

Fourth Edition

PENSIONS AND OTHER EMPLOYEE BENEFITS

*A Financial Reporting and
ERISA Compliance Guide*

Richard M. Steinberg
Ronald J. Murray
Harold Dankner

PENSIONS and OTHER EMPLOYEE BENEFITS

A Financial Reporting and ERISA Compliance Guide

Fourth Edition

**RICHARD M. STEINBERG
RONALD J. MURRAY
HAROLD DANKNER**

Coopers & Lybrand

JOHN WILEY & SONS

New York Chichester Brisbane Toronto Singapore

SUBSCRIPTION NOTICE

This Wiley product is updated on a periodic basis with supplements to reflect important changes in the subject matter. If you purchased this product directly from John Wiley & Sons, Inc., we have already recorded your subscription for this update service.

If, however, you purchased this product from a bookstore and wish to receive (1) the current update at no additional charge, and (2) future updates and revised or related volumes billed separately with a 30-day examination review, please send your name, company name (if applicable), address, and the title of the product to:

Supplement Department
John Wiley & Sons, Inc.
One Wiley Drive
Somerset, NJ 08875
1-800-225-5945

This text is printed on acid-free paper.

Copyright © 1993 by Coopers & Lybrand (United States)

All rights reserved. Published simultaneously in Canada.

Reproduction or translation of any part of this work beyond that permitted by Section 107 or 108 of the 1976 United States Copyright Act without the permission of the copyright owner is unlawful. Requests for permission or further information should be addressed to the Permissions Department, John Wiley & Sons, Inc., 605 Third Avenue, New York, NY 10158-0012.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. *From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.*

Library of Congress Cataloging in Publication Data:

Steinberg, Richard M.

Pensions and other employee benefits: a financial reporting and ERISA compliance guide/Richard M. Steinberg, Ronald J. Murray, Harold Dankner—4th ed.

p. cm.

Rev. ed. of: Pensions. 3rd ed. c1987.

Kept up to date with supplements.

Includes index.

ISBN 0-471-55942-3 (alk. paper)

1. Pension trusts—Law and legislation—United States. 2. Pension trusts—Accounting—Law and legislation—United States. 3. Employee fringe benefits—Law and legislation—United States. 4. Employee fringe benefits—Accounting—Law and legislation—United States.

I. Steinberg, Richard M. II. Murray, Ronald J. III. Dankner, Harold. Pensions. IV. Title.

KF3512.S73 1993

344.73'01252—dc20

[347.3041252]

92-17262

CIP

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Preface

Our first edition of *Pensions* was published in 1975, shortly after the enactment of ERISA, which dramatically changed the nature of pension plans and imposed significant obligations on companies that sponsor them. The book was designed to assist plan sponsors, plan administrators, trustees, accountants, auditors, and others in dealing with the complex requirements of the then new law.

The Preface to the first edition stated, "It will be years before the clouded picture of pension accounting, auditing and reporting becomes clear." In the ensuing years, we have seen the issuance of new laws, regulations, accounting standards, and auditing rules on these topics. The second and third editions of *Pensions* were developed to enable those involved with pension plans to better understand and cope with the evolving requirements.

In our third edition we said, "We have learned to expect continuing change in the pension area and our expectations have been met." Certainly, this is still the case. In recent years we have seen new rules and regulations affecting pension plan accounting, auditing, financial reporting, and regulatory compliance. Most significant, however, are three new pronouncements related to health and welfare benefit plans. The Financial Accounting Standards Board issued Statement No. 106 on accounting for postretirement benefits other than pensions, dramatically altering the way companies account for and report these benefit obligations and costs. The AICPA developed new rules for health and welfare benefit plan accounting and financial reporting, and a new audit guide for auditing employee benefit plans.

Based on these very significant developments, we decided to expand the book's scope in this fourth edition to address health and welfare benefit topics. As with the pension coverage, the material on health and welfare benefits extends to accounting, auditing, financial reporting, and related compliance issues for both the sponsoring employer company and the plan as an entity. Just as we believe the need for an authoritative work on pensions has been obvious from the start, so is the need for such a work covering other employee benefits. The title of the book has been changed to reflect its broader scope.

