CASH BALANCE PENSION PLANS: THE ROLE OF ACCOUNTING

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Abstract

Accounting for and ownership of employee pensions has long been a controversial and contested arena. Previous research has focused on the role of accounting in formulating pension liabilities and perceptions of capital market participants regarding the contested ownership of pension assets and measurement of pension obligations.

The newest chapter in this ongoing debate has emerged as increasing number of United States companies have switched from conventional defined benefit plans to cash balance plans. Because of the pervasive and public nature of pension benefits, the impact of these changes on both companies and employees has received substantial publicity in both the popular and financial press. This paper explores the role of accounting, the popular press, and politicians in illuminating or failing to illuminate the ramifications when companies change from traditional defined benefit plans to cash balance plans.
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Introduction and Description of Cash Balance Plans

During recent years, companies in the United States have attracted publicity in both the popular and financial press by changing their defined benefit pension plans. More than three hundred companies with hundreds of billions of dollars in pension assets have switched from conventional defined benefit plans to cash balance plans (Hitt, December 15, 1999). Sixteen of the 100 largest U.S. companies now have cash-balance plans; none of this group had these plans a decade ago (Oppel, July 14, 1999).

Though legally cash balance plans are classified as defined benefit plans (Elgin, 1991), cash balance plans involve changes to the corporate pension formula so that they resemble defined contribution plans (Geisel, 1998). Most traditional defined benefit plans base pension payments to retirees on a formula that combines a percentage of final pay (or highest final average pay) with the number of years worked. Under typical cash-balance plans, companies contribute a percentage of an employee's pay (usually four percent to seven percent) to an account every year, and then guarantee that money will grow at a certain rate, e.g., the yield on a U.S. Treasury bill. At retirement, or when employment is terminated (if vesting requirements are met), the amount in that account is the pension. Cash balance plans are subject to the same ERISA funding regulations as traditional benefit plans (Rohrer, 1995), and also are insured by the Pension Benefit Guaranty Corporation (Stewart and Yaffe, 1989).

Accounting for and ownership of employee pensions has long been a controversial and contested arena. Much research has focused on assessing current accounting rules, or on looking at forces impacting how standards setters established the rules (e.g., Daley and Tranter; 1990; Francis, 1987). Other researchers have focused on whether pension liabilities or “excesses” (as defined by applicable accounting standards) are impounded in equity prices and debt prices (e.g., Tinker and Ghicas, 1993; Reiter, 1991; Pontiff, et al, 1990). The controversy surrounds ownership of pension funds, and the role of accounting in this debate.

The newest chapter of this continuing saga has emerged in the form of cash-balance pension plans. This study was motivated as the author observed, with increasing frequency, press coverage of companies changing from traditional defined benefit pension plans to cash-balance plans, and became curious about how accounting rules and reporting either illuminated or failed to illuminate this debate. Changes in accounting standards are generally reactive rather than proactive (Reither, 1997). Since standard setters tend to act in response to perceived problems, construction and visibility of problems is an essential component of revising accounting rules. Because of the pervasive and public nature of pension payments, the popular and financial press play a key role in formulating positions for players in this arena. Accordingly, this paper explores popular financial press perceptions of the cash balance plans from both the company and the employee perspective, political aspects of the plans, and the role of accounting in this discourse.
Popular and Financial Press View -- Company Perspective

Companies publicly espouse many reasons for changing from traditional defined benefit plans to cash balance plans. Employers position these changes as advantageous for the employees, or often for both the company and the employees. I have reviewed the assertions presented by companies who made the change, as well as popular news and financial press descriptions of these changes, and categorized the stated rationales into four categories. The discussion within each section focuses on press coverage of specific companies that have altered their pension plans. These categories are not mutually exclusive, and thus there is frequently overlap in the discussion. Nonetheless, the following sections provide some structure for exploring the companies’ stated positions.

Reduction of Pension Costs/Cash Flow Benefits

Press coverage suggests that a primary driver for companies implementing cash balance plans is that these plans are less costly than traditional defined benefit plans. The New York Times reports that cash-balance plans often save companies millions of dollars a year (Oppel, July 14, 1999). "Reducing front-end costs was one reason Thompson Consumer Electronics . . . switched from a traditional defined benefit to a cash balance plan . . . We could not afford the final average earning plan," says Linda Wych, pension fund manager for Thompson's U.S. division (Elgin, 1991).

