Accounting and Financing Features of Selected Qualified Deferred Compensation Plans.

George Watson Fair

Louisiana State University and Agricultural & Mechanical College

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ACCOUNTING AND FINANCING FEATURES OF SELECTED QUALIFIED DEFERRED COMPENSATION PLANS

A Dissertation

Submitted to the Graduate Faculty of the Louisiana State University and Agricultural and Mechanical College in partial fulfillment of the requirements for the degree of Doctor of Philosophy

in

The Department of Accounting

by

George Watson Fair
B.A., Centenary College, 1940
M.B.A., Louisiana State University, 1946
January, 1960
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ABSTRACT

The 1954 Internal Revenue Code contains the requirements for qualifying employee benefit plans of the deferred compensation type. Earlier legislation on the subject of pension and profit sharing has been revised in order to bring as much standardization and non-discrimination as is possible into the governing regulations. Enough time has elapsed since the enactment of the provisions of the Code, permitting favorable tax treatment of employer contributions to the trust and the earnings therefrom, to appraise the immediate and future effects. Both direct and indirect effects on the employer and employee offer a wide research field in the technical and professional area as well as in the more apparent aspect of the sociological ramifications. The purpose of this study is to consider one specialized area of the broad subject of post-retirement benefits; namely, the accounting and financing requirements and techniques incident to those plans qualified by the Treasury.

Much of the research in this study has been accomplished by case studies of corporations operating either a pension or profit sharing plan. Personal contact aided materially in the assimilation of the pertinent data for inclusion in this restricted study. The presentation of the factual material strengthens the conclusions reached.

Questionnaires were used in this study to substantiate earlier
published results relating to the specific handling of pension informa-
tion in the accounts and on the statements. No major change in ac-
counting treatment was noted in comparing the results of the current
survey with a similar survey conducted ten years earlier.

Books, periodicals, research bulletins, statutes, regulations,
and writings of scholars in the field have been drawn from extensively
to provide basic information for evaluation and review. Specific
financing alternatives and accounting treatments are summarized and
recommendations made in appropriate cases.

The results obtained indicate that the accounting practitioner
through his individual contacts and through his participation in
recommendations made by the leading professional accounting asso-
ciations has provided effective guides for the profession. Uniformity
in the treatment of pension costs on the financial statements may not
exist to the extent that the theorist desires, however it should be
noted that full disclosure in the statements may be achieved in
widely varying forms. The general agreement on the handling of
past service cost as a charge to current expense rather than to surplus
provides an example of the result of the widespread discussion on the
alternative accounting treatments possible. As conditions change and
additional procedures need to be developed, the accounting reporting
is flexible enough to meet the demand yet maintain conformity with
generally accepted accounting principles.

Labor and management negotiations often result in a new contract
containing revised fringe benefits. The accountant is responsible to both parties to maintain the records and present such information at designated intervals that will be correct, informative, and understandable. Evidence is presented in this study to indicate that the accountant is doing an efficient job on this score.

Accounting has provided the answers to retirement financial problems that have been asked of it by management, employees, stockholders, tax authorities, and the public. With the increasing emphasis on old age security, the problems of the professional accountant will inevitably increase. The awareness of this responsibility should urge the accounting teachers and practitioners to do research, to publish articles, and to train staff replacements and additions to meet the needs of specialized reporting. A conclusion may be drawn from this study that concerted efforts are being made by the accounting group to accomplish this desired objective.
CHAPTER I

INTRODUCTION

All segments of the economy are vitally interested in retirement plans in a direct manner or through indirect effect. The employees and the employers are the two groups that are most directly concerned with the choice, operation, and maintenance of the plans. Dependents of the employees, owners of the sponsoring business entity, the taxing authorities, and the public at large comprise some of the major groups that are indirectly affected by the plan provisions. The general subject of retirement plans has many facets. This study will encompass only the principal accounting and financing problems of specially selected employee benefit plans. Limiting the coverage in this undertaking to those plans qualified by The Internal Revenue Service will permit more intensive and more detailed presentation of the pertinent points.

IDENTIFICATION OF TERMS

Qualified Plan--A qualified plan is one that meets the requirements as set forth in the Internal Revenue Code and in the Regulations and Rulings of the Treasury Department and Internal Revenue Service. Although no attempt will be made to introduce specific requirements at this particular point, recognition of the specific regulations concerned with qualification will be noted for the sake of clarity. Section 401(a) of the Internal Revenue Code of 1954 (Section 165(a) of the 1939 Code)
outlines the requirements necessary for qualification. Additional information is found in the Treasury Regulations, Section 1.401, interpreting the Code section. Two of the type plans that may be qualified, namely, pension and profit sharing, will be covered in this paper. Primary attention will be given to pension plans. Stock bonus plans and executive compensation are excluded from consideration.

Pension Plan—A pension plan is a plan established and maintained by an employer primarily to provide for the payment of definitely determinable benefits to his employees over a period of years, usually for life, after retirement. Years of service and compensation received by the employees serve as the basic factors in determining the amount and the extent of retirement benefits. As a result of the foregoing, it may be observed that profits are not the determining factor in either the amount of the benefits or the amount of the contributions necessary to provide the benefits.

Profit Sharing Plan—A profit sharing plan is a plan to enable employees or their beneficiaries to share in the profits of the employer's business according to a definite formula for allocating the contributions and for distributing the funds accumulated in connection with the plan. A definite formula for the determination of the amount of the profits to be shared is no longer required by the Treasury. Principal factors to be considered in determining exactly when distribution is to be made are the following: the passing of a definite number of years, the reaching of a stipulated age, or upon the prior
occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.

STATEMENT OF PURPOSE

The primary purpose of this study is to define clearly the problems posed to management in the financing of and the accounting for deferred compensation plans; to enumerate and discuss certain technical points involving funding media and methods; to spell out very clearly the tax provisions with emphasis on the advantages of the qualified plan; to point out alternate treatment of specific accounting techniques where applicable; and, to present the current treatment of these plans in published financial statements.

No effort will be made to recommend a particular type plan for a particular business. Certain hypothetical cases will be included in the chapters where appropriate. Generally accepted accounting procedures will be reviewed and recommendations will be made in connection with the establishment and operation of the two principal type plans being covered in this study.

ORGANIZATION OF THIS STUDY

Although this study is in the area of accounting and financing aspects of employee deferred compensation benefit plans, it would not be feasible to attempt to divorce from the primary emphasis of the study some of the closely allied subjects. In the chapter immediately following, attention is called to many of the factors leading to the
establishment and growth of both pension and profit sharing plans. The historical background of the emergence and development of these plans is outlined to reveal the necessity for more detailed and expanded accounting and financing requirements that is evident with each change which broadens the coverage of the plans and adds to the complexity of the plans. The human relations side of this broad question is considered in the following chapter as a further coordinating thread in the study. What does the future hold for the employee and the employer with regard to pensions and profit sharing? If present trends in wage and fringe benefit bargaining between management and labor and the expanded Federal legislation concerned with this subject may be used as effective guides in appraising the future outlook, the apparent answer is that more plans will be instituted and many of the present plans will be expanded. With the tax advantage afforded under the 1954 Internal Revenue Code for qualified plans of the pension and profit sharing type, the qualification of a plan is of primary importance to the management of a sponsoring enterprise. Although the corporate form of business organization has the largest number of retirement plan participants, the tax advantage afforded a business with a qualified plan is not restricted to a corporation. A sole proprietor or a partnership is able to share in the tax advantage attaching to a qualified plan.

Chapter three brings into focus one of the major problems encountered when providing for the inclusion of a pension plan in the
operation of a business. What is this major problem? The decision as to what budgetary arrangements, or funding methods, are to be utilized in providing the funds that will be required to meet retirement benefits. When a method or combination of methods for funding has been selected, the next step is the choosing of the particular type of legal instrument under which this funding is to be carried out. The funding method and medium selected by a particular business may be decided upon as a simultaneous action. Six principal funding media will be presented along with the attendant accounting and financing aspects of each medium outlined.

The owner or owners of any legitimate and conscientiously formed business organization know and appreciate the place that the employees hold in the past, present, and future success of the enterprise. The recognition of the aforementioned fact has had much to do with the establishment and expansion of the various employee retirement benefit plans that are in operation today. At the same time, the owners of the business want to get as much as possible out of the funds expended. Chapter four emphasizes this latter situation. The problem of qualifying a pension or profit sharing plan as outlined in the Internal Revenue Code of 1954 is presented in this chapter. Certain other earlier Federal legislation is reviewed in order to bring the discussion up to the point of the enactment of the 1954 Code. How did the enactment of the legislation in 1954 help the employer get more out of the dollars contributed to the fund or funds for the retirement of
employees? The contributions made to a fund under a plan that is qualified by the Internal Revenue Service are deductible as expenses in computing the Federal income tax obligation of the business. Certain limitations are imposed on these deductions by the law. These limitations will be covered in detail in the chapter because they have a direct bearing on the accounting requirement. In an effort to cover as many aspects of the tax problem as possible, reference will be made to the tax advantage afforded the recipient of benefits from the plan.

Almost without exception one of the first points to be considered when entering into any type of financial commitment is the amount of present and future cash outlay that can reasonably be expected to be involved. The total cost of a pension plan is more than the dollar amount of benefits received by pensioners. The American Institute of Certified Public Accountants deemed the subject of Pension Plan Costs important enough and of sufficient current interest to warrant the issuance of a research bulletin on the subject. In September, 1956, Accounting Research Bulletin Number 47, "Accounting for Costs of Pension Plans" was published by the Institute. This particular bulletin was the updating of chapter thirteen, section A, of Accounting Research Bulletin Number 43, published in 1953. Chapter five of this study takes the content of this bulletin into account in developing the material concerning pension plans costs; however, the chapter encompasses much more than the intended limited discussion in the bulletin. The bulletin is not concerned with funding as such, whereas
the discussion throughout this study is based primarily on funding. Although in the majority of cases the accountant does not possess the technical training of an actuary, his position in the business involves not only the preparation of financial statements but the interpretation of these statements for those not trained in this technical field. Unless the accountant is thoroughly acquainted with the many related parts of an actuarially sound pension plan, the value of his counsel on this subject will be minimized. Determining the total cost of a pension plan is no simple matter. There are certain fixed and certain variable elements in the computation. Even though there is no physical unit of production for which a cost estimate is to be made as is the case in a typical job order or process cost system, there is an application of cost accounting in estimating the cost of so many units of dollar benefit to be distributed at some later date.

No single retirement plan has had as much impact on such a large percentage of the working population as has the Federal legislation establishing the various components of what is commonly called Social Security. The Federal Insurance Contribution Act of the broad social security legislation has been amended and expanded since its enactment by Congress in 1935. The changes in rates, maximum earnings per year subject to tax, and individuals or groups covered by the provisions of the Act have all had their effects on the accounting requirements of the employer. Some of these changes have been in the area of routine procedural and bookkeeping modifications and expansions.
Another aspect of these changes is the secondary effect that each may have had on the planning for the individual retirement plan of the particular business entity. Chapters five and six of this study develop the integration pattern of privately sponsored pension and profit sharing plans with the FICA. Certain case material is used in these chapters to enable the reader to see in actual published reports the effect of employer contributions to both type plans.

The majority of the coverage outlined so far has been concerned primarily with qualified deferred compensation pension plans. One of the basic reasons for this disproportionate amount of space devoted to pension plans as contrasted with the amount of space devoted to profit sharing plans is the funding problem incident to the former type plan in operation and use today. Chapter six is devoted almost exclusively to the presentation of the accounting requirements of a qualified profit sharing plan. Certain comparisons have been drawn between the actuarial computations under the pension plan and the participant accounting under the profit sharing plan.

The concluding chapter in this study is in the form of a summary chapter with certain conclusions presented that were drawn from research and observations. The limitation of coverage in the preceding six chapters to qualified pension and profit sharing plans in itself restricts the comments in the concluding chapter to points pertinent to those two type plans. The size and complexity of these plans has brought into contention the point of whether or not they should be thought
of as fringe benefits. The classification of employee retirement benefit plans as fringe benefits or otherwise has no significant bearing on the accounting and financing aspects of the subject, therefore the treatment accorded these plans in this paper has been that of an independent accounting and financing problem that has blossomed in the past decade.

What does the future hold for these plans? Much of the answer to this question may come from the future health of our economy. If many of these plans have been constituted with a tax saving as the primary consideration, less profitable years with a possibility of lower tax rates may well see a decline in the number and size of the plans in operation today and a resistance on the part of management to inaugurate new plans. If on the other hand the spread of the popularity of these plans has resulted from negotiations based on mutual benefit concepts, a decline, if and when it comes, in our gross national product may not bring with it any appreciable decline, percentagewise at least, in the number and size of the plans. The accountant, controller, and other top level management will be faced with the major points connected with qualified pension and profit sharing plans in the future to a greater degree than these problems exist today. The present magnitude of the obligation imposed on the company in accounting for and managing its pension fund is evidenced by the following information: "In 1957, pension funds were the largest net purchaser of common stock; the $1 billion worth they bought was the equivalent to close to 30% of all new stock issued......In a few cases--such as Sears, Roebuck--the
Company's pension fund has become the company's biggest stockholder."¹

CHAPTER II

THE EMERGENCE AND GROWTH OF PENSION AND
PROFIT SHARING PLANS

The thought of security is an item of utmost importance in the minds of many employees. What ramifications does the concept of security have to the accountant, the lawyer, management in general, the labor force both individually and collectively, and to the every day man in the street? Security certainly goes much deeper than the mere assurance that under ordinary conditions the individual will be able to maintain his present position and earn a living for himself and his family. The realization that each of us will all too soon reach the age at which our productivity and consequently our effective earning power will be either greatly reduced or completely terminated leads each of us to strive for security in the sense of independence after retirement from active endeavor. Only a small segment of the population would be willing to accept outright dole if means of self sustenance are not prevented by some force beyond the control of the individual. In the remaining pages of this chapter the factors and events leading to the establishment, maintenance, and growth of two of the principal deferred-benefit type employee benefit plans will be enumerated. Both pension and profit sharing plans will be covered with the emphasis placed on pension plans.
Although the human relations side of these plans must be considered, the financial impact on the employer of the establishment and continuation of the plans is of basic consideration in this study. The accounting and financing techniques and procedures utilized in connection with these plans form the core of this work.

WHY BENEFIT PLANS?

Superannuated Employees—One of the principal reasons for and the value resulting from an effective retirement plan is the systematic removal of employees that are no longer able to render the service required in a business that is operating in a highly competitive society. If an equitable pension or retirement plan is not in operation in a particular business, the management of that business is often reluctant to replace the superannuated employee with a younger and theoretically at least more efficient worker. If a workable retirement plan is in operation, management can feel that the employee upon reaching retirement age has been provided a measure of security and self satisfaction in receiving benefits that he has earned.

Pension plans should not be regarded lightly. They should not be considered as a dole, charity or "something for nothing." "They're no longer considered a gift bestowed by an employer on his faithful employee, but rather a sort of deferred wage which a worker has earned by his sweat and labor."¹ The words of the staff writer of Business Week, op. cit., p. 91.

¹Business Week, op. cit., p. 91.
Week seem most appropriate today when one hears so much unfounded criticism by misinformed individuals alluding to the amounts the United States Government is giving to individuals covered by the Federal Insurance Contribution Act. Payments made to covered individuals under the aforementioned Act come from a fund created by the contributions of both the employee and employer. The principal of this fund is augmented by interest received from investments made with idle cash. More employees are covered under this one retirement plan than under any one other single plan in operation today. The basic accounting requirements placed on the business as a result of this legislation will be discussed in the appropriate chapter of this study.

Supplementing of Social Security Benefits—Although the benefits under the Social Security Act have been increased in recent years, the cost of living has increased as rapidly or more rapidly from a percentage standpoint. The need for the company to supplement the Social Security benefits of its employees has been recognized by management. The recognition of this need is not restricted to the desire of management to keep employee morale at a high level. The innate consideration of one individual for another has had much to do with this facet of the overall retirement system. Other factors have had their distinct influence on management in providing supplemental benefits to retired workers. Mr. Jay V. Strong listed the following factors: The Internal Revenue Act of 1942, by permitting tax credit for bona fide pension and profit sharing plans, encouraged private industry to supplement social
security retirement benefits; World War II, with its demands for labor and
its wage-stabilization programs, caused many companies to inaugurate
these plans in order to retain workers; and, union demands have resulted
in the establishment of large numbers of retirement plans through collect-
tive bargaining.2

Labor Turnover—It is very difficult to measure objectively the
exact effect of a retirement plan on the labor turnover rate of a par-
ticular business. Many factors other than the retirement plan offered by
a particular employer will enter into the decision of an individual either
to remain with his present employer or to leave and accept a position
elsewhere. It is feasible to say that an employee, especially if he has
reached middle age, will weigh heavily his vested interest in the retire-
ment plan of his present employer in making a decision of a contemplated
move. A sound observation is that management, in general, feels that
an attractive retirement plan will tend to produce a lower labor turnover
rate especially with the employees that have had service with the
company beyond a mere training or apprenticeship period. Some of the
factors to be considered in making an appraisal of the effect of pension
plans on labor turnover are as follows:

The conservative opinion would seem to demand
a qualified viewpoint of pension plans in relation to
their effect on labor turnover. These qualifications
would relate mainly to the nature of an industry; the

2Jay V. Strong, Employee Benefit Plans in Operation (Washington,
composition of the working force of a particular enterprise; the adequacy of the wage or salary scale maintained; the existence of other employee-benefit plans; and the liberality of the pension plan itself.\textsuperscript{3}

**Recruiting Aid**—As pointed out earlier in the chapter, security, with all of its implications, has become an important factor in the decision of a young person in accepting a particular offer of employment and to an older person in making a decision as to whether he will or will not move. The company with a well organized and administered retirement plan has a selling point in the recruiting of prospective employees. Questions asked company representatives by students graduating from Colleges and Universities are pertinent to this particular point. Many of the questions such as salary, exact nature of the work, geographical locality, etc., are more or less routine. However, the question "What type of retirement plan does the particular company have in operation?" is being asked company representatives more and more by prospective employees. Competitive advantage or at least equal advantage in respect to a retirement plan available in a given company is a distinct factor to be considered in present day recruiting. The top men available to industry upon graduation from school will often make a decision based on one particular feature offered by a particular company. This feature affecting the decision can very well be the possibility of securing adequate retirement benefits when that person reaches retirement age.

\textsuperscript{3}Hugh O'Nellig, Modern Pension Plans (New York: Prentice-Hall, Inc., 1947), pp. 5-6.
**Esprit de Corps**—The morale problem is an ever present threat to the leaders of any group of individuals. The armed forces, a football team, a church group, and certainly the management of a business organization realize the importance of *esprit de corps*. If an employee feels that he has a chance for advancement with his company, he ordinarily will put forth more effort to prove that he warrants a promotion. In what way can a retirement plan provide this incentive? A retirement plan can assure the younger worker that the older workers who are holding higher and better paying positions will be retired in a systematic manner, thus providing places at the top sooner than under conditions where older employees are retained and "pensioned" on the job. This feature coupled with the knowledge that the retirement benefits in most cases are related directly to earnings during employment tend to instill a greater sense of loyalty and team work among all employees, subordinates and superiors.

**Product Acceptance**—Irrespective of whether the business is of the service, trading, or manufacturing type, the acceptance of the end product of the efforts of the employees and the owners of the business is of prime importance. In a highly industrialized community it is necessary to consider what it means to have good public relations in a company. Each employee is an individual, not merely a number on a time ticket or a daily performance report. If a person is happy in his work and feels that he has selected a good company to work for, he is going to spread the news. Each and every employee can be an
ambassador helping to build good public relations for his company. A well administered pension or profit sharing plan in a company can do much to influence the individual employee to tell others what his company has to offer. "A retirement plan is a particularly important influence upon public relations since a comfortably retired employee is a constant reminder to those about him of the sincere and continued interest of his former employer in the welfare of its old and faithful employees."^4

As Eric Johnston, former President of the U. S. Chamber of Commerce, has put it:

> It is good business to create depreciation reserves for replacement of manpower in the same manner that such reserves are commonly set up for the replacement of obsolete plant equipment. The cost of this replacement is amortized in the same manner over a period of years through the maintenance of the retirement program."^5

HISTORICAL BACKGROUND

According to the U. S. Department of Labor the first formal industrial pension system in America was that of the Grand Trunk Railway of Canada which was organized in October, 1874."^6 In the United States,

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^4 Strong, op. cit., p. 9.


the American Express Company lays first claim in the priority of pension installation in 1875.7

One of the earliest profit sharing plans established in the United States was in 1794 by Albert Gallatin at the glass works at New Geneva, Pennsylvania.8 Almost a century later the Baltimore and Ohio Railway and the Procter and Gamble Company established plans that have been continued with modifications to the present time.

The ten year period, 1910-1920, found a modest increase in the number and type of retirement plans in industry in the United States. Some extra impetus was generated in respect to pension plans during the years of World War I. The desire of management to maintain its labor force with as little labor turnover as possible during the war years accounts for some of the added interest in the establishment and maintenance of pension plans during those years. Immediately after World War I and until the depression of the 1930's, the continuance of existing pension plans and the establishment of new plans continued at a moderate rate. The depression years of the 1930's caused a marked decline in the installation of new retirement plans. "Then with improved conditions it picked up speed, moved into a gallop during World War II,


and was soon flying with the speed of a modern Pegasus.  

Will a recession and/or declining tax rates cause an abandonment of many existing plans and the curtailment of the establishment of new plans? This is a question that is yet unanswered. Up until this time we have not experienced in the United States a major recession since the close of either World War II or the Korean conflict. It is conceded that many industries were influenced in the establishment of retirement plans during the 1940's by the high profits and large corporate and personal income tax rates. If it is true, as many have voiced the opinion, that the retirement plan has become an integral part of the business planning, the industrialized United States will not likely drop this popular method of retirement security. If and when business conditions show a marked decline, we may find some slackening in the introduction of new plans.

At the close of 1958 there were over 4.9 million persons in the United States covered by 25,730 insured pension plans. The year of 1957 set a record for net increases in number of persons covered, 385,000, and in reserves, $1.6 billion. The increases in 1958 were somewhat less than in 1957. Group annuities of either the conventional or the deposit administration type accounted for over 80 per cent of the persons covered by insured pension plans in recent years. Group annuity contracts totaling 6,800 in 1958 covered over 3.9 million persons. At

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the end of 1958 there were about 14 million persons covered by non-insured private pension plans.  

Three Distinct Periods—In tracing the development of pension plans in the United States, three distinct periods are evident. The first period covers the years from 1900–1925. Prior to 1900 there were so few pension plans in operation that the turn of the twentieth century will be used as the earliest date for the establishment of retirement plans of any magnitude. During this first twenty-five years of the twentieth century the majority of the plans were company-administered plans. "By a company-administered pension plan is meant one in which both the administration and the financial control of the plan in whole or part is at the discretion of the employer or management." In this early period a distinction was drawn between an informal and a formal pension plan. The informal plans of this era vested in management the right to determine such things as which employees should receive pensions, when the pensions would be paid, the amount of the pensions, and other decisions which rendered the plan unattractive to the employee. Significant changes took place in the establishment and administration of the formal pension plans of this twenty-five year period. The most significant of these changes came in the administration of the plan and


the financing of the plan. It may well be that these changes referred
to above had much to do with the future development of pension plans
on a wide scale. It is evident that the accounting and financing
problems related to the earlier informal plans were meager as compared
to the very complex and rigid requirements of our modern pension plans.

A lack of adequate financial provisions in the early pension
plans followed the rather broad uncertainties of the administration and
the plan itself. A pay-as-you-go concept was followed by the majority
of the companies in making payments to retired employees. Operating
results of the company for a particular fiscal period exerted a great in­
fluence on the amount of the pension payments for that period, on
whether the payments were to be suspended or discontinued, and on
whether accumulated earnings of prior periods would be used for pen­
sion purposes.

"As management became conscious of the financial problem of
providing pensions, some attempts were made to anticipate assumed
pension obligations by setting up reserves. This came to be known as
the balance-sheet reserve system for pensions."¹² The "reserves"
that were established were more than merely an internal bookkeeping
entry. The basic shortcoming of the amount provided rested in the in­
experience of management in estimating the amounts that would be re­
quired to meet the payments when due. Insurance companies, actuaries,

¹²Ibid., p. 36.
and trained personnel in accounting had not entered the field of employee retirement accounting and financing at this particular time. Management lacked the expert advice that was needed in projecting expected future expenditures demanded by the plans containing contractual commitments. Under early plans, funds set aside for the payment of pensions could be invested, almost without exception, within the discretion of the management of the particular company. The investment of the funds in the stock of the company itself was not uncommon. In a disastrous year involving smaller earnings and correspondingly lower market value of the shares of stock, the accumulations in the fund were inadequate to meet payments required. Contributions to the fund were made in many cases without respect to necessary future disbursements to be made from the fund. Profitability of operations of the concern for a particular year was in many cases the deciding factor as to what size addition would be made to the fund. In retrospect, it is easy to see why the method of financing of these early pension plans had to be drastically revised if any workable and continuing program of retirement benefits was contemplated. The entrance of the insurance companies into the field of pension planning and administration has had a significant place in the rapid development and expansion of the plans.

The second period or phase of development in the field of pensions covers the period from 1925 through 1942. In Great Britain very few pension plans were being operated through insurance companies prior to 1930. By 1935, however, it is estimated that over 1,000
pension plans were utilizing their services. After 1930, in the United States the growth of the group annuity plan was rapid. One of the underlying reasons for the rapid growth of this type plan is that the administration and financial responsibilities of operating the plan rests with the insurance company. For clarification, an annuity may be defined as a series of annual money payments. What are some of the advantages that this type plan offered as compared with the earlier pay-as-you-go or "reserve" plans discussed previously? Accuracy through mathematical formulae for the accumulation of the funds required was substituted for the judgment decisions of untrained personnel in actuarial computations. Another important advantage concerns the investment of the funds provided. No longer would the securities of the particular company be acceptable as investment securities for the pension fund of that particular company. This preceding dictum applied to the period under consideration in this section. As indicated by the information presented in Chapter I, there has been a decided change in the thinking and in the statutes of some states with respect to permitting the pension plan funds of a particular company to be invested in stock of that company.

"A contractual agreement by the employer to pay a pension to a specific employee if the group annuity plan should be maintained until such employee's retirement, or thereafter, was rarely an ingredient of

early group annuity plans.\textsuperscript{14} The preceding apparent indictment of this type plan needs clarification. The insurance company would be unable to calculate pension requirements unless management made available to the insurance company the names of the employees to be covered under the particular plan. Discrimination by management could be practiced between groups of employees, however the inclusion of all employees in a particular group or classification of employment was necessary. Many prerogatives still rested with the management of a company especially if the plan was a non-contributory type.

The period from 1942 until the present date embraces the third period of development of pension plans. Our contemporary plans are characterized by the insured and the self-administered type plans. The popularity of the insured type plans increased with the advent of the individual annuity policy plan. The entrance of banks into the field of pension fund management created a stimulus for the adoption of this type plan. Two other factors characterizing this third period must be considered. The increasing rates on personal and corporate income for income tax purposes coupled with the amendment in 1942 of the section of the Internal Revenue Act concerned with employee pension and profit sharing plans had a marked influence on plan adoption and coverage.

The previous discussion has been centered on both pension and

\textsuperscript{14}O'Neill, \textit{op. cit.}, p. 39.
profit sharing plans for employees. This background material is pertinent to the introduction of the more specific part of this study which is concerned with the qualified type benefit plan. The rapid rise in popularity of this type plan may be traced, in part at least, to the special tax advantage accorded to pension, profit sharing and stock bonus trusts, and nontrusteed group annuities afforded by section 401(a) of the Internal Revenue Code of 1954. This section of the Code outlines the requirements necessary for qualification of the plan.

The Diamond Life Bulletins of the National Underwriter Company indicated that late in 1957 there were about 9,000 plans in operation of the deferred profit sharing type.\footnote{The Diamond Life Bulletins, \textit{op. cit.}, p. 47.} Statistics available indicate that many small companies are adopting this type plan. In the last quarter of 1955 those plans approved by the government as qualified plans averaged fifty-three participants each. Further evidence of the growth in popularity of deferred profit sharing plans is the fact that during the first quarter of 1957 the Pension and Profit Sharing Division of the Internal Revenue Department qualified 746 new profit sharing plans compared with 979 pension plans.

**THE FUTURE OUTLOOK FOR BENEFIT PLANS**

In any attempt to predict or forecast the future popularity and use of employee benefit plans it is necessary to set down very clearly what
type of benefits are being considered. The type of profit sharing plan utilizing a scheme of current distribution of a percentage of the earnings to the employees is excluded from consideration at this point. Why should this type plan be excluded from consideration? One basic reason for exclusion is that this type plan is not a "plan" in the strict sense of the term as used in this paper. A current distribution of earnings to employees should be thought of more properly as a type of bonus arrangement. The outlook for the establishment, continuance, and expansion of pension and profit sharing plans will be limited here to the qualified plans under the Internal Revenue Code of 1954.

Bargaining on Pensions—"A recent study of nearly 500 business firms reveals that fully 80% of the pension plans established by them since 1949 were set up through collective bargaining. Nothing could make clearer the fact that the forces and problems peculiar to collective bargaining must be reckoned with in the formulation of industrial retirement plans."16 The question as to whether or not management desires to bargain with its unionized employees on the question of pensions has been more or less replaced by the question of what type plan, if any, is to be adopted. The content of the particular plan will be discussed and reviewed by both bargaining groups. Although fringe benefits per se are not to be considered in the discussions that follow,

it is apparent to the most casual observer that the inclusion of these benefits in negotiated wage contracts now forms a hard core for bargaining. This one area of the outlook for continued growth in the number of pension and profit sharing plans lends support to the idea that eventually almost all employees will be covered by some formal retirement plan.

**Influence of Social Security Legislation**—Twenty-four years after the enactment of the Social Security Act of 1935 it is possible to make some observations concerning this particular part of the old age benefit program. Did the depression that this country experienced in the 1930's play an important part in the enactment of the Social Security legislation? Professor Edwin E. Witte, the executive director of the Committee on Economic Security which drafted the original legislation, felt very strongly that the conditions that existed in the economy at that time had much to do with the final passage of the bill. In Professor Witte's own words his position is very clear: "I doubt very much whether this or any similar measure could have passed, at least for many years, had it come before Congress later than 1935."\(^{17}\)

With each subsequent change in the Social Security Act more workers are either brought directly under the coverage of the Act or given the opportunity to become covered if they so elect. The continuation and expansion of this the largest of all retirement plans is now

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unquestioned. Of primary consideration now is the integration of the individual pension or profit sharing plan benefits of the particular business with the Social Security benefits. Future pension and profit sharing plans will be constructed in light of the current developments in the Social Security legislation. The most recent change, effective January 1, 1959, increased the rate for both employee and employer contribution to 2-1/2 per cent of the individual's earnings up to a maximum of $4,800 in each calendar year. The employer in contributing fifty per cent of the amount remitted to the fund must integrate his own plan with the Social Security plan in order to determine total cost to the firm. This item certainly must be considered with respect to the percentage of the total payroll represented by the contributions.

