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This paper was presented at a meeting of the Detroit Chapter ASWA.

The discussion this evening is devoted to the accounting problems arising out of the industrial pension plans which have been negotiated during the past year by many of our major industries and the bargaining agents of their employees. While it is true that pension plans have been in existence many years these earlier plans were generally restricted to a relatively small number of people, and the amounts involved were rarely significant.

During the various labor negotiations, there was much printed concerning the various types of pension plans being considered, primarily the method of "funding" to be used. To readers who did not know the principles upon which the various funding methods were based, the articles were not very understandable. Tonight I want to describe the various types of pension plans (primarily the methods of funding) which are in existence, and to discuss the accounting problems which have been presented by these plans.

Because these plans have been negotiated primarily in 1950, the problems of accounting and financial statement presentation will not have to be met by the various companies until the release of their 1950 financial statements. At this time there has been very little discussion of these accounting problems, and the Committee on Accounting Procedure of the American Institute of Accountants has not as yet published an official release on their recommendations with respect to these problems. Therefore, the discussion this evening can only be directed toward pointing out these problems with the arguments pro and con.

All of the pension plans to be discussed this evening are contractual, i.e., the companies do not have the right to terminate them at their will. Most of them are provided for by labor agreements effective for five years. However, the employees covered by these plans look at them as continual plans, feeling sure they will be extended after the end of five years. Most of the plans call for a fixed monthly pension (usually $100) payable on retirement at age 65 to employees with 25 years service at that time. All of these plans give credit to employees for service prior to installation of the plan. This is commonly referred to as the past service obligation. The monthly pension usually includes primary social security benefits, and the earlier plans provide that if these primary social security benefits are increased, the company portion of the pension will be correspondingly decreased. However, commencing with the General Motors plan, this latter provision has generally been eliminated.

The method of funding these pension plans refers to the method of determination of the annual amounts which are to be paid over by the company to a trustee, to be held by such trustee and used by him to pay the agreed-on pensions to retired employees.

The simplest pension plans are the so-called "pay-as-you-go" pension plans. These plans call for no funding at all, but merely provide that the company will pay the monthly pensions to retired employees, as they fall due, out of company funds.

"Full funding at maturity" plans provide for the payment by the company to the trustee at the time of retirement of employees of a sufficient amount to fund the pensions of these employees in their entirety. Under this type of funding arrangement, the fund is actuarily sufficient in amount to pay pensions for all retired employees, but no provision is made in the fund for current or past service for employees not retired. This type of funding is prevalent in most of the agreements negotiated in the steel industry and is generally known as the "Bethlehem Formula."

The so-called "level funding" plans provide for funding pensions for employees before they retire. These "level funding" plans call for the payment to the trustee of an amount sufficient to provide for the current service of all active employees. These plans recognize the amount of the past service obligation at the date of the institution of the plan, and they vary from requiring a payment to the trustee for interest on this past service obligation, thus leaving the unprovided past service obligation frozen, to requiring a payment to the trustee of an amount sufficient to amortize this past service obligation over ten, twenty, or thirty years. Under the plans calling for the funding of only interest on the past service obligation, the fund would never be actuarily sound, but would always be deficient in amount by the amount of the past service obligation. Under the latter plans, the fund would be actuarily sound at the end of the ten, twenty, or thirty year amortization period.

An interesting variation of the "level funding" arrangement is an agreement in which the employer promises to pay into a fund a specified number of cents per hour worked. The contracting parties state that it is their intention that the amount paid into the fund each year shall be sufficient to provide for current service costs and also for the amortization of past service costs over a certain number of years. These plans have the advantage of simplicity in operation and administration, but they are weak from an actuarial point of view since there is not necessarily any relationship between the number of hours worked and the amount necessary for proper funding.

The pension plans granted in the automobile industry are of the "level funding" type.

There are primarily three accounting problems presented by these pension plans: (1) What will be the basis of the annual charge to operations for the cost of pensions? (2) What information concerning the pension plan should be disclosed in a footnote to the financial statements? (3) What will be the treatment given the unprovided-for past service obligation in the financial statements?

