

Continuing Unresolved Issues of Pension Accounting

Joseph C. Rue and David E. Tosh

Joseph C. Rue is Associate Professor, School of Management and David E. Tosh is Assistant Professor, both at Syracuse University.

Introduction

In December 1985, the Financial Accounting Standards Board (FASB) finished the second phase of the pension reporting project by issuing Statement of *Financial Accounting Standards No. 87* (SFAS #87). The project was begun in 1974. The time required for its completion attests to the complexity and controversy associated with the issues confronting the Board. The pronouncement's issuance lends credibility to the Board's ability to shape a policy position from a set of conflicting perspectives on a number of fundamental accounting questions. While this accomplishment is laudable, the compromises necessary to achieve policy closure in the pension area have resulted in some reporting requirements which are difficult to defend on either strict theoretical or practical grounds. While a number of issues can be raised concerning the requirements of SFAS #87, in this paper we have chosen to focus primarily on the balance sheet effects. In particular, we question the proposed measurement and recognition of both the pension obligation and the related intangible asset.

Beyond the focus on the specific aspects of the pension pronouncement, we believe it worthwhile to explore some possible reasons for the conflicting perspectives which ultimately gave form to SFAS #87. Insights into the origins of the conflicting perspectives facilitate and strengthen our proposed solutions to the specific problems identified. Moreover, such inquiry may suggest areas where improvements are possible in the conceptual structure underlying the standards setting process.

In the discussion which follows we will: provide some background on these pension reporting issues; examine some potential sources of

the reporting problems; and propose solutions which will address the problems we raise.

Background

Employers' reporting of defined benefit pension plans has evolved over a number of years. Early attempts at setting accounting standards for pensions are found in *Accounting Research Bulletins No. 34 and No. 47*. Prior to the issuance of SFAS #87, employer accounting for pensions was based on APBO No. 8. The reporting under APBO No. 8 was directed primarily at periodic expense measurement. The accounting rules prescribed by the opinion resulted in a balance sheet liability for the sponsor only if cumulative plan funding was less than cumulative pension expense. Since periodic pension expense under APBO No. 8 was determinable by any of a number of acceptable actuarial techniques, and since the inclusion in periodic pension expense of a component representing benefits granted for prior years of service (past and/or prior service cost) was at the discretion of the sponsor, many observers believed that the liability disclosure was inadequate. In particular, many were concerned that the failure to recognize a liability for past and prior service cost distorted the portrayal of the firm's financial position by ignoring what was, in many cases, a significant obligation of the firm.

The counter arguments to this view took one of two perspectives.¹ First, some argued that the liability for past and prior service is executory only. Although these benefits are granted

¹ AICPA, "Accounting for Pension Costs," *AICPA Professional Standards* (New York: American Institute of Certified Public Accountants, 1980), pp. 8525-26.

retroactively (based upon prior service), the conventional view is that they will induce greater work force productivity in the future. Accordingly, it was argued that the firm's liability for these benefits does not accrue until the enhanced productivity is delivered in the future. The second argument relied heavily on the going concern assumption. Under the assumption that the firm, its pension plan, and work force will continue intact indefinitely into the future, a more or less permanent deferral of the past and prior service obligation can exist. While the specific composition of the obligation will change with the work force, the magnitude may remain relatively stable. Given this view, some argued that accounting recognition of this amount was unnecessary since it was not payable in the foreseeable future.

In 1974 the Employee Retirement Income Security Act (ERISA) became law. This legislation clarified many of the sponsors' duties and obligations associated with the operation of a pension plan. ERISA imposed a contingent liability upon employers for accrued, unfunded pension benefits (including past and prior service costs). The legislative extension of the employer's legal liability was a catalyst for the pension project begun by the FASB in 1974.

Statement No. 36

SFAS #36 was promulgated in 1980 as an interim reporting measure pending the completion of the project. The thrust of this statement was to require footnote disclosure of the sponsor's unfunded accumulated benefit obligation. The accumulated benefit obligation is the actuarial present value of benefits (both vested and nonvested) attributed by the pension benefit formula to service before the reporting date and based upon employee service and compensation prior to that date. The procedure contemplated by *SFAS #36* for measuring the obligation adopted a comparatively uniform actuarial technique for identifying periodic pension cost (the accumulated benefit method) and included past and prior service costs in the computation.