The book's organization remains the same. Part One deals with ERISA requirements, actuarial concepts, and other employee benefit plan fundamentals; Part Two, with employer company accounting, auditing, and financial reporting; and Part Three, with accounting, auditing, and reporting relating to the plan.

This book represents the efforts and ideas of many people. The following Coopers & Lybrand professionals made significant contributions: Martin Abra-

hams, Tracy S. Black, Curtis L. Crider, P. Jeffrey Davis, William E. Decker, Jr., Steven J. Derrick, James S. Gerson, Murray B. Hirsch, John M. Hollenbeck, Charles D. Lockwood, and Debra A. Rudin. We owe a special acknowledgment to Murray S. Akresh, Keith F. Jensen, and Sandra O. Wheeler for their assistance in drafting sections of this book and reviewing other portions of the manuscript. Our thanks are also due to Myra D. Cleary, who was the senior editor of the book and helped to shape it into a coherent work. To all those individuals go not only our thanks, but also the usual absolution from blame for any errors and omissions.

RICHARD M. STEINBERG
RONALD J. MURRAY
HAROLD DANKNER

New York, NY
August 1992

About the Authors

Richard M. Steinberg is a partner in the Business Assurance Directorate in Coopers & Lybrand's National Office. Mr. Steinberg headed his firm's team in developing a broad range of accounting, auditing, and ERISA-compliance policy and technical material, and he continues to serve as a consultant to the practice on pension and other employee benefit plan requirements. He has served on a variety of AICPA committees and task forces concerning pension plans, pension costs, ERISA, and employee benefits. He is currently a member of the AICPA Employee Benefit Plans Committee and DOL Liaison Task Force, and is Chairman of the AICPA's Statement 106 Task Force. He has also provided technical advice to the FASB, AICPA, and DOL on their proposed rules, and has written extensively on the subject. Mr. Steinberg, a CPA, is a graduate of the University of Pennsylvania Wharton School and holds an MBA from New York University's Graduate School of Business.

Ronald J. Murray, CPA, is Director of Accounting, Auditing & SEC Consulting in the National Office of Coopers & Lybrand. Mr. Murray is a member of the American Institute of Certified Public Accountants and the New York State Society of Certified Public Accountants. He is the AICPA representative to the Board of the International Accounting Standards Committee (IASC) and the Chairman of IASC's Financial Instruments Steering Committee. Mr. Murray is also a member of the Financial Accounting Standards Board Task Force on Accounting for the Reporting Entity, including Consolidations, the Equity Method, and related matters; the FASB Emerging Issues Task Force; and past chairman of the AICPA Task Force on Accounting for Pension Plans and Pension Costs. He joined the New York office of Coopers & Lybrand upon graduation from Lehigh University. Mr. Murray was graduated with highest honors and received numerous academic honors including election to Phi Beta Kappa, Beta Alpha Psi, and Beta Gamma Sigma.

Harold Dankner is a partner and National Technical Director of Coopers & Lybrand's Actuarial, Benefits, and Compensation Consulting Group. He has over 20 years of diversified experience in employee benefits and an extensive tax background including experience as a Tax Law Specialist in the Pension Trust Branch of the IRS. An established author and professional speaker, Mr. Dankner has written numerous articles on employee benefits and has co-au-

thored studies for the National Association of Accountants and the Financial Executives Research Foundation. Mr. Dankner received his B.A. and J.D. degrees from the State University of New York at Buffalo. He is a CPA in Virginia and a member of the New York Bar. He was a member of the ERISA Advisory Council's Task Force on Asset Reversions and is currently a member of the Tax Management Compensation Advisory Board, the Board of Directors of the ERISA Industry Committee, and the Association of Private Pension and Welfare Plans.

