# ASC 715 for Pensions: What Your Clients and Their Auditors Need to Know

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# Agenda

- NOT ASC 960
- ASC 715 overview – focus on qualified defined benefit plans
  - Also applies to non-qualified and foreign plans
- My viewpoints on best practices
- You, your clients, and their auditors should communicate, often before any actuarial valuations are performed

# ASC 715

- ASC = Accounting Standards Codification
- ASC 715 – compensation – retirement benefits, reflected on plan sponsors' financial statements
- Annual pension expense = net periodic benefit cost – P&L
- Annual disclosures = PBO less assets, etc. – balance sheet

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# Pension Benefit Obligation

- PBO = present value of accrued benefits, but reflecting salary increases through retirement

- ABO = present value of accrued benefits
  – Similar to funding target

- PBO less assets = funded status and on balance sheet

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# Net Periodic Benefit Cost

- Service cost
- Interest cost
- Expected return on assets
- Amortization
  - Transition asset/obligation
  - Prior service cost/credit (plan amendments)
  - Actuarial gain/loss (includes changes in assumptions)

# Net Periodic Benefit Cost – Smoothing

- Transition and prior service costs are amortized over future years, not fully reflected immediately
- Cumulative actuarial gains/losses outside of corridor of greater of PBO and assets amortized over average working lifetime of actives
- Smoothed asset value allowed, ten-percent corridor

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# Net Periodic Benefit Cost – Smoothing

- Portion of funded status not yet recognized in income is recognized on balance sheet as accumulated other comprehensive income

- Will be recognized over time

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# Mark to Market

- Acceptable to recognize gains and losses faster, even immediately
- Will increase volatility of NPBC
- But could use hedging or other investment strategies to lessen volatility

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# Mark to Market – Why?

- If losses outside of corridor, must gradually be recognized anyway, taking hit now perhaps give analysts a better picture of company performance
- If terminating plan in near future, take the hit, or most of hit now
- “Transparency”

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# Actuarial Assumptions

- Should be best estimate – IRS prescribed assumptions are not necessarily best estimate
- Technically responsibility of plan sponsor
- Expected input from actuary and/or auditors
- Auditor must confirm in accordance with U.S. GAAP

# Discount Rate

- Based on high-quality corporate bonds as of measurement date
- Government bonds may be necessary in some countries
- Rates as of the measurement date – not average for month or longer
- Cash flow matching of expected benefit payments with appropriate yield curve and solve for single equivalent rate
- Calculation similar to determination of EIR for funding purposes

# Discount Rate (continued)

- Various acceptable yield curves
- Citigroup commonly used
- Most larger actuarial firms have their own pension curves
- Bond matching also used

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# Discount Rate (continued)

- Preferable a separately determined rate for each plan
  - Best practice
  - Spinoffs

- Common to use qualified plan rate for SERP, but…

- Often equal to ASC 960 interest rate if using alternative “settlement rate” approach under ASC 960

- Negatives rates?  Europe – how to handle?

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# Discount Rate – Spot-Rate Approach

- Use individual spot rates instead of single equivalent rate
- Lowers service cost and interest cost and therefore net periodic benefit cost
- Approach is “more refined,” “theoretically correct,” and “more precise”
- PBO does not change – only impacts NPBC

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# Discount Rate – Spot-Rate Approach

- SEC will not object
- Prospective change only
- Considered a “change in estimate”

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# Discount Rate – Spot-Rate Approach

- Must be considered a preferred method
- Therefore, permanent change, and perhaps required for all plans
- Must disclose effect of this change
- About 30 percent of Fortune 1,000 companies with DB plans have adopted

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# Discount Rate – Spot-Rate Approach

- Smaller gains and larger losses occur (upward yield curve)
- Larger losses amortized over future years
- Spot-rate approach considered incompatible with bond-matching approach to discount rate determination

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# Expected Long-Term Rate of Return

- Not involved in determination of PBO
- May be equal to interest rate under ASC 960 – similarly defined
- Based on expected returns weighted by asset class allocation
- Building-block approach – investment consultant for expected returns by class

# Expected Long-Term Rate of Return

- Trend is downward – roughly from 8.0 to 8.5 percent range to 7.0 to 7.5 percent range

- Expected return by assets class has decreased?