The issuance of *SFAS #36*, while establishing a tentative position on the measurement of the pension obligation, also produced some controversy. Several observers expressed the view that any measure of the pension obligation should exclude nonvested benefits. This same concern was expressed often as the pension project progressed.² Those holding this view

argued that nonvested benefits do not meet the definition of a liability because they are contingent on future events. The event necessary to cause the vesting of these benefits is the employee's continuing affiliation with the firm, clearly a future occurrence.

Preliminary Views and Exposure Draft

The FASB's *Preliminary Views* proposed that sponsors report a liability equal to the unfunded project benefit obligation. This measure is conceptually similar to the accumulated benefit obligation in that it incorporates past and prior service cost and reflects a benefit approach to periodic cost attribution, but it explicitly considers expected future employee compensation levels if the plan is pay-related (*i.e.*, career-average or final-pay plans). A strong argument was made for the inclusion of salary progression in the liability measure since, ultimately, future cash outflows for pension benefits would be a function of salary levels at that time. Opposing viewpoints took the position that including expected future salaries in the computation was tantamount to recording an executory liability since the level of the future compensation depends upon uncertain future events.³

An additional feature associated with the liability measurement and recognition question was how to treat the debit which would arise when the liability was booked. Under *APBO No. 8*, the liability recognized was equal to normal cost plus interest and, in some cases, amortization of past and prior service cost. The related debit was treated as an expense. As the pension project progressed, however, several proposals were made to include all past and prior service costs in the recognized liability. The proposed recognition of this additional liability (unamortized past and prior service costs) was not only controversial in itself (as discussed above), but also resulted in different views on how to treat the related debit.

The debit could be thought of as measuring the cost of retroactive pension benefits granted

²Lorensen, Leonard and Rosenfield, Paul, "Vested Benefits - A Company's Only Pension Liability," *Journal of Accountancy* (October 1983), pp. 64-76.

³Kirk, Donald, "Pension Accounting: A Major Theme of the 1980's," *Journal of Accountancy* (October 1981), pp. 92-100.

for service prior to plan adoption or amendment. While most would agree with this conceptual interpretation of the debit, there was some disagreement regarding its financial statement disposition. Various respondents to the FASB *Exposure Draft* and *Preliminary Views* suggested alternative treatments for the debit ranging from recognizing the amount as an expense in the current period to offsetting it against the liability.

The rationales for their various positions are, to some extent, related to the arguments discussed in connection with the liability question. The argument for recognizing the debit as an asset is derived from the notion that retroactive benefits are granted with the expectation that improved employee services will be received in the future. Some view these expected benefits as future economic resources accruing to the firm as the result of past events and accordingly perceive them as assets. Others question the degree of control which the firm has over these benefits. The benefits occur only as an employee delivers services in the future.⁴ From this perspective, they are viewed as uncertain future benefits (contingent assets) which do not satisfy the concept of an asset. Thus, the Board was also confronted with a variety of viewpoints concerning the treatment of the pension "asset."

The discussion above highlights several of the major points of contention which arose during the debate over, and the development of, balance sheet reporting principles for pension costs. A general theme running through these controversial issues is the degree of certainty or uncertainty with which future services can be expected from employees. In a later section of the paper we will consider the way in which disagreement over the probability of future service delivery impacted both the debate and the pronouncement (SFAS #87) on pension accounting. First, however, we explore a possible reason for the disagreement.

Sources of the Disagreement – The Unit Problem

What we observe with respect to both the liability and asset questions is a wide range of views concerning the accounting nature of the phenomena. Although lacking evidence, we suspect that most observers would agree upon the intrinsic nature of these phenomena (*i.e.*, the retirement benefits represent some form of obligation to the firm; by granting retroactive

benefits there will likely be improved work force morale and therefore, productivity). Given this agreement and the existence of accepted theoretical constructs for assets and liabilities, it may, at first, seem surprising that the financial reporting constituency could hold such a diversity of views. Moreover, since the FASB appears to consider this range of views in structuring acceptable pronouncements, the level of diversity will set operational parameters for the standard setting process. The interpretation of accounting constructs as well as the consistency with which the interpretations are made will likely be influenced by the level of disagreement within the constituent group. Accordingly, we believe an inquiry into the underlying causes of such diversity of opinion on pension accounting may provide valuable insights to the profession in examining other controversial subjects.

