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# A Conceptual Analysis of the FASB's Preliminary Views on Employers Accounting for Pensions

Steven Gustafson

A CONCEPTUAL ANALYSIS

OF THE FASB'S PRELIMINARY VIEWS ON

EMPLOYERS' ACCOUNTING FOR PENSIONS



by
Steven Jay Gustafson
Bachelor of Science
College of Business and Public Administration

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TABLE OF CONTENTS

# PREFACE

There are many reasons why a study on pension accounting could be made. The writers reasons for making this study are twofold: first, it is a very current and topical issue. In the last three years the Financial Accounting Standards Board (FASB) has issued four documents directly related to the accounting for pension plans. Two have been Discussion Memorandums on how an employer should account for pensions and other postemployment benefits (a discussion memorandum being a document containing arguments and implications pertaining to a problem and alternative solutions). The third document, entitled Preliminary Views on Employers' Accounting for Pensions and Other Postemployment Benefits, proposes revolutionary changes in accounting for pensions, mainly, the movement onto the balance sheet of a company's obligation for pension benefits as defined by the terms of the plan. The fourth document, Preliminary Views - A Field Test, reports on and analyzes the results of a field test performed by volunteer companies pertaining to the proposed accounting in Preliminary Views. The results obtained and comments received by these last two documents will likely change the course of accounting for pensions. This leads to the writer's second reason for making the study: the controversy surrounding this change.

The dollar amount of unfunded pension obligations for plans based in the U.S. that employers may eventually be liable for is staggering, the total is already running in the hundreds of billions of dollars.

Some doubt has been expressed about whether some of these obligations will ever be funded and/or eventually paid out in benefits to retirees. Because of this, there has been a movement to require companies to report these unfunded obligations directly on the balance sheet instead of being reported as disclosures to the balance sheet. This would result in a material additional amount being reported as a liability. This change is hoped to provide a company with financial statements that more realistically represent the state of a company's financial position. Not surprisingly, this change has met stiff resistance, not only by the corporate community but also by some of the nation's largest public accounting firms (including seven of the "Big-8" firms).

The purpose of this study is to evaluate the FASB's Preliminary Views on pension accounting. The scope of this paper is limited to the accounting and reporting by noncontributory defined benefit pension plans sponsored by a single employer in the U.S. that is not funded using contracts with insurance companies. This paper is organized into four chapters. The first chapter reviews some of the problems experienced with present pension accounting rules and discusses these current pension accounting rules. The second chapter discusses and examines the FASB's Preliminary Views on pension accounting and analyzes the effect they would have on corporate balance sheets. The third chapter evaluates the theory and soundness of the proposed accounting in light of the FASB's Statement of Financial Accounting Concepts. The fourth and final chapter summarizes the issues discussed and conclusions reached.

# CHAPTER I

# INTRODUCTION

## Current Problems in Pension Accounting

The amount of money associated with pensions in the U.S. is staggering; as indicated by a research study done by the accounting firm of Coopers and Lybrand for the Financial Executives Research Foundation. This study indicated there were approximately 500,000 private pension plans in the U.S. in 1979 with assets totaling more than $320 billion. The 1982 edition of Pension Facts reported that these assets had increased to more than $470 billion by the end of 1981.[1]

However, in an annual survey by Business Week on unfunded pension obligations of 100 U.S. companies, it was found that unfunded prior-service costs, which are pension costs assigned to years prior to the inception of a plan, had increased 21.4% in 1979 over 1978 following an 8% increase in 1978 over 1977.[2] Thus, of the hundreds of billions of dollars invested in pension-plan assets, there are billions more of promised benefits that have yet to be funded. One of the problems encountered by the existence of these huge unfunded obligations is demonstrated by the fact that the Pension Benefit Guaranty Corporation, which is obligated

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[1] William E. Decker; John W. Joyce and Ronald J. Murray, "Pension Accounting: Analysis of Preliminary Views," CPA Journal, August 1983, p. 10.

[2] Accounting Section, "Pension Survey: Unfunded Liabilities Continue to Grow," Business Week, August 25, 1980, p. 94.

to pay beneficiaries of bankrupt pension plans, has absorbed about $585 million in losses since its inception in 1974.[3] Combining this fact with the continued uncertainty over the future of tax and inflation rates, the promise of pension benefits through retirement has become an increasingly important question facing both employers and employees. In turn, determining how to account for these promises has become one of the most perplexing problems facing the business community and the accounting profession.

To understand how pension plan liabilities can affect major decisions of management, consider the following report, "Esmark announced recently that it was putting its meatpacking subsidiary, Swift Fresh Meats Division, on the market--and funding the subsidiaries sizeable unfunded pension liabilities. 'They had to do that to make it salable,' one Esmark analyst commented."[4] In another example, when Kaiser Steel was considering liquidation in 1980, it was originally thought the sell-off would clear at least $44 per share more than the stock's then current market price. However, when the amounts for unfunded pensions were later analyzed, the decision was made not to liquidate: the liquidation value would have been 'below' the market price of the stock.[5] In these situations, which are by no means unique, pension obligations had an unexpected economic effect on the finances of a company. The pension obligations

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[3]Edwin M. Jones, "PBGC At The Crossroads," (Paper delivered at the Conference Board 1983 Employee Benefit Conference: Straws In The Wind, New York City, March 30, 1983).

[4]Betsy Ann Hollowell and Timothy S. Lucas, "Pension Accounting: The Liability Question," Journal of Accountancy, October 1981, p. 57.

[5]Mary Greenebaum, "The Market Has Spotted Those Pension Problems," Fortune, December 1, 1980, p. 146.

were not suddenly created but had existed all along. The fact is that the obligations were not reported as a liability on the balance sheet even though the financial statements were prepared in conformity with Generally Accepted Accounting Principles (GAAP).

Employer pension accounting is currently covered by APB Opinion No. 8 issued in 1966. In recent years concerns have been expressed over the adequacy of this opinion. Several factors suggest that its principles need to be reconsidered. Concern with existing pension accounting practice has focused on four points: (1) items included (or not included) on the employer's balance sheet, (2) the annual cost reported by the employer, (3) the actuarial methods used in measuring the magnitude of items 1 & 2, and (4) additional information that might be provided in the notes to the financial statements.[6]

As stated earlier, pension plans have continued to grow rapidly, both in terms of their variety and their significance within the american economy. Analysts and others are concerned about the growing magnitude of unfunded pension obligations - largely the result of periodic improvements in benefits in order to keep pace with inflation and employee demands and expectations.

There have been suggestions that a portion of American industry is in financial trouble because some companies have large unfunded pension obligations that are not recorded as liabilities on their balance sheet. The opposite view is that the unfunded liability concern is exaggerated and that these amounts should not be of great concern as long as the em-

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[6]Timothy S. Lucas and Paul B.W. Miller, "Pension Accounting: Impacting the Financial Statement," Journal of Accountancy, June 1983, p. 90.

ployer is in sound financial condition and able to fund the pension plan.

The Financial Accounting Standards Board (FASB) has expressed considerable concern over the apparent lack of comparability of pension costs among companies. Currently, GAAP permit the use of several different actuarial cost methods, stipulating only the acceptable minimum and maximum expense levels.