Contents

PART I EMPLOYEE BENEFIT PLAN FUNDAMENTALS AND ERISA PROVISIONS

Chapter 1 Introduction 3

Historical Background	4
<i>Legislation Since ERISA</i>	5
Pension Benefit Plans	6
Health and Welfare Benefit Plans	7
Financial Reporting Under ERISA	7
Accounting for Pension Costs	7
Accounting for Other Postretirement Benefits	8

Chapter 2 Actuarial Concepts, Assumptions, and Methods 9

Introduction	11
The General Nature of Pension Costs	11
Actuarial Cost Methods	13
<i>Accrued Benefit Cost Method</i>	14
<i>Projected Benefit Cost Methods</i>	14
Actuarial Assumptions	16
<i>Mortality</i>	17
<i>Employee Turnover</i>	17
<i>Retirement Age</i>	17
<i>Salary Scales</i>	17
<i>Interest Rate</i>	18
<i>Other Assumptions</i>	18
Actuarial Gains and Losses	18
<i>Computing Actuarial Gains or Losses</i>	19
<i>Actuarial Gain or Loss Adjustment</i>	20
Valuation of Plan Assets	21
Measurement Issues Related to Retiree Health Benefits	21
<i>Determining the Terms of the Substantive Plan</i>	22
<i>Gathering and Analyzing Demographic Information</i>	24
<i>Developing Average Per Capita (Baseline) Costs</i>	24
<i>Selecting Actuarial Assumptions</i>	25
<i>Estimating Obligations and Expense</i>	28

Chapter 3 Funding Arrangements 29

Introduction	30
Trusteed Pension Plans	30
Insured Pension Plans	31
<i>Individual Policy Plan</i>	31
<i>Group Annuity Plan</i>	32
<i>Deposit Administration Group Annuity Plan</i>	33
<i>Group Permanent Plan</i>	34
<i>Immediate Participation Guarantee Contract</i>	34
<i>Separate Accounts</i>	35
<i>Guaranteed Investment Contracts</i>	35
<i>Split Funding</i>	36
Retiree Health Benefit Plans	36
<i>Financing Retiree Health Benefits</i>	37
<i>Prefunding Retiree Health Benefits</i>	38

Chapter 4 Principal ERISA and Code Provisions 43

Introduction	45
General Coverage of ERISA	45
Establishment of Plan and Trust	46
Fiduciary Responsibilities	46
<i>Fiduciary Duties</i>	46
<i>Bonding Requirement</i>	47
<i>Prohibited Transactions</i>	47
Requirements Applicable to Pension Plans	48
Coverage and Nondiscrimination	48
<i>Coverage Rules</i>	48
<i>Benefiting</i>	49
<i>Highly Compensated Employees</i>	49
<i>Excludable Employees</i>	50
<i>Separate Lines of Business</i>	50
<i>Nondiscrimination Rules</i>	50
Eligibility and Minimum Participation Requirements	51
<i>Minimum Age and Service Requirements for Plan Eligibility</i>	51
<i>Plan Entry Dates</i>	51
<i>Maximum Age Limitations</i>	51
<i>Minimum Participation</i>	52
Minimum Vesting Requirements	52
<i>Vesting Schedules</i>	52
<i>Top-Heavy Plans</i>	53
<i>Normal Retirement Age</i>	53
<i>Employee Contributions</i>	53
<i>Plan Termination or Partial Termination</i>	53
Crediting Service	54
<i>Year of Service and Hour of Service</i>	54
<i>Elapsed Time Method of Calculating Service</i>	54
<i>Computation Periods</i>	54
Break-in-Service Rules	55
<i>Maternity or Paternity Leave</i>	55
<i>Rule of Parity</i>	55

<i>Special Rule for Defined Contribution Plans</i>	56
<i>Plans With Immediate Vesting After Two Years</i>	56
<i>One-Year Waiting Period</i>	56
Accrued Benefits	56
<i>Crediting Service for Benefit Accruals</i>	56
<i>Defined Contribution Plans</i>	57
<i>Defined Benefit Plans</i>	57
<i>Reduction of Benefits</i>	58
Limitations on Contributions and Benefits	58
<i>Defined Contribution Plans</i>	59
<i>Defined Benefit Plans</i>	59
<i>Multiple Plan Limits</i>	59
Distribution Rules	59
<i>Minimum Required Distributions</i>	60
<i>Participant Consent</i>	60
Survivor Benefits	60
<i>Automatic Survivor Benefits</i>	61
<i>Waiver of Survivor Benefits</i>	61
<i>Explanation and Notice Requirements</i>	61
Minimum Funding Requirements	61
<i>Funding Standard Account</i>	62
<i>Waivers</i>	63
<i>Full Funding Limitation</i>	63
<i>Underfunded Plans</i>	64
<i>Alternative Minimum Funding Standard Account</i>	67
<i>Required Quarterly Contributions</i>	67
<i>Excise Tax on Funding Deficiency</i>	68
Deduction Limits	68
Top-Heavy Plans	69
Plan Termination Insurance	70
<i>Reportable Events</i>	71
<i>Penalties</i>	71
Employee Stock Ownership Plans	71
Multiemployer Pension Plans	73
Enforcement	73
<i>Penalties</i>	73
<i>Effect of Disqualification</i>	74