*Filial Responsibility*—With the significant changes that have taken place in the social and economic aspects of our society in the past twenty-five years, the responsibility for the aged or retired workers has shifted. The traditional caring-for of parents by children has been drifting more and more toward government aid. This sociological and sometimes political facet of our society is not pertinent to the subject of this particular study. The pertinent point of the subject under consideration is the development in the past twenty-five years of the various retirement plans which have aided materially in the lessening of individual burden of support of a person's elders. This apparent permanent change in responsibility leads one to the conclusion that the only way for the number of retirement plans to go is constantly upward.
SUMMARY

The previous discussion has pointed out the reasons for the many retirement plans, the growth of the plans, and the future outlook for the plans as it appears at the present time. Substantial evidence exists and has been presented to support the view that the retirement plans are now and will be in the future an integral part of the planning of management.

This introductory material has been broad and general in scope. The chapters that follow will be specific and will be limited to the accounting and financing requirements of certain types of employee benefit plans. The specific type plans to be considered are the pension and profit sharing plans that are known as "qualified" plans. These plans must meet the requirements of the Internal Revenue Code for special tax considerations.
CHAPTER III

FUNDING METHODS AND MEDIA FOR PENSION PLANS

Although there is no universally accepted age for effective retirement of employees, age sixty-five appears to have become a rather generally accepted norm. Serious consideration should be given to the problem of establishing a retirement age with regard to the sex of the employee. Congress acted officially to recognize a difference in sex in establishing a retirement age. In recent legislation the age requirement for retirement for women covered under the Social Security Act has been reduced from sixty-five to sixty-two. The integration of employee retirement plans with the Social Security benefits means that the lower retirement age for women will call for the recognition of this element in the individual plan structure.

The employer is inevitably faced with the problem of what can be done with the aged employees. One alternative is to retire them with no benefits being provided the retired employees by the company. The election of this choice may have a very serious effect on the business from the standpoint of public relations. Another possible solution open to the employer is to retain these aged employees on the payroll even though it is recognized that the employees are being pensioned, at least partially, while still on the job. A third possibility is the retirement of the employees on pensions financed on a pay-as-you-go.
basis. Although this method has been used extensively, retirement benefits of this type will not be covered in this study. A fourth alternative for the employer is the establishment of a qualified funded pension plan. The problems incident to funding these qualified plans will be covered in the remaining pages of this chapter.

Before proceeding with this discussion, it is desirable to draw a clear cut distinction between funding methods and funding media. Funding methods refer to the budgetary arrangements whereby the funds required to meet the pension needs can be accumulated or budgeted. Funding media involve the legal instruments under which the funding methods are carried out.

PAY-AS-YOU-GO APPROACH

Technically speaking there is no funding in the operation of this method. "The receipt of benefits by the employees is completely dependent upon the employer's willingness and ability to pay them. The employees can look to no earmarked fund, irrevocably committed to the payment of pension benefits and administered by an impartial third party, for the satisfaction of their claims."¹ This characteristic feature of the pay-as-you-go method of financing a retirement plan as outlined by Mr. McGill shows conclusively that this method does not fall within the scope of qualified plans as outlined by the Internal Revenue Service.

TERMINAL FUNDING

When terminal funding is used by an employer, the benefits payable to retired employees are funded in full. This technique may be accomplished by the employer in either of two generally accepted methods: (1) an immediate annuity can be purchased in the appropriate amount for each employee as he reaches retirement, or (2) an amount may be transferred to a trust company of a principal sum actuarially estimated to be sufficient to provide the benefits promised. The benefits accruing to the active employees are completely unfunded. During the time that the employees are rendering efforts to help produce profits for the business there is no contribution to a fund to provide benefits for this particular group. From a solvency point of view this method cannot be regarded as adequate and its adoption for any plan is probably conditioned by considerations outside those of orderly financing.  

A deterrent to the use of terminal funding can stem from the unusually large contribution that may be required of an employer in any one year. If a large number of employees retire in a particular year in which the working capital of the business is deficient, a financial strain is placed on the employer. Tax considerations have their influence in the selection of terminal or advance funding. Special emphasis is placed on this part of the problem in Chapter IV. The interest factor involved in the absence of a fund accumulation under terminal funding

\[2\text{Ibid.}, \ p. \ 130.\]
and in the case of a fund accumulation under advance funding will be brought out in Chapter V which deals with Pension Plan Costs.

ADVANCE FUNDING

Advance funding has the most widespread use today in pension plans. When the principle of advance funding is applied it should not be assumed that full funding has taken place in all cases because it is possible that the initial accrued liability may never be funded. The past service liability may be "frozen." The accomplishing of this freezing process is the financing of the past service benefits of retired employees out of the current service contributions for active employees. The employer pays the interest on the obligation without making any payment on the principal. The employer has the option of reducing this "frozen" past service liability by making payments to apply against the principal. Even under a contributory type plan, the employee makes no payment toward past service costs. It must be assumed that the plan will continue indefinitely for the freezing process to be carried out.

Advance funding encompasses all of the procedures whereby sums are set aside with proper legal safeguards for the payment of retirement benefits to employees. The sums accumulated under any of the various media would of necessity have to be accumulated prior to the retirement date of the employees.

Assuming that the principle of advance funding has been selected for use by a particular employer, his next step is the decision as to
whether the fund is to be accumulated on a self-administered basis or whether an insurance company will handle it as an insured plan. From the employer's standpoint cost is one of the primary considerations in funding. It is imperative for the employer to realize that regardless of the method of funding selected and the specific medium used, the cost of providing pensions to his retired employees is going to be paid for by him and not by any outside individual, group, or entity. Cost, as the term is being used at this point, includes not only the actual contributions necessary to provide the required funds at a later date but includes all expenses incident to administration. If the employer elects to purchase annuities, costs are included in the premium payments. Under a self-administered procedure the costs of an actuary, trustee fees, and other administrative costs will be in addition to the amounts contributed to the fund itself. Individual cases under particular conditions may dictate the selection of the exact type of financing to be used especially if it is evident that the overall cost will be less under a given choice.

FUNDING METHODS

From an actuarial standpoint, funding involves essentially a forecasting of future benefit payments, the determination of a present value of such benefits and redistribution of that present value in accordance with some systematic procedure.\(^3\) Specific methods of funding will

be presented with individual characteristics of each method emphasized as total cost determining factors.

**Unit-Purchase Type**—The Unit-Purchase formula is one of the two components of what is generally known as the "single premium" method of funding. The relation of the benefit to each year's earnings is an essential characteristic of this type of funding. Contributions under this arrangement may be made by both the employer and the employee or by the employer only. In most cases where the plan is of the contributory type the amount of the contribution of the employee is a fixed percentage of his earnings. Viewing the contribution of the employer for each individual employee it is easily observed that the rate will increase each year due to the passing of another birthday by the particular covered individual. It is impossible to say that the overall rate for an employer will automatically increase each year because the average age of the participants may change from year to year. More younger employees may have entered the plan to replace older and retired employees.

Under the Unit-Purchase method separate calculations are necessary for past service cost accruing at the inception of the plan and for current service cost. By the time an employee retires his benefits should be funded completely.

To illustrate the working of this Unit-Purchase formula a hypothetical case will be presented. The following condensed table and the condensed table appearing on the following page provide the basic figures for the computations.
### TABLE I

**SINGLE PREMIUM METHOD**

<table>
<thead>
<tr>
<th>Earnings Class</th>
<th>Annual Earnings</th>
<th>Earnings for Purpose of Determining Employee's Contribution and Benefit</th>
<th>Employee's Monthly Benefit of 1% Earnings for Each Year of Service</th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>$2880.01-3120</td>
<td>$3120 $260 $5.20</td>
<td>$2.60</td>
</tr>
<tr>
<td>10</td>
<td>3120.01-3360</td>
<td>3360 280 5.60</td>
<td>2.80</td>
</tr>
<tr>
<td>11</td>
<td>3360.01-3600</td>
<td>3600 300 6.00</td>
<td>3.00</td>
</tr>
<tr>
<td>12</td>
<td>3600.01-3840</td>
<td>3840 320 6.40</td>
<td>3.20</td>
</tr>
</tbody>
</table>


Assume that an employee started to work for a company at age 50 at an annual wage of $3,000. He earns $3,000 annually for five years and $3,600 annually for ten years prior to retirement at age 65. His average monthly salary for the 15 years amounted to $283.33. With the assumption of a monthly benefit of one per cent of earnings for each year of service as indicated in the extreme right hand column of Table I, this employee will receive a $43 monthly annuity. The average monthly salary of $283.33 multiplied by 15 per cent yields $42.50. The monthly annuity of $43 fulfills the guaranteed rate under the plan. Column (3) of Table II points up the fixed rate of contribution of the employee within the two salary class brackets. Column (7) of this same table indicates the progressively higher premium paid by the employer with each year that passes even though the salary was constant at $3,000.
### TABLE II

**DEFINITE-BENEFIT PLAN**
**MODIFIED CASH REFUND ANNUITY WITH INTEREST***

<table>
<thead>
<tr>
<th>Age Class</th>
<th>Monthly Salary Contribution</th>
<th>Employee's Monthly Annuity Purchased by Employee's Contribution</th>
<th>Total Monthly Annuity to be Purchased</th>
<th>Monthly Annuity to be Purchased by Employer (5) - (4)</th>
<th>Employer's Monthly Premium** for Year in Purchase Amount in (6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>9</td>
<td>$5.20</td>
<td>$.40</td>
<td>$2.60</td>
<td>$2.20</td>
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<td>2.22</td>
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<tr>
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<td>2.22</td>
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<td>2.23</td>
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<td>9</td>
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<td>.36</td>
<td>2.60</td>
<td>2.24</td>
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<td>.41</td>
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<td>.34</td>
<td>3.00</td>
<td>2.66</td>
</tr>
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<td>64</td>
<td>11</td>
<td>6.00</td>
<td>.33</td>
<td>3.00</td>
<td>2.67</td>
</tr>
</tbody>
</table>

**Monthly Total**  
$86.00  
$66.84  

**15-Year Total**  
$1032.00  
$516.00  

**Current Equitable Life rates—no return at death in connection with employer's purchase.**

**The relatively higher amounts of annuity purchased by the employer's dollar as compared with the employee's dollar result from the fact that the premium rates used by the employer are discounted for mortality.**

annually for five years and at $3,600 annually for ten years. This illustrative case assumed contributions by both the employer and employee to the purchase of an annuity through an insurance company.

This Unit-Purchase procedure could be adapted to trust-fund plans. This type funding is also referred to as a step-rate method because of the increasing cost element as retirement approaches.

*Money-Purchase Type*--The second of the illustrations of the principle of "single premium" method of funding is the Money-Purchase type. The basic feature of this type of funding involves the contribution each year of a fixed percentage of each employee's earnings. This contribution may be made by the employer only or by the employer and employee together.

Under the Money-Purchase formula the benefit varies dependent upon the sex, attained age of the individual employee, and the normal retirement age. This is the key difference in this formula and the Unit-Purchase formula. Under the Unit-Purchase formula the benefit is fixed and not the contribution as is the case under the Money-Purchase formula. If a certain amount is contributed to buy a deferred annuity for an employee that is twenty-five years of age, that same amount at the same time will purchase much less of a deferred annuity for an employee that is forty-five years of age. This characteristic makes it difficult to compute an exact amount that will be provided at maturity because the percentage of contribution is fixed and is applied to earnings to buy whatever amount of deferred annuity that particular amount
of money will provide taking into consideration the attained age and sex of the particular individual.

In recent years there has been a definite tendency for money purchase plans to be changed over to unit benefit plans. Although popular in former years, the money purchase formula is used very little today in private pension plans.\(^4\)

**Level Premium Cost Method**—One of the forms of the level premium cost method of funding is referred to as "attained age level premium." As is indicated by the title, the attained age level premium method is based on the calculation of the premium as of the attained age of the employee to provide the benefits that would be payable to the employee if his rate of compensation remains unchanged to normal retirement age. The older an employee at the time of premium computation the higher the level premium cost because of the shorter period over which these premiums will be paid to produce pre-determined benefit amounts.

If a change takes place in the compensation rate of an individual employee, additional premium computations will have to be made if increased benefits are to be provided.

Under this method there is no distinction between past and current service costs. Although there is an amount attributable to past service, the computation results in an annual premium that provides benefits for

the entire period of credited service. The total amount funded each year is simply the sum of the premiums on all contracts issued under the plan.\textsuperscript{5}

Under this method, the accrued liability can be defined as the single sum present value at the average attained age at the effective date of the plan, of the pension credits accrued in respect of the average service prior to the effective date of the plan.\textsuperscript{6}

\textbf{Entry Age Normal}—The "entry age normal" method of funding is the second of the forms of those classed under the level premium cost category. The expression "entry age" has reference to the age of the employee at the time of employment or at the time of fulfilling the eligibility requirements for participation in the plan on the assumption that the plan had always been in effect.

Under this method the past service liability is apparent. Upon the adoption of a plan using the "entry age normal" procedure the contribution for each employee is based on his "entry age" and not on his attained age. Thus, the initial past service cost is the sum of the reserves, as of the effective date of the plan, which would have accumulated with respect to each employee included if the pension plan had been in existence throughout his entire period of past employment.\textsuperscript{7}

\textsuperscript{5}McGill, \textit{op. cit.}, p. 143.

\textsuperscript{6}Memorandum on Actuarial Methods, The Chase Manhattan Bank, New York, unnumbered and not dated.

\textsuperscript{7}Black, \textit{op. cit.}, p. 182.
If and when full contributions have been made for all employees with prior service, there is no distinction between the attained age and the entry age methods.

**Aggregate Cost Method**—Under this method there is no separate provision for past service liability. This method corresponds closely in basic principle to the "attained age level premium" method. The point of departure in the two methods is that under the aggregate cost method the benefits and contributions are calculated on a collective basis.

The portion of the cost which is to be met each year is generally expressed as a percentage of annual covered payroll, which percentage is called the "accrual rate" or the "aggregate cost ratio."\(^8\)

With the entry of new employees, recalculations will have to be made to revise the rate. It is evident from this aggregate cost ratio principle that the individual participant equities are not maintained in a trust-fund.

**Application of Methods**—Although the preceding discussion of funding methods is not 100 per cent inclusive of every method that could be used, those outlined here are the principal methods used either individually or in combination with the funding media that will be discussed in detail in the latter part of this chapter.

One of the principal applications of the unit purchase method is

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\(^8\)McGill, *op. cit.*, p. 145.
in deferred group annuity plans, however it is also adaptable to trust-fund plans. It is applicable in a situation where complete funding is desired as credits are earned. The other "single premium" method of funding, the money-purchase type, is usually applied only to certain deferred group annuity plans.

The "attained age level premium" type of funding is used with group permanent plans, but it can be used with deposit administration plans. The "entry age normal" method of funding does not have the characteristics to warrant its use with the deferred group annuity plan, but like the "attained age level premium" type it may be used with the deposit administration type of plan.

The aggregate cost method may be used under deposit administration and immediate participation guarantee contracts type media. It is rarely used in connection with insured plans.

FUNDING MEDIA

The preceding discussion involved the budgetary arrangements necessary under the funding methods presented. The various legal instruments under which these methods may be carried out will be covered in the remaining pages of this chapter. The selection by a particular company of a specific funding medium will be influenced by the funding method selected by that company. In considering the adoption of a particular funding medium for use with a retirement plan the selection is basically between an insured type plan and a trusted type plan.
The following pages will be devoted to a description and discussion of the major funding media beginning with the insured type plans. The Deferred Group Annuity of the "standard" or "unit benefit" type will be covered first primarily because of the large number of individuals covered under this type. The second insured type plan to be presented is the Deposit Administration Group Annuity. Other insured type alternatives follow these first two major choices.

The Self-Administered Pension Trust affords a company initiating a pension plan a choice of a plan with more flexibility than is possible under many of the insured type plans. Major accounting and financing responsibilities placed on the management of the initiating company will be emphasized in the presentation of the key points of this non-insured type plan.

After having considered the alternatives of an insured or a non-insured type plan, it may appear to some that a combination of the two types might be advisable under particular conditions. The possibilities of combination will be explored with primary attention devoted to cost differentials and plan integration.

Deferred Group Annuities---If a deferred group annuity plan is selected by the business as the medium for funding its pension plan, a contract is entered into with an insurance company. This contract provides for the purchase of annuities for each of the employees that is covered by the contract. Each employee receives a certificate from the insurance company containing basic information about the benefits
under the plan and the principal conditions agreed upon. Some misunderstanding may exist as to exactly what is meant by the term "group annuity." Although the establishment of a pension plan in a particular business involves varying numbers of individuals dependent on the size and type of business, this coverage of a group of individuals is not the basic reason for the nomenclature. The group aspect of the term originates from the purchasing by the business of a number of annuities on the individual lives constituting the covered employees in the plan. The American College Dictionary defines an annuity as follows: "A specified income payable at stated intervals for a fixed or a contingent period, often for the recipient's life, in consideration of a stipulated premium paid either in prior installment payments or in a single payment." With a clarification of the two words that make up the title of this medium of funding, the discussion of the accounting and financing aspects of this type contract may be viewed in proper perspective.

Certain minimum requirements are imposed by the insurer in connection with the number of individuals to be covered by the master contract and the percentage of eligible employees participating if the plan is contributory. The minimum participants required under the deferred group annuity type has declined from a commonly used figure of fifty a few years ago to as low as ten today. If the plan is contributory, seventy-five per cent participation of all eligible employees has been

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established as a standard percentage for a minimum performance requirement.

"No trust instrument is ordinarily used under the group annuity plan. All of the provisions of the plan as to eligibility requirements, benefits formula, and the like are written into the master contract."10

There are instances where under certain circumstances a trustee might be employed if in addition to the group annuity there are individual contracts in effect for benefits on compensation in excess of a certain amount.

The typical contract provides that the benefit shall be a specified percentage, ranging from around 1/2 per cent to 2 per cent, of current earnings for each year of service. A salary class schedule, similar to the one presented in Table I on page 36 of this chapter, may be used in the determination of the benefits. The application of the group annuity described here is to the unit-purchase or unit benefit type formula. It is standard practice with the insurance companies engaged in the writing of group annuity contracts to guarantee premium rates for the first five years. Certain companies have offered an additional guaranteed premium rate period of five years.

A key accounting problem is the handling of the cost of past service benefits. Past service benefits, as used here, refers to the pensions based on service rendered by the employees before the adoption

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of the plan. Discussion of the treatment of this particular cost will be deferred until Chapter V when the entire content of Accounting Research Bulletin Number 47, including paragraph 3 which is concerned with this particular problem, will be analyzed. It suffices to say at this point that the initial past service cost may be paid initially in a lump sum or it may be spread over a period of from 10 to 20 years. The tax treatment of the lump sum payment for past service obligation will be presented in Chapter IV.

In the majority of the contracts written under the group annuity principle there is a vesting requirement. What is vesting? It is best described with respect to a plan participant who leaves the employment of the company prior to normal retirement, and whose reason for leaving is not excepted by the plan. He is able to retain some of the equity built up on his behalf by the employer's contributions. As an illustration of this vesting requirement, the following excerpt is taken from a specimen group annuity contract issued by the Prudential Insurance Company of America:

If, prior to termination of employment, the Participant has completed at least ten years of continuous employment with the Employer, he fulfills the vesting requirements for a percentage, determined from the following table according to the number of years of his continuous employment with the Employer, of the portion of the Normal Retirement Annuity which has been purchased for him as Future Service Annuity by each application of the Employer's Contributions.

If, prior to termination of employment, the Participant has completed at least ten years of continuous employment with the Employer, he
fulfills the vesting requirements for the percentage, determined from the following table according to the total number of such years of continuous employment prior to any failure or refusal to make a Contribution when due, of the Normal Retirement Annuity that has been or may be purchased for him as Past Service Annuity by each application of the Employer's Contributions. 11

In the table referred to above in the extract from this group annuity contract the percentage of normal retirement annuity runs from 50 per cent for 10 but less than 11 years of continuous employment to 100 per cent for 20 or more years of continuous employment. The vesting requirement is concerned solely with the contributions that have been made by the employer. If the employee withdraws from employment prior to normal retirement age under a contributory type plan, he will ordinarily have the option of receiving a return of his contributions in cash or of retaining the paid-up deferred annuities that they have purchased.

If a plan participant leaves the employment of a business without a vested interest in the pension, amounts contributed, less a surrender charge, will be credited to the employer by the insurance company. To prevent adverse selection against the insurance company the withdrawing participant must be in good health.

Due to the fact that the typical group annuity contract provides retirement benefits only, the premium paid by the employer is discounted in advance for mortality. An actuarial determination is made of the

number in the group who may be expected to die before reaching retirement age. A higher premium would be necessary if it was assumed that each individual in the group would live to receive benefits after retirement. Although the practice of discounting in advance for mortality as a factor in premium determination has been standardized, discounting for severance of employment is not done. The effect of this premium cost determining factor is that when severance does occur credit may be issued against the next payment due from the employer. Reductions in the amount of the premium payment by the employer, if and when these reductions occur, are referred to as dividends in mutual life insurance companies and as rate credits in stock companies.

If a qualified plan of the deferred group annuity type is terminated, all contributions made become the sole right of the individual plan participants. This is in accordance with the provision in the tax law which prohibits the return of any of the contributions to the employer. The individual participant receives credit for the amount of his paid-up annuity at the time of the plan cessation.

**Group Annuity—Deposit Administration**—The deferred group annuity of the conventional type as discussed in the preceding pages lacks flexibility in plan provisions. Contributions by the employer is one of the provisions of the conventional type deferred group annuity contract that does not afford the employer leeway. The Deposit Administration type plan has been developed to provide more flexibility in the group annuity type contract. Under this plan there is no allocation of funds
to purchase benefits for the participant until he retires. The plan may be of the contributory type. "Premiums are accumulated in a deposit fund. If employees contribute, their individual accounts are kept in a separate deposit fund. Upon retirement the necessary single premium to provide the employee's total benefit is transferred from the deposit account to the purchase of an annuity."

This type plan may be appropriate in cases where the amount of benefit under the annuity will be based on final earnings of the employee rather than based on his earnings throughout the years of employment. The money is invested by the insurance company with a guaranteed rate of interest accruing to the credit of the fund being maintained. Upon the retirement of an individual participant, the insurance company withdraws from the fund enough to provide for an immediate annuity.

Recent developments in the area of deposit administration have been toward the placing of the responsibility for the plan and its administration on the employer. Under this concept the contract entered into between the employer and the insurance company represents a holding medium for the deposits during the operative period of the plan. "The insurance company sets a minimum interest return on the prior-retirement deposit fund and guarantees the principal against reduction (except in certain terminal situations). The annuity rates at retirement are based on single premiums which are guaranteed to hold—on a

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first-in, first-out basis—in respect to deposits made within a stipulated
number of years."  

Under this type plan it is not necessary to have a fixed normal re-
tirement age. This is one of the points of flexibility inherent in this type
plan. The fact that no annuities are purchased prior to retirement means
that if an employee terminates his employment there will be no credits
to the employer that might accrue under other type plans. In essence
this type plan places the insurance company in the position of a trustee
of a self-administered plan.

In the case of deposit administration, the in-
dividual approach exists either at time of service
retirement (and more importantly on disability re-
tirement if such benefits are funded in advance) or
in the event of discontinuance or termination of the
contract. The reserves required for each individual,
and not for each age group, are segregated and ear-
marked for him upon service retirement (and,
possibly, upon disability retirement), even though
there may be an annual adjustment for mortality and
interest thereafter.  

The selection of this medium of funding provides the employer
with a greater degree of control over the operations of the process and
at the same time it imposes on him a degree of risk that is not a charac-
teristic of the conventional group annuity.

**Group Permanent Insurance**—Under this plan there is a combina-
tion of life insurance coverage and retirement income issued under a

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13Dorrance C. Bronson, *Concepts of Actuarial Soundness in Pen-

14Trust Fund vs. Deposit Administration, The Chase Manhattan
Bank, New York, unnumbered and not dated.
group contract between the employer and the insurance company. When it is desired to provide death benefits and retirement income benefits under one contract, the use of group permanent insurance is a logical choice. If a high labor turnover rate exists, the use of this type plan is more expensive due to higher termination costs. Although the state laws vary as to the requirement of number of lives necessary under group life insurance contracts, either 25 or 50 lives is required in the majority of the state statutes. Another major provision is the fairly common inclusion in the contracts of the requirement for a minimum of $250,000 face amount of insurance. This coverage may be written on a contributory or non-contributory basis. Due to the functions performed by the insurance company under the master contract there is ordinarily no need for a trust agreement. The trust agreement can be an integral part of the plan in those states that do not have adequate group insurance laws.

The ratio of insurance to retirement income that is most generally used is $1,000 of insurance for each $10 unit of retirement income, however in some instances it is found to be $1,000 of insurance for each $20 or each $30 unit of retirement income up to a certain maximum of insurance. Detailed coverage of the specific provisions of the plan as to employee benefits will not be covered as it is not pertinent to this study.

A level annual basis is used for the determination of premiums under group permanent insurance with a guarantee of the rate for the
policy once it has been issued. The insurance company has the right to revise the rate structure at the end of each five year period. The employee's attained age is used in computing premium costs if additional units are purchased after the initial coverage of the particular employee. A level percentage of salary formula, a year's service formula, or a money purchase formula may be used as a basis in calculating the amount of the pension. The features as described indicate that the plan is actuarially sound from the funding medium standpoint.

Individual Retirement Income Policies in Trust--The period of 1940 through 1944 saw a marked rise in the number of individual policy plans. The higher cost of this type plan as compared to the group annuity was not a major consideration to management during the years of World War II. The reason for this apparent lack of economical financing is explained in a number of ways. The excess profits tax was in full force at this time, and the net cost to an employer for contributions made to an approved plan during these years was small because these expenditures were deductible as business expenses. If a freeze on salary scales was imposed on a particular employer or industry during the war emergency, the use of the individual policy plan made the job or position much more enticing than would have otherwise been the case if a less attractive plan was offered. It should be noted here also that

relatively few insurance companies were engaged in the group annuity underwriting at this particular time.

In contrast to the group annuity, the individual policies are written in the names of the persons covered. The individual policies do not contain such information as to the benefit formula being used, eligibility requirements, and other basic provisions which are found in the trust agreement. Under the provisions of a pension trust these policies are generally placed in the custody of a trustee to hold as long as the individual remains in the employment of the business. The terms of the trust agreement provide that the death and retirement benefits are automatically payable to the participant. The individual policy plans almost always contain a provision for insurance benefits to insurable employees in addition to the pension feature. Insurance is provided equal to 100 or 150 times the monthly pension.

If an employee is uninsurable, a retirement annuity contract is purchased for him. Death benefits are limited to return of premiums or cash value, whichever is greater at date of death.

An important feature of this type plan is outlined by Mr. Bronson in the following quotation: "They must meet the minimum level-premium reserve requirements of the state insurance department, and there is no segregation of assets by reason of their being issued to the single ownership of the custodian trustee for a pension plan."\[16\]

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\[16\] Bronson, \textit{op. cit.}, p. 58.
The insurance company guarantees annual level premium cost for the life of each individual contract. The employer cost may be reduced by dividends if the policies are of the participating type. In the essence, the net cost will depend on the insurance company experience.

As summarized in the Diamond Life Bulletins, the advantages of the type plan outlined in this section are as follows:

(1) Invaluable life protection is afforded the employee.

(2) Benefits payable to the employee are guaranteed by the insurance company.

(3) The cost is guaranteed for the entire life of each individual policy, while rates on group annuities are subject to change after 5 years and cost of self-administration will vary with actual experience.

(4) This plan is very simple to administer. The trustee need only collect the money and pay the premiums; he has no responsibility for investments.

(5) The use of individual policies is desirable in small groups (under 50) because mortality and severance cannot be forecast accurately in such groups nor can spread of investments for safety of principal and stability of income be obtained in a small fund.17

**Uninsured Trust Funds**—This medium of funding a pension plan does not make use of an insurance company. In some instances the self-administered trust is referred to as a "self-insured" plan. For clarity sake it seems advisable to designate this medium of funding in

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such a manner that a misleading impression will not be given by the association of words in the title of this plan with their everyday common usage. Since it is not an insured plan, it is an uninsured plan. The usage of the term "self-administered" as the designation for the uninsured trust fund type plan presents an element of inconsistency. It is impossible for the plan to administer itself. The administering of the plan is by the employer through a trustee.

Two of the basic differences that exist in this medium of funding and that of the insurance company medium are as follows: (1) the individual life is the heart of the insurance company medium; the employee group as a whole is the underlying force in the trust fund method, and (2) the insurance company premium charge includes "loading" to take care of actuarial and other expenses; under the trust fund method the hiring of an actuary and other professional services is an independent transaction involving costs completely separate from the regular contributions to the fund.

If this method of funding is selected, a trust agreement will be drawn up. This instrument provides that a plan has been established and that contributions will be made to fund the cost of the benefits. It further stipulates that investments will be made from the fund and that upon proper authorization benefits will be paid. The exact terms of the pension plan set up in conjunction with this trust are completely independent of the formal trust agreement. The trustee in the majority of cases is a bank or other commercial trust institution. The funding
method selected may be any of the methods discussed earlier in this chapter.

Flexibility has been given as one of the favorite characteristics of the trust-fund plan. Two distinct viewpoints may be taken of this characteristic. One viewpoint is that this type plan gives more latitude to the employer in either making the investments from the fund or in dictating to a large degree what the trustee can do in making the investments. In any event the particular state law governing trust-fund transactions will have to be observed by the responsible party. The other viewpoint is that the flexibility afforded under this plan shifts the responsibility for the investments, earnings on these investments, expenses incident to the operation of the plan, and the life expectancy calculations to the employer initiating the plan. The degree of responsibility retained by the employer establishing the plan will depend on the extent of outside professional services secured from a trust institution and an actuary.

Flexibility in the trust-fund plan goes beyond decision making in respect to what investments to make from the contributions in the fund. There is generally no necessity for a waiting period for employee eligibility as is the case under the majority of the insured type plans. The cost element associated with this elimination of a waiting period should be of no significance because there is no surrender charge for withdrawals as is required under nearly all of the insured plans. The reason for a surrender charge in an insured plan is to cover the costs of
establishing, maintaining and terminating an employee's coverage under the plan. This charge is usually assessed against the employer. If immediate full vesting is provided under any type plan, the expense would be very heavy if the turnover rate is high during the initial years of employment.