These concerns came into sharp focus in 1974 because of the Employee Retirement and Income Security Act (ERISA) passed by Congress. ERISA established standards for participation, vesting, minimum funding, and termination insurance coverage. Critics of APB Opinion No. 8 noted ERISA's provision that the employer is liable for up to 30 percent of its net worth if the guaranteed benefits exceed the accumulated plan assets that are allocable to those benefits when the plan terminates. However, FASB Interpretation No. 3 reaffirmed the position of APB No. 8 by stating that ERISA did not create a legal obligation for unfunded pension costs that warrants accounting recognition as a liability.[7]

In summary, most commentaries on the perceived deficiencies of APB Opinion No. 8 center on one or more of the following: acceptance of a variety of actuarial methods and amortization practices, failure to recognize certain obligations as liabilities, artificial smoothing of pension expense and too much latitude in the selection of actuarial assumptions.[8]

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[7] FASB Interpretation No. 3, "Accounting For the Cost of Pension Plans Subject to ERISA of 1974," (Stamford: FASB, 1974), par. 5.

[8] FASB Discussion Memorandum, "Employers' Accounting For Pensions and Other Postemployment Benefits," (Stamford: FASB, 1981), par. 10.

## Current Pension Accounting

Employers' accounting for pensions is presently based on APB Opinion No. 8, as amended by FASB Statement No. 36, and FASB Statement No. 35, which covers the financial reporting for defined benefit pension plans.

The first authoritative guideline of employers' accounting for pensions was APB Opinion No. 8 issued in 1966. It established the parameters for a basic accounting method, identified actuarial cost methods acceptable for determining pension costs, prescribed treatment for actuarial gains and losses, and identified the employees who should be included in the cost calculation.

The APB agreed that the entire cost of benefit payments ultimately to be paid should be charged to income subsequent to the adoption or amendment of a plan and that no portion of the cost should be charged directly to retained earnings. However, they disagreed on the measurement of the costs of such payments so they compromised their views by establishing a minimum and maximum that bracketed their differing views.

> ... Accordingly, the Board believes that the annual provision for pension costs should be based on an accounting method...and results in a provision between the minimum and maximum...[9]

Thus, the minimum cost to be charged to pension expense should not be less than:[10]

1. The normal cost of the plan.
2. Interest on any unfunded prior-service costs.
3. If necessary, a provision for vested benefits.

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[9] Accounting Principles Board Opinion No. 8, "Accounting For The Cost of Pension Plans," (New York: AICPA, 1966), par. 17.

[10] Martin A. Miller, Millers Comprehensive GAAP Guide, (New York: Harcourt Bruce Jovanovich, Inc., 1982), p. 31.09.

The maximum cost should not be more than:[11]

1. Normal cost.
2. Ten-percent of past-service costs (until fully amortized).
3. Ten-percent of any increase or decrease in prior-service costs arising from plan amendments.
4. Interest on the difference between the provision and the amount funded.

The ten-percent limitation on amortization of past and prior service costs is considered necessary to prevent the distortion of pension costs in the early years of the plan. It is this limitation on amortization that gives rise to the charge of encouraging the artificial smoothing of income.

With respect to the question of recognition of a liability, the APB said:

> The difference between the amount which has been charged against income and the amount which has been paid should be shown on the balance sheet as accrued (liability) or prepaid (asset) pension cost... unfunded prior-service costs are not a liability which should be shown on the balance sheet.[12]

Thus, under current GAAP, most balance sheets do not include a line item labeled "pension liability." Under APB Opinion No. 8, the actuarial cost of the pension plan for the year becomes a liability of the enterprise and contributions to the pension plan are recorded as a discharge of that liability. Since, for most companies, the methods used to determine the yearly cost of a plan is usually the same as the method used to fund the plan, the resulting net liability is zero.[13]

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[11] Ibid., p. 31.10.

[12] APB Opinion No. 8, par. 18.

[13] Decker, Joyce, and Murray, p. 58.

In discussing actuarial cost methods, the APB stated that to be acceptable for determining cost for accounting purposes, the actuarial cost should be rational and systematic and should be consistently applied so that it results in a reasonable measure of pension costs from year to year.[14]

It was also the APB's opinion that:

> ...Actuarial gains and losses, including investment gains and losses, should be given effect in the provision for pension cost in a consistent manner that reflects the long-range nature of the pension cost...[15]

The APB ruled that actuarial gains and losses should normally be spread over the current year and future years or recognized on the basis of an average of past and projected experience applied to normal cost--the artificial spreading device. This spreading application is a separate adjustment of the normal cost for the year and should be done over a period of from 10 to 20 years.[16]

Other provisions of APB Opinion No. 8 are:

1. Pension plan assets are not recognized as assets of the employer.
2. The present value of accumulated plan benefits and the plan's net assets are disclosed in the footnotes.
3. Changes in plan amendments are reflected prospectively.

The objective of SFAS No. 35, Accounting and Reporting by Defined Benefit Pension Plans, is to provide financial information that is useful in assessing the plan's present and future ability to pay benefits

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[14] FASB Discussion Memorandum, p. 117.

[15] APB Opinion No. 8, par. 30.

[16] Miller, p. 31.07.

when due.[17] A defined benefit plan is a plan that specifies a determinable pension benefit to be received at retirement, usually based on factors such as age, years of service, and salary.

The requirements of financial statements of defined benefit pension plans include:[18]

1. A statement of net assets available for benefits as of the end of the plan year.
2. A statement of changes in net assets during the plan year.
3. Information on the actuarial present value of accumulated plan benefits as of the beginning or ending of the plan year.
4. The effects, if significant, of certain factors affecting the year-to-year change in the actuarial present value of accumulated plan benefits.

Also, information regarding net assets are to be preparaed on the accrual basis of accounting and plan investments are to be presented at their fair values. In addition, in measuring accumulated plan benefits, future salary increases are not be be considered.

As a result of a decision by the FASB that the lack of comparable disclosures in employers' financial statements about the financial status of their plans, an amendment was made to existing disclosures in SFAS No. 36, Disclosure of Pension Information, which amended APB Opinion No. 8, par. 46.

This statement requires revised disclosures about defined benefit pension plans in employers' financial statements. Specifically this statement requires an employer, for its defined benefit plans, to dis-

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[17] FASB Statement No. 35, "Accounting and Reporting By Defined Benefit Pension Plans," (Stamford: FASB, 1980), par. 5.

[18] Ibid., par. 6-21.

close the following data, determined in accordance with SFAS No. 35.[19]

1. A statement that a plan exists.
2. A statement of the companies accounting and funding policies.
3. The provision for pension costs for the period.
4. Nature and effect of all significant matters affecting comparability for all periods presented.
5. The actuarial present value of vested accumulated plan benefits.
6. The actuarial present value of nonvested accumulated plan benefits.
7. The assumed rates of return in determining the actuarial present value of vested and nonvested accumulated plan benefits.

## Reasons For Change In Pension Accounting

Although APB Opinion No. 8 narrowed the diversity of practice, it permitted a choice among actuarial methods for determining the periodic provision for pension expense. That flexibility and the resulting apparent lack of comparability among companies is a matter of concern to many, including the FASB. In addition, increases in the amounts of unfunded pension benefits and unfunded prior-service costs is causing some financial statement users to express doubt about the validity and representational faithfulness of the balance sheet. Some, including the FASB, consider the amounts designated as "unfunded prior-service costs" to have the characteristics of a long-term liability. Others, include seven out of the "Big-8" national accounting firms, believe that the present accounting required by APB Opinion No. 8, which states that unfunded

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[19] FASB Statement No. 36, "Disclosure of Pension Information," (Stamford: FASB, 1980), par. 7-8.

prior-service costs are not a liability, is appropriate.