Devine puts these problems into perspective when he discusses "the unit problem." The unit problem revolves around the selection of the scope or perspective from which to apply measurement and recognition conventions. This choice is critical and will affect the outcome of the application. Devine states:

We begin with the old, but important, procedural problem: whether to select small units and aggregate them so long as they prove to be useful or to select a large unit and use imputation devices until interest wanes... Many of the arguments and controversies in accounting result from undisclosed differences in points of view with regard to the accountability units selected.⁵

The problem is one of selecting appropriate attributes for characterizing the event for which one wishes to account. The accounting process involves the identification, grouping and measurement of what are believed to be relatively homogeneous events. If the events are not strictly homogeneous, however, a problem can arise in selecting the attributes of the group or class to be portrayed by the accounting process. Some may take a specific or individual perspective which examines the attributes of one member of the group and assumes

⁴FASB, "Employers' Accounting for Pensions," *Exposure Draft* (Stamford, Conn.: Financial Accounting Standards Board, 1985), p. 43.

⁵Devine, Carl Thomas, "The Unit Problem," *Essays in Accounting Theory* (Sarasota, Fla.: American Accounting Association, 1985), p. 2.

that those attributes may be generalized to the other members. Others may take an aggregate perspective which attempts to identify attributes relevant to the accounting process by examining the behavior of the group taken as a whole rather than focusing on individual members. Given some nontrivial degree of heterogeneity within the group, an observer adopting an individual perspective will most likely identify a different set of accounting attributes for the class of events than someone who takes the aggregate perspective. Thus, supportable alternative perspectives (individual versus aggregate) can emerge which will lead to different positions on the relevant attributes of an accounting phenomenon and to different conclusions concerning its accounting disposition.

An example of this is found in *SFAS #5, Accounting for Contingencies*. The statement recommends accounting recognition for those contingent obligations (*i.e.*, liabilities which do not yet exist with certainty) which are both probable and measurable. The statement specifically cites warranty obligations as a contingent liability which will be given accounting recognition if the warranties satisfy the above conditions. Judging from current practice it appears that most warranty obligations qualify for recognition. Yet, it is unlikely that a warranty obligation will arise from a given sales transaction. The probability that a particular product will be defective is small. The basis for recognizing warranties as an accounting liability must, therefore, be grounded in an aggregate perspective of the nature of the obligation: a perspective which evaluates the probability of a liability, not the attributes of an individual sales event. Experience with aggregate sales and related warranties provides the rationale. Thus, the perspective from which the evaluation is made will affect the conclusion concerning the existence of a warranty obligation.

Accounting Perspective

The choice of perspective from which to evaluate a class of accounting phenomena should be based upon our understanding of their underlying nature. If the phenomena are seen as members of a group where each member's range of potential behavior has impact only to the extent that it contributes to the behavior of the group, then an aggregate perspective is suggested. Alternatively, if this range of potential is fully realizable for each phenomenon under normal

conditions, then an individual perspective is suggested.

This argument is supported in portfolio theory. If an investor decides to invest money in a group of securities, the price behavior of an individual security is relevant to his assessment of the profitability of the investment only to the extent that it contributes to the portfolio's return. Alternatively, if the money is invested in only one security, the full range of that security's price behavior is relevant to the profitability assessment. In the first case, the identification of security price behavior relevant to investment profitability should be made from an aggregate perspective. In the second case, the individual perspective is appropriate.

The perspective issue becomes a problem when the standard-setting process moves forward without achieving some consensus on the appropriate level from which to address the accounting question. Failure to resolve this issue can lead to accounting pronouncements which are internally inconsistent from a perspective standpoint. We believe that such is the case with the pension pronouncement. Secondly, given the resolution of perspective in one area of accounting, consistency in standard setting would suggest that such resolution be relied upon, where appropriate, as a precedent. However, judging from conflicting standard-setting efforts regarding oil and gas exploration costs and computer software development costs, consistency in perspective across pronouncements is not occurring.⁶

We believe that much of the controversy over the reporting of the pension obligation and related asset arises from conflicting perspectives on the phenomena in question. As was noted earlier, we take as given a consensus on the general nature of the phenomena. There appear, however, to be a number of different interpretations concerning whether or not these phenomena satisfy the criteria for asset and liability recognition. We submit that the perspective from which they are viewed affects the interpretation process.

