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PENSION ACCOUNTING



Accounting Changes for Recognition of Pension Liability Settlements

An update to ASC 715 incorporating new pension accounting standards will impact the way plan sponsors approach the recognition of pension liability settlements. Accounting Standards Update (ASU) 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*, which was issued by the Financial Accounting Standards Board in March 2017, is effective in 2018 for fiscal years starting after December 15, 2017, for public entities and effective in 2019 for fiscal years starting after December 15, 2018, for private entities. Concurrently, many pension plan sponsors are considering or in the process of executing significant liability settlements. Such transactions will hit financial statements in fiscal years 2018, 2019 and beyond. Although these accounting standard changes will impact all pension plan sponsors, the focus of this paper is on the treatment of additional pension costs resulting from pension risk transfer activities such as lump sum windows and liability settlements from group annuity purchases.

CONTACT

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PRIOR PENSION ACCOUNTING STANDARDS

Many organizations that sponsor a defined benefit pension plan have a significant portion of their balance sheet and income statement tied to and influenced by the volatility of pension liabilities and assets. Accounting for the long-term nature of these liabilities has always been complex. Users of financial statements often found it difficult to interpret operating results when pension finance is blended into the numbers. ASU 2017-07 was designed to provide more transparency in the sponsoring entity's operating results while providing more alignment between pension accounting under U.S. GAAP and international accounting standards.

Pension accounting requires recognition of an annual bookkeeping expense called Net Periodic Pension Cost (NPPC). The NPPC is comprised of

- ▶ Service Cost
- ▶ Interest Cost
- ▶ Expected return on assets
- ▶ Amortization of actuarial gains & losses
- ▶ Amortization of prior service costs
- ▶ Recognition of curtailments and settlements

Service Cost is the value of new benefits being earned for active employees for an additional year of service during the fiscal year. Service Cost is essentially \$0 for a frozen pension plan since no new benefits are being earned. It's important to understand that Service Cost is the only component of NPPC that truly represents an annual compensation/operating cost. The remainder of the cost or income components of NPPC represent a by-product of pension asset and liability changes that have accumulated from prior years.

For example, the Interest Cost represents the increased value of pension benefits earned in the past due to one less year of discounting the present value of those future obligations, the expected return on assets is a credit for what prior contributions are expected to earn in the market for the upcoming year, and the amortizations represent a partial recognition of costs attributable to past changes in funded status (e.g., unexpected changes in past assets and liabilities such as changes in interest rates or improved life expectancies).

Under ASC 715, all components of NPPC were aggregated and typically included with compensation costs as part of operating results in the income statement. This treatment is being changed to isolate Service Cost from the other components of NPPC.

NEW PENSION ACCOUNTING STANDARDS

Under ASU 2017-07, defined benefit plan sponsors will typically present NPPC as follows:

- ▶ Service Cost will continue to be included as a compensation cost in operating results;
- ▶ All other components of NPPC will be presented separately outside of operating results;
- ▶ The other components of NPPC can be presented in one or more separate line items, e.g., "Other expense/(income)" in the income statement and should be denoted with an appropriate description.

This new presentation will create more transparency for compensation and operations within the income statement. Operating results will now only include the value of new pension benefits being earned, which again, is \$0 for a frozen legacy plan. However, underfunded frozen plans can still cause a sizable expense from the Interest Cost, Amortization and Settlement components. In that case, those items will now be presented outside of operating results. This should make it easier for plan sponsor executives to explain true operating results separate from special pension items which are based on market economics and related to benefits earned in prior years.

The next question is how pension lump sum windows and annuity settlements, both of which can cause a large one-year accounting expense, are accounted for under ASU 2017-07.

NEW ACCOUNTING FOR PENSION CURTAILMENTS AND SETTLEMENTS

A curtailment occurs when future service or benefits in a pension plan are significantly reduced or eliminated, such as when a plan is frozen and no longer provides new benefits. A settlement occurs when a significant percentage of liabilities is irrevocably transferred outside of the plan, such as a lump sum window that cashes out the benefit for plan participants or a group annuity purchase that transfers all future obligations to an insurance company.

As previously described, settlement and curtailment accounting for pensions previously flowed from Other Comprehensive Income through compensation costs and operating results. The result could theoretically be positive or negative in the financial statements but, given the current state of large unrecognized pension losses that many plan sponsors face, settlement and curtailment accounting today usually involve recognition of an additional one-time expense.

One problem with ASC 715 for a settlement charge is that a settlement usually happens during a fiscal year with the result being a large unexpected increase in operating expenses at year end. The investing public, credit rating agencies and lenders then react to the operating results with little initial understanding of certain non-operating drivers, i.e., how the pension impacted the results. For this reason, many executives would defer desired pension settlements until a time when the impact could be planned and communicated in advance. Unfortunately, since the annuity markets and plan assets change daily, this delayed timing approach would often result in losing favorable market conditions for an annuity purchase and reduce the predictability of the outcome.

In contrast, ASU 2017-07 should make settlement and curtailment expenses easier to communicate and understand. Rather than aggregating these expenses into NPPC and operating results, one-time settlement and curtailment charges can be itemized with their own line items outside of compensation costs. With executives being evaluated and compensated based on their ability to predict and meet forward-looking earnings projections, the ASU 2017-07 treatment of non-operating pension expenses should provide investors, credit agencies and lenders with more transparency about the executive team's ability to deliver consistent operational results.

IMPLICATIONS FOR THE PENSION RISK TRANSFER MARKET

The pension risk transfer market has heated up in recent years and is expected to continue growing as more and more plan sponsors seek to eliminate their legacy pension liabilities and costs when markets are favorable. ASU 2017-07 should make it easier for executives to isolate the impact of these transactions on their financial statements and eliminate some of the rationale for delaying a transaction when it otherwise seems optimal to move forward. However, these changes will NOT alter the actual costs of a lump sum window or group annuity purchase, nor the amount of the settlement charge itself, so many might still choose to avoid exceeding settlement accounting thresholds until more favorable conditions are presented.

For many that executed a lump sum window or group annuity purchase in 2018, the new accounting treatment will be required for fiscal year 2018 disclosures starting over the next few months. Others planning to execute a pension liability settlement in 2019 will be disclosing these expenses as non-operating items for fiscal year 2019.

Pension Accounting Standards Under ASU 2017-07

Prior <i>Net Periodic Pension Cost</i>		New <i>Net Periodic Pension Cost</i>	
Operating Costs	Non-Operating Costs	Operating Costs	Non-Operating Costs
Service Cost		Service Cost	
Interest Cost			Interest Costs
Expected Asset Return			Expected Asset Return
Amortization Costs			Amortization Costs
Curtailment Costs*			Curtailment Costs*
Settlement Costs**			Settlement Costs**

*Curtailment costs include effects of plan freezes and workforce reductions

**Settlement costs include effects of plan terminations, annuity buyouts and bulk lump sums

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