At first glance, it might be felt that the amount of the charge to operations for pension costs should not vary as between the types of funding plans indicated previously, as long as the benefits to be paid employees at retirement are the same. It would seem that operations of any year should be charged with the cost of providing for the current service of active employees during that year, plus some consistent amortization over a reasonable period of the past service obligation assumed at the inception of the plan. Under the "level funding" plans, the charge to operations will probably be on this basis, inasmuch as the corporation has to fund amounts with the trustee on this same basis. In these cases the labor agreements provide that if the level funding plan is terminated, any amounts in the fund will go on some basis for the benefit of the employees and will not be returnable to the corporation. (Without this provision, the funding arrangement would not be acceptable for federal income tax purposes.)

Under the "pay-as-you-go" or "full funding at maturity" plans, inasmuch as there is no requirement for the funding for current service or past service of active employees, and inasmuch as the agreements providing for the plans only run for a period of five years, the companies are obligated to grant pensions to only those individuals who retire within that five-year period, and have no contractual liability for current or past service of active employees at the end of that five-year period. Thus, companies with these types of plans can reasonably take a position that their operations during this five-year period should not be charged with any provisions for current service of active employees. In these cases the charge to operations will probably be the amount required to fund in full pensions for employees who will retire during the five-year period. However, some companies may take the position that even though the present agreement terminates in five years, it will be renewed under the same general principles, and, therefore, the plan is in effect a continual one, although not being so contractually. Therefore, they may elect to provide for current service of active employees and amortize the past service obligation over a reasonable period of years by a charge to operations, in which case the amount so provided in excess of the payments to the trustee would be shown as a liability on the balance sheet.

Many of the earlier voluntary employer-granted pension plans were of the "pay-as-you-go" type, and the accounting was usually done on a cash basis. In the case of an involuntary "pay-as-you-go" plan, however, it does not appear that merely charging to operations the cash payments made for pensions during the year would result in an adequate charge to operations, in view of the fact that under the involuntary plan the corporation has the liability of paying pensions to all employees who retire during the five-year period, and therefore they should provide for retired employees' pensions in their entirety. Therefore, under the involuntary "pay-as-you-go" plan, it would seem that the minimum charge to operations should be the amount that would be required to fund pensions of retired employees in full at their maturity date, the difference between this amount and the actual payments to pensioners being shown as a liability in the balance sheet.

Under both the "pay-as-you-go" and "full funding at maturity" plans, a charge to operations sufficient to provide pensions in full at the retirement date during the five-year period would be distorted as between the five years because of the varying number of employees who would be eligible for retirement during each year. Primarily, the chrage in the original year of the plan might be considerably in excess of the charges in later years, because of the number of employees who are past age 65 and still working, who would be eligible for retirement in the first year. To overcome this situation, it has been proposed that the total charge for the five-year period might be computed and 1/5 of such a charge charged to operations in each year. In the case of a "full funding at maturity" plan, the discrepancy between the amount of the payment to the fund and the charge to operations would be handled as either a deferred charge or an accrued liability on the balance sheet. The difference between the charge to operations and the cash payments for pensions in connection with a "pay-as-you-go" plan would also constitute a liability.

Under the "level funding" plans, the payment to the trustee for current service would be consistent as between years and would represent the current service obligation and as such would be a reasonable charge to operations. If the past service obligation is to be spread over a reasonable period of years, the amount of past service obligation amortized in any year would also be a charge to operations of that year. The Committee on Accounting Procedure of the American Institute of Accountants in its Bulletin Number 36 took the position that even though the past service obligation is provided for service performed in prior years, it is in effect payment in contemplation of future service and as such constitutes a charge to future operations rather than a charge to surplus at the inception of the plan. Amortization of this past service obligation over future periods, however, must be made under a reasonable program and the amount amortized in any one year must be determined on a basis consistent with other years.

As indicated previously, the amount charged to operations will not necessarily be the same as the amount paid out in any given year to the fund or to the pensioners. However, for federal income tax purposes, a tax deduction is allowed only for actual cash payments either to a qualified fund or to pensioners. Thus, if the company's method of recognizing pension costs necessitates the accrual of a liability or creation of a deferred charge on the balance sheet, the amount thereof should be reduced by the federal income taxes thereon.

It can be seen that radically different charges to operations can result from the varying funding provisions of the current group of pension plans. Because of the fact that the current pension plans cover all employees of a company, the amounts of these charges to operations can be material, and they, therefore, will have a major effect on the comparability of the net earnings figures as between companies. For this reason, it seems necessary that a company disclose its charge to operations for the current year in its financial statements, and describe in a footnote thereto the provisions of its pension plan and a brief explanation as to its method of charging the cost of pensions to operations. Because these plans provide for significant pension costs over an extended period of years, some indication of the amount of the future charges to operations should also be included in the pension footnote.