AT&T adopted cash balance pension plans as part of a strategy initially designed to eliminate about one fourth of its 50,000 manager population during 1998. Only approximately three percent of the management population was over age fifty-five and thus eligible to retire under the old defined benefit plan. Even if all employees over fifty-five elected to leave, targeted downsizing still would not have been achieved, so AT&T exposed a broader group of people to an early retirement incentive program. According to the transition plan, for employees with at least five years of service who voluntarily decided between April 1 and May 22, 1998 to leave (at a later date), the company agreed to place a specified percentage of eligible pay per year of service into that employee's cash balance account. Thus all managers electing to leave under this program would have some level of "portable" retirement benefit corresponding to age and length-of-service. This strategy allowed AT&T to use pension assets instead of operating cash to encourage early retirements (Burlingame and Gulotta, 1998). Employees were clearly dissatisfied with the change; a class-action suit has been filed against AT&T (Schultz, Auerbach, and Burkins, 1999).

When IBM changed its pension plan, it initially gave all Canadian workers, and only certain U.S. workers, the right to remain in the old pension plan. When asked the rationale for such disparate treatment, J. Thomas Bouchard, IBM's senior vice president for human resources, said it "simply would have cost too much" (Burkins, 1999). Because of employee protests, IBM altered its initial decision and decided that anyone forty years old or older with at least ten years of service could remain in the old plan; this doubled the number of employees who had a choice. According to IBM spokesperson John Bukovinsky, the company’s cost of the pension revision “won’t be insignificant” (Schultz, Auerbach and Burkins, 1999). When Eastman Kodak established a cash-balance pension plan, it also softened the impact on older workers by giving
all U.S. workers a choice of remaining in the old plan or joining the new one (Schultz, Auerbach and Burkins, 1999).

In 1999, SmithKline and Aetna converted to cash-balance pension plans. The Wall Street Journal reports that, "by switching to the new-style plans, the companies are phasing out generous early-retirement subsidies that were built into the old pension plans, and changing the way people accrue pension benefits." Aetna is softening the impact on affected workers by providing the better of the old or new benefit for vested employees who leave the company within the next eight years. In contrast, SmithKline is providing no transition benefits for workers over age sixty (Schultz, April 8, 1999).

CBS switched from its conventional pension plan to a cash balance plan effective April 1, 1999. Unlike some companies that deny cost savings as a motivator, CBS openly acknowledges that the cash-balance pension plan will save the company money and reduce employee pensions. Employees who are fifty-five years or older and whose years working for the company and age total seventy can stay in the old plan (Schultz and Pope, 1999).

Consultants frequently contend that employers do not typically adopt these plans to cut costs; instead they are designed to be cash-neutral (Cowans, 1996). Such assertions clearly contradict the pervasive notion in this section that companies implement cash balance plans because traditional defined benefit plans are too costly.

Opportunity for Interest Arbitrage

Cash balance plans provide companies with an opportunity to utilize pension assets to generate earnings in excess of those promised and paid to employees. This interest arbitrage strategy is possible because from the employee perspective, cash balance plans appear similar to defined contribution plans since the employer promises a specified return. However, many companies anticipate that actual return on pension assets will exceed the return promised to employees (and credited to their pension accounts), and thus these companies can keep the excess amount earned (Rohrer, 1995). Anand (May 17, 1999) notes that cash balance plans “exist only on paper, and the employer continues to use professional money managers to invest the underlying assets, hoping to best the return it offers participants, and pocket the difference.” Healthcare Financial Management notes that companies usually set the rate of interest paid below the rate of return on the investment, thus allowing employers to "realize a gain . . . thereby reducing future contributions to the pension fund” (Stewart and Yaffe, 1989). Of course, the opposite outcome is also possible. Employers bear the risk that cash-balance pension assets will earn less than the pay and interest credits accumulated on employee pension accounts.

NationsBank Corp. (now Bank of America) has taken a somewhat different approach to its cash balance plans, apparently in hope of the same interest arbitrage gains. Instead of guaranteeing a specified rate of return, the plan allows participants to direct cash balance pay credits to as many as eleven investment options. An employee's cash balance plan account is then credited with the rate of return earned by the funds he or she has chosen. If the selected funds have negative returns, employees still will receive their pay credits. But from the employer's perspective, these transactions are just on paper. Because the cash balance plan is a
defined benefit plan, NationsBank has the right to invest those contributions as it sees fit, which may differ from investment options selected by employees. "While NationsBank won't discuss the matter, those who have studied the plan and plan documents say NationsBank believes its actual investments will earn a higher rate of return than the options selected by employees. And that, in turn, will mean lower future pension contributions by NationsBank." ("Don't Bank," 1998).

More Attractive to Today’s Workforce

The previous two sections discuss how cash-balance pension plans can reduce corporate pension costs and provide the opportunity for excess returns. Because of the sensitive nature of pension benefits, one would expect astute managers to verbalize more politically acceptable rationales for altering pension plans. This appears to be occurring in the financial press as many managers take the position that these changes enhance benefits for the majority of workers.