If the employer elects to handle the majority of the administrative functions incident to the trust-fund, an employee-employer relationship may be maintained through correspondence, benefit disbursements, etc. that does not exist when a third party is handling this phase of the program. Contacts maintained in this manner can add to the overall effectiveness of the retirement plan.

Contributions to the trust-fund do not have to be made on specified dates and in stipulated amounts as is required under an insured type plan. In certain periods of business recession this may prove to be an alleviating factor. It is imperative not to lose sight of the fact that contributions will have to be made eventually in sufficient amount to provide the benefits agreed upon in the plan itself. There is the necessity of keeping the trust-fund type plan actuarially sound in the same manner that an insured plan is reviewed periodically to determine its adequacy. A well conceived plan, sound actuarial computations, prudent investments, and frequent recalculation of contribution requirements are all requisites for the safeguarding of the moneys contributed and for the adequacy of provisions made for participants.

An alternative to making benefit payments directly to the
recipients from the fund accumulated under the trust-fund type plan is the
purchasing of annuities from an insurance company under which payments
are made to retired employees.

What factors must be taken into consideration by an actuary in
establishing the amount of contributions necessary to provide desired
benefits under a plan of the trust-fund type? Interest and post-retirement
mortality are two principal factors of the mandatory type that are taken
into account by the actuary. Other factors that may be given recognition
in determination of deposits required are turnover and pre-retirement
mortality. The actuarial computations will be affected by the following
factors if they are provided for in the plan: disability benefits, death
benefits, and vesting rights.

If the plan is of the qualified type, none of the contributions can
revert to the company in the case of discontinuance of the plan. A pro-
vision in the plan or trust agreement will set forth the basis to be used
in distributing the fund accumulation to the participants. The more general
provision is that the fund be distributed in cash or that annuities be pur-
chased for the employees.

Combination Plans--The preceding discussion of four media
offered under the insured type plan and the trust-fund plan of the unin-
sured type may be used in varying combinations to provide desired
benefits. An intelligent combination plan can not be recommended unless
the various factors and conditions in an individual case are studied to
determine which type combination, if a combination at all, is most
feasible. One possible combination is the funding of past service costs through the use of the group annuity medium or a trust-fund with the individual policies or group permanent medium used for the funding of future service benefits.

A logical explanation of the use of the combination plans in a given case is that the flexibility, especially in the matter of contributions, of the uninsured plans can be very desirably coupled with the advantages afforded by an insured plan. If the intent of the business is to qualify the plan, the content of the combination plans must be such that it meets the requirements of the Code. A reserve created through the purchasing of ordinary life insurance to be converted to annuities at retirement age may provide an annuity of such a small size that it will serve to keep the plan from qualifying. A quotation from the rulings of the Revenue Department concerning this point will serve as the basis for this observation: "Primarily for the payment of definitely determinable benefits to employees over a period of years after retirement." ¹⁸

A combination that permits the insurance company to perform its principal function, the handling of life contingencies, and the trust company to engage in the activities for which it is best suited, handling, investing and accumulating the required funds, would seem to contain the requisites for the most efficient and economical arrangement. If this type arrangement develops, the responsibility for interest or

¹⁸Reg. 118, Sec. 39.165-1 (a) (2); Rev. Rul. 54-67, 1954-1 CB 149.
earnings on the investments would fall on the trust fund prior to retirement of the individual, and the responsibility for the interest factor after retirement would shift to the insurance company.
CHAPTER IV

QUALIFYING PENSION AND PROFIT SHARING PLANS

Although the aim of this particular chapter is to present the currently effective Federal legislation outlining the requirements for qualification of benefit plans, a few points of general interest on the subject as a whole warrant discussion before proceeding with the main topic. The material in this chapter will not be slanted toward the individual choice of funding method or medium. The law in outlining the requirements for qualification of a trust and/or a plan does not recommend either methods or media of financing. The choice of financing arrangements rests solely with the plan sponsor. No attempt will be made at this point in the study to call attention to any possible conflict that may exist between the strict accounting theory treatment of a particular item and the requirement for handling the item under the tax law. Chapter V, Pension Plan Costs, will contain an analysis of the alternatives and points of departure between tax accounting and strict accounting theory when and if these variations concern elements of this study.

The material presented in the following pages of this chapter will consist of empirical data for the most part. Since the primary consideration in this study is not to present the detailed tax treatment connected with all of the parts of this comprehensive field of deferred benefit plans, the rulings and decisions of the responsible Federal agencies
and the courts in interpreting the Code provisions will be excluded from detailed presentation. Sections 401 through 404 are the principal sections of the 1954 Code covering deferred compensation benefit plans. These specific sections are interpreted by Treasury Decision 6203 issued on September 24, 1956. Revenue Ruling 57-163, issued April, 1957, constitutes another source of authoritative data for clarification of these specific Code sections. The exclusion of the Code interpretations in this chapter in no way means that they are being minimized or that they were overlooked in covering the tax phase of the qualified pension and profit sharing plans. These rulings and decisions are of vital importance in individual cases of conflict of opinion with respect to the content or intent of a particular Code section. Stress in this chapter of the study is placed on the particular pertinent Code provisions as written and enacted by the Congress of the United States.

To the employer establishing a deferred compensation plan of the pension or profit sharing type, the desirability, from the tax standpoint at least, of "qualifying" the plan is unquestioned. The tax advantage is not limited to the provision in the Code permitting employer deductions, under specified conditions, for contributions to a qualified trust. Of great importance from a tax standpoint is the provision in the Code permitting the income from the qualified trust to be exempt from tax. A dollar invested at two per cent compound interest will double itself in thirty-five years. This statement makes it quite evident how much the tax exempt status of a trust means to the accumulation of
funds to be used in distributing benefits.

Certain rigid requirements imposed under a qualified plan may dis-suade an employer in applying to the Internal Revenue Service for qualification of his plan. The discussion in this chapter will proceed on the premise that the tax advantages afforded by a qualified plan weigh so heavily in favor of qualification that whatever disadvantages may exist in connection with a qualified plan as compared to a non-qualified type plan will be of secondary consideration.

The first Internal Revenue Code was approved by the Congress of the United States on February 10, 1939. After the enactment of the first Code, major amendments were made to it through the Revenue Act of 1942. The most recent Federal legislation having considerable impact on pension and profit sharing plans is embodied in Sections 401 through 404 of the Internal Revenue Code of 1954. Coupled with these sections of the Code are the subsequent amendments to them and the code sections that have cross reference applicability. Prior to the discussion of the provisions of the first Code, adopted in 1939, six Revenue Acts, dating back to 1921, will be discussed. Each of the six Acts contain provisions relative to retirement plans. The content of the earlier Acts on this subject was very meager as compared to the extensive provisions of the 1954 Code which is in effect at the present time.

The development of the legislation on this subject will be traced chronologically to point up how the Congress has acted in an attempt to correct inequalities that become apparent in the earlier Acts. As times
change and the problem of old age retirement increases in intensity, the
Congress will be called on to make certain alterations in the existing
statutes to deal more adequately with the changed conditions.

LEGISLATION PRIOR TO THE 1939 CODE

The Revenue Act of 1921--Section 219(f) of the Revenue Act of 1921
contained provisions of importance to a business with a stock bonus or
profit sharing plan. Although stock bonus plans are excluded from cover-
age in this study, frequent reference is made to this type plan in the
Federal Acts. Pension plan trusts were not covered by section 219(f) of
the Revenue Act of 1921. The wording of this section as it appears in
the statutes is as follows:

A trust created by an employer as a part of a stock
bonus or profit-sharing plan for the exclusive benefit
of some or all of his employees, to which contribu-
tions are made by such employer, or employees, or
both, for the purpose of distributing to such employees
the earnings and principal of the fund accumulated by
the trust in accordance with such plan, shall not be
taxable under this section, but the amount actually
distributed or made available to any distributee shall
be taxable to him in the year in which so distributed
or made available to the extent that it exceeds the
amount paid in by him.¹

The above quotation came from the first legislation enacted to
exempt employee trusts. No reference is included in this legislation
to the employer taking as deductions the contributions made by him to
the trust. Seven years later under section 23(q) of the Revenue Act of

1928 the employer was given specific permission for the first time to
deduct his contributions to the trust. Specific sections of later Revenue
Acts cover the two distinct parts of the contributions—(1) for past
service liability, and (2) for current service. A number of years later
the wording of the above section of the Revenue Act of 1921 as con-
cerns "some or all of his employees" was changed in order to close a
possible loophole for discrimination against certain employees.

The Revenue Act of 1926--The only change made in the wording of
section 219(f) of the Revenue Act of 1926 as compared to that same sec-
tion of the Revenue Act of 1921 was the inserting of the word "pension"
immediately following the word "profit-sharing."2 This exemption,
afforded the pension trust by section 219(f) of the Revenue Act of 1926,
merely formalized the practice of the preceding five years.3

The Revenue Act of 1928--Two sections of this Revenue Act are
concerned with the composite subject of employee retirement plans.
Section 23(q) deals specifically with the allowing as a deduction the
amounts contributed to the trust in excess of the amount required for the
pension liability accruing during the year. Section 165 of this Act con-
tained basically the same information that was contained in section
219(f) of the Revenue Act of 1926.

Assuming that the trust is exempt from tax under section 165 of
the Revenue Act of 1928, the employer is allowed to deduct a "reasonable"

244 Stat. 33-34 (1927).

amount transferred or paid into such trust during the taxable year in excess of the amount for pension liability accruing during the year. The limitations imposed by the law in allowing the deduction is that:

(1) the amount has not been allowable as a deduction previously, and
(2) apportionment is made of the allowable deduction over a period of ten consecutive years beginning with the year in which the transfer or payment is made.4

The effect of the provision outlined in the preceding paragraph was to permit employers that had established "reserves" in connection with their pension plans in the immediately preceding six to eight years to transfer to a trustee the amount provided. The total funded amount had to be spread over a period of ten years for tax purposes. The preceding point should not be construed to mean that the employer must have previously established a "reserve" to be able to take advantage of this section of the Act. The wording of the section is such that a deduction may be taken for a lump sum payment covering past service liability even though the plan is being initiated with this first payment to the trust.

The Revenue Act of 1932—Minor changes were made in sections 23(q) and 165 of the Revenue Act of 1928 by the Revenue Act of 1932. Section 23(q) contained the same provisions in the 1932 Act as was contained in the 1928 Act with the following additional proviso--

445 Stat., 802 (1929).
... any deduction allowable under section 23(q) of the Revenue Act of 1928 which under such section was apportioned to any taxable year subsequent to the taxable year 1931 shall be allowed as a deduction in the years to which so apportioned to the extent allowable under such section if it had remained in force with respect to such year.\(^5\)

Section 165 of the Revenue Act of 1928 provided that the amounts contributed by the employer to a fund and the earnings on that fund would be taxed to the distributee in the year in which distributed or made available to him. The change made in this section of the Revenue Act of 1932 was as follows: "... but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him."\(^6\) This change in the wording of section 165 restores the basic provision of section 219(f) of the Revenue Act of 1921 as pertains to the taxability of the amount received by the distributee in excess of the amount contributed by him. This section of the 1932 Act in no way altered the tax exempt status of the trust.

The Revenue Act of 1936—There was no change made in section 165 of the Revenue Act of 1936 as compared with section 165 of the Revenue Act of 1932. Section 23(p) of the 1936 Act contains basically the same provisions as section 23(q) of the 1932 Act. Section 23 (p) of the 1936 Act permitted the continuation of deductions that were apportioned under

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\(^5\) 547 Stat. 182-183 (1933).

\(^6\) Ibid., p. 221.
a corresponding section of any earlier Act in the same manner as if it had remained in force with respect to such year.

The Revenue Act of 1938—Section 23(p) of the 1938 Act in dealing with Pension Trusts was more detailed than was the corresponding section of prior Acts. The three parts of this section are as follows:

(1) General Rule, (2) Deductions under Prior Income Tax Acts, and

(3) Exemption of Trusts Under Section 165. Under the General Rule part of this section the employer's contributions to a Pension Trust for prior service liability are permitted as deductions in determining tax obligation. Two specific stipulations are made concerning this allowable deduction. One of the restrictions required that the amount had not been allowable previously as a deduction, and the other stipulation required the apportionment of the amount over a period of ten consecutive years beginning with the year in which the transfer or payment was made.

Part (2) of Section 23(p) extends the provision of the corresponding section of any earlier Act under which apportionment of contributions had been made to taxable years beginning after December 31, 1937. The deduction will be allowed in the years to which the apportionment had been made to the extent allowable under such section if it had remained in force with respect to such year.

Part (3) of Section 23(p) places a qualification on the deduction under either of the first two paragraphs of this section of the Act.

". . . the deduction under either paragraph shall be allowable only with respect to a taxable year (whether the year of the transfer or payment or a subsequent year) of the employer ending within or with a taxable year of trust with respect to which the trust is exempt from tax under section 165."\(^8\)

The important change made in Section 165(a) of the Revenue Act of 1938 was the adding of the requirement that no diversion take place in respect to corpus or income of the trust. This no diversion provision is one of the requirements for the employees' trust to be exempt from tax under section 165 of this Act. An excerpt from the Act will serve to clarify this important requirement which added protection for the employee:

". . . (2) if under the trust instrument it is impossible, at any time prior to the satisfaction of all liability with respect to employees under the trust, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than the exclusive benefit of his employees . . .\(^9\)

The previous requirement does not preclude an employer from reserving the right to recover at the termination of the trust an amount accumulated through erroneous actuarial computations during the previous life of the trust.\(^10\)

Summary--The material presented on the preceding pages in this

\(^8\)Ibid., p. 463-464.

\(^9\)Ibid., p. 518.

\(^10\)Reg. 111, sec. 29.165-2 (b).
chapter was a synopsis of the sections of six Revenue Acts from 1921 to 1939 that contained provisions directly affecting Employees' Trusts and Pension Trusts. Three principal points should be noted with respect to the key sections of the Revenue Acts discussed: (1) assuming all requirements were met by the employer, his contributions to a pension trust were deductible for tax purposes; (2) the earnings on the investments of an employee benefit trust were not subject to tax; and (3) the employee had to report for tax purposes in the year in which distributed to him or made available to him the amount that was in excess of the amounts paid in by him.

THE 1939 INTERNAL REVENUE CODE

In chronological order, the Internal Revenue Code of 1939 is the next Federal tax legislation relevant to the subject of this study. Section 23 of the Code, "Deductions from Gross Income," incorporated under paragraph (p), "Pension Trusts," the same wording as this same numbered section contained in the Revenue Act of 1938. Section 165, "Employees' Trusts," paragraph (a) "Exemption from Tax," contained the same provisions as were stated in the 1938 Revenue Act.

THE REVENUE ACT OF 1942

The most significant tax change that took place in employee deferred benefit plans in the first half of the twentieth century occurred in 1942. Section 162 of the Revenue Act of 1942 amended sections 23(p) and 165(a) of the 1939 Code. Also included in the 1942 Act was the
addition of a new subdivision (B) to the Code section 22(b)(2), relating to the taxation to employees of annuity benefits purchased by the employer, or by the employer and employee together. The ramifications of this change will not be explored here because it involves the personal income tax problem of the benefit recipient. The primary purpose of the following discussion is to relate the effect of the 1942 Revenue Act on the employer qualifying his trust; obtaining approval of his plan; and, the deductability of contributions made to a trust or to an insurance company.

Section 162 of the Revenue Act of 1942—Section 165(a) of the 1939 Code, relating to Employees' Trusts being exempt from tax, was amended by Section 162 of the Revenue Act of 1942 to require the following:

(1) It is necessary for there to be a trust forming part of a stock bonus, pension, or profit sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries.

(2) The employer, or employees, or both must make contributions to the trust for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust.

(3) The trust instrument must provide that it is impossible for any part of the trust corpus or income to be used for or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries prior to the satisfaction of all liabilities with respect to employees and their beneficiaries.
(4) Minimum coverage for benefit of the trust is defined as:

(a) seventy per cent or more of all the employees, or eighty per cent of all the employees who are eligible to benefit under the plan if seventy per cent or more of all the employees with certain exclusions, are eligible to benefit under the plan. These exclusions include employees who have been employed not more than a minimum period prescribed by the plan, not exceeding five years, and certain irregular or temporary employees; or (b) employees in a class established by the employer and found by the Commissioner not to be discriminatory in favor of employees who are officers, shareholders, supervisory personnel, or highly compensated personnel. Employees on leave of absence (e.g., in the armed forces) are included in the percentage computation under (a) above if such employees are eligible under the plan.\(^\text{11}\) The provisions as outlined in (a) above are referred to as the "arbitrary" rule for determining minimum coverage for benefit of the trust. The "discretionary" rule does not require the minimum inclusion of fifty-six per cent (80 per cent of 70 per cent) of the eligible employees. The Commissioner of Internal Revenue has the authority to approve any classification of eligibles set up by an employer which does not discriminate in favor of the four types of employees enumerated above. This prerogative of the Commissioner is spelled out in (b) above. "Some plans covering as few as ten per cent have, in fact, received approval. . . . Some plans have covered

\(^{11}\text{Reg. 111, sec. 29-164-3.}\)
only salaried employees as distinct from wage earners."

(5) The contributions or benefits provided under the plan must not discriminate in favor of the four classes of employees enumerated in part (b) of paragraph (4) above.

(6) The requirements of paragraph (4) above (section 165(a) (3) 1939 Code as amended) shall be considered as having been met during the whole of any taxable year of the plan if on one day in each quarter it satisfied such requirements.

The requirements outlined above indicate the attempt that was made by the Congress to strengthen section 165 of the 1939 Code. As will be pointed out later in the proper place in this chapter, very minor changes were made in section 165(a) in the 1954 Code. The fact that no amendments were made to section 165(a) of the 1939 Code after the very thorough overhauling it received in the Revenue Act of 1942 leads to the conclusion that the major changes desired and considered to be in the best interest of all parties concerned were contained in those requirements of the 1942 Act as paraphrased above.

In the light of developments that have taken place in the past fifteen or more years, an observation made in December, 1942, by a lawyer from North Carolina, who has spent much time in research and

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12Joseph P. McNamara, "The Tax Side of Pension Planning," National Association of Cost Accountants Bulletin (On July 1, 1957, the name of this organization was changed to the National Association of Accountants), XXXI (July, 1950), 1324-1325.

1356 Stat. 862-863 (1943).
practice in the field under scrutiny in this study, seems appropriate to include at this point:

It is to be expected that the Board and the Courts will construe the new statute in the light of the spirit which surrounded its enactment. Ways can be found to uphold the exemption of good faith plans, particularly where they were in existence prior to the adoption of the Act. . . . The establishment in the future of plans which in reality are for the benefit of a favored few should be undertaken with caution, if at all.  

Section 23 of the 1939 Code Amended by Revenue Act of 1942--

Previous legislation dealing with the deduction of employer contributions to pension trusts was found in Section 23(a) and (p) of the 1939 Internal Revenue Code. Section 23(a) related to ordinary and necessary business expenses incurred during the taxable year. Although section 23(p) related specifically to pension trusts, reference was made in this section to 23(a). Prior service liability payments were covered in section 23(p). Deductions for contributions constituting current service payments were allowed under 23(a). The provision in section 23(p) granting the deduction for contributions contained two principal qualifications which were as follows: (1) that the excess contribution over and above the current service liability requirement had not been previously allowable as a deduction, and (2) that this excess be apportioned over a ten year period beginning with the year of contribution.

Section 162 of the Revenue Act of 1942, amending section 23(p) of

the 1939 Code, removed section 23(a) from the field of pension trust contribution deductions. The part of the General Rule of 23(p)(1) that places the deductions for contributions paid by the employer to a stock bonus, pension, profit sharing, or annuity plan or accrued on account of any employee under a plan deferring the receipt of such compensation under this section only is as follows:

\[
\ldots \text{such contributions or compensation shall not be deductible under subsection (a) but shall be deductible under subsection (a) without regard to this subsection, under this subsection but only to the following extent . . .} \]

The "extent" referred to in the above extract from the quoted amendment to the Code will be discussed because the limitations and restrictions imposed by this part of section 23(p) are material in employer planning for deferred compensation plans. The general rule is that the maximum deduction for an employer for contributions to a tax-exempt pension trust under section 165(a) in the taxable year when paid is 5 per cent of the compensation otherwise paid or accrued during the taxable year to all employees under the trust.\(^\text{16}\) It is possible that this 5 per cent rate may be reduced by the Commissioner as provided

\(^{15}\text{Internal Revenue Code of 1939, section 23(p)(1) as amended by 56 Stat. 863-866 (1943).}\)

\(^{16}\text{Internal Revenue Code of 1939, section 23(p)(1)(E), as amended, provides:}\)

\[\text{For the purpose of subparagraphs (A), (B), and (C), a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made within sixty days after the close of the taxable year of accrual.}\]
in paragraph (A)(i) of section 23(p). In clause (ii) of this same citation provision is made for deductions that exceed 5 per cent of the compensation otherwise paid or accrued during the taxable year to all the employees under the trust. These two cases of variation from the general rule of 5 per cent maximum deductability will be analyzed.

Clause (i) provides that the Commissioner may make periodical examinations at not less than five-year intervals to determine whether the stipulated rate of 5 per cent is more than the amount reasonably necessary to take care of the unfunded cost of past and current service benefits of the employees under the plan. The Commissioner is given the power to reduce the rate if he finds it excessive. 17

Clause (ii) makes provision for deductions in excess of 5 per cent under certain conditions. The condition under which this excess over the normal 5 per cent maximum contribution deduction is permitted for tax purposes is as follows:

. . . any excess over the amount allowable under clause (i) necessary to provide with respect to all of the employees under the trust the remaining unfunded cost of their past and current service credits distributed as a level amount, or a level percentage of compensation, over the remaining future service of each such employee. . . 18

The preceding allowable deduction must be determined under


regulations prescribed by the Commissioner with the approval of the Secretary of the Treasury. It is further provided that if more than 50 per cent of the remaining unfunded cost is attributed to 3 employees, the amount attributable to such individuals shall be distributed over a period of at least 5 taxable years for deduction purposes.

Still further qualification of the general rule of 5 per cent maximum for deduction is provided in clause (iii) of 23(p)(1)(A). The provision in this clause is that the deduction may be an amount equal to the normal cost of the plan, as determined under regulations prescribed by the Commissioner with the approval of the Secretary, plus an amount not in excess of 10 per cent of the unfunded cost of past service benefits, if any, as of the date when they are included in the plan.19

Clause (iv) of this section 23(p) provides for a carry over to succeeding taxable years for deduction purposes the amounts paid in a taxable year in excess of the amount deductible in such year under the limitations outlined above. This clause further provides that the deduction in any of such succeeding years is subject to the prescribed limitations as to amount.

The discussion above concerned the deductions for contributions to a qualified pension trust. The general rule and the modifications provided in the clauses under paragraph (A) of section 23(p) did not pertain to annuity purchases. Paragraph (B) of section 23(p)(1) provides

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that deductions may be taken for payments to purchase retirement annuities to the same extent, and subject to the same limitations, as provided in subparagraph (A) of paragraph (1), section 23(p), if the plan meets the exemption requirements of section 165(a), paragraphs (3), (4), (5), and (6) of the Internal Revenue Code. The content of these paragraphs of section 165(a) was outlined in earlier pages of this chapter. A further provision of this paragraph (B), in reference to deduction of amounts paid for annuities, pertains to refunds of premiums. "... and if refunds of premiums, if any, are applied within the current taxable year or next succeeding taxable year towards the purchase of such retirement annuities."\(^{20}\)

Paragraph (C), section 23(p)(1) is concerned with the deductibility of contributions made to a stock bonus or profit sharing trust. The stipulations as set forth in this paragraph of the Code for stock bonus or profit sharing trusts are different from those of the pension trust or annuity retirement purchases as set forth in paragraphs (A) and (B) of this section. If the trust is exempt under section 165(a) of the Code, deductions may be taken for contributions paid into a stock bonus or profit sharing trust in an amount not in excess of 15 per cent of the compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit sharing plan.\(^{21}\)


Another feature of the provision as to the deductability of contributions under paragraph (C), section 23(p)(1) is the carry-over of non-deductible contributions in the same manner as was permitted in the case of pension trusts and annuity purchases. The limit on deductions in later years is 15 per cent of the compensation otherwise paid in such years to employees covered by the plan. If less than 15 per cent of compensation otherwise paid or accrued during the taxable year to all employees under the stock bonus or profit sharing plan is paid into the trust, the excess, or if no amount is paid, the amounts deductible, shall be carried forward and be deductible when paid in the succeeding taxable years. The same limitation on deductions in later years applies in this case as it did in the carry-over limitation.

The provisions of paragraph (D), section 23(p)(1) applies to plans not meeting the tax exemption requirements of section 165. Although the content of this paragraph (D) is outside of the scope of this particular study, the content of the paragraph will be presented for the sake of continuity and completeness of coverage of the provisions of this important legislation in the field of deferred compensation plans. The deduction is permitted the employer for contributions to a non-exempt plan if the employees' rights are non-forfeitable at the time the contribution is made. The key point here is that if the employer gets the deduction there can be no delayed reporting of income for tax purposes by the employee. "... if the interest of the employee is forfeitable at such time (when contribution is made), the employer gets
no deduction, and the employee is not subject to tax."22

The final paragraph of section 23(p)(1) is paragraph (F) which limits deductions for contributions to plans which include combinations of pension and profit sharing trusts, or combinations of trusts and annuity plans. The limit as imposed is 25 per cent of the compensation otherwise paid or accrued during the taxable year to the covered employees. A limit of 30 per cent is placed in cases where there is a carry-over of excessive contributions from prior taxable years.23

THE 1954 CODE

Following the amendment of the 1939 Code by the Revenue Act of 1942, the next major tax legislation involved was the writing and the enacting of the Code of 1954 by the Congress. Many of the sections of the 1939 Code had become overworked with amendments, and the codification of all changes since the enacting of the 1939 Code was the feasible way to resolve the problems. At the present time hearings are in progress in the Congress with a view to the enacting of a new Code sometime within the next few years.

Section 165 of the 1939 Code has become sections 401 and 402 of the 1954 Code. Section 23(p) of the 1939 Code has become section 404 of the 1954 Code. These two sections of the 1939 Code, 165 and


23(p), as amended by the Revenue Act of 1942, cover the requirements for qualification of the trust or plan and provide for the deductions of contributions and exempting of the income on the trust. Section 22(b)(2)(B) of the 1939 Code, dealing with the taxation of employees' annuities, has become section 403 of the 1954 Code.

Section 401 Code of 1954—Section 165(a) of the 1939 Code was embodied almost intact in the 1954 Code under section 401(a). One of the specific changes that should be noted in section 401(a) of the 1954 Code is the inclusion of the phrase "created or organized in the United States" with reference to the trust. This requirement was not included in the provision of section 165(a) of the 1939 Code. It should be pointed out that even though the trust may be qualified under section 401(a) and exempt under section 501(a), the income is taxable on distribution to the employees or their beneficiaries under section 402(a).

The second specific change in section 401(a) in the 1954 Code concerns affiliated groups of corporations.\textsuperscript{24} The provision is that an affiliated group of corporations having a common profit sharing plan may permit certain member corporations of the group to make contributions for a member or members of the group that had a loss in a given year. These contributions are deductible by the corporation or corporations making the contributions.\textsuperscript{25} "We have heard a lot about carry-overs

\textsuperscript{24} An affiliated group of corporations is defined under section 1504 of the Code as corporations with 80 per cent common ownership.

\textsuperscript{25} Internal Revenue Code of 1954, section 404(a)(3)(B).
and carry-backs. This new provision might be described as a carry-
sideways—something new in the tax law."\textsuperscript{26}

\textbf{Sections 402 and 403 of the 1954 Code}—Sections 402, "Taxability
of Beneficiary of Employees' Trust," and 403, "Taxation of Employee
Annuities," will not be covered in this study due to the restricted
coverage of the broad subject selected. The accounting and financing
aspects of qualified pension and profit sharing plans is not directly
concerned with the provisions of the sections of the Code relating to
the taxability of the benefits received by the plan participants or their
beneficiaries. Section 404 of the 1954 Code contained some provisions
that differ from the corresponding section, 23(p), of the 1939 Code. The
major changes made by this section of the 1954 Code will be covered
later in this chapter.

\textbf{Section 404 of 1954 Code}—In the remaining pages of this chapter
attention will be devoted to some of the major changes affecting the
employer as reflected in section 404 of the 1954 Code and other related
rulings. Some of the problems encountered by a business attempting to
qualify a pension or profit sharing plan warrant attention.

A few of the following points may appear basic and possibly
would be taken for granted, however, to overlook a requirement for
qualification can be very costly to the plan applicant. The plan must

\textsuperscript{26}Russell S. Bock, "Tax-saving Opportunities in Deferred Com-
pensation under the New Revenue Code," \textit{The Journal of Accountancy},
99 (March, 1955), 40.
be in writing and must be communicated to the employees. Provisions of the plan relating to eligibility requirements, benefits, vesting rights, etc. must be made known to the employees. To avoid confusion or misunderstanding among the employees it should be made very clear that the plan is either a pension plan, profit sharing plan, or a stock bonus plan.

It is provided in the 1954 Code that an employer on the accrual basis has until the due date of the employer's income tax return, including any extension of time for filing the return, to actually make his contribution into the plan.\(^{27}\) This provision extends the period as compared to the time limit contained in the earlier Code. The provision of the 1939 Code required the contribution to be made within 60 days after the end of the year. Footnote number 16 provides the 1939 Code requirement verbatim.

As was pointed out earlier, exemption of the trust under the 1954 Code is based on the fact that it is created or organized in the United States. The 1954 Code provides that contributions to a trust created or organized outside of the United States by an employer which is a resident, or corporation, or other entity of the United States, shall be deductible.\(^{28}\) This provision does not exempt any income the trust may receive. This point is brought out in the statement that follows:

\(^{27}\) Internal Revenue Code of 1954, section 404(a)(6).

\(^{28}\) Internal Revenue Code of 1954, section 404(a)(4).
The change effected under the 1954 Code permits a foreign situs trust to make investments in U. S. sources, but subjects the income therefrom to tax by denying exemption to the trust. Thus the tax would be withheld at the source (Code Section 1441) on such items as interest and dividends on stock and bonds of U. S. Companies. 29

It has been held that the establishment of a plan during years in which the tax rates are high and the abandonment of the plan within a few years without a valid business reason when profits fall off, does not meet the requirement for qualification under section 401(a) of the Code. 30 This Ruling continues in making it clear that a plan qualifying under section 401(a) is a permanent and continuing program.