Chapter 5 ERISA Reporting and Disclosure Requirements 75

Introduction	77
Annual Report—Form 5500 Series	77
Penalties for Failure to File Annual Report	107
Filing Requirements for Pension Plans	107
<i>80-to-120 Rule</i>	108
<i>Providing Information to Plan Administrator</i>	108
Pension Plans Excluded From Filing Requirements	109
Simplified Reporting Requirements for Certain Pension Plans	109
<i>Nonqualified Deferred Compensation Plans</i>	109
<i>Severance Pay Plans</i>	109
<i>Supplemental Payment Plans</i>	110

<i>Tax-Sheltered Annuity Plans</i>	110
<i>Simplified Employee Pensions and Individual Retirement Plans</i>	110
Reporting Requirements for Health and Welfare Benefit Plans	111
<i>Filing Requirements</i>	112
<i>Funded Plans</i>	112
<i>Plan as the Reporting Entity</i>	113
<i>Group Insurance Arrangements</i>	114
<i>Specified Fringe Benefit Plans</i>	114
<i>Financial Information Required for Form 5500</i>	115
<i>Form 5500</i>	115
<i>Supplemental Schedules</i>	119
<i>Separate Financial Statements</i>	122
Accountant's Opinion	124
<i>Accountant's Report</i>	125
<i>Limited Scope Audits</i>	125
Investment Arrangements That File Directly With the DOL	126
<i>Common or Collective Trusts/Pooled Separate Accounts</i>	126
<i>Master Trusts</i>	126
<i>Master Trust Information to Be Filed Directly With the DOL</i>	127
<i>103-12 Investment Entities</i>	128

PART II EMPLOYER ACCOUNTING, AUDITING, AND FINANCIAL REPORTING

Chapter 6 Accounting for Pension Costs 131

Introduction	133
<i>FASB Statement No. 87</i>	133
<i>FASB Statement No. 88</i>	134
<i>FASB Staff Special Reports</i>	134
<i>FASB Statement No. 106</i>	137
Defined Benefit Pension Plans: Annual Provision for Pension Cost	137
<i>Measurement Date</i>	137
<i>Components of Pension Cost</i>	138
<i>Attribution Method</i>	139
<i>Selecting Assumptions</i>	140
<i>Amortization of Prior Service Cost</i>	142
<i>Gains and Losses</i>	143
<i>Balance Sheet Recognition</i>	144
<i>Transition</i>	145
<i>Illustration of Pension Cost Calculation</i>	145
Defined Contribution Pension Plans	145
<i>Plans With Both Defined Contribution and Defined Benefit Features</i>	147
<i>Floor-Offset Plans</i>	148
<i>Excess Benefit (Top-Hat) Plans</i>	148
<i>Insured Plans</i>	148
<i>Multiemployer Pension Plans</i>	149
<i>Parent/Subsidiary Plans</i>	150

Disclosure	150
Funding and Plan Administration	152
Accounting for Settlements and Curtailments of Defined Benefit Plans and Termination Benefits	154
<i>Accounting for Settlements</i>	154
<i>Accounting for Curtailments</i>	158
<i>Partial Settlement and Curtailment</i>	158
<i>Termination Benefits</i>	159
<i>Recognition, Classification, and Disclosure</i>	160
Other Issues	161
<i>Business Combinations</i>	161
<i>Rate-Regulated Enterprises</i>	162
<i>State and Local Governments</i>	163
<i>Government Contracts</i>	164
<i>Plan Compliance With ERISA</i>	165

