Intermediate Accounting IFRS Edition

Kieso, Weygandt, Warfield

Fourth Edition

Chapter 20

Accounting for Pensions and Postretirement Benefits

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Learning Objectives

After studying this chapter, you should be able to:

LO 1 Discuss the fundamentals of pension plan accounting

LO 2 Use a worksheet for employer's pension plan entries.

LO 3 Explain the accounting for past service costs.

LO 4 Explain the accounting for remeasurements.

LO 5 Describe the requirements for reporting pension plans in financial statements.

LO 6 Explain the accounting for other postretirement benefits.

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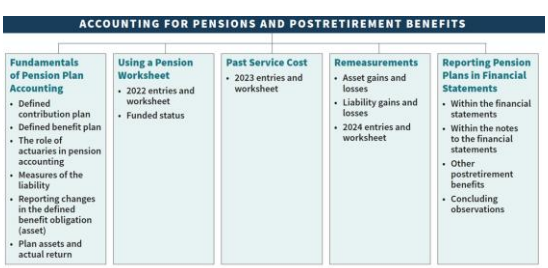
PREVIEW OF CHAPTER 20



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Learning Objective 1
Discuss the fundamentals of pension plan accounting.

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Fundamentals of Pension Plan Accounting

An arrangement whereby an employer provides benefits (payments) to retired employees for services they performed in their working years.

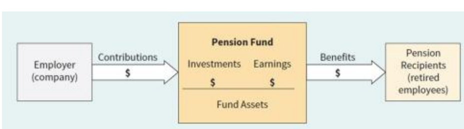

ILLUSTRATION 20.1

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Pension Plan Accounting

Pension plans can be:

- **Contributory:** employees voluntarily make payments to increase their benefits.
- **Non-contributory:** employer bears the entire cost.
- **Qualified pension plans:** offer tax benefits.

Pension fund should be a separate legal and accounting entity.

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Defined Contribution Plan vs. Defined Benefit Plan

Defined Contribution Plan

- Employer contribution determined by plan (fixed)
- Risk borne by employees
- Benefits based on plan value

Defined Benefit Plan

- Benefit determined by plan
- Employer contribution varies (determined by actuaries)
- Risk borne by employer

Companies engage **actuaries** to ensure that a pension plan is appropriate for the employee group covered.

LO 1 7

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The Role of Actuaries in Pension Accounting

Actuaries make predictions of mortality rates, employee turnover, interest and earnings rates, early retirement frequency, future salaries, and other factors necessary to operate a pension plan.

They also compute the various pension measures that affect the financial statements, such as

- the pension obligation,
- the annual cost of servicing the plan, and
- the cost of amendments to the plan.

LO 1 8

8

Measures of the Liability

Two questions:

1. What is the pension obligation that a company should report in the financial statements?
2. What is the pension expense for the period?

LO 1 9

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Measures of the Liability
Different Measures of the Pension Obligation

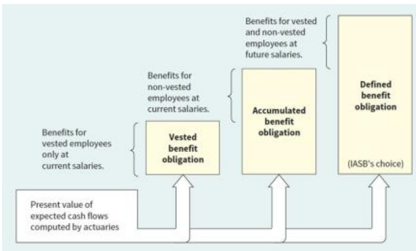

ILLUSTRATION 20.3

Net Defined Benefit Obligation (Asset)

- The **net defined benefit obligation (asset)** (also referred to as the **funded status**) is the deficit or surplus related to a defined pension plan.
- The deficit or surplus is measured as follows.

Defined Benefit Obligation – Fair Value of Plan Assets (if any)

Deficit		Surplus	
Defined benefit obligation	€(1,000,000)	Defined benefit obligation	€(150,000)
Plan assets	900,000	Plan assets	200,000
Net defined benefit obligation	€ (100,000)	Net defined benefit asset	€ 50,000

ILLUSTRATION 20.4

Reporting Changes in the Defined Benefit Obligation (Asset)

The **IASB** requires:

- All changes in the defined benefit obligation and plan assets in the current period be recognized in **comprehensive income.**
- Companies report changes arising from different elements of pension liabilities and assets in **different sections of the statement of comprehensive income**, depending on their nature.

