

Pension Accounting and Disclosure  
Under the New Pension Reform Act

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The problems of pension disclosure and accounting certainly did not arise because of the Employee Retirement Income Security Act of 1974, but that Act has accentuated the need for solutions. For some years, the pension area has been troublesome to accountants and analysts since it has represented one in which corporations have made major commitments and incurred substantial costs which have not been fully accounted for, disclosed or understood. The methods used in calculating the amounts involved have varied substantially, depending in part on the arbitrary choice of methods and assumptions made by actuaries and managements, and as a result there have been suspicions that pension costs were being used as a means by which earnings (as contrasted with operations) were managed.

Two factors occurring in 1974 have made the problem more significant and called more attention to it. The first was the dramatic decline in equity values which have had the effect of eroding pension fund portfolios, with resulting implications for future pension costs and the ability of some funds to meet their liabilities. The second was the passage of the Act which increased potential liabilities and injected a number of additional unknowns into the measurement process.

While the Act did make substantial changes in the pension environment, its impact on corporate financial reporting was perhaps overstated by some of the stories which appeared at the time of its passage. Business Week, for example, ran an article entitled "The Hidden Corporate Debt" -- referring to the \$30 billion or so unfunded payment commitments which would be created upon the enactment of the Act. Let me borrow, if I might, from the "restrained" language of the article: "Scores of companies are deeply in hock to their pension plans. For some, the debt is so enormous it could impede their profitability, growth, and borrowing power for years to come." While a few companies who have used their pension funds as a self-financing device may indeed face some problems, for a large majority of companies the Act will not have such a material impact.

Nevertheless, a careful examination of pension accounting and disclosure is clearly overdue, and the Act should serve as a healthy stimulant both to the Financial Accounting

Standards Board and to the Securities and Exchange Commission to undertake this necessary review.

A policy of full and fair disclosure is the touchstone of the Federal Securities Law and the raison d'être of the Commission. Although the Commission is given no new statutory role under this new legislation, it must decide how much pension information a reasonably prudent investor and his financial interpreters ought to have about the financial implications of pensions for the 10,000 registrants subject to the continuous disclosure requirements of the Securities Act of 1933, and the Securities Exchange Act of 1934. This information should enable them to make more rational economic decisions and if economic decisions are rational, then the capital markets will be more efficient.

Regulation S-X prescribes the form and content of financial statements filed with the Commission. In adopting these financial standards, the Commission has indicated that its policy is “. . .to support the development of accounting principles and methods of presentation by the (accounting) profession but (to be) free to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which have gained general acceptance.” (SEC Accounting Series Release No. 96).

The Commission has identified the Financial Accounting Standards Board as the body in the private sector which it will look to in the private sector to provide leadership in improving accounting principles and standards. The Board has placed the subject of pension accounting on its technical agenda. In addition, it has published an interpretation of Accounting Principles Board Opinion No. 8 (which is currently the authoritative statement on the subject of pension accounting) setting forth the following views on the impact of the Act:

- (1) The funding requirements of the Act. . .do not per se affect the accounting for the cost of pension plans under the Accounting Principles Board Opinion #8.
- (2) The new law gives rise to no legal obligation (i.e., balance sheet liability) for unfunded costs except to the extent of annual

required funding or in anticipation of actual or probable plan termination. (This settles, I think, Business Week's concern about the imminent appearance of huge new liabilities in the corporate financial statements of "going concerns.")

- (3) If compliance with the Act's vesting and funding requirements will have a significant impact on an enterprise's provision for, or funding of, pension costs in the future, this impact shall be disclosed in the notes to the financial statements.

This interpretation is an auspicious beginning. However, substantial problems remain to be dealt with and will no doubt be addressed when the subject is fully dealt with by the Board.

The basic financial reporting problems can be divided into three categories: the fundamental accounting approach, methods of implementing this approach, and disclosure.

#### The Fundamental Accounting Approach

The first question that must be resolved is the way in which pension costs should be measured. The Accounting Principles Board in Opinion No. 8 effectively adopted actuarial methods for calculating pension costs even though these methods were designed primarily with the objective of developing funding plans. The actuary was recognized as expert and his computations were rather uncritically accepted.

In fact, adoption for accounting purposes of actuarial principles based on discounted cash flow concepts was a major departure from traditional accounting thinking. There remain serious questions as to whether such techniques are consistent with the "accounting model" and whether their use may not result in data which is misunderstood by investors and other users of statements.

In essence, the discounting technique used by the actuary reduces current pension expense by amounts which are expected to be earned in the future on the investment of pension funds, and this reduction occurs whether or not any funds are set aside to meet pension

obligations. This would seem to violate both the principle of non-anticipation of income and the principle that offsetting expenses and revenues should not be netted on the income statement.

