

Pension plan paper

Business



The Post Retirement Benefit of Pension Plans Marcus Womack Intermediate Accounting II (ACC 306) Professor Rick Kwan September 29, 2010 There are several different types of employment compensation.

Salaries and wages that people earn while they are working provide immediate compensation for services provided and are a key factor in managing one's day to day life. However, there are also various types of compensation that one can earn from employment after they have retired from a company. The purpose of these post-retirement benefits is to ensure livelihood for a person when they are no longer able to work.

A pension is one such plan. A pension is an arrangement—paid in regular installments—to provide people with an income when they are no longer earning a regular income from employment.

The goal of pension plans is accomplished by setting aside funds during the years that an employee is working and making those funds along with earnings from investing those funds available when retirement occurs. A pension created by an employer for the benefit of an employee is commonly referred to as an occupational or an employer pension and for tax reasons, are usually advantageous to the employer and employee.

Favorable tax treatment is an added benefit of pension plans established under specific guidelines. Employers earn special tax deductions while employees are only taxed on the fund contributions after retirement occurs. There are other mutual benefits as well. An employee with a pension plan often feels a sense of retirement security that will cause them to work harder and stay at their job longer.

Increased productivity and decreased turnover as a result of sufficient retirement plan offerings enhances a company's competitive ranking in the labor market.

Pension plans may be classified as either defined benefit or defined contribution plans depending on how the benefits are determined. Defined contribution plans are plans in which the employer agrees to contribute a fixed amount to the employee's pension fund each year that the employee is employed. Retirement benefits are contingent on how much money the plan accumulated during employment and the return of investment of those funds. Employers offer designated options for employees to choose where their funds are invested such as stocks or fixed income securities. 01(k) plans offered by private sector employees and 403(b) plans offered by public and non-profit employers are two types of defined contribution plans.

In a defined benefit plan the contract between employer and employee states that the employer contributes a specific amount to a pension fund and at retirement pays the employee a fixed monthly income for life. The benefit on retirement in this plan is determined by a set formula. This formula is usually either a dollar times service or final average pay calculation, or a combination of both. Sometimes the age of the employee is a factor as well.

In this arrangement, it is up to the employer to ensure that the funds are available to provide the benefits to employees once they retire.

In addition to the burden of being completely financially responsible for funding this type of plan there are other reasons for which defined benefit plans have lost their popularity. Three main reasons are the fact that

government regulations make administering the plan costly and cumbersome, employers have become more interested in attracting new talent as opposed to building long-term loyalty and there are several market risks that go along with the company's obligation to contribute to the plan.

Kilgour (2007) discussed many of the issues surrounding pension plan funding and the creation of the Pension Protection Act of 2006. The Bush administration proposed an overhaul of pension law that served to strengthen pension plan funding and protect the Pension Benefit Guaranty Corporation (PBGC) by increasing the cost of employer contributions. The requirements outlined added significant costs, risk and complexity to defined benefit plan sponsorship and is a contributor to the fact that today more than two-thirds of workers are covered by defined contribution plans.

The market risk that exists is associated with the changes in the value of investments with the plans. While both types of plans carry market risks, the risks associated with defined benefit plans lies on the shoulders of the employer while those associated with defined contribution plans are assumed by the employee. During periods of economic growth the cost of maintaining a pension fund decreases due to the rising values of investments. Employers are able to contribute less and still meet future pension obligations.

However, when markets go down the employer has to contribute more money to the plan to ensure that they are able to pay retirees their promised funds.

Retirees receive the same dollar amount of income regardless of market conditions. With defined contribution plans the risks and rewards are reversed. Since the retiree both assumes risks and reaps benefits, periods of economic growth cause the retiree's wealth and income to increase and negative market changes cause the opposite to occur. Employers have agreed to a fixed amount and are unable to adjust their contributions downwards.

In essence, with this type of pension plan the employer does not take on the risk of their obligation changing unexpectedly, the pension funds being inadequate to meet their obligation or any added periodic expense of carrying a pension plan. Once retirement occurs, the company's financial commitment ends.

The pension obligation is defined as attributable to retirees and other employees entitled to benefits and current employees depending on their service to date. In regards to pension accounting, there are three different ways to measure the pension obligation.