The method of disclosing the amount of unprovided-for past service in the financial statements has been more widely discussed than the question of determination of the charge to operations. As mentioned previously, the Committee on Accounting Procedure of the American Institute of Accountants has taken the position that the amount of the past service obligation is an obligation contracted in consideration for future service and, as such, constitutes a charge to future operations. This is the basis for amortizing past service by a charge to operations over a reasonable period of time. The method used for charging the cost of pensions to operations can have a material effect on the amount of the unprovided past service. As we indicated earlier under the "level funding" plan providing for the amortization of past service in 20 years, there would be no past service obligation at the end of this 20-year period, while under the "level funding" plan providing for interest only on the past service obligation, the amount of the unprovided-for past service would still be the same at the end of the 20-year period as at the date of inception of the plan. It is suggested, therefore, that the estimated amount of unprovided past service at the end of any year should be disclosed in the pension footnote to the financial statements. The amount of this unprovided past service can only be a very rough estimate because of the various factors involved in the computation of this figure. Of course, this figure will have to be furnished by an actuary, and it has been suggested that it might be wise in disclosing this figure in the financial statements to also indicate the major premises on which computed. For instance, in the case of a pension plan providing for the reduction of the company portion of the pension to correspond with any increase in social security benefits, the basis on which the past service obligation was computed would have to be disclosed, due to the fact that an increase in social security benefits could have a major effect on the amount of the unprovided-for past service. Inasmuch as these plans are merely five-year plans, it is true that contractually the company does not have an obligation for the entire amount of the past service. However, because of the fact that the plans will probably be extended at the end of five years, it has been recommended that the amount of the past service should be shown, and, if the company desires, it can indicate in the balance sheet footnote that the plan terminates at the end of five years and that the company therefore has no agreement for any pension costs past that date.

It has also been suggested that the amount of the past service obligation probably should be recorded in the financial statements as a liability with a corresponding deferred charge. Because of the uncertainty of the amount of the past service obligation and also the question as to whether it is in effect an actual liability of the company in its entirety, this position has not been pushed very strongly.

As can be seen by this discusison, there are definite accounting and financial statement problems with respect to the new 1950 pension plans. It will be interesting to see how these pension plans are treated in the company financial statements for the year 1950.

COAST-TO-COAST

VIRGINIA THRUSH, Toledo, Ohio

CHICAGO

The subject discussed at the October meeting was "Budgets Are Not A Panacea." The speaker at the November meeting, Mr. W. J. Madden, vice-president, treasurer and director of Consolidated Grocers spoke on "The Thirteen Month Calendar and Branch Accounting." An open house in honor of Alice Aubert, past national president of ASWA, was held in November. The chapter participated in a "Whee Of A Wee Week-End" the first week-end in December at the Hotel Moraine on the Lake in Highland Park, Illinois.

CINCINNATI

The speaker at the October meeting was Mrs. Iphigene Bettman, author of "Hereabouts," a column in the Cincinnati Times Star. She spoke of "Romance of Ohio." The September meeting was highlighted by a talk given by Mr. Burl Graham, Senior Partner with Gano & Cherington, who spoke on "Qualifications and Requirements for Certified Public Accountants in Ohio."

CLEVELAND

Mr. Richard Austin of Westinghouse Electric Co. and president of NACA, Cleveland Chapter, spoke at the November meeting on "Controlling Costs and Expenses." An interesting addition to the monthly bulletin was noted—a "Quiz Corner," in which pertinent questions are answered monthly. Cleveland Chapter sponsored a tea in Pittsburgh during November for women accountants in that city. Plans are being formulated for an ASWA chapter in Pittsburgh.

COLUMBUS

"Speech As An Aid To The Woman Accountant" was the subject chosen by Miss Allene Montgomery, Assistant Professor of Speech at Capital University, the speaker at the October meeting. Mr. Horace Domigan, of Keller, Kirschner, Martin and Clinger, spoke at the November meeting on "History of Taxation."

DETROIT

Several members attended the Charter-Installation dinner of the newly formed Lansing Chapter of ASWA.