Chapter 7 Accounting for Employee Stock Ownership Plans 167

Introduction	168
Nonleveraged ESOPs	168
Leveraged ESOPs	169
<i>Balance Sheet Recognition</i>	169
<i>Measuring Compensation Expense</i>	171
<i>Earnings per Share and Dividends</i>	172
<i>Disclosure</i>	174
Convertible Preferred Stock ESOPs	174
<i>Put Options</i>	174
<i>Earnings per Share</i>	175

Chapter 8 Auditing Pension Costs 177

Introduction	178
Basic Objectives and Audit Procedures	178
<i>Audit Implications of FASB Statement No. 87</i>	179
<i>Using the Work of the Actuary</i>	179
<i>Obtaining the Necessary Pension Information</i>	180
<i>Confirmation From Actuaries</i>	181
<i>Audit Procedures</i>	183
<i>Illustrative Audit Documentation</i>	187
<i>Defined Contribution Plans</i>	189
<i>ESOPs</i>	189
<i>Multiemployer Plans</i>	190
<i>Insured Plans</i>	190
<i>Settlements, Curtailments, and Termination Benefits</i>	191
Audit Procedures Related to ERISA	191
<i>Compliance of Individual Plan Provisions With ERISA</i>	192
<i>Funding</i>	193
<i>Reporting and Disclosure</i>	193
<i>Fiduciary Responsibilities</i>	194
<i>Recordkeeping</i>	194

Reporting Considerations	194
<i>Changes in Accounting Principles and Accounting Estimates</i>	194
<i>Departures From Statement Nos. 87 and 88</i>	196

Chapter 9 Accounting for Other Postretirement Benefits 197

Introduction	199
Effective Dates for Adoption of SFAS No. 106	199
Plans Covered by SFAS No. 106	202
Recognition of Net Periodic Cost of Other Postretirement Benefits	207
<i>Determining the Terms of the Substantive Plan</i>	208
<i>Attribution</i>	209
<i>Assumptions</i>	210
<i>Assumptions Unique to Health Care</i>	210
<i>Measurement Date</i>	213
<i>Components of Cost of Other Postretirement Benefits</i>	213
Balance Sheet Recognition	217
<i>Accrued (Prepaid) Cost of Other Postretirement Benefits</i>	217
Disclosures	218
<i>Required Disclosures for Defined Benefit Plans Under SFAS No. 106</i>	218
Other Issues	221
<i>Multiemployer and Multiple-Employer Plans</i>	221
<i>Defined Contribution Plans</i>	221
<i>Business Combinations</i>	221
<i>Settlements and Curtailments</i>	222
<i>Insurance Contracts</i>	223
<i>Termination Benefits</i>	223

Chapter 10 Auditing Other Postretirement Benefits 225

Introduction	226
Basic Objectives and Audit Procedures	226
<i>Audit Implications of FASB Statement No. 106</i>	226
<i>Obtaining Necessary Information</i>	228
<i>Confirmation From Actuaries</i>	228
<i>Substantive Plan</i>	230
<i>Per Capita Claims Costs</i>	231
<i>Other Actuarial Assumptions</i>	232
<i>Illustrative Audit Procedures</i>	233
<i>Defined Contribution Plans</i>	233
<i>Multiemployer Plans</i>	237
<i>Settlements, Curtailments, and Termination Benefits</i>	238
<i>Immediate Recognition of Transition Obligation or Asset</i>	238
<i>Insurance Contracts</i>	238
Audit Procedures Related to ERISA	239
Reporting Considerations	239
<i>Changes in Accounting Principles and Accounting Estimates</i>	239
<i>Disclosures</i>	240
<i>Departures From Statement No. 106</i>	241