Section 503 of Revenue Code of 1954--An important section of the 1954 Code concerned with a particular segment of the deferred compensation plans is section 503, "Requirements for Exemption." Part (a)(1) of this section provides for the loss of exemption of an employees' trust if it engaged in a prohibited transaction after March 1, 1954. Part (c) of this section lists the six classes of transactions that constitute the group known as "prohibited transactions." This provision in the Code is one of those which may be categorized as a restrictive type provision.

Section 503 of the Code clearly defines the term "prohibited transaction" as being any transaction in which an organization subject to the provisions of that particular section of the Code does--


30 Revenue Ruling 57-163 (h), April, 1957, p. 133.
(1) lend any part of its funds without receiving adequate security and a reasonable rate of interest, to;

(2) pay compensation in excess of reasonable allowance for salaries or other personal services actually rendered to it, to;

(3) make any part of its services available on a preferential basis, to;

(4) purchase securities or other property for more than an adequate consideration, from;

(5) sell securities or other property of substantial amount for less than adequate consideration, to; or

(6) engage in any other transaction resulting in a substantial diversion of its funds, to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 per cent or more of the combined voting power of all classes of stock entitled to vote or 50 per cent or more of the total value of shares of all classes of stock of the corporation.\(^3\)

If the loss of tax exempt status of the trust occurs as a result of its engaging in one or more of the above mentioned transactions, the Treasury Department has to notify the offender before the loss of tax exempt status is effective. "The adverse tax effects are ordinarily

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\(^3\)Internal Revenue Code of 1954, section 503(c).
prospective—that is, they operate only with respect to taxable years subsequent to the taxable year in which the notice is given, unless there was an intentional diversion of corpus or income which involved a substantial part of corpus or income of the trust." It is possible for the trust to be restored to a tax exempt status by the Treasury Department in the future if evidence is presented that indicates to the Department that good faith obtains with respect to the Trust not knowingly in the future engaging in any of the "prohibited transactions."

It is possible for stock or securities of the employer to be purchased with funds in an exempt employees' trust. Certain stipulations must be met before acquiring stock or securities of the employer with funds of the trust. Both the trust instrument and the local law must permit this type investment, and the purpose must be for the benefit of the employees or their beneficiaries. For the employer's stock or securities to be acceptable as investment media, section 503 of the Code, relating to "prohibited transactions," must not be violated.

Revenue Ruling 57-163 specifies that notification is to be given to the Internal Revenue Service if stock or securities of the employer are acquired by the trust. This notification is required so as to permit a determination of whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees. There are two possibilities for complying with the notification requirement.

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Form 990-P, an annual information return required of a trust, contains a section in which the notification is to be included. If the desire of the trust if for an advance determination, the appropriate district director of Internal Revenue may be notified at the time of seeking his decision on acceptability of the anticipated purchase. Six major items must be submitted in this notification. A certification of these items by the accounting or other responsible officer is required. As outlined by Revenue Ruling 57-163, these six items are as follows:

1. Balance Sheets of the employer as at the close of the last accounting period and for the taxable year ended prior thereto.
2. Comparative statements of income and profit and loss for the last and four prior taxable years.
3. An analysis of the surplus account for the last 5 years, specifically showing the amount and rate of dividends paid on each class of stock.
4. A statement accounting for all material changes from the latest dates of the aforesaid statements to the date of filing the information.
5. A schedule showing the nature and amounts of the various assets in the trust fund.
6. A statement showing the amount of the investment, the type of investment, the present rate of return, the security if a loan is involved, and the reasons for the investment.33

Miscellaneous 1954 Code Sections Related to Pensions and Profit Sharing—Section 404(c) of the 1954 Code outlines the procedure for the deduction of an employer's contributions to a trust under pension and welfare plans established prior to January 1, 1954. The plan must have been the result of an agreement between employee representatives and

33Revenue Ruling 57-163(k), April, 1957, p. 135.
the United States Government while the facilities of the company were being operated by the Government under seizure powers. The deduction for the contribution is not permitted under section 404(c) nor is the contribution made nondeductible by the provisions of this section. Section 162 of the Code, relating to trade or business expenses, is to be the governing provision as to the deductability of the contribution. The content of section 404(c), "Certain Negotiated Plans," was not contained in any similar provision of the 1939 Code.

One writer summarizes the effect of sections 511-514 of the 1954 Code in these words: "The net effect of these sections is to limit an employees' trust to purchasing and holding securities." These sections mentioned in the above quotation from the article by Mr. Wallis deal with the income received from "unrelated trade or business." As used in the Rulings applying to employees' trusts, "unrelated trade or business" means "any trade or business regularly carried on by such trust or by a partnership of which it is a member." Beginning with the taxable years that are effective after June 30, 1954, the trust will be taxed on income received from an "unrelated trade or business."

Section 381 of the 1954 Code covers the subject of "Carryovers in Certain Corporate Acquisitions." Within this section, paragraph (c) (11), concerned with the "Contributions to Pension Plans, Employees' Annuity Plans, and Stock Bonus and Profit-Sharing Plans," contains a

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provision pertinent to the specific subject of this study. Provision is
made for the acquiring corporation to be considered the distributor or
transferor corporation after the date of distribution or transfer for the
purpose of determining the amounts deductible under section 404 of the
Code, with respect to pension plans, employees annuity plans, and
stock bonus and profit sharing plans. 35

For the immediately preceding few paragraphs individual cases of
special nature have been presented to point up some of the specific
changes made as a result of the enacting of the 1954 Code or to indicate
the relevant provisions of the 1954 Code that did not exist in the prior
Code or Acts. As an indication of the complexity that may result from
the various provisions of a plan qualified under the 1954 Code, the
following are some of the provisions that may be included in a profit
sharing plan:

1. Incidental life, accident or health insurance
benefits (Reg. 1.401-1 (b) (1) (ii) ),

2. Supplementary unemployment benefits (Special
Ruling. December 29, 1955),

3. Distribution of employer contributions to em-
employees in less than two years for reasons specified in
the plan, such as disability (Rev. Rul. 54-231, C. B.
1954-1, 150; Rev. Rul. 57-163, I. R. B. 1957-16, 10),

4. Withdrawal by the employee in time of financial
need of funds accumulated to his credit (Rev. Rul. 56-
693, I. R. B. 1956-52, 13) and,

5. An annual election by the employee to partici-
pate in the trust or to accept his share of the employer's
contribution in cash (Rev. Rul. 57-163, I. R. B.
1957-16, 10). 36

35Internal Revenue Code of 1954, section 381(c)(11).

36Raymond E. Graichen, "Qualification of Pension, Profit-Sharing
SUMMARY

This chapter has traced the development of the legislation concerning pension and profit sharing plans from 1921 through the 1954 Code. No attempt has been made in this chapter to present detailed cases with the decisions rendered on them involving interpretations of the particular governing statutory provisions. A very lengthy study could be undertaken on almost any facet of the tax aspects of this very broad subject.

In this chapter certain fairly lengthy quotations are included in the form in which the original work appeared. This direct quoting was done to avoid paraphrasing in cases where the injection of a word or the shading of a meaning by someone other than the original author could be misleading to the reader or could be erroneous. Certain paraphrasing has been done where it was felt that the content and the intent of the original work would not be distorted.

Specific Code Sections, Treasury Decisions, Revenue Rulings, and Regulations should be consulted in cases where technical points are in debate. Additional Decisions and Rulings by the appropriate Federal Agencies and the courts concerning the subject under discussion in this study are being handed down at the present time. The constant changes that are brought about by new and different situations point up the necessity for the writing of a new Code. The stage is set now for the groundwork on this new Code.

The 1954 Code provisions governing the qualification of deferred
Benefit compensation plans may not contain what many had hoped that it would contain. This is evidenced by the fact that the Code as it was enacted did not contain many of the more stringent recommendations that were made in the House. This does not mean that the Code did not represent a distinct step forward in encouraging the establishment of qualified plans. The rate at which the plans are being submitted for approval attests to the favorable effect of the Code provisions.
CHAPTER V

PENSION PLAN COSTS

If the recognition of an expense is made only when the cash is disbursed and the recognition of income occurs only upon the receipt of cash, the accounting procedure being followed by the business is known as the "cash basis." The recognition of expense in the period in which incurred and the recognition of income in the period in which earned form the basis for the "accrual" system of accounting. If a corporation is following strictly the cash basis of accounting, the preparation of its income tax return will ordinarily involve modifications to include some items that are by nature and structure a part of the accrual system. Either of these two fundamental accounting concepts of recording and reporting the financial information of the business may be employed in determining the pension cost of a funded plan for a given fiscal period.

ACCOUNTING METHODS

Cash vs. Accrual Basis—The results of a survey published in the Journal of Accountancy in 1952 indicate the predominance of the cash basis in accounting for the pension plans in the two hundred companies covered by the report. If we can assume that these

companies selected for the survey represent a cross section of the United States corporations providing pension plans for their employees, what are the reasons for the selection of the cash basis by the majority of these businesses? As a possible answer to this query, The Accountants' Handbook lists three reasons for the widespread use of the cash basis in accounting for pension costs. These three reasons are summarized as follows: (1) the requirement for deduction of contributions under the currently effective regulations of the Internal Revenue Code of 1954 is that the plan must be funded. For those plans that are not qualified under the Code, the employer is permitted to make deductions only when payment is made to retired employees; (2) the determination of the cost of pensions involve actuarial computations. The many variables involved in these computations have caused some accountants to be hesitant in accepting "costs" based on these factors. Interest rates and Social Security benefits are two of the variables to be considered in any estimating cost procedure; and (3) the fact that some of the pension plans are terminated at a given date has influenced some accountants to view the plans as temporary, and thus the idea of accruing a liability beyond the legal technicalities of the pension agreement may not be acceptable.²

Although there is validity contained in the reasons outlined above,

it may be that in many cases expediency dictates the use of the cash basis. The position taken in the discussion of this point in the

*Accountants' Handbook* is contained in the following quotation:

The view most commonly held is that the cost of providing a retirement benefit for an individual should be accrued over the working life of that individual. The most important qualification of this rule applies to the firm which recognizes in the benefit formula service rendered prior to the adoption of the plan. The cost of providing this portion of the benefit is the much discussed "past service cost."

The use of the accrual system of accounting in the general accounting records by the majority of the businesses large enough to maintain a pension plan poses the following question: "Should not the cost of deferred pensions be handled on the accrual basis without regard to the funding procedures used by the business?" For consistency in reporting, an affirmative answer to this question seems in order. In the words of a practitioner, the following suggestion is made for an accounting principle: "The total estimated cost of providing an employee's pension should be accrued rateably over his period of active service beginning either with the date of his employment or the date a pension plan is adopted, whichever is later, and ending with the date he retires from productive service."  

*Variations in Methods Used*—Surveys that have been made

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3*Ibid.,* 8.34.

4Ogden, *op. cit.*, p. 47.
within the past ten years indicate the widely differing methods in use in pension plan accounting and in statement presentation of the pension plan data. The results of the survey by Mr. Ogden, referred to earlier in this chapter, indicate the need for much additional work by the accountant in the area of pension plan accounting in order to bring as much standardization or uniformity as is possible into the accounting techniques of this specialized problem. The difficulties in accomplishing this desired result of uniformity in recording and reporting of pension plan information in the financial statements are set forth very clearly by Mr. Percival Brundage, a past president of the American Institute of Certified Public Accountants, in the following quotation:

...There is likely to be little similarity between companies in their treatment of pensions, and due to differences in their previous plans and the terms of the contracts with the labor unions, no comparability can be expected. A company on a pay-as-you-go basis would show results widely different from what they would be on a complete or partially-funded basis. There is bound to be criticism from uninformed readers as well as from those who think they understand the problem... It is difficult to bring home to readers of financial statements the necessary limitations on the presentation of a company's position and its operating results and that in presenting the known facts as clearly and simply as possible it is necessary to use accounting conventions which have been established over the years as most suitable for the purpose.\(^5\)

ELEMENTS AND FACTORS OF PENSION COSTS

Cost Determining Factors—As the preceding conditions, described

by Mr. Brundage, exist today in very much the same manner as they did then, this chapter will cover the problem of pension plan costs for a funded plan from the basic cost determining factors to the requirements imposed by Regulation S-X of the Securities and Exchange Commission in cases where this Regulation is applicable. The discussion of these cost determining factors will follow the brief outlining of the content of the remainder of this chapter.

Cost Allocation and Statement Presentation--Following the discussion of the elements of cost determination for pensions will be an investigation of the alternatives in cost allocation for financial statement presentation. This allocation process will be covered from the standpoint of possible classifications of the cost element on the operating statement of a given fiscal period in addition to the advisability of cost apportionment between or among fiscal periods in cases where past service cost is involved. As an integral part of the statement presentation of pension plan data, the problem of accruing liabilities incident to the plan will be discussed. The recommendations of the Committee on Accounting Procedure of the American Institute of Certified Public Accountants as outlined in Accounting Research Bulletin No. 47, "Accounting for Costs of Pension Plans," will be examined in detail.

Questionnaire Survey--A list of one hundred corporations was selected from the "Fortune 500 List" to be used in a questionnaire seeking to find out what is actually being done in the field at the present time on some of the more difficult accounting problems encountered in pension plan recording and reporting. All of the corporations selected
are industrials, and they represent several of the major types of in-
dustries within that category. The five questions used on this question-
anaire were originally prepared and used ten years ago by the Controllers
Institute of America, Inc. The results obtained by that group in the
survey made by them will be presented in this chapter in addition to
the results of the survey conducted by the author of this study. The
Controllers Institute was considerate enough to permit the use of their
questions so that a comparison could be made of the results obtained
in 1949 and ten years later. Although each survey selected its own
reporting corporations, observations may be made from the results ob-
tained in the individual surveys and in comparison of the results ob-
tained in the two surveys.

Case Study—One case study will be included in this chapter. The
information included in this chapter on this utility is the result of a
personal inspection of the installation. A study similar to the material
presented in this chapter in connection with the operation of a pension
plan will be included in the following chapter in which profit sharing is
emphasized. The purpose of the inclusion of the key points of the
observations made from the personal inspection is to bring a certain
degree of realism into the chapter with the thought that it may add
clarity to the entire coverage of the subject.

GENERAL CONSIDERATIONS INCIDENT TO PENSION COSTS

Basic Factors Assumed—Certain basic factors will be assumed
throughout this chapter. These factors will be enumerated now so as
to clarify the intent of this chapter and to place the content of the chapter in the proper perspective.

Since the coverage of this entire study is limited to plans of the pension or profit sharing type that are qualified by the Internal Revenue Service, the discussion in this chapter of the accounting features of a pension plan will be based on the premise that the plan is funded. Since some of the major methods and media for funding have been covered in an earlier chapter, they will not be reexamined in any detail in this chapter. The object of this chapter is to describe the accounting requirements for a funded plan irrespective of the exact funding arrangements selected by a particular employer.

The type of plan, contributory or non-contributory, is not an important consideration of this particular chapter. The accounting principles involved on the employer's books for his contributions under either a contributory or a non-contributory arrangement are basically the same. Even under a contributory type plan, the cost of past service liability is paid by the employer in almost all cases.

Permanency of the plan will be assumed to exist in all discussions in this chapter. Although the plan may be subject to constant review and changes as conditions dictate, the permanency of the plan requirement for qualification is not affected by this periodic updating process. The accounting procedures outlined or recommended are based on the concept of a continuing plan operation.

_Pension Cost_—Before proceeding with the discussion of the
specific accounting principles and practices incident to pension plans, it is important to clarify the term "pension cost" as it is being used in this chapter. "Pension cost" means the net financial outlay required of a business to meet the employer's part of the benefits agreed upon. This cost includes all administrative costs in addition to the actual net contributions required to meet the premium payments or fund accumulations. The dollar cost to the employer is affected directly by the amount of the benefits that the plan will yield to the participants or their beneficiaries. Each of the various cost determining factors to be considered in the paragraphs that follow must be viewed with respect to the partial cost determination that each exhibits.

Pension Cost Reduction?—Although the subject of intangibles is not at all uncommon to accounting terminology, the inclusion in the statements of an item that is both an intangible and also of an uncertain amount must be handled with care and full disclosure. The intangible feature of a pension plan lies in the favorable effect that it may produce for the employer in the way of increased employee productivity in a collective sense. This type of cost reduction, if it occurs, is difficult for the accountant to measure objectively. In reality, how much did the pension plan cost the employer if we are permitted to inject into the cost determination this intangible referred to above? The answer to this question would involve too many variables to justify the presentation of a pension cost arrived at principally by the use of conventional accounting procedures but tempered with modifications of questionable accuracy.
The point discussed here should not be construed to mean that estimates have to be eliminated from cost calculations. This is not the intention of the discussion in this regard.

Cost Estimate Limitation—Correct estimates are essential in many entries involved under a properly functioning accrual system of accounting. Errors may result in estimating certain items, but this is no justification for shelving the estimating procedure where it serves the need not met by other means.

If the benefit formula provides for a calculation tied directly to earnings, the pension cost will be larger as wages increase. The actuary in estimating cost based on a given wage rate is unable to inject into his computation what may happen to wage scales during the period for which the estimate is made or for the periods thereafter. Even though the cost estimate rendered may not have projected the same figure as was proved at some later date to be the net financial cost, accounting recording and reporting procedures still embrace the use of estimates but recognize the limitations inherent in the estimating process. If no attempt is made to reflect in the accounts an item that requires an estimate, the resultant statement may be more misleading through lack of full disclosure than a statement presenting an estimated account balance that may not be 100 per cent accurate in dollar amount.

The Committee on Accounting Procedure of the American Institute of Certified Public Accountants emphasized the point of utilizing actuarial techniques and estimating procedures in accounting for pension
costs in Accounting Research Bulletin No. 47. The Committee statement on this point is as follows:

... There are other business costs for which it is necessary to make periodic provisions in the accounts based upon assumptions and estimates. The Committee believes that the uncertainties relating to the determination of pension costs are not so pronounced as to preclude similar treatment.6

COST DETERMINING FACTORS

It is recognized that some of the following factors are not within the realm of the responsibility of the accountant, however if complete coverage is to be accorded this phase of the subject, space must be devoted to consideration of all of the factors having bearing on the end product. The accountant must be aware of the variable with which he is dealing in the broad subject of pension plan costs.

Mortality--It is impossible to know exactly how many employees out of a given number will live to reach the retirement age designated in a pension plan. It is likewise impossible to know exactly how long each pensioner will live after he begins to draw his pension. The use of a Standard Annuity Table provides the actuary with a basis for predicting with reasonable accuracy the percentage of the particular group that will be living at a designated age. The Table also will provide information on life expectancy after this designated age. In our

6Committee on Accounting Procedure, American Institute of Accountants, "Accounting for Costs of Pension Plans," American Institute of Accountants (On June 1, 1957 the name of this organization was changed to The American Institute of Certified Public Accountants.), Accounting Research Bulletin No. 47 (September, 1956), p. 15.
discussion we will arbitrarily use age 65 as the normal retirement age.

If a particular company can make available to an actuary the information as to the mortality experience in that company covering a representative number of past years, a table may be designed that could conform more closely to the mortality experience in the future in that company than would be provided by a Standard Annuity Table. Particular conditions may prevail in a given company that would render this possibility a truism. As an example, if it is estimated that out of 1,000 employees covered under a pension plan only 800 of this group will reach retirement age due to the mortality factor alone, the computation of the amount required to be contributed by the employer to provide for the prospective pensioners can be discounted for mortality.

The increasing life span that is indicated by statistics available today will have its effect on pension plans. There is a distinct possibility that in the future a normal retirement age may be selected that is higher than the one being used at the present time. "If the assumptions as to mortality decreases are realized, increases in pension costs at a fixed retirement age are inevitable and must be faced with realism and prudence." 7

Actuarial soundness in a pension plan implies that a careful analysis has been made of the covered group and the most current Annuity Table applicable in the given situation has been used. If the

7 Black, op. cit., p. 163.
1937 Standard Annuity Table, which indicates a higher mortality for the younger and middle age groups than is evident today among the employed categories, is employed in connection with a plan that has a full and early vesting provision, the choice of this particular Table could be seriously questioned.8

The following extract from statistics rendered by the National Office of Vital Statistics, U. S. Department of Health, Education, and Welfare reveals the upward trend in life expectancy as traced in the twentieth century:

TABLE III

EXPECTATION OF LIFE AT BIRTH IN THE UNITED STATES (YEAR)

<table>
<thead>
<tr>
<th>Year</th>
<th>White</th>
<th></th>
<th>Non-White</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Male</td>
<td>Female</td>
<td>Male</td>
</tr>
<tr>
<td>1900</td>
<td>46.6</td>
<td>48.7</td>
<td>32.5</td>
</tr>
<tr>
<td>1910</td>
<td>48.6</td>
<td>52.0</td>
<td>33.8</td>
</tr>
<tr>
<td>1920</td>
<td>54.4</td>
<td>55.6</td>
<td>45.5</td>
</tr>
<tr>
<td>1930</td>
<td>59.7</td>
<td>63.5</td>
<td>47.3</td>
</tr>
<tr>
<td>1940</td>
<td>62.1</td>
<td>66.6</td>
<td>51.5</td>
</tr>
<tr>
<td>1950</td>
<td>66.5</td>
<td>72.2</td>
<td>59.1</td>
</tr>
<tr>
<td>1955</td>
<td>67.3</td>
<td>73.6</td>
<td>61.2</td>
</tr>
<tr>
<td>1956</td>
<td>67.3</td>
<td>73.7</td>
<td>61.1</td>
</tr>
</tbody>
</table>


8 Bronson, op. cit., p. 37.
An examination of the information in this table indicates an increase in life expectancy in years from 62.1 in 1940 to 67.3 in 1956 for a white male, and for the same interval from 54.9 years to 65.9 years for a non-white female. These increases in life expectancy range from approximately 5 to 11 years in an intervening period of only 16 years. This important factor involved in the calculation of insurance premiums and in the estimating of contributions to be made to a fund must be recognized with respect to the latest life expectancy projections. Pension plan costs will be determined in part by this factor.

**Interest**—The interest factor has its effect in the overall determination of premium rates for annuities under an insured plan and in the determination of the contributions required in a trustee plan. "The importance of the interest assumption in premium rates is shown by the fact that a difference of 1/4 of 1 per cent in the interest rate used will affect the resulting premiums by an average of about 6 per cent."  

Conservatism dictates that a safety margin be maintained between the rate assumed and what the actual rate may prove to be in practice. The employer will not lose anything under either the insured plan or the trustee plan by the use of a lower interest rate than is being yielded by the investments. In the future the effect will be a lowering of the insurance premiums or a smaller amount required in contributions to the fund to accumulate the desired amount. If the interest rate begins to

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drop, a period of close observation is required before action is taken by either the insurance company or the responsible officer in the trusteed plan. If the fluctuations are not wide enough to warrant a change in calculations, no immediate action is required. On the other hand if the fluctuation in rate is of such magnitude and is apparently not of a short duration, recalculation of the premium rates or contributions to the fund are in order.

Certain differences exist in the insured and the trusteed plans that affect the interest factor. A few of the major points involved in the determination of an assumed interest rate will be pointed out. These points to be noted may result in a different performance of the interest factor under the two alternatives being considered.

In many cases the life insurance companies may be limited by the statutes as to the types of investments permitted. Some states do not permit insurance companies to make investments in common stocks. Although there has been some relaxing of restrictions imposed on investments in stocks by businesses subject to various state and federal regulatory agencies, there still remain in effect many provisions limiting the investment portfolio of these companies. On the other hand the trustee of a fund can be given a great deal of discretionary power with respect to the investment of the assets of the trust.

The earnings on a qualified trust are exempt from tax under the provisions of the Internal Revenue Code of 1954. The investment income of insurance companies is subject to a federal income tax. The
rate of federal income tax on the investment income of the stock insurance companies has been increased materially by HR 4245 which was passed in June, 1959 by the Congress.

The funds held by an insurance company are considered in the aggregate, and the entire investment portfolio shares proportionately in the earnings of the company. The trustee plan operates under the principle of each fund being an independent entity. Each of these particular arrangements may serve to either raise or lower the interest factor in given cases. If a part of the funds remain idle for any part of a given fiscal period, the effective interest earned on the total accumulation will be less than the rate earned on the dollar amount actually invested for the elapsed period of time.

How do the ages of the individual plan participants and the amount of the advance funding carried out affect the interest factor? The younger the covered employees in a plan the longer the funds committed in advance funding will be affected by the interest factor. An example will serve to expand this point. If we assume that an employee is forty years of age when a plan is adopted and also assume that age sixty-five is the minimum normal retirement age, the contribution made at the time of plan adoption will have more than doubled in the next twenty-five years if 3 per cent compound interest is maintained. The points listed above serve to point up the place the interest factor holds in the partial cost determination.

Expenses--Investment expenses are excluded from consideration
under this heading. Any investment expenses are treated as deductions from gross investment earnings to give a net percentage yield on the funds invested. This point was considered under "Interest" in the preceding section. Due to the differences that exist in the expenses under an insured plan and under a trustee plan, it is necessary to outline clearly which items are included in each composite expense amount.

Expenses of an insured plan involve what is known as a "loading" factor. This loading factor in the insurance company premium rate structure is intended to cover such items as the following: commissions to agents or brokers, state premium taxes (in those states assessing such a tax), insurance company administrative expenses, and contingencies. In addition to the loading factor included in the premium calculations, the employer will incur some administrative and legal expenses in the routine of establishing the plan and in maintaining whatever records are required by the plan.

The expenses of a trustee plan include the following: fees to the trustee, actuaries' fees, legal fees, and the costs of the increased administrative record keeping within the business that has been brought about by the installation and maintenance of the pension plan.

The summary above of the elements comprising the "expense" segment of the total pension plan cost did not indicate any difference in cost that would become apparent at the time of a plan cessation. If an insured plan is terminated, the premiums already paid included enough in the loading factor to absorb the administrative and other
incidental expenses incident to termination. The handling of the "expenses" under a non-insured plan is ordinarily on a current basis of cash disbursement for the expense item as it is incurred. Additional out of pocket costs would be incurred during the period of time elapsing from the termination date of the plan to the final accounting.

It is a safe observation to make that the "expenses" discussed in this section do not comprise a major part of the total pension cost. An employer initiating a plan should make whatever cursory examination that he feels is necessary to compare the cost of the expenses under an insured plan with those under a trustee plan.

Turnover--Turnover is one of the dominant cost determining factors in the calculation of the total cost of a pension plan. The vesting provision of the particular plan must be considered in order to reflect correctly the part labor turnover plays in the total pension cost. The effect that turnover may have in the initial calculations of cost under an insured plan and under a trustee plan is significant. A deferred group annuity contract will be assumed as a representative insured type plan to be used for comparison purposes with a trustee plan.

"Since the insurance companies do not feel that a risk which is within the control of the employer and employee should be included in any guaranteed rates, premiums for deferred group annuity plans are not discounted for employee turnover."¹⁰ This means that if an employee

¹⁰Black, op. cit., p. 174.
terminates his employment before vesting takes place, the employer receives credit against future premium costs for an adjusted amount based on his premium payments in the past toward the retirement of this separated employee. If full vesting has occurred at the time of an employee's withdrawal from employment, the employer will not receive any credit because the insurance company must consider that the separated employee is a member of the plan although credits to this employee ceased on his termination of employment. The extent of vesting at the time of an employee's separation from employment can have a substantial effect on the total cost of the plan. Vesting provisions in a plan should be reviewed carefully to insure compliance with the Code provisions; to insure equitable treatment to the employees; and, to recognize the extent to which this item may be a cost determinant.

The discounting for turnover may be employed in the initial calculations of contributions required under a trustee plan. What basis is to be used in determining this withdrawal factor? The past experience in the particular business may be used, but caution is demanded. Number of withdrawals alone can lead to erroneous assumptions. The number of years of service involved in each case of termination is very important because the amount contributed to the fund for that individual has been based on his age and length of service among other considerations. Such factors as vesting, disability retirement, and early retirement must be considered in adopting a rate to be used in discounting for turnover. A conservative measure would suggest the lowering of the
calculated rate arbitrarily to provide a buffer against contingencies.
The installation of a pension plan may reduce the labor turnover in the particular business, thus the conservatism suggested in establishing a rate factor for discounting for turnover would be justified. If the pension plan accomplishes one of its primary objectives, the turnover rate should decline after the installation of the plan.

**Retirement Age**—In estimating the total cost of a pension plan the assumed age or selected age for normal retirement of the employee will be an important partial cost determinant. Consideration must be given to whether the normal retirement age is also the mandatory retirement age or whether provision is made for the employee to continue working for an extended period beyond the normal retirement age. If a plan contains a provision permitting late retirement, the plan must indicate if the employee will receive any additional credits after normal retirement age assuming that he continues in active employment of the business.

The inclusion of a disability retirement feature in a trustee plan necessitates a weighting of this factor in the overall cost computation of the plan. The extent to which this feature will affect the cost of the plan is determined in part by the specific stipulations relating to total, partial, and permanent disability. An insured pension plan will ordinarily not contain a disability retirement clause.

**Compensation Rate**—Changes in the rate of compensation of employees will have a direct bearing on the cost of the pension plan if the plan constructs the benefit formula in relation to wage rates. The
earnings of the employees at the inception of the plan and the projected earnings rate of the employees in the future must be taken into account in accurately estimating the total cost of the plan. As was pointed out earlier in the chapter, a constant review of estimates is required in order to produce results in conformity with changes that have taken place or are taking place at the time.

There is some statistical evidence to show that the salary scale for an individual employee tends to rise through the years to a peak around middle age. Assuming the average age of all employees is much less than middle age at the time of a pension plan installation, costs of the plan must be viewed in terms of the highest salary scale years of these employees. "Generally, the factor of turnover tends to offset that of a salary scale, and it is only the net effect of these two factors which will produce any marked increase or decrease in cost." 12

Social Security Contributions--The contributions made by an employer on behalf of his employees under the Federal Insurance Contribution Act requirement form a part of the cost of the entire

11According to one study "family income tends to reach a peak as the head of the family reaches the highest level of earning power, inasmuch as he is the principal earner in most families. In addition, the size of the family and number of earners per family tend to reach a peak as the head of the family approaches middle age. Also, the proportion of family heads in the labor force declines after age 55." "Employment and Economic Status of Older Men and Women," Bulletin No. 1213, p. 34. December, 1955, United States Department of Labor, Bureau of Labor Statistics.

retirement program of a business. The subject of the integration of the Social Security benefits with a private pension plan in operation within a given concern will be discussed later in this study. It suffices to say at this point that if the employees are covered under the provisions of the Social Security legislation and are also provided coverage under a private pension plan, the employer must recognize the costs and obligations imposed under both plans in his accounting records and on his statements.

