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SFAS 87 – Improvement in Pension Disclosure?

By Mary Ann Merryman

Introduction and Background

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 87 in 1985. This project sought greater consistency in pension reporting which would subsequently provide pension information more understandable and more useful to financial statement users.

SFAS 87 was implemented in two stages. Part one (required for fiscal years beginning after December 15, 1986) changed the measurement of annual pension expense, the recognition of retroactive benefits, and the composition of the pension footnote disclosure. A more standardized method with six specified components, show below in Exhibit A, now determines annual pension expense. The transition amount shown is the unrecognized net obligation or asset at the date of implementing SFAS 87.

The remaining service life of active employees regulates the recognition of retroactive benefits. Part one also requires significant additional disclosures in the pension footnote, including the breakdown of annual pension expense by the components listed above.

This first phase of SFAS 87 had significant impact on companies' financial statements, however, the second, or delayed, requirement of the Statement (effective for fiscal years beginning after December 15, 1988) generated the most controversy. This phase required the recording of a new "minimum liability" when the accumulated benefit obligation under the pension plan exceeds the fair value of the plan assets. This paper summarizes the impact and disclosure of this additional requirement on companies' financial statements in fiscal 1989.

Exhibit A

Composition of Annual Pension Expense

1. Service cost (+)
2. Interest cost (+)
3. Return on plan assets (-)
4. Amortization of prior service cost (generally +)
5. Amortization of gains and losses (+ or -)
6. Amortization of the transition amount (+ or -)

What Is the Minimum Liability?

Prior to SFAS 87, when the amount a company paid into the plan differed from the expense recorded, a pension asset or liability appeared in the financial statements. This resulted in prepaid pension cost if payments exceeded expense, or accrued pension cost if expense exceeded payments. No reflection (except in footnotes) existed of the situation where obligations of the pension plan exceeded the assets of the pension plan. Previous pension standards argued that the assets and obligations of the plan belonged to the plan itself and not to the company. The FASB in SFAS 87, however, contended that the company does have a liability for those situations where plan assets do not sufficiently meet plan obligations. In accordance with conservative accounting practice, however, they will not allow a company with assets greater than obligations to report an additional asset.

The new minimum liability equals the difference between the accumulated benefit obligation (ABO) and the fair value of the plan assets. The accumulated benefit obligation equals the actuarial present value of benefits earned to date without considering future pay increases. It differs from the projected benefit obligation (PBO, which is used in calculating service cost and interest cost for annual pension expense, in that the PBO includes those pay increases. The ABO more conservatively represents the obligation and approximately equals the obligation if the plan terminates. (The next article, "A Decision Rule Approach to Minimum Pension Liability Recognition under SFAS No. 87," presents a step-by-step method of computing the minimum liability.)

A comparison of the minimum liability and the previously recorded prepaid or accrued pension cost yields, if necessary, and additional liability. The recording of this additional liability results in a total pension liability equal to the minimum liability. The credit for the additional liability necessitates a debit to either an intangible asset (representing the expected future benefit of plan amendments) or to a contra stockholders' equity account if no future economic benefit appears likely. A comparison of the additional liability to any unrecognized prior service

Exhibit B

Minimum Liability Calculation

1. Accumulated benefit obligation
   - Fair value of plan assets
   Minimum liability (unfunded accumulated benefit)
2. Minimum liability
   +/- Prepaid/accrued pension cost
   Additional liability
3. Prior service cost > additional liability?
   Yes - record intangible asset
   No - record contra stockholders' equity account

cost determines the future benefit. If prior service cost exceeds the liability, the company records the intangible asset. Prior service costs arise from plan amendments which generally improve the plan and benefit future periods. If prior services costs do not exceed the additional liability, the company assumes no future benefit. Exhibit B summarizes this rather complex calculation. The company amortizes neither the intangible asset nor the contra stockholders' equity account. The company adjusts the balances of these accounts each year to reflect the funding status.

Summary of Earlier Research

In earlier research, the author examined the annual reports of 100 publicly traded companies, with defined benefit pension plans, for the year in which they made the transition to phase one of SFAS 87.

The results were significant. Of the 100 companies, twenty-eight reported pension *income*, rather than expensed, under the new requirements. This resulted primarily from the offsetting of the return on plan assets against the other components. Sixty-five of the 100 companies reported a decrease in pension expense in the year of transition. This decrease was over 100 percent for thirteen companies. One company reported a increase in net income of 121 percent due solely to this change.

In anticipation of the new minimum liability, the 100 companies were also examined to determine whether, if the FASB had required phase two at the time of initial transition, the companies would have recorded an additional liability. Thirty-two companies had unfunded accumulated obligations (the accumulated obligation exceeded the assets) at that time. However, only nineteen would have been required to report an additional liability since the previously recorded accrued pension liability was greater than the unfunded amount. The amount of this additional liability ranged from a immaterial percentage to five percent of the company's total assets.

