

Mark-to-Market Pension Accounting As a Strategy

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Brief Description: In light of an expected shift to mark-to-market (MTM) accounting of pension assets and liabilities mandated by regulatory standards, we review the MTM approach and examine why plan sponsors might consider adopting the change now.

We have [previously written](#) about the International Accounting Standards Board's (IASB) project to change defined benefit (DB) plan accounting, which would generally eliminate current provisions in International Accounting Standard 19 (IAS 19) that allow delayed or non-recognition of certain changes in a plan's funded status (e.g., experience losses).

We expect that either the U.S. Financial Accounting Standards Board (FASB) will eventually use the IASB's new rule as a model for U.S. pension accounting, or that the Securities and Exchange Commission (SEC) will make a decision to adopt International Financial Reporting Standards (IFRS) in the U.S. In either case, the eventual result would be that U.S. companies sponsoring DB plans will have to move to a more "mark-to-market" (hereafter, "MTM") world. Moreover, even under current FASB rules, sponsors who terminate their DB plans are required to recognize any funding shortfall not previously recognized in the income statement as a charge against earnings in the course of winding up the plan.

In this context, some U.S. companies have already moved to a (modified) MTM accounting approach, and others are considering it. In this article we briefly review:

- the "buffers" (non-MTM elements) in the current system;
- flexibility within the current system to move to an MTM approach;
- alternative MTM approaches that may be considered; and
- the "why or why not" of this decision.

Buffers in the Current System

Just to be clear: we are discussing how a reporting entity (e.g., a plan sponsor/issuer of securities) reflects the cost of maintaining a DB plan in its financial statements. Our specific focus is the plan's effect on the sponsor's income statement, generally governed by Accounting Standards Codification Topic 715-30 (ASC 715-30), which was previously referred to as Financial Accounting Standard No. 87 (FAS 87).

There have been a number of recent developments with respect to balance sheet reporting that move towards MTM. In particular, the adoption of FAS 158 in 2006 required that a plan sponsor fully recognize the funded status of a DB plan as an asset or liability on the balance sheet. However, considerable "buffers" remain for income statement reporting. What are those buffers? In calculating the charge/credit to earnings with respect to a DB plan:

First, the value of plan assets may be smoothed for a period of up to five years. An expected rate of return on this smoothed amount is then credited to the income statement. The expected rate of return on assets (EROA) is based on the allocation of the plan's asset portfolio.

Second, under ASC 715-30-35-24, gains and losses (excluding the difference between market and smoothed assets) are netted, and net gains/losses are only required to be recognized to the extent they exceed 10% of the higher of the (smoothed) value of plan assets or the plan's projected benefit obligation (roughly, liabilities taking into account future pay increases). If gains/losses do exceed this 10% "non-recognition corridor," that excess is not required to be charged to the current year but can be amortized in future years over the average remaining

service of active plan participants (or the average remaining lifetime of inactive participants, if the plan is almost all inactive).

Third, the recognition of past service benefits (resulting, e.g., from a plan amendment) is also delayed. The cost of such past service benefits is generally amortized into the income statement over average remaining service or average remaining lifetime, similar to the treatment of gains/losses.

The portion of a plan's funded status that has not yet been recognized in the income statement (e.g., unamortized gains/losses) is recognized on the balance sheet in a component of equity referred to as "accumulated other comprehensive income." As these items are recognized in the income statement over time, they are "recycled" out of accumulated other comprehensive income and into retained earnings.

Flexibility in the Current System

As a general matter, a reporting entity (plan sponsor) may take a different approach to plan expense recognition. ASC 715-30-35-25 states:

Any systematic method of amortization of gains or losses may be used in lieu of the minimum specified in the preceding paragraph [ASC 715-30-35-24] provided that (a) the minimum is used in any period in which the minimum amortization is greater (reduces the net balance included in accumulated other comprehensive income by more), (b) the method is applied consistently, [and] (c) the method is applied similarly to both gains and losses.

The bottom line is that plans can recognize gains and losses faster than required by ASC 715-30, so long as they are consistent. If an alternative amortization approach is used, it must be disclosed as required by ASC 715-20-50-1.

What Changes When a Plan Moves to MTM?