There have been frequent, and increasing expressions of concern about the inadequacy of pension accounting and reporting in recent years. These criticisms of current GAAP include:

> ...information is piecemeal and imprecise; data are not comparable from company to company, and not always from year to year in care of the same company.[20]

> ...the balance sheet ramifications were shunted...[21]

> ...APB Opinion No. 8 does not generally require "unfunded prior-service costs" to be treated as a liability. The rational for this is strained and difficult to support on a logical basis...[22]

These charges among others, combined with the fact the FASB had employers' accounting for pensions on its agenda since 1974, were the imputus for a pension accounting project. In 1981 the FASB issued a Discussion Memorandum (DM) entitled Employers' Accounting For Pensions And Other Postemployment Benefits. This DM was the first step in a project to review how an employer should account for the costs incurred in connection with postemployment benefits provided to employees. It was thought the project would result in significant changes in GAAP. The FASB considered the issues addressed in the 1981 DM and in 1983 decided to publish their preliminary views on those issues for comment. These views are contained in a publication entitled Preliminary Views: Employ-

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[20] Financial Analyst Federation, "Corporate Information Committee Report," Published December 1981.

[21] Harold Q. Langenderfer, "Accrued-Past Service Pension Costs Should Be Capitalized," New York CPA, February 1971, p. 138.

[22] William D. Hall and David L. Landsittely, "A New Look At Accounting For Pension Costs," for the Pension Research Council, (Homewood: Richard D. Irwin, Inc., 1977), p. 32.

ers' Accounting For Pensions and Other Postemployment Benefits. The remainder of this paper will consider these preliminary views.

## CHAPTER II

## THE FASB'S PRELIMINARY VIEWS

### Preliminary Views On Pension Accounting

In the words of FASB Chairman Donald J. Kirk, the Board's current proposals for pension accounting "will probably generate more controversy than anything the board has done to date."[23] Preliminary Views is a new method of communication that was added to the Board's due process on pension accounting. This document is not an exposure draft; that will be issued later, after the Board has defined, sought comment on, and addressed the additional issues. The Preliminary Views document describes and explains the Board's tentative views on the issues included in the 1981 Discussion Memorandum on pension accounting.

The proposed changes would affect all companies that sponsor U.S.-based, single-employer, noncontributory defined benefit pension plans not funded by insurance contracts. Other types of pension plans are discussed in a FASB Discussion Memorandum issued in April of 1983.

The Board's Preliminary Views rest on a series of issues covering several aspects of a defined benefit pension plan. These views can be summarized as follows:[24]

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[23] "FASB Chairman Discusses Controversy Generated By Preliminary Views Documents," BNA Reporter, February 21, 1983, p. 350.

[24] Timothy S. Lucas, "How The FASB Views Pension Accounting," Financial Executive, September 1983, p. 42.

1. Pension benefits are not a gift or gratuity; they are a form of compensation for employee service. Because payment is deferred, the pension benefits may be described as "deferred compensation."

2. It follows that the cost of an employee's pension should be recognized, to the extent possible, in the periods in which the employee renders service.

3. The employer has an obligation for benefits promised based on service already rendered.

4. Information about the pension obligation is useful and the terms of the plan provide the evidence of how benefits are earned and how the obligation arises.

5. Funding policies (the schedule for providing cash to satisfy the obligation) may be appropriately based on factors other than on how the obligation arises. A company's decision on how to fund its pension plan does not necessarily produce the most useful measure of its liability or cost.

The Proposed Accounting Requirements

The Board's proposal would introduce two new items to the balance sheet of a typical plan sponsor: a net pension liability (asset) and an intangible asset.[25] The net pension liability (asset) is the net total of:

1. The pension benefit obligation measured using current assumptions about future events.

2. Less the plan's net assets available for benefits measured at fair value.

3. Plus or minus a measurement valuation allowance (MVA).

The intangible asset is the unamortized cost of past plan amendments (or the plan's initiation) that grants credit for prior service.

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[25] Financial Accounting Standards Board's Preliminary Views, "Employers' Accounting For Pensions and Other Postemployment Benefits," (Stamford: FASB, November 1982), par. 8.

Under the proposal, plan assets would be deducted from the pension obligation in computing the net pension liability that would appear on the balance sheet (See Figure 1, appendix). The net pension liability could also be described as the unfunded liability. If the plan assets were to exceed the pension benefit obligation, which would be the case for some employers, the net amount will be an asset that might be described as a prepaid pension cost. Some have argued that the plan assets should be shown separately from the obligation as assets of the employer. The Board concluded, however, that the assets ordinarily will be used only to pay benefits under the plan; therefore, a right of offset exists.

The next section presents, in detail, the provisions of the Preliminary Views. The balance sheet effect is discussed first, starting with the makeup of the net pension liability (the pension benefit obligation, pension plan assets, and the measurement valuation allowance) followed by a discussion of the intangible asset. The income statement effect is then looked at, which includes the amortization method and the periodic pension cost. Last, the transition approaches and disclosure requirements are discussed.

## Net Pension Liability, The Balance Sheet Effect

### The Pension Benefit Obligation

The pension benefit obligation would be measured as the actuarial present value of benefits attributed to employee service to the date of the financial statements. The benefits are to be attributed to employee service based on the terms of the plan.[26] For a plan that defines pen-

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[26] Ibid., par. 10.

sion benefits as a function of future compensation levels, the pension benefit obligation is measured based on an estimate of such future compensation levels. In all other respects, the measurement of the pension benefit obligation would be consistent with the measurement of the actuarial present value of accumulated plan benefits as specified in SFAS No. 35.[27]

Pension Plan Assets

The second component of the net pension liability would be the pension plan net assets available for benefits. The plan's net assets should be determined in accordance with SFAS No. 35, except that receivables for employer plan contributions would not be included. Plan investments would be reflected at fair value and plan operating assets at cost less accumulated depreciation.[28]

Measurement Valuation Allowance

One of the problems with estimates of pension obligations is that they are very volatile. Changes in assumptions and short-term variations result in a measure that changes from period to period. Volatility per se is not bad, but there is a difference between volatility of the real underlying obligation and volatility introduced because of measurement problems.

The Board concluded that problems with measurement techniques available contribute significantly to the volatility. So, as a practical matter, the measurement valuation allowance (MVA), the third element

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[27]Ibid., par. 11.

[28]Decker, Joyce, and Murray, p. 16.

of the net pension liability, is used to reduce that volatility. Under the proposal, measurement changes would not immediately affect the net pension liability or expense, but instead would be carried in the MVA account and amortized.[29]

These measurement changes include the following:

1. Experience gains and losses related to the pension benefit obligation (actual results differ from expected).
2. The effects of changes in assumptions.
3. Changes in asset fair value except to the extent they are a part of the assumed rate of return.

As an example, if actual salary increases are less than the level of increases assumed, an actuarial gain (experience gain) would result that would reduce the pension benefit obligation. At the same time, the MVA would be increased so that the net pension liability would remain unchanged. The opposite situation results in an actuarial (experience) loss and in increase in the pension benefit obligation. These measurement changes would not be recognized immediately, but, rather prospectively through amortizing the MVA.[30]

The Intangible Asset

An increase in the pension benefit obligation resulting from plan initiation or improvements that gives credit for prior service would increase the net pension liability. At the same time, the employer would recognize an intangible asset on its balance sheet.[31] The Board's rea-

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[29]Preliminary Views, par. 14.

