptions about many uncertainities. After making these assumptions, the actuary chooses the actuarial cost method which best allocates the total cost of the plan over the life of the plan in a systematic and rational manner. The cost method can

---

[37]Drucker, p. 11.

[38]Pomeranz, Ramsey, and Steinberg, p. 19.

be compared to the selection of the depreciation method for allocating the cost of depreciable property. As with depreciation, there are many acceptable methods which will expense the same total cost over the same period of time. However, the actuary must select the "method most properly reflecting the matching of expenses to appropriate periods."[39]

The size of the annual pension expense and the amount of the unfunded past service cost depends on the choice of actuarial cost method. Three of the five cost methods have an unfunded past service cost. Under these methods, the pension expense is composed of the normal cost and a provision for the amortization of the past service cost over a period of thirty to forty years. Under the other two methods, past service costs is combined with the normal cost and is amortized over the service life of the employees. Because the service life of an average employee is less than forty years, the pension expense under these methods is higher in the early years and smaller in the later years of the plan.[40]

Under the accrued benefits cost method the cost for the period is equal to the present value of an annuity for each employee that would provide for retirement payments. The amount of the retirement payments provided by the annuity

---

[39]Smith, pp. 44-45.

[40]Patrick J. Regan, "Potential Corporate Liabilities Under ERISA," Financial Analysts Journal 32 (March-April 1976): 27.

must equal the level of pension credits generated in that period. With the advancing age of the employee, the costs for each employee will increase. The increase is a result of the shorter time remaining before the retirement of the employee and the greater likelihood that the employee will survive until retirement. Since there is a shorter time until retirement, the funds in the pension fund will have less time to earn interest.[41]

The accrued benefits cost method follows the idea that the total pension of an employee is divided into units of benefits. Each unit of the pension is related to a year of service that the employee provided. The normal cost of any one year under the accrued benefits method is the provision needed to provide in full for all the units assigned to that year by all the employees. Each employee produces the same number of pension units per year. However, the cost per unit increase each year that the employee draws closer to retirement. Even though the cost per employee increases each year, the total cost of the plan to the employer usually remains the same because of the effect of replacement. When older employees with high pension costs per year retire, they are replaced with younger individuals with lower pension costs.

The past service cost under the accrued benefits method is the amount of funds needed to provide for all the credits

---

[41] Pomeranz, Ramsey, and Steinberg, p. 18.

that have been awarded to the employees at the inception of the plan. The past service cost can be funded in a number of ways. The most common method is to fund the cost with a series of payments over a number of years. Most plans require that the past service cost be funded before the employee retires.[42]

The other major category for the funding of pension costs is the projected benefits cost method. This category uses rates that are level in dollar amounts or a level percentage of earnings. By assigning costs in level amounts over the life of the plan, the projected benefits category avoids increases in the normal cost of each employee as the employee gets older. Therefore the costs assigned by the projected benefits method are higher in the early years of the plan than with the accrued benefits method, and lower in the later years. The projected benefits cost category method is made up of four similar but distinct methods, the entry-age normal cost method, individual level cost method, aggregate method, and the attained-age normal method.

Under the entry-age normal cost method, the level cost is determined by computing the annual cost of the plan at the age of the employee when the employee could have entered the plan if the plan was in existence at that time. The normal cost is equal to the annual amount that is needed to fund the retirement benefits over the entire working life of the employee assuming that the current plan was always in effect.

---

[42] Ibid., pp. 18-19.

When the entry-age normal cost method is used, the past service cost can be defined as the fund that would have been accumulated at the inception of the plan if yearly payments would have been made all during the service life of the employees. At the inception of the plan the past service cost can be determined at the difference between the present value of all the expected payments throughout the life of the plan and the present value of all future normal costs. In later years additional valuations can be made of the amount of unfunded past service costs. The unfunded amount is equal to the present value of all expected payments less the present value of all future normal costs less the funds that have been accumulated to date.[43]

With the individual level cost method, the level annual cost is the amount that is needed to be funded to spread all future pension costs over the remaining future service life of each individual employee. The past service cost is included with the normal cost. The past service cost of each employee is amortized over the remaining service life of the individual. This results in high costs in the early years of the pension plan because the older employees retiring in the early years of the plan have a short time to amortize their past service cost.

The aggregate method is similar to the individual level cost method. Instead of spreading the cost over the service life of each employee, the aggregate method spreads

---

[43]Ibid., pp. 20-21.

the total cost of the pension over the average future service costs being amortized over the average service lives of all employees. Therefore the aggregate method avoids the heavy costs in the early years of the plan.

The fourth method to project the costs of a pension is the attained-age normal method. The normal cost under this method is "the annual amount necessary to fund future service benefits over the period beginning with the age the employee has attained at the date of the plan's inception."[44] The benefits are divided into units which are related to the services of past and future years. Past service costs are made up of all units that are applicable to past years. Costs of service in years after the inception of the plan is spread over future years.

The choice of the funding method affects the timing of pension costs, but the actuarial assumptions determine the total amount of funds that will have to be accumulated to provide the retirement benefits. Actuaries

> have to estimate (a) how many employees will remain with the company until retirement age or leave with vested benefits, (b) what the normal retirement age will be, the benefit formula and the degree to which benefits will be reduced for those who take early retirement, (c) the length of service and income at retirement, (d) the length of time the employee will live beyond retirement, and (e) the expected level of Social Security payments, inflation and other factors.[45]

---

[44] Ibid., p. 22.

[45] Regan, p. 27.

An actuary must make an assumption about the mortality rates of the employees because no benefits are paid if the employee dies before retirement and benefits may stop or be reduced when the employee dies after retirement. If the life span of an average employee increases, the annual contribution made by the sponsoring business must increase because more benefits will be given.

An actuarial assumption must be made about the rates of employee turnover. This assumption is needed because termination by an employee reduces or eliminates benefits which in turn reduces pension costs. When employee turnover is studied, the effects of age, sex, length of employment, and type of work are considered. If the rate of employee turnover increases, the annual cost will decrease.

The number of employees that will retire at various ages must be estimated by the actuary. This assumption is only needed for plans that allow early or late retirement. If an employee retires earlier than normal, the annual cost will be higher because there are less years to accumulate the needed funds. Some plans adjust the benefits downward if an employee retires early to be "equivalent, actuarily, to those at normal age."[46]

The main source of funds to pay benefits to retired employees is the contributions made by the employer. Another large source of monies is the income generated on the invest-

[46] Pomeranz, Ramsey, and Steinberg, p. 24.

ments made with the fund assets. The actuary must make an assumption about the interest rate that the investments will earn. Also, the actuary must estimate the net gains or losses from the sale of fund assets. If the interest earned or the net gains is greater than expected, the annual cost will be less.

Sometimes retirement benefits are keyed to future salary levels, such as the last three years of employment. When this situation occurs, an assumption must be made about the future salary schedules. This assumption is especially important for plans which base benefits on the salaries for the periods immediately before retirement. If the later years salaries are higher than first expected, the annual cost must be adjusted upward.

Actuarial gains or losses occur when the actual event is different that the actuarial assumption made by the actuary at the initial valuation. An actuarial gain arises when the annual contributions turns out to be larger than necessary for the defined level of benefits. A loss arises when the contributions are less than needed for projected benefits. For example, an actuarial gain results when more employees turnover than expected. The amount of benefits payable will be less which results in a lower amount of contributions every year.[47]

Periodic valuations are needed to determine which actuarial assumptions should be changed. In situations where

---

[47] Ibid.

the group is not large enough for averages to work out correctly over a short period of years, the assumptions should not be changed. However, when experience indicates that the assumption is not applicable to the group of employees, the assumption should be changed.

Any occurance which reduces the present value of the contributions more than was expected in the actuarial assumption is an actuarial gain. A gain arises if any of the following are greater than expected: (1) reduction in the present value of benefits, (2) reduction in the present value of expenses, or (3) increase in the funds on hand. Some examples that would be actuarial gains are: the investment income is greater than expected, the mortality rate is lower, and the interest rate is higher. Any change that are caused by circumstances outside the plan, such as a change in the benefit formula, are not treated as actuarial gains or losses.

At most valuation dates, actuaries determine the actuarial gain or loss on an overall basis for all the assumptions. Occasionally it is necessary to compute the individual gains and losses for each assumption so that adjustments to the assumptions can be made.

There are three methods to apply the actuarial gains or losses to the cost of the pension plan. Under the immediate method, the gain is subtracted (or loss is added) to the following year's normal cost. When there is a large loss, the loss may be added to the past service cost. The immediate method is used for the accrued benefit cost method.[48]

The averaging method takes the average of the actuarial gains and losses that are expected in the future years and applies this average to normal cost each year. Under this method the amount that is applied to normal cost is the same every year.

The spread method also applies the gains or losses over future years. This method is used primarily for the projected benefit cost methods. The amount of the gain or loss from each individual year which is applied to normal cost may fluctuate from year to year. Usually the future period to which the gain or loss is spread is the same period over which the unfunded past service cost is being amortized. In some situations some of the gain or loss may be applied to past service cost.