Many employers contend that traditional defined benefit plans were designed for a workforce where employees spent the bulk of their career with one company, and that this model no longer portrays today’s economy. Accordingly, companies assert that cash balance plans are more attractive to today’s workforce. Because of this portability, company rhetoric suggests that these plans help attract young skilled workers who "jump from job to job," rather than making a lifetime commitment to one firm (Hitt, December 15, 1999).

Employers also attempt to position cash-balance plans as fairer, because traditional plans are heavily weighted toward older, longer-serving workers and away from the shorter-term employees that make up an increasingly visible segment of the U.S. labor force. According to the legislative bulletin for the Erisa Industry Committee, a group of employers, law firms and actuarial consultants, “Cash-balance designs offer significant advantages [to those] who move in and out of the workforce. [Such employees] are more likely to accrue a significant and secure retirement benefit under cash-balance plans than under many other designs,” (Schultz, December 16, 1999). A spokesperson for Casual Corner Group says, “With a young work force with high turnover, the cash-balance plan provides a significantly bigger benefit for younger associates.” (Schultz, December 16, 1999).

Ease of Understanding

Some companies have suggested that traditional defined benefit plans were difficult for employees to understand, and as a result, employees did not appreciate these plans. Because amounts are credited directly to employee accounts, on the surface cash balance plans are clearly easier to understand. However, this author confesses some skepticism over the image of companies changing the entire retirement plan structure because employees do not understand it. Absent other benefits that accrue to the employer, explaining plans as opposed to changing plans would appear to be a viable alternative.

The BOC Group, an international company with about 35,000 employees worldwide, and 10,000 based in the United States, was one of the first companies to adopt cash balance plans in
1986. This company's stated reason for abandoning its traditional final-average-pay plan was that "it was too expensive and was not appreciated by the employees" (Murray and Murphy, 1997, p. 33). BOC's workforce was changing, and career employees were becoming a rarity. After examining some alternatives senior management decided that the cash-balance plan, by virtue of its age-neutral approach to benefit delivery, would be a more equitable, cost-effective alternative. However, not to disadvantage older workers, a grandfather provision was included to guarantee them a retirement benefit at least equal to what they would have received under the final-average-pay plan. The company's view is that the cash-balance plan provides

"equal pay for equal service, regardless of the participant's age at hire. For example, a 25-year-old new hire and a 45-year-old new hire who consistently earn the same compensation accumulate equal cash-balance pension benefits during the time they work for BOC. This is a shift away from the earlier plan, which would provide higher benefits to the 45-year old and cost the company more." (Murray and Murphy, 1997)

Effective in 2000, Citigroup is moving the 36,000 eligible U.S. employees in its Citibank unit to a cash-balance pension plan. The stated reason for the change is to bring Citibank's benefits more in line with those of Travelers Group. (Citicorp, Citibank's parent, and Travelers Group merged last October to form Citigroup.) Travelers has had a cash-balance plan for most of its employees for many years. The new Citigroup plan will not apply to Citibank's overseas employees or to Citigroup's Salomon Smith Barney brokerage concern (Beckett, 1999).

**Popular Financial Press View -- Employee Perspective**

Changes in accounting rules and reporting requirements tend to lag the underlying events triggering concern. Thus employees have relied on alternative sources for the bulk of information initially accompanying changes to cash balance pension plans. Consistent with reduction of political and regulatory costs, one would expect astute managers to position these plans as broadly beneficial to employees. This section will explore popular and financial press perceptions of both benefits and disadvantages to employees involved with these plan changes. I have grouped pervasive views into two categories, though clearly some overlap exists between the categories. The discussion within each group will focus on employees of specific companies that have changed pension plans.

**Ease of Understanding/Appreciation**

Because cash balance plans accumulate the pay and interest credits from which benefits are ultimately paid, they clearly are easier for participants to understand than plans using final pay formulas (Rohrer, 1995). According to David Clements, director of compensation and benefits for Catholic Health Corporation, employees like the cash balance plan because it is similar to having a savings account with a balance that they can watch grow (Elgin, 1991). *Business Insurance* notes that "making pension plans more visible and understandable was a key motive in adopting hybrid plans." (Geisel, 1997). *Healthcare Financial Management* notes that, for the most part, "younger workers do not think about retirement. Traditional retirement plans
seem complex and irrelevant. With a cash balance plan, which usually gives employees a statement showing exactly how much has been accrued, younger workers gain a sense of ownership.” (Stewart and Yaffe, 1989).

When the BOC Group switched to a cash balance plan, Financial Executive notes that the company’s “task of communicating employees’ responsibility for their own retirement was far easier” (Murray and Murphy, 1997). The article continues by noting that, "Instead of an esoteric formula, participants see a straight dollar amount, and they understand that better. This allows participants to appreciate the value of the pension benefit that the company is providing to them.” (Murray and Murphy, 1997).

