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"Pension accounting is the most controversial subject the FASB has addressed to date."[1]
----Donald Kirk
FASB Chairman

The topic of pensions has become one of the most controversial issues in the field of Accounting today. Both the preparers and users of financial statements have voiced an urgent need for better disclosure of pension costs and liabilities. The powerful impact of pensions on corporations and their labor force has drawn much concern over an increase in the level of disclosure. The billions of dollars believed to be involved in pension plans is a question mark in many employee minds. It is held by many in the profession that if more thorough and detailed pension plan data were required to be disclosed in the financial statements, firms would be more responsible for pension obligations to employees. There are others who believe pension plan funding and pension plan accounting are two separate items and should be kept separate.

In 1982, the Financial Accounting Standards Board (FASB) issued its "Preliminary Views on Employers Accounting for Pensions" in response to the controversy. In doing so, the ruling body added fuel to the already hot debate. As of today, the FASB has not yet issued a statement on employer's pension accounting, and a need remains to improve current GAAP accounting for pensions.

This paper is based on a past perspective. It does not attempt to project or predict the FASB's soon forthcoming new proposal. Since the FASB's "Preliminary Views" were issued in 1982, much heated controversy has existed over the potential economic consequences of the drastic changes proposed. This paper will attempt to clarify what the controversy was and still is about. It will focus on the economic effects of the preliminary views had they and should they be adopted and how those economic effects would impact users of the financial statements. Attention will also be given to the evolution of pension accounting and the situation today in 1985.

A pension plan is defined as being, "an arrangement whereby an employer can provide benefits for employees in recognition of their service to the company before retirement." [2] By offering employees a pension, the employer has created an obligation to fulfill the terms set in the plan. The problem of accounting for these pensions was first analyzed in 1953 with the issuance of Accounting Research Bulletin (ARB) No. 43 which declared that past service cost should not be allocated to earned surplus. In 1956, the entire issue was discussed in ARB No. 47 which remained the pension accounting standard for ten years. In 1966, the Accounting Principles Board (APB) initiated a major breakthrough in pension accounting with the issuance of APB No. 8, "Accounting for the Cost of Pension Plans." APB No. 8 was a much more comprehensive document than ARB No. 47. This opinion is still recognized today as GAAP for recognizing pension expense.

APB No. 8 made the recognition of pension expense mandatory, whether funded in the current period or not. It defined the maximum and minimum provisions for pension expense, The minimum provision for any particular year equals a) normal cost, b) interest equivalents on any unfunded prior service costs, and c) a provision for vested benefits. The maximum is set at a) normal cost, b) ten percent of past service cost, c) ten percent of any changes in prior service costs, and d) interest equivalents on the difference between the total provision and the amount actually funded. [3]

The pension plan costs are determined by using an actuarial method that formulates assumptions regarding such future events as employee turnover and mortality. The determination is very complex and requires the use of an actuary. APB No. 8 allows five different actuarial methods to be used. The opinion also establishes accounting for actuarial gains and losses and requires disclosure in the footnotes to the financial statements the amount of unfunded vested employee benefits.

APB No. 8 was merely the first step toward relevant and reliable pension accounting. Amendments to APB No. 8 were made in 1980 to keep current with changing practices. FASB issued Statement of Financial Accounting Standards (SFAS) No. 25 "Accounting and Reporting by Defined Benefit Pension Plans", and SFAS No. 36, "Disclosure of Pension Information." SFAS No. 35 standardized measurement rules. SFAS No. 36 improved the disclosure requirements of APB No. 8 by "requiring the following additional disclosures:

> 1) the actuarial present value of vested and non-vested accumulated plan benefits; 2) the fair value of assets available for benefits; 3) the rate of return used in determining the actuarial present value of the vested and nonvested accumulated plan benefits; and 4) the date on which the above amounts were valued." [4]

The main criticisms of current pension accounting and APB No. 8 are 1) the abscence of a liability on the firm's balance sheet to represent the firm's unfunded pension obligations, 2) the inadequate treatment of prior service costs, and 3) the wide variety of actuarial approaches which are acceptable. This variety leads to non-comparability among firms financial statements. The non-recognition of a liability is the largest perceived deficiency of APB No. 8 by the profession.

In response to the above deficiencies and other factors, the FASB published its "Preliminary Views on Employers Accounting for Pensions and Other Post-Employment Benefits." The "Preliminary Views" recognized a net pension liability. The liability would be computed as follows:

Pension Benefit Obligation
-Pension Plan Assets
+-Measurement Valuation Allowance
$ Net Pension Liability [5]

The pension benefit obligation is the present value of benefits attributable to employees' service. This obligation would be computed using one actuarial method sanctioned by the FASB. The pension plan assets are what is available for benefits. The measurement valuation allowance is a smoothing device that would have alleviated widespread flucuations. Rather than the changes in measurement being recognized immediately, they would be amortized over the remaining useful lives of participants. The actuarial cost method chosen by the FASB in its "Preliminary Views" was the accumulated benefits method.

