

Statement of Financial Accounting Standards No. 110

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Reporting by Defined Benefit Pension Plans of
Investment Contracts

(an amendment of FASB Statement No. 35)

August 1992



Financial Accounting Standards Board
of the Financial Accounting Foundation
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Reporting by Defined Benefit Pension Plans of Investment Contracts
an amendment of FASB Statement No. 35
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FAS 110: Reporting by Defined Benefit Pension Plans of Investment Contracts

an amendment of FASB Statement No. 35

FAS 110 Summary

This Statement requires a defined benefit pension plan to report an investment contract issued by either an insurance enterprise or other entity at fair value. This Statement amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, to permit a defined benefit pension plan to report only contracts that incorporate mortality or morbidity risk at contract value.

This Statement is effective for fiscal years beginning after December 15, 1992. It need not be applied to deposit administration and immediate participation guarantee contracts entered into before March 20, 1992. Restatement of financial statements of prior years is required only if those statements are presented with statements for plan years beginning after December 15, 1992.

INTRODUCTION

1. FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, establishes standards of financial accounting and reporting for the annual financial statements of a defined benefit pension plan. Paragraph 11 of Statement 35 states that "plan investments, whether equity or debt securities, real estate, or other (excluding contracts with insurance companies) shall be presented at their fair value at the reporting date." Paragraph 12 of that Statement states that "contracts with insurance companies shall be presented in the same manner as that contained in the annual report filed by the plan with certain governmental agencies pursuant to ERISA" (footnote reference omitted). The instructions to Forms 5500 and 5500-C permit unallocated contracts recognized as plan assets to be reported either at fair value or at amounts determined by the insurance company (that is, contract value).

2. Some have interpreted the exception in Statement 35 for contracts with insurance

companies to allow guaranteed interest contracts, also referred to as "guaranteed investment contracts" or "GICs," to be reported at contract value. A GIC is a negotiated contract generally between an insurance enterprise (issuer) and an investor, typically a pension plan or savings and investment plan. GICs held by defined benefit pension plans generally provide for a specified return on principal invested over a specified period. Entities other than insurance enterprises have also offered instruments with similar characteristics. However, paragraph 11 of Statement 35 refers only to contracts with insurance companies. That reference raised questions about whether defined benefit pension plans that hold investments with characteristics similar to those of a GIC but issued by entities other than insurance enterprises may be permitted to report those investments at contract value.

3. The Emerging Issues Task Force (EITF) discussed the issue in EITF Issue No. 89-1, "Accounting by a Pension Plan for Bank Investment Contracts and Guaranteed Investment Contracts," but did not reach a consensus. As a result, the FASB added a project on pension plan accounting for investment contracts to its agenda.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Reporting of Contracts

4. A defined benefit pension plan shall report investment contracts at fair value. A defined benefit pension plan shall report insurance contracts in the same manner as they are reported in the annual report filed by the plan with certain governmental agencies pursuant to the Employee Retirement Income Security Act of 1974 (ERISA). For purposes of this Statement, the terms *insurance contract* and *investment contract* are used as those terms are described for accounting purposes in FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises*, and No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

5. Paragraph 1 of Statement 60 describes insurance contracts:

The primary purpose of insurance is to provide economic protection from identified risks occurring or discovered within a specified period. Some types of risks insured include death, disability, property damage, injury to others, and business interruption. Insurance transactions may be characterized generally by the following:

- a. The purchaser of an insurance contract makes an initial payment or deposit to the insurance enterprise in advance of the possible occurrence or discovery of an insured event.

- b. When the insurance contract is made, the insurance enterprise ordinarily does not know if, how much, or when amounts will be paid under the contract.
6. Paragraphs 7 and 8 of Statement 97 describe insurance and investment contracts:

Long-duration contracts that do not subject the insurance enterprise to risks arising from policyholder mortality or morbidity are referred to in this Statement as investment contracts. A mortality or morbidity risk is present if, under the terms of the contract, the enterprise is required to make payments or forego required premiums contingent upon the death or disability (in the case of life insurance contracts) or the continued survival (in the case of annuity contracts) of a specific individual or group of individuals. A contract provision that allows the holder of a long-duration contract to purchase an annuity at a guaranteed price on settlement of the contract does not entail a mortality risk until the right to purchase is executed. If purchased, the annuity is a new contract to be evaluated on its own terms.