The fund assets must be valued before the pension plan's costs and actuarial gains and losses can be calculated. Valuation is also needed to determine the extent that the past service cost and the vested benefits are overfunded or underfunded. Until APB No. 8 ruled that investments can not be valued at cost, most portfolios were valued in this manner. By valuing at cost, all unrealized gains or losses were not used in the calculations until the investments were sold. The easiest method to value investments is to use market price. However, short-term fluctuations make this option undersirable. Other various methods smooth out

---

[48] Ibid., p. 27.

the short-term effects or market valuation.[49]

---

[49] Ibid., pp. 28-29.

CHAPTER III

BACKGROUND OF METHODS OF ACCOUNTING FOR PENSION PLANS

The accounting for the first pension plans was handled on a pay-as-you-go basis. This basis was justified for informal plans because the retirement payments were sporadic and based on the whims of the employer. Usually there were no long range committments with the informal plans. Employers which offered more formal plans justified the pay-as-you-go method because the plans were voluntary on the employer's part, and it could be terminated at any time. Also, the employers contended that there was too much variation in the ways to compute actuarial liabilities to make the computations meaningful. After the conclusion of World War II, concern about the pay-as-you-go method was expressed. With higher pension benefits, the charges to income grew greatly. Concern was expressed that income was being charged as the sporadic payments were being made rather than on a more systematic basis when the employees performed services.[50]

When pension plans were made more formal, there was a need to determine the amount of contributions required to

---

[50]Hall and Landsittel, p. 7.

fund the plan. This led to the concept of past service costs as part of the funding contribution. Accountants next asked how to fund for past service costs. Two options were available. Should the contribution for past service cost be charged to income in the current period or should it be charged to retained earnings. Contributions for normal cost were charged to the income statement.[51]

In response to these questions, some companies created a surplus for pension costs by debiting retained earnings at the inception of the plan. When payments were made, they charged the surplus account instead of charging current income. They rationalized this process by saying that pension costs are not operating costs. Instead they contended that pension costs were distributions of income. At that time only operating items were taken directly to the income statement, and all other items were adjusted from retained earnings.

Three other variations were used. Some corporations created the reserve at the inception of the plan for only the past service cost and not for the entire future cost of the plan. These corporations charged the reserve to retained earnings. Other corporations charged the past service cost to income in the year of inception of the plan instead of to retained earnings. The third variation involved the recording of an accrued liability for past service cost. An offsetting debit to a deferred charge was also made and the deferred

[51]Pomeranz, Ramsey, and Steinberg, p. 84.

charge was charged to income in succeeding years.[52]

In November 1948, the Committee on Accounting Procedure issued Accounting Research Bulletin (ARB) No. 36, which was the first official pronouncement on accounting for pension plans by the accounting profession. The Committee said that the past service costs are based on past services, but these costs "are incurred in contemplation of present and future services, not necessarily of the individual affected but of the organization as a whole."[53] The opinion stated that the cost of the plan based on past services should be allocated to the future. The Committee said that past service costs should not be charged to retained earnings. The opinion neither established the position that past service costs must be recognized, nor suggested a method to reflect pension costs in the income statement.[54]

In the decade after the issuance of ARB No. 36, many businesses continued to use the cash basis for recording pension costs. The companies kept charging income when they paid the employees or the pension fund. As years passed it became evident that the companies which adopted pension plans incurred a huge ongoing obligation to their employees,

---

[52] Hall and Landsittel, p. 8.

[53] American Institute of Certified Public Accountants, "Accounting for the Cost of Pension Plans," <u>APB Opinion No. 8</u> (New York, 1966), par. 23.

[54] Pomeranz, Ramsey, and Steinberg, p. 84.

even if it was not a legally enforceable one.[55]

The Committee on Accounting Procedure issued its second pronouncement on pension plans when it issued ARB No. 47[56] in September 1956. The Committee stated that variations in pension plans resulted in large differences in the methods of accounting for pension costs. The Committee wanted businesses to accrue the full cost of the plan over the remaining service lives of the employees covered by the plan, using actuarial calculations. The Committee held the position that the accrual of pension costs should not be dependent on the method that the plan is funded nor on the legal obligations of the employer. Instead, the costs should be based on current and future services of the employees. These costs should be charged to income systematically during the active service life of the employees. The Committee also wanted past service costs to be charged off over a reasonable period on a systematic and rational basis which will not distort the income statement.[57]

Even though the Committee wanted strict standards it backed off when the final draft of the pronouncement was made. It required only the accrual of the amount of pension rights that have been vested in the employees. The Committee insisted that the vested rights should not just be measured

---

[56]American Institute of Certified Public Accountants, "Accounting for the Cost of Pension Plans," <u>ARB No. 47</u> (New York, 1956).

[57]Ibid.

on their legal basis. The opinion stated that past service cost should be charged to income in a rational manner so as to not distort the income statement.[58]

Because the Committee backed off, the opposite effect than what the Committee wanted occurred. Accounting for pension costs still varied greatly after the opinion was passed. Some companies that had previously made large accruals for pension costs drastically reduced or eliminated their accruals. The companies justified this action because previous funding provided enough funds to handle current pension payments and vested rights that were required by the opinion. Another problem with ARB No. 47 is that it did not require disclosure of the amount of pension costs charged to income or the method used.

In 1965 the Accounting Principles Board (APB) authorized a research study on the problems of accounting for pension plans. The study resulted in the Accounting Research Study No. 8.[59] This study recognized that the employer had a large pension obligation to his employees. The Study said the discretionary and inconsistent treatment of actuarial gains and losses was not acceptable. Also, it re-established the position that the provision for pension costs is not dependent on the way the plan is funded.

The Accounting Principles Board issued APB No. 8

---

[58]Ibid.

[59]Ernest L. Hicks, "Accounting for the Cost of Pension Plans," Accounting Research Study No. 8 (New York: American Institute of Certified Public Accountants, Inc., 1965).

"Accounting for the Cost of Pension Plans" in 1966. The purpose of the opinion was to eliminate the wide fluctuations in the amount of the annual provision for pension costs. APB No. 8's conclusions agreed in most respects with the Accounting Research Study of the previous year. The opinion was successful in narrowing the acceptable alternatives available for accounting for pension costs.[60]

The Opinion required that

> . . . the provision for pension costs should be based on an actuarial cost method that gives effect, in a consistent manner, to pension benefits, pension fund earnings, investment gains or losses (including unrealized gains and losses), and other assumptions regarding future events. The method selected should result in a systematic and rational allocation of the total cost of pensions among the employee's years of active service.[61]

If the pension plan uses a method which combines past service cost and normal cost, the provision for pension costs should be normal cost plus an adjustment due to unfunded vested benefits. The adjustment should be equal to the possible earnings that would result if the past service cost and vested benefits were completely funded. For plans that use a method which accounts for past service cost separately from normal cost, the provision is equal to the normal cost plus an amount for past service costs,

---

[60]Vincent C. Hennessy, "Accounting for Pension Liabilities Created by ERISA," Journal of Accounting, Auditing & Finance 1 (January-March 1978): 319.

[61]American Institute of Certified Public Accountants, "Accounting for the Cost of Pension Plans," APB Opinion No. 8 (New York, 1966), par. 23.

and an adjustment for the effect on pension fund earnings of differences between amounts accrued and amounts funded.

APB Opinion No. 8 further stated that the provision for pension cost should not be influenced by the amount that is contributed to the fund, the legal liability the fund has to the employees, or wide fluctuations in gains or losses on fund investments. The Opinion closed the span of alternatives in which the provision may be set. The minimum that could be expensed was increased to include a provision for vested benefits. Actuarial gains and losses are not allowed to exert undue influence on the annual provision if they result from short-term market fluctuations. APB No. 8 required the actuarial gains and losses to be included in the annual cost using a long-range method. The pay-as-you-go method and terminal funding methods of accounting for the cost of pensions were eliminated as acceptable methods. All employees who could be expected to receive retirement benefits should be included in the calculations used to compute the cost of the plan. The Opinion also required that any change in method of accounting for a plan should not be handled retroactively.[62]

Opinion No. 8 provided a minimum and maximum provision for pension costs. The maximum provision established by the Board is the sum of 1) normal cost, 2) ten percent of past service cost, 3) ten percent of prior service costs which arise from amendments to the plan and 4) interest equivalents

---

[62]Ibid., par. 47.

on the difference between the amount which has been previously expensed and the amount which has been funded. The ten percent is applied to the past service cost at the inception of the plan and the prior service cost at the adoption of the amendment, not to a declining balance. The ten percent also includes an interest factor. Therefore, it will take at least a minimum of thirteen years to fully amortize the past service and prior service costs.[63]

The annual provision for pension cost can not be less than the sum of 1) normal cost, 2) interest on unfunded prior service cost and 3) a provision for vested benefits, if needed. The provision for vested benefits is only required when the unfunded vested benefits at the end of the year is not at least five percent less than the comparable amount at the beginning of the year. When the provision for vested benefits is required, the provision may be satisfied in two ways. First, the provision may be fulfilled by providing the amount necessary to reduce the unfunded vested benefits at the end of the year to five percent less than what it was at the beginning of the year. The provision can also be satisfied by funding an amount necessary to make the total annual provision equal to the sum of 1) normal cost, 2) interest on prior service cost and 3) amortization of prior service cost over forty years.[64]

---

[63] Ibid., par. 17.