⁶ Computer software development costs are viewed as assets only at the point where the commercial viability of the individual project is established (the individual perspective), whereas the full costing approach to exploration cost accounting treats the costs of drilling a dry hole as an asset since they further the overall exploration effort (an aggregate perspective).

Inconsistent Perspective in the Pension Debate and Pronouncement

Much of the debate over the various issues in the pension area results from the adoption of different perspectives in identifying the relevant accounting attributes of the employee group. Many of the arguments made can be traced to an individual perspective where the characteristics of an individual employee's working life are used in conceiving the phenomenon to be portrayed by the accounting. Other positions are more directly linked to an aggregate perspective which evaluates the properties of the entire employee group.

These different perspectives identify different attributes of the work-force as being useful in resolving pension accounting questions. Many of the accounting issues hinge on the probability of the employees remaining with and rendering services to the employer in the future. For those adopting the individual perspective, the prospect of future service delivery is not viewed as sufficiently probable to warrant accounting recognition since a particular employee may not remain with the firm throughout his or her career. Those working from an aggregate perspective, however, will probably come to a different conclusion. While the delivery of future services from an individual employee is not particularly certain, there is a much higher probability that the employee group as a whole will render such services. Thus, the different perspectives will give rise to different assessments. This can lead to different conclusions concerning the disposition of the various pension accounting issues.

Salary Progression

On the question of salary progression, most observers would agree that the future obligation for benefits payable from a pay-related plan will reflect future salary levels if the employee in question remains with the firm until retirement. Those arguing against recognition of the salary progression effect are making the evaluation from an individual employee perspective.

If an employee with vested benefits did not render future services, the employer's obligation would be limited to amounts based on compensation to date.⁷

Similar to the warranty liability example discussed earlier, the obligation to a particular employee for future pay-related benefits may

not be sufficiently probable to merit recognition. However, if the question is viewed from the perspective of the entire work force, a different conclusion would be reached because the uncertainty associated with individual cases is diversified away.

Parts of *SFAS #87* suggest that the FASB looks at the salary progression problem from an individual employee point of view. But actually, the FASB, in the pronouncement, straddles the salary progression issue. Salary progression is reflected in the measurement of periodic pension expense. However, where an additional liability is recognized for unamortized past and prior service costs (*i.e.*, the minimum liability discussed), expected future salary levels are not reflected.

Nonvested Benefits and Past Service Costs

Differing views on the likelihood of future service delivery can also be linked with the debate over recognition of nonvested benefits and past and prior service costs. Both of these potential obligations are frequently viewed as executory liabilities which will not accrue until services are rendered in the future. If, however, they represent probable future sacrifices of cash, an argument can be made for their immediate recognition. Those arguing in favor of recognition most likely base their beliefs on an aggregate perspective (*i.e.*, the probability of future service delivery and related future cash outflow is high). Those opposing such treatment probably base their evaluation on the individual perspective.

The balance sheet liability required by *SFAS #87* is the larger of the minimum liability or unfunded accrued pension expense. The minimum liability is the unfunded accumulated benefit obligation which reflects past and prior service costs and nonvested benefits, but includes no provision for salary progression (as noted above). The alternative measure (*i.e.*, unfunded accrued pension expense) results from the failure to fund accrued periodic pension expense and incorporates nonvested benefits and salary progression for normal service but not unamortized past and prior service costs. The lack of a consistent perspective in defining these alternative measures is evidenced by the pronouncement's differential

⁷FASB, *SFAS No. 87 Employers' Accounting for Pensions* (Stamford, Conn.: Financial Accounting Standards Board, 1985), p. 44.

treatment of past and prior service costs. Since the minimum liability includes unamortized past and prior service cost, this implies that an aggregate perspective was taken. The exclusion of past and prior service costs from the alternative measure suggests an individual perspective.

Pension Asset

The above discussion also bears directly on the pension asset recognition issue. The pension asset recognized pursuant to *SFAS #87* will most often be associated with unamortized past and prior service costs and will reflect, therefore, the expected future services discussed above. The evaluation of whether or not these services are probable and under the control of the employer (*i.e.*, qualify for asset recognition) depends upon which of the above perspectives is adopted. By recognizing a pension asset the FASB appears to be adopting an aggregate perspective. The asset could be thought of as representing the employee group's acceptance of the pension plan and their promise to deliver future services. But, the statement requires the recognition of an intangible asset only in those years when a minimum liability is recorded. Thus, the factors which influence when and to what extent the minimum liability is booked will similarly determine the existence of the intangible asset. Consequently, the intangible has the unusual property of existing in some years and disappearing in others. The reporting perspective can shift significantly from year-to-year: when the minimum liability is recognized, an aggregate view of the sponsor's control over the benefits of future employee service is in operation; when the minimum liability is not recognized, an individual view must be assumed.