- Asset allocation more conservative
  - Frozen plans – glide path
  - Risk averse post-2008

# Salary Increases

- Need at least some input from plan sponsor
- Needed for PBO but not ABO or hard-frozen plans
- Roughly from 4.0 to 4.5 percent range to 3.5 to 4.0 percent range
- Very plan-specific

# Mortality

- Far more scrutiny last few years
- Best estimate not IRS prescribed tables
- RP-2014 with MP-2014/MP-2015 and perhaps MP-2016
- Society of Actuaries may produce annual updates
- ASOP – improvement scale

# Mortality

- Several versions of RP-2014
  - Collar, income, headcount
- If cash balance plan, far less important
- Non-cash balance lump sum conversion mortality?
  - Current 415(e) table  - prescribed by law and plan document
  - Project mortality improvement as for annuities

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# Mortality

- ASC 855 subsequent events – audited financial statements should reflect all available information through the date the accounting firm signs the audited financial statements
- Recently required some rerunning  of disclosures

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# Mortality

- Description of mortality assumption more complicated

- Are these the same table?
  - RP-2006 mortality table with fully generational projection using scale MP-2015
  - RP-2014 mortality fully generational using projection scale MP-2015
  - RP-2015 projected with scale MP-2015
  - RP-2014 adjusted to reflect scale MP-2014 from the 2006 base year and projected forward using scale MP-2015 on a fully generational basis

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# Retirement Rates

- Depending on plan provisions, retirement decrements may be preferred over single age
- Less need for decrements if early retirement benefits are actuarial equivalent or approximately so
- Recently – ultimate 100 percent decrement rate at age 70.
- Decrement critical if early retirement subsidy, supplements, or OPEB plan

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# Other Assumptions

- Withdrawal/termination
- Marital status and spouse's age
- COLA
- Cash balance interest crediting rate
- Optional forms – particularly portion opting for lump sums

# Special Events

- Plan freezes – soft and hard
- Vested terminated participants lump-sum windows
- Annuity buyouts – usually retirees
- Curtailment and/or settlement accounting required in some cases

# Soft-Plan Freeze

- Soft-plan freeze – no immediate accounting impact
- Be certain plan sponsor understands this
- PBO could increase even with no change in discount rate – mostly actives
- Duration of plan likely to decrease and therefore discount rate to decrease over time

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# Hard-Plan Freeze

- Hard-plan freeze – immediate accounting impact
- Be certain plan sponsor understands this and provide estimated impact – no surprises
- PBO could increase even with no change in discount rate – mostly actives, but less likely than soft freeze
- Duration of plan likely to decrease and therefore discount rate to decrease over time

# Annuity Purchase and Lumps Sums

- Both have – immediate settlement accounting impact possible
- Be certain plan sponsor understands this and provide estimated impact – no surprises
- Estimate ongoing impact if annuity purchased
- Estimate impact of lump-sum window – plan duration could decrease – also could limit to avoid settlement accounting

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# Curtailments

- An event that significantly reduces expected years of service for actives or eliminates the accrual of benefits for a significant number of actives
- Rule of thumb on "significant":
  - Ten percent – curtailment
  - Five to ten percent – maybe
  - Less than five percent – not a curtailment
- Plan hard freeze generally requires curtailment accounting, soft freeze does not
- Impacts both balance sheet and P&L

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# Curtailments

- If net effect of curtailment is a loss, should be recognized as soon as probable, and the results can be reasonably estimated.  If net effect is a gain, should be recognized when curtailment occurs, which could be date the employees are terminated or the date the pension is suspended, amended, or terminated.

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# Settlements

- A transaction that is irrevocable
- Relieves the employer (or the plan) of primary responsibility for a pension obligation and plan assets used to affect the settlement
- Paying lump sums may trigger settlement accounting (lump sums greater than sum of SC and IC)
- Impacts both balance sheet and P&L

# Settlements

- Settlement gains and losses are recoded when the settlement occurs (annuities purchased, lump sums paid, or pension obligation is assumed by someone else)

- Maximum amount should be recognized in earnings if entire PBO is settled.

- If only part of PBO is settled, should recognize in earnings a pro-rata portion equal to the percentage reduction in the PBO

# Buy-Ins

- Annuity purchased by plan, not plan sponsor
- A plan asset
- Not settlement accounting
- Several accounting treatments possible – need to value both the value of the annuity as well as the PBO for covered group

# Recent FASB Pronouncements

- Additional disclosures on valuation of plan assets

- 52/53-week fiscal years now have practical option
  - Use month-end nearest fiscal-year end
  - Contributions and significant events between dates need to be recognized

# Hints for Dealing With Auditors

- Providing some information upfront may lessen questions from auditors

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# Hints for Dealing With Auditors

- Separate periodic benefit payments and lump-sum payments
- Label what amendments are reflected in PVAB/PBO
- Details of gain/loss by source

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# Hints for Dealing With Auditors

- Rationale for each significant assumption or assumption changes
  - ASOP 27 and 35 anyway

- Reviewing actuary and responding actuary

# Questions?

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