[30]Decker, Joyce, and Murray, p. 16

[31]Preliminary Views, par. 15.

soning for this is that a plan change gives rise to probable future economic benefits qualifying as an intangible asset of the employer. The probable future economic benefits in a particular case may include reduced employee turnover, improved productivity, reduced demands for increases in cash compensation, and improved prospects for attracting additional qualified employees. The cost of the intangible asset can be measured at the date of the plan change based on the amount of the liability incurred to acquire it. The Board recognized that the value of the intangible asset would diminish over its life and that it should therefore be amortized in an appropriate manner.[32]

## Income Statement Effect

### Amortization

The first income statement to be discussed centers on the amortization of both the MVA and the intangible asset. The amortization costs of both would be computed each year by multiplying the unamortized balance at the end of the year by a percentage. The amortization percentage would be equal to 100 divided by the average remaining service period of active plan participants. The average remaining service period is the average number of years of future service expected from each active participant based on the actuarial assumptions used in estimating the pension benefit obligation.[33]

### Periodic Pension Cost

The second income statement effect, periodic pension cost, would

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[32] Ibid., par. 40.

[33] Ibid., par. 16.

require the employer to recognize as pension expense for a period, the sum of the changes in the net pension liability and intangible asset, excluding decreases in the net pension liability that results from employer contributions. That number is also the sum of the following changes in the net pension liability and the intangible asset:[34]

1. The increase in the pension benefit obligation attributable to employee service during the period.

2. The increase in the pension benefit obligation attributable to the accrual of interest of the obligation.

3. The increase in plan assets resulting from earnings on the assets at the "assumed rate," which reduces the periodic pension cost (if actual returns are greater or less than assumed, the difference is an experience gain or loss which would be included in the MVA).

4. Amortization of the intangible asset.

5. Amortization of the MVA, which may either increase or decrease the periodic pension cost.

Transition

Under the proposal, employers would have a choice between two transition methods. Both would result in recognition of an initial net pension liability (asset) equal to the difference between the pension benefit obligation and the plan's assets. Under the "retroactive" method, the unamortized balance of the intangible asset related to past plan amendments and plan initiation would be recognized as an asset and the resulting net debit or credit would be recognized as a change in equity in the earliest period restated.

The Board recognized that the retroactive method could create

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[34]Ibid., par. 9.

[35]Lucas and Miller, p. 105.

serious problems for some employers and that measuring or estimating the unamortized balance of the intangible asset would be difficult if not impossible in some cases. Accordingly, the proposal allows a "prospective" transition method that would recognize the net pension liability (asset) and a transitional intangible asset (or deferred credit). This method would have no immediate effect on equity and would avoid the need to determine separately the unamortized cost of past plan amendments.[35]

The proposal also includes views on required disclosures to accompany the financial statements. They are very similar to current requirements, however, there are a couple of major changes. They are:[36]

1. The makeup of the three components of the net pension liability.
2. The unamortized balance of the intangible asset.
3. The amount of pension cost for the period.
4. The amortization rate applied to the MVA and the intangible asset.

Other Basis For Preliminary Views

The basis of the proposal is that a pension plan represents an exchange of benefits for employee service and the plan is therefore a form of deferred compensation. The FASB has also decided that the obligation is to the employee, not to the plan (or trust) or the employee group. The Board does not believe that the creation of a separate legal entity to receive and invest contributions and pay benefits changes the

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[35] Lucas and Miller, p. 105.

[36] Preliminary Views, par. 17.

nature of that obligation.[37]

A critical point in the Board's view is that the establishment of a pension plan and the service of employees are past transactions or events. Even though an employer may establish a plan in anticipation of future economic benefits, if the plan provides for pension benefits based on prior years of service, the FASB believes that a current recognizable obligation results.[38]

The Board concluded that the understandability and comparability of financial reporting would be improved if a single approach was used to measure the pension benefit obligation and pension cost. The Board's proposed measurement approach is the same as the accumulated benefits approach defined in SFAS No. 35 except that it includes consideration of estimated future salary increases for plans with benefit formulas based on salary.[39]

The method of amortization chosen, a percentage based upon the estimated average remaining service period of active plan participants, would produce charges that decline in amount as the balance is reduced. That method reflects the view that the economic benefits realized by an employer from granting credit for prior service are likely to be greatest in the years immediately following the plan amendment or initiation. That pattern results primarily from the fact that the pool of active employees affected by the grant would grow smaller as time passes.

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[37]Ibid., par. 25.

[38]Decker, William E.; Joyce, John W. and Murray, Ronald J., "Pension Accounting: Analysis of Preliminary Views-Part II," CPA Journal, August 1983, p. 42.

[39]Lucas and Miller, p. 94.

The Board also decided that an actuarial computation, even though based on estimates and assumptions of future events, provides financial information that is reliable enough to be recognized in the basic financial statements. The Board recognizes that the pension obligation may not be calculated with the same degree of precision as other liabilities but believes that the relevance of the information is of overriding importance.[40]

## Implications of the FASB's Proposal

### Results of the Field Test

A few months after issuing Preliminary Views, the FASB issued a special report, Preliminary Views - A Field Test: Employers' Accounting For Pensions, which summarizes the results of a field test conducted on the Board's Preliminary Views on pension accounting. The report includes a discussion of several major questions regarding the proposal, including information concerning the effects of the proposed changes on the income statement, balance sheet, and the year-to-year change in the net pension liability and pension cost.

The purpose of the test was to provide data about actual situations which would enable the Board to compare the accounting proposed in Preliminary Views with current accounting as specified in APB Opinion No. 8.[41]

The test was limited by the fact that the companies who volun-

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[40] Decker, Joyce, and Murray, Part II, p. 42.

[41] Financial Accounting Standards Board, "Preliminary Views - A Field Test: Employers' Accounting for Pensions," (Stamford: FASB, 1983), p. iii.

teered to participate in the test were relatively large and mature and they did not include all of their plans in the test. The companies are not necessarily a representative sample and the test results could have differed significantly for periods having different economic conditions.[42]

Thirty-two companies participated in the field test and 46 plans were tested. The companies applied the accounting proposed in Preliminary Views to their specific situations for the years 1979-1982 in order to determine what the pension cost and net pension liability (asset) would have been if the proposed accounting would have been in effect during these periods.

## Balance Sheet Effects

Virtually every company participating in the test showed an increase in total liabilities in the year of the intial application of the Preliminary Views compared with the accounting under APB Opinion No. 8. In 1982, eight out of ten companies that tested at least 90 percent of their pension assets, liabilities, and cost, would have recognized net pension liabilities. The amounts of those liabilities ranged from 0.5 to 30 percent of 1982 total liabilities and from 1 to 34 percent of 1982 stockholders' equity. The average was 13 percent of total liabilities and 13 percent of stockholders' equity. The other two companies would have recognized net pension assets equal to 1 percent and 4 percent of stockholders' equity.