[64] Ibid.

A closer look at the third item in both the minimum provision requirements and the second alternative for the vested benefits provision shows us that the provision for vested benefits can be satisfied by amortizing the prior service cost over forty years. This is how many authors came to believe that the maximum time to amortize prior service cost was forty years. However, if the unfunded vested benefits is decreased without funding prior service cost, the time needed to amortize prior service cost can exceed forty years.

In the first alternative for providing for vested benefits, the five percent is applied to the declining balance of the unfunded vested benefits at the beginning of the year. Forty-five years are needed to amortize ninety percent of the unfunded vested benefits under this method if no other reductions were made. A company has three choices in the procedure it wants to use for the provision for vested benefits. The company may always use the first one above, called the interest plus vesting method, or the second one called the forty year amortization method. The company can also use the lower of the two methods computed on an annual basis.

The vested benefits of employees must be periodically valued. This determination is needed to determine the annual pension expense. Also, the amount of unfunded vested benefits must be disclosed. Vested benefits include the benefits which are payable to all retired and terminated employees who have vested credits, and the benefits which would accrue to present employees if they were to terminate employment as of the valuation date. The Opinion states that the accrued benefits cost (unit credit) method should be used to value vested benefits no matter what method is used for other purposes.[65]

APB Opinion No. 8 narrowed considerably the options when selecting an actuarial cost method. The pay-as-you-go and terminal funding methods were declared unacceptable because they do not recognize any cost to the employer until the employee retires. The Board did allow the pay-as-you-go method only if there was no material difference in the annual pension cost if the pay-as-you-go method was used instead of an actuarial cost method. The Board then spelled out a specific example. The pay-as-you-go method can be used for employees who are retired at the date the Opinion went into effect.[66]

When computing the minimum provision for pension costs, interest on prior service cost must be computed. One component of the maximum provision is interest equivalents on the difference between provisions expensed and amounts funded. To determine the interest on these unfunded amounts, an appropriate rate must be used. An acceptable rate that may be used is the rate used by funded pension plans of other

---

[65]Ibid., par. 23.

[66]Ibid., par. 24.

companies. Also, the plan may use the borrowing rate of the business. However, the "use of an assumed rate of return on the employment of additional capital would generally not be appropriate."[67]

The Opinion said that actuarial assumptions should be reasonable and applied consistently. The assumptions should be based on current conditions. Because there is a need to make the actuarial assumptions about future events, actuarial gains and losses result. The Board said that these gains and losses should not be handled in the short run. Rather, the adjustments required by the development of actuarial gains and loses should reflect the long-range nature of pension plans. Therefore, the APB disallowed the immediate recognition of actuarial gains and losses and suggested that they spread or averaged over ten to twenty years.[68]

When the actuarial gain or loss is averaged, the average annual amount of actuarial gains and losses is computed for the past five to ten years. This average is then added or subtracted to the normal cost each year. The averaging method is suitable for gains or losses which are repetitive. It should not be used for a large, rare gain or loss.

The actuarial gain or loss in a certain year may be

---

[67]Pomeranz, Ramsey, and Steinberg, p. 93

[68]<u>APB Opinion No. 8</u>, par. 30.

spread over the next ten to twenty years.[69] A cumulative effect can result when the spread method is used when the gains or losses are repetitive. For example, a gain of one thousand dollars a year for each of ten years which is being spread over twenty years will result in a reduction to normal cost of fifty dollars in year one, one hundred dollars in year two, one hundred fifty dollars in year three, and so on.[70] For best results, a combination of the average and spread methods should be used. Recurring items should be averaged.

The Board allowed one exception to the ban on immediate recognition of actuarial gains and losses. They said that a gain or loss which is due from a non-plan incident, such as a plant closing or an acquisition or a subsidiary, should be recognized immediately. The Board also suggested another method to handle actuarial gains and losses.

> APB Opinion No. 8 recognized that 'an effect similar to spreading or averaging may be obtained by applying net actuarial gains as a reduction of prior service cost in a manner that reduces the annual amount equivalent to interest on, or the annual amount of amortization of, such prior service cost and does not reduce the period of amortization.' For example, the application of one hundred thousand dollar gain to prior service cost would, assuming a four percent rate, reduce the 'interest' charge by four thousand dollars annually.[71]

APB Opinion No. 8 allows the investments in the pension fund to be valued at cost or market. If they are valued at market, the unrealized appreciation or depreciation of the investments are recognized as an actuarial gain or loss

---

[69] Hall and Landsittel, p. 155.

[70] Pomeranz, Ramsey, and Steinberg, p. 94.

[71] Ibid.

and are handled in that manner. When the investments are valued at cost, the unrealized appreciation or depreciation are not part of actuarial gains or losses. According to the Opinion, the unrealized changes in the investment must be recognized in the determination of the pension cost on a rational and systematic basis. The recognition is only required for equity investments, not for debt securities which are expected to be held to maturity.[72]

APB No. 8 requires the following specific disclosures in the financial statements or notes:

1. A statement that such plans exist, identifying or describing the employee groups covered.
2. A statement of the company's accounting and funding policies.
3. The provision for pension cost for the period.
4. The excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance-sheet pension accruals, less any pension prepayments or deferred charges.
5. Nature and effect of significant matter affecting comparability for all periods presented, such as changes in accounting methods (actuarial cost method, amortization of past and prior service cost, treatment of actuarial gains and losses, etc.), changes in circumstances (actuarial assumptions, etc.), or adoption or amendment of a plan.[73]

Some companies have more than one pension plan. Current law prohibits using assets of one plan to pay benefits required under another plan. Therefore, if one plan is underfunded, and the other is overfunded, the amounts cannot be netted. Since disclosure of the amount

---

[72]Hall and Landsittel, p. 156.

[73]APB Opinion No. 8, par. 46.

of unfunded vested benefits, the unfunded amount in the underfunded plan has to be disclosed. The same requirement holds true for underfunded past service cost. No disclosure is required, but one is desirable, if the fund assets plus balance sheet accruals less prepayments and deferred charges exceeds vested benefits.[74]

---

[74]Pomeranz, Ramsey, and Steinberg, p. 97.

CHAPTER IV

GOVERNMENT INVOLVEMENT IN PENSION PLANS

President Gerald Ford signed the Employee Retirement Income Security Act, also known as the Pension Reform Act, into law on Labor Day, 1974. ERISA changed pension claims on retired workers from gracious offerings from employers to corporate liabilities which can be enforced in the courts. Previously the legal claim of pension plan participants was limited to the pension fund assets. Now, under ERISA, the retired employees have claim to up to thirty percent of the sponsoring company's net assets. If a plan is terminated, such claims have "the status of a federal tax lien and thus rank before the claims of other corporate creditors."[75]

The Act completely changed the private pension plan system in the United States. ERISA affected

> . . . virtually every private retirement plan. It mandated minimum standards of employee participation, funding, and vesting. It provided for expanded reporting and prescribed stiff penalties for both employers and fiduciaries failing to live up to the new rules. Must unfunded 'pay-as-you-go' arrangements were abolished. The Pension Benefit Guaranty Corporation was set up under the Act to administer an insurance program guaranteeing certain pension benefits to some thirty-three million participants in private defined benefit plans.[76]

---

[75]Regan, p. 45.

[76]Capelli and Moser, p. 295.

ERISA was designed to assure that pension plans are operated and funded so that employees will be sure to receive their benefits. The Act does not require that an employer maintain a pension plan. It only specifies uniform federal standards for plans already established.[77]

ERISA repealed the Welfare and Pension Plans Disclosure Act of 1958. The effective dates of the various provisions of ERISA range from July 1, 1974 to June 30, 1984. The Act also amended the related sections of the Internal Revenue Code. All plans which have been established by interstate businesses are covered by the Act except government and church plans.[78]

A pension plan must allow an employee to become eligible to participate in the plan at no later than twenty-five years of age and one year of service. The plan may withhold eligibility until the employee is twenty-five and has served for three years if the employee is fully vested at that time. Also, the employee can be excluded from the plan if he starts work within five years of normal retirement.[79]

When an employee is vested, he has the right to receive benefits when he retires. If the employee contributes funds to a pension plan, he always has the right to receive all of the benefits which have derived from the contributions.

---

[77]Cramer and Neyhart, p. 22.

[78]Pomeranz, Ramsey, and Steinberg, p. 39.

[79]Cramer and Neyhart, p. 22.

ERISA has provided three standards which set minimum timetables in which employees must have vested rights in employers contributions. The three alternatives are:

> 15-year Full Vesting. Under this standard the employee must be at least twenty-five percent vested after five years of service, must receive an additional five percent vesting for each of the next five years, and an additional ten percent for each of the following five years. Full vesting must be achieved after a maximum of fifteen years.
>
> Ten-year Vesting. An employee must be one hundred percent vested after ten years of service.
>
> Rule of 45. An employee is entitled to at least fifty percent vesting when the sum of his years of service and age totals forty-five. Vesting will increase ten percent for each of the following five years. Full vesting must be assured after fifteen years of employement regardless of age.[80]

The Ten-year Vesting alternative is the most widely used vesting standard because no vesting is required until the employee has been of service for ten years. When an employee is at least fifty-percent vested, the removal of the employee's contributions will not result in the forfeiture of the benefits that have been earned through employer contributions. Of the three alternatives, an employer must select one. Under all three alternatives, an employee must be fully vested after not more than fifteen years. Also, benefits must be partially vested within ten years.[81] Because of the additional vesting requirements, the level of pension costs and employer contributions has increased.