Reporting Changes in the Pension Obligation (Assets)

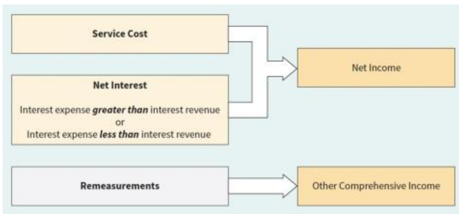

ILLUSTRATION 20.5

LO 1 13

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Components of Pension Cost
Service Cost

- **Current service cost** - increase in the present value of the defined benefit obligation from employee service in the current period.
- **Past service cost** - change in the present value of the defined benefit obligation for employee service for prior periods—generally resulting from a plan amendment.
- Reported in the statement of **comprehensive income in the operating section of the statement and affects net income.**
- **Companies must consider future compensation levels in measuring the present obligation and periodic pension expense.**

LO 1 14

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Components of Pension Cost
Net Interest

- **Computed by multiplying the discount rate by the funded status** of the plan (defined benefit obligation minus plan assets).
- Net defined benefit **obligation** results in **interest expense.**
- Net defined benefit **asset** results in **interest revenue.**
- Amount is often shown below the **operating section of the income statement** in the financing section.
- **Discount rate** is based on the yields of high-quality bonds with terms consistent with the company's pension obligation.

LO 1 15

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Components of Pension Cost
Remeasurements

- **Gains and losses** related to the defined benefit **obligation.**
- **Gains or losses** on the fair value of the plan **assets.**
- This component is reported in **other comprehensive income**, net of tax.
- Remeasurement gains or losses therefore affect comprehensive income but **not net income.**

LO 1 16

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Plan Assets and Actual Return

Plan Assets

- **Investments** in shares, bonds, other securities, and real estate.
- Reported at **fair value.**
- **Employer contributions** and the **actual return on plan assets** increase pension plan assets.
- **Benefits paid** to retired employees decrease plan assets.

LO 1 17

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Plan Assets and Actual Return Example
Determination of Pension Assets

Hasbro SA has pension plan assets of €4,200,000 on January 1, 2022. During 2022, Hasbro contributed €300,000 to the plan and paid out retirement benefits of €250,000. Its actual return on plan assets was €210,000 for the year. **Compute the amount of plan assets at December 31, 2022.**

Plan assets, January 1, 2022	€4,200,000
Contributions by Hasbro to plan	300,000
Actual return	210,000
Benefits paid to employees	(250,000)
Plan assets, December 31, 2022	€4,460,000

ILLUSTRATION 20.6

LO 1 18

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Equation for Computing Actual Return

Illustration: Hasbro SA has pension plan assets of €4,200,000 on January 1, 2022. During 2022, Hasbro contributed €300,000 to the plan and paid out retirement benefits of €250,000. Its actual return on plan assets was €210,000 for the year. **Some companies compute the actual return as follows.**

$$\text{Actual Return} = \left(\begin{array}{c}\text{Plan Assets} \\ \text{Ending Balance}\end{array} - \begin{array}{c}\text{Plan Assets} \\ \text{Beginning Balance}\end{array}\right) - (\text{Contributions} - \text{Benefits Paid})$$

ILLUSTRATION 20.7

LO 1 19

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Computation of Actual Return on Plan Assets

Stated another way, the actual return on plan assets is the difference between the fair value of the plan assets at the beginning of the period and the end of the period, adjusted for contributions and benefit payments. **Illustration 20.8** uses the equation method to compute actual return, using the information provided in **Illustration 20.6**.

Plan assets, December 31, 2022		€4,460,000
Plan assets, January 1, 2022		(4,200,000)
Increase in fair value of plan assets		260,000
Deduct: Contributions to plan	€300,000	
Add: Benefit payments to employees	250,000	(50,000)
Actual return		€ 210,000

ILLUSTRATION 20.8

LO 1 20

20

Learning Objective 2
Use a worksheet for employer's pension plan entries.

LO 2 21

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Basic Format of Pension Worksheet

Companies often use a worksheet to record pension-related information. As its name suggests, the worksheet is a working tool. A worksheet is **not** a permanent accounting record. It is neither a journal nor part of the general ledger. The worksheet is merely a device to make it easier to prepare entries and the financial statements.

Pension Worksheet

A	B	C	D	E	F
	General Journal Entries			Memo Record	
Items	Annual Pension Expense	Cash	Pension Asset/ Liability	Defined Benefit Obligation	Plan Assets

ILLUSTRATION 20.9

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2022 Entries and Worksheet

Illustration: Zarle AG provides the following information related to its pension plan for the year 2022.

- Plan assets, January 1, 2022, are €100,000.
- Defined benefit obligation, January 1, 2022, is €100,000.
- Annual service cost is €9,000.
- Discount rate is 10 percent.
- Funding contributions are €8,000.
- Benefits paid to retirees during the year are €7,000.

