



Accounting for Pensions



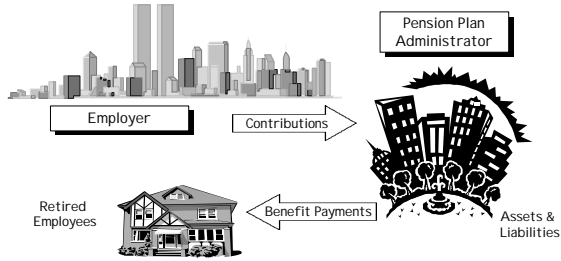
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Nature of Pension Plans

A Pension Plan is an arrangement whereby an employer provides benefits (payments) to employees after they retire for services they provided while they were working.



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Types of Pension Plans

Defined Contribution Plan

- Employer contribution determined by plan (fixed)
- Risk borne by employees
- Benefits based on plan value

Defined Benefit Plan

- Benefit determined by plan
- Employer contribution varies (determined by Actuaries)
- Risk borne by employer

Actuaries estimate the employer contribution by considering mortality rates, employee turnover, interest and earning rates, early retirement frequency, future salaries, etc.

Statement of Financial Accounting Standard No. 87, "Employers' Accounting for Pension Plans," 1985

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Components of Pension Expense

1	Service Costs	+
2	Interest on Liability	+
3	Actual Return on Plan Assets	-
4	Amortization of Unamortized Prior Service Costs	+
5	Gain or Loss	+ -

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Using a Pension Work Sheet

Important to accounting for pensions under *Statement No. 87* is the fact that **several significant items of the pension plan are unrecognized in the accounts and in the financial statements.**
This includes:

- Projected benefit obligation (PBO)
- Pension plan assets
- Unrecognized prior service costs
- Unrecognized net gain or loss

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Illustration - Work Sheet & Journal Entry

E21-3 Rebekah Company provides the following information about its defined benefit pension plan for the year 1999:

Service cost	\$90,000
Contribution to the plan	105,000
Prior service cost amortization	10,000
Actual and expected return on plan assets	64,000
Benefits paid	40,000
Accrued pension cost liability at Jan. 1, 1999	10,000
Plan assets at Jan. 1, 1999	640,000
Projected benefit obligation at Jan. 1, 1999	800,000
Unrecognized prior service cost at Jan. 1, 1999	150,000
Interest/discount (settlement rate)	10%

Instructions
Prepare the journal entry to record pension expense for the year ending December 31, 1999.

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Reporting in F/S

Balance Sheet		Income Statement	
Assets:	2000	Revenues:	2000
Cash	(105,000)	Expenses:	
Liabilities:		Pension expense	116,000
Accrued cost	(11,000)		↓
Equity:		Net (income) loss	116,000
Retained earnings	116,000		

Debit (Credit)


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Gain or Loss

Unexpected swings in pension expense could be caused by:

- (1) large changes in market value of plan assets and
- (2) changes in actuarial assumptions that affect the PBO.

Question: What is the potential negative impact on Net Income?




Volatility
The profession decided to reduce the volatility with smoothing techniques.

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Smoothing Gains and Losses on Plan Assets

The expected return on the plan assets is to be included as a component of pension expense, not the actual return.

Question: What happens to the difference between the expected return and the actual return?



Answer
Recorded in **Unrecognized Net Gain or Loss** account.
Amortized to pension expense over the **average remaining service period of active employees expected to receive benefits under the plan.**

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Smoothing Gains and Losses on PBO

In estimating the PBO, actuaries make assumptions about such items as mortality rate, retirement rate, turnover rate, disability rate, and salary amounts.

Question: What happens with unexpected gains or losses from changes in the Projected Benefit Obligation (PBO)?



Answer

Recorded in **Unrecognized Net Gain or Loss** account.

Amortized to pension expense over the **average remaining service period of active employees expected to receive benefits under the plan.**

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Corridor Amortization

The **unrecognized net gain or loss** balance is considered too large and must be amortized when it exceeds the arbitrarily selected FASB criterion of 10% of the larger of the beginning balances of the PBO and the market-related value (FMV) of the plan asset.

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