The Preliminary Views require that estimated future salary increases be reflected in the pension benefit obligation. For most of the plans, the percentage of the pension benefit obligation resulting from

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[42]Ibid.

anticipation of future salary increases was between 20 and 40 percent. If future salary increases were disregarded, many of the companies would have had a net pension asset instead of a net pension liability.[43]

Virtually all field test companies showed an increase in total assets as a result of recording the intangible asset along with the net pension liability or because the market value of the plan's assets exceeded the pension benefit obligation which gives rise to a net pension asset.

The average of the individual increases in total assets utilizing either transition approach were:[44]

| Retroactive Approach | | Prospective Approach | |
|---|---|---|---|
| 1/1/79 | 3.2 percent | 1/1/79 | 6.9 percent |
| 1/1/81 | 2.6 percent | 1/1/81 | 3.7 percent |

## Effect on Net Worth

Under the prospective transition approach, an offsetting intangible asset to the net pension liability is recorded and thus, net worth is not immediately affected. Under the retroactive transition approach, the pension liability might be more or less than the recorded intangible asset, making the effect on net worth unpredictable.

Sixteen of the 28 companies showed increases in net worth upon the initial application of the Preliminary Views under the retroactive transition approach as of 1/1/81 and 18 out of 27 showed decreases in net

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[43]Danker, Harold; Friedman, Kenneth L. and Goldstein, Murray H., "Financial Accounting: How Companies Are Affected By The Preliminary Views," Financial Executive, December 1983, p. 14.

[44]Ibid., p. 15.

worth under the same method as of 1/1/79.[45]

Because of the concern that the intangible asset will be viewed by many users as a "soft" asset, net worth disregarding the intangible asset was examined. Under this test the impact on net worth was the same under both transition methods and more companies showed a decrease in net worth and the average decrease ran between 10.1 and 13.3 percent. The total decrease in net worth as a result of disregarding the intangible asset was over $4 billion for the 26 companies.[46]

Income Statement Effect

For 9 out of 10 companies that tested more than 90 percent of their applicable pension cost, the effect of applying Preliminary Views to 1982 pretax net income ranged from a 2 percent increase to a 3 percent decrease. For the tenth company, which reported a small pretax net income, their pretax income would have increased by 22 percent.[47]

Where the retroactive transition approach was applied, plans showing a decrease in pension expense outnumbered plans showing an increase by approximately three to one. When the prospective transition approach was applied, the number of plans showing an increase and decrease in pension expense were approximately equal. The reason for this is that under the retroactive approach, a portion of the overall change in pension expense is absorbed as a direct charge to equity in the initial year of application, where under the prospective transition approach, the

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[45] Ibid.

[46] Ibid.

[47] Preliminary Views: A Field Test, p. ix.

entire change is reflected in future pension expense.[48]

Other Results

The amortization periods used in the test (averaged from 6 to 28 years) were generally shorter than the amortization periods used in current practice. As a result, pension expense under the Preliminary Views generally increased.[49]

The impact of using market value of plan assets instead of actuarial value of assets differed substantially during the test period resulting in more plans showing a decrease in expense.

The measurement of pension expense under Preliminary Views often resulted in expenses that fell outside the boundaries of the IRS maximum deductible amount and the minimum required contribution under ERISA. Only eight plans tested had pension expense for the entire test period, under both transitional approaches, that was within the maximum and minimum boundaries.[50]

Other Implications of the Preliminary Views

Recording a net pension liability and intangible asset may immediately and significantly impact the balance sheet analysis of tangible net assets and financial ratios, particularly the debt-to-equity ratio. The proposed accounting may cause some companies to be in violation of loan covenants, such as those relating to maximum indebtedness, minimum tangible net worth, and specified relationships of debt to equity.

[48] Danker, Friedman, and Goldstein, p. 19.

[49] Ibid., p. 20.

[50] Ibid., p. 21.

Changes in loan agreements would be required, not only for those companies who would be in default immediately, but also to safeguard against possible violations from plan benefit increases in the future.[51]

The impact of the Board's proposal on financial position and earnings could influence assessments of a company by security and credit analysts and by bond rating agencies. These reassessments could impair the availability of capital or loan funds for some companies and could escalate borrowing costs for others.[52] Labor unions also might be influenced by the proposed accounting to demand accelerated funding. These pressures could in turn impact dividend policies.[53]

Strategies to avoid the accounting results of the proposal also could affect the structure of the pension system in this country. The proposal would tend to inhibit plan improvements. Companies instituting a new plan would be motivated to adopt a defined contribution plan. Companies with defined benefit plans may terminate, if possible, and arrange new plans. Undoubtedly, yet other schemes would be devised to avoid liability recognition and reduced earnings reports.[54]

Others charge that if the proposal were adopted, it would confuse many readers of financial statements. The amounts to be reported on the balance sheet would be complex; an explanatory footnote would be required. The volume of information given would be disproportionate to other data

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[51]Dennis R. Beresford; Richard Schwartz and Ronald D. Wilson, "Proposed Changes To Pension Accounting: Issues and Implications," Financial Executive, November 1983, p. 23.

[52]Ibid., p. 24.

[53]Ernst & Whinney, "Employers' Accounting For Pensions," (Cleveland: Ernst & Whinney, July 1983), p. 30.

[54]Ibid.

in the financial statements in terms of relevance and the information might tend to obscure other information.[55]

In summary, the Field Test demonstrates that the Preliminary Views can have a significant impact on the balance sheets and income statements of companies maintaining defined benefit pension plans. But, according to FASB Chairman Donald J. Kirk in a testimony before a Senate Subcommittee, the proposal is not intended to be the straw that breaks the camel's back, but a standard that will affect the way in which the pension obligations are being presented and where it is presented.[56]

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[55] Peat, Marwick & Mitchell, Executive Newsletter, December 26, 1983, Vol. IX, No. 12. ("Objections Stated By PMM to Proposals For Pension Accounting").

[56] Deloitte, Haskins & Sells, "Accounting and Reporting," Week In Review, May 6, 1983, Vol. 83-18.

# CHAPTER III

## PRELIMINARY VIEWS AND THE CONCEPTS STATEMENTS

### The FASB's Conceptual Framework Project

The Statements of Financial Accounting Concepts are the cornerstone of the FASB's conceptual framework project. The conceptual framework is a coherent system of interrelated objectives and concepts that are expected to lead to consistent financial accounting and reporting.[57] The framework is to provide a sense of direction and tools for resolving problems, and should determine the bounds for judgement.[58] Unlike a Statement of Financial Accounting Standard, the Statements of Financial Accounting Concepts (SFAC's) do not establish generally accepted accounting principles, which require a change in existing accounting practice, or justify changing existing accounting and reporting practices. Therefore, it follows quite logically that if a new accounting standard is being proposed, it should be able to survive the "fire" test of the objectives and definitions contained in the SFAC's. It is thus the objective of this chapter to evaluate the FASB's Preliminary Views on pension accounting in light of the definitions and objectives set forth by the SFAC's.

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[57] FASB Discussion Memorandum, par. D-1.

[58] Ibid., par. D-9.

## SFAC No. 1: Objectives of Financial Reporting By Business Enterprises

The objectives listed in this statement are those of general purpose external financial reporting by business enterprises. These objectives stem primarily from the informational needs of external users who lack the authority to prescribe the financial information they want from an enterprise and therefore must use the information that management communicates to them.[59]

Each objective is listed separately, followed by its relation to the Preliminary Views on pension accounting.