---

[80] Martin J. Schwimmer and Edward Malca, Pension and Institutional Portfolio Management (New York: Praeger Publishers, 1976), pp. 21-23.

[81] Cramer and Neyhart, p. 22

For the purpose of determining when an employee is eligible for vesting, rules for determining what constitutes a year of service are required. Pension funds usually establish a minimum number of hours an employee must work in a twelve month period to allow credit for a year's service. The specified hours usually range from one thousand to twelve hundred hours.[82] To assist in determining employee's vesting levels, the employer must keep records of the employee's years of service and vesting percentage. Additional records are needed to determine the employee's benefits such as age, hours worked, salary, and employee contributions. The employer may be assessed a penalty of ten dollars per employee for not keeping these records.[83]

Under the Welfare and Pension Plans Disclosure Act of 1958, contributions to pension plans were only required to include normal cost and interest on unfunded past service cost. This level of contributions kept the unfunded past service cost from increasing, but it did not reduce the liability.[84]

Employers are required to make contributions equal to the sum of the normal cost, interest on unfunded prior service cost, and a portion of the unfunded prior service cost. Normal cost includes adjustments for actuarial gains and

---

[82] Charles B. Jackson, "Trust Fund Accounting for Multi-Employer Trust Funds," Management Accounting 60 (October 1978): 50.

[83] Pomeranz, Ramsey, and Steinberg, p. 45.

[84] Schwimmer and Malca, p. 18

and losses.[85] Prior service cost includes both past service costs and costs which arise due to amendments to the plan. The contributions to the pension fund should be determined by a recognized actuarial cost method, in amounts that will be sufficient over time to pay all pension benefits.[86]

The funding level must be determined by using the following requirements. The value of the plan's assets shall be determined on the basis of any reasonable actuarial method which takes into account fair market value. However, bonds and other debt securities may be valued at their amortized cost. Normal cost, past and prior service cost, and actuarial gains and losses shall be determined under the same actuarial method used to determine costs under the pension plan. Other specifications involving funding include:

> All costs, liabilities, rates of interest, and other factors under the plan shall be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which in combination, offer the actuary's best estimate of anticipated experience under the plan; and if the funding method for a plan is changed, the new method (or plan year) can be used only if the change is approved by the Secretary of the Treasury.[87]

Unfunded past service cost must be completely funded in equal annual installments over various periods. All plans in existence on July 1, 1974 must be amortized over a period not to exceed forty years. The amortization period

---

[85]Cramer and Neyhart, p. 22.

[86]Hennessy, p. 320.

[87]Pomeranz, Ramsey, and Steinberg, p. 46.

shall not exceed thirty years for single-employer plans adopted after July 1, 1974; whereas, multi-employer plans may use up to forty years. When unfunded prior service costs increase due to an amendment in the plan, the same amortization periods are used as for past service costs. If unfunded prior service costs decrease due to an amendment in the plan, "the amount of the decrease is amortized over the same number of years to reduce the amount otherwise required to be funded."[88]

Actuarial losses must be funded over a period not to exceed fifteen years by single-employer plans and twenty years by multi-employer plans. Actuarial gains are amortized over the same number of years to reduce the amount required to be funded. ERISA requires all companies with pension plans to reassess their actuarial assumptions every three years by studying actual experiences. When the plan's actual results differ significantly from the actuarial assumptions, the plan must adjust the assumptions to more closely correlate to actual experience. If actuarial assumptions are changed, losses due to the change must be funded over a period of no more than thirty years. Resulting gains must be amortized to reduce the amount otherwise required to be funded.[89]

A Funding Standard Account must be maintained by a pension plan for the purpose of determining whether the plan is

---

[88] Ibid., p. 47.

[89] Schwimmer and Malca, p. 18.

fulfilling the minimum funding requirements. Charges (debits) to the Funding Standard Account are due for the normal cost, amortization of unfunded past service costs, amortization of prior service cost which arise due to amendments to the plan, and actuarial losses. Credits to the Account are for employer contributions, amortization or plan cost decreases resulting from plan amendments, actuarial gains, and gains resulting from a change in an actuarial assumption.[90]

The deductible contribution for tax purposes is limited to a maximum of normal cost plus the amount required to amortize the past service cost over a period of not less than ten years. When the past service cost is amortized over ten years, twelve to fourteen percent of the cost is amortized each year depending upon the level of the assumed interest rate which can be maintained by fund investments. If the minimum funding rules require a larger amount to be funded that the maximum rules allow, the minimum amount will be allowed to be deducted.

Limits on benefits were instituted in the law to discourage pension plans from giving high salaried employees and officers higher than needed pensions. Pomeranz interpreted the limitations set by ERISA to vary according to the type of plan. For defined benefits plans, the maximum which an employee may receive in retirement benefits generated from employer contributions is the greater of a) seventy-five thousand dollars per year, or b) one hundred percent of the

---

[90]Pomeranz, Ramsey, and Steinberg, p. 52.

employee's average yearly salary during the highest paid three years. The seventy-five thousand dollar limit will be adjusted upward for the effects of inflation. It is not reduced to allow for early retirement.[91]

For defined contribution plans, ERISA says that an employee may be credited with no more than the lesser of twenty-five percent of compensation or twenty-five thousand dollars per year. The twenty-five dollar floor is allowed to increase for cost of living increases.

If a pension plan provides retirement benefits to employees in the form of annuities, ERISA requires these plans to offer joint and survivor annuities to married employees. The survivor annuity must be at least equivalent to one-half the employee's annuity. The employee may elect to receive something other than a joint and survivor annuity. Without exercising the option, all married employees will receive a joint and survivor annuity. The employee must be granted reasonable time to exercise this option. If the employee dies within two years of the election, the election is void. An accidental death will not absolve the election. So as not to increase the cost of the plan, the joint and survivor annuity should be actuarially equivalent to the employee's accrued benefits.[92]

To protect employees and retirees in case the plan terminates without sufficient funds to pay benefits, ERISA

---

[91]Ibid., pp. 55-56.

[92]Ibid., pp. 56,58.

created the Pension Benefit Guaranty Corporation (PBGC) within the Department of Labor. This federal corporation guarantees the basic benefits of all participants who have vested rights under a pension plan.[93] All plans must pay termination insurance premiums to the PBGC. Premiums were initially set at fifty cents per employee for multi-employer plans, and one dollar per employee for single-employer plans. The rates will be adjusted in later years as necessary to carry out the duties of the PBGC.

The PBGC guarantees the vested benefits of employees when a plan is terminated. The guarantee is limited to the lesser of a) seventy-five hundred dollars per month or b) one hundred percent of the average wage paid to the employee during his highest five years of employment. Since most plans compute the benefits on the highest three years of employment, the guarantee does not usually cover the retirees full benefit.

When a plan terminates, monies that have been funded will be used to provide some benefits. However, most plans have unfunded benefits which are payable to employees. ERISA has empowered the PBGC with the authority to hold the employer liable for payments of unfunded benefits to employees to a maximum of thirty percent of the company's net worth.[94] In other words, the PBGC can obtain a lien against the employer's assets for the excess of any present value of guaranteed

---

[93]Hennessy, p. 320.

[94]Schwimmer and Malca, p. 26.

benefits over plan assets.[95] The property lien has the status of a federal tax lien. Therefore it has priority over the claims of all but secured creditors.

With the power of the PBGC to enforce a tax lien, unfunded pension liabilities can now be a debit item on corporate balance sheets. If the unfunded amount is large enough, it may impair the corporation's ability to raise needed capital. Corporations may insure this contingent liability with the PBGC or through private insurance companies. Thus far, private companies have been hesitant to insure these costs.[96]

The design of ERISA is to relieve the employee of the risk of the plan, and put it on the employer. If the employer can not pay the benefits through the pension fund, the PBGC will step in to pay the benefits and charge the corporation for the difference between the guaranteed benefits and the fund assets. The lien that the PBGC can levy on the employer cannot exceed thirty percent of the net worth of the corporation. The PBGC can define net worth and will use a definition which reflects market value rather than book value. Therefore, the PBGC stands no risk unless the corporate net worth is less than three and one third times the unfunded benefits. The PBGC will use the market value of the company's stock as an indicator when there is a risk of

---

[95]Hennessy, pp. 320-321.