Exhibit C

Additional Pension Liability

	# of Companies
Recorded	12
Not recorded, not yet required	5
Not recorded, no explanation	3
Total with liability calculated	20

Impact and Disclosure of the Minimum Liability

In order to evaluate the impact of the additional liability requirement, an attempt was made to obtain the 1989 annual reports of the same 100 companies in the earlier sample. Reports for ninety-five of the companies were received. The other five were not available because of acquisitions and bankruptcies. Of the ninety-five examined, sixty-eight had overfunded plans and twenty-seven had underfunded plans with unfunded accumulated benefits. Of particular interest were the companies, within the twenty-seven, required by SFAS 87 to record an additional liability. The following questions were asked: Which companies were required to record an additional pension liability and in what amount? If so, did they? Surprisingly, all did not. (See Exhibit C.) Of the twenty companies for which an additional liability was calculated, twelve recorded an additional amount; five did not because their fiscal years ended before December 15, 1989, and thus they are not required to record until fiscal 1990; three did not record and provided no explanation for the failure to do so.

Exhibit D

Minimum Liability Disclosure

	# of Companies Yes	No	Total
Separate line item in reconciliation	10	10	20
Identification of debit (i.e., intangible asset or contra stockholders' equity	6	14	20
Narrative discussion in footnote	7	13	20

The amounts of the additional liability did not appear significant in comparison to the total assets of the company.

However, the disclosure of the minimum liability requirement appeared insufficient. If the FASB set out to make pension information more understandable and useful, there appears to be a question as to whether or not they have accomplished their goal. Exhibit D summarizes the extent of the disclosure. Exhibit D includes the five companies not yet required to record the additional liability because they chose to disclose what the liability would be when required. SFAS 87 requires that the pension footnote include a reconciliation of the funded status of the plan with amounts that are reported on the balance sheet. Specifically, that reconciliation should include a *separate* line item for the amount of any additional liability. Only fifty percent (ten out of twenty) included this item in the reconciliation. As discussed earlier, the offset, or debit, for the liabilities is an intangible asset or a reduction in stockholders' equity. Only six companies identified this debit in any way. Probably most significant was the fact that even though this is a new requirement and new disclosure, only seven companies included *any* narrative discussion or explanation.

One argument for eliminating the disclosure might have been that of materiality. However, it can be maintained that there are two types of materiality relating to financial statement disclosure: material amounts and material information. New requirements and new disclosures are material information in

Exhibit E
Partial Pension Footnote Example

Note X Pensions ...
Actuarial present value of benefit obligations:

Vested benefit obligation	$(XX)
Accumulated benefit obligation	(XX)
Projected benefit obligations	(XX)
Plan assets at fair value	XX
Projected benefit obligation (in excess of) or less than plan assets	XX
Unrecognized net (gain) or loss	(XX)
Unrecognized prior service cost	XX
Unrecognized net obligation from adoption of SFAS 87	XX
Adjustment required to recognize minimum liability	(XX)
Prepaid pension cost (pension liability) recognized in the balance sheet	$(XX)

SFAS No. 87 "Employers' Accounting for Pensions" required the Company to adopt its **minimum liability requirement** in 1989, due to the **accumulated benefit obligation under the pension plan exceeding the fair value of plan assets**. This required the Company to record an **additional liability of $XX, included in other noncurrent liabilities** on the balance sheet. An **intangible asset (included in other assets)** of $XX was also recorded. A **reduction of stockholders' equity of $XX** was made for the excess of this liability over the intangible asset, net of related deferred taxes.

that they are unfamiliar, situations have changed, and reporting is not consistent with previous information.

If individuals like this author, with some pension knowledge, become frustrated with the way pension information is disclosed, how are other financial statement users reacting? If the FASB believes the reconciliation of funded status to balance sheet amount is important enough to require its inclusion, the financial statement user should be able to find that amount on the balance sheet (or, at least, be informed as to where it is included). This was not the case for the companies examined. Typically, there was no mention of where pension assets or liabilities were and the user was left to speculate.

An example of the ability to trace a significant amount to the balance sheet is the SFAS 95 "Statement of Cash Flows" requirement that the Cash and Cash Equivalents amount at the bottom of the new Statement of Cash Flows tie to a line item on the balance sheet. In any situation where a reconciliation is being made to a balance sheet amount, this should be the case (or if the amount is not material by itself, an explanation of where it is included should be provided).

Given the complexities of pension plans, the footnote will probably always be involved and detailed. However, that is all the more reason to make it as understandable as possible. The annual reports for only two of the companies examined included footnotes that were felt to adequately explain the minimum liability requirement. The minimum liability adjustment (the additional liability) was included as a separate line item in the reconciliation. A paragraph discussing the requirement included an explanation of the debit(s) for the adjustment as well as where these items were included on the balance sheet. An example of a partial pension footnote, without amounts, derived from these reports is presented in Exhibit E. (Bold print is used for emphasis.)

Conclusion

The pension footnote has long been one of the most complicated notes accompanying published financial statements. As a result, many financial statement users have either ignored the information included or misinterpreted it. The FASB set out in SFAS 87 to standardize pension calculations and improve disclosure. The minimum liability requirement, that caused so much previous controversy, does not appear to have had the significant dollar impact on financial statements that was anticipated. However, it does appear that pension footnotes are still falling short in connecting to the financial statements, particularly the balance sheet, and in adequately explaining pension accounting, particularly the new minimum liability requirement. The full disclosure principle, basic to generally accepted accounting principles, states that adequate disclosure should be made of any economic information that could affect an informed financial statement user's decisions regarding the company. These users are not all CPAs with pension expertise. If disclosure is made but is not understandable, what has been accomplished?

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Financial Accounting Standards, *Statement of Financial Accounting Standards No. 87*, "Employer's Accounting for Pensions," 1985.

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