Objective No. 1:

> Financial reporting should provide information that is useful to present and potential investors, creditors, and other users in making rational investment, credit, and other decisions.[60]

The Board concluded that the information about the obligation incurred, based upon employee service and other events during the period, is useful because it provides information about a company's financial position and results of operations.[61] If the accounting requirements of the <u>Preliminary Views</u> document do in fact provide this information, then those requirements would be useful in making rational investment, credit, and other decisions.

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[59] Financial Accounting Concepts No. 1, "Objectives of Financial Reporting By Business Enterprises," (Stamford: FASB, 1978), par. 28.

[60] Ibid., par. 34.

[61] Preliminary Views, par. 33.

Objective No. 2:

> Financial reporting should provide information to help present and potential investors in assessing the amounts, timing, and uncertainty of prospective cash flows.[62]

Ernst & Whinney, among other companies and individuals, have suggested that the mandate of a single actuarial cost method would lessen the ability to predict cash flows. Under current practice, what the company expenses as pension cost is usually the same as the amount used to fund the plan during the period, thus making it easy to determine cash flow. Under the proposal, there is concern that the expensing and funding of plans would grow more divergent, thereby weakening the ability to predict cash flows.

The Board did not dispute the unsefulness of cash flows, but notes that accrual accounting frequently differs from cash-basis accounting and that information about cash flows is provided in the statements of changes in financial position.[63] The Board also stated that information about earnings and its components measured by accrual accounting generally provide a better indication of enterprise performance than information about cash flows.[64]

Objective No. 3:

> Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources, and the effects of transactions, events, and circumstances that change resources and claims to those resources.[65]

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[62] SFAC No. 1, par. 34.

[63] Preliminary Views, par. 33.

[64] SFAC No. 1, par. 44.

[65] Ibid., par. 40.

The Preliminary Views meet this objective by displaying the economic resources of an enterprise, the intangible asset or net pension asset (if applicable); claims to those resources, the net pension liability; and the effects of transactions, events, and circumstances that change the resources or claims to those resources, the change and makeup of the net pension liability has to be disclosed along with the period's pension cost.

This objective is also met because plan amendments, which increase the pension benefit obligation, are reflected immediately in the financial statements by an increase to the intangible asset and pension benefit obligation thereby providing up-to-date information in the changes in economic resources and claims to those resources.

Objective No. 4:

> Financial reporting should provide information about factors that may affect an enterprise's liquidity or solvency.[66]

As was mentioned earlier, the intangible asset resulting from liability recognition might be viewed as a "soft" asset by many analysts. Others view the intangible asset as an impediment to a user's ability to measure or predict liquidity, financial flexibility, or future cash flows.[67]

Whether or not the intangible asset is a valid asset will be addressed later. The concepts statement does say that cash flows and earnings are major determinants in predicting solvency, liquidity, and

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[66]Ibid., par. 49.

[67]Beresford, Schwartz and Wilson, p.25.

funds flow. However, it is doubtful that many analysts include goodwill, if shown on the balance sheet, in assessing these factors so there is no reason to believe that the inclusion of another intangible asset on the balance sheet will significantly change analyst's ability to predict solvency, liquidity, and funds flow.

Actually, the inclusion directly on the balance sheet of the net pension liability may help in emphasizing the nature of this obligation, that large amounts of cash are eventually going to have to be used to fund these obligations which can have a significant impact on an enterprise's liquidity and solvency.

## SFAC No. 2: Qualitative Characteristics of Accounting Information

The objectives of this statement is to examine the characteristics of accounting information that make that information useful.[68] The characteristics of information discussed in this staament are the qualities that make information useful and are to be sought when accounting choices are made. These characteristics are viewed as a hierarchy of qualities with usefulness for decision making being the most important. Without usefulness there would be no benefits from information to set against its costs.[69]

Understandability occupies a position as a link between the characteristics of users and decision-specific qualities of information. Information cannot be useful to decision makers who cannot understand it,

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[68]Financial Accounting Concepts Statement No. 2, "Qualitative Characteristics of Accounting Information," (Stamford: FASB, 1980), par. 1.

[69]FASB Discussion Memorandum, par. D-23.

even though it might otherwise be relevant to a decision and be reliable. Simply put, information cannot be useful to a person who cannot understand it.

Preliminary Views could, if adopted, at first reduce the understanding of pension information appearing in the financial statements. However, that fact alone is not enough evidence to hinder the adoption of the proposal. As the FASB stated in SFAC No. 1, information provided by financial reporting should be comprehensible to those who have a reasonable understanding of business and economic activities and are 'willing to study the information with reasonable diligence' (Emphasis Added).[70] It is therefore reasonable, at first, to expect there may be some confusion with the new accounting but it can also be expected that, in due time, those individuals who rely on external financial reporting will study the standard and will soon have comprehension of it.

Relevance and reliability are the two primary qualities that make accounting information useful. Subject to the constraints imposed by cost and materiality, increased relevance and increased reliability make information a more desired commodity. Although ideally accounting information should be both relevant and reliable, it may be necessary to sacrifice some of one quality for a gain in another.[71]

To be relevant, accounting information must be capable of making a difference in a decision by helping users form predictions about the outcomes of past, present, and future events or to confirm or correct

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[70] SFAC No. 1, par. 34.

[71] FASB Discussion Memorandum, par. D-26.

expectations.[72]

As mentioned, the proposal would affect the balance sheets and income statements of all companies that maintain defined benefit pension plans. Some companies may find themselves in technical default under existing loan agreements. Assets, liabilities, and net worth for these companies could be materially affected. All these changes would no doubt make a difference to users in predicting the outcomes of past, present, and future events or make a difference in confirming or correcting expectations. it is plain to see the information proposed by Preliminary Views would be very relevant.

The reliablity of information rests upon the faithfulness with which it represents what it purports to represent, coupled with the assurance for the user, which comes through verification, that it has representational quality.[73]

The FASB received many comments on the fact that any measure of the pension obligation requires estimates of future events including mortality, turnover, and rates of interest. The argument was that the lack of precision inherent in such estimates makes a reliable measure of the obligation impossible.[74]

The Board recognized that the precision obtainable in a measure of the pension obligation is less than that of many financial statement measures but concluded that the relevance of the information is sufficient for that lack of precision. The Board also concluded that the

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[72]SFAC No. 2, par. 47.

[73]Ibid., par. 59.

[74]Preliminary Views, par. 34.

reliability of the above estimates is adequate to provide useful information.[75]

The Board also decided that the proposed liability in Preliminary Views, as opposed to the liability recognition in APB Opinion No. 8, is more reliable because the measure is a more faithful representation of a liability because it is an estimate of a present obligation to make a future cash outlay as a result of past transactions and events. The alternative does not purport to be a measure of an obligation, it is a residual (difference between amount expensed and funded), and therefore it cannot be a faithful representation of a liability.[76]

Neutrality means that in formulating or implementing a standard, the primary concern should be the relevance and reliability of the information that results, not the effect the new rule may have on a particular interest.[77] The FASB also rejects the view that financial accounting standards should be slanted for political reasons or to favor one economic interest over another. The FASB will, however, be alert to the economic impact of the standards they promulgate.[78]

Some commentaries have charged that the FASB is not concerned with the adverse economic impact of having to recognize a net pension liability. However, the economic consequences of not recognizing the obligation

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[75] Ibid.

[76] Ibid., par. 36.

[77] SFAC No. 2, par. 98.