[96]Pomeranz, Ramsey, and Steinberg, p. 60.

loss. Therefore, ERISA now "imposes on the employer an obligation to pay at some point in time any unfunded guaranteed benefits."[97]

A plan must have a named fiduciary and the fiduciary must be bonded. A fiduciary can be defined as:

> any person, regardless of title (including outside independent certified public accountants, actuaries, registered investment advisors and consultants), who exercises discretionary authority or control over management or disposition of a pension plan's assets, who renders investment advice for compensation with respect to property of a pension plan, or who has discretionary authority or discretionary responsibility in administration of an employee benefit plan.[98]

The following duties and restrictions have been placed upon pension fund fiduciaries. He must manage assets solely in the interest of participants and beneficiaries. A fiduciary must act with the care of a prudent man in similar circumstances. Investments must be diversified to minimize the risk of large losses, and no more than ten percent of the plan assets may be invested in the stock, marketable securities, and real estate of the employer.[99]

Fiduciaries are prohibited from engaging the plan in certain transactions with a party of interest, which includes fiduciaries, administrators, employers, officers, unions trustees, counsel, and employees. Relatives of one of the above, such as a spouse, ancestor, or lineal descendant, are also excluded. Transactions prohibited by fiduciaries

---

[97]Hennessy, pp. 320-322.

[98]Schwimmer and Malca, p. 22.

[99]Pomeranz, Ramsey, and Steinberg, p. 61.

when involving a party of are a) an exchange, sale, or lease or property, b) an extention of credit, c) the furnishing of facilities, services, or goods, and d) a transfer of plan assets to the party of interest for the benefit or use of the party of interest.[100]

ERISA has given the Department of Labor and the Internal Revenue Service many methods to enforce its requirements. These methods include criminal and civil penalties, and direct methods to remedy injured employees. The Department of Labor watches over the rights of the employees. The IRS is responsible for seeing that funding, vesting and other requirements are being met. The Act also requires that all plans file an annual registration statement with the Secretary of the Treasury. The statement must contain the names of all terminated employees who are entitled to vested benefits. This information is passed along to the Department of Health, Education, and Welfare (HEW). When an individual is eligible for social security benefits, HEW informs the retiree of their rights to pension benefits.[101]

The amount of reporting and disclosure requirements established by ERISA is staggering. Changes have been started by the IRS, Department of Labor, and the PBGC to simplify procedures. The annual report Form 5500 series has been jointly issued by the IRS, Department of Labor, and the PBGC. A single filing with the IRS is due seven months after

---

[100] Charles A. Moran, "Let's Streamline ERISA's Regulatory Provisions," Pension World 14 (September 1978): 15.

[101] Pomeranz, Ramsey, and Steinberg, pp. 64-65.

the plan's year end. The IRS will process the returns and provide information to the Department of Labor, PBGC, and the Social Security Administration. Simplification of these procedures are in "response to the wave of pension plan terminations occuring since the passage of ERISA, particularly of smaller pension plans."[102]

ERISA requires the administrator of a pension plan to engage an independent qualified public accountant, not necessarily a certified one, to perform an audit of the financial statements of the plan. Reeves summarizes the duties of the accountant as follows. He:

> . . . shall conduct such an examination of any financial statements of the plan . . . to enable the accountant to form an opinion as to whether the financial statements . . . are presented fairly in conformity with generally accepted accounting principles applied on a basis consisent with that of the preceding year. Such examination shall be conducted in accordance with generally accepted auditing standards, and shall involve such tests of the books and records of the plan as are considered necessary by the independent qualified public accountant.[103]

The accountant is also required to include in his opinion as to whether the separate schedules present fairly the information they contain when considered with the financial statements.

An accountant may use the work of outside professionals if he indicates that he is using other professionals. When referring to actuaries, the accountant must indicate the

---

[102]Marilyn Schwarz, "ERISA Today: An Updated Checklist on Reporting and Disclosure Requirements of a Fast-changing Law," Management Focus (July-August 1978): 46, 49.

[103]Reeves, pp. 14-16.

degree of reliance he is placing on the professional's work.

All of the effects of ERISA are not known yet. However, some of the results have been predicted. The cost to provide benefits to employees will increase for sponsoring corporations. Many pension plans will be terminated. There will be a trend toward more conservative methods of investing in securities and away from innovative methods. More fund assets will be invested into fixed income securities instead of equity securities.[104]

---

[104]Schwimmer and Malca, p. 27.

CHAPTER V

PROBLEMS, ISSUES, AND PROPOSED CHANGES

When the Accounting Principles Board issued Opinion No. 8 in 1977, a compromise was made between the accounting and actuarial professions. Opinion No. 8's provisions and objectives were in tune with the accounting environment when it was issued. The Opinion was a step in the right direction, but it has outlived its usefulness. Most pension plans in 1977 contained provisions which specified that the employer could not be forced to make contributions to the pension fund. Also, beneficiaries' claims could not be paid in excess of the assets which were available in the pension fund.[105]

As compared to plans in existence in 1966, pension plans now cover many more employees. This is one reason why the annual cost has increased dramatically. Due to these facts, accounting for pension plans needs to be revised. Because of double-digit inflation, many plans have been amended to raise the level of benefits. In 1966 when APB Opinion No. 8 was issued, less than ten percent of pre-tax profits went to pensions. In 1978, twenty-four percent of pre-tax profits was funneled into the pension system. By

---

[105]Hennessy, p. 319.

1983, many accountants feel that U.S. companies will be contributing over thirty percent of their pre-tax profits into pension funds.[106] A second reason for the increase in the cost of pension plans is that fund investments have not earned as high of a return as predicted. Besides raising the annual cost of the pensions, these two factors have also increased the amount of unfunded past service cost and unfunded vested benefits.

The Financial Accounting Standards Board is presently studying the problems surrounding pension accounting. Some of the questions that accountants and authors believe the FASB should answer include the following:

Should the employer entity or the pension fund entity be responsible for accounting and reporting?

What are the financial statement objectives of accounting and reporting for pension plans?

Should the cash, modified-cash, or accrual basis of accounting be used to prepare the financial statements of pension plans?

Should the sponsoring business record a liability for unfunded past service cost, unfunded vested benefits, the amount payable in the event of a plan termination, or no liability at all?

Should the number of acceptable alternative actuarial cost methods be reduced?

---

[106] Hall and Landsittel, pp. 31-32.

Should the number and flexibility in application of actuarial assumptions be reduced?

What measurement basis should be used to value the assets of the pension fund? Should the same basis be used to determine the annual provision for pension costs and for the disclosure of unfunded amounts?

How should the realized and unrealized gains and losses of the fund investments be treated?

Should the various spreading and leveling techniques be continued?

What disclosures should be made in the financial statements of the sponsor?

May the auditor rely on the work of other professionals when expressing an opinion on the fairness of presentation of the financial statements of pension plans?

Does the auditor have to expand the scope of his audit work due to the requirements of ERISA?

The federal government must answer some pressing questions about defiencies in ERISA. Will a new law close the nagging loop-holes involving the stripping of benefits from vested participants because of disloyalty charges? Will the major cause of plan terminations, that of excessive paperwork and red tape, be corrected?

Since the passage of ERISA in 1974, accountants have been calling for a revision of the methods of accounting and reporting for pension plans. Some advocates recommend that previously unrecorded liabilities be included on the balance sheet. Because of the requirements of ERISA, most accountants are speaking out for additional disclosures. On April 14, 1977 the FASB issued an exposure draft on accounting and reporting by defined benefit pension plans. The draft was withdrawn after a multitude of negative responses. The FASB plans to issue the draft again in the near future.[107]

Accounting for the costs of pension plans is complicated by the existence of two entities, the pension plan sponsor and the pension fund. Which of these two entities should be the reporting and accounting entity has been debated since the issuance of APB No. 8. Many accountants have taken the easy way out by considering the trust as the accounting entity. Thus, they have been able to ignore the liabilities of the plan's sponsor.[108] Nevertheless, the plan is a major part of the fund and the FASB should proclaim this fact by requiring all the liabilities of the plan to be recorded.

ERISA requires that the financial statements of a pension plan be in conformity with generally accepted accounting principles (GAAP) and that they be understandable to the plan participants. Besides considering the needs of

---

[107] Frank G. Burianek, "An Actuary's Views on Pension Plan Accounting and Reporting," Management Accounting 60 (January 1979): 46.

[108] Finacial Accounting Standards Board, "An Analysis of Issues Related to Accounting and Reporting for Employee Benefit Plans," Discussion Memorandum (Stanford, Conn., 1974).

administrators and advisors. However, because the accounting profession has not defined GAAP for pension plans, differing interpretations as to what makes up GAAP has caused problems in reporting on the financial statements. In the exposure draft, the FASB stated:

> . . . that the primary objective of the financial statements of a defined benefit pension plan should be to 'provide information . . . that is useful to plan participants in assessing the security with respect to receipt of their accumulated benefits.' The FASB reached the following tentative conclusion: 'In order for participants to be in a position to assess the benefit security that is provided by plan assets, it is essential to present a measure of benefits. The financial status of a plan cannot be properly evaluated, analyzed, or understood in the absence of such information.'[108]

Another question that should be answered by the FASB is whether the objectives of financial statements for pension plans should be influenced by congressional intent. The intent of the federal government should be studies, but detailed rules should not be looked for in federal laws. However, the accounting and actuarial professions should work together closely to coordinate their objectives on pension-related accounting.[109]

In a Discussion Memorandum issued in October, 1975, the FASB presented the pros and cons on using the accrual, cash, and modified cash basis of accounting for pension plans. Auditing standards presently require the accrual basis. However, most plans use the cash or a form of a

---

[108] Financial Accounting Standards Board, "An Analysis of Issues Related to Accounting and Reporting for Employee Benefit Plans," Discussion Memorandum (Stanford, Conn., 1974).