When accounting for changes in the plan, FASB would have them booked immediately along with an intangible asset of equal worth. This offsetting asset preserves the basic accounting equation. The asset would be amortized to expense over the remaining life of the plan.

Much concern has arisen over the economic effects the application of the above proposed changes would have on the firms.

> "While rejecting the view that financial accounting standards should be slanted for political reasons or to favor one economic interest or another, the Board recognizes that a standard-setting authority must be alert to the economic impact of the standards that it promulgates. The consequences of the standards will usually not be easy to isolate from the effects of other economic happenings, and they will be harder to predict with confidence when a new standard is under consideration but before it has gone into effect. The Board will consider the probable economic impact of its standards as best it can and will monitor that impact as best it can after a standard goes into effect." [6]

And many corporate leaders have stated that

> "Recording a (new and potentially very large) net pension liability may immediately and significantly affect financial ratios, particularly the debt-to-equity ratio. Some companies may suddenly find themselves in violation of loan covenants, including those relating to maximum indebtedness and tangible net assets. Loan agreements would have tobe modified, not only for companies that would be in

> default immediately, but also to protect against possible violations resulting from plan benefit increases in the future...labor unions (might be influenced) to demand accelerated funding...companies with defined benefit plans might...terminate those plans and substitute other accounting arrangements... (Also), insurance annuities may seem more attractive resulting in a shift of funds from bank trusts to insurance companies." [7]

The liability recognition is of great concern to the firms as the size of the pensions greatly magnifies their effect. Pension assets are reaching $1 trillion and could double by the turn of the century. "Unfunded pension liabilities today compose a long-term debt of staggering dimensions. Though no one knows exactly how much money is included, the debt runs to the tens of billions of dollars, and it is growing every year. This future debt represents a time bomb in our economy." [8]

Another concern of firms is the use of employees' inflation-adjusted salaries in the determination of the pension plan obligation. This practice is heavily opposed because the net pension liability could be significantly increased.

Firms are also concerned about a potentially material expense being recorded. Under the preliminary views, the pension expense can increase in the following ways: 1) increase in pension obligation from services rendered in the current period; 2) any interest on the obligation; 3) the amortization of any intangible asset, and 4) the amortization of any intangible allowance, which may either increase or decrease the expense.

The possible occurrence of the economic events could seriously and permanently hurt firms through depressed stock prices, withheld credit, etc.

"The accountants want it, the actuaries will fight it, the business community will scream bloody murder, and some place along the line the FASB will propose it." [9] This quote from a financial executive sums up the controversy surrounding the liability recognition issue.

In order to support the conceptual argument for liability recognition, the view that pension costs are a form of deferred compensation is implicit. Although once viewed as a gratuity to employees, plans are now viewed as a form of deferred compensation. [10] The plans are viewed as an exchange between employer and employee. The employee exchanges his service for the employers' promise to pay defined benefits. The following excerpt from the FASB Discussion Memorandum on Pensions clarifies this point: "The pension benefits are earned by employees who have chosen (explicitly or implicitly) to accept lower current compensation in return for the promise of pension benefit payments." [11] Statement of Accounting Concepts No. 3 gives the rationale for liability recognition. The statement defines a liability as "probable future sacrifices of economic benefits arising from...past transactions or events." [12] Thus, there are arguments that firms opposing balance sheet recognition of their pension plan obligation need to reconsider the definition of a liability. The future benefits represent future economic sacrifices to the firm from a present obligation which should be measured and recorded when the employee performs the services.

To lesson any detrimental impact on firms, the FASB proposed using a transition period. During this transitional period, firms could use either a retroactive approach or a prospective approach. The retroactive approach would account for the effect of the net pension liability and any unamortized asset resulting from plan initiation or previous plan amendment as a change or credit to equity. "In contrast, the prospective method would not charge or credit equity initially, but would create a transitional intangible asset or deferred credit equal to its respective net pension liability or asset."[13] This amount would then be amortized over the average service life remaining for active participants. This would allow a firm to recognize the effect on equity of the new approach over a number of years.

Under either approach, firms would be allowed to restate their financial statements for as many prior periods as they felt necessary, or none at all. The FASB felt that comparability between all firms with noncontributory, single employer defined benefit pension plans would be increased.

