



Financial Reporting Alert 15-4 | October 30, 2015

Financial Reporting Considerations Related to Pension and Other Postretirement Benefits

This publication highlights some of the more important accounting considerations related to the calculations and disclosures entities provide under U.S. GAAP in connection with their defined benefit pension and other postretirement benefit plans.

Contents

Discount Rate

- Discount Rate Approaches Used to Measure Benefit Cost Components

- Discount Rate Selection Method

- Entity's Use of a Yield Curve Developed by a Third Party to Support Its Discount Rate

- Other Postretirement Benefit Plans — Discount Rate and Health Care Cost Trend Rate

Mortality Assumption

- Mortality Tables Used for IRS Tax-Qualified Plans

Expected Long-Term Rate of Return

Accounting Policies for Gains and Losses and Market-Related Value of Plan Assets

Measurement Date of Plan Assets — Employer-Sponsored Pension Plan

Other Considerations Related to Assumptions

Recent SEC Staff Views

- MD&A — Critical Accounting Policies and Estimates

- Disclosure of Changes in Mortality Assumption

FASB Standard-Setting Projects Related to Pension and Other Postretirement Benefits

Discount Rate

Over the past few years, we have provided insights into the assumptions used for discount rates for defined benefit plans. Specifically, we have discussed the different methods of developing discount rates (e.g., hypothetical bond portfolio, yield curve, index-based discount rate) and considerations related to how the discount rates should be applied when an entity measures its benefit obligation. In the current year, the most discussed emerging issue related to discount rates is the use of individual spot rates along the yield curve (as opposed to the traditional single weighted-average rate) to measure the service cost and interest cost components of net periodic benefit cost. Also highlighted below are (1) the discount rate selection method, (2) yield curves developed by a third party to support a discount rate, and (3) the relationship between the health care trend rate and the discount rate used in postretirement benefit plans other than pension plans.

Discount Rate Approaches Used to Measure Benefit Cost Components

The SEC staff recently met with representatives of the Big Four accounting firms and expressed its views on applying an alternative approach for using discount rates to measure the components of net periodic benefit cost for a defined benefit retirement plan obligation (e.g., a pension or other postretirement obligation) under ASC 715.¹ Specifically, the alternative approach focuses on measuring the service cost and interest cost components of net periodic benefit cost by using individual spot rates derived from an acceptable high-quality corporate bond yield curve and matched with separate cash flows for each future year.

The SEC staff responded to inquiries from the Big Four firms by stating that it would not object to registrants' use of such an approach instead of the single weighted-average discount rate approach that is currently often employed. The change in approach would not alter the measurement of the related benefit obligation as of the reporting date. The SEC staff also stated that it would not object if a registrant treats the change in approach as a change in accounting estimate. Please refer to Deloitte's [Financial Reporting Alert 15-3, Employers' Accounting for Defined Benefit Plans — Alternatives for Applying Discount Rates to Measure Benefit Cost](#) for further background on this topic and discussion of the relevant considerations an entity should contemplate in connection with such a change.

Discount Rate Selection Method

ASC 715-30-35-44 requires the discount rate to reflect rates at which the defined benefit obligation could be effectively settled. In the estimation of those rates, it would be appropriate for an entity to use information about rates implicit in current prices of annuity contracts that could be used to settle the obligation. Alternatively, employers may look to rates of return on high-quality fixed-income investments that are currently available and expected to be available during the benefits' period to maturity.

One acceptable method of deriving the discount rate would be to use a model that reflects rates of zero-coupon, high-quality corporate bonds with maturity dates and amounts that match the timing and amount of the expected future benefit payments. Since there are a limited number of zero-coupon corporate bonds in the market, models are constructed with coupon-paying bonds whose yields are adjusted to approximate results that would have been obtained through the use of the zero-coupon bonds. Constructing a hypothetical portfolio of high-quality instruments with maturities that mirror the benefit obligation is one method that can be used to achieve this objective. Other methods that can be expected to produce results that are not materially different would also be acceptable — for example, use of a yield curve constructed by a third party such as an actuarial firm. The use of indexes may also be acceptable.

Entities should focus on the requirement to use the best estimate when determining their discount rate selection method. ASC 715-30-55-26 through 55-28 state that an entity may change its method of selecting discount rates provided that the method results in "the best estimate of the effective settlement rates" as of the current measurement date. This change would be viewed as a change in estimate, and the effect would be included in actuarial gains and losses and accounted for in accordance with ASC 715-30-35-18 through 35-21. When an entity's method of selecting a discount rate results in higher rates than those being used by similar entities or in rates that remain consistent from year to year despite a fluctuating market, questions may be raised about whether the method is producing a reasonable result.

