Toward Business Literacy: Accounting Outlines

Pensions

Employers provide benefits to employees after they retire for services provided during employment

- There is accounting for the employer who sponsors and funds plan
- There is accounting for the pension fund that receives contributions, administers assets, makes benefit payments as a separate entity

Types of plans

- Contributory plans have employees bearing a part of the cost
- Non-contributory plans have the employer bearing the full cost
- Qualified pension plans (government) have provisions
  - Employer can deduct contributions
  - Earnings on assets are tax-free
- **Defined Contribution Plan**
  - Employer contributes to pension trust based on a formula:
    - Factors include age, length of service, employer's profits, levels of compensation
  - Employee collects from the trust based on:
    - Amounts contributed, income accumulated, treatment of forfeitures caused by early termination
  - Benefit of gain or risk of loss is carried by employee
  - The employer's contribution is the current pension expense
  - Disclosures must be made for:
    - Plan description, employee groups covered, basis for determining contributions, and matters affecting comparability
  - In a defined contribution trust, beneficiaries are employees
- **Defined benefit plan**
  - Based on years of service and compensation levels near retirement
  - Must determine contribution needed today to meet future benefits
  - Benefits are based on uncertain variables
    - Actuaries assign probabilities based on assumptions
      - Mortality rates, employee turnover, interest and earnings rates, early retirement frequency, future salaries
    - Actuaries figure:
      - Pension obligation
      - Cost of servicing plan
      - Cost of amendments
  - In a defined benefit trust, beneficiary is the employer
      - Substance belongs to the employer

Notes in financials

- Show a schedule of pension expense components
- Show a reconciliation of: PBO←→FMV of plan assets and changes
- Funded status of plan
- The rates used (discount rate, expected return, rate of compensation increase

Toward Business Literacy: Accounting Outlines

Pension Obligation

- Discounted to present value
- Employee is vested if entitled to benefits, even without future service
- Accounting for pension obligation has three choices:
  - Vested benefit obligation: @current salary for vested employees
  - Accumulated benefit obligation: vested and not at current salaries
  - Projected benefit obligation: vested and not @ future salaries
- FASB #87 chose the projected benefit obligation and non-capitalization approach (off-balance sheet financing)
  - Economic substance: only employer's promise and employee's services affect liability
- Pension liability is reduced through benefit payments

Pension expense has five components

- Service Cost- increase in payable for current year's services
- Add: Interest on liability: interest expense on pension benefit obligation
  - Uses a settlement rate; obligation is at present value, discounted
- Less: Actual return on plan assets: earnings reduce employer's cost
  - [Ending assets-beginning assets] – [contributions – benefits paid]
- Plus: Amortization of unrecognized prior service cost
  - When plan is initiated, benefits are retroactive and amortized over remaining service life
- Less Gain or Plus loss: arises from
  - Actual vs. expected return on plan assets
  - Amortization of unrecognized net gain or loss
  - The corridor approach of recognition is used for amortizing accumulated balance in unrecognized gain or loss
    - Must exceed 10% of the larger of beginning balance in the PBO or FMV of plan assets: excess is amortized→expense

Minimum liability

- If amount funded in cash < annual expense→pension liability
- If amount funded in cash > annual expense→prepaid pension cost
- Recognize a minimum liability if: accumulated benefit obligation is greater than FMV of plan assets
  - Must compare this to prior service cost and reduce comprehensive income if additional liability is not enough to cover prior service cost

From Intermediate Accounting by Keiso
Last modified 7/26/2013