Obviously, MTM by itself will increase the volatility of a DB plan's impact on company earnings – a generally undesirable thing. One approach to reducing that volatility is to undertake an asset-liability management strategy, in effect using fixed income instruments to reduce volatility. We would expect that plans moving to MTM would seriously consider such a strategy.

Another thing that changes when a plan moves to MTM is that, generally, it is no longer booking an EROA to company income. Rather, it will generally be booking actual return. The current ASC 715-30 EROA rule allows companies to credit a portfolio-based rate of return to earnings while delaying recognition of actual asset gains and losses.

When a plan moves to MTM, these two changes reinforce each other. That is, there may be more desire for hedging (e.g., fixed income) investments and less desire for more volatile high return/high risk investments.

Why Move to MTM Before Required?

The current system provides certain clear benefits. Most obviously, it allows sponsors to take a longer-term view with respect to, e.g., plan investments and valuation interest rates, while limiting period-to-period earnings volatility to at least some extent. So why move to MTM?

We see two reasons for moving to MTM before being required to by future changes in accounting standards. First, to the extent that losses are outside of the non-recognition corridor (that is, to the extent that losses must, under current rules, be recognized at some point): they represent a drag on future earnings. Recognizing them now in effect unburdens future earnings and lets analysts – in the future at least – better focus on what's really going on with the company.

Second, if a sponsor is considering terminating its DB plan in the relatively near term, it faces the prospect (at termination) of marking everything to market anyway. Some companies may believe that it is better to get this charge behind them now.

Versions of MTM

No major company that we are aware of has gone fully to MTM as of this date. If a plan were to go fully to MTM, then it would simply eliminate all the above-described buffers and credit/charge earnings with actual gains/losses in each period.

At least one company – Honeywell – has recently taken a modified MTM approach: keep the non-recognition corridor but mark everything outside it to market. This approach eliminates the drag-on-future earnings problem discussed above while continuing to defer losses inside the corridor.

The last point deserves further explanation. Retaining the non-recognition corridor has, practically, two effects. First, it avoids recognizing any losses that do not, under current rules, have to be booked against future earnings. If all a plan wants to do is avoid a drag on future earnings, it can continue to ignore losses in the non-recognition corridor. Second, it in effect allows the ultimate write-down of losses in the non-recognition corridor to continue to take place off of the income statement. And that latter approach may fit with a particular view of where interest rates or asset returns are headed.

MTM, Interest Rates and Plan Finance Strategies

Interest rates, including those used to value DB plan liabilities, reached historic lows earlier this year. Many believe that interest rates will, at some point in the future, go higher, and are prepared to "bet" on that view. (We want to state unambiguously that we have no view on which way interest rates are headed.) Increases in interest rates will generally produce gains in liability valuations (higher interest rates = lower liability values). Those gains can, in effect, be used to write down unrecognized losses inside and outside the non-recognition corridor. Thus, the resolution of the "problem" of unrecognized losses can take place within accumulated other comprehensive income and outside of the income statement.

Of course, the same approach to plan finance would apply if, for instance, a sponsor were confident that asset values would increase, again producing gains that could be used to write down earlier unrecognized losses.

The Situation Right Now

Significant asset losses in 2008 and historic low interest rates have put many companies in a pension funding "hole." At the same time, and for the same reasons, many companies also find themselves in a pension accounting hole – i.e., facing substantial charges to the income statement in the years ahead. Obviously, different companies will have different views about what to do about this situation. Some companies have addressed the funding hole with large, discretionary pension contributions. Moving to MTM and, in effect, recognizing these losses in the income statement now, is an analogous approach for dealing with the accounting hole.

Conclusion

Moving to MTM is not yet a widespread trend, but is being seriously considered by some companies. A company moving to MTM would generally need to apply the change retrospectively as a change in accounting principle.

Whether a move to MTM is right for a particular sponsor/issuer will depend on a number of variables, most obviously the size of losses that would be recognized under such a strategy. Adoption of MTM will also depend on a company's general philosophy of DB plan finance and on whether it anticipates terminating the plan in the near future.



Contact Information

Brian Donohue

Senior Vice President

Aon Hewitt

+1.312.381.5674

brian.donohue@aonhewitt.com