Annuity contracts may require the insurance enterprise to make a number of payments that are not contingent upon the survival of the beneficiary, followed by payments that are made if the beneficiary is alive when the payments are due (often referred to as *life-contingent payments*). Such contracts are considered insurance contracts under this Statement and Statement 60 unless (a) the probability that life-contingent payments will be made is remote or (b) the present value of the expected life-contingent payments relative to the present value of all expected payments under the contract is insignificant. [Footnote references omitted.]

Amendment to Statement 35

7. Statement 35 is amended as follows:
- a. The parenthetical comment (*excluding contracts with insurance companies*) in paragraph 11 is replaced by (*excluding insurance contracts*).
 - b. Paragraph 12 is replaced by the following:

Insurance contracts shall be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA; that is, either at fair value or at amounts determined by the insurance enterprise (contract value). A plan not subject to ERISA shall present its insurance contracts as if the plan were subject to the reporting requirements of ERISA.

Effective Date and Transition

8. This Statement is effective for financial statements for fiscal years beginning after December 15, 1992. Earlier adoption is encouraged. This Statement is not required to be applied to deposit administration and immediate participation guarantee contracts (as described in paragraphs 114-119 of Statement 35) entered into before March 20, 1992. Those contracts may continue to be presented in the same manner as insurance contracts as set forth in paragraph 12 of Statement 35 as amended by this Statement.

9. Accounting changes adopted to conform to the provisions of this Statement shall be made retroactively by restating the beginning balance of net assets available for plan benefits for the earliest period presented. Financial statements of prior plan years shall be restated to comply with the provisions of this Statement only if presented with financial statements for plan years beginning after December 15, 1992. If accounting changes are necessary to conform to the provisions of this Statement, the effect on the beginning balance of net assets available for benefits shall be disclosed in the financial statements for the year in which this Statement is first applied.

**The provisions of this Statement need
not be applied to immaterial items.**

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Joseph V. Anania
Victor H. Brown
James J. Leisenring
Robert H. Northcutt, Jr.
A. Clarence Sampson
Robert J. Swieringa

Appendix

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

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Appendix: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

10. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

11. An FASB Exposure Draft, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, was issued for public comment on March 20, 1992. The Board received 48 comment letters in response to that Exposure Draft. The Board concluded that it could reach an informed decision on the basis of existing information without a public hearing.

Background

12. Paragraph 5 of Statement 35 states that "the primary objective of a pension plan's financial statements is to provide financial information that is useful in assessing the plan's present and future ability to pay benefits when due" (footnote reference omitted). The Board concluded that the reporting of plan investments at fair value provides the most relevant information about the resources of a plan. Statement 35 requires that defined benefit pension plans report investments at their fair value.

13. Although the Board recognized that there might be practical problems in determining the fair value of certain types of investments, it initially concluded that the relevance of fair value was sufficient to require its use. As a result, the July 1979 FASB Exposure Draft, *Accounting and Reporting by Defined Benefit Pension Plans*, that preceded Statement 35 required contracts with insurance companies to be reported at fair value. However, many respondents to that Exposure Draft expressed concerns about the complexity and feasibility of determining fair value for contracts with insurance companies.

14. Because the Board was concerned about delaying the issuance of Statement 35 to address those concerns, it concluded that contracts with insurance companies should be reported in the same manner as that required for filings under ERISA. The instructions to Form 5500 permit contracts with insurance companies to be reported at contract value. Therefore, in Statement 35, the Board permitted for practical reasons an exception to fair value reporting for contracts with insurance companies.

Application of Fair Value Exclusion to Insurance Contracts

15. Paragraph 74 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, states:

The Board concluded that disclosures about fair value should not be required for insurance contracts. . . . The Board believes that definitional and valuation difficulties are present to a certain extent in those contracts and obligations, and that further consideration is required before decisions can be made about whether to apply the definition to components of those contracts and whether to require disclosures about fair value for the financial components.