Instructions: Prepare a pension worksheet for Zarle Company for the year ending December 31, 2022.

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Pension Worksheet—2022

Pension Worksheet—2022

A	B	C	D	E	F
	General Journal Entries			Memo Record	
Items	Annual Pension Expense	Cash	Pension Asset/ Liability	Defined Benefit Obligation	Plan Assets
Balance, Jan. 1, 2022			—	100,000 Cr.	100,000 Dr.
(a) Service cost	9,000 Dr.			9,000 Cr.	
(b) Interest expense	10,000 Dr.			10,000 Cr.	
(c) Interest revenue	10,000 Cr.				10,000 Dr.
(d) Contributions		8,000 Cr.			8,000 Dr.
(e) Benefits				7,000 Dr.	7,000 Cr.
Journal entry for 2022	9,000 Dr.	8,000 Cr.	1,000 Cr.*		
Balance, Dec. 31, 2022			1,000 Cr.**	112,000 Cr.	111,000 Dr.

*€9,000 – €8,000 = €1,000
**€112,000 – €111,000 = €1,000

ILLUSTRATION 20.10

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2022 Journal Entry to Record Pension Expense

Zarle makes the "formal journal entry" on December 31, which records the pension expense in 2022 as follows.

Pension Expense	9,000	
Cash		8,000
Pension Asset/Liability		1,000

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Learning Objective 3
Explain the accounting for past service costs.

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Types of Past Service Costs

Past Service Cost

- Change in the present value of the defined benefit obligation resulting from a **plan amendment** or a **curtailment**.
- **Expense** past service cost in the period of the amendment or curtailment.

Past Service Costs
(Expense in Current Period)

Plan Amendments	Curtailments
• Introduction of a plan. • Withdrawal of a plan. • Changes to a plan.	• Significant reduction in the number of employees covered by the plan.

ILLUSTRATION 20.12

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2023 Entries and Worksheet

Illustration: On January 1, 2023, Zarle AG amends the pension plan to grant employees past service benefits with a present value of €81,600. The following additional facts apply to the pension plan for the year 2023.

- Annual service cost is €9,500.
- Discount rate is 10 percent.
- Annual funding contributions are €20,000.
- Benefits paid to retirees during the year are €8,000.

Instructions: Prepare a pension worksheet for Zarle Company for the year ending December 31, 2023.

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Pension Worksheet—2023

Pension Worksheet—2023

	General Journal Entries			Memo Record	
Items	Annual Pension Expense	Cash	Pension Asset/ Liability	Defined Benefit Obligation	Plan Assets
Balance, Dec. 31, 2022			1,000 Cr.	112,000 Cr.	111,000 Dr.
(f) Additional PSC, Jan. 1, 2023	81,600 Dr.			81,600 Cr.	
Balance, Jan. 1, 2023				193,600 Cr.	
(g) Service cost	9,500 Dr.			9,500 Cr.	
(h) Interest expense	19,360 Dr.			19,360 Cr.	
(i) Interest revenue	11,100 Cr.				11,100 Dr.
(j) Contributions		20,000 Cr.			20,000 Dr.
(k) Benefits				8,000 Dr.	8,000 Cr.
Journal entry for 2023	99,360 Dr.	20,000 Cr.	79,360 Cr.		
Balance, Dec. 31, 2023			80,360 Cr.	214,460 Cr.	134,100 Dr.

ILLUSTRATION 20.13

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Learning Objective 4
Explain the accounting for remeasurements.

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Remeasurements

Uncontrollable and unexpected swings that can result from

1. sudden and large changes in the **fair value of plan assets** and
2. changes in actuarial assumptions that affect the amount of the **defined benefit obligation.**

Gains and losses reported in other comprehensive income.

LO 4 31

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Remeasurements
Asset Gains and Losses

Difference between the actual return and the interest revenue computed in determining net interest.

- **Illustration:** Shopbob SE has plan assets at January 1, 2022, of €100,000. The discount rate for the year is 6 percent, and the actual return on the plan assets for 2022 is €8,000. In 2022, Shopbob should record an asset gain of €2,000, computed as follows.

Actual return	€8,000
Less: Interest revenue (€100,000 × .06)	6,000
Asset gain	€2,000

ILLUSTRATION 20.15

LO 4 32

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Remeasurements
Liability Gains and Losses

Any change in actuarial assumptions that affect the amount of the defined benefit obligation.