COST ALLOCATION AND STATEMENT PRESENTATION

The total cost determination of a funded pension plan involves the use of variables and the application of estimating procedures. The accounting problem is only partially solved when the elements of cost of the plan are combined to yield a cost figure. Should this cost figure be reported on the income statement of one or more fiscal periods? Should the cost of pensions be lumped together with other salary costs and associated employee benefits? Is it desirable to reflect pension information in the financial notes accompanying the income statement and the balance sheet? How are the liabilities connected with the pension plan to be reported? What distinction should be made between past service cost and current service cost? The answers to these questions are contained in the many financial statements and reports of the companies having pension plans in operation. The results of surveys of the companies as a group and on an individual basis will be exhibited to show, in part at least, the answers to the questions posed above.
The discussion that follows will attempt to focus attention on how these accounting problems are being handled in the light of recommendations made by the leading professional accounting organizations. Alternative treatment to that recommended for the handling of some of the more acute problems will be suggested and discussed. A logical starting point for this discussion is the much discussed element of past service cost.

PAST SERVICE COST

**American Institute of Certified Public Accountants**—The element of past service cost is present in those cases of pension cost in which the business recognizes the services rendered by the employees prior to the adoption of a pension plan. In the Restatement and Revision of Accounting Research Bulletins issued in 1953, the Committee expressed the following opinion about the accounting treatment of past service cost:

4. The committee, accordingly, is of the opinion that:
   (a) Costs of annuities based on past service should be allocated to current and future periods; however, if they are not sufficiently material in amount to distort the results of operations in a single period, they may be absorbed in the current year;
   (b) Costs of annuities based on past service should not be charged to surplus.\(^{13}\)

The recommendations of the Committee as set forth above are clearly expressed. There is no qualifying phrase or statement in the

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pronouncement that would imply that under certain conditions some of the cost incurred as a result of past service could be charged against the accumulated earnings of prior fiscal periods. The majority of the Committee had changed its thinking on this point some three years later as is evidenced by the issuance of Research Bulletin No. 47.

In September, 1956, the Committee issued Accounting Research Bulletin No. 47 on the subject of "Accounting for Costs of Pension Plans." This Bulletin is more exhaustive in its treatment of past service cost than was the corresponding part of Bulletin No. 43 which was quoted above. For comparison with the content of paragraph 4, Bulletin No. 43, the wording in Bulletin No. 47 is presented below:

3. ... It, therefore, is of the opinion that past service benefit costs should be charged to operations during the current and future periods benefited, and should not be charged to earned surplus at the inception of the plan. The Committee believes that, in the case of an existing plan under which inadequate charges or no charges for past services have been made thus far and the company has decided to conform its accounting to the preferred procedure expressed in this bulletin, it may be appropriate to charge to earned surplus the amount that should have been accumulated by charges to income since inception of the plan.14

The recommendation of the Committee contained in the last sentence of the above quotation is the point of departure from the recommendation contained in the quotation extracted from Bulletin No. 43.

Bulletin No. 47 was adopted unanimously by all twenty-one members of the Committee with six assenting members qualifying their approval with respect to the part of the Bulletin that appears to sanction the charging to earned surplus in some circumstances of pension costs based on past service.

Securities and Exchange Commission--In cases where past service cost exists it has been recognized as a problem by trained accounting personnel engaged in the preparation and review of financial statements. Certain regulatory and supervisory agencies have considered the accounting for this element of cost of sufficient significance to justify the issuance of a recommendation for handling it or in some cases the necessity of issuing a requirement pertaining to the treatment accorded it or disclosure made concerning it. The Securities and Exchange Commission in its Regulation S-X in connection with General Notes to Balance Sheets sets forth the following requirement: "... (3) If a plan has not been funded or otherwise provided for, the estimated amount that would be necessary to fund or otherwise provide for the past service cost of the plan shall be disclosed."15

In a speech given some twelve years ago an official of the Securities and Exchange Commission stated the position of that Federal agency on the subject of past service cost. No evidence has been found to indicate any major change in the position of this

body, thus an excerpt from the speech by Mr. Earl C. King is presented below:

... Payments based upon past service of employees currently on the payroll are claimed by some to be proper charges to earned surplus on the grounds that the payment is for service rendered in prior years. We have held in such cases that the payment is actually made for a current benefit in the form of better employee relations, reduced labor turnover and similar benefits currently and in the future and hence the charge should be to profit and loss. ... 16

In its thirteenth annual report issued in 1947 the Securities and Exchange Commission calls attention to the considerable diversity of opinion existing at that time as to the proper accounting treatment that should be accorded payments for past service cost. In its report the Commission leaves no doubt about the handling of current service cost as being properly treated as a profit and loss charge. The report embodies the position of the Commission on the accounting treatment of past service cost as enunciated in the above quotation from the Commission official, however, the report expands on the subject as follows:

... However, where the payments were substantial and would have seriously distorted current income figures no objection has been raised to direct charges to earned surplus, although even in this situation the preferred method would seem to be to treat these items as extraordinary charges to profit and loss. 17


Results of Surveys Conducted in 1949 and 1959--The positions taken on the subject of past service cost treatment by the authorities referred to so far in this chapter indicate the preferred accounting treatment of this item is to reflect it as a charge against profit and loss. The exact manner of reporting the revenue charge will be considered in some detail later in this chapter. The essence of the influence of the recommendations made by the various authorities on the personnel responsible for the preparation of the financial statements may be revealed by the examination of the results of a survey conducted by the Controllers Institute of America, Inc. in 1949 and the results of a survey conducted by the author of this study in 1959.

In April, 1949, an article in The Controller presented the results of five questions that were sent to Institute members on the subject of pension accounting. The questions and results of this survey are presented at this point in this study to refer specifically to the method of handling past service costs. The survey covers other accounting aspects of the pension problem, and the portions of this survey pertaining to points to be covered later in this study will be referred to at that time.

The Controllers Institute granted permission to the author of this study to use these five questions in a questionnaire in order to provide a practical comparison of the results obtained in 1949 and the results obtained in 1959. The names of the firms contacted in the 1949 survey were not disclosed, therefore an exact comparison of the results obtained
under the two surveys is impossible. The size and types of the corporations queried are such that valid comparisons can be made of the results obtained on the identical questions. The one hundred corporations chosen to be sent questionnaires in 1959 were selected at random from the "Fortune 500 List." Out of the one hundred corporations to which questionnaires were sent, ninety-one replies were received. The prompt response of each of these ninety-one corporations in answering the questionnaire and in returning it for compilation in this study attests to the interest shown in this problem which is faced today by the executives of these leading industrial giants. The author appreciates the many helpful comments made on the questionnaires that were returned. It is impossible to include all of these individual case peculiarities and techniques in the summary of results obtained, however, in many of the cases these comments explained why certain questions could not be answered or possibly were not applicable.

The following tabular presentation gives the results of the two surveys. The questions asked in the survey and the results obtained by the Controllers Institute are identified below by the year 1949. The results obtained by the author of this study are identified below by the year 1959. The questions and replies are as follows:

---

<table>
<thead>
<tr>
<th>Questions</th>
<th>Replies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Are past service contributions treated as:</strong></td>
<td>1949</td>
</tr>
<tr>
<td>a. A charge to surplus</td>
<td>8%</td>
</tr>
<tr>
<td>b. A charge to current expense</td>
<td>92%</td>
</tr>
<tr>
<td><strong>2. Under income tax regulations one-tenth of the total past service liability may be charged off each year, thus producing a substantial savings in income taxes. How is this income tax saving treated?</strong></td>
<td>1949</td>
</tr>
<tr>
<td>a. As a credit to the income tax provision against regular current earnings</td>
<td>91%</td>
</tr>
<tr>
<td>b. As a credit to surplus</td>
<td>9%</td>
</tr>
<tr>
<td><strong>3. How are current service contributions treated:</strong></td>
<td>1949</td>
</tr>
<tr>
<td>a. As a single item charged to some general account</td>
<td>36%</td>
</tr>
<tr>
<td>b. Charged to the individual departments where the members of the pension plan are employed (similar to F.O.A.B. and Compensation Insurance)</td>
<td>60%</td>
</tr>
<tr>
<td>c. Other treatment (specify)</td>
<td>4%</td>
</tr>
</tbody>
</table>

**1949**
1. Charged to locations but not departmental.

**1959**
1. Charged to General and Administrative Expense as a single item but all General and Administrative expenses are distributed to operating departments on an overall basis.

2. Charged to major subdivisions. In some instances it is then redistributed to Departments and in others it is left as a general charge.
3. These are prepaid for a year. Charged to a prepaid account and then charged monthly to individual departments using an estimated percentage of labor dollars.

4. If past service contributions are charged as a current expense, is this expense treated:
   
a. Similar to current service contributions as per question 3 above
     79%  89%
   b. Otherwise (specify)  21%  11%

1949
   1. Charged to miscellaneous income and expense.
   
   2. In internal accounting charged to general management. In published reports--charged to "other charges."
   
   3. Charged to general administrative expenses.

1959
   1. As other charges.
   
   2. As a single item charged to some general account.
   
   3. Charged to General Corporate account.
   
   4. Separate account takes 100% of "Past Service" cost.
   
   5. Special charge on General Books in a Profit and Loss Account.
   
   6. Considered as a corporation charge and classified in the "Other Income and Deduction" section of the Profit and Loss Statement.
7. Charged in one account as "Financial Expense."

5. If a Trustee Plan is in operation, how are payments made to the trustee for:

a. Future service contributions
   (1) Annually  50%  30.8%
   (2) Monthly  50%  52.3%
   (3) Other --  16.9%

b. Past service contributions
   (1) Annually  50%  41.4%
   (2) Monthly  33%  43.1%
   (3) Made over reasonable period of years  17%  15.5%

The results obtained in these surveys as shown by the answers to questions 1, 2 and 4 point up the fact that the predominant number of those institutions queried were following the recognition of past service cost for pensions as a revenue charge. The alternatives possible in reporting this revenue charge on the income statement will be covered later in this chapter.

Out of the ninety-one replies received in this current survey five corporations did not complete any questions on the questionnaire. These five corporations indicated that they either did not have a pension plan in operation or the plan was of the pay-as-you-go type.

A few of the corporations indicated that the past service obligation had been fully funded, therefore answers were not given to those questions pertaining to this particular item. In part b of question three some of the corporations indicated a change in the word
"department" to "division." In computing the results of this survey in question three, those corporations using the term "division" have been included with those using the term "department." Those corporations with an insured plan did not submit answers to question five.

The results obtained to question three show marked similarity to the results obtained in the earlier survey. This particular question involves primarily internal procedures determined in many cases by the type of business reporting. Within a particular type industry uniformity of reporting of this particular item is desirable for comparative analysis purposes. Unless disclosure is made of a change, uniformity from period to period within the same company is expected.

More variation is noted in the results of question five of the current survey as compared to the same question of the earlier survey than was evident in the other four questions. The decisions made by the management of a particular business as pertains to the payments made to the trustee are internal policy problems. If exactly the same corporations were compared and there was a significant shift from an annual payment to the monthly payment, a generalization might be drawn that the companies were interested in smoothing out the disbursement over a longer period. It also might indicate that the working capital position had changed to a point that it influenced the decision to change. This particular item does not present a significant accounting reporting problem.

**Summary**—As indicated in the discussion above, the results
obtained under the two surveys are very similar. The results obtained to those questions that involved either controversial or debatable accounting treatment alternatives clearly indicate that the majority of the corporations surveyed are following the recommendations of the leading organizations and authorities in the field of accounting.

**Past Service Cost Presentation**--As an indication of the prominent position that the past service cost for pensions can hold in the financial statements of a business as a result of the decision to reflect this cost as a revenue charge, a portion of the United States Steel Corporation's Consolidated Statement of Income for 1956 is reviewed. The revenue for 1956 from the sale of products and services amounted to slightly over four and one-quarter billion dollars. The wages and salaries for the same year amounted to slightly less than one and one-half billion dollars. The pension and other employee benefits for 1956 amounted to slightly more than one-quarter billion dollars. The breakdown of the pension cost and additional employee benefits for 1956 is as follows:

Non-Contributory part of pension plan:

Funding of current service cost (including interest on past service cost) ........ $79,800,389
Funding of portion of past service cost ........ 38,000,000

Contributory part of pension plan--current service cost .......................... 7,406,294
Total for pensions ........................................... 125,206,683

Social Security taxes ................................. 39,747,127
Insurance costs ........................................... 25,117,691
Payment to industry welfare and retirement funds and other employee benefit costs . 35,281,460
Total cost of employee benefits $225,352,981

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19The information is provided by the President's letter accompanying the financial statements. The letter indicates that there is no unfunded past service cost in connection with contributory pensions, since no service prior to the date of employee participation is involved in determining benefits.
Approximately 17 per cent of the total cost of employee benefits is represented by the one item of the funding of portion of past service cost. This percentage would be higher, possibly materially so, if the information was available to indicate how much interest on past service cost is included in the $79,800,389 reported as funding of current service cost. Out of an estimated total cost of $496 million for past service obligation that existed on March 1, 1950, the effective date of the present plan, $237 million is unfunded at December 31, 1956.

With an assumed interest rate of 3 per cent, an additional $7 million would be added to the $38 million reported for past service cost funding. This would indicate that one-fifth of the total cost reported for employee benefits for 1956 is a direct result of past service cost.

If the choice is made to reflect the cost of funding past services of employees in the operating expense section of the income statement, the resulting per cent of rate earned on owners' equity will be smaller than it would have been if retained earnings had been charged for the past service cost. A variation in a measurement device in statement analysis is not necessarily a reason to select one method over the other, but it indicates that comparability of statements dictates uniformity in reporting from period to period regardless of the method selected.

The significance of the size of the absolute amount or of the relative of this item of past service cost in the United States Steel report is justification for the time and thought devoted to this element
of cost by the groups responsible for the establishing of the accepted principles and practices in accounting.

In the eleventh edition of *Accounting Trends and Techniques in Published Corporate Annual Reports* the Research Department of the American Institute of Certified Public Accountants presents the accounting aspects of the annual reports of 600 industrial and commercial corporations. Within section three of this report Pension and Retirement Plans are covered. A Table from this report will be included immediately following the summary of past service cost in this chapter. The table summarizes the methods of funding used by the 376 companies reporting 413 plans in their 1956 reports. The information contained in this report will be referred to at different times in this chapter because of its scope and content. In addition to indicating the methods of funding used in the plans the table sets forth how the companies reflected the current service, past service, or pension costs in their 1956 statements.

**Summary of Alternatives for Past Service Cost Presentation**—As was indicated in the chapter, the item of past service cost for pensions may be charged to operations or to retained earnings. The evidence presented shows conclusively that the accounting profession favors charging this item as a revenue expenditure. In Research Bulletin No. 47 the Committee on Accounting Procedure of the American Institute of Certified Public Accountants modified slightly its earlier stand on the charging of past service costs. As noted previously,
six members of the Committee did not favor this modification in position that had been taken rigidly in Bulletin No. 36. The content of Bulletin No. 36 was later restated in essence in Bulletin No. 43.

A leading practitioner has posed the question of treatment of this problem in the following manner:

... Would not the ideal method of absorbing these costs be to amortize them over the actuarially computed productive life of the worker, just as the pension costs for his future service benefit are treated? The only distinction between the two costs would be a higher rate for past service than for future service costs resulting, in the main, from the disparity in elapsed and future time in the case of older employees.

---

# TABLE IV

## PENSION AND RETIREMENT PLANS

Charge to Income Set Forth For*:

<table>
<thead>
<tr>
<th>Combined Costs</th>
<th>Separately Costs</th>
<th>Current Service Costs</th>
<th>Current Costs</th>
<th>Pension Costs with Charges</th>
<th>Total</th>
<th>1956</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shown</td>
<td>Shown**</td>
<td>Current</td>
<td>Past Service</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Funded or Partially Funded Plans:**

- **Current funding of current service costs with installment funding of past service costs:**
  - 49
  - 50
  - 5
  - 24
  - 4
  - 9
  - 141

- **Current funding of current service costs with funding completed for past service costs:**
  - 2
  - 3
  - 7
  - 4
  - -
  - 4
  - 20

- **Current funding of current service costs with past service costs not to be funded:**
  - -
  - 1
  - 1
  - 1
  - 1
  - 1
  - 5

- **Basis of funding not disclosed:**
  - 8
  - 8
  - 8
  - 51
  - 2
  - 23
  - 100

**Total:**

- 59
- 62
- 21
- 80
- 7
- 37
- 266
TABLE IV (Continued)

<table>
<thead>
<tr>
<th>Current and Past Service Costs:</th>
<th>Current Costs with Other Not Set</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shown</td>
<td>Shown**</td>
<td></td>
</tr>
<tr>
<td>Combined</td>
<td>Separately</td>
<td>Costs</td>
</tr>
<tr>
<td>1956</td>
<td>6</td>
<td>4</td>
</tr>
</tbody>
</table>

Unfunded plans with related costs to be absorbed at time of retirements or as benefits are paid.................

Unidentified plans with no reference made to funding or nonfunding of related costs

**Includes those in which the past service costs are shown somewhere in the report even though the combined cost may have appeared in the Income Statement.

PENSION PLAN COST REPORTING

It might appear at first glance that the posing of the question of pension plan cost reporting should not offer any major problem to an accountant in rendering an answer. The fact is that it is often impossible to look at the financial statements of a business and ascertain under which category or caption this item of cost is reported. In a survey of 600 companies it was found that less than 65 per cent of them mentioned pension plans in their reports, and only 76 per cent of those mentioning pension plans in their reports disclosed the related costs.21

Some companies report the pension information in notes to the financial statements. This is particularly true in the year in which the pension plan is installed and in any subsequent year in which a major change is made in the plan. Other companies disclose the pension cost directly on the income statement, and in some instances supplementary schedules or letters to stockholders forming a part of the financial reporting contain the explanatory pension figures and remarks. Although each of the above described methods of reporting the pension information may resolve the problem as far as the individual concern is involved, the heterogeneous methods used add to the problem of a non-accountant in his attempt to understand the content of the financial statements. Valid comparisons in statement analysis

21Accounting Trends and Techniques, op. cit., p. 140.
are either much more difficult or are impossible depending upon the extent to which this pension cost has been combined or buried in the financial information. As pension plans grow in size and number, the desirability of uniformity in reporting procedures will become even more evident. In this specialized accounting problem the fundamental concept of the matching process can be carried out very effectively if the accrual principle is adopted and applied consistently.

If past service cost is charged as a revenue expenditure, the section of the income statement in which it is included may vary from one business to another. Some accountants take the viewpoint that this cost is incurred in much the same manner as other operating expenses of the business, and thus it is proper to report the item as an administrative cost. Other procedures involve the allocation of this item to departments of the business on some acceptable cost allocation principle. This allocation process can be accomplished in much the same manner as certain overhead costs are applied to departments in a manufacturing operation. The distribution of the cost within a given business as a manufacturing, selling, or administrative cost element or as a combination of the three is an internal accounting problem. The disclosure of the procedure applied is of primary importance if full disclosure and clarity of statements are to be achieved.

An alternative to reporting the past service cost in the manufacturing cost or in the operating expense section of the income
statement is to treat the expenditure as a financial cost item and report it in the other expense section of the income statement. This particular handling of the past service cost would be advisable if distortion of an operating expense section would result from the inclusion of the item in that particular section. Consistency in reporting should be followed during the ten, twelve, twenty, or whatever number of years has been selected for the allocation of this past service cost.

In referring to the survey conducted in 1949 by the Controllers Institute and to the survey conducted in 1959 by the author of this study it is seen that over 50 per cent of the firms elected to charge current service contributions to the individual departments of the business for income statement reporting purposes. Slightly more than one-third of the businesses canvassed elected to charge this current service cost as a single item of a general classification. There is uniformity in this reporting in regard to the operating expense section of the income statement. In those concerns that are of the manufacturing type a part of the current service cost for pensions will be reflected indirectly as a part of the cost of sales figure. In published financial statements the classification of the current service cost has not occasioned as much variation as the problem of what dollar amount should be included in the particular fiscal period in view of the funding method employed.

Paragraph 5 of Accounting Research Bulletin No. 47 has this to say about the problem of pension cost allocation: "In the view of
many, the accrual of costs under a pension plan should not necessarily be dependent on the funding arrangements provided for in the plan or governed by a strict legal interpretation of the obligations under the plan." This statement emphasizes the desirability of accruing pension costs in relation to the active service of the covered employees. The reporting of the liability item or items created as a result of following the practice of systematic accrual will be covered later in this chapter.

In the survey of 260 Pension Plans by Mr. Warde B. Ogden it is noted that of the 172 plans offering either adequate or inadequate explanations of the methods used to determine pension costs less than 25 per cent used what might be broadly referred to as an "accrual basis." The variation that occurred in these 41 plans of the "accrual basis" type is reflected in the following tabulation:

**TABLE V**

**METHOD USED TO DETERMINE COSTS FOR YEAR**

Current service, plus the following portion of past service costs:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on unfunded costs</td>
<td>1</td>
</tr>
<tr>
<td>Amortization over:</td>
<td></td>
</tr>
<tr>
<td>10 years</td>
<td>3</td>
</tr>
<tr>
<td>24 years</td>
<td>1</td>
</tr>
<tr>
<td>Entire additional amount resulting from modification of plan</td>
<td>1</td>
</tr>
<tr>
<td>Unexplained</td>
<td>6</td>
</tr>
</tbody>
</table>

\(^{22}\)Accounting Research Bulletin No. 47, *op. cit.*, p. 15.
**TABLE V (Continued)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total estimated cost of pensions granted during the year</td>
<td>6</td>
</tr>
<tr>
<td>Total estimated cost of pensions payable to all employees becoming eligible to retire during the year (whether actually retired or not)</td>
<td>4</td>
</tr>
<tr>
<td>One-fifth of total estimated cost of pensions expected to be granted during five-year union contract period</td>
<td>2</td>
</tr>
<tr>
<td>One-fifth of total estimated pension payments within five-year union contract period</td>
<td>1</td>
</tr>
<tr>
<td>Unexplained</td>
<td>61*</td>
</tr>
<tr>
<td></td>
<td>41</td>
</tr>
</tbody>
</table>

*Apparently a transposition error.


Mr. Ogden points out that in 11 of the 41 cases the accruals were reduced by estimated future tax savings. It was also disclosed in the report of this survey that a much higher per cent of the plans indicated the financing arrangements that were followed than indicated the method used to determine costs. Slightly more than eighty per cent of the 260 plans gave a description of the financing, however almost 25 per cent of those that described the financing did not explain the accounting method. These figures and percentages substantiate the position taken by many accountants that adequate disclosure of pension costs is not being made in many cases. The practitioner is faced with the problem of whether he should "certify" a statement that fails to disclose methods used in arriving at pension costs.
DISCLOSURE OF PENSION LIABILITY

The accounting profession recognizes the responsible position that it holds in presenting to all interested parties the financial statements of a business. These statements must reflect as accurately as possible the result of the business activity for a given period and the financial condition as it exists as of a specific date. In an attempt to maintain and improve the high quality of professional accounting reporting the Committee on Auditing Procedure of the American Institute of Certified Public Accountants has set down certain Standards of Reporting. Three of these standards are listed below:

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report. 23

These standards impose on the responsible accounting personnel the obligation of providing the financial information in accordance with the comprehensive requirements as set forth. The recognition of all liabilities existing at the time of statement preparation is only one example of the many points implicitly covered in the concise statement

of standards.

The exact method of reporting a liability, such as may exist in connection with a pension plan, may take one of several forms. If the method selected for reporting the liability follows the generally accepted accounting practices, the cardinal point of disclosure of the item has been accomplished.

With the foregoing well established principle of full disclosure in accounting statements in mind, what reasons have been advocated by some writers in attempting to justify the failure to recognize pension liabilities on the balance sheet? The argument by some of these writers in attempting to justify the omission of the liability item for pensions is based on the fact that many of the plans now in force are, by their very terms, not permanent. Other views expressed in justifying the failure to disclose the liability item are predicated on the fact that many variables exist in the determination of an amount that is very indefinite. These points seem to indicate that those advocating the exclusion of a pension liability feel that a failure to disclose the obligation is less misleading than the disclosure of an estimated amount that may be inaccurate.

Although figures are not at hand to substantiate the observation, it seems reasonable to conclude that the accountants either favoring

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or attempting to justify the failure to disclose adequately a liability item are in the minority. A very straightforward comment on this point is made by an industrialist in the following quotation:

... The decision as to whether this item should appear in the accounts themselves or should take the form of an adequate footnote may be left to a qualified accountant, who will make the most meaningful presentation possible. Omission of so material an amount in the report is indefensible. 25

In Table VI presented on the following page the use of the term "reserve" is followed by the majority of the companies having employee benefit reserves in reporting the particular obligation in connection with employee benefits. The figures indicate that in each of the four years tabulated there were fewer than 20 per cent of the 600 companies using the "reserve" procedure. An example of the presentation of this reserve item on the balance sheet in 1956 by one of the 89 companies covered in the report by the American Institute of Certified Public Accountants is presented as representative of the majority of the companies reflecting this item below the current liability section:

25Ibid., p. 728.
### TABLE VI

EMPLOYEE BENEFIT RESERVES

<table>
<thead>
<tr>
<th></th>
<th>1957</th>
<th>1956</th>
<th>1955</th>
<th>1954</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Balance Sheet Presentation:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Among: Current liabilities for--</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Incentive compensation plan</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Profit sharing plan</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Welfare or benefit plan</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Pension plan not funded</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Pension plan--past and current service costs</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Pension plan--current service costs</td>
<td>-</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Above:</strong> Stockholders' Equity for--</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonus plan</td>
<td>6</td>
<td>7</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>Deferred or contingent compensation plan</td>
<td>23</td>
<td>21</td>
<td>13</td>
<td>16</td>
</tr>
<tr>
<td>Incentive compensation plan</td>
<td>9</td>
<td>8</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>Profit sharing plan</td>
<td>2</td>
<td>2</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Retired employee benefits</td>
<td>9</td>
<td>8</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Welfare or benefit plans</td>
<td>4</td>
<td>7</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Employment contract</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Severance pay</td>
<td>2</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Pension or Retirement Plan:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Annuity costs</td>
<td>1</td>
<td>4</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Pension plan costs</td>
<td>31</td>
<td>28</td>
<td>33</td>
<td>29</td>
</tr>
<tr>
<td>Past service costs</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Past and current service cost</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Current service cost</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Future service cost</td>
<td>1</td>
<td>-</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>Former plan liability</td>
<td>2</td>
<td>1</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td><strong>Within:</strong> Stockholders' Equity for--</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employment contract</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Pension plan--past service costs</td>
<td>1</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Retired employee benefits</td>
<td>1</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>109</td>
<td>106</td>
<td>96</td>
<td>95</td>
</tr>
<tr>
<td><strong>Terminology Used</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>&quot;Reserve&quot;</td>
<td>63</td>
<td>60</td>
<td>56</td>
<td>61</td>
</tr>
<tr>
<td>&quot;Provision&quot;</td>
<td>14</td>
<td>16</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Various other terms</td>
<td>32</td>
<td>30</td>
<td>26</td>
<td>20</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>109</td>
<td>106</td>
<td>96</td>
<td>95</td>
</tr>
<tr>
<td><strong>Number of Companies With:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Employee benefit reserves</td>
<td>102</td>
<td>91</td>
<td>84</td>
<td>85</td>
</tr>
<tr>
<td>No employee benefit reserves</td>
<td>498</td>
<td>509</td>
<td>516</td>
<td>515</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>600</td>
<td>600</td>
<td>600</td>
<td>600</td>
</tr>
</tbody>
</table>

THE AMERICAN SUGAR REFINING COMPANY

Consolidated Balance Sheet

Above Capital Stock and Surplus:

Pension Fund Reserve.................. $9,883,668

Noncurrent Assets:

Pension Fund:

- Cash ........................................ $ 526,367
- U. S. Government, state and municipal securities ...................... 8,724,651
- Company's own preferred stock, 5,000 shares at cost .................. $9,883,668

ACCOUNTING METHODS ANALYZED

The particular method of accounting for pensions that is selected by a business will in its operation allocate the item of pension cost to various fiscal periods. In the preceding pages an effort has been made to acquaint the reader with the many sides of the problem and to present some of the ways in which the accounting profession has attempted to meet the problem. At least two of the basic functions of accounting—-to record the financial information and to report the results of the recorded information in an acceptable manner—-have been covered in this study.

Mr. Arthur H. Dean has indicated four possibilities of accounting

---

for the cost of pensions. The names chosen by him to distinguish these methods are as follows: (1) the cash disbursement method; (2) the funding method, (3) the vesting method, and (4) the provision method. Since this study has been limited in scope to pension plans that are both qualified and funded, an analysis of the concepts of the last three methods mentioned above will serve to consolidate the thinking on the varied possibilities of accounting treatment.

The Funding Method—The funding method relates the revenue charges of a given period to the actual disbursements made to the agency handling the funding arrangements. The possibility of distortion of the income figure between or among fiscal periods is apparent when it is realized that in many cases the amount of the funding in a particular period may be a management decision. Comparative horizontal income statement analysis of the same company or of several companies would be most difficult or in some cases meaningless if this accounting technique is employed in varying ways and degrees.

The Vesting Method—Under the vesting method of accounting for pensions the revenue charge for the pension cost would be determined at the time the employees rights to receive pensions actually vest. In this method there is the lack of relationship between the

27 These descriptive titles distinguishing the possible methods of accounting for pension costs were used by Mr. Dean in his article that has been cited earlier in this study.
services rendered and the current costs. The employee with a vested
right either before retirement or at retirement is being provided for;
however, no provision is being made in the accounting entries for
the active employees with no vested interest.