In addition, the system has the result that aggregate pension expense from identical plans will vary depending upon the method of funding used even though the APB opinion emphasizes that funding and accounting matters should be kept separate. The plan that is funded more rapidly will result in lower reported pension cost, although that difference is solely the result of incremental investment earnings generated by one funding plan compared with the other.

Finally, the accounting approach adopted in APB Opinion 8 has the effect of omitting from the balance sheet both a substantial pool of funds whose investment may significantly benefit the corporation and a liability which may be important in the long-term analysis of demands upon the corporate exchequer.

To say these things is not to criticize the efforts of actuaries. They have developed a system designed to answer the question originally asked them which was to calculate cash inflows and outflows contemplated by various pension plans. There is no evidence that they expected their system simply to be picked up and dropped into financial accounting.

If, for example, actuaries had been asked to calculate the average number of pension dollars that might be expected to be paid out to employees for each dollar of wages over their working lives, they could have computed this number as well. There is much to be said for an accrual of pension costs on this basis which would exclude the investment factor from the computation.

If this approach were followed, pension funds might be recorded as a special class of long-term asset on the corporate balance sheet, and income earned on this fund might be recorded as pension fund income which could appear in the income statement. With a little ingenuity, a wide variety of entries and statements could be constructed following variants of this non-discounting approach.

Such an approach is not set forth as the ideal solution to pension accounting, nor necessarily as an improvement to the current system. It is recognized that when cash out flows

and expenses arise at widely separated times, the conventional accounting approach of equating the two is subject to valid criticisms on economic measurement grounds.

The conventional economic measurement technique for equating cash flows at different points in time is the use of present values based on discounting. In Opinion 21, the Accounting Principles Board provided for the limited use of this approach, and the Commission has utilized it in its disclosure requirements relating to lease commitments. Nevertheless, with the exception of pensions, discounting techniques have only been used in accounting in the valuation of contractually fixed cash commitments. If they are to be extended, the full implications of the approach should be explored. Is it desirable, for example, to record pension expense on a net present value basis, while recording deferred tax expense at a gross full dollar amount? Should discounting techniques be used in allocating the cost of fixed assets to the periods of their use?

It is apparent that the Financial Accounting Standards Board will have to answer some fundamental questions before it can realistically expect to develop a sound approach to the measurement of pension cost which is consistent with the accounting model. The actuary's model cannot be accepted as a "black box" which may be assumed to generate the right answer for users of financial statements.

### Implementation

Once a fundamental model has been decided upon, there still remain many problems of implementation. These are of two sorts, theoretical and empirical. Theoretical problems are those which deal with the way in which the fundamental measurement approach is to be used. If discounting methods are to be used, for example, should they be designed to produce an equal charge over an employee's life, a charge based on a fixed percentage of wages or a charge which grows as the date of retirement grows nearer? How should the system deal with payments to be made on the basis of service before a plan was adopted or amended? To what extent should vesting requirements affect accounting measurement judgments?

These theoretical implementation problems are subject to solution on a uniform basis among companies, and it is to be hoped that they will be addressed by the FASB in its analysis of pension accounting. One of the major problems of APB Opinion 8 was that it did not attempt to limit the actuarial cost methods used to any major degree. Then, on top of this deficiency, it failed even to mandate a particular accounting method once actuarial computations were complete. Past service costs, for example, could be amortized or not. Actuarial gains and losses could be recognized in a number of different ways. Companies today, therefore, may exercise wide discretionary choice over the amount of pension expense included in income.

Beyond the theory, there are major empirical problems which must be solved in applying costing techniques. These lead to the well known need for actuarial assumptions which define future parameters that go into cost calculations. Such assumptions include investment returns, cost of plan administration, mortality of the pensioner group and assumptions which define the amount of the pensions to be paid such as employee turnover, rate of salary increase, expected retirement age, vesting and other items which may affect level of benefits on particular plans.

Since all these assumptions relate to a particular plan and the benefits provided thereunder, it is not practical to define a single set of such assumptions to be made by all. Mortality probably differs significantly between coal miners and college professors, for example, and the use of a single table to cover both would result in erroneous calculations. Similarly, turnover and promotion rates and retirement ages vary among companies.

The investment return assumption is not one which varies based on the terms of the plan, but rather based on its investment approach and success. While other assumptions may be derived on the basis of historical analysis, it is less clear that future investment results can be projected from the past. This assumption is therefore little more than an arbitrary guess in most cases. Since end results are highly sensitive to this assumption, it provides the potential for significant control over those results, and this is a control which it appears has been used by a number of managements to manage earnings.

It may be feasible to prescribe a single uniform investment return assumption for all plans, together with a standard period for the amortization of investment performance which differs from the standard. In this fashion, the discretionary nature of pension cost measurements may be substantially reduced.