Editor's Note: In determining the appropriate discount rate, entities should consider the following SEC staff guidance (codified in ASC 715-20-S99-1):

At each measurement date, the SEC staff expects registrants to use discount rates to measure obligations for pension benefits and postretirement benefits other than pensions that reflect the then current level of interest rates. The staff suggests that fixed-income debt securities that receive one of the two highest ratings given by a recognized ratings agency be considered high quality (for example, a fixed-income security that receives a rating of Aa or higher from Moody's Investors Service, Inc.).

¹ For titles of *FASB Accounting Standards Codification* references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*." (As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.)

Entity's Use of a Yield Curve Developed by a Third Party to Support Its Discount Rate

To support its discount rate, an entity may elect to use a yield curve constructed by an actuarial firm or other third party. Many yield curves constructed by actuarial firms or other third parties are supported by a white paper or other documentation that discusses how the yield curves are constructed. Management should understand how the yield curve it has used to develop its discount rate was constructed as well as the universe of bonds included in the analysis. If applicable, management should also evaluate and reach conclusions about the reasonableness of the approach the third party applied to adjust the bond universe used to develop the yield curve.

We have been advised by some third parties, in particular those constructing yield curves for non-U.S. markets (e.g., eurozone and Canada), that because of a lack of sufficient high-quality instruments with longer maturities, they have employed a method in which they adjust yields of bonds that are not rated AA by an estimated credit spread to derive a yield representative of an AA-quality bond. This bond, as adjusted, is included in the bond universe when the third party constructs its yield curve. Management should understand the adjustments made to such bond yields in the construction of those yield curves and why those adjustments are appropriate.

Other Postretirement Benefit Plans — Discount Rate and Health Care Cost Trend Rate

ASC 715-60-20 defines "health care cost trend rate" as an "assumption about the annual rates of change in the cost of health care benefits currently provided by the postretirement benefit plan The health care cost trend rates implicitly consider estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of the plan participants." The health care cost trend rate is used to project the change in the cost of health care over the period for which the plan provides benefits to its participants. Many plans use trend rate assumptions that include (1) a rate for the year after the measurement date that reflects the recent trend of health care cost increases, (2) gradually decreasing trend rates for each of the next several years, and (3) an ultimate trend rate that is used for all remaining years.

Historically, the ultimate health care cost trend rate had been less than the discount rate. While discount rates have started to recover from their record lows in recent years, the discount rate for some plans is below the ultimate health care cost trend rate. Some parties have raised concerns regarding this phenomenon, since expectations of long-term inflation rates are assumed to be implicit in both the health care cost trend rate and the discount rate. In such situations, entities should consider all the facts and circumstances of their plan(s) to determine whether the assumptions used (e.g., ultimate health care cost trend rate of 5 percent and discount rate of 4 percent) are reasonable. Entities should also remember that (1) the discount rate reflects spot rates observable in the market as of the plan's measurement date, since it represents the rates at which the defined benefit obligation could be effectively settled on that date (given the rates implicit in current prices of annuity contracts or the rates of return on high-quality fixed-income investments that are currently available and expected to be available during the benefits' period to maturity), and (2) the health care cost trend rate is used to project the change in health care costs over the long term (which, as discussed above, includes the effects of changes other than inflation).

Mortality Assumption

Many entities rely on their actuarial firms for advice or recommendations related to demographic assumptions, such as the mortality assumption. Frequently, actuaries recommend published tables that reflect broad-based studies of mortality. Under ASC 715-30 and ASC 715-60, each assumption should represent the "best estimate" for that assumption as of the current measurement date. The mortality tables used and adjustments made (e.g., for longevity improvements) should be appropriate for the employee base covered under the plan.

Last year, the Retirement Plans Experience Committee of the Society of Actuaries (SOA) released a new set of mortality tables (RP-2014) and a new companion mortality improvement scale (MP-2014). Further, on October 8, 2015, the SOA released an updated mortality improvement scale, MP-2015, which shows a decline in the recently observed longevity improvements. Although entities are not required to use SOA mortality tables, the SOA is a leading provider of actuarial research, and its mortality tables and mortality improvement scales are widely used by plan sponsors as a starting point for developing their mortality assumptions. Accordingly, it is advisable for entities, with the help of their actuaries, to (1) continue monitoring the availability of updates to mortality tables and experience studies and (2) consider whether these updates should be incorporated in the current-year mortality assumption.