[109] Capelli and Moser, p. 300.

modified cash basis. Some auditors have covered this deficiency by carefully wording the scope and opinion paragraph of the auditors report so that most readers can not determine that it is not the standard short form report. The FASB should prescribe the accrual basis of accounting for pension plans, and if some other than accrual basis is used, the auditors report should clearly state that the financial statements are not presented in accordance with GAAP.[110]

The most heated debate involving the accounting for pension plans is whether to record a liability for unfunded past service costs, a liability for unfunded vested benefits, a liability for benefits payable in the event of a plan termination, or no liability at all. Some accountants feel that no liabilities should be recorded, but the amount of unfunded past service cost and unfunded vested benefits should be disclosed in the footnotes. However, if the FASB should decide the cash basis should be followed, this issue would not have to be raised.[111] Other accountants feel that if the financial statements do not include a liability of the plan's obligation for future benefits, the statements are not in conformity with GAAP.[112]

APB No. 8 does not require most unfunded past service costs to be recorded as a liability. The Opinion says that

---

[110]Lewis, p. 20.

[111]Ibid., p. 21.

[112]Thomas P. Kelly and David V. Roscetti., "Two CPAs View the Responsibilities of Actuaries and Accountants Under ERISA's Reporting Requirements," The Journal of Accountancy 146 (July 1978): 66.

a liability only has to be recorded if the company has a legal obligation for pension benefits in excess of the amounts which are accrued or funded. Generally, legal obligation has been interpreted to mean that the employer assumes full and direct responsibility for the payment of benefits described in the plan.[113] The APB seems to feel that since the liability is funded through contributions to the fund, the fund serves to insulate the employer from the liability. APB No. 8 only requires the disclosure of the amount of unfunded vested benefits. To understand the nature of unfunded vested rights, the amount of the vested benefits and the value of the pension fund should be disclosed.[114]

In a survey published in late 1977, the following statistics demonstrate the impact that the recording of pension liabilities would have on the financial statements. For the seventy-five largest companies in the study, unfunded prior and past service cost exceeded thirty-six billion dollars, and unfunded vested benefits exceeded eighteen billion dollars. During the preceeding two years, unfunded vested benefits increased forty-eight percent. The average firm had unfunded vested benefits equal to twenty-three percent of its net worth.[115] In the third quarter statement of 1977, Bethlehem Steel announced a loss of nearly a half

---

[113] Cramer and Neyhart, p. 23.

[114] Regan, p. 30.

[115] Capelli and Moser, p. 300

billion dollars, the largest quarterly loss ever reported by any U.S. company. The main reason for the loss was a pension-related charge which exceeded the quarter's half-billion dollar loss "for future estimated benefits payable to workers who had been permanently laid off."[116] This half billion dollar liability did not appear on any of the corporation's prior balance sheets.

The minimum funding, vesting requirements, and termination insurance provisions of ERISA have taken away the insulation between the employer and the pension fund. ERISA now requires companies to fund all past service costs and vested benefits. If a plan is terminated, the PBGC will pay all vested benefits which are not fully funded. THE PBGC can then attach a lien on the company's assets up to a maximum of thirty percent of its net worth. Since the employer has to fund all the benefits defined in the plan, its obligation to pay the benefits is more direct. ERISA has instructed the PBGC to develop insurance for employers that would protect them in case of a plan termination. The insurance industry has not become involved. If the company does not buy this insurance, some authors believe the unfunded vested benefits should be set up as a liability.[117]

In December, 1974, the FASB issued Interpretation No. 3, "Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974." The FASB

---

[116] Hennessy, p. 318.

[117] Regan, p. 30.

reported that "no change in the minimum and maximum limits for the annual provision for pension cost . . . is required as a result of the Act."[118] However, even if no change in accounting is made, ERISA may result in a higher charge to income. The Interpretation did recognize two exceptions which would allow a liability to be recorded. The company should record as a current liability the amount of the minimum funding requirement set up by ERISA. The Interpretation says that if the plan is going to terminate, and the fund assets are less than vested benefits, liability should be recorded. Without termination, the PBGC will not pay any benefits, so there is no obligation to the PBGC by the company. In this regard,

> . . . the FASB appears to have reasoned that ERISA imposes a legal obligation either to fund pension costs on an ongoing basis, or to fund them when the plan is terminated. Following this reasoning, the excess of guaranteed benefits over plan assets is not a presently enforceable legal obligation. The obligation is enforceable each year with respect to that year's required contribution or, in the event the plan terminates, it is enforceable with respect to the entire obligation. Thus, as long as a plan termination is not imminent, the obligation ripens into a liability for accounting purposes only as each year's contributions come due and becomes legally enforceable. . . .
>
> . . . That kind of reasoning . . . confuses the present enforceability of an obligation with its existence in the first place. . . . A look at the typical installment-loan arrangement makes this clear. As long as the debtor is making the required payments on schedule, the creditor generally has no legal remedy to presently enforce his

[118] Financial Accounting Standards Board, "Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974." Interpretation No. 3 (Stanford, Conn., 1974).

> claim to the remaining principal. But the debtor recognized the entire liability in his financial statements. . . . The pension obligation under ERISA is indistinguishable in concept from this type of recorded liability.[119]

When a finished product is delivered, or when services are rendered, a liability is recognized in the statements. The same is true for pensions. An exchange transaction has taken place when the employee group has promised to provide labor services during future and present periods. The employer should record the present value of this service as an asset. The employer should record a corresponding liability for its promise to pay pension benefits based on the employees' services. It does not make sense to wait until the expense is recognized under an arbitrary actuarial cost method to record the liability.[120]

The FASB must decide which liabilities to record. Some say that only the "actuarially determined obligations for pensions in force at the statement date should be accrued."[121] Others argue that the present value of vested benefits should be recorded. Some even insist that the present value of all benefits should be accrued, even if the benefits are not vested.

Many plans have a large unfunded past service cost and unfunded vested benefits. Most readers of financial statements would not understand that the newly recorded

---

[119]Hennessy, pp. 322-24.

[120]Cramer and Neyhart, p. 23.

[121]Lewis, p. 21.

liability is designed to be funded over a number of years, no matter the extent of footnote disclosure. This is one strong reason to only include the liability for unfunded benefits in the footnotes. Many feel that this approach would best serve the users and readers of financial statements.[122]

If a liability is recorded for unfunded pension costs, the question arises as to what to do about the offsetting debit. Is it an asset, an expense chargeable to income immediately, or a contra-equity account? The APB says that it should be recorded as a deferred charge. However, the deferred charge should only be recorded for an amount which the company expects to receive in benefits from its employees. The amount of benefits and when the benefits will be received are questions which are difficult to answer. To charge a part of the pension costs off to income when the plan is adopted or amended would be completely against APB No. 8. Actually, when the company adopted the plan, it was not assured of future benefits from its employees. Therefore, it appropriates a part of the stockholder's equity in the corporation to the employee group. Following this line of thought, the debit should be a contra-stockholders equity account. Some authors believe that treating the debit in this way is a good solution until the accounting for pensions can be completely revamped.[123]

---

[122] Ibid.

[123] Hennessy, pp. 328-29.

The minimum provision for pension costs under APB No. 8 includes normal cost plus interest on unfunded past service costs. There is no required provision to reduce the past service cost. ERISA requires the past service cost to be funded. Therefore, some accountants feel that the method used to fund the plan does not control the method used to determine the annual expense. Therefore the FASB contends that no change is needed in the minimum and maximum limits for pension expense as a result of ERISA. The Interpretation based its opinion on the concept that the provision for normal cost plus interest on past service cost is sufficient to pay all benefits. The provision only needed to be large enough to amortize unfunded vested benefits. The idea was that there was no need to fund past service cost if they will never be paid to employees. Now, since ERISA requires past service cost to be funded, it is hard to argue that past service cost amortization should not be charged to income.[124]

When different actuarial cost methods are applied to the same data, widely differing costs result. The methods differ in many essential respects, such as whether future compensation levels should be considered in determining current costs. Other differences involve whether past service costs should be identified separately or combined with normal costs, and whether costs should be related to services

---

[124] Pomeranz, Ramsey, and Steinberg, pp. 103-104.

performed by the employee. The differing results that various actuarial cost methods produce is compounded by APB No. 8's provision which allows past service cost to be amortized over a period ranging from ten to forty years or longer. In some circumstances, no amortization of past service costs is required.[125]

Presently there are five actuarial cost methods. These methods are designed to only determine the annual funding requirements, not to allocate costs in a systematic and rational manner. The aggregate cost method relates the current year's pension expense to the current salary expense in the same proportion as the present value of future benefits relates to the present value of future salary expenses. If the aggregate cost method were used by all plans, pension expense would be related to the funding of the plan.[126]

When equally accepted alternative methods exist in other areas of accounting, the differences in results are disclosed. For example, when the lifo method of valuing inventory is used, the difference in the valuation of the inventory when compared to the fifo method is disclosed. When an accelerated method of depreciation is used, the excess depreciation which is charged over the straight line method is disclosed. This is not so with pensions. The method of determining pension costs is not disclosed in the

---

[125]Hall and Landsittel, pp. 32-33.