- Companies report liability gains and liability losses in **Other Comprehensive Income (G/L).**
- They accumulate the asset and liability gains and losses from year to year in **Accumulated Other Comprehensive Income.**
- This amount is reported on the statement of financial position in the **equity section.**

LO 4 33

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2024 Entries and Worksheet

Illustration: The following facts for Zarle Company apply to the pension plan for 2024.

- Annual service cost is €13,000.
- Discount rate is 10 percent.
- Actual return on plan assets is €12,000.
- Annual funding contributions are €24,000.
- Benefits paid to retirees during the year are €10,500.
- Changes in actuarial assumptions establish the end-of-year defined benefit obligation at €265,000.

Instructions: Prepare a pension worksheet for Zarle Company for the year ending December 31, 2024.

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2024 Pension Worksheet—2024

Pension Worksheet—2024

	General Journal Entries				Memo Record	
Items	Annual Pension Expense	Cash	OCI—Gain/Loss	Pension Asset/ Liability	Defined Benefit Obligation	Plan Assets
Balance, Jan. 1, 2024				80,360 Cr.	214,460 Cr.	134,100 Dr.
(l) Service cost	13,000 Dr.				13,000 Cr.	
(m) Interest expense	21,446 Dr.				21,446 Cr.	
(n) Interest revenue	13,410 Cr.					13,410 Dr.
(o) Contributions		24,000 Cr.				24,000 Dr.
(p) Benefits					10,500 Dr.	10,500 Cr.
(q) Asset loss			1,410 Dr.			1,410 Cr.
(r) Liability loss			26,594 Dr.		26,594 Cr.	
Journal entry for 2024	21,036 Dr.	24,000 Cr.	28,004 Dr.	25,040 Cr.		
Accumulated OCI, Dec. 31, 2023			0			
Balance, Dec. 31, 2024			28,004 Dr.	105,400 Cr.	265,000 Cr.	159,600 Dr.

ILLUSTRATION 20.16

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Defined Benefit Obligation Balance

December 31, 2023, DBO balance	€214,460
Service cost [entry (l)]	13,000
Interest expense [entry (m)]	21,446
Benefits paid	(10,500)
December 31, 2024, DBO balance (before liability increases)	238,406
Liability Loss	26,594
December 31, 2024, DBO balance	€265,000

ILLUSTRATION 20.17

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2024 Journal Entry to Record Pension Expense

Zarle makes the "formal journal entry" on December 31, which records the pension expense in 2024 as follows.

Pension Expense	21,036	
Other Comprehensive Income (G/L)	28,004	
Cash		24,000
Pension Asset/Liability		25,040

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Learning Objective 5
Describe the requirements for reporting pension plans in financial statements.

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Within the Financial Statements
Pension Expense

- Report these components in one section of the statement of comprehensive income and report total pension expense.

or

- Report the service cost component in operating income and the net interest in a separate section related to financing.

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Within the Financial Statements
Gains and Losses (Remeasurements)

- Asset and liability gains and losses are recognized in other comprehensive income.
- Not recognized in net income.

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Gains and Losses (Remeasurements)

Obey ASA provides the following information for the year 2022.

Net income for 2022	€100,000
Liability loss for 2022	60,000
Asset loss for 2022	15,000
Accumulated OCI, January 1, 2022	40,000

Computation of Other Comprehensive Income

Liability loss	€60,000
Asset loss	15,000
Other comprehensive loss	€75,000

ILLUSTRATION 20.20

Computation of Comprehensive Income

Net income	€100,000
Other comprehensive loss	75,000
Comprehensive income	€ 25,000

ILLUSTRATION 20.21

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Comprehensive Income Reporting

The components other comprehensive income must be reported using one of two formats:

1. a two statement approach or
2. a one statement approach (a combined statement of comprehensive income).

Two statement approach

ILLUSTRATION 20.22

Obey ASA
Comprehensive Income Statement
For the Year Ended December 31, 2022

Net income		€100,000
Other comprehensive loss		
Liability loss	€60,000	
Asset loss	15,000	75,000
Comprehensive income		€ 25,000

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Computation of Accumulated Other Comprehensive Income

Accumulated other comprehensive income, January 1, 2022	€40,000
Other comprehensive loss	75,000
Accumulated other comprehensive loss, December 31, 2022	€35,000

ILLUSTRATION 20.23

Reporting of Accumulated OCI

Obey ASA
Statement of Financial Position
As of December 31, 2022
(Equity Section)

Equity	
Share capital—ordinary	€100,000
Retained earnings	60,000
Accumulated other comprehensive loss	35,000
Total equity	€125,000

ILLUSTRATION 20.24

LO 5 43

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Recognition of the Net Funded Status of the Pension Plan

- Companies must recognize on their statement of financial position the overfunded (pension asset) or underfunded (pension liability) status of their defined benefit pension plan.