Mortality Tables Used for IRS Tax-Qualified Plans

For defined benefit pension plans (particularly IRS tax-qualified plans) that permit settlement of the obligation to an employee through payment of a lump sum at retirement, entities generally compute the payment by using IRS-mandated tables in effect on the date of the lump-sum payment. Similarly, for qualified cash balance plans, if an employee elects to convert the lump-sum benefit amount at retirement to an annuity, the entity uses IRS-mandated tables to calculate the annuity. In making assumptions about either the amount of future lump-sum benefits expected to be paid or any annuities expected to be paid that are related to a cash balance plan, entities have questioned whether they should base these assumptions on the IRS's practice of annually updating the current tables with an additional year of longevity improvement as well as on the IRS's expected future adoption of new tables (e.g., the RP-2014 tables).

We would typically expect entities to incorporate a best estimate of the effect of the RP-2014 tables on measurements related to lump-sum payments. The primary rationale for this view is that the Pension Protection Act of 2006 mandates the IRS to update its mortality tables at least every 10 years, and the next update is expected to occur in 2017.² This requirement can be viewed for financial reporting purposes as a basis for incorporating the SOA's updated tables as a best estimate of the expected regulatory requirement for measuring lump-sum settlements. Similarly, we expect that the measurements would take into account the IRS's practice of annually updating its current tables for longevity improvements. This approach is consistent with the guidance in ASC 715-30-35-31, which indicates that indirect effects on the amount of a benefit, such as future changes in Social Security benefits or benefit limitations required by existing laws, should be taken into account in the measurement of the defined benefit obligation (although amendments to a law should not be anticipated).

Under an alternative view, entities would not incorporate the effect of the RP-2014 tables that is expected to result in an update to the IRS-mandated mortality tables because the IRS's update to its mortality tables is akin to a new law or regulation, which should not be anticipated. This view only pertains to the effects of the IRS's update to its tables to be used in compliance with the regulatory requirements for measuring lump-sum settlements for tax-qualified plans and is not related to an entity's determination of its best estimate of the mortality assumption for those plans.

We believe that both approaches are acceptable under U.S. GAAP. However, if an entity chooses the alternative approach of not incorporating the effects of new mortality data in its estimates of future lump-sum settlements for an IRS tax-qualified plan and the results of applying the two respective approaches are expected to differ materially, the entity should consider consulting with its independent auditors.

Expected Long-Term Rate of Return

The expected long-term rate of return on plan assets³ is a component of an entity's net periodic benefit cost and should represent the average rate of earnings expected over the long term on the funds invested to provide future benefits (existing plan assets and contributions expected during the current year). The long-term rate of return is set as of the beginning of an entity's fiscal year (e.g., January 1, 2015, for a calendar-year-end entity). If the target allocation of plan assets to different investment categories has changed from the prior year, an entity should consider whether adjusting its assumption about the long-term rate of return is warranted.

Some entities engage an external investment adviser to actively manage their portfolios of plan assets. In calculating the expected long-term rate of return, such entities may include an adjustment ("alpha" adjustment) to increase the rate of return to reflect their expectations that actively managed portfolios will generate higher returns than portfolios that are not actively managed. If an entity adjusts for "alpha," management should support its assumption that returns will exceed overall market performance plus management fees. Such support would most likely include a robust analysis of the historical performance of the plan assets.

² Notice 2015-53 indicates that although the IRS is currently considering the comments received on the use of the RP-2014 mortality tables and MP-2014 improvement scale, any new IRS regulations related to mortality tables will not apply until 2017.

³ As defined in ASC 715-30, the "expected return on plan assets is determined based on the expected long-term rate of return on plan assets and the market-related value of plan assets."

Accounting Policies for Gains and Losses and Market-Related Value of Plan Assets

Many entities record the minimum amortization amount (reflecting the excess outside the “corridor”).⁴ The amortization is based on accumulated gain or loss as of the beginning of the year. Accordingly, the change in discount rates and the difference between actual and expected asset returns in the current year will not affect net periodic benefit cost until the following year.