Historically, managements had wide discretion to fix assumptions and actuaries had no independent responsibility for assumptions selected. Accountants did have responsibility for assuring themselves that assumptions fell within broad ranges of reasonableness, but this was only effective in dealing with extreme cases. Actuaries and accountants are given new responsibilities under the Pension Reform Act. The new pension act has made it clear that these “independent” professionals now owe their primary duty to the pension plan beneficiaries, although they may still be chosen or paid by the sponsor. These experts must opine on the overall empirical reasonableness of pension plan assumptions and the plan financial statements which result. It is hoped that this responsibility assigned to outsiders will improve the accuracy and consistency of actuarial assumptions. It is not likely that the FASB will be able to improve empirical estimates by the promulgation of an accounting standard.

### Disclosure

The final financial reporting problem relevant to pension costs is that of disclosure. At the present time, it is safe to say that disclosures made have not been adequate to enable users of financial statements to sort out the many differences in accounting, cost determination and actuarial assumptions used by various companies. In addition, there has been virtually no disclosure of the terms of plans, the assets accumulated or work force characteristics.

The basic problem of pension disclosure arises from the complexity of pension calculations and the lack of understanding of the implications of different methods of computing pension costs. It is not realistic to expect the “average investor” to understand the detailed disclosure which would be required to enable an analyst trained in the area to develop an understanding in depth of the pension cost data. In the pension field more than most, communications must be differentiated based upon the user’s ability to use them. Such abilities

are sharply divided, and previous efforts of the Accounting Principles Board and the SEC to provide for a middle ground of data have not been successful. The SEC, for example, has required disclosure of the unfunded past service cost of a plan. Without details underlying the methods of calculation, such a piece of data is largely useless. It does not provide a basis for comparison among companies since calculation variations can make a major difference in the number. It does not measure a total pension commitment nor the present value of such a commitment since it deals only with past service costs. It can fluctuate from period to period as a result of undisclosed changes in one or several variables.

While the APB's requirement for disclosure of the "nature and effect of significant matters affecting comparability for all periods presented" is more promising, it too has tended to lead to disclosure which is sufficiently complex to be confusing to the average investor while insufficiently detailed for the analyst studying trends.

The optimum disclosure for average investors would seem to be a simple figure for pension cost, with an explanation in "Management's Analysis of the Summary of Earnings" of major computational differences from year to year. This investor might also have an interest in a general description of a plan's terms in case he wishes to make social or behavioral judgments about the Company. Typical disclosure might be as follows:

The Company has a non-contributory pension plan for employees which is designed to provide pensions at age 60 to all vested employees equal to 60% of compensation during the employee's five highest paid years before retirement. Employees become fully vested after ten years of service. Pension costs were \$40 million in 1973 and \$45 million in 1974. Costs increased because of revisions in the plan which raised benefits during the year.

The analyst, on the other hand, would require a very substantial amount of additional detailed disclosure in order to appraise the significance of the pension expense, understand its comparability to that computed by other companies, and make a judgment as to the future implications of pensions for the firm. Such disclosure might include the following elements:

1. A description of the plan or plans. This would include a statement of which and how many employees were covered, the level of benefits and vesting policy and funding policy.
2. A description of the actuarial cost methods used, and the effect of these methods on cost calculations.
3. A description of the accounting methods used, and the accounting components of pension cost such as amortized gains and losses and past service costs. This would require a statement of how past service costs were accounted for and the amount of such costs included in pension expense.
4. A statement of the investment return assumption used in computing pension cost and disclosure of the sensitivity of pension cost to changes in that assumption.
5. A statement of actual investment returns achieved by the plan over a period of five years, a description of how variations between estimated and actual returns are accounted for and the extent to which the current year's pension cost is affected by such variations.
6. A summary statement of pension fund investments at cost and at market at the balance sheet date, including:
  - (a) Types of securities and yields
  - (b) Any investments which are not readily liquidatable
  - (c) Any investments which are made in the securities of the company or of related parties
  - (d) Any other investments which are restricted under the Act.
7. A statement of changes in pension fund assets during the year, including any prohibited transactions and excise taxes paid under the Act.
8. Disclosure of any qualifications existing in the reports of independent accountants and actuaries for any plan.
9. A description of other actuarial assumptions such as employee turnover, rate of salary increase and mortality used in computing cost, and the effect on cost of any changes made in these assumptions in the current year. In addition, if assumptions differ significantly from current experience, this should be disclosed.
10. Disclosure of the anticipated impact of the current pension plan on corporate income and liquidity over the next five years.

With these disclosures, the analyst should be able to study the plan and make a reasonable appraisal of pension costs.

### Summary

It is apparent that the new pension legislation will accentuate a trend already in effect of making pension cost an increasingly important part of compensation in the years ahead. As the importance of these costs increases, they become of greater significance to investors in arriving at sound investment decisions. This emphasizes the need for careful study of the most appropriate way to account for these costs, and the need for comprehensive disclosure to enable investors to understand the nature of these costs and their implications. Both the Securities and Exchange Commission and the Financial Accounting Standards Board will be addressing these subjects in the year ahead in fulfilling their joint mandate of providing adequate information for investors.