[126]Smith, p. 46.

financial statements. Also, if all plans were required to compute pension costs under the same method, the information would be much more comparable between plans.[127]

Actuaries must make many assumptions about the interest rate, retirement age, employee turnover, mortality rates, and the salary rates at retirement. Many authors believe that there is too much flexibility in the application of these actuarial assumptions. The FASB should determine whether some degree of uniformity can be established in the assumptions. "A degree of uniformity in the actuarial assumptions would most certainly make statement analysis easier."[128] Most pension plans specify that the retirement benefits are to be tied to the salary rates in the years just preceeding retirement. Some accountants believe that the benefits which are presently earned can only be measured on current salary levels. Benefits which result from higher future salary levels should be charged to the future period when the salary rates increase. Others argue that the cost of benefits which are earned currently must be based on the benefits that will be ultimately paid, which are based on future salary levels.[129]

Many accountants have asked what basis should be used to measure the value of the assets of the pension fund.

---

[127] Burianek, p. 47.

[128] Smith, p. 46.

[129] Hennessy, p. 325.

According to a study of pension funds, forty-six percent valued their pension assets at cost, twenty-two percent at market, eighteen percent used a long-range appreciation method, and fourteen percent used other methods. General Electric uses a long-range appreciation method in which the value of the assets is increased each year. The belief is that the value of the assets will continue to climb in step with the reduced buying power of the dollar. The danger of this method can be illustrated by the occurances which surrounded the General Electric pension fund:

> At the end of 1974, the adjusted carrying cost of the pension fund was nearly $2.8 billion. Subtracting the assets from the total vested benefits of approximately $3.1 billion, GE reported that its 1974 liability for unfunded vested benefits was only $345 million. But the market value of the pension was $415 million below the adjusted book value at the end of 1974, indicating that the liability for unfunded vested benefits would have been twice as great - $760 million - if the assets had been valued at market.[130]

Most accountants feel that the FASB should adopt the market valuation to value the fund's assets. This will cause the problem of what to do with the unrealized gains and losses. In replying to the Discussion Memorandum, most accountants suggested that unrealized gains or losses should be direct charges or credits to the trust and appear below income from operations on the income statement. Most actuaries, however, believe that the gains and losses should be amortized over a five year period.[131]

---

[130] Regan, pp. 27-28.

[131] Lewis, p. 21.

In accounting, emphasis is placed on arriving at a smooth income level even when leveling techniques are contrary to economic facts. Financial gains and losses on investments and underwriting gains and losses are thought of as being abnormal and various spreading and leveling methods are used to achieve an average income. This has been justified as being more useful and results in a better matching of expenses with revenues. These techniques are emphasized in APB No. 8. The Opinion is the basis for averaging or spreading actuarial gains and losses and amortizing past service costs. By spreading the past service costs over a long future period, these costs have not been recognized as a liability. A majority of the accounting profession believes that increases and decreases in the values of the funds assets should be recognized in the current period instead of spread over a future period.[132]

Among other disclosures, the APB has required the disclosure of the excess of vested benefits over the pension fund, plus balance sheet accruals, less prepayments and deferred charges. In addition to the APB disclosure requirements, the Securities and Exchange Commission (SEC) requires that when plans are not fully funded, the amount of unfunded past service cost must be disclosed. Since ERISA requires past service cost to be funded, disclosure of past service cost becomes important to statement readers. Some accountants feel the past service cost and the funding period should

[132]Hall and Landsittel, p. 36.

be disclosed because future cash outlays are required. Others say it is not necessary because the income statement already gives the amount of funding that is being charged to income.[133]

Most readers of the financial statements of pension plans cannot understand the meaning of complex actuarial liability figures intended to disclose the financial status of the plan. The mathematics is very involved and requires the expertise of experienced actuaries to be understood. It is not necessary for the statement readers to understand actuarial mathematics and accounting techniques. The reader only needs to be able to determine if the employer is making the required minimum contributions and whether or not benefits will be paid if the plan is terminated.

Besides the provision for pension expense, the current normal cost and previous normal cost should be disclosed. Information on the past service cost, such as the original amount, the current amount, the date it was established, the amortization period, and the required annual payment should be disclosed. Actuarial gains or losses should also be indicated. Because it is possible to contribute more than is required and build up a credit that can be used in future years, this amount should be disclosed. The actuarial cost method which is being used should be indicated without detailed information on how the method

---

[133] Pomeranz, Ramsey, and Steinberg, p. 105.

works.[134]

Both the independent auditor and the actuary are professionals which are involved in the accounting for pension plans.

> The role of the independent auditor is to perform the attest function for the financial statements of the sponsoring company and the pension plan. . . The actuary, by use of the actuarial cost methods and assumptions, will determine the annual amount needed to provide for estimated future pension benefits promised to be paid to employees during their retirement years.[135]

ERISA requires pension plans with one hundred or more participants to have an auditor examine the financial statements of the plan and to form an opinion as to whether the financial statements are presented in conformity with GAAP applied on a consistent basis. The Act says that the auditor shall perform the examination in accordance with generally accepted auditing standards (GAAS) and allows the auditor to rely on the correctness of any actuarial matter certified to by an enrolled actuary, if he so states his reliance.[136]

ERISA is allowing auditors to accept the work of actuaries if the auditor indicates that fact and the degree of reliance he is putting on their work. However, the auditor still has to follow Statement of Auditing Standards No. 11, "Using the Work of a Specialist." According to SAS No. 11, the auditor should understand the "methods and assump-

---

[134]Burianek, pp. 47-48.

[135]Smith, p. 45.

tions used by the specialist to determine whether they are suitable."[137] Therefore, even though ERISA allows auditors to use the reports of other professionals, SAS No. 11 requires the auditor to do some digging to determine how the professional arrived at those answers.

The auditors report on the financial statements of a pension plan does not contain a reference to the work of an actuary because SAS No. 11 prohibits it. If the auditor would refer to the actuary in an unqualified opinion, it might be misunderstood as a qualification or a division of responsibility. Also, a reader might believe that an auditor citing an actuary made a more thorough audit than one who did not refer to an actuary. Some believe that the auditor should only report on the statements of the fund and the actuary should report on the future obligation of the plan. However, since ERISA requires the auditor to examine the financial statements of the plan, he must examine all aspects of the plan, including determinations made by an actuary.[138]

According to ERISA, the actuary must form an opinion on the actuarial values of the plan and express his opinion in a separate actuarial report. Most actuaries feel that auditors do not need to examine the work on an actuary because the Act allows the auditor to rely on the work of

---

[137] American Institute of Certified Public Accountants, "Using the Work of a Specialist," SAS No. 11 (New York, 1975) par. 8.

[138] Kelly and Roscetti, pp. 69-70.

the actuary. They feel that an auditor forming an opinion on their work is "an inappropriate interference with the process set up by ERISA."[139]

Auditors have asked whether ERISA has required them to expand the scope of their audit. The law has disclosed areas which are now required to be covered which were previously ignored. The auditor must review all investment transactions to certify that the fund has not invested in more than the maximum limits set up in ERISA. Someone must review the records to determine that all contributions have been paid to the plan. A payroll audit is the best method to determine if all employees credits have been figured into the amount of the contribution.[140]

One of the purposes of ERISA was to outlaw the forfeiture provisions in many pension plans. These provisions stripped vested benefits from dishonest or disloyal employees. Two employees were terminated after the passage of ERISA by the Edison Brothers Stores. When the employees applied for pension benefits, they were denied. The plan administrator determined that the employees were engaged in the dishonest acts prior to ERISA. Therefore they did not accumulate any vested benefits. Plan participants are now wondering if the government will protect their vested benefits by passing a law which disallows forfeiture of benefits due to

---

[139]Blackburn H. Hazelhurst, "A Leading Actuary's Views on the Problems of Auditors and Actuaries in Complying with ERISA," The Journal of Accountancy 146 (July 1978): 59.

[140]Reeves, p. 17.

acts which occured prior to ERISA.[141]

The purpose of ERISA was to insure that the benefits that the employees expected to receive would be available when they retired. Since the Act was passed, employers have amended plans, filled out forms, written reports and adopted new administrative procedures in order to comply with ERISA. Because of this administrative headache, over thirty percent of the pension plans in existence when ERISA was passed have gone out of business.[142]

Three surveys have been made which suggest that ERISA has had a negative effect on the small employer. According to a study by Senator Richard Lugar of Indiana, small employer plans with less than five hundred participants have a far greater chance of terminating that the larger plans. The Lugar Survey indicates that the size of the business has more bearing on the termination of a plan than does the structure of the business. In a survey by Meidinger and Associates, Inc., it was determined that ERISA was the cause of termination in three out of four cases. Almost one half of the terminations were caused by administrative burdens put on by ERISA, such as reporting and disclosure requirements. The Meidinger survey indicated that the small employer does not object to the provisions of ERISA which protect the employee. However, they do object to the admini-

---

[141]Noel Arnold Levin, "ERISA's 'Bad Boy' Clauses Are Surfacing Again?" Pension World 14 (April 1978): 63.