LO 5 44

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Classification of Pension Asset or Pension Liability

- The excess of the fair value of the plan assets over the defined benefit obligation is classified as a noncurrent asset.

LO 5 45

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Aggregation of Pension Plans

- The only situation in which offsetting is permitted is when a company:
  1. Has a legally enforceable right to use a surplus in one plan to settle obligations in the other plan, and
  2. Intends either to settle the obligation on a net basis, or to realize the surplus in one plan and settle its obligations under the other plan simultaneously.

LO 5 46

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Within the Notes to Financial Statements

A company is required to disclose information that:

a. Explains characteristics of its defined benefit plans and risks associated with them.
b. Identifies and explains the amounts in its financial statements arising from its defined benefit plans.
c. Describes how its defined benefit plans may affect the amount, timing, and uncertainty of the company's future cash flows.

LO 5 47

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Learning Objective 6
Explain the accounting for other postretirement benefits.

LO 6 48

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Differences Between Pensions and Postretirement Healthcare Benefits

Item	Pensions	Healthcare Benefits
Funding	Generally funded.	Generally not funded.
Benefit	Well-defined and level dollar amount.	Generally uncapped and great variability.
Beneficiary	Retiree (maybe some benefit to surviving spouse).	Retiree, spouse, and other dependents.
Benefit payable	Monthly.	As needed and used.
Predictability	Variables are reasonably predictable.	Utilization difficult to predict. Level of cost varies geographically and fluctuates over time.

ILLUSTRATION 20.27

LO 6 49

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Learning Objective 7
Compare the accounting for pensions under IFRS and U.S. GAAP.

LO 7 50

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Global Accounting Insights

The underlying concepts for the accounting for postretirement benefits are similar between U.S. GAAP and IFRS—both U.S. GAAP and IFRS view pensions and other postretirement benefits as forms of deferred compensation. At present, there are significant differences in the specific accounting provisions applied to these plans.

LO 7 51

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Global Accounting Insights
Similarities

- U.S. GAAP and IFRS separate pension plans into defined contribution plans and defined benefit plans. The accounting for defined contribution plans is similar.
- Both U.S. GAAP and IFRS recognize the merit of reporting the primary components of pension expense (service cost and net interest) in different sections of the income statement.
- U.S. GAAP and IFRS recognize a pension asset or liability as the funded status of the plan (i.e., defined benefit obligation minus the fair value of plan assets). (Note that defined benefit obligation is referred to as the projected benefit obligation in U.S. GAAP.)
- U.S. GAAP and IFRS compute unrecognized past service cost (PSC) (referred to as prior service cost in U.S. GAAP) in the same manner.

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Global Accounting Insights
Differences

- While U.S. GAAP and IFRS include interest expense on the liability in pension expense, GAAP subtracts an asset return component based on expected return. Under IFRS for asset returns, pension expense is reduced by the amount of interest revenue. Other changes in asset value measurements are recorded in other comprehensive income.
- U.S. GAAP amortizes PSC over the remaining service lives of employees, while IFRS recognizes PSC as a component of pension expense in income immediately.
- While IFRS permits the primary components of pension expense (service cost and net interest) to be reported in different sections of the income statement, U.S. GAAP requires this method of reporting.

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Global Accounting Insights
More Differences

- U.S. GAAP recognizes liability and asset gains and losses in “Accumulated other comprehensive income” and amortizes these amounts to income over remaining service lives (generally using the “corridor approach”). Under IFRS, companies recognize both liability and asset gains and losses (referred to as remeasurements) in other comprehensive income. These gains and losses are not “recycled” into income in subsequent periods.
- U.S. GAAP has separate standards for pensions and postretirement benefits, and significant differences exist in the accounting. The accounting for pensions and other postretirement benefit plans is the same under IFRS.

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Global Accounting Insights
On the Horizon

The I A S B and the F A S B have been working collaboratively over the years on a postretirement benefit project and, as a result, their accounting is this area is similar. Significant differences remain in the components of pension expense. If the F A S B restarts a project to reexamine expense measurement of postretirement benefit plans, it likely will consider the recent I A S B amendments in this area.

LO 7 55

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