[78] Ibid., par. 106.

presumes the markets and decision makers will not be aware of the liability if it is not recorded. That assumption conflicts with the basic objective of reporting neutral and unbiased information that is not relevant to decision makers.[79]

Consider, for example, the suggestion that recording a pension liability will deny some companies access to credit. Credit decisions are based, in part, on accounting information, and those who must decide to grant or deny credit rely on having unbiased (neutral) information, including information on a company's liabilities. It is inappropriate for the FASB to refuse to recognize a liability that exists just because knowledge of that liability might cause the banker to deny credit to a particular company.[80]

Comparability is a quality that enables users to identify similarities in and differences between other enterprises and with similar information about the same enterprise for some other point in time.[81] The FASB received comments that a single mandated approach would not achieve comparability because of differences in the assumptions required, or would impair comparability because it would obscure the different circumstances that call for different approaches.[82]

The Board was not convinced that there are differences among employers that required different accounting approaches and concluded that the use of a single approach would improve comparability of finan-

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[79]Hollowell and Lucas, p. 66.

[80]Ibid.

[81]SFAC No. 2, par. 111.

[82]Preliminary Views, par. 57.

cial reporting even if it were determined that no one approach provided a better measure than the alternatives.[83]

Ernst & Whinney stated, in their position paper to the FASB on Preliminary Views, that the comparability would be illusory. The actuarial assumptions used are still subjective and would differ from company to company. They also pointed out that since the Board is not requiring all companies to use the retroactive transitional approach, the financial statements will differ for years between those companies that chose the prospective transitional approach and those who chose the retroactive transitional approach.[84]

Information is material when its omission or misstatement, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.[85] As with the earlier example on neutrality, the judgments of investors and creditors will be influenced if a net pension liability makes its way onto the balance sheet. There is no doubt, the proposed accounting information is material.

Information can be useful and yet too costly to justify providing it. To be useful and worth providing, the benefits of information should exceed its costs.[86] Providing the information required by Preliminary

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[83] Ibid., par. 58.

[84] Ernst & Whinney, "Position Paper on the FASB's Preliminary Views," (Cleveland: Ernst & Whinney, December 1, 1983), p. 5.

[85] SFAC No. 2, par. 123.

[86] Ibid., par. 33

Views is certainly not going to be cheap. However, much of the information that would be needed is already required under SFAS No. 36 and it should be the incremental costs of obtaining the extra information that should be weighed against the benefits to be obtained by providing it. By viewing it this way, there shoudl be no problem justifying the cost of the information needed.

## SFAC No. 3: Elements of Financial Statements of Business Enterprises

This statement defines the elements of financial statements of business enterprises. The elements are the building blocks with which financial statements are constructed. The elements defined are an enterprises resources, the claims to those resources, and the changes therein from transactions and events. Definition of the elements are significant in determining the content of financial statements.[87] One way to evaluate the Preliminary Views is to see how the proposed elements meet the definitions.

ASSETS:

> "Are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events."[88]

An asset has three essential characteristics: (1) it embodies a probable future benefit, (2) the enterprise can obtain the benefit and control others access to it, and (3) the transaction or event giving rise

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[87] Financial Accounting Concepts Statement No. 3, "Elements of Financial Statements of Business Enterprises," (Stamford: FASB, 1980), par. 17.

[88] Ibid., par. 19.

to it has already occurred.[89]

The Board concluded that a plan change gives rise to probable future economic benefits qualifying as an intangible asset of the employer. These benefits include reduced employee turnover, improved productivity, reduced demands for cash compensation, and improved prospects for attracting qualified employees. While the intangible asset proposed by the Board appears to meet the definition, commentaries have pointed out that the asset has characteristics similar to advertising and research and development costs, which are expensed out under current accounting rules. They view the intangible asset as a pragmatic solution to avoid any immediate impact on equity or earnings.[90]

The intangible asset is obtained and controlled by the enterprise and it is a result of past transaction or events, the initiation or amendment of a pension plan, thus meeting the last two characteristics of an asset.

LIABILITIES:

> "Are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events."[91]

The essential characteristics of a liability are (1) there is at present, legal, equitable, or constructive duty to transfer assets in the future, (2) little or no discretion to avoid the future sacrifice, and (3) the transaction or event obligating the enterprise has already

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[89] Ibid., par. 20.

[90] Decker, Joyce, and Murray, Part II, p. 44-46.

[91] SFAC, No. 3, par. 28.

occurred.[92]

The Board concluded that the employer's obligation for defined pension benefits is a present obligation of the employer to transfer assets to others to the extent that the services on which the benefits are based has already been rendered. The obligation requiring a probable future sacrifice of economic benefits results from the establishment of the plan and from employee service as specified by the plan and thus results from past transactions or events.[93] Accordingly, the Board stated it meets the definition of a liabiltiy.

Some have argued that the obligation is not the result of past transactions or events. That the benefit improvements are granted in exchange for anticipated future service and not as an additional reward for past services. They conclude that any obligation based upon prior service has a clear relationship to future events and as such, the pension obligations is in many respects like an executory contract which generally are not reported as liabilities.[94] Others believe that a liability should be recognized, but only to the extent of the benefits that have vested. Before the benefits of an employee vest, no pension obligation exists that is a result of past transactions or events.[95]

However, the Board concluded that vesting, the legal part of the

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[92] Ibid., par. 29.

[93] Preliminary Views, par. 28.

[94] Ernst & Whinney Position Paper, p. 2.

[95] Leonard Lorenson and Paul Rosenfield, "Vested Benefits - A Company's Only Pension Liability," Journal of Accountancy, October 1983, p. 68.

obligation, should not be the ceiling in liability recognition. The Board stated that unless there is evidence to the contrary, accounting should be based on an assumption that the plan will continue in operation and the benefits defined in the plan will be provided. Under that assumption, the employer's probable future sacrifice is not limited to either the termination liability or amounts already vested.[96]

The Board decided that the pension plan's net assets available for benefits should be deducted from the pension benefit obligation in arriving at the net pension liability (asset). The right of offset exists since the plan assets must first be used by the plan trustee to pay the pension liability. Deducting the plan assets from the pension benefit obligation reflects the net pension obligation for what the employer is liable.[97]

Many commentators believe that the plan assets are not assets of the employer. The employer has little, if any, control over the assets and usually cannot appropriate or withdraw any excess assets from an ongoing plan.[98] Therefore, this position holds that the plan assets are not assets of the employer and do not belong on the employer's balance sheet.

The FASB's Preliminary Views to recognize the plan assets held in trust as assets of the employer seems to be in direct contradiction with the position taken by the FASB in its recent standard "Statement on

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[96] Preliminary Views, par. 31.

[97] Ibid., par. 72.

[98] Decker, Joyce, and Murray, p. 44.

Extinguishment of Debt." In this statement, assets placed in trust to be used solely for satisfying a debt obligation are no longer considered assets of the company. The Preliminary Views states that assets held in trust to be used solely for satisfying a pension obligation should be considered assets of the sponsoring company.