An entity may consider moving to a “mark-to-market” approach in which it immediately recognizes actuarial gains and losses as a component of net periodic benefit cost. Any change in the amortization method selected for gains and losses is considered a change in accounting policy accounted for in accordance with ASC 250. Once an entity changes to an approach in which net gains and losses are more rapidly amortized, the preferability of a subsequent change to a method that results in slower amortization would be difficult to support. However, if an entity plans to terminate its defined benefit retirement plan in the near term, a change in the amortization method to mark-to-market may not be preferable under ASC 250-10-45 depending on the facts and circumstances. Accordingly, an entity should consider consulting with its independent auditors.

As with all defined benefit retirement plans, plan sponsors’ use of computational shortcuts and estimates is appropriate “provided the results are reasonably expected not to be materially different from the results of a detailed application.”⁵ Entities that use the mark-to-market approach should be vigilant when using shortcuts and approximations, since all changes in the measurement of the benefit obligation and plan assets immediately affect net periodic benefit cost.

Editor’s Note: When entities adopt a policy to immediately recognize actuarial gains and losses as a component of net periodic pension cost, they may present non-GAAP financial measures that “remove the actual gain or loss from the performance measure and include an expected long-term rate of return.”⁶ The SEC staff has noted that in the absence of sufficient quantitative context about the nature of the adjustment, such measures may confuse investors. The staff has suggested that registrants clearly label such adjustments and avoid the use of confusing or unclear terms in their disclosures.

Measurement Date of Plan Assets — Employer-Sponsored Pension Plan

In April 2015, as part of its [simplification initiative](#),⁷ the FASB issued [ASU 2015-04](#)⁸ to amend the measurement-date guidance in ASC 715. The ASU contains a practical expedient that would allow an employer whose fiscal year-end does not fall on a calendar month-end (e.g., an entity that has a 52- or 53-week fiscal year) to measure retirement benefit obligations and related plan assets as of the month-end that is closest to the employer’s fiscal year-end. The expedient would need to be elected as an accounting policy and be consistently applied to all plans if the entity has more than one plan. Because third-party plan asset custodians often provide information about fair value and classes of assets only as of the month-end, such an accounting policy would relieve the employer from adjusting the asset information to the appropriate fair values as of its fiscal year-end. Further, if the occurrence of a significant event (e.g., curtailment or settlement) during the interim period requires an entity to remeasure its defined plan assets and obligations, the practical expedient would allow the entity to remeasure its defined plan assets and obligations by using the month-end that is closest to the date of the significant event.

The ASU should be applied prospectively. For public business entities, the ASU is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. For all other entities, the ASU is effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. Earlier adoption is permitted.

⁴ ASC 715-30-35-24 provides guidance on net periodic pension benefit cost and defines the corridor as “10 percent of the greater of the projected benefit obligation or the market-related value of plan assets.” Likewise, ASC 715-60-35-29 provides guidance on net periodic postretirement benefit cost and defines the corridor as “10 percent of the greater of the accumulated postretirement benefit obligation or the market-related value of plan assets.”

⁵ Excerpted from ASC 715-30-35-1 and ASC 715-60-35-1.

⁶ For more information, see the [highlights](#) of the June 27, 2012, CAQ SEC Regulations Committee joint meeting with the SEC staff.

⁷ Launched in June 2014, the FASB’s simplification initiative is intended to reduce the cost and complexity of current U.S. GAAP while maintaining or enhancing the usefulness of the related financial statement information. The initiative focuses on narrow-scope projects that involve limited changes to guidance.

⁸ FASB Accounting Standards Update No. 2015-04, *Practical Expedient for the Measurement Date of an Employer’s Defined Benefit Obligation and Plan Assets*.

Editor’s Note: An entity that has a 52- or 53-week fiscal year may find that the fiscal year in which it is required to adopt the ASU has a year-end that coincides with a month-end. For example, December 31, 2016, falls on a Saturday and may be the fiscal year-end for a 52- or 53-week fiscal year that ends in December. In these circumstances, an entity may need to disclose that it has elected the practical expedient for the year-end measurement date even though in that particular year, the measurement date under the practical expedient is no different from the entity’s fiscal year-end.

Other Considerations Related to Assumptions

In measuring each plan’s defined benefit obligation and recording the net periodic benefit cost, financial statement preparers should understand, evaluate, and reach conclusions about the reasonableness of the underlying assumptions, particularly those that could be affected by continuing financial market volatility. ASC 715-30-35-42 states that “each significant assumption used shall reflect the best estimate solely with respect to that individual assumption.”