The Provision Method—The provision method involves the
charging against revenue each year an amount for current service
and where applicable a charge for past service. Although the charge
against revenue for current service involves estimates because of the
mortality factor, etc., the relationship of the charges for pensions
and the services of the employees on which these pensions are
based is much closer than in the other methods described. Mr.
Dean concludes that this method of accounting for pensions is
preferable. Some of the reasons that he gives to support his view
are as follows:

...It would cause little or no distortion in reporting income either as between years or, if generally
adopted, as between comparable companies. It
would relate the cost of pensions (apart from the
cost of past-service benefits) to the production of
the employees who, assuming continuous service so
as to meet the length-of-service requirements of
the plan, normally would be the recipients of those
pensions; it would be in keeping with the concept
of deferred compensation; and it would serve to set
aside and accumulate savings for the account of the
employees.\(^{28}\)

\(^{28}\)Dean, op. cit., p. 105.
A CASE STUDY—THE CAROLINA POWER AND LIGHT COMPANY

Plan History--The pension plan of the Carolina Power and Light Company (hereafter referred to as the Company) is known as the Supplemental Retirement Plan. The plan was made effective on September 1, 1944, and since that date seven amendments to the plan have been adopted. Each of the seven amendments has had the effect of improving either the employee position or the retirement benefits provided under the plan. One of the recent amendments to the plan provides for a more liberal formula in computing retirement benefits through a percentage change in the integration of the plan with the Social Security

29The writer wishes to acknowledge the whole-hearted cooperation of the executive management of the Carolina Power and Light Company in assisting with the accumulation of the data for the following factual presentation of significant parts of that Company's "Supplemental Retirement Plan."

Special recognition is accorded Mr. R. B. Carpenter, Treasurer of the Carolina Power and Light Company, for his contribution of time and assistance in discussing the plan provisions and internal administration of the plan. Staff personnel of the Raleigh, North Carolina branch of the Wachovia Bank and Trust Company, trustee of the plan, were most cooperative in providing detailed information concerning the bank's function as outlined in the trust agreement.

The information contained in the remainder of this case study was obtained by the author of this study in personal contacts with the parties mentioned above; in examination of the provisions of the Supplemental Retirement Plan; in review of the sections of the Trust Agreement; in examination of the report of the Actuary for the fiscal year ended December 31, 1958; and, in the inspection of other Company reports such as the Annual Report for 1958 and a Prospectus issued in March, 1958.
benefits. The additional cost to the company for past service contributions and current service contributions brought about by this amendment will be covered under the discussion of integration of the plan with the Social Security benefits. The plan is qualified by the Internal Revenue Service.

**Selected Plan Provisions**—Although each provision of the plan must be considered if a detailed and critical analysis of the plan as a whole is to be rendered, some of the plan provisions are not developed in this study because of their lack of applicability to accounting techniques. Instances will occur in which non-accounting requirements in the plan provisions are described in order to provide continuity of thought and to reveal indirectly related procedural effects.

**Eligibility and Retirement**—Every regular full-time employee with ten or more years of continuous service at the date of normal retirement is covered by the plan. Normal retirement date is the first day of the month following the sixty-fifth birthday of the employee. Provision is made for disability retirement and for early retirement under stipulated conditions. If the employee is retained in service after age sixty-five and a later retirement is provided, the Board of Directors of the Company must authorize this extended service period. Pension credit will accrue to age seventy for an employee retained in service beyond normal retirement age. If an employee dies before reaching retirement age, retirement benefits
will not become payable.

Type of Plan--The plan is of the non-contributory, trustee type. Contributions are made monthly by the Company to the Wachovia Bank and Trust Company, trustee of the plan. The bank is to administer the funds under a trust agreement for the sole benefit of the employees. On retirement, pension payments to employees who were not sixty-five on September 1, 1944, are made directly from the fund by the trustee. Any employees of the Company who were sixty-five on September 1, 1944, were not covered by the plan; however, these employees were eligible to receive pensions directly from corporate funds computed on the same formula as the Plan provides. Of the fifteen employees that were sixty-five or over on September 1, 1944, four were still living and receiving monthly pensions from the Company in June, 1959. The cost of these direct payments made by the Company to these retired employees is reflected in the Other Operation cost element on the Statement of Income.

Plan Administration--A Retirement Board of seven (7) members is charged with the responsibility of administering the plan and carrying out its provisions. One of the duties of this Board is to have prepared within a reasonable time after the end of each fiscal year a report or reports showing the fiscal transactions under the Plan and Trust Agreement for the preceding fiscal year and the financial condition of the trust fund as of the end of such fiscal year. The two reports prepared as of the close of the fiscal year, 1958, in
compliance with this provision of the Plan are included in this study as Tables VII and VIII on the pages immediately following this page. References to the figures on these two Tables will be made later in this case study when specific accounting treatments and techniques are being discussed.

An actuarial study and computation is required after the close of each fiscal year in order to determine the amounts to be contributed by the Company to the trustee for the ensuing twelve months' period.

In addition to the duties listed above, another important function of this Retirement Board is the notification of the trustee of the retirement of an employee and the monthly pension amount due him.

**Benefit Formula**—The amount of monthly pension to be received by an employee at either normal or late retirement is computed in the following manner:

1. In determining the average monthly earnings during employment a dual computation is necessary for all employees with service prior to 1948. The base salary as of January 5, 1948, is used for all months of creditable service prior to that date. The actual base salary is used for all months of creditable service after January 5, 1948, exclusive of earnings for temporary or part-time employment, earnings after age 70, and overtime pay;

2. Multiply the average monthly earnings as determined in (1) above by 2 1/5 per cent for each year of service up to 25 years plus 1 1/5 per cent for each year of service over 25 years. This gives the gross monthly pension;
TABLE VII
CAROLINA POWER & LIGHT COMPANY

SUMMARY OF TRANSACTIONS OF RETIREMENT PLAN TRUST FUND
DURING 1958

1. Balance in Fund on January 1, 1958 $4,700,987.46
2. Contributions Received $556,157.36
3. Earnings of Fund (line 10e) 179,315.24
4. Gain on Sale of Securities 1,563.86
5. Unrealized Gain in Market Value of Stocks Held 567,947.66
6. Total (2 plus 3 plus 4 plus 5) 1,304,984.12
7. Pensions Paid 95,662.99
8. Expenses of Administration 7,619.68
9. Balance in Fund on December 31, 1958 (1 plus 6 minus 7 minus 8) $5,902,688.91

ANALYSIS OF EARNINGS DURING YEAR

10. Interest and Dividends
    (a) Collected During Year $173,331.76
    (b) Accrued but Unpaid at End of Year 43,699.61
    (c) Accrued at Purchase 2,702.97
    (d) Accrued but Unpaid at Beginning of Year 35,013.16
    (e) Interest and Dividends Earned
        (a plus b minus c minus d) $179,315.24

### TABLE VIII

**CAROLINA POWER & LIGHT COMPANY**

**ASSETS AND LIABILITIES OF RETIREMENT PLAN ON DECEMBER 31, 1958**

#### ASSETS

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$(13,376.58)</td>
</tr>
<tr>
<td>Accrued but Unpaid Interest</td>
<td>43,699.61</td>
</tr>
<tr>
<td>Bonds (at Book Value)</td>
<td></td>
</tr>
<tr>
<td>U. S. Government Obligations</td>
<td>$386,417.40</td>
</tr>
<tr>
<td>Public Utility Bonds</td>
<td>1,471,093.92</td>
</tr>
<tr>
<td>Railroad Bonds</td>
<td>160,153.27</td>
</tr>
<tr>
<td>Industrial and Miscellaneous Bonds</td>
<td>1,528,314.84</td>
</tr>
<tr>
<td><strong>Total Bonds</strong></td>
<td><strong>3,545,979.43</strong></td>
</tr>
<tr>
<td>Preferred Stocks (at Market Value)</td>
<td>162,450.00</td>
</tr>
<tr>
<td>Common Stocks (at Market Value)</td>
<td><strong>2,163,936.45</strong></td>
</tr>
<tr>
<td><strong>Total Present Assets</strong></td>
<td><strong>$5,902,688.91</strong></td>
</tr>
<tr>
<td>Unfunded Liability</td>
<td><strong>1,363,911.09</strong></td>
</tr>
<tr>
<td><strong>Total Accrued Assets on December 31, 1958</strong></td>
<td><strong>$7,266,600.00</strong></td>
</tr>
</tbody>
</table>

#### LIABILITIES

<table>
<thead>
<tr>
<th>Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve for Pensions Payable to Retired Members</td>
<td>$1,022,562.00</td>
</tr>
<tr>
<td>Reserve for Pensions Accrued to Active Members</td>
<td>6,244,038.00</td>
</tr>
<tr>
<td><strong>Total Accrued Liabilities on December 31, 1958</strong></td>
<td><strong>$7,266,600.00</strong></td>
</tr>
</tbody>
</table>

**Source:** Actuarial Report Rendered to Carolina Power and Light Company Covering the Fiscal Year of 1958.
(3) From the gross monthly pension as determined in (2) above deduct 65 per cent of the primary Social Security benefits. For a former employee of the Tide Water Power Company, a company that was merged with and into the Company in 1952, now covered under this plan, a deduction must also be made for benefits bought for that employee by Tide Water under its plan prior to the date of merger. The resultant answer is the amount of benefit to be paid monthly by the trustee to the retired employee until his death.

A hypothetical case will be presented to indicate not only the application of the benefit formula as pertains to an individual's benefit but also to point up a part of the problem faced by the actuary in estimating the annual contribution necessary to provide the benefits promised by the Company. The illustrative case is as follows: Mr. X was born on December 2, 1890. He was employed by the Company on November 1, 1925, and was retired January 1, 1960. His base monthly salary on January 5, 1948, amounted to $325. Total actual basic earnings from January 1, 1948, to retirement amounted to $57,600.

With the foregoing assumptions about Mr. X, a computation may be made to arrive at the net monthly pension payable to him by the trustee of the Plan. The application of the benefit formula is indicated in the figures that follow:
Salary credit for service before 1948 ........ $ 86,450.00
Salary credit for service after January 1, 1948 ... 57,600.00
$144,050.00

Total service to retirement .................... 410 months

Average monthly earnings ....................... $ 351.34

Percentage for service:
25 years X 2 1/5% ....... 55%
91/6 years X 1 1/5% ..... 11%
66%

Gross monthly pension equals 66% X $351.34 .... $ 231.88
Primary Social Security Benefit (assumed) ....... 119.00
Sixty-five per cent of Primary Social Security 
Benefit ........................................ 77.35
Net monthly pension from Plan ................. $ 154.53

Contingent Beneficiary and Ten Year Certain options are provided in the plan. Under such options monthly benefits are actuarially reduced to fit each case. These options will not be covered in this study as they do not affect materially the overall financing and accounting aspects of the plan.

Pertinent Trust Agreement Provisions--The original Trust Agreement between the Company and the Wachovia Bank and Trust Company was entered into September 1, 1944, with respect to the Plan as it then became effective. This original Trust Agreement was cancelled and annulled as of June 1, 1950, and a new Trust Agreement was entered into whereby the funds of the Plan are administered by the Wachovia Bank and Trust Company. This latter Trust Agreement is in effect at this time, June, 1959. Certain provisions of this agreement that have particular significance from an accounting and
financing standpoint will be examined.

A portion of Section 2 of the Trust Agreement provides that at no time, prior to satisfaction of all liabilities under the Plan, shall any part of the corpus or income of the Fund be used for or diverted to purposes other than the uses and purposes set forth in the Plan. This provision is in direct accord with one of the requirements for qualification as contained in Section 401 (a) (2) of the Internal Revenue Code.

Section 3 of the Trust Agreement provides in part that it is the duty of the Trustee to hold, to invest and to reinvest the Fund. This Section further specifies that the Trustee is to pay moneys to or on the order of the Retirement Board provided for in the Plan, including, when the Retirement Board shall so order, payments to eligible employees. The Trustee shall not be responsible for the adequacy of the Fund to meet and discharge retirement benefits and other liabilities under the Plan.

Stipulations concerning the types of securities permitted for investment purposes is contained in Section 4 of the Trust Agreement. Fund assets may be invested in securities of the following types: common stocks, preferred stock, bonds, mortgages, or real or personal property (including securities of the Company), as shall, from time to time, be approved by the Trust Investment Committee. A restriction is imposed on the amount of securities of the Carolina Power and Light Company that may be held at any one time in the Fund. The total investment in stock and other securities of the Company shall
not exceed 30 per cent of the book value of all securities held in the
Trust and that the total investment in the Common Stock of the
Company shall not exceed 10 per cent of the book value of all
securities held in the Trust. Figure 1 on the following page indicates
that in 1958 only 6 per cent of the market value of the Fund invest-
ments was in Carolina Power and Light Common. Using book value,
as prescribed by the Trust Agreement, this percentage is only 3.6 as
compared with the limitation of 10 per cent. Earlier years show even
a smaller proportion of the Fund in the Company common stock.
Figure 1 also indicates that the total securities of the Company held
by the Trust is well within the 30 per cent maximum as prescribed by
the Trust Agreement. A few percentage comparisons will serve to
point up the difference in the relatives based on book value and on
market value. The book value of the Carolina Power and Light
Company Common stock held by the Fund on December 31, 1958,
amounted to $175,637.86. The book value of total assets of the Fund
on December 31, 1958, amounted to $4,927,172.78. In this case 3.6
per cent of the total assets of the Fund is in the Company common
stock. On December 31, 1958, the market value of the Company
common stock in the Fund amounted to $343,476.25. On the market
value basis the total assets of the Fund on December 31, 1958,
amounted to $5,659,683.68. Using the latter figures it is seen that
6.1 per cent of the Fund is represented by the Company common stock.
Based on book value figures 4.4 per cent of the Fund is represented
CAROLINA POWER & LIGHT COMPANY

PENSION TRUST FUND INVESTMENTS (MARKET VALUE)

PERCENT INVESTED BY CLASS OF INVESTMENT

LEGEND

- CP&L Common Stock
- CP&L Preferred Stock
- Other Common Stock
- CP&L Bonds
- Other Bonds

Figure 1
by common stock and bonds of the Company. If market values of the
Company common stock and bonds is used for the computation, 6.7
per cent of the Fund is represented by the Company's securities on
December 31, 1958. On December 31, 1958, all common stock make
up 23.8 per cent of the Fund based on book value. On this same date
using market value of the common stock, 38.2 per cent of the total
Fund is represented by common stock.

Figure 2 on the following page presents the market value of the
Fund dollars invested in the four types of securities for the years 1954
through 1958. For comparison purposes Figure 3 is presented to re-
fect the composition of corporate Pension Funds on a national basis.
This latter Figure was contained in Statistical Series Release No. 1605
of the Securities and Exchange Commission on May 26, 1959. The
survey by the Securities and Exchange Commission does not include
funds administered by insurance companies and unions, and funds of
non-profit organizations. The growth and composition of the Company
Fund parallels very closely the national picture as shown by the
graphic presentation prepared by the Securities and Exchange Com-
mission. In the Securities and Exchange Commission survey it is
noted that Common stock investments accounted for 27 per cent of
the pension funds, based on book values, at the end of 1958. In
1951 only 12 per cent of the total was accounted for by investment
in Common stock. Based on market values at the end of 1958,
common stock investments comprised 39 per cent of the total fund
CAROLINA POWER & LIGHT COMPANY

PENSION TRUST FUND INVESTMENTS (MARKET VALUE)

Figure 2

Figure 3
assets. An inspection of Figure 1 shows that slightly over 38 per cent of the fund assets (at market value) of the Fund of the Company is represented by the common stock of the Company and other corporations' common stock.

Section 7 of the Trust Agreement relieves the Trustee from liability in the making, retention, or sale of any investment or reinvestment made by it as provided in the Trust Agreement or for any loss or diminution of the Fund, except due to its own negligence, willful misconduct, or lack of good faith.

The final section of the Trust Agreement to be considered in this particular study is Section 8 which deals with record keeping. The Trustee is required to keep accurate and detailed accounts of all investments, receipts, disbursements and other transactions under the Trust Agreement. All accounts, books and records relating thereto shall be open to inspection and audit at all reasonable times by any person designated by the Retirement Board. Within ninety (90) days following the close of each fiscal year, the Trustee is required to file with the Retirement Board a written account setting forth all investments, receipts, disbursements and other transactions effected by it during such fiscal period. On the following page is Table IX illustrating the Summary of Account provided by the Trustee in compliance with the provision of the Trust Agreement cited immediately above. In addition to this concise Summary Report a detailed listing of all activities of the Trust for the particular fiscal period is provided by the Trustee.
### Table IX

**Summary of Account**

**Employees' Trust**

For Accounting Period Ending Close of Business ______, 19 __.

<table>
<thead>
<tr>
<th>LINE</th>
<th>ITEMS</th>
<th>PRINCIPAL</th>
<th>INCOME</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Securities at Market Value</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>2</td>
<td>Cash</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Total Value of Assets At Close of This Accounting Period</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>4</td>
<td>Total Value of Assets At Close of Last Previous Accounting Period</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td>Additions as Follows:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Contributions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Less Distributions to Beneficiaries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Sub-Total Above Net (Line 4 plus 5 less 6)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>8</td>
<td>Net Profit Received on Assets Disposed of</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>9</td>
<td>Net Increase in Market Value of Assets Held</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Gross Income Received</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Sub-Total Above Profit, Increase and Income (Line 8 plus 9 plus 10)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td></td>
<td>Deductions as Follows:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Accrued Interest Paid on Purchases</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>13</td>
<td>Expenses of Administration Paid</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Sub-Total Above Deductions (Line 12 plus 13)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>15</td>
<td>Net Increase (Line 11 less 14)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>16</td>
<td>Sub-Total Above Assets (Line 7 plus 15)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>17</td>
<td>Transfers From Income to Principal</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Total Value of Assets at Close of This Accounting Period (Line 3)</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

Source: Trust Department, Wachovia Bank and Trust Company, Raleigh North Carolina Branch.
Function of the Actuary—An independent Actuary is employed by the Company to render an annual report to be used by the Company as a basis for making the monthly contributions to the Trustee for the Fund. In the Actuary's report covering the calendar year of 1958 twelve tables were included covering experience under the Plan during the year.

These twelve tables covered the following elements:

I  Distribution of Active Members on December 31, 1958 by Sex and Year of Entry.

II Distribution of Withdrawals, Excluding Deaths, During 1958 by Sex and Year of Entry.

III Distribution of Active Members on December 31, 1958 by Sex and Age at Entry.

IV Distribution of Withdrawals, Excluding Deaths, During 1958 by Sex and Age at Entry.

V Distribution of Active Members on December 31, 1958 by Sex and Attained Age.

VI Distribution of Withdrawals, Excluding Deaths, During 1958 by Sex and Attained Age.

VII List of Members Who Were Active on January 1, 1959 and Whose Normal Retirement Date Falls on or Before July 1, 1960.

VIII Distribution of Pensions Payable to Retired Members on January 1, 1959 by Sex and Attained Age.

IX Changes in Number of Active Members During 1958.

X Statement of Reserves Released on Death Together With Expected Reserve Releases.


XII Summary of Transactions of Trust Fund During 1958.
Tables XI and XII on the Actuary's report, as listed above, are the most pertinent to this particular case study. These tables have been reproduced and are included in this study as Tables VII and VIII immediately following the Plan Administration discussion.

In the report from the Actuary it was stated that the liabilities (shown in Table XI of the Actuary's report) and costs were computed on the basis of the 1949 Annuity Table for Men, set up one year for men and set back four years for women, with interest assumed to accrue at the rate of 3 per cent per annum. The report further states that it is assumed that men, on the average, will retire at age 67 and that women will retire at age 65. Over the four year period, 1955-1958, this latter assumption has worked out satisfactorily, with an average retirement age for men (weighted by benefits paid) of 67.2 years.

Integration With Social Security Benefits--The Plan is integrated with the Social Security benefits. In January, 1958, the plan was amended to increase benefits by reducing the deduction for Social Security benefits from 100 per cent of Primary Social Security benefits to 70 per cent of such benefits. The impact of this thirty per cent reduction in one element of the benefit formula is brought out very clearly by note 8 to the financial statements included on page 13 of a Prospectus of the Company, dated March 18, 1958. Information extracted from this part of the Prospectus is contained in the following discussion. In 1957 the current and past service pension contributions charged to expenses for the year amounted to $455,794. Of the total
expense reported for the Plan $46,777 represented past service contributions. On December 31, 1956, the Actuary's Report indicated that approximately $575,178 was necessary to fund the past service cost. The amendment of the Plan referred to in this paragraph would have the effect of increasing the unfunded past service liability approximately $1,500,000 and the current service contribution approximately $73,000.

As was illustrated in the hypothetical case on page 148 of this study, sixty-five per cent of the Primary Social Security benefit is deducted from the gross monthly pension to determine the net monthly pension from the Company Plan. In a 1959 amendment to the Plan the benefits to be paid to the employees on retirement were increased by decreasing the deduction item from the gross monthly pension figure. This reduction of the negative item in the formula was effected by changing the application rate of Primary Social Security benefits from seventy per cent to sixty-five per cent. The amendment was made to restore to retired employees the increase in Social Security benefits that became effective on January 1, 1959.

Table VII in this study shows that contributions of $556,157.36 were received by the Trustee of the Fund from the Company in 1958. This total contribution is approximately $100,000 more than the amount contributed by the Company in 1957. Several factors enter into the actuarial computation of the amount of contribution required each year to adequately fund the Plan. It is not to be assumed necessarily that the entire increase in the total contribution in 1958 as compared
with the contribution in 1957 was the result of the amendment to the benefit formula referred to above. The increase in one year of approximately 25 per cent in the total amount of the contribution covering a fiscal year is significant. If there has not been a significant change in the number of employees and/or the rates of pay, it is a good indication that the increased cost to the Company was due principally to the amendment to the benefit formula.

The extra benefit that a husband or a wife of an employee may receive from Social Security upon reaching age 65 in no way affects the amount that the retired employee will be paid under the Company Plan.

**Disclosure of the Plan in the Financial Statements**--On the Asset side of the Balance Sheet of the Company there is no indication of a Fund being accumulated for the payment of pensions to employees. The accounting treatment accorded the monthly contributions to the Trustee of the Fund follows the same principle as a revenue charge for salaries. A relatively small amount of the contribution made each year is capitalized. The capitalization of a part of the pension contribution occurs in connection with the construction payroll. The total pension cost in 1958 amounted to approximately 5 per cent of the total payroll. Construction payroll was loaded to the extent of approximately 4 per cent in 1958. For capitalization purposes this item amounted to approximately $72,000. On the balance sheet presented in the Annual Report for 1958 the amount capitalized on
construction work in progress is included in the figure representing the Electric Utility Plant (at original cost), the initial asset classification. The amount capitalized in connection with the payroll for dismantling certain plant items is included under the Deferred Debits heading as a part of Retirement Work in Progress. This latter item will ultimately be transferred to the Depreciation Reserve.

The obligation of the Company for unfunded past service liability is reflected in the Notes to Financial Statements. Note 4, page 21 of the 1958 Annual Report, indicates that the amount of the unfunded past service liability at December 31, 1958, was approximately $1,300,000.

With the exception of the amount capitalized, the contribution for both past service cost and current service cost is reflected directly in the Statement of Income. The specific section of the Statement of Income in which the item of pension cost is included in "Other Operation" under the general classification of Operating Expenses. The total contributions for 1958 amounted to $556,157 of which $114,500 represented past service contributions.

Summary—The primary objective of the material presented in the pages of this case study is to point out the practical application of the procedures incident to the operation of a medium sized employee pension plan. The Carolina Power and Light Company Plan offers a typical example of a non-contributory, trustee type plan. The internal procedural routine of administering a plan will undoubtedly vary from company to company. The basic requisites of qualification, funding,
and statement reporting are carried through in much the same manner in all well organized plans.

The Carolina Power and Light Company has complied with all requirements of the Internal Revenue Code in regard to qualification of the trust and the exemption from tax of the income of the trust. The contributions to the trust, within limits as specified by the Code, are deductible for income tax purposes.

The accounting treatment accorded the past service cost by the Company follows the recommendations contained in Accounting Research Bulletin No. 47 of the American Institute of Certified Public Accountants. Disclosures of pertinent Plan costs including the balance of the estimated unfunded past service cost obligation have been made in the notes to the financial statements. Changes in the provisions of the Plan that had a material effect on the financial reporting have been referred to in the Annual Reports of the Company at the appropriate times.

Although the Plan of the Company is comprehensive and complete in its structure and operation, the communication of the provisions of the Plan to the employees has been accomplished with a minimum of technical language. The Retirement Board offers the employee an opportunity to discuss points in the plan that may not be clearly understood. The personal attention given by the group of seven men on the Retirement Board to the individual employee before retirement, at the time of retirement, and after his retirement means much in good public relations for the Company.
CHAPTER VI

ACCOUNTING AND ADMINISTRATION REQUIREMENTS OF DEFERRED PROFIT SHARING PLANS

In an earlier chapter of this study the emergence and growth of the deferred-benefit type of employee benefit plan was set forth. The tax advantages afforded a business operating a qualified pension or profit sharing plan of the type included in the discussion in this study have been covered in detail in Chapter IV. The details of the above mentioned factors which are related to accounting for deferred profit sharing plans will not be restated in this chapter. A brief summary of the tax advantages of a qualified profit sharing plan is included at this point to indicate some of the important considerations that management, which includes the executive level accountant, should maintain before it in decision making. A summary of these advantages is as follows:

(1) the Code provisions allow the employers to deduct the contributions to such plans on a current basis; (2) the depository of the funds of the plan, the trust, is exempt from all Federal income taxes; and (3) the taxing of the participant's share of the trust accumulation is delayed until he actually or constructively receives the benefits.

Although this third advantage does not in any way affect the internal operation of the plan from the employer's standpoint, it may be a
significant factor in the ultimate success of the plan. If the individual employee is aware of the possibility of a capital-gain treatment of his retirement benefit, an added incentive is present for increased personal productivity. In this latter respect the employer is vitally concerned.

Throughout this study the underlying concept has been that the plan, either pension or profit sharing, is of the deferred-benefit type and the intention of the business is to qualify the plan and keep it qualified. In order to achieve this objective there are certain requirements that must be complied with. Four of these principal requirements in a condensed form are the following: (1) the written plan, including a trust agreement, must provide a definite formula for allocation of the contributions among participant accounts of those employees included in the plan; (2) the plan must contain definite rules concerning the manner and time that distribution of benefits will be made from the trust to the employees; (3) discrimination in favor of highly paid employees who are officers, stockholders or supervisors is prohibited; and (4) the plan and trust must be for the exclusive benefit of the employees, and the trust agreement must be irrevocable.

A major change brought about by the Treasury Regulations under the 1954 Code concerns the determination of the amount of profits to be shared. In 1956 the Treasury amended its Regulations to remove a former requirement that a profit sharing plan must provide a definite formula for determining the profits to be shared.¹ This change by

₁Reg. Sec. 1.401-1(b)(1)(ii); T.D. 6189, IRB 1956-29, p. 58.
the Treasury does not preclude an employer from including a definite formula for determining contributions in the provisions of the plan. An alternative to the strict, definite formula procedure is the inclusion in the contribution formula provision of the plan a qualifying clause permitting the Board of Directors to adjust the amount or method of contribution in any year. The final choice would be to have an indeterminate formula whereby the amount to be contributed each year will be determined annually by the Board or executive group. Regardless of the formula adopted by the business, contributions must be made on more than an occasional basis. The Treasury has made it clear on this point by saying that if the plan does not result in "recurring and substantial contributions out of profits" it is not a qualified profit sharing plan.\(^2\)

Table X appearing on the following page presents data to show in selected cases the type of plan being employed and the size of the company in which the particular type plan is in operation. The data contained in this table were obtained by Mr. Flippo through questionnaires from 350 companies in the United States having profit sharing plans. As explained by Mr. Flippo in a footnote to the original Table, 9 questionnaires out of the 350 replies were deficient in answering this part of the survey, therefore only 341 companies are shown in the Table. An inspection of the Table information shows

\(^2\)Reg. Sec. 1.401-1(b)(2).
TABLE X
NUMBER AND PERCENTAGE DISTRIBUTION OF COMPANIES, BY SIZE, BY TYPE OF PROFIT SHARING PLAN

<table>
<thead>
<tr>
<th>Size of Company (Number of Employees)</th>
<th>Type of Plan</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current</td>
<td>Deferred</td>
<td>Combination</td>
<td>Plan</td>
<td>Total</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>--------------</td>
<td>----------</td>
<td>--------------</td>
<td>------</td>
<td>-------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under 250</td>
<td>120</td>
<td>44</td>
<td>14</td>
<td></td>
<td>178</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>250-499</td>
<td>31</td>
<td>22</td>
<td>5</td>
<td></td>
<td>58</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>500-999</td>
<td>8</td>
<td>31</td>
<td>5</td>
<td></td>
<td>44</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1,000-4,999</td>
<td>18</td>
<td>22</td>
<td>6</td>
<td></td>
<td>46</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5,000-19,999</td>
<td>5</td>
<td>7</td>
<td>1</td>
<td></td>
<td>13</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20,000 and Over</td>
<td>1</td>
<td>1</td>
<td></td>
<td></td>
<td>2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>183</td>
<td>127</td>
<td>31</td>
<td></td>
<td>341</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Percentage Distribution

<table>
<thead>
<tr>
<th>Size of Company (Number of Employees)</th>
<th>Percentage</th>
<th>Current Distribution</th>
<th>Deferred Distribution</th>
<th>Combination Plan</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under 250</td>
<td>67.4</td>
<td>24.7</td>
<td>7.9</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>250-499</td>
<td>53.5</td>
<td>37.9</td>
<td>8.6</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>500-999</td>
<td>18.2</td>
<td>70.5</td>
<td>11.3</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>1,000-4,999</td>
<td>39.1</td>
<td>47.8</td>
<td>13.1</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>5,000-19,999</td>
<td>38.5</td>
<td>53.8</td>
<td>7.7</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>20,000 and Over</td>
<td>50.0</td>
<td>50.0</td>
<td>100.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>53.7</td>
<td>37.2</td>
<td>9.1</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Edwin B. Flippo, Profit Sharing in American Business (Columbus, Ohio: Bureau of Business Research, College of Commerce and Administration, The Ohio State University, 1954), Table 1, p. 30.
that the concentration in the number and in the percentage of the current
distribution type plan is in the companies with the smallest number of
employees. It is possible that a comparable table prepared today
would show results moving more in the direction of the deferred dis-
tribution type of plan. The full impact of the changes made in the 1954
Code in respect to profit sharing plans had not been realized when the
data for Table X were accumulated.

SELECTED BASIC PLAN CONSIDERATIONS

Initial Planning Decisions—Each employer who is contemplating
the establishment of some type of employee benefit plan of the deferred-
benefit type is anxious to make as wise a decision as possible in the
plan selection. The answer to the question of the type of plan to be
adopted may not be obtained easily. In certain cases the decision
may require lengthy discussions involving past business performance
as indicated by the financial statements. The reason for this critical
analysis of past operating results and the projection of future earn-
ings is clear when the magnitude of the fund that may be accumulated
in the future is considered. It is not impossible to find that the size
of a profit sharing fund of the deferred-benefit type is larger in dollar
amount than the total assets of the business that created it. One of
the principal reasons for the rapid growth of a fund of this type is the
tax free earnings. Assuming the investment of the funds in common
stocks, it is easily seen that a controlling interest might be acquired
in other corporations. Although this latter situation may not offer any significant advantages under certain conditions, it could in other cases enable a corporation to insure a source of supply of goods or in other ways strengthen trade relationships.

