PENSION PLANS

A. Pension plans can be classified as defined benefit plans and defined contribution plans. The CPA exam has emphasized defined benefit plans in which an employer provides an employee with defined retirement benefits in exchange for current or past services. As employees work, the pension benefits accumulate and actuarial computations are necessary to determine the present value of the future payments due.

B. A defined benefit pension plan has two main components:

1. Plan Assets—The cash and investments set aside by the employer to pay retirement benefits. Plan assets are measured at fair value. The change in plan assets during an accounting period is calculated as follows:

   Beginning fair value of plan assets
   + Contributions
   - Benefits paid
   + Actual return on plan assets
   Ending fair value of plan assets

2. Pension Plan Liability—The actuarial present value of the pension benefits owed to employees for current and past service. There are two measures of pension plan liability:

   a. The Accumulated Benefits Obligation (ABO) is the actuarial present value of benefits based on current and past compensation levels.

   b. The Projected Benefit Obligation (PBO) is the actuarial present value of benefits based on expected future compensation levels. The change in the PBO during the accounting period is calculated as follows:

      Beginning projected benefit obligation
      + Service cost
      + Interest cost
      + Prior service cost from current period plan amendments
      + Actuarial losses incurred in the current period
      - Actuarial gains incurred in the current period
      - Benefits paid to retirees
      Ending projected benefit obligation

   c. Under IFRS, the pension plan liability is called the defined benefit obligation (DBO).

C. Both U.S. GAAP and IFRS require that companies report the funded status of all pension plans on the balance sheet. A plan's funded status is calculated as follows:

   Fair value of plan assets
   - PBO (or DBO)
   Funded status
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A plan is underfunded when the PBO (or DBO) exceeds the fair value of the plan assets. Under U.S. GAAP, underfunded pension plans are aggregated and reported as a current liability (to the extent that benefits payable in the next 12 months exceed the fair value of the plans' assets), a non-current liability, or both. Under IFRS, underfunded pension plans are reported as a net defined benefit liability. IFRS do not specify whether the liability should be reported as current or non-current.

A plan is overfunded when the fair value of the plan assets exceeds the PBO (or DBO). Under U.S. GAAP, overfunded pension plans are aggregated and reported as a non-current asset. Under IFRS, overfunded pension plans are reported as a net defined benefit asset. IFRS do not specify whether the asset should be reported as current or non-current.

D. Under U.S. GAAP, changes in the funded status of a pension plan due to gains or losses and prior service cost are reported, net of tax, in other comprehensive income (PUFE) in the period incurred. Accumulated other comprehensive income (AOCI) is adjusted when the gains and losses and prior service costs are recognized as components of net periodic pension cost through amortization. Any remaining net transition assets or obligations are also reported in AOCI and amortized to pension expense.

1. Under IFRS, prior (past) service cost is reported as a component of service cost on the income statement in the period incurred. Pension gains and losses are reported in other comprehensive income in the period incurred and are not reclassified (amortized) to the income statement.

E. Under U.S. GAAP, net periodic pension cost (SIRAGE) is the net of six components:

1. + Current service cost
2. + Interest cost
3. – Return on plan assets
4. +/- Amortization of prior service costs (cost of retroactive benefits due to changes in plan)
5. +/- Amortization of gains/losses
6. +/- Amortization of existing net obligation or net asset at implementation of plan

The tax effects of the components of net periodic pension cost must be recognized when net periodic pension cost is recorded.

Under U.S. GAAP, net periodic pension cost is reported in total on the income statement. Under IFRS, defined benefit cost includes service cost and net interest on the defined benefit liability (asset). The components of defined benefit cost are generally reported separately on the income statement; there is no requirement that these amounts be aggregated and presented as one amount.
II. POSTRETIRED BENEFITS OTHER THAN PENSIONS
   A. The cost of retirement health care and other benefits is accrued if the obligation is
      attributable to services already rendered; these rights accumulate or "vest"; payment is
      probable; and the amount can be reasonably estimated.
   B. Benefits are accrued over the attribution period, the period from the date of hire to the date
      fully eligible for the benefit.
   C. Postretirement benefit plans must be reported as described above for pension plans.

III. OTHER DEFERRED COMPENSATION AND BENEFITS
   A. Post-employment benefits
      These benefits (severance pay, salary continuation, etc.) are enjoyed after employment
      and are not the same as postretirement benefits. GAAP requires the accrual of a liability if
      the same four criteria as for postretirement benefits are met.
   B. Deferred compensation
      When companies offer separate deferred compensation arrangements that are individual
      employment contracts, these contracts are accounted for individually on an accrual basis at
      the present value of the benefits expected to be provided in exchange for the employee's
      service to date.
   C. Compensation for future absences
      A liability for employees' compensation for future absences is accrued if the same four
      criteria as for postretirement benefits are met. Sick pay benefits are generally not accrued,
      unless they meet the four criteria.

IV. ACCOUNTING FOR INCOME TAXES
   A. GAAP and tax accounting rules differ considerably. Some of the differences are permanent
      because they never reverse. Other differences are temporary because they involve mere
      timing differences between the financial and tax accounting rules.
   B. Only temporary differences cause deferred tax consequences.
   C. Tax expense is subdivided into two components: current tax expense (CTE) and deferred
      tax expense (DTE).
   D. Current tax expense (CTE) is merely the result of multiplying taxable income from the tax
      return by the tax rate. The exam routinely ignores estimated tax payments by firms.
   E. The deferred tax account(s) in the balance sheet must be adjusted at the end of each year
      to reflect the appropriate amount of deferred tax liability (DTL) and/or the appropriate
      amount of a deferred tax asset (DTA).
   F. Permanent differences, such as tax-exempt interest on municipal bonds, or life insurance
      premiums when the corporation is beneficiary, are embedded in tax law and will not reverse
      in the future; therefore they only affect current tax paid and not the deferred tax accounts.
G. Temporary differences will "turn around" in the future and are part of the deferred tax calculations. GAAP requires accrual accounting, while tax law treats some items on a cash basis: e.g., estimated liabilities or bad debt expense. When an item is recognized for book purposes before it is deductible for tax purposes, a deferred tax asset (DTA) will result. Using straight-line depreciation for the books and MACRS for tax purposes will result in lower taxable income in the early years of the asset life and a deferred tax liability (DTL). The Corporate Taxation Summary gives an excellent breakdown of various differences between book and tax income.

H. DTAs and DTLs must be recalculated each year based on enacted tax rates in the year(s) in which the taxable item is expected to be realized (DTA) or paid (DTL). IFRS allows the use of enacted or substantively enacted tax rates.

I. Under U.S. GAAP and IFRS, all deferred tax assets and liabilities are reported as non-current.

J. Under U.S. GAAP, if it is more likely than not that all or part of a deferred tax asset will not be realized, a valuation allowance must be set up to reduce the asset. IFRS prohibits the use of a valuation allowance. Under IFRS, a deferred tax asset is recognized when it is probable that sufficient taxable profit will be available against which the temporary difference can be utilized.

K. Operating loss carrybacks are "assured" and can be recognized as a reduction in the book loss in the year of the loss. An operating loss carryforward is a DTA and is recognized to the extent that it is "more likely than not to be realized."

L. Undistributed earnings of an investee are presumed to be distributed in the future and are a temporary difference.

M. Intraperiod tax allocation relates to apportioning the total tax provision among the various Income Statement sections (IDA) from F1.