16. The Board recognized in its discussions about investments held by defined benefit pension plans that it may be difficult to determine the fair value of an insurance contract that, as discussed in paragraph 1 of Statement 60 and paragraphs 7 and 8 of Statement 97, incorporates either a mortality or morbidity risk. The Board decided the fair value exclusion in Statement 35 should continue for insurance contracts as a result of the definitional and valuation difficulties.

17. Some respondents to the 1992 Exposure Draft argued that investment contracts with benefit-responsive provisions are insurance contracts or have valuation difficulties similar to insurance contracts with mortality or morbidity risk. Benefit-responsive investment contracts typically transfer investment-yield risk (that is, uncertainty as to the ultimate amount of investment income that will be earned on the net funds invested in the contract) and some principal payment timing risk to the issuer of the contract. However, the plan remains at risk for the ultimate amount of benefit payments. The Board concluded that a contract with benefit-responsive provisions should be reported as an investment contract if it cannot otherwise be considered an insurance contract as discussed in this Statement.

Reporting Investment Contracts at Fair Value

18. The Board considered whether the exception to fair value in Statement 35 should apply to investment contracts held by defined benefit pension plans. Paragraph 15 of Statement 97 states that "investment contracts issued by an insurance enterprise . . . do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts." Further, paragraph 39 of Statement 97 states that ". . . the Board concluded that the accounting for investment contracts issued by insurance enterprises should be consistent with the accounting for interest-bearing and other financial instruments." Statement 107 requires holders of investment contracts, including defined benefit pension plans, to disclose the fair value of those contracts.

19. Several respondents to the 1992 Exposure Draft argued that contract value provides the most relevant information about a plan's ability to pay benefits when due because it represents the amount the plan will receive at the contract's maturity. Several respondents also questioned the relevance of reporting investment contracts at fair value. Because an established secondary

market for investment contracts does not currently exist, the plan will be unable to realize fair value.

20. The Board continues to believe that fair value is more relevant as explained in paragraphs 105 and 107 of Statement 35 as follows:

Plan administrators or other fiduciaries who manage plan assets are accountable not only for the custody and safekeeping of those [plan] assets but also for their efficient and profitable use in producing additional assets for use in paying benefits. Investment performance is an essential element of stewardship responsibility. Measuring changes in fair value provides information necessary for assessing annual investment performance and stewardship responsibility. Historical cost provides that information only when investments are sold.

For fixed-income investments held to maturity, the Board recognizes that market fluctuations will reverse before maturity (assuming no defaults). However, at the reporting date, it is the fair value, not the historical cost or the expected value at maturity, that is relevant to an assessment of the plan's ability to pay benefits. Changes in value from period to period are relevant to an assessment of investment performance and discharge of stewardship responsibility. Presenting fixed-income investments at historical cost (whether or not the intent is to hold them to maturity) does not provide essential information about the effect on investment performance of the decision to hold. Further, it may be difficult to determine whether the plan has both the intent and ability to hold a particular fixed-income investment to maturity.

21. The Board understands that the lack of an active secondary market limits the ability of the holder of an investment contract to realize fair value through a sale. However, it is inconsistent to require fixed-income investments that the plan has the ability and intent to hold to maturity to be reported at fair value and to allow investment contracts that generally have similar characteristics to be reported at contract value. In addition, reporting investment contracts at fair value based on current, not historical, interest rates is consistent with how the actuarial present value of accumulated plan benefits is measured.

22. The Board reaffirmed its belief that fair value provides the most relevant information about the resources of the plan and concluded it should require defined benefit pension plans to report investment contracts at fair value. The Board also concluded that investments with similar terms should be measured in a consistent manner whether an insurance enterprise or another entity issues the investment.

23. Several respondents to the 1992 Exposure Draft suggested that the Board provide additional guidance for determining the fair value of investment contracts. Those respondents expressed concern that the lack of an established secondary market would result in the determination of fair value based on subjective estimates that would result in inconsistent

measurements. Other respondents suggested that if additional guidance is not provided by the Board, many plan trustees may inappropriately conclude that contract value equals fair value. The Board believes that the broad guidance provided in Statements 35 and 107, as noted in paragraph 26 of this Statement, should be sufficient to determine fair value. The Board realizes that it cannot anticipate the variety of terms that can be included in an investment contract and that application of this Statement may, in some cases, require considerable judgment. However, the Board noted, as it did when it issued Statement 107, that considerable judgment also is needed when complying with other longstanding accounting and reporting requirements.