Assuming the business elects to establish a profit sharing plan of the deferred-benefit type or a combination of that type plan and a pension plan, the details of putting the plan into operation must be worked out. One of the major decisions required is the determination of the types of benefits to be provided by the plan.

Types of Benefits That May be Provided—Some of the favorable, tangible results that a business may experience from an effective profit sharing plan can be the changes in the following items: a reduction in unit cost; less spoilage and waste; reduced absenteeism and turnover; and, increased output. Other results of a more intangible nature may also accrue to the business as a result of a more stable and better satisfied group of employees. In addition to retirement income, the various benefits that may be provided in a deferred-benefit plan of this type can provide much of the answer to the very favorable overall effect of the inclusion of this type item in the business program.

From a strictly monetary standpoint the key provision of a deferred profit sharing plan is the providing of retirement income to the employee. This payment may take the form of a lump sum cash payment, or the employee may elect to receive monthly payments from an annuity purchased with his share of the trust fund at the date of his retirement.
Death and disability benefits may be included as provisions in the plan. If an employee dies during employment and a death benefit provision is included in the plan, his beneficiary can receive the deceased participant's share of the trust fund. A provision of this type may be viewed as a type of insurance that is without cost to the individual sharing in the fund. Payments may also be made to an employee in case of an accident occurring while he is performing his duties in the business.

Some plans include a provision for sick pay. It may be provided that this type payment will be made only in cases of lengthy illness periods. A provision of this type may have a healthy psychological effect on the employee especially if he has heavy financial responsibilities.

An employee may be faced with an unusual financial strain in his personal affairs. He may be unable to give sufficient security to warrant a commercial loan from a recognized lending institution. The plan may contain a provision permitting the employee to apply for the withdrawal of a part of his share of the fund. If the withdrawal is granted, the immediate help rendered the employee by the plan should serve to strengthen his loyalty to the firm.

Severance pay may be included as a part of the plan. The employee's share of the fund may serve as a type of emergency buffer after employment severance and before relocating.

The profit sharing principle may be added to a pension plan.
The advantages of both type plans are enjoyed by the employee when a business is able to incorporate both of them into the retirement program.

With each additional benefit provision that is included in any employee benefit plan the requirements imposed on the accounting department increase to some degree. The increased work load and responsibility may be more routine and internal system problems than decision making. In other unusual or more complex plan provision content the accountant may be called on to exercise his technical knowledge in outlining procedures that follow accepted principles and will yield results permitting accurate statement presentation.

The Contribution Formula—In selecting a profit sharing plan all parties concerned should be aware of the fact that the inherent characteristics of this type plan preclude the determination in advance of the exact amount of benefit to be provided the employee at retirement. No fixed commitment in dollar amount is imposed on the employer. Regardless of the formula used by the business in determining contributions to the trust, the profit variation from period to period is a material determining factor in the eventual benefits a retired employee will receive. The services of neither an actuary nor an insurance company are necessary in the formula determination or in the operation of the plan. A well qualified trustee is essential to the successful operations of the function of the trust. From an administrative standpoint the past service of employees does not offer as much of a problem in the formula computations under a deferred-benefit profit sharing plan
as it occasions in the determination of employer contributions under a pension plan. If past service is not recognized in the composition of the allocation formula, the retirement benefits will be smaller for the employee who is older and is approaching retirement age at the time of the plan inception. Under a pension plan, compensation can be made for entrance age and past service.

If a business selects a definite profit sharing formula, it breaks down into two basic parts:

(1) A definition of "profits" for purposes of the plan, and

(2) A provision specifying what part of these "profits" is to be contributed to the trust under the plan.

As a collateral matter, a provision specifying whether or not the annual contribution shall be reduced by forfeitures resulting from termination of employment of members will serve to augment (2) above.  

The usage of the term "profit" is so varied that a definition of it spelled out in terms that leave no doubt as to what is intended is essential in a benefit formula. "The excess of revenue, proceeds, or selling price over related costs" is a definition of profit.  

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in many cases of a general application. In order to define "profit" for use in a formula computation a prefix and numerous suffixes of limiting or qualifying type may be required.

The maximum amount of profit to be contributed to the trust by the employer may be influenced or even determined by the amount of the contribution permitted for deduction in tax computation under the 1954 Code. In any event, the part of the profit to be contributed to the trust under a definite profit sharing formula must be set forth clearly in the plan.

The plan must indicate what will happen to the amount of shares of the fund arising from the employer's contribution that are forfeited by an employee who withdraws from employment without having a vested interest in the plan. The more generally followed alternative is for the shares of the remaining participants of the fund to be increased by the amount of the forfeited shares. This allocation to the accounts of remaining participants must be done on a nondiscriminatory basis. The other choice is for the employer to apply this forfeited amount against subsequent contributions. The selection by the employer of the particular alternative is a point that will affect both the internal administration and accounting for the plan as well as the amount of benefit ultimately to be received by each participant.

Extracts of certain information from four corporate profit sharing plans are shown in Table XI on the following page. This information was taken from the compilation of profit sharing data on 300 companies
## TABLE XI

**UNIVERSAL OR MAJORITY ELIGIBILITY**

**Deferred Plans**

<table>
<thead>
<tr>
<th>Serial Number of Plan</th>
<th>Number of Employees</th>
<th>Employer Contribution Before or After Taxes</th>
<th>Allocation to Individuals</th>
<th>Vesting</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>B</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>125</td>
<td>17,500</td>
<td>8%, but company contr. must not reduce net earnings below 7% of capital or exceed tax-deductible maximum. Company assumes various fringe costs previously paid by employees.</td>
<td>B 1 unit for each $100 of total compensation to $50,000, 1 unit for each year of service. Forfeitures allocated like company contr.</td>
<td>4% per year of service. Misconduct clause.</td>
</tr>
<tr>
<td>128</td>
<td>14,500</td>
<td>Profit in $ millions</td>
<td>B Acc. to base pay. Forfeitures acc. to credit balances.</td>
<td>10% after 5 years of participation, then 15% per year to 100% after 11.</td>
</tr>
<tr>
<td>130</td>
<td>12,000</td>
<td>After 6% of net worth, 10%, up to 10% of participants' pay.</td>
<td>B Acc. to salary.</td>
<td>Full immediate vesting.</td>
</tr>
<tr>
<td>162</td>
<td>3,000</td>
<td>10%, up to 15% of participants' pay</td>
<td>B 1 pt. each $ of employee contrib. 1 pt. each year of service to 15. 2 pts. ea. year over 15. Forfeitures treated as fund earnings.</td>
<td>20% for first 5 years of service, then 5% per year to 100% after 20 years.</td>
</tr>
</tbody>
</table>

as published by the Profit Sharing Research Foundation. The companies with the Deferred Plans and Majority Eligibility ranged in size from 130,000 employees to 10 employees. As noted in the information contained in the Table, the employer contribution in each of the four cases is different. This points up the latitude open to management in establishing a formula. It may be an indication in some cases that the formula resulted from bargaining between management and the union.

Although the Treasury does not now require a definite formula for determining contributions, it does require a definite formula for allocating contributions among eligible employees. Columns H and M of Table XI contain representative provisions of plans illustrating the requirements in effect at the present time under the 1954 Code concerning the contribution and the allocation of the contribution. An analysis of the various plans covered in the survey referred to above shows considerable variations in the methods of allocation to individuals even though all allocations were made on a definite formula stated in the plan. Plan 125 in Table XI contains a provision for allocation to individuals that has received wide-spread adoption. Vesting provisions as shown by column N of Table XI will be considered in the paragraphs that follow.

Vesting--The term "vesting" is being used in this discussion to mean the individual plan participants' rights to credits becoming fixed or nonforfeitable. The length of service required of an individual employee by a particular employer before any vesting begins will vary
among employers. The business may be guided by the Code qualification requirement in establishing its vesting schedule. If the vesting right takes place "at some reasonable time," the plan meets this particular element of the overall nondiscriminatory requirement. Table XI indicates the variation in the vesting rights in the four plans illustrated. Full immediate vesting is provided in one of the cases shown. This immediate vesting provision is in the minority of the cases presented. "Most companies provide for some form of graduated vesting. Some cut the graduation off at, say, 50% and limit full vesting (100%) to termination of employment on account of retirement, disability, or death."\(^5\) Full vesting is required by the Internal Revenue Service if a plan is terminated or if the employer discontinues making contributions to the trust.

Portions of Table 28 appearing in Studies in Personnel Policy, No. 162, National Industrial Conference Board, Inc. have been included as Table XII in this study on the following page. Certain detailed listings of full vesting from 11 years through 35 years was omitted in the preparation of Table XII without the loss of important data pertinent to the present point of discussion. The concentration of vesting rights upon termination of employment occurs in the graduated full vesting. Almost 60 per cent of the 150 plans reviewed in the study by the National Industrial Conference Board contained a

\(^5\)G. Barron Mallory, op. cit., p. 140.
## TABLE XII

### VESTING RIGHTS UPON TERMINATION OF EMPLOYMENT

<table>
<thead>
<tr>
<th>Vesting Rights</th>
<th>No. of Plans</th>
<th>% of Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immediate vesting of full amount</td>
<td>32</td>
<td>21.5</td>
</tr>
<tr>
<td>Full vesting after:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 year</td>
<td>11</td>
<td>7.4</td>
</tr>
<tr>
<td>2 years</td>
<td>2a</td>
<td></td>
</tr>
<tr>
<td>3 years</td>
<td>2b</td>
<td></td>
</tr>
<tr>
<td>4 years</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>5 years</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>10 years</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>10 years as contributor, 15 years' service</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Graduated full vesting</td>
<td>89</td>
<td>59.7</td>
</tr>
<tr>
<td>Full vesting, 3 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>33 1/3% each year</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Full vesting, 4 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd year, 33 1/3%, increasing 33 1/3% each yr</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Full vesting, 5 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 year, 40%, increasing 20% each year</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Under 5 years, 50%</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>1 year, 10%; 2 years, 30%; 3 years 50%; 4 years 75%</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>1 year, 50%; increasing 10% each year</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Full vesting, 6 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 year, 50%, increasing 10% each year</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Full vesting, 7 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 years, 60%, increasing 10% each year</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Full vesting, 9 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 years, 12 1/2%, increasing 12 1/3% each yr</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Full vesting, 10 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10% each year</td>
<td>23</td>
<td></td>
</tr>
<tr>
<td>3 years, 12 1/2%, increasing 12 1/2% each yr</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>5 years, 20%, increasing 20% each year</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>5 years, 50%, increasing 10% each year</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>Full vesting, 11 years through 35 years omitted</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less than full vesting</td>
<td>6</td>
<td>4.0</td>
</tr>
<tr>
<td>Graduated on basis of age</td>
<td>3</td>
<td>2.0</td>
</tr>
<tr>
<td>Amount of vesting depends on cause of termination</td>
<td>6</td>
<td>4.0</td>
</tr>
<tr>
<td>No vesting</td>
<td>2</td>
<td>1.3</td>
</tr>
<tr>
<td>Not specified</td>
<td>1</td>
<td>0.7</td>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>150</td>
<td>100.0</td>
</tr>
</tbody>
</table>

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*In one company deduct share for preceding year
bIn one company deduct two preceding years

graduated full vesting provision. It is noted that within the graduated full vesting group the full vesting after ten years with a 10 per cent vesting each year provision accounted for approximately 25 per cent of this majority group. A sufficient amount of the original table is included in Table XII to indicate the diversity of provisions of the plans studied as pertains to the vesting rights of the individual participants. The fact that the Code does not specify an exact number of years as a vesting requirement may have resulted in the greater variety of vesting right provisions than would have been the case if a uniform rate or time period had been required.

Investment of Trust Funds—The size and complexity of the trust operation will afford some indication of the type of trustee that will be required in the proper administration of the trust. If permitted by the statutes and approved by internal business agreement, an individual may act as trustee. If an individual is selected for this responsibility, complete impartiality must be exhibited by that person in all transactions involving the trust. Assuming permanency of the profit sharing plan, the need for proficiency and continuing service of a trustee are basic requisites for an efficiently administered plan. The certainty of reduced activity and ultimately the retirement of a particular individual may weigh heavily in favor of the selection of a corporate trustee. Under certain conditions there is no alternative to the selection of a well qualified and well equipped corporate trustee. Within the business a committee may perform the function of a trustee,
and a custodian, generally a bank, can perform the operating duties of the trust. This section of the study is concerned with the operations of the trust to a much greater degree than with the formation or composition of the trust itself.

The Code provisions do not restrict to any significant extent the type of investments that may be made from the trust. The Code requires that at all times the trust must be operated for the benefit of the employee participants. As has been pointed out earlier in this study, certain income of the trust may be subject to tax depending on the source of the income. Engaging in "prohibited transactions" by the trust, as outlined on page 85 of this study, will result in the loss of tax exempt status to the trust. Specific requirements contained in Revenue Ruling 33 are included in the quotation that follows:

... a sale of securities to the trust may benefit the vendor in that it may have resulted in a profit to him, but essentially the purchase by the trustee must have been for the best interests of the trust; i.e., the cost must not exceed fair market value at time of purchase, a fair return commensurate with the prevailing rate should be provided, sufficient liquidity should be maintained so as to permit distributions in accordance with the terms of the plan, and the safeguards that a prudent investor would look to should exist. These essentials are equally applicable to the stock or securities of the employer.  

The routine investment of profit sharing trust funds in so called "blue chip securities" will be excluded from consideration in this discussion. The investment in the stock or obligations of the creator of

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6Revenue Ruling 33, 1953-1 CB 272.
the trust require careful appraisal of the immediate and long range
effect of such holdings. The Internal Revenue Service requires that
in cases of trust ownership of the company's own stock full disclosure
must be made of the reasons for such investment.

Certain specialized cases resulting from investments of the
profit sharing trust funds will be developed. A number of business
problems may be solved as a result of the purchase of the company's
own stock by the trust. Four situations in which the favorable effect
of the purchase of the company's own stock by the trust may be realized
are set forth in the following headings:

2. Transferring Ownership of Business.
3. Control of Business Through Profit-Sharing Trust.
4. Financing a Growing Corporation Through a Profit-
   Sharing Trust.

Some expansion of the individual situations referred to above
will indicate the indirect or auxiliary effects possible as a result of the
existence and application of the profit sharing trust funds in the cor-
poration's own stock.

In an effort to relieve the tax pressure that may be placed on the
estate of a deceased major stockholder in a closely held corporation,
an agreement can be made whereby the trust will purchase all or part
of the stock of the individual at his death. The result of the trust ful-
filling its part of this agreement will mean that the control of those

7 Tax Ideas Report, (Englewood Cliffs, New Jersey: Prentice-
shares of stock acquired is retained in the "family." The funds used to purchase these shares of stock were accumulated out of earnings before taxes. This is vastly different from those cases where the continuation of the business, if desired, must be accomplished through the accumulation of funds from earnings after taxes.

If an individual stockholder or group of stockholders wishes to dispose of their holdings in a corporation before death, certain alternatives are possible. The open market, even on an over the counter basis, usually will offer a ready means of disposing of the shares. This method of disposal of the stock may result in wide and diversified ownership with only a small portion of the stock being purchased by employees and other stockholders of the company. Another alternative is for the profit sharing trust to purchase the shares. The advantages under such circumstances are:

(a) The stock is purchased with money BEFORE taxes, rather than after taxes.
(b) The employee-beneficiaries receive the stock (and have the consequent incentive value in its ownership) in much the same manner as they would have had they purchased the stock directly, except that it is held in their trust accounts rather than in their personal accounts (and, thus, its earnings are not currently taxed to them).
(c) Under such an arrangement, distribution of part or all of the stock can be made to the employees at their retirement or their accounts can be liquidated on the basis of the actual cash value of their holdings.
(d) If desirable, provision can also be made for re-purchase of the stock by the trust at an employee's death or in case he desires to sell, thus assuring
its ultimate redistribution to the next employee generation.8

The third specialized case of the use of the funds of the profit sharing trust to retain the control of the business finds its principal applicability in a corporation of sufficient size to have its stock listed on an exchange. A continuing process of stock acquisition through open market or other means can result in the eventual effective control of the corporation being vested in the trust. In combination, the stock held by management and the stock held by the trust serve to form a voting bloc capable of internal management perpetuation.

The application of the principle of self financing is exhibited in the case of a profit sharing trust providing funds for the expansion of the company. The individual employee should recognize this particular procedure as a further strengthening of his position in his "own" business. If added financial success develops as a result of the expansion program, capital appreciation of the shares of stock is almost axiomatic. Depending upon the top income bracket of the company, the dollars provided for expansion through the profit sharing trust can be double or more the amount provided by comparable earnings on an after tax basis.

Table XIII on the following page shows that slightly over 40 per cent of the total assets in dollars of the 114 companies is invested in common stock. This investment in common stock is almost evenly

8Ibid., p. 7551.
TABLE XIII
TOTAL ASSETS IN 114 DEFERRED PROFIT SHARING TRUSTS, CLASSIFIED BY KINDS OF ASSETS AND SIZE OF FUND DOLLARS (IN THOUSANDS)

<table>
<thead>
<tr>
<th>Kind of Assets</th>
<th>Total Assets</th>
<th>Assets under $500</th>
<th>Assets $500 to $999</th>
<th>Assets $1,000 to $1,999</th>
<th>Assets $2,000 to $4,999</th>
<th>Assets $5,000 and over</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Cash and deposits</td>
<td>21,917</td>
<td>594</td>
<td>1,039</td>
<td>3,200</td>
<td>5,831</td>
<td>11,253</td>
</tr>
<tr>
<td>United States obligations</td>
<td>113,868</td>
<td>2,113</td>
<td>3,556</td>
<td>10,605</td>
<td>18,824</td>
<td>78,770</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>77,309</td>
<td>1,039</td>
<td>2,927</td>
<td>6,597</td>
<td>15,559</td>
<td>51,187</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>12,541</td>
<td>367</td>
<td>550</td>
<td>2,120</td>
<td>2,244</td>
<td>7,261</td>
</tr>
<tr>
<td>Common stock, own co.</td>
<td>86,157</td>
<td>635</td>
<td>2,122</td>
<td>2,089</td>
<td>12,998</td>
<td>68,312</td>
</tr>
<tr>
<td>Common stock, other co.</td>
<td>93,594</td>
<td>1,099</td>
<td>2,387</td>
<td>5,221</td>
<td>15,213</td>
<td>69,673</td>
</tr>
<tr>
<td>Other assets</td>
<td>39,846</td>
<td>379</td>
<td>1,223</td>
<td>1,964</td>
<td>6,584</td>
<td>29,697</td>
</tr>
<tr>
<td>Total assets</td>
<td>445,232</td>
<td>6,226</td>
<td>13,804</td>
<td>31,796</td>
<td>16,753</td>
<td>316,153</td>
</tr>
</tbody>
</table>

Number of companies: 114 26 19 21 25 23
Number of participants: 194,259 10,805\(^a\) 11,871\(^a\) 17,959\(^a\) 42,302\(^a\) 111,322\(^a\)

\(^a\)Number of participants not given in one company.

divided between the company's own stock and stock of outside companies. An analysis of the data used in preparing Figure 3, page 154 of this study, showed that 39 per cent of the assets of corporate pension funds at the end of 1958 was represented by common stocks. This latter percentage is based on the market value of securities at the close of 1958. The composition of the pension fund assets on a national basis and the composition of the profit sharing trust assets in the 114 selected companies revealed an almost identical percentage for common stock holdings. Although there may be more flexibility or freedom of selection of types of securities in the profit sharing trust than in the pension fund, the figures presented show that the investment pattern has held fairly constant through the two types of fund assets. United States obligations and corporate bonds account for approximately 43 per cent of the total profit sharing trust assets as recorded in Table XIII. The fixed value type investment still holds a prominent place in portfolios representing funds of independent groups for which a trustee is responsible.

Integration With Social Security Benefits—The same coverage requirements must be met for a qualified deferred-benefit plan of the profit sharing type that are required for a pension plan. Section 401(a) of the Code prescribes the requirements. Under section 401(a) (3)(B) the Commissioner is empowered to approve a profit sharing plan to include:

such employees as qualify under a classification set up by the employer and found by the Secretary or
his delegate not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees.\(^9\)

From the foregoing quotation it is clear that not all employees of the business have to be included in the plan for the trust to be qualified. Classifications may be established by the employer according to "wages." "Thus, a classification which excludes all employees whose entire remuneration constitutes "wages" under section 3121(a)(1), will not be considered discriminatory merely because of such exclusion."\(^10\) Section 3121(a)(1) refers to "wages" for purposes of the Federal Insurance Contribution Act. The employer is matching the contribution of the employee each year up to the maximum amount prescribed under the provisions of the Social Security Act as amended. The contribution made by the employer for his employee under Social Security is apparently one of the principal reasons for the non-discriminatory treatment that may be accorded a classification excluding "wages" personnel.

In the discussion that follows, reference will be made to the base figure of $4,200 for Social Security tax purposes. As of June 1, 1959, the Regulation 1.401-3 has not been revised to reflect the change in the social security tax base from $4,200 to $4,800, enacted


\(^10\)Reg. 1.401-3(e)(1).
by P.L. 85-840, effective with respect to tax years beginning after 1958.

The determination of the maximum limits applicable to a profit sharing plan, which excludes salary below $4,200 from the allocations formula, is somewhat complicated. Essentially, however, excess-benefit or integrated profit sharing plans are subject to the following restrictions:

1. The maximum, including any forfeitures that can be allocated to any employee in any year is 9 3/8 percent of the participating employee's covered compensation above $4,200. However, a minimum allocation of $60 may be made in any year allocations are made.

2. Allocations must generally be made on a straight ratio-of-salary basis and distribution of benefits can be made only at retirement or separation from service.

3. An employer can have no other plan involving integration (such as a pension plan with a Social Security offset) covering the same group of employees.\(^\text{11}\)

Other detailed conditions incident to the profit sharing plans that are integrated with social security will not be covered in this study. The primary emphasis is focused on those profit sharing plans that are designed for the rank-and-file employees. The accounting techniques to be discussed in the following section of this chapter are those of general applicability.

**PARTICIPANT ACCOUNTING REQUIREMENTS**

Unless the accounting department of a business provides the

\(^{11}\text{Tax Ideas Report, op. cit., p. 7542.}\)
financial information required in all types of internal and public reporting, its primary function is not being fulfilled. The adoption by a business of a deferred-benefit type of profit sharing plan imposes additional and specialized accounting techniques on the accounting department. In order to fulfill its function completely in connection with pertinent fund activities, accounting should do the following:

1. Provide the records necessary for making yearly reports required by the tax regulations.

2. Give the value of the entire fund on the dates specified by the terms of the plan for determining members' interest.

3. Furnish the investment committee with adequate information so that they can tell whether they are running the fund profitably.

4. Segregate employee contributions, if any, from company contributions.

5. Provide a full accounting of the fund whenever required.

6. Reallocate forfeitures to remaining members of the plan.12

Actuarial Computations vs. Participant Allocations—In earlier chapters attention was given to the demanding requirements of an actuarially sound pension plan. The choice of an insured pension plan or of a non-insured plan was presented with the accounting and financing features of each type developed in some detail. Although involved actuarial calculations are not required in the planning for and

12 Mallory, op. cit., p. 516.
the administration of a profit sharing plan, the determination of each employee's changing equity in the trust through detailed accounting records is exacting. An inherent characteristic of the deferred profit sharing type plan, uncertainty of the amount of the eventual distribution to each participant, emphasizes the need for constant review and adjustments to reflect changes in market value of securities in the trust. The use of the original cost of securities in determining the dollar value of the total units due a participant at the time of his withdrawal will generally prove unsatisfactory. The accounting problems involved in the adjustment of participants' accounts will be considered in its proper place in the periodic summary work. "Proper participant accounting under a profit-sharing plan requires more exacting accuracy than even the complex actuarial computations that go into a well-run pension plan."13

Basic Accounting Records to be Maintained--The type of trustee selected by the establishing business entity will determine to some extent at least the variety and design of the accounting records. If an individual is selected as the trustee, the records required may vary from those maintained if a corporate trustee is employed. Each company will tailor the records to fit into its own internal system. The application of the principle of machine accounting within a business is only one instance to be noted among many factors leading to literally hundreds of variations in accounting techniques.

A review of the journals, ledgers, and supporting documents that are utilized in the profit sharing financial record keeping and report preparation precedes the discussion of the specialized accounting requirements. At least two journals, as constructed in the generally accepted manner, are needed in the recording of the trust fund transactions. A cash receipts and disbursements record and a standard two column general journal will enable the individual trustee to record any transactions arising in connection with the trust activities. A combined journal may be used in cases where conditions justify it. The relatively small variety of types of transactions to be recorded in the trust operations permits the use of only a few journals with flexibility attaching to the use of these records. The key point in this connection is not to describe the physical arrangement or composition of the journals, but rather to indicate that an accounting record of the journal type should be provided for all entries involving both cash and non-cash trust transactions. If a corporate trustee is employed by a company, the journals referred to above would be maintained by the agency employed.

In terminology applied in a general accounting sense, a general ledger is required for the relatively small number of accounts needed to summarize fund transactions. If the number of plan participants is small and all of the records referred to above are maintained by the company, the detailed information of each member's equity may be maintained as a subdivision of the general ledger. In cases involving
the separation of some of the basic records between the company and
the corporate trustee, a subsidiary ledger of participants' accounts is
needed. This membership ledger is ordinarily maintained by the em-
ployer.

In addition to the journals and ledgers referred to above, certain
forms or exhibits peculiar to accounting for profit sharing are essential
to proper administration. Assuming the existence of an advisory com-
mittee to the trustee, a statement summarizing the cash position of the
fund at designated intervals is a guide for this committee in making
recommendations and decisions. The report may be prepared on a
monthly basis or at such times as designated in the plan provisions.
In essence this report is an itemized, chronological analysis of the
cash account of the fund.

An exhibit similar to the conventional balance sheet is prepared
to report the dollar value of the fund assets at a given date. A point
of difference in this report and a balance sheet as commonly con-
structed is the valuing of fund securities at market price without
regard to the relationship of the cost of these securities to their
current market price. The frequency of the preparation of this state-
ment by the trustee depends on the interval selected for adjusting the
unit value of the plan participants. The adjustment must take place
at least once a year to comply with a qualification requirement, thus
the report of asset values would be prepared at least once each fiscal
year.
The type balance sheet referred to above is supported by schedules providing detailed information about all trust fund transactions in securities during the designated period. Also included in the schedules is the listing of the balance of each security class as of the end of the period. From current information furnished to them, the advisory committee will be able to make comparisons with previous periods as regards the income earned on the securities and the market value of the securities on the respective dates.

A multi-column report of the working paper type is a convenient device for accumulating all the information necessary to determine per unit value at a designated date. The subsidiary participants' ledger is the source accounting record for the preparation of this working paper. The responsibility for the preparation of this material lies with the party maintaining the subsidiary ledger. All units paid to members during the year for retirement, death benefit, disability, etc. must be accounted for as reductions. If forfeitures are used to increase remaining participants unit, the increase due to this occurrence will be reflected indirectly on this working paper through per unit value increase.

Depending upon the internal system arrangement, a plan participant will be furnished either a statement of his account balance or an account book containing the information of the account activity. This information should be furnished the participant at least once a year, generally immediately after the fund valuation. The subsidiary
participants' ledger furnishes the information for the preparation of these notices.

Reports and Forms Required by Internal Revenue Service—Section 1.404(a)-2 of the Regulations prescribes the materials and schedules that are to be filed with the tax return. Points to be included in these schedules are the following: balance sheets that give details of the trust activities; the number of employees that came into the plan and went out of the plan within the designated period; and, the pay status and benefits of the plan participants.

Section 6033(a) of the Internal Revenue Code requires that an annual return be filed setting forth in detail the activities of the trust. Form 990-P is furnished for compliance with this Code provision. This report is due by the 15th day of the 5th month following the close of the trust's annual accounting period. If the trust received unrelated business income, it is required to file Form 990-T. By February 28th following each calendar year the trustee must file Forms 1099 for all beneficiaries of the trust who have received or had made available taxable amounts of $600 or more. Summary Form 1096 is required in cases where Forms 1099 were filed as prescribed.

The company is required to furnish substantiating evidence of the bases on which the allowable deductions and limitations of these deductions were calculated.

Annual Adjustments to Participants' Accounts—For each year after the year of the initial contribution by the company in establishing
the fund, certain adjustments must be made in the accounts of the active members of the plan. Two basic factors give rise to the need for these adjustments. These factors are: (1) changes in the amount of the fund balance due to earnings and gains or losses realized or unrealized during the year; (2) forfeitures by former participants of all or part of their fund credits.

Actual fund earnings and realized gains and losses through security transactions present no particular problem in ascertaining a net dollar increase or decrease for the period. An audit of the trust transactions can be performed to provide a verification of and certification to the existence and correctness of the figures displayed. The evaluation of the trust assets in order to reflect current market values is undertaken at the adjustment date. For those securities that are actively traded on the exchanges or in the over-the-counter dealings a market price can be obtained with no particular difficulty. In those cases involving securities for which there is no readily ascertainable market value, an appraisal of the present value based on original cost and other supporting current data provides a basis for valuation.

Section (j) of Revenue Ruling 33 pertaining to this point is reproduced below:

Valuation of securities on inventory date.—Any type of qualified plan which provides for distributions in accordance with amounts, stated or ascertainable, credited to participants (i.e., profit-sharing, stock bonus, and some self administered trusteed money purchase pension plans) must provide for a valuation of securities held by the trust, at least once a year, on a specified
inventory date in accordance with a method consistently followed and uniformly applied. For such purpose, fair market value on the inventory date is generally acceptable. The respective accounts of participants are then to be adjusted in accordance with the valuation.\textsuperscript{14}

Assuming the determination of an increase or decrease in the fund during a given fiscal period as a result of the operation of factor (1) described above, the apportionment of this amount to the accounts of the plan participants is the next step. The plan may provide that this credit or debit be allocated to the accounts of the active members of the plan under exactly the same formula as company contributions are allocated. In an attempt to avoid the dilution of participants' interests in a profit sharing trust, an alternative method may be used for the adjustment process. One view on this problem is presented in the following quotation:

To prevent "watering" of benefits already credited to participants, every profit-sharing plan which defers distributions should provide for annual adjustment of credits just prior to the time new entrants are admitted. Otherwise the newcomers will realize unanticipated accretions at the expense of their seniors in participation, or the reverse may happen, and the new entrants will be the losers.\textsuperscript{15}

The percentage gain or loss in the fund based on the beginning of the year balance may be applied to each participants' account that made up the beginning cumulative figure. The change that has taken place

\textsuperscript{14}\textit{Revenue Ruling 33, 1953-1 CB 272.}

during the year will thus be reflected in the accounts of those partici-
pants that had been in the plan prior to the given fiscal period and were
in the plan during the entire current period.