[142]Michael W. Dunigan, "ERISA Misfire - The Small Employer," Journal of Pension Planning and Compliance 4 (July 1978): 252-56.

strative burden placed upon them by the law. A survey by the Small Business Administration (SBA) indicated that eighty percent of plan terminations were partly caused by ERISA. ERISA was listed as the sole reason for termination in thirty percent of the cases. The SBA survey also indicated that administrative costs doubled or tripled because of ERISA.

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Five years have passed since the Congress passed ERISA. Undoubtedly, many more years will pass before the problems surrounding and accounting, reporting, and auditing of pension plans will be solved. The Financial Accounting Standards Board, American Institute of Certified Public Accountants, and the Securities and Exchange Commission are all presently studying the issues involved with pensions.[143]

By its own admission, APB Opinion No. 8 is a temporary solution. Even if ERISA had not been passed, the Opinion would have needed re-examination. Because the FASB is looking at all the sides of many complex problems, it is likely that the Board will not be able to meet its 1980 target date to issue a Standard on pensions. A long delay can only serve to erode the credibility of the accounting profession "in the eyes of investors and creditors."[144]

Pension plans have grown tremendously in the past decade. The number of plan participants has increased into the millions. Benefits paid to participants has a strong financial impact on the economy. Accountants have an opportunity to be frontrunners in establishing the generally

[143] Pomeranz, Ramsey, and Steinberg, p. v.

[144] Hennessy, p. 330.

accepted principles for this important economic situation.[145] Accounting and auditing principles are based on the support of the members of the accounting profession. Accountants and auditors should help the Financial Accounting Standards Board in reaching a decision on the future of accounting for pension plans.[146]

The amount of the unfunded obligation for all benefits which have been earned as of the balance sheet date should be recorded as a liability. The liability should be determined using the actuarial cost method used to determine the annual funding contribution. The liability will include all vested benefits, benefits earned currently, and benefits earned in past periods. The liability should be recorded by the sponsoring employer.

When the situation occurs where the provision for pension expense exceeds the amount of funding, the liability for unfunded benefits would be offset by a debit to pension expense. For past service costs, the liability has not previously been recorded. When the liability that relates to past service cost is recorded, the offsetting debit should be a deferred charge. The deferred charge should be amortized into income over the remaining service life of the employees which gave rise to the liability for past service cost. The liability and deferred charge would not necessarily be amortized at the same rate. The deferred charge would be amortized systematically, whereas the lia-

---

[146]Reeves, p. 18.

bility will be erased when it is funded.[147]

Five actuarial cost methods, which can be applied to the same identical data with differing results, are now acceptable under current generally accepted accounting principles. All except the aggregate method should be eliminated. Many actuarial assumptions should be standardized so as to make the financial statements of pension plan sponsors more comparable. The standards should not be fixed by the FASB permanently. Instead, a committee of the Board should continuely adjust the assumptions for all plans to meet changing conditions. Actuarial gains and losses result from the adjustment of actuarial assumptions. These gains and losses should be charged to income in the current period instead of spread or averaged over ten to twenty years. An actuarial gain or loss which arises from increases or decreases in the value of fund assets should be designated as a separate line item on the income statement.[148]

The employer entity should be responsible for the accounting and reporting of pension plans. The accrual basis of accounting should be used so that the financial statements which report the plan can be more useful to the employees and to the users of the statements. The same accounting principles which govern short-term and long-term equity investments should be used to value the assets of the pension fund.

---

[147]Hall and Landsittel, p. 5.

[148]Ibid., p. 6

There should be an increase in the amount of disclosures in the area of pension plans. Besides the disclosures required in APB No. 8, the current and previous years normal cost and the level of actuarial gains and losses should be disclosed, along with the original amount, period of amortization, date it was established, and required annual payment. The actuarial cost method which is being utilized should be given.[149]

The accounting and actuarial professions should continue to work together to solve the many problems which ERISA has created. The AICPA must consult with actuaries before it develops auditing standards regarding auditor responsibility for information that is based on the work of an actuary.

---

[149]Burianek, pp. 47-48.

SELECTED BIBLIOGRAPHY

BOOKS

Drucker, Peter F. The Unseen Revolution: How Pension Fund Came to America. New York: Harper & Row, 1976.

Hall, William D., and Landsittel, David L. A New Look at Accounting for Pension Costs. Homewood, Ill.: Richard D. Irwin for the Pension Research Council.

Nader, Ralph, and Blackwell, Kate. You and Your Pension. New York: Grassman Publishers, 1973.

Pomeranz, Felix; Ramsey, Gordon P.; and Steinberg, Richard M. Pensions: An Accounting and Management Guide. New York: Ronald Press Co., 1976.

Schwimmer, Martin J., and Malca, Edward. Pension and Institutional Portfolio Management. New York: Praeger Publishers, 1976.

PUBLISHED PROCEEDINGS

Lewis, Sheldon P. "Generally Accepted Accounting Principles for Employee Benefit Plans: What the Future May Hold." Fund Advisors Institute, Proceedings (White Sulphur Springs, W.VA.: n.p., 1976): 19-23.

Reeves, Gilbert K. "Generally Accepted Auditing Standards for Employee Benefit Plans: What Does ERISA Say?" Fund Advisors Institute, Proceedings (White Sulphur Springs, W.Va: n.p., 1976): 13-18.

ARTICLES IN JOURNALS

Burianek, Frank G. "An Actuary's Views on Pension Plan Accounting and Reporting." Management Accounting 60 (January 1979): 46-49.

Capelli, Andrew J., and Moser, S. Thomas. "The Pension Plight: Major Challenges for Financial Accounting and Reporting." Journal of Financial Planning 1 (Fall 1977): 293-303.

Cartano, David J. "Rule 10b-5 and ERISA After the Daniel Case." Journal of Pension Planning and Compliance 4 (May 1978): 183-97.

Cramer, J., and Neyhart, Charles A. "Accounting for Pensions: A Contemporary Perspective." The CPA Journal 46 (June 1976): 19-24.

Dunigan, Michael W. "ERISA Misfire - The Small Employer." Journal of Pension Planning and Compliance 4 (July 1978): 252-60.

Hazlehurst, Blackburn H. "A Leading Actuary's Views on the Problems of Auditors and Actuaries in Complying with ERISA." The Journal of Accountancy 146 (July 1978): 58-65.

Hennessy, Vincent C. "Accounting for Pension Liabilities Created by ERISA." Journal of Accounting, Auditing & Finance 1 (January-March 1978): 317-330.

Jackson, Charles B. "Trust Fund Accounting for Multi-Employer Trust Funds." Management Accounting 60 (October 1978): 49-54.

Kelly, Thomas P., and Roscetti, David V. "Two CPAs View the Responsibilities of Actuaries and Accountants Under ERISA's Reporting Requirements." The Journal of Accountancy 146 (July 1978): 66-70.

Levin, Noel Arnold. "ERISA's 'Bad Boy' Clauses Are Surfacing Again?" Pension World 14 (April 1978): 63-65.

Moran, Charles A. "Let's Streamline ERISA's Regulatory Provisions." Pension World 14 (September 1978): 14-18.

Regan, Patrick J. "Poetential Corporate Liabilities Under ERISA." Financial Analysts Journal 32 (March-April 1976): 26-32.

Schwarz, Marilyn. "ERISA Today: An Updated Checklist on Reporting and Disclosure Requirements of a Fast-changing Law." Management Focus (July-August 1978): 46-50.

Smith, Jack L. "Needed: Improved Pension Accounting and Reporting." Management Accounting 59 (May 1978): 43-46.

PROFESSIONAL PRONOUNCEMENTS

American Institute of Certified Public Accountants, Cost of Pension Plans," APB Opinion No. 8 (New York, 1966).

American Institute of Certified Public Accountnats, "Accounting for the Cost of Pension Plans," ARB No. 47 (New York, 1956).

American Institute of Certified Public Accountants, "Pension Plans - Accounting for Annuity Costs Based on Past Services," ARB No. 36 (New York, 1948).

American Institute of Certified Public Accountants, "Using the Work of a Specialist." SAS No. 11 (New York, 1975).

Financial Accounting Standards Board, "Accounting for the Cost of Pension Plans Subject to the Employee Retirement Income Security Act of 1974," Interpretation No. 3 (Stamford, Conn., 1974).

Financial Accounting Standards Board, "An Analysis of Issues Related to Accounting and Reporting for Employee Benefit Plans," Discussion Memorandum (Stamford, Conn., 1974).

Hicks, Ernest L. "Accounting for the Cost of Pension Plans," Accounting Research Study No. 8 (New York: American Institute of Certified Public Accountants, Inc., 1965).

LEGAL CASES

Daniel v. International Brotherhood of Teamsters, 561 F.2d 1223 (7th Cir. 1977).

Inland Steel Co. v. Lebold, 62 SCt. (U.S.), 1045.