Accumulated benefit obligation (ABO) and projected benefit obligation (PBO) are two of these methods. The accumulated benefit obligation is the estimate of the total retirement benefits (at their discounted present value) earned by employees so far. It applies the pension formula using existing compensation levels. The ABO assumes that the employee is fired or retires on the date that the calculation is performed and is therefore what the pension fund must pay the employee should the employer and or employee make no further contributions and the employee retires immediately.

It is the present value of the future liability of an employee's pension. In contrast, the projected benefit obligation is the estimate of the total retirement benefits earned by the employee so far and applies the pension formula using estimated future compensation levels. The PBO assumes that the employee will continue to work and make contributions to the pension plan. It also assumes that the contributions to the fund will increase as the employee's salary increases.

While the ABO's objective estimate of benefits is reliable it does not take into account that between the present time and retirement there will likely be increase in salary so calculating the benefits and taking this increase into consideration may offer a more realistic picture. The projected benefit obligation is an estimate of the present value of the future liability of the pension.

When examining a calculation of the PBO, substituting the employees existing compensation in the formula for their projected salary at retirement would result in the accumulated benefit obligation. Pension plan reporting is an often-changing and complex topic of discussion. The funded status of a pension plan is one such aspect. This is the status of the pension plan that has accumulated assets that have been set aside for the payment of retirement benefits. It is defined as the difference between the projected benefits obligation and the fair value of plan assets—employer contributions and accumulated earnings on the investment of those contributions to be used to pay retirement benefits.

In Reilly's (2006) article he discusses the fact that for almost twenty years companies have been required to include the amount owed to employees
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based on the PBO in the footnotes of financial statements. Even though neither the PBO nor the plan assets are reported on the balance sheet, in 2006 it became a requirement that companies report the difference between these two values on the balance sheets rather than just showing them in the footnotes.

Reporting of the funded status sparked debate because moving this information to the balance sheet could force companies to recognize a large liability, which could possibly cut their net worth, hinder dividend payments or jeopardize lending agreements. Reilly argued that this change could prompt more companies to freeze pension plans. Pension obligations change from year to year for several reasons. These reasons include the performance of investments, switching methods and assumptions and changes in benefits.

To help provide greater transparency of assets and related liabilities of post-retirement benefits The Financial Accounting Standards Board (FASB) has established rules for reporting benefit plans in accounting statements. There are several steps companies must take in this reporting in addition to disclosing the funded status of their plans. First, companies must “ recognize as a component of other comprehensive income, net of tax, any gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost” (Reinstein, 2007).

Amounts of comprehensive income are reported on a cumulative basis in the balance sheet. Companies must also measure defined benefit plan assets and obligations as of the date of the employer’s fiscal year-end balance

sheet. In their financial statements companies must disclose certain information about effects on net periodic benefit costs for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits and transition assets or obligations (Reinstein, 2007).

Companies are required to report pension assets for overfunded benefit plans and liabilities for underfunded plans. An actuary, a professional trained in the particular branch of statistics and mathematics to assess the various uncertainties and to estimate a company's obligation to employees in connection with its pension plan, plays a vital role in post-retirement benefit reporting. Actuaries use skills in mathematics, economics, computer science, finance, probability and statistics to help companies assess the risk of certain events occurring and to help formulate policies that minimize the cost of that risk.

In regards to pension benefits, actuaries also address financial questions involving the level of pension contributions required to produce a specific retirement income and the different ways that companies should invest their resources to maximize the return on investments despite the potential risks. Many events, such as death, are inevitable so the role of the actuary is to help a company minimize the financial impacts of those events when they occur since these events can affect both sides of the balance sheets.

Managing these risks requires asset and liability management and valuation skills.

In conclusion, pension plans are a very important aspect of post-retirement planning which can be beneficial to both employer and employees. To

maintain the integrity of their financial statements, it is important for companies to adhere to proposed guidelines for post-retirement reporting and manage their benefits plans wisely. Likewise, it is important for employees to gain full understanding of their companies post-retirement plans before and during employment so that they are adequately prepared for life after their working years. References Kilgour, J.

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