The use of trust units has been suggested as a means of correcting
the flaw (dilution of interest) in a plan. This technique involves the
recording of a participant's benefits in terms of trust units, the value
of which would be determined at the end of each year prior to the
company contribution for that period and prior to the issuance of new
credit units. The application of this principle establishes an equitable
treatment for all participants regardless of whether it is a favorable or
an adverse change in equity.

The reallocation to remaining participants of the amounts forfeited
during the period by withdrawals of participants is assumed in the fol-
lowing discussion. This procedure is more generally used in profit
sharing plans than is the alternative of permitting forfeitures to reduce
future company contributions. There are several bases that may be
used in this reallocation process. It is important for the company to
adopt a method for forfeiture reallocation that will not result in the dis-
qualification of the trust as a result of a ruling that discrimination has
been practiced.

Forfeited amounts may be apportioned to remaining plan members
in the same manner that annual company contributions are apportioned.

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If desired, a stipulation in the plan may provide that the reallocation of the forfeited amounts will be made to each account entitled thereto which was held at the beginning of the year in the same proportion that this account bears to the total balance of all accounts at the end of the year.

A CASE STUDY - THE AUDUBON INSURANCE COMPANY

The Audubon Insurance Company, a Louisiana Corporation, has permitted the author of this study to make a personal inspection of the operation of its Profit Sharing Retirement Plan. The effective date of its Plan was December 31, 1954, however it was applicable to the entire fiscal year ending on that date. The participants do not contribute to the trust created by the Plan and by the Trust Agreement. On March 31, 1959, an adjustment date of the Plan, the Plan had 22 active participants.

In the discussion that follows, certain provisions of the Plan and the Trust Agreement are reviewed. Particular attention is devoted to the parts of the instruments that either prescribe or influence the accounting treatment of contributions and allocations.

General Considerations—The Plan provides for complete vesting at the end of twenty years of service. No withdrawal of any part of his share of the trust fund is permitted while the employee is in the active service of the company. Two years of continuous employment as of the adjustment date on March 31st is necessary before the
employee is eligible for membership in the Plan. The normal retirement
date is the adjustment date coincident with or next following the 65th
birthday of a participant.

A committee, appointed by the Board of Directors of the company,
is to act as the profit sharing committee. Article III of the Trust Agree­
ment provides that this same committee will act as the investment com­
mittee. A corporate trustee is engaged to act as custodian for the fund
and to perform duties as set forth in the Trust Agreement.

**Company Contribution Formula**—The annual contribution of the
company to the trust fund is to be 5 per cent of the "adjusted net
profit" of the company for that particular fiscal period. In no case will
this contribution exceed 15 per cent of compensation otherwise paid
or accrued during the taxable year to all employees under the plan.

As stipulated in the Plan, "adjusted net profit" means the net
income available for undivided profits, surplus and dividends, after
provision for federal and state income taxes without giving considera­
tion to the amount to be contributed to the trust and the resulting re­
duction of federal and state income taxes by reason of such contribu­
tion. An adjustment to the foregoing procedure provides that any gains
or losses from the sale, exchange or other disposition of assets other
than furniture, trade fixtures, office equipment or motor vehicles shall
be excluded. A further qualification provides that the remaining portion
of the company's adjusted net profit after deducting any company con­
tribution and after deducting for all federal and state income taxes,
must be an amount equal to at least 6 per cent of the average of its net worth at the beginning and end of the fiscal year under determination.

Allocation Formula—In determining the amount of the company's contribution to be credited to each participant two factors are considered. These two factors are the salary of the individual and the length of service of the individual participant. One unit is awarded for each $100 or fraction equalling or exceeding $50 of his annual normal compensation for the latest calendar year and for the immediately preceding twenty-four years of his employment by the company. "Annual normal compensation" means payment for straight time or regular salary. One unit share is awarded for each year period of his employment by the company up to and including the then current adjustment date, but not to exceed a total of twenty-five unit shares attributed to years of employment. Six months or more in any calendar year shall be credited as one year and less than six months shall be disregarded.

Provision is made for the employees to receive credit for prior service. At the inception of the plan each employee was entitled to the number of unit shares based on his service with the company prior to the plan adoption. When the employee has been with the company for a total of twenty-five years, the computation of his unit credit based on compensation shall constantly move forward by the dropping of the earlier year and the adding of the latest year.

Membership Accounting—It is required by the Plan that a separate account be maintained for each participant or retired or
deceased participant having an amount to his credit under the Plan. If payments are being made from the fund to a former participant or his beneficiary, the amount paid during the year is subtracted from the account balance. In the case of a participant, a credit is made to his account for his share of the company's contribution for that fiscal year as determined by Article III of the Plan. The basic content of this Article of the Plan is outlined immediately above.

The forfeitures or other sums to be reallocated under the provision of the Plan and the annual net income or net loss of the trust shall be divided pro rata and credited or debited to each account entitled thereto which was held at the beginning of the year in the same proportion that this account bears to the total balance of all such accounts as of the end of the year. This requirement as pertains to forfeitures, etc., is contained in Article VI of the Plan.

Figure 4 on the following page is a reproduction of the form used by the Audubon Insurance Company to account for the equity of each participant in the Plan. The combination of these forms constitutes the subsidiary ledger to the control account balance as reflected by the Trust Fund. This form has been designed to suit the needs of this business based on the provisions of the Plan as they are operative. After adjustment, the total of the amounts taken from the extreme right-hand column of each participant's account must agree with the total dollar equity balance as reflected on the balance sheet which is prepared by the trustee.
**PROFIT SHARING TRUST ACCOUNT**

<table>
<thead>
<tr>
<th>NAME OF EMPLOYEE</th>
<th>BENEFICIARY</th>
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<tbody>
<tr>
<td>DATE OF BIRTH</td>
<td>DATE AGE 65</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>No.</th>
<th>Yr.</th>
<th>Base Pay Year</th>
<th>Commission Earned Pay</th>
<th>No. of Cts. Particip</th>
<th>Total No. of Cts.</th>
<th>Free-Rate &amp; Total</th>
<th>Prod-Date of 2% Particip</th>
<th>Total Net</th>
<th>Less Premium</th>
<th>Net Cr.</th>
<th>Total Cumulative Net Cr. End of Yr.</th>
</tr>
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<tbody>
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*Figure 4*
The company prepares a statement of account balance for each participant in the Plan each year. The individual account of each member in the subsidiary ledger serves as the basic document for the preparation of this annual account summary. Each participant has the opportunity of checking the balance of his account as reported if he feels there has been some erroneous calculation.

A worksheet, as discussed earlier in this chapter, is desirable in the calculation of the amount or amounts to be allocated or reallocated to participants on the adjustment date. The provision of the Plan concerning the allocation of the Company's contribution for a particular fiscal period will not in all cases yield the same percentage for allocation as is obtained in the reallocation of forfeitures, etc. The reason for this possible percentage variation is the addition of new members to the Plan during the fiscal year as a result of the employee completing two years of service with the company. Two columns have been provided for these figures as seen on the individual Profit Sharing Trust Account in Figure 4. The individual participant accounts serve as the basis for the preparation of this worksheet. Inaccuracies in these calculations can result in the account of each participant reflecting an erroneous balance. This particular point has led some observers to point out that the accounting incident to this type plan is more exacting than the complex actuarial calculations that go into a pension plan.

Investment Procedures--The investment committee is charged
with the responsibility of making the decisions on the investment of the funds of the trust. The trustee is notified in writing by the committee as to the securities to be purchased. At the present time the size of the fund does not justify diversity of security types. Shares of organizations secured by an agency of the United States Government are maintained in the portfolio of the trust at this time. The value of this type security does not fluctuate from the par or face value amount, thus the trustee has no problem of current market valuation of these securities.

The investment committee can direct the investment of a part of the funds of the trust in securities issued by the Audubon Insurance Company. The Trust Agreement contains a provision restricting the amount of the trust corpus that may be invested in this manner.

A CASE STUDY--THE PROCTOR & GAMBLE COMPANY

Mr. E. B. Tetrault, Public Relations Department of The Procter & Gamble Company, has assisted materially in providing the author of this study with the material concerning the history and operation of the profit sharing plans in his Company. The assistance rendered by Mr. Tetrault and his colleagues has made it possible to include in this study a discussion of the oldest profit sharing plan in continuous operation in the United States. The author wishes to express his appreciation to Mr. Tetrault and the other Procter & Gamble personnel for their enthusiastic cooperation in this project.

A well conceived purpose is essential to the successful continuation of any plan. As an introduction to the discussion of the plan
provisions and accounting requirements, the purpose of the plan as set forth in Article I of the Profit Sharing Trust Plan is reproduced below:

In originating and continuing this Profit Sharing Trust Plan it was and is the purpose of the Company to assist financially those employees who remain in its employ and to create an incentive for its employees to promote in every way the continuing growth and welfare of the Company. It has always been the declared policy of the Company to recognize that its interests and those of its employees are inseparable and in keeping with that policy the Company proposes in accordance with the terms and conditions set forth in this Plan to provide a means of acquiring for certain of its employees shares of the Common Stock of The Procter & Gamble Company and other securities at the discretion of the Trustees, so as to assist these employees in providing a satisfactory income after retirement.17

The administrative requirements of a deferred compensation type profit sharing plan have undergone many changes since the initiating of Procter & Gamble's first plan in 1887. The enormous increase in profit sharing activity is illustrated by the fact that since 1887 Procter & Gamble has either paid to employees or credited to employees more than $118 million through its profit sharing plans. Included in this total of $118 million is $13,342,062 which was credited to or paid to the 16,000 employees participating in the Company's profit sharing plans in the year 1958. The foregoing figures reveal that over 11 per cent of the total profit sharing credits since plan inception occurred in 1.4 per cent of the total elapsed time interval. The demands imposed in administering a plan of this magnitude are being met by the trained

17The Procter & Gamble Profit Sharing Trust, Article I, 1955, p. 3.
accountants and professional personnel engaged in this facet of the complex modern business organization. At Procter & Gamble, as is the case in many of the large industrial concerns, the use of an IBM 705 provides the speed and accuracy required in the detailed mathematical computations. The multipurpose electronic equipment available today has taken much of the burdensome work off of the shoulders of the accounting department personnel.

**Growth of the Plans**—Within a quarter century after the cessation of hostilities in the War between the States the management of The Procter and Gamble Company recognized the mutual advantage to the Company and to its employees that could be derived from profit sharing. In 1887 the Company instituted profit sharing. Although changes have been made in the Plan from time to time, the underlying concept has been carried forth in expanded form throughout the intervening years.

At the present time, Procter & Gamble has two profit sharing plans for its employees: a profit sharing trust plan and a profit sharing dividend plan. Oversimply put, the trust plan is for salaried employees and the dividend plan is for hourly-paid employees.

The profit sharing trust plan was established in 1944. The dividend plan, revised to its present form in 1948, is divided into two parts. Detailed plan provisions that are pertinent to this study will be covered in the discussion that follows.

**The Dividend Plan**—Fund A of this plan is figured on the total pay of each participant each year up to $2,000. Each participant contributes
5 per cent of his pay up to the $2,000 maximum. This $100 maximum contribution by the participant is in effect for the first 6 years of plan participation. The Company contributes an increasing amount from 5 per cent to 7 per cent during the six year period and buys Company stock in the employee's name. At the end of six years each employee receives all shares of stock bought in his name, plus any money left over in his account. The Company continues profit sharing payments of up to 15 per cent of the first $2,000 of wages. In addition, the employee continues to collect dividends on his stock.

There is also a "Fund B" part of the dividend plan into which Procter & Gamble makes a further contribution on a basis similar to the trust plan. This contribution is invested and held in trust for each employee for his retirement, death or disability.

The Trustees of the Plan are required to maintain separate accounts for Profit Sharing Fund A and for Profit Sharing Fund B for each participant. It is the responsibility of the Company to advise the Trustees of the names of the participants who are to share in Profit Sharing Fund A and the Annual Fund of Profit Sharing Fund B, and the portion of each to be credited to the participants, as provided in Article VIII of the Plan.

After ten years of continuous participation, a participant may submit a written request to the Trustees for the purchase of a Deferred Annuity. As soon as practicable after the receipt of the request, the Trustees may sell all or any part of the securities which have been
allocated to the account of the participant in Profit Sharing Fund B and use the proceeds of such sale, together with any part or all of the uninvested cash standing to the credit of the participant, to purchase a Deferred Annuity.

The Trustees of the Plan are charged with the responsibility of accurate record keeping as pertains to investment, receipts and disbursements and other transactions related thereto. The Trustees are required to file with the Company annually, before the end of the calendar year, a statement of accounts and proceedings during the previous fiscal year. In addition, the Trustees must also file with the Company from time to time throughout the year statements showing the amount of cash and the number of shares of the common stock of the Company credited to the accounts of participants in Profit Sharing Fund A, and before the end of the calendar year a statement showing the number and character of the securities allocated to each account in Profit Sharing Fund B at the end of the previous fiscal year. Upon the receipt of the above statements the Company furnishes the participants individual statements showing the status of their accounts in the Profit Sharing Funds. The forms used by the Company to report to each participant the status of his account at the end of each year are presented in Figure 5 on the following page.

The Profit Sharing Trust Plan—The profit sharing trust plan was established by the Company in 1944. Each year the Company sets aside from its profits a sum of money which is divided among the
According to the terms of the Procter & Gamble Profit Sharing Dividend Plan, the Plan's Trustees have advised the Company that your fund & account shows the following for the fiscal year just ended:

<table>
<thead>
<tr>
<th>LOCAL DEPT.</th>
<th>NAME</th>
<th>SOC. SEC. NO.</th>
<th>EMPLOYMENT DATE</th>
<th>DATE OF PARTICIPATION</th>
<th>REPORT FOR FISCAL YEAR ENDING</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>BEGINNING BALANCES</th>
<th>INCOME EARNED THIS YEAR</th>
<th>SHARES ALLOCATED THIS YEAR</th>
<th>ANNUAL FUND CREDIT</th>
<th>YEAR END BALANCES</th>
</tr>
</thead>
<tbody>
<tr>
<td>SHARES</td>
<td>CASH</td>
<td>QUANTITY</td>
<td>COST</td>
<td>SHARES</td>
</tr>
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<td></td>
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</tbody>
</table>

G. S. WOODWARD, JR., TREASURER

The Procter & Gamble Co. and Certain Subsidiaries

Figure 5
participants in the Plan according to a formula which takes into consideration the size of the profits, the length of time the employee has worked for the Company and the employee's base salary. This money is credited to the employee's account, invested in Procter & Gamble common stock or other securities and is held in trust until retirement at age 65. After 10 years' participation in the Plan, however, the employee has a vested interest in his trust and can take it with him if he leaves the Company.

Under this plan the Annual Fund is composed of the contribution of the Company at the end of any fiscal year, plus forfeitures accumulated during that year, plus any amount contributed by the Company and not credited to the accounts in a prior year plus any income therefrom. As provided in sections 3, 4, and 5 of Article VII of the Plan, the credits to the accounts of the participants are to be computed in the following manner:

3. If the Annual Fund is less than five per cent of the aggregate salaries for the fiscal year of all participants in this plan for that portion of said year during which they were participants, the accounts of the participants shall be credited, in so far as practicable, pro rata on the basis the salary of each participant during his period of participation for the fiscal year bears to the aggregate salaries of all participants for said fiscal year.

4. If the Annual Fund is equal to, or in excess of five per cent of the aggregate salaries for the fiscal year of all participants in this Plan for the portion of the said year during which they were participants, then an amount equal to five per cent of the salary of each participant during the period of participation for that fiscal year shall be credited to the account of said participant, and any amount in excess of five per cent shall be credited in the manner prescribed below.
5. Any balance remaining in the Annual Fund after crediting the accounts, as outlined in section 4 above, shall be credited, in so far as practicable, to the accounts of the respective participants in the proportion that the salary of each for said year multiplied by his "Credit Service Years" bears to the total salaries of all participants for said year multiplied by their respective "Credit Service Years." The credits to the accounts as computed in the above manner shall be in addition to the credits provided for in section 4. 18

A hypothetical case will be presented to illustrate the operation of the above formula for determining individual credits to the accounts of the participants. Assume that the X Company has net earnings in 1958 of $70,000 after taxes and has five participating employees as follows:

<table>
<thead>
<tr>
<th>Employee</th>
<th>Annual Salary</th>
<th>Years of Employment</th>
<th>Credit Service Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$5,000</td>
<td>16</td>
<td>14</td>
</tr>
<tr>
<td>B</td>
<td>$4,000</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>C</td>
<td>$6,000</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>D</td>
<td>$10,000</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>E</td>
<td>$3,600</td>
<td>25</td>
<td>20 (maximum)</td>
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<tr>
<td></td>
<td>$28,600</td>
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Composition of the Annual Fund:

Company contribution for the year 1958 $2,450.00
Amount contributed by the Company in prior years not credited to accounts 2.00
Forfeitures 2.00
Total $2,452.00

18 Ibid., p. 15-16.
Five per cent of $28,600 is less than annual fund so distribution would be made on basis of sections 4 and 5 as outlined above.

Amount to be credited at 5% of salaries:

$28,600 \times 5\% = 1,430.00

Balance to be distributed under sec. 5 = 1,022.00

Calculation of the Unit Credit Percentage:

\[
\begin{align*}
\frac{100 \times 1,022}{(5,000 \times 14) + (4,000 \times 8) + (6,000 \times 3) + (10,000 \times 10) + (3,600 \times 20)} &= 0.35\% \\
\end{align*}
\]

From the above results the credits to the individual accounts would be calculated as follows:

**Employee A**

Credit under section 4... $5,000 \times 5\% = 250.00

Credit under section 5... 5,000 \times 14 \times 0.35\% = 245.00

Total credit 495.00

The entire amount of the Annual Fund was distributed as it was less than 15 per cent of the $28,600 aggregate salaries of all participants.

**SUMMARY**

The number of profit sharing plans of the deferred-benefit type has increased very rapidly in the ten year period since 1949. Undoubtedly the favorable tax treatment of the employer's contribution to the trust has had its effect on the expansion in this type employee benefit. Many employers have realized the mutual benefit possible in a well administered incentive plan of this type. Mr. Walter H. Wheeler, Jr., made a characteristic statement in calling attention to the desirability of the use of profit sharing as a part of the business planning. His words are as follows: "Without profit sharing, it is an almost insuperable task to educate the great mass of people on the economic facts of life--all
to defend what must appear to be the special privileges of the few.\footnote{17}

Along with the increased number of plans and the increased coverage of participants in the plans came the extra burden of internal administration and accounting requirements. The experiences and applied techniques of businesses that have had success over the years with profit sharing are invaluable to the business initiating a plan. In researching this subject there was found to be a dearth of published accounting reference books on the specific subject of profit sharing principles and practices. Many articles and special reports are available for specialized and selected reference work. As the accounting requirements increase, it is logical to envision greater coverage of the subject by the leading groups and individuals in the accounting profession.

Although the discussion in this chapter has been directed primarily toward specific problems of an accounting nature, reference has been made to some apparent advantages of deferred profit sharing. All of the attributes are not necessarily favorable. It has been pointed out that it is not possible to schedule benefits in advance under profit sharing. Mr. Matthew Blake adds two more disadvantages to the one just mentioned. He indicates that the inclusion of past service costs is discouraged by the Internal Revenue Service. Where discrimination

is likely to result from forfeiture under a profit sharing plan, the Service requires fairly rapid vesting. It is further pointed out that the 15 per cent of compensation ceiling placed on the deduction for the employer on his tax return does not apply in the case of pension plans.

All factors must be weighed carefully when selecting a particular type plan to include in the future operation of a company. If a deferred-benefit plan of the profit sharing type is selected, the major accounting points of responsibility developed in this chapter may be used as a framework for the construction of the specific records desired in the individual case.

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CHAPTER VII

SUMMARY AND CONCLUSION

The increased intensity of the sociological problem of the inactive post-retirement years of a large segment of the population of the United States has had its effect on business policy. When it became evident that emphasis had shifted toward retirement security, management acted either voluntarily or through bargaining agreements to meet the demands of active employees to provide at least partial means of support after retirement. The transition from the filial responsibility concept to the self sustenance concept through earned retirement income or care by the society at large has taken place rapidly within the past quarter century. This change is pertinent to this study through its effect on the accounting and financing aspects of the business. The full effect of the change is yet to be felt. Each year many businesses are faced with modifications and expansions of the existent programs that take place as a direct result of Social Security changes, negotiations of new wage contracts, introduction of incentive devices, and other contributing factors. This study has attempted to take selected employee benefit plans of the deferred benefit type and develop the relevant accounting points from the theory, practice, and tax considerations.
SUMMARY

Limitation Imposed in Covering Retirement Plans—The area of fringe benefits is too comprehensive to consider in a study of this type. Even though all elements of the very broad subject of additional employee benefits do not have accounting or financing requirements necessitating elaborate treatment, there are segments of the subject warranting scholarly research and reporting that were excluded from coverage in this project. Although not covered as a part of this study, the accounting for additional executive compensation provided through the issuance of stock options is an example of a component of the overall employee benefit subject that warrants thorough research.

The necessity of considering each business move with an ever watchful eye on the tax effect was a factor leading the author of this study to limit the coverage to qualified plans. Although some techniques and requirements for pension and profit sharing plans are either identical or very similar, attention has been called to the specific provisions pertaining to each type plan.

Since there is no funding involved in a current distribution type of employee benefit plan, the deferred-benefit type plan was selected for this study. Funding considerations were carried through in the discussion in more than a cursory manner. As qualification refers to a plan of the deferred-benefit type, in essence the limitation to selected qualified deferred compensation plans was self constricting.

Pension vs. Profit Sharing—The accounting considerations in
all likelihood will not have as much influence on the selection of the type plan as will some other factors. Assuming the business is able to exercise its own volition in the type of plan adopted, the fixed annual commitment of the pension plan, regardless of the operating results of the fiscal period, may be a deciding element in the plan selection. The limitation imposed by the Internal Revenue Code on the amount of deduction allowed under a qualified profit sharing plan may bring serious objections from the business in weighing the pros and cons of each type plan. Each type plan will offer some advantages and some disadvantages. This study did not attempt to make specific recommendations of a particular type plan for a particular business, but an effort was made to set forth clearly the characteristics of each type plan. The accounting and financing points came as a natural consequence to the individual plan provisions.

**Funding of Pension Plans**—An employer electing to establish a pension plan of the deferred-benefit type has a variety of funding arrangements available for the selection of the one meeting the needs of the particular business. An initial decision must be made as to whether the plan is to be insured through an insurance company or whether it is to be of the non-insured type. Each type of funding media offers certain advantages. The internal accounting requirements, including statement presentation, are minimized when an insured type plan is in operation. Regardless of the funding
arrangements provided, the plan must be actuarially sound.

A plan of the non-insured type is often referred to as being self-administered. The terminology, self-administered, may be somewhat misleading to say the least. The majority of those plans that fall within the category of "self-administered" are in actuality trustee plans. A trustee is ordinarily engaged by the business to act as custodian of the fund and to perform duties as prescribed in the trust agreement. The services of an actuary are necessary in the orderly functioning of the plan as pertains to the calculation each year of the contribution necessary to provide the benefits promised. The overall financing decision making under this type plan permits the party initiating the plan to exercise much more control than is possible when an insured type plan is in use.

The Qualification of a Plan—Under the current regulations, The Internal Revenue Code of 1954, provision is made for the qualification of a plan. This qualification enables the business to take as deductions for tax purposes the contributions made under the plan provisions. It also provides for tax free earnings on the trust and the deferral of income recognition by the plan recipient until such time as the income is constructively received. Implementing the Code sections pertaining to the deferred-benefit type plans are the Treasury Decisions, Regulations, and Court Decisions. Beginning with the Revenue Act of 1921 and continuing to the present date, the provisions of the various acts and codes have been enacted to provide
tax advantages for the employing unit and to provide protection and
tax alternative treatment to the recipient. If a capital gain treatment
is elected by the recipient, it may offer a distinct tax advantage.
The choice in this matter should be conditioned by the immediate need
for a lump sum settlement as compared to the prolonged installment
payments.

The business having a qualified plan must conform to the Code
requirements in order to keep the plan qualified. The trust is pro­
hibited from engaging in certain types of transactions. Discrimination
in favor of high salaried personnel in the plan operation is grounds for
disqualification.

Although the accounting requirements under a qualified plan are
not materially different from the accounting procedures in connection
with a non-qualified plan, the installation of a plan in a business
may be based on the possibility of the plan being qualified. Additional
exhibits and reports are required to comply with the regulatory agencies
having jurisdiction over businesses with qualified plans.

**Data for Statement Presentation**—The reporting of the financial
aspects of pension and profit sharing plans in published statements
is an integral part of the accountant's responsibility. Due to the
major structure differences in the two types of plans, the reporting of
the pension plan information in the financial statements presents more
of a problem than does the profit sharing plan reporting.

Past service cost in connection with pension plans has evoked
lengthy discussion concerning the proper treatment to be accorded this item in the accounts and on the statements. The American Institute of Certified Public Accountants' Committee on Accounting Procedure recommended in Accounting Research Bulletin No. 47, September, 1956, that at the inception of a plan past service cost be treated as a charge against operations of the current and future periods benefits. The Bulletin further provided in the recommendation of the Committee that in the case of an existent plan where the company decided to conform its accounting to the preferred procedure expressed in the Bulletin, it may be appropriate to charge to earned surplus the amount that should have been accumulated by charges to income since inception of the plan. Although the content of Accounting Research Bulletin No. 47 was adopted unanimously by the twenty-one members of the committee, six members of the committee assented with qualification. The six members of the committee objected to the part of paragraph three of the Bulletin which appears to sanction the charging to earned surplus in some circumstances of pension costs based on past service.

Surveys conducted by independent organizations and by the author of this study show conclusively that the vast majority of the businesses are following the recommendations of the Committee in the accounting treatment accorded past service cost. It is a logical conclusion that the thinking of the majority of the practitioners in the field coincides with the published opinion of the twenty-one
members of the Institute Committee. Published statements of many corporations indicate in the notes or comments accompanying the statements the amount of the past service cost included in the current operations charge.

The disclosure of unfunded past service liability is strongly recommended. Uniformity in statement presentation does not exist in this particular phase of pension plan reporting. Although it would be helpful in comparative statement analysis involving two or more corporate entities, the exact location of the disclosure of this unfunded obligation is not as compelling as is the actual disclosure. If statements are to be certified, full disclosure is basic. Since the contributions made by the employer under a trusteed plan are irrevocable, no asset category should contain the amount of the fund being accumulated. For general information the existence and size of the fund may be included as appended material to the formal statement.

Profit sharing plans of the deferred-benefit type do not present a particular accounting problem for statement presentation purposes. Since the amount to be contributed to the trust by the employer is dependent upon the profits of the business for the particular period, no reference will be found to this item in the operating section of an Income Statement or in the extraordinary charges and credits section of an all-inclusive type of Income Statement. Contributions to a qualified trust are deductions for tax purposes, thus the reporting of the provision for income tax on the statements will reflect the income
subject to tax after profit sharing allocation. There is no unfunded past service cost to be considered in a profit sharing plan as is the case in many pension plans.

CONCLUSION

Assuming continued economic growth and expanded gross national product in the United States in the years that lie ahead, the continued growth of pension and profit sharing plans can easily surpass the rapid increase in the size and number of plans that has taken place in the second quarter of the twentieth century. If time proves this conjecture to be a reality, the demand on management for expanded and more detailed record keeping will mean that present accounting personnel must be augmented with trained actuaries in order to fulfill its proper place in the organization. This problem can be partially solved at least by increased emphasis on this phase of study in the institutions offering specialized training in the business field.

Valuable information on the subject of pension and profit sharing plans and their operation can be obtained from several agencies created for the specific purpose of fostering the development and expansion of these plans. The information obtained will in many instances provide the answer to a particular question that a business may have concerning the installation, expansion, or even cessation of a plan. These organizations, such as the Profit Sharing Research Foundation, are eager to lend assistance to researchers in the field. Added employee benefits provides an area that is fertile for research
in the sociological aspect of the subject as well as the administrative
and financial aspects. This study was intended to cover the major
accounting and financing problems incident to the qualified pension
and profit sharing plans. A much broader field is available if other
types of employee benefits are to be considered.

Unless some unforeseen factor or factors arise to curtail
activity in the establishment and maintenance of employee benefit
plans, the demands on the accountant's skill in presenting the most
accurate and detailed financial information will increase materially
in the years to come. The increased interest shown in this subject
by the accounting profession attests to the fact that it is cognizant
of its place of responsibility and is preparing to meet the growing
demand for this specialized field.
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G. MISCELLANEOUS


The Procter and Gamble Company. *Profit Sharing Trust.*
VITA

George Watson Fair, son of the late LeRoy Roach Fair and Catharine Watson Fair, was born in Mansfield, Louisiana on May 29, 1919. He was graduated from Mansfield High School with honors in 1936. He attended Centenary College from 1936 to 1940, receiving the degree of Bachelor of Arts in 1940.

In 1940, he entered Louisiana State University to study toward the degree of Master of Business Administration. At the close of the academic year 1940-1941, he entered active duty in the United States Army. He served as an enlisted man from June 1941, until December, 1942, when he was commissioned a Second Lieutenant. He served in the continental United States and overseas until his release from active duty in January, 1946, with the rank of Major.

Upon his discharge from the Army, he returned to Louisiana State University to complete the requirements for the Master of Business Administration degree. He served as a graduate assistant during his work toward the Master's degree, and was awarded the degree in August, 1946. In September, 1946, he accepted a position as instructor in Accounting at Louisiana State University. Upon completing all requirements for the Doctor of Philosophy degree with the exception of the dissertation, he was promoted to assistant professor in accounting at Louisiana State University. In November, 1950, he passed the
uniform Certified Public Accountant's examination and was awarded a certificate by the State Board of Certified Public Accountants of Louisiana. He is now a candidate for the degree of Doctor of Philosophy at the January commencement.
EXAMINATION AND THESIS REPORT

Candidate: George Watson Fair

Major Field: Accounting

Title of Thesis: Accounting and Financing Features of Selected Qualified Deferred Compensation Plans

Approved:

[Signatures]

Major Professor and Chairman

Dean of the Graduate School

EXAMINING COMMITTEE:

[Signatures]

Date of Examination: November 23, 1959