Though cash balance plans can be easy to understand once they are implemented, comparison of benefits between those provided under traditional defined benefit plans and new ones to be received under cash balance plans is usually far from clear. When Central & South West Corporation announced its changeover to cash balance plans, Jim Bruggeman, a company engineer, spent about a year trying to understand the new system (“Employers Win Big,” 1998). The December 4, 1998 issue of the Wall Street Journal notes that, "Short of hiring an actuary, you probably can't figure out whether you're better or worse off if you're a veteran at your company." (Schultz, December 4, 1998).

According to the Wall Street Journal (Schultz, January 21, 1999), unlikely alliances develop when companies convert to cash balance plans. Generally, employers can unilaterally reduce or eliminate future pension benefits for nonunionized workers. In contrast, collectively bargained employees typically have the option of rejecting cash balance plans, or negotiating better provisions – if they understand the issues. When Niagara Mohawk Power Corporation adopted a cash balance plan for salaried employees in July, 1999, it also convinced the International Brotherhood of Electrical Workers union that it was good for those workers as well. Several union members subsequently filed charges against the company and the union with the National Labor Relations Board, charging the company did not provide sufficient information for the union to make an informed decision. At the same time, midlevel managers at the utility were trying to determine how their benefits under the new plan compare to benefits under the old plan. A group of managers worked with the union to construct computer models, and they estimated that pensions for some longtime employees had been reduced by forty percent (Schultz, January 21, 1999).

Manager and executive-level protests are likely to become more visible. David Certner, senior coordinator for economic issues at the American Association for Retired Persons, notes that

“As companies lean to big reduction in benefits for older long-tenure workers, you'll see more and more of these executive protests . . . The managers are the first to know about the changes and most likely to understand the impact” (Schultz, July 1, 1999).
Company rhetoric generally suggests that cash balance plans are advantageous for employees both because they promote a better understanding/appreciation of retirement benefits and because they are portable. The Third Millennium, a New York-based non-partisan research organization working on issues of concern to Generation X, is exploring cash balance pension plans. "Cash balance plans are often seen as damaging to people on the brink of retirement, but there's a pro side to that -- they are also enormously beneficial to younger workers," according to Richard Thau, executive director of the organization. Thau continued, "The idea of having an even amount being put into a defined benefit plan is fairer than a defined benefit plan that only gives a great benefit in the last five years of employment" (Anand, April 19, 1999). This view is echoed by Gordon Gould, chief actuary at Towers Perrin, who says that cash balance plans can be an effective way for companies to attract younger workers who are likely to change jobs frequently (Dugas, 1999).

Northern State Power adopted a pension-equity plan (similar to cash-balance plans) in 1999, but workers there did not protest because every current employee could choose between remaining enrolled in the traditional pension plan or switching to the new plan. Nearly two-thirds of the non-union workers opted for the new plan; they tended to be the younger workers with relatively few years on the job. All new hires after January 1, 1999 are automatically enrolled in the new plan (Schultz and Rundle, 1999). Lucent set up a cash balance plan for non-union workers hired after January 1, 1999 because "younger workers prefer these hybrid plans to stodgy traditional pension plans." However, Lucent did not alter the $45 billion traditional defined benefit pension plan covering existing employees (Anand, May 17, 1999).

As noted earlier, when IBM changed its pension plan, it initially limited the number of workers who could choose to remain in the old pension plan. In September of 1999, IBM scaled back the impact of conversion to cash balance plans by giving workers age forty or above with ten years of service the option to stay in the old plans (Schultz, Auerbach, and Burkins, 1999). But before IBM relented to some aspects of the change, an employee coalition of IBM dissatisfied with the change sponsored a plane with a banner reading, "IBM’s pension theft could happen to you!" to fly over the Minnesota State Fair (Anderson, 1999).

Even if younger, more mobile employees benefit from cash balance plans, this benefit comes at a cost, and that cost is frequently a reduction in benefit for older, longer-term workers (Dugas, 1999). The New York Times reports that cash-balance plans can reduce the money older workers receive in retirement by one-third or more (Oppel, July 14, 1999). For older workers near the end of their careers, switching to cash balance plans can mean a loss in some cases of as much as fifty percent of the value of their pensions (Hitt, December 15, 1999; Schultz, September 22, 1999).

The Wall Street Journal reports that in traditional plans, employees see most of the benefit accruing near retirement; in contrast, with cash balance plans, all employees receive the same annual credit. For example, if four percent of employee pay is contributed by the employer to the pension fund, and the balance earns an interest credit, the employer contribution for
younger employees will be higher for cash balance plans than for traditional plans. However, the contribution for older employees tends to be substantially less ("Employers Win Big," 1998).