Entities should comprehensively assess the relevancy and reasonableness of each significant assumption on an ongoing basis (e.g., by considering the impact of significant developments that have occurred in the entity’s business). Management should establish processes and internal controls to ensure that the entity appropriately selects each of the assumptions used in accounting for its defined benefit plans. The internal controls should be designed to ensure that the amounts reported in the financial statements properly reflect the underlying assumptions (e.g., discount rate, estimated long-term rate of return, mortality, turnover, health care costs) and that the documentation maintained in the entity’s accounting records sufficiently demonstrates management’s understanding of and reasons for using certain assumptions and methods (e.g., the method for determining the discount rate). Management should also document the key assumptions used and the reasons why certain assumptions may have changed from the prior reporting period. A leading practice is for management to prepare a memo supporting (1) the basis for each important assumption used and (2) how management determined which assumptions were important.

Recent SEC Staff Views

The SEC staff continues to emphasize the disclosures related to how registrants account for pension and other postretirement benefit plans and how key assumptions and investment strategies affect their financial statements. Further, registrants may be asked how they concluded that assumptions used for their pension and other postretirement benefit accounting are reasonable relative to (1) current market trends and (2) assumptions used by other registrants with similar characteristics.

MD&A — Critical Accounting Policies and Estimates

Recent SEC staff comments have focused on inadequate disclosure of critical accounting policies and estimates related to a registrant’s benefit plans. The SEC staff expects registrants to provide robust disclosures of their critical accounting policies and estimates in MD&A instead of duplicating documentation from the accounting policy disclosures in the financial statement footnotes. In addition, the staff has indicated that it may be appropriate for a registrant to disclose:

- Whether a corridor is used to amortize the actuarial gains and losses; and, if so, how the corridor is determined and the period for amortization of the actuarial gains and losses in excess of the corridor.
- A sensitivity analysis estimating the effect of a change in assumption regarding the long-term rate of return. This estimate should be based on a reasonable range of likely outcomes.
- The extent to which historical performance was used to develop the expected long-term rate of return assumption. If use of the arithmetic mean to calculate the historical returns yields results that are materially different from the results yielded when the geometric mean is used to calculate such returns, it may be appropriate for an entity to disclose both calculations.
- The reasons why the assumption regarding the long-term rate of return has changed or is expected to change in the future.

Disclosure of Changes in Mortality Assumption

As discussed in the [Mortality Assumption](#) section above, registrants now have the opportunity to use the SOA's RP-2014 mortality tables and related underlying data, which were made available in 2014, when developing the mortality assumption used to measure a benefit obligation. The SEC staff has asked registrants in comment letters to explain why they have either adopted or not adopted the RP-2014 mortality tables. If a registrant has adopted the RP-2014 mortality tables, the SEC staff would like to understand the quantitative impact of the new tables or underlying data on the registrant's pension and postretirement liabilities compared with that of the mortality tables used before adoption. If the registrant has not adopted an updated mortality table, the SEC staff would expect the registrant to provide disclosures about the mortality table used and why the mortality rate assumption used represents the best estimate for the participant population.

For more information, see Deloitte's [SEC Comment Letters — Including Industry Insights: What "Edgar" Told Us](#).

FASB Standard-Setting Projects Related to Pension and Other Postretirement Benefits

The table below summarizes the objectives⁹ and current status of the FASB's active standard-setting projects related to pension and other postretirement benefits:

Project	Objective	Status
Disclosure framework: disclosure review — defined benefit plans	To improve the effectiveness of disclosure requirements that apply to defined benefit plans.	At its June 29, 2015, and July 9, 2015, meetings, the FASB decided to add certain disclosure requirements and to remove others. The FASB expects to issue a proposed ASU in the fourth quarter of 2015. For more information, see Deloitte's July 2, 2015 , and July 10, 2015 , journal entries.
Improving the presentation of net periodic pension cost and net periodic postretirement benefit cost	To "simplify and improve the reporting of net periodic pension cost and net periodic postretirement benefit cost ('net benefit cost')."	<p>At its June 29, 2015, meeting, the FASB added a project and made tentative decisions to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. For more information, see Deloitte's July 2, 2015, journal entry. The Board tentatively decided to propose the following:</p> <ul style="list-style-type: none"> • An entity should present current service cost with other current employee compensation costs in the income statement and present the remaining components of net benefit cost as a separate line item outside of operating items. • The net benefit cost eligible for capitalization (e.g., as part of inventory) should be limited to service cost. <p>The FASB expects to issue a proposed ASU in the fourth quarter of 2015.</p>

⁹ The quoted material related to the projects' objectives is from the respective project pages on the FASB's Web site.