PART III PLAN ACCOUNTING, AUDITING, AND FINANCIAL REPORTING

Chapter 11 Pension Plan Accounting 245

Historical Background	247
<i>FASB Statement No. 35</i>	247
Financial Statements	248
<i>Use of Averages or Approximations</i>	250
Plan Assets	250
<i>Contributions Receivable</i>	250
<i>Investments</i>	251
<i>Other Assets</i>	256
Plan Liabilities	257
<i>Administrative Expenses</i>	257
Reporting Actuarial Benefit Information	257
<i>Assumptions Used in Determining the Actuarial Present Value of Accumulated Plan Benefits</i>	257
<i>Salary Increase Assumption</i>	259
<i>Interest Assumption</i>	259
<i>Disclosures</i>	259
Other Financial Statement Disclosures	260
<i>SEC Reporting Requirements</i>	262
<i>Terminating Plans</i>	262
Internal Control	263
<i>Contributions</i>	263
<i>Investments</i>	264
<i>Benefits</i>	264
<i>Bonding Requirements</i>	265
<i>Administrative Expenses</i>	265
Illustrative Financial Statements	265

Chapter 12 Auditing Pension Plans 285

Introduction	287
Audit Scope	288
Information Gathering	288
Independence	289
Investments	290
<i>Trusted Investments</i>	290
<i>Contracts With Insurance Companies</i>	295
Contributions	298
<i>Multiemployer Plans</i>	298
<i>Employer Records</i>	300
<i>Alternative Procedures for Employer Records</i>	302
Participant Accounts	302
Benefit Payments	303
Administrative Expenses	303
Subsequent Events	303

Actuarial Information	304
Scope Limitations	305
<i>DOL Limited Scope Exemption</i>	305
<i>Other Scope Limitations</i>	306
Audit Requirements Due to ERISA	307
<i>Plan Compliance With ERISA</i>	307
<i>Prohibited Transactions</i>	308
<i>Form 5500</i>	309
Other Audit Considerations	310
<i>Bonding</i>	310
<i>Potential Plan Termination</i>	310
<i>Lawyers' Letters</i>	311
<i>Letter of Representation</i>	311

Chapter 13 Health and Welfare Plan Accounting

315

Introduction	316
ERISA	316
Historical Background	316
Financial Statements	317
Plan Assets and Nonbenefit Liabilities	320
Benefit Obligations	321
<i>Claims</i>	321
<i>Premiums Due Under Insurance Arrangements</i>	322
<i>Accumulated Eligibility Credits</i>	322
<i>Postretirement Benefits</i>	323
Other Financial Statement Disclosures	324
Illustrative Financial Statements	324

Chapter 14 Auditing Health and Welfare Plans

339

Introduction	340
Audit Scope	340
Information Gathering	341
Independence	341
Investments	341
Contributions	341
Deposits With and Receivables From Insurance Companies	342
Benefit Payments	342
Participant Accounts	343
Benefit Obligations	343
<i>Claims Payable</i>	344
<i>Premiums Due Under Insurance Arrangements</i>	344
<i>Claims Incurred But Not Reported</i>	345
<i>Accumulated Eligibility Credits</i>	345
<i>Postretirement Benefits</i>	346
Administrative Expenses	346
Subsequent Events	346
Audit Requirements of ERISA	346
Other Audit Considerations	346

Chapter 15 Auditor Reporting 347

Introduction	348
Standard Reports	348
<i>Defined Benefit Pension Plans</i>	348
<i>Defined Contribution Pension Plans</i>	350
<i>Health and Welfare Plans</i>	350
<i>Participant-Directed Investment Programs</i>	351
<i>Reference to Confirmation of Investments</i>	351
<i>Reference to Actuaries in Auditor's Report</i>	351
<i>Reference to Other Auditors in Auditor's Report</i>	352
<i>ERISA-Required Supplemental Schedules</i>	353
Departures From the Standard Report	354
<i>Limited Scope Audit Pursuant to DOL Regulations</i>	354
<i>Scope Limitation</i>	358
<i>Investment Valuation</i>	359
<i>Internal Control Deficiency</i>	360
<i>Non-GAAP Basis</i>	361
<i>ERISA-Required Supplemental Schedules</i>	362
<i>Material Related-Party Transactions</i>	364
<i>Terminating Plans</i>	365

Appendix A Disclosures to Participants and Beneficiaries 367

Appendix B Illustrative Letters to Actuary 385

Index 399

PART

I

Employee Benefit Plan Fundamentals and ERISA Provisions