Defined Contribution Plans

24. The Board discussed whether the project should include the reporting of investments held by defined contribution plans since a significant number of investment contracts are held by those plans. The Board has not previously addressed issues related to financial statements of defined contribution plans. The current authoritative guidance on the issue is the AICPA Audit and Accounting Guide, *Audits of Employee Benefit Plans*. That Guide follows the requirements of Statement 35 by requiring that investments held by defined contribution plans be reported at fair value except for contracts with insurance companies, which are permitted to be reported at contract value.

25. The Board decided not to address the measurement of plan assets held by defined contribution plans in this project. Pursuing the differences between defined benefit pension plans and defined contribution plans would significantly expand the project. The issues that would have to be resolved before the Board could reach a conclusion about the appropriate measurement attribute would include the following: Who are the principal users of financial statements of defined contribution plans, what information is most relevant to their needs, and what are plan assets? Resolving those questions for all types of defined contribution plans, including those in which all investment decisions are made by the individual participants, would be time-consuming. The Board asked the AICPA, in view of its experience with defined contribution plans, to further address the appropriate reporting of investments held by defined contribution plans. The AICPA has undertaken a project to review the appropriate reporting for investment contracts held by defined contribution plans and health and welfare benefit plans.

Cost-Benefit Considerations

26. The benefits of this Statement are twofold. First, investment contracts held by defined benefit pension plans will be reported at fair value so that changes in the economic value of those contracts will be reflected in amounts reported to financial statement users. Second, the AICPA will be able to address defined contribution plan issues in light of the requirements of this Statement. However, those benefits have a cost; that is, the incremental cost of developing, implementing, and maintaining a system to generate the required valuations. The Board believes the cost of implementing this Statement is reduced by retaining the general guidance provided in paragraph 11 of Statement 35:

If there is not an active market for an investment but there is such a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved. [Footnote reference omitted.]

In addition, Appendix A of Statement 107 provides examples of procedures for estimating fair value that are consistent with the general guidance provided in paragraph 11 of Statement 35.

Credit Quality Issues

27. The Board also discussed how to incorporate the credit quality of the issuer in determining the fair value for an investment that is not actively traded. Some plans may receive less than the amount that the issuer is legally obligated to pay due to the issuer's financial difficulties. The Board believes that the guidance provided in paragraph 11 of Statement 35 and by Statement 107 is appropriate for estimating fair value.

28. The credit quality of the issuer also must be evaluated when using contract value to report a contract with significant insurance risk. FASB Statement No. 5, *Accounting for Contingencies*, requires the accrual of a loss when both criteria of paragraph 8 of that Statement are met. The need to recognize a contingent loss always should be considered when there is an existing condition, situation, or set of circumstances involving uncertainty as to possible loss.

29. The Board noted that financial instruments held by a defined benefit pension plan are subject to the disclosure requirements of FASB Statement No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*.

Effective Date and Transition

30. The Board decided that some plans may need time to implement procedures necessary to determine fair value. Accordingly, this Statement is effective for fiscal years beginning after December 15, 1992.

31. In the basis for conclusions of Statement 35, the Board discussed the characteristics of both deposit administration and immediate participation guarantee contracts. Plan sponsors may have reported those contracts at contract value based on their discussion in Statement 35. The Board decided, for practical reasons, not to require the application of the provisions of this Statement to those contracts entered into before March 20, 1992. The 1992 Exposure Draft required deposit administration and immediate participation guarantee contracts entered into after March 19, 1992 to be reported at fair value. Several respondents to the 1992 Exposure Draft said that a few deposit administration and immediate participation guarantee contracts are still being issued and that some of those contracts may have significant insurance risk. The

Board decided that any contract entered into after March 19, 1992 should be classified as either an insurance or investment contract pursuant to the requirements of this Statement and reported by the defined benefit pension plan accordingly.