Chapter 17 Pensions and Other Postretirement Benefits

POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

As a result of the adoption of SFAS #106 the expected future health care costs for retirees must be recognized as an expense over the service years that the employees become eligible for such benefits.

Postretirement Benefit Plans
Eligibility is normally based on age and/or years of service.

To estimate postretirement health care benefits the following assumptions are required:
1. The discount rate must be determined
2. If the plan is funded, the expected return on plan assets must be established
3. Employee turnover must be estimated
4. Expected retirement age must be estimated
5. If the plan is pay-related, the expected compensation increases must be estimated
6. Expected age of death must be estimated
7. The number and ages of beneficiaries and dependents must be determined

Assumptions unique to postretirement health care benefits are:
1. Current cost of providing health care benefits at each age that the participants might receive such benefits
2. Demographic characteristics of plan participants that might affect the amount and timing of benefits
3. Benefit coverage provided by Medicare, other insurance, or other sources that will reduce the net cost of the employer-provided benefits
4. The expected health care cost trend rate

POSTRETIREMENT BENEFIT OBLIGATION
• Expected postretirement benefit obligation (EPBO)
The discounted present value of the actuary’s estimate of the total postretirement benefits expected to be received by plan participants.
• Accumulated postretirement benefit obligation (APBO)
The portion of the EPBO attributed to employee service to date.

Measuring the Obligation
EPBO is provided by the actuary. The fraction of the service to date over the number of years of service for full eligibility is used to compute the APBO.

Example: At December 31, 2002 the actuary for Spencer Company has determined that the present value of the estimated future total postretirement benefits is $40,000. All employees have completed 6 years of service. To be eligible for this postretirement benefit the employee must have completed 25 years of service and reached age 55. The appropriate discount rate is 6%. The following is a computation of the APBO as of December 31, 2002.
Two elements enter into the computation of APBO at the end of December 31, 2003. The obligation increases as a result of interest and one additional year of service. The following is the computation of the APBO as of December 31, 2003.

\[
\begin{align*}
\text{APBO, January 1, 2003} & \quad $9,600 \\
\text{Interest cost} & \\
\text{APBO, January 1, 2003} & \quad $9,600 \\
\text{Discount rate} & \quad 6\% \\
\text{Interest cost for 2003} & \quad 576 \\
\text{Service cost} & \\
\text{EPBO, December 31, 2003} & \quad 42,400 \\
\text{Fraction for one year of service} & \quad 1/25 \\
\text{Service cost for 2003} & \quad 1,696 \\
\text{APBO, December 31, 2003} & \quad $11,872 \\
\end{align*}
\]

**Analysis of EPBO, December 31, 2003:**
\[
\begin{align*}
\text{EPBO, 1/1/03} & \quad $40,000 \\
* \text{1 Plus the discount rate} & \quad 1.06 \\
\text{EPBO, 12/31/03} & \quad $42,400 \\
\end{align*}
\]

**Alternative calculation:**
\[
\begin{align*}
\text{EPBO, 12/31/03} & \quad $42,400 \\
\text{Service completed through 12/31/03} & \quad 7/25 \\
\text{APBO, 12/31/03} & \quad $11,872 \\
\end{align*}
\]

**Attribution**
The cost of benefits (EPBO) is attributed to the years during which the benefits are earned by the employees. The attribution period does not include years of service beyond the date of eligibility.

**Postretirement Benefit Expense**
In many respects postretirement benefit expense is handled in a similar manner as pension accounting. In most cases, the postretirement benefit obligation is not funded which means that the company continues to incur an increasing liability as benefits accrue to currently employed participants.
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Components of Postretirement Benefit Expense
1. **Service cost**
   Unlike pension accounting the postretirement benefits are a fixed cost, which do not increase with salary. The service cost reflects one additional year of service until the employee is fully eligible.

2. **Interest cost**
   Interest cost reflects the interest accrual on the beginning balance of the APBO. Remember that the APBO is the present value of the future obligation (earned to date) so to bring the records current we need to add interest at the end of each year to obtain the present value at that date.

3. **Return on plan assets**
   As mentioned above, most postretirement benefit plans are unfunded so there are normally no plan assets. If a plan is funded then there would be a return on assets calculated in the same manner as pension accounting.

4. **Amortization of prior service cost**
   Unlike pension accounting, any plan amendments will involve prior service costs from the date of amendment to the date of eligibility, not retirement. Because SFAS #106 has had such a negative effect on financial statement ratios many corporations have amended their plans by reducing benefits. A negative plan amendment creates a negative prior service cost.

5. **Amortization of deferred net losses or net gains**
   As with pension accounting there are two components to deferred net losses or net gains: 1) revisions in the assumptions in computing APBO and 2) the return on plan assets that is greater than or less than expected. Amortization is only applied if the net gain or loss exceeds an amount equal to the greater of 10% of the APBO, or 10% of plan assets.

6. **Amortization of transition obligation**
   As your book mentions, most corporations either recorded the entire cumulative effect at the adoption of SFAS 106 or have fully amortized the transition obligation at this point.

Recording Postretirement Benefit Expense
Postretirement benefit expense is recorded in the same manner as pension expense. In the previous example pension expense of $2,272 for 2003 consisted of $576 interest cost plus $1,696 service cost. If the company contributed $290 to the fund the journal entry would be recorded as follows:
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Postretirement Benefit Expense

<table>
<thead>
<tr>
<th>Service cost</th>
<th>$1,696</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest cost</td>
<td>576</td>
</tr>
</tbody>
</table>

Expected return on plan assets:
- Actual return on plan assets | 0 |
- (gain) loss on plan assets | 0 |

Amortization:
- Amortization of prior service cost | 0 |
- Amortization of net (gain) loss | 0 |
- Amortization of transition liability | 0 |

Total postretirement benefit expense | $2,272 |

The journal entry to record postretirement benefit expense for 2003 is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/03</td>
<td>Postretirement benefit expense</td>
<td>$2,272</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>290</td>
</tr>
<tr>
<td></td>
<td>Accrued postretirement benefit cost</td>
<td>$1,982</td>
<td></td>
</tr>
</tbody>
</table>

To record post retirement benefit expense, contributions and accrued postretirement benefit cost at December 31, 2003.