The controversial switch to a cash balance plan led older employees at Onan Corp., a Cummins Engine company, to file suit in May 1997 alleging that their cash-balance plan adopted in 1989 discriminates in favor of younger employees. The suit was originally expected to go to trial in December, 1999 (Corry, 1999). However, the courts have certified the case as a class action under the age-discrimination and pension laws, and trial is now scheduled for April, 2000. The Internal Revenue Service (IRS) has sided with employees and asked the court to disqualify Onan’s pension plan (Schultz, Auerbach, and Burkins, 1999).

CBS switched from its conventional pension plan to a cash balance plan effective April 1, 1999. Perhaps because CBS openly stated that the cash-balance pension plan will save the company money and reduce employee pensions, an employee at a Philadelphia television station is quoted as saying, "(E)verybody's scared to death." (Schultz and Pope, 1999).

When Prudential agreed to sell its Prudential HealthCare unit to Aetna, many longer-service Prudential employees realized that their pensions would be cut by as much as forty percent. After vigorous employee complaints, the company agreed to allow departing employees to remain eligible for an early-retirement subsidy that workers usually lose when their units are spun off to new owners. It is doubtful that Aetna’s changes would have been made in the absence of employee outcries. Schultz observes that the impact of cash-balance plans increasingly extends beyond unionized labor. “As pension cutbacks sweep corporate America, there’s a growing backlash among employees – and increasingly, they’re on the executive floor.” (Schultz, July 1, 1999).

Emerging evidence suggests that even younger employees may not benefit when companies convert to cash balance plans. Despite espoused advantages of these plans for today’s workforce, many young employees do not benefit when companies implement them because they do not vest any sooner than traditional pension plans. According to Labor Department data, the median job tenure for workers aged 25 to 34 is 2.7 years (Schultz, December 16, 1999). Since the vesting period is generally five years, it is clear from this data that substantial numbers of employees do not benefit from the portability feature of cash balance plans. Based on a review of pension documents filed with the IRS for 1997, The Wall Street Journal also reports that the five-year vesting requirement prevents countless younger employees from gaining any benefit at all from cash-balance plans. For example, at SBC Corporation’s Southern New England Telephone unit, fifty-four percent of unionized employees who were in cash-balance plans (but had not yet vested) left the company in 1997. At MCI Communications, fifty-seven percent of those who were in the plan but had not yet vested left in 1997. The companies involved declined to comment for the article (Schultz, December 16, 1999).

**Political And Legal Aspects**

The previous two sections addressed both employee and employer perspectives of changes to cash balance pension plans utilizing a popular/financial press approach. Because of the pervasive publicity these plans have elicited, this issue has received much attention from
politicians in the United States. This section will explore the role of political and legal aspects of the cash balance pension debate, primarily throughout the past year.

The December 31, 1998 issue of the *Wall Street Journal* reported that the U.S. Senate had begun to draft legislation tightening disclosure rules when employers shift from traditional pensions to cash balance plans. Senate staffers noted that their concerns arose following a series of *Wall Street Journal* articles reporting that such conversions could significantly reduce pension benefits for longer-term employees. A member of the Senate Finance Committee expressed concern about adequate disclosure of pension changes. Employees appear unaware of how much their pensions can be cut, and are often unaware that they may be working for years - a decade or more in some cases - to regain their previous pension standing (“Senate Bill,” 1998).

In March of 1999, legislation to address these concerns was introduced into both the U.S. House and Senate. Senators Daniel Patrick Moynihan, Chuck Robb, and Bob Kerrey (all Democrats) introduced the Pension Right to Know Act, which would require companies to provide greater disclosure when making changes to pension plans. A companion bill was introduced in the House of Representatives by Jerry Weller, a Republican, and Representative Ken Bentsen, a Democrat. If adopted, the legislation would require employers who make changes to their pension plan to provide individualized benefits statements for employees comparing their pensions before and after the changes over various periods: on the date of conversion; three, five and ten years after conversion; and at normal retirement age (“Bill Seeks,” 1999).

The Clinton administration also proposed in July, 1999 that companies changing from traditional plans to new plans be required to tell workers roughly how much retirement money they stand to lose from the switch. The Administration’s proposal required companies to provide specific examples of how the change would affect different groups of workers. In addition to the Right to Know legislation described above, Senator William V. Roth (Republican) considered introducing cash-balance disclosure language as part of a tax bill. Bill Archer, chair of the House Ways and Means Committee, included language in his tax bill requiring that employees be given "sufficient information" to understand the effect of conversions when companies change to cash balance plans (Oppel, July 14, 1999).

