

Week 4 - DQ 2

What are the components of pension expense? How do the components of pension expense differ among the various types of contribution and benefit plans? How is the interest rate determined? Why are prior service costs amortized? Based on your knowledge of the components of pension, what would make you more or less likely to invest in a company?

Response #1

There are five components to pension expense and they are service costs, interest on the liability, the return on the plan asset, amortization of unrecognized prior to its cost, and the last one is the gain or loss component. The interest rate of a pension is determined by computing the interest for the period on the anticipated benefit debt outstanding during the period. The previous costs are amortized as the FASB says that most organizations would not provide credit for past years of service unless they are expected to eventually benefit. I think that the gain/loss component would change depending on the different types of contributions and the different types of benefit plans.

Response #2

Determining pension expense is extremely complicated but is comprised of service cost, interest on the liability, actual return on the plan assets, amortization of unrecognized prior service cost, and gain or loss. The service cost would remain the same because it based solely on new benefits earned my employees during the year. This service cost could be used in the contribution plan to determine the amount the employer should contribute and in the benefit plan as an addition to the employees guaranteed retirement amount.

According to our reading, "The Board states that the assumed discount rate should reflect the rates at which companies can effectively settle pension benefits. In determining these settlement rates, a company looks to available information about rates implicit in current prices of annuity contracts. (Under an annuity contract, an insurance company

unconditionally guarantees to provide specific pension benefits to specific individuals in return for a fixed consideration or premium.) Companies may also employ other rates of return on high-quality fixed-income investments" (p. 1027).

Prior service costs are amortized because plan amendments often include provisions to increase benefits for employee service in prior years. Because of this, the cost of the retroactive benefits should be allocated to pension expense.

Before investing in a company, I would love to see the actual return on the plan assets to make sure the actuary is safeguarding and monitoring the plan correctly and effectively. I would also like to see the gain/loss of the plan to ensure that the company can meet the plan obligations.

Response #3

The components for pension expense are: service cost, interest on the pension liability, actual return on plan assets, amortization of unrealized prior service cost, and gain or loss. The defined-benefit plan has to use the components of pension expenses because the total amount of benefit an employee will receive in the future is equated. Companies do not pay the interest until the pension is matured therefore interest is computed on the discounted basis. The company applies the beginning year balance of the pension expense using the discounted rate. Companies compute the settlement rate which is the amount paid on pension liabilities to fulfill the current pension obligation to employees. Prior service costs (PSC) are the retroactive benefits for the amount of years service when a company initiates a pension obligation. FASB does not require companies to grant retroactive benefits. The prior service cost is amortized by using the years-of-service amortization method. The years-of-service method is similar to the units of production depreciation method. A company will calculate an annual amortization for each year of service per employee. I am very unfamiliar with pension benefits therefore it's difficult to say in how I would invest. After review of our readings, I think I would prefer to invest in a company that has the defined-benefit plan because the amount of cost in the future is equated. On the flip-side, the defined-contribution plan is more risky for the employee than the employer. I will probably have a more definite decision a week end.

Response #4

There are 5 different components of pension expense. They include

1. Service Cost
2. Interest on the liability
3. Actual return on Plan assets
4. Amortization of unrecognized prior service cost
5. Gain or Loss

While there is the possibility for gain or loss on the return of the trust, plan assets affect the different types of contribution and benefit plans. The actuary approach has an expected rate of return so it is easier to see what to expect on the return.

The interest rate is usually discounted and is such that the company can effectively settle the pension benefits.

Because this is a way that the company can increase benefits for employees who provided service in earlier years. This allows them to provide retroactive benefits to the pension expense.

I would want to see that data about the pension fund before I make any decision. My understanding is that information about this liability is not usually on the balance sheet. I would want to have a better understanding of where the company is financially with this aspect. If they are not making wise choices, the company could be paying a lot to keep this liability current, so that may lead me to decide to not invest. On the other hand, if the company has made good decisions, then they would seem to be a more solid company for me to consider investing with.