The measurement valuation allowance (MVA) is a practical means of reducing the volatility that would otherwise be introduced by measurement changes while at the same time explicitly disclosing the amount of those changes.[99] The MVA is an example of a separate account that is part of the accounting representation of an asset or liability. Such an account is neither an asset nor liability, but is used as a "valuation account."[100]

It has been argued that the MVA is a device that has been created to accommodate the conflict between recognizing a liability affected by actuarial changes and current market valuations of assets. Used to smooth income from extreme volatility, they charge the MVA is not even a true valuation account, which reduces an asset or liability to its present value or proceeds.[101]

However, the amortization of the MVA does have a conceptual counterpart in current practice. The actuarial methods used in APB Opinion No. 8 include a variety of techniques for recognizing actuarial gains and losses over several time periods.[102]

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[99] Preliminary Views, par. 71

[100] Ibid., par. 72.

[101] Ibid., par. 121.

[102] Lucas and Miller, p. 100.

Whether or not the net pension liability is an element that should be recognized depends on what kinds of things belong on balance sheets. If it is not included, analysts would still add the "footnote liabilities" to those on the statement and construct their own adjusted balance sheets, but the convenience of having a complete balance sheet would be lost and some users might be misled because they expect all liabilities to be included.[103]

The question we must ask is "is there an obligation to make a probable future payment?" "Has the event that obligated the company already occurred?" If so, the pension obligation is similar to other obligations that are recorded as liabilities and the balance sheet would be incomplete--its usefulness diminished--if the pension liability was excluded.

EXPENSE:

> "Are outflows or other using of of assets or incurrence of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services, or carrying out other activities that constitute the enterprise's ongoing operations."[104]

The Board concluded that the amount of the liability incurred based upon services rendered during a period and the increase in the liability due to accrual of interest qualify as an expense.[105] This view is consistent with the "asset and liability" view of income measurement where expenses are measured by the amount of increases in liabilities or decreases in assets (or a combination of both).

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[103] Hollowell and Lucas, p. 60.

[104] SFAC No. 3, par. 65.

[105] Preliminary Views, par. 30.

Advocates of the "revenue and expense" view, who hold that earnings are best determined directly as the difference between revenues and expenses, believe that the focus of pension expense should be on the annual charge to income rather than the incremental increase in the net pension liability. This is the view currently held in APB Opinion No. 8. Here the focus is on the pension expense incurred as the employee renders service during a particular period.[106] Here pension expense is the annual actuarially determined amortization of the pension benefit obligation with a liability resulting only if this amount is not funded.

Others believe that the radical change in determining pension expense is unwarranted in the absence of clear support from a conceptual framework that is complete with respect to reporting earnings.[107]

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[106] Decker, Joyce, and Murray, p. 45.

[107] Ernst & Whinney Position Paper, p. 4.

## CHAPTER IV

## CONCLUSION

### Summary of the Issues

The FASB's Preliminary Views on pension accounting would apply to all noncontributory defined benefit pension plans sponsored by a single employer in the U.S. that is not funded using insurance contracts. The proposed accounting involves recognition in the employer's statement of financial position of pension-related liabilities that are not currently recognized under generally accepted accounting principles.

Under the proposal, an employer would include two pension-related items in its balance sheet. The first of these, the net pension liability (asset) represents the employer's obligation to provide pension benefits to employees in exchange for services already rendered by the employees. Some companies would have pension plan assets greater than their benefit obligation and would report a net pension asset.

The net pension liability (asset) is made up of three components which would be described in the footnotes. The components are (1) the pension benefit obligation, (2) the plan's assets, and (3) a measurement valuation allowance that would reduce the measurement volatility of the net pension liability (asset) that is inherent in the predictions of future events that must be made.

The second new item to be included in the balance sheet is an intangible asset representing expected economic benefits to be realized by the employer as a result of past plan amendments or the initiation of a plan.

When a plan is amended or initiated and credit is given retroactively for employee services already rendered, the result is an increase in the pension benefit obligation and in the net pension liability. The amendment or initation is expected to benefit the operations of future periods. Those future economic benefits underlie the intangible asset which will be amortized to periodic pension expense in future periods. Under the proposal, a plan amendment or initation may not immediately stockholder's equity.

Plan assets will be measured at fair value because of the relevance of that information. The Board believes that the use of a single actuarial method will result in information about pension costs and obligations that are relevant, reliable, understandable, and more comparable than amounts currently reported.

Original pension measurement methods were originally developed as funding methods to provide for the systematic setting aside of funds for future pension benefit payments. The Board believes that plan funding is a financing decision and therefore quite different from the accounting problems of measuring assets, liabilities and expenses.

The volatility that would result from measuring pension benefit obligations and plan assets is a result of the measurement process rather than changes in the underlying obligation and therefore the measurement valuation allowance (MVA) would be used to smooth that volatility. Changes in plan assets or the pension benefit obligation as a result of actuarial assumptions or experience gains and losses would initially be offset with equal and offsetting changes in the MVA. Initially then, no change would result in the net pension liability (asset) but gradually through the amortization of the MVA.

The accrual of pension expense for a period would be the sum of the changes in the net pension liability, excluding decreases in the net pension liability that results from employer contributions. Depending on the accounting and funding methods used at present, pension expense may be higher or lower than what is currently reported or funded under present practice. Companies may choose to use either a retroactive transitional approach, which would immediately affect net worth, or a prospective transitional approach, which would allow an employer to recognize the effect on equity gradually or a number of years.

Recording a net pension liability and intangible asset may immediately and significantly impact the balance sheets of companies with defined benefit plans. Analysis of trangible net assets and other ratios, particularly the debt-to-equity ratio, would be affected immediately. There are concerns that the proposal, if adopted, would cause some companies to be in violation of loan covenants which would require changes in loan agreements. Concern has also been expressed that some companies may be put in a position where their credit ratings would be damaged.

The financial impact on pension expense is difficult to assess. Its effect will vary from employer to employer depending on several factors such as actuarial assumptions made about the employee group. Pension expense could decrease for some companies, increase, or remain the same for others.

There are a variety of reasons why the FASB believed a change was needed in pension accounting. One of them is the concern that a portion of American industry is in trouble because some companies have large unfunded pension obligations that, under APB Opinion No. 8, are not currently reported on the balance sheet. There is also considerable concern over the apparent lack of comparability of pension costs among companies. These reasons, among many others, caused the FASB to decide a change was needed in pension accounting. It also gave the FASB an opportunity to rework a standard that could be in line with their conceptual frameworks project.

## Viewpoints

If the FASB's Preliminary Views evolve into an acocunting standard, the changes that would result would no doubt be dramatic. For most companies this would mean a new approach to the determination of pension cost as well as the inclusion on the balance sheet of an intangible asset and a net pension liability (asset). Whether the change would paint a clearer picture of pension information depends on whether the estimates of the pension benefit obligation can be computed with sufficient reliability to provide a credible representation of a liability.

The writer concurs with the FASB's objective of pushing for financial statements that will show fairly the statement of position and results of operations for companies, not only in conformity with GAAP, but in line with the conceptual framework project. Whether Preliminary Views meets this objective is open to debate.

The writer also believes that an accounting liability does exist for pension obligations and that including it on the balance sheet would significantly improve the usefulness of financial statements. The balance sheet should show a company's obligations as defined by SFAC No. 3, if the pension benefit obligation meets the definition, then it should be appearing on the balance sheet accordingly. Accounting reports should provide relevant and reliable information, if that happens to include reporting a pension liability, so be it. The evolution of a theory of accounting should not be sidetracked by politics or special interests.

Although Preliminary Views has been met by stiff opposition, the writer believes that a working solution can be reached, not necessarily by compromising the concepts statements, but by ironing out the differences of what are the objectives of financial reporting.