In addition to the U.S. Congress, the Internal Revenue Service and the Equal Employment Opportunity Commission have also been drawn into the debate. Representative Bernie Sanders leaked to the press an IRS memo (dated September, 1998) saying that the cash-balance plan at an unnamed company “does not satisfy the clear and straight-forward requirement” of age bias law because the benefit accrual rate “decreases as a participant attains each additional year of age” (Anderson, 1999). Thus the IRS’s position is that there appears to be age discrimination in this pension plan. This is a critical issue because the IRS is the government body responsible for granting tax-deferred status to pension plans. Sanders is among forty members of Congress who have requested an investigation of these changes by the EEOC and the Labor Department. He notes that, "If the rate of accrual goes down as workers get older, then the plan violates the law” (Anderson, 1999). Sanders is pushing legislation requiring companies to make a detailed disclosure forty-five days before converting to a cash balance plan. The bill would impose a fifty-percent tax on a company's pension surplus if the concern failed to give
employees the option to remain in the old plan (Hitt, October 8, 1999). This same story received coverage in *The New York Times* (Oppel, September 2, 1999).

Though the EEOC has investigated age-bias complaints with pension plans, the agency but has not established a definitive position on the issue. The EEOC investigated 26,350 age-discrimination complaints in 1998, and only about 1.5 percent of these involved pensions or other benefits. EEOC chairwoman Ida Castro notes, “There is a reason I’ve taken a very measured approach” on whether cash-balance plans involve age bias. “It’s very complicated. It’s really difficult to come up with a broad-stroke decision” (Schultz, Auerbach, and Burkins, 1999).

In August, 1999, the Justice Department (representing the IRS) filed an amicus brief on behalf of employees of Georgia-Pacific Corporation. The workers had sued their employer alleging that it had miscalculated when it made lump-sum payments from the cash-balance plan to departing employees. A footnote to the brief states that, “A determination letter from the IRS applied only to the tax consequences and is meaningless as to participant litigation.” The Justice Department’s position is that it does not matter that the plan received an IRS letter confirming tax-favored status; these plans still might violate pension laws. (Schultz, September 2, 1999)

Throughout the month of September, U.S. legislators increased pressure on several groups that had legal or regulatory jurisdiction with cash balance plans. The *Wall Street Journal* reported that a bipartisan coalition of twenty-one lawmakers asked Labor Secretary Herman to investigate consultants helping companies set up cash balance plans. The group accuses the consultants of "contempt and disregard" for employees ("Pension Tensions," September 10, 1999). Lawmakers also stepped up pressure on IRS Commissioner Rossotti to curb tax benefits for these plans ("Pension Tensions," September 10, 1999).

Following Senate hearings in September, Senator Paul Wellstone (Democrat) called for investigating consulting firms that advised companies on changing pension plans. Specifically, Wellstone wants more information on how human resource consulting firms are analyzing “aging population trends” for companies considering conversions to cash balance plans (Schultz, September 22, 1999). He notes, “I am deeply concerned that serious age discrimination may be taking place” . . . Congress should find out whether cash balance pension plans are “appropriate, and how common the practice is” (Schultz, September 22, 1999). Wellstone also notes that if legislation mandating that all workers be allowed to choose between their old and new pension plans were brought to the floor, "It would be very difficult for people to vote against . . . " it (Hitt, December 15, 1999). However, actually getting something passed will not be easy, and attempts to push through a proposal in the waning days of the recent legislative session fell short. "What we're concerned about is that this is going to become a political football," according to Mark Ugoretz, president of the ERISA Industry Committee. "Democrats are going to want to make Republicans look bad, and Republicans won't want to look bad, and the real policy issues of how to provide good solid information are going to get lost in a spitting contest," (Hitt, December 15, 1999).

The debate over cash balance pension plans has also found its way into the rhetoric of U.S. presidential candidates. Both Al Gore (Democrat) and Gary Bauer ("social conservative"
Republican) have aired concern regarding the American people's pervasive unease surrounding their financial security at retirement. Gore spokesman Chris Lehane says, "It might not dominate the front page of the paper, but it's an issue people talk about at the breakfast table . . . We're at the breakfast table" (Hitt, December 15, 1999). Bauer says, "The move by IBM and others violates basic American fairness . . . In fact, it is kind of like changing the rules of the game in the third quarter. This is the kind of thing that invites government regulation, which no one wants." (Hitt, December 15, 1999).

