Pension accounting – how it developed over time

Objective
1 The current paper is a short summary of the historical development in pension accounting and the theories underlying the different stages of evolution.

How pension accounting has evolved\(^1\)
2 Over time, the focus on pension accounting has moved from reporting the cost of pension to measure the rights and obligations under the plan.
3 Historically pensions were viewed as a gratuity act from the employer – therefore, the pension cost was linked to the cash outflow as the employer was not seen to have any obligation. The cost was then measured either by the pension benefit paid; or by the contribution paid in a funded scheme. The cost could also include the guaranteed return, if the contributions were not segregated to buy securities.
4 The gratuity theory was challenged by the view that a pension is a deferred pay and that employees accepted lower wages in exchange for future pension benefits. This led to the conclusion that an entity should account for the cost to provide the future benefits. The accounting change was also brought by Governments granting tax deduction for pension costs. Cost was measured based on actuarial calculations (when the firm was using internal funding) or contributions to external funds, also determined based on actuarial calculations. In this last case, the cost would still correspond to the cash outflow of the period.
5 The US APB Opinion No.8 *Accounting for the Cost of Pension Plans* was issued in 1966, and focused mostly on the treatment for the cost attributed to past or prior service. There was strong recourse to cost deferral, for instance in reference to past service costs and actuarial differences – these would be spread over a number of years, or capped at a certain amount per each period. This treatment was also influenced by tax rules, that limited the deductibility of these components.
6 The implicit consequence of the Opinion was to ensure a certain degree of alignment between the pension cost recognised and the contributions paid for funded plans. The Opinion accepted the use of different actuarial approaches.

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\(^1\) This part of the paper draws from Napier, C. (2008) *The logic of pension accounting*
7 The accounting theory further developed by introducing the notion that pension benefits are an exchange. However, while the employer’s promise was identifiable – the future payment of the benefits – the employee’s side was less clear. It was suggested that the employee accepts to provide services in exchange of the future pension promise; since it is not possible to allocate benefits to specific unit of services, the objective of accounting should be to spread the value of the benefits to the full period of service. This was also influenced by changes in US laws that codified employer sponsors’ duties and obligations associated with the operation of a pension plan.

8 This line of thinking viewed pensions as an integral part of an ‘implicit lifetime contracts’ between employees and firms, and led to the notion of projected unit credit method – that is, the cost should reflect the increase in the current expectation of future benefits, rather than only the increase in the current rights at the reporting date.

9 The UK SSAP 24 Accounting for Pension Costs was issued in 1998 and stated that the accounting objective was to recognise the cost of providing pensions on a systematic and rational basis over the period during which the employer benefits from the employees’ service. Entities needed to consider if the funding arrangements were in line with the objective.

10 However, SSAP 24 had difficulties in dealing with two issues: the first was the treatment of actuarial gains/losses - which could be spread over time - and the second was that the pension cost could be assessed on the basis of assumptions that were different from those used to determine the contributions (for instance, in relation to the return on plan assets). When some entities stopped making contributions to plans that had a surplus generated by the increase in the value of the plan assets, they would still report a ‘normal’ pension cost under SSAP 24; on the other side, the smoothing mechanism could lead to reporting an asset for a plan with a deficit, or a liability for a plan in surplus).

11 The accounting research started to move the focus away from the pension cost to the pension liability. The US SFAS 87 Employers’ Accounting for Pensions was issued in 1985 and required the assessment of the Projected Benefits Obligation (‘PBO’) based on future compensation levels. However, SFAS 87 stopped short of accounting for the full liability and allowed to recognise a minimum pension liability equal to the negative difference of the fair value of the assets less the Accumulated Benefits Obligation (‘ABO’), which was the present value of the employee rights but without considering the future salary increases. Since SFAS 87 required to disclose the PBO deficit, it was possible to study the value relevance of different pension measures, and some studies found the PBO to be the most relevant.

12 Around 2000, both IFRS and UK GAAP moved closer to a full liability approach with the publication of IAS 19 Employee Benefits (1998) and FRS 17 Retirement Benefits (2000), although they both allowed alternatives in relation to the treatment of actuarial differences. Similarly in the US, SFAS 158 Employers’ Accounting for Defined Benefits Pensions and Other Post-Retirement Plans published in 2006 required to measure the liability by comparing the fair value of the plan assets with the PBO rather than the ABO. At the same time, these new Standards required to measure the plan assets mostly at their fair value.

Requirements on discount rates

13 APB Opinion No. 8 was not very specific on the measurement method for the pension cost, and allowed the use of a range of funding methods to serve as the basis for determining net periodic pension cost.
14 SFAS 87 indicated that the discount rates should reflect the rates at which the pension benefits could be effectively settled. It was appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement of the obligation (including rates publicly disclosed by the Pension Benefit Guaranty Corporation). In making those estimates, entities could also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits.

15 The Standard also required to determine an expected long-term rate of return on plan assets. In estimating that rate, appropriate consideration should be given to the returns being earned by the plan assets in the fund and the rates of return expected to be available for reinvestment.

16 The net periodic pension cost under SFAS 87 would include:
   (a) The interest cost, calculated by applying the discount rate to the opening balance of the projected benefit obligation;
   (b) The actual return on the plan assets.

17 The entity would also apply the expected return on plan assets to a market-related value of those assets, which could be calculated in a variety of ways. The difference between the actual return and the expected return would be included in the plan gains/losses. These gains/losses had to be recognised in a systematic way, and for not less than a specified annual amount.

18 IAS 19 currently requires to determine the present value of the defined benefit obligation with a discount rate that references to market yields at the end of the reporting period on high quality corporate bonds. The discount rate determined at the beginning of the period is applied to determine the net interest included in profit or loss.

19 An explanation of the discount rate requirements is included in paragraph 134 of the Basis for Conclusion accompanying IAS 19. It notes that the IASB had not identified clear evidence that the expected return on an appropriate portfolio of assets provides a relevant and reliable indication of the risks associated with a defined benefit obligation, or that such a rate can be determined with reasonable objectivity. Consequently, it was decided that the discount rate should reflect the time value of money, but should not attempt to capture those risks. Furthermore, the discount rate should not reflect the entity’s own credit rating, because otherwise an entity with a lower credit rating would recognise a smaller liability. The IASB considered that the rate that best achieves these objectives is the yield on high quality corporate bonds.

20 SFAS 158 and FRS 17 have similar requirements to determine the discount rate for the defined benefit obligation. However, for both pronouncements the periodic pension cost includes the interest cost (calculated using the discount rate at the beginning of the period) and the expected return on plan assets. FRS 17 requires the latter to be based on long-term expectations at the beginning of the period and states that the expected long-term return is expected to be reasonably stable. For assets such as equities, the expected return should be set having taken advice from an actuary.

Questions for EFRAG TEG

21 Does EFRAG TEG require additional background material on the historical development of pension accounting?