The variable perspective observed to be at work in the case of the intangible asset was probably neither intended nor the result of compromise on the asset question. Rather, we suspect that its treatment follows from concessions made to competing perspectives on the liability issue and an unwillingness on the Board's part to expense the resulting debit. We are not aware of any other asset which would react in such a way. Thus, we observe that this "debit" may not be an asset, but merely a necessity to give balance sheet recognition to the liability.

Recommendation—Need for Consensus on Perspective

Our primary suggestion is that a consistent perspective should have been adopted in identifying accounting procedures in this area. While we believe that an aggregate perspective would be more appropriate in the pension context (discussed below), having a consistent perspective underpinning the final pronouncement is fundamental. In addition to providing a conceptual handle to grasp for those who are responsible for the pronouncement's implementation, a consistent perspective should improve the user's ability to understand the various pension disclosures which will result. Secondly, allowing the diversity of perspective observed in the debate to carry over to the pronouncement can have adverse consequences for the standard-setting process. On the one hand such a result is a basis for challenging the FASB's ability to establish generally accepted accounting principles in controversial areas. Moreover, such a result sets a confusing precedent not only for purposes of future standard-setting but also for the exercising of professional judgment.

Diversity of opinion is probably vital to the standard-setting process, but when the debate is ended, some consensus on the relevant accounting attributes of the phenomenon in question must be achieved. The exact steps to be taken in achieving consensus are not clear. We suspect, as a preliminary step, that sensitizing the profession to the need for consensus on perspective will help. This awareness should stimulate a dialogue involving members of both the practitioner and academic communities which we hope will lead to an acceptable resolution.

With respect to the pension accounting questions, our belief is that an aggregate perspective should have been adopted. Any serious attempt at identifying a meaningful measure of the employer's pension obligation depends upon the attributes of the employee group. The attributes of individual employees are relevant to this process, but only to the extent that they are revealed through the group. Since the nature of measurement in this area relies so heavily upon the aggregate actuarial attributes of the phenomenon, we feel that the accounting measures should have been grounded in the same perspective. Thus, salary progression, non-vested benefits, and past and prior costs should be taken into consideration in both asset

and liability recognition in determining pension expense. The pension asset should be shown in all years.

Unfortunately, the new pension pronouncement does not result in accounting measures which consistently represent what they purport to represent. As a result of this, financial statement users may have to adjust reported financial statement pension liabilities for past and prior service cost and for salary progressions as they have previously done before *SFAS #87*.⁸

Conclusion

The purpose of this paper has been to explore some of the theoretical and reporting problems associated with the pension accounting arising under *SFAS #87*. A potential source of the conflict concerning accounting treatment for pensions and other related areas is "the unit problem." This problem revolves around the selection of a perspective from which to apply measurement and recognition conventions. Viewing the pension issues from different perspectives can produce different interpretations regarding the satisfaction of the requirements for asset and liability recognition.

If not mediated, these differences can result in the promulgation of a variety of conflicting and inconsistent accounting principles as evidenced by the above observations. Some level

of controversy is probably a prerequisite to the development of accounting principles which have general application. The determination of representative accounting rules and their acceptance by the accounting constituency is more likely to follow from a process which encourages a variety of opinions, if it also provides a mechanism to achieve consensus among them. Unfortunately, the existing mechanism of due process seems only to be able to achieve compromise among various positions. The distinction between consensus and compromise is that the former implies agreement over matters of opinion while the latter does not.

The problem of unmediated conflicts in perspective, we believe, ultimately stems from the lack of a well-articulated and operational framework by which accounting perspectives may be evaluated and criticized. This is not so much a criticism of the conceptual framework as it currently exists as it is a call for ongoing attempts to clarify the theoretical constructs and linkages that are found there. These efforts to bring resolution to the elements of the framework may render some of the controversy and debate groundless, thereby improving the efficiency of the standards setting process.

⁸Feldstein and Seligman, "Pension Funding, Share Prices and National Savings," *Journal of Finance* (September 1981), p. 801.