During the 1980s, many companies with overfunded pension plans terminated these plans after being acquired by new owners. Because of the public outcry resulting from reduction in pension benefits, Congress instituted a fifty percent excise tax on pension reversions in 1990, thereby effectively prohibiting companies from utilizing overfunded pension plans as a source of operating cash. Despite efforts by Congress to curtail companies from terminating their pension plans, such activity has not ceased. The June 15, 1999 issue of The Wall Street Journal describes the case of Cheryl Clevenger, a fifty-year old widow with two dependent children who had worked at Mercantile’s department store for 12 years, and planned to retire from there. After Mercantile was purchased by Dillard’s, the new owner terminated the overfunded pension fund. Ms. Clevenger got a lump sum for the pension’s current worth of approximately $6,000 and lost her job (Schultz, June 15, 1999). This occurred because the tax code also contains a loophole provision allowing companies to pay only a twenty percent excise tax rather than the fifty percent excise tax if a fourth of the plan’s surplus goes into a “replacement plan.” Dillard’s employed this approach, and even after paying the twenty percent excise tax, it was still left with nearly $117 million of former pension assets to use for any purpose (Schultz, June 15, 1999).

The Constitutive Role of Accounting

Do current accounting rules provide enlightenment and insight to participants in the cash balance pension plans debates? The notion of corporate pension obligations has long been a contested arena. An initial issue is determining exactly what was promised to employees. The fundamental question is whether the obligation to employees is the explicit written legal liability, or the implicit economic liability implied by past and existing company practice (Frances and Reiter, 1987). Ambiguities are unavoidable in contracting, because not only is it impossible to enumerate every eventuality, contingency, and qualification in a written form, but it is usually uneconomic to do so (Tinker and Ghicas, 1993). Thus the accounting profession, management, the unions, politicians, the courts, and perhaps the popular press, are all significant players in adjudicating differences. This section will explore the role of accounting in this debate.

GAAP View of Pensions

The Financial Accounting Standards Board portrays the role of accounting as a neutral one. In its Conceptual Framework, the FASB states that, “Neutrality means that either in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest” (FASB, 1980, paragraph 98). The FASB accentuates this point by including a quote from then-Securities and Exchange Commission chair Harold Williams noting that,
“If it becomes accepted or expected that accounting principles are determined or modified in order to secure purposes other than economic measurement . . . we assume a grave risk that confidence in the credibility of our financial information system will be undermined (FASB, 1980, paragraph 104).”

Current U.S. pension accounting and reporting rules relevant to this paper are governed by *Statement of Financial Accounting Standards 87*, “Employers’ Accounting for Pensions,” and *Statement of Financial Accounting Standards 132*, “Employers’ Disclosures About Pensions and Other Postretirement Benefits.” SFAS 87 initially contained both accounting and disclosure requirements, but it is only used now for accounting purposes. SFAS 132 was issued in February, 1998, to “improve disclosures about pensions and other postretirement benefits,” (FASB, 1998, paragraph 1) but the pronouncement did not re-address any measurement issues. The FASB sets forth six components of pension expense in SFAS 87. (This pronouncement does not directly address cash balance pension plans because they were not utilized when it was issued.) When companies change from traditional defined benefit plans to cash balance plans, several of the six components of pension expense may be affected to some degree: service cost, return on plan assets, and prior service cost. The following paragraphs will explore the potential impact on the specified components of pension expense.

**Service Cost.** The FASB defines service cost as, “the actuarial present value of benefits attributed by the plan’s benefit formula to services rendered by employees during the period” (FASB, 1985, paragraph 16). Thus, according to the requirements of SFAS 87, since conversion to cash balance plans constitutes a change in the benefit formula, and benefit formulas drive service cost, the service cost component may be affected. The pronouncement further states that,

“For purposes of this Statement, pension benefits ordinarily shall be attributed to periods of employee service based on the plan’s benefit formula to the extent that the formula states or implies an attribution. . . For plan benefit formulas that define benefits similarly for all years of service, that attribution is a ‘benefit/years-of-service’ approach because it attributes the same amount of the pension benefit to each year of service. For final-pay and career-average-pay plans, that attribution is also the same as the ‘projected unit credit’ or ‘unit credit with service prorate’ actuarial cost method.” (paragraph 40)

Since most traditional defined benefit plans utilize final-pay or career-average pay, the bulk of expense tends to be recognized in the later periods of employment. This results in companies recognizing more expense for older workers near retirement than for younger workers earlier in their career, largely because service cost is recorded at present value, and as employees near retirement, present value increases. It would appear that service cost tends to decrease when companies convert to cash balance plans, but specific circumstances may vary based on many factors, including actuarial assumptions and age of the workforce. Most importantly, SFAS 132 contains no requirement to disclose changes in service cost when plan formulas change.
**Return on Plan Assets.** Return on plan assets is a negative component of pension expense (it serves to reduce this cost), and it is not directly impacted when companies change plan types. However, as discussed in previous sections, companies frequently anticipate an interest arbitrage advantage by earning a greater return on plan assets than the amount credited to employees’ pension accounts. How interest arbitrage strategies flow through the components of pension expense appears somewhat unclear and subjective, but successful strategies could serve to increase the return on plan assets, thereby reducing pension expense.