Would financial statement users be benefited, unaffected or hurt by the proposals in the FASB's "Preliminary Views" if they were adopted? To answer that question, it is necessary to understand what one of the objectives of financial reporting is. One conceptual objective established by the FASB holds that

> "Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions -- for amking reasoned choices among alternative usesof scarce resources in the conduct of business and economic activities." 14

Investors, creditors, and other financial statement users must evaluate the information presented. As stated previously, present disclosure of pension data is inadequate and may be causing the market to ignore the information disclosed in footnotes on pensions. The answer by many is that the users will be benefited by this type of change. The "Preliminary Views" would provide more useful information and enhance the measures of financial leverage and profitability. The proposal changes would allow the users to be in a better position to compare performance between firms.

Users of financial statements want to be assured that financial statements are depicting the "true" economic performance of the firm. This includes applying the matching principle to all of their accounts, including those related to their pension plan. Not accounting for all of the pension plan obligations will cover up a firm's actual economic costs for the period by postponing these costs into the future periods. Future management should be held responsible soley for its performance, and not for costs incurred by past management. Proper accounting for these past promises brings present costs into proper perspective, allowing shareholders, lenders, and others to view a firm's true present financial performance, including all of its costs. "In fact, stockholders (and creditors and other financial statement users) should know what to expect when management promises labor retirement benefits. A pension plan is a promise to share the future income or cash flow of the company with labor."[15] Users would be able to analyze a firm's performance with an accurate reflection of these promises incorporated in the statements.

In conclusion, while the "Preliminary Views" of the FASB on pension accounting are worthy of selected criticism, the simple fact remains that the proposals advanced a more realistic economic portrayal of pension accounting than any previous recommendation. The "Preliminary Views" fulfilled most of the accounting profession's obligation to fulfill the concepts of relevance, reliability, the matching principle, comparability, materiality and neutrality. Neutrality means that "regardless of its economic impact...an accounting standard must not be made to favor one group or another; rather it must portray economic events as neutrally as possible...information is not neutral or reliable it it is not complete."[16]

The proposal must be revised, simplified and refined on certain issues. Within the year, FASB should issue a standard on the issue of accounting by employers for pensions. The controversy will by no means come to end. But, make no mistake, a change will be and should be made in current practive. Pension funds constitute too large of a place in our economy, and there are too many firms and employees and dollars involved to place pensions on the shelf anymore. Just what changes the FASB standard will contain is unknown.

The cost of truth in pension accounting most probably will be high, but the benefits of a simpler, more useful and understandable method should outweigh these costs not only to the firms, and ultimately the users, but to the accounting profession also. The credibility of the accounting profession by relaying to financial statement users the relevant information they need can only be raised to a higher level.

NOTES

[1]"Sharp Criticism Voiced on FASB View of Pensions," Journal Of Accountancy. March 1983, p. 14.

[2]Felix Pomeranz, Gordon P. Ramsey, and Richard M. Steinberg, Pensions: An Accounting and Management Guide (New York: Ronald Press Co., 1976), p. 5.

[3]Donald E. Kieso and Jerry J. Weygandt, Intermediate Accounting, 4th ed. (New York: John Wiley & Sons, 1983), p. 948.

[4]Michael H. Morris and William D. Nichols, "Pension Accounting and the Balance Sheet: the Potential Effect of FASB's Preliminary Views," Journal of Accounting, Auditing, and Finance. 7 (Summer 1984), p. 296.

[5]Financial Accounting Standards Board, "FASB Preliminary Views: Employers Accounting for Pensions and Other Post-employment Benefits," (Stamford, Connecticutt: FASB, November 1982).

[6] Financial Accounting Standards Board, "FASB Discussion Memorandum: Employer's Accounting for Pensions and Other Post-employment Benefits," (Stamford, Connecticutt: FASB) February 19, 1981, pp. 8-9.

[7]Norman N. Strauss and Richard Schwartz, "FASB Pension Proposal: Are Changes Coming in Pension Accounting?" Pension World. April 1983, p. 25.

[8] Harry E. Figgie, Jr., "Defusing the Pension Liability Bomb". Harvard Business Review 59 (November-December 1981), p. 157.

[9]"Unfunded Pension Liabilities: A Continuing Burden," Business Week, 14 August 1978, p. 64

[10]Financial Accounting Standards Board,"Discussion Memorandum", p. 13

[11]Ibid, p. 13.

[12]Financial Accounting Standards Board, FASB Concept NO. 3: "Elements of Financial Statements of Business Enterprises," (Stamford, Connecticutt: FASB, December 1980), p. 3090.

[13]Morrisand Nichols, p. 299.

[14]Financial Accounting Standards Board, "FASB Discussion Memorandum: Employer's Accounting for Pensions and Other Post-employment Benefits," (Stamford, Connecticutt:FASB, April 19, 1983), p. 2.

[15]Joseph C. Rue and Ara G. Volkan, "Financial and Economic Consequences of the New Pension Accounting Proposals: Is the Gloom Justified?", Journal of Accounting, Auditing and Finance. 7, Summer 1984, p. 321.

[16]Rue and Volkan, p. 314.

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