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Financial Accounting Standards No. 87 —A Survey*

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Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions*, was released in December, 1985, culminating an effort that began in December of 1974 and took many turns. The final version covers what amounts to an accounting/actuarial standard with significant income statement and balance sheet implications. It is a difficult document, for both professions, since it freely mixes and adapts from each. For others, it can be mind boggling.

Survey

While there were certain exceptions, FAS 87 was required beginning with calendar year 1987 financial statements. Earlier application was encouraged. To find out about FAS 87 results, companies voluntarily complying in 1986 were sampled in 48 Mercer-Meidinger-Hansen offices in the USA in order to investigate the choice of certain assumptions and the relationships between the resulting pension expense and the range of IRS tax-deductible contributions. The following discussion will be of particular value to those who have participated in FAS 87 determinations of pension expense.

There were 307 companies included in this survey with a total market value of pension assets of about $17.6 billion in mid-1986.

Interest Rates

The three basic interest rates essential to understanding the significance of FAS 87 are the assumed valuation interest rate, the discount rate and the expected long-term rate. The assumed valuation interest rate is, of course, the interest rate used in the regular actuarial valuation of the pension plan. It is used to calculate tax-deductible contributions and is included for comparison with the other two rates. The discount rate is used to calculate the present value of liabilities and normal costs for FAS 87, while the expected long-term rate is used to calculate the expected return on plan assets.

The discount rate is intended to be a current rate at which pension benefits could be settled. Possibilities for determining this rate include a current annuity buyout rate, current PBGC rates, a long-term bond rate reflecting high-quality securities with a term similar to the period over which benefits will be paid. These alternative bases encompass a fairly wide range of acceptable rates at any given date. The expected long-term rate is to reflect the average rate of earnings on funds invested or to be invested.

Based on the sample, the interest rates used by the companies were:

Interest Rate	Average
Assumed Valuation Interest Rate	7.63%
Discount Rate	8.56%
Expected Long-Term Rate	8.63%

In this first full year in which FAS 87 could be applied, it is interesting to note that the discount rate and the expected long-term rate were nearly the same and the assumed valuation interest rate was about one percent less.

The last two interest rates, combined with the projected unit credit funding method and complex amortization rules, are used to produce a pension expense which may affect balance sheet assets and liabilities as well.

Tax Deductions

Comparisons of pension expense were made with the range of IRS tax-deductible contributions disclosing that only 15 percent of the companies developed a pension expense greater than the minimum, but less than the maximum or within the tax-deductible range. With 85 percent of the companies sampled producing a pension expense, per FAS 87, outside of the IRS tax-deductible range, the distinction between the actual contribution made to the pension fund and the amount charged to the company for accounting purposes, the pension expense, is emphasized.

Of the companies falling outside of the range of tax-deductible contributions, almost 71 percent of the total sample were below the IRS minimum while 14 percent were above the IRS maximum. Of the 71 percent below the minimum, 16 percent were below the minimum but produced a positive pension expense. The other 55 percent were below the minimum and produced a negative pension expense, so that pension expense literally became pension income. Presumably, the anomaly of an expense becoming income is due to its "over-funded" status measured by FAS 87, but this is a function of the discount rate which most observers consider to be volatile from year to year. This rate is selected anew at each measurement date and is almost certain to change.

Problems

Many of those who spoke before the FASB, prior to the adoption of FAS 87, mentioned the possibility of the pension expense being outside of the tax-deductible range, pointing out that this could create problems. Longer term such differences cannot prevail: a pension expense consistently outside of this range could hardly fund a pension plan in a rational manner and therefore not represent a reasonable expense. With several "permissable" pension expense and contribution numbers available (IRS and FAS 87), there may be a tendency by plan sponsors to prefer the lower amount and actively seek ways to accomplish this. Such reactions would weaken plan funding and lessen employee security. In addition, such differences cast doubt on the usefulness of pension reporting in financial statements.

Amortization

As part of this study, the amortization periods used in these calculations were examined: the average was 16.0 years. This is, of course, much more rapid amortization than the 20-30 years common in determining pension contributions over recent years.

Conclusion

Now that the FAS 87 pension expense is mandatory for most companies in the USA, it remains to be seen how results such as those disclosed in this survey will affect future pension expense accounting. To the extent that pension expense for financial statement purposes diverges from pension tax-deductible contributions actually made to the pension fund, the appropriate level of contributions will have to be reexamined by all parties so as not to mislead nor affect benefit security.

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