**Unrecognized Prior Service Cost.** When companies change pension plans, SFAS 87 generally requires amortization of the net impact of the change as prior service cost. Conversion from traditional defined benefit plans to cash balance plans generally constitutes a negative plan amendment, thereby reducing the firm’s PBO, so the benefit is amortized prospectively (Arcady and Mellors, 2000). This PBO reduction must be disclosed in a single line item reconciling beginning and ending PBOs. Accounting rules require that the “benefit” from a cash balance conversion must first be offset against any balance in unrecognized prior service cost, if such balances exist. While the required reconciliation appears to be the most visible disclosure requirement for cash balance conversions, it is possible for the impact of these conversions to be “netted out” with other prior service cost items, rendering this specific conversion virtually invisible.

**A Contested Arena**

Others do not share the FASB’s view of accounting as a neutral arbiter, but assert that by its very nature, accounting plays a major role in constructing reality rather than portraying reality (Morgan, 1988; Tinker, 1988; Chua, 1986). Even when establishing current pension current rules, the Board did not adopt its own preferred method of accounting. Though SFAS 87 corrected some problems with its predecessor statement, SFAS 36, the Board noted that some preferred methods would represent “too great a change from past practice to be adopted at the present time” (FASB, SFAS 87, paragraph 107). Disparities between the FASB’s theoretically preferred neutral stance and resulting pronouncements generally result from myriad economic and political pressures (Miller and Redding, 1992; Revsine, 1991; Daley and Tranter, 1990).

From a balance sheet perspective, a case can be made that SFAS 87 underestimates pension liabilities by requiring recognition only of the minimum liability. The service cost component of pension expense is based on projected future salary levels, so this particular understatement does not impact the income statement. Since the balance sheet minimum liability recognition is based on current salary levels, the pronouncement adopts the explicit contract view, and not the generally more prevalent implicit contract perspective (Wolk and Tearney, 1997).

Because of the nebulous nature of the pension agreement, perceptions of market players and stakeholders become important. Reiter (1992) found that participants in debt markets view pension contracts in terms of implicit agreements to continue plans into the future. Reiter’s research added to the work of Pesando (1982) and Ippolito (1985) who found that participants in labor and equity markets view pension agreements as economic obligations (implicit contract model) rather than termination obligations (explicit contract model).
Tinker and Ghicas (1993) continue the dialogue re the constitutive role of accounting by asserting that current accounting practice is consistently biased against employee interests, and may help constitute conflicts. Specifically, these authors found that pension “excesses” motivated a significant number of corporate takeovers between 1981 and 1985. Though their study was based on existing GAAP (SFAS 36) during that time period, current GAAP does not resolve the ambiguities inherent in cash balance pension plan conflicts.

In its background discussion issued with SFAS 87, FASB acknowledges the contested nature of the ownership of pension assets. In addressing the notion that pensions do not belong to the employer, the Board observes that, “numerous recent situations in which significant amounts of assets have been withdrawn by employers provide compelling evidence that rebuts that argument” (FASB, 1985, paragraph 112).

**Concluding Observations and Implications**

Based on the popular and financial press coverage of cash balance pension plan conversions, it seems reasonable to generalize that companies tend to benefit at the expense of many employees. It seems equally valid to assert that current accounting rules do little to illuminate the impact of this change for either employees or other financial statement users. While failure to provide insight is always a disquieting issue for the accounting profession, it is particularly disturbing given the pervasiveness of public concern and social welfare in the pension arena.

Tinker and Ghicas (1993) assert that, “Accounting is not merely a reporter in such conflicts, it may help constitute them by encouraging takeovers and terminations without considering the full social costs of such restructuring.” While the objective of that study was to explore whether pension excesses contributed to corporate takeovers, the issues with cash balance plans are merely another chapter in the same saga. The common theme is that employee benefits are being reduced, and accounting provides a paucity of information to illuminate this reduction. Employees in companies that have changed to cash balance plans have relied upon either internal calculations and analyses, politicians, or the courts to adjudicate the contested nature of the pension promise. Other stakeholders in this domain – primarily financial statement users who might be concerned about the equity of employee pensions – receive little information from the accounting and financial reporting process. Absent press coverage of this issue, it appears doubtful that any legal or regulatory remedies to protect employee interests would have been pursued.

This author’s personal experience suggests an increasing emphasis on the part of standard setters and regulators to increase “transparency” in financial reporting (e.g., SEC, 1999). The FASB’s stated intention in issuing SFAS 132 was to improve pension disclosure effectiveness (FASB, 1998). Yet despite these emphases and efforts, accounting makes no significant contribution toward illuminating the arguments and positions of various parties in the cash balance pension debate.
REFERENCES


Geisel, J., “Defined Benefit is Redeemed,” Business Insurance (October 5, 1998), pp. 1, 64.


