Financial Reporting Alert 18-13
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Contents

Financial Reporting Considerations Related to High Court of Justice Ruling on Equalization of U.K. Pension Benefits

Introduction

On October 26, 2018, in *Lloyds Banking Group Pensions Trustees Limited vs. Lloyds Bank plc and Others*, the High Court of Justice in the United Kingdom (the "High Court") issued a ruling (the "Court Ruling") requiring Lloyds Bank plc to equalize benefits payable to men and women under its U.K. defined benefit pension plans by amending those plans to increase the pension benefits payable to participants that accrued such benefits during the period from 1990 to 1997. The inequalities arose from statutory differences in the retirement ages and rates of accrual of benefits for men and women related to Guaranteed Minimum Pension (GMP) benefits that are included in U.K. defined benefit pension plans. In its ruling, the High Court also provided details on acceptable alternative methods of amending plans to equalize the pension benefits. While the effects of the Court Ruling will vary by individual pension plan, current estimates of the potential increase in the projected benefit obligation of an affected defined benefit pension plan are in the 0–3 percent range.

This *Financial Reporting Alert* addresses the Court Ruling's accounting implications under U.S. GAAP for reporting entities that conclude that the ruling is applicable to their defined benefit pension plans. The alert also discusses considerations related to disclosures and IFRS® Standards.

Background

On May 17, 1990, the European Court of Justice issued a ruling in *Barber vs. Guardian Royal Exchange* (the "Barber Judgment") requiring defined benefit pension plans that provide GMPs to grant equal pension benefits to men and women. GMPs were the minimum level of pension benefits that entities in the United Kingdom were required to provide if they opted out of the United Kingdom's State Earnings-Related Pension Scheme (SERPS) before 1997 (when the laws related to the types of minimum benefits were changed). Companies and their workers that opted out of SERPS paid lower National Insurance contributions, with alternative arrangements for GMPs to be provided by a company-sponsored defined benefit plan that would broadly replace the SERPS benefit.

The calculations applied for the accrual of GMPs under U.K. law prescribed differing retirement ages for men and women related to payment of GMP benefits. As a result of those retirement age differences, GMPs accrued at different rates for men and women. Since these differences resulted from U.K. law, pension plan trustees have been unable to unilaterally equalize GMPs for men and women participants in a pension plan.

Further, it was unclear whether the existing laws and the Barber Judgment required pension plans to offer non-GMP pension benefits that compensated for and equalized the differences caused by GMPs such that total pension benefit offered by a pension plan (the combined GMPs and non-GMPs) would be equal for men and women. As a result, the GMPs offered by most pension plans that contracted out of SERPS between 1990 and 1997 remained unequal, with very few pension schemes attempting to equalize the benefits.

Equalization Methods

In the Lloyds Bank plc case, the High Court ruled on the methods that pension plans can use to equalize the benefits between men and women. Although the High Court rejected several methods, it provided three acceptable options for equalizing the benefits for men and women. An entity should consider consulting with its advisers to discuss the various options and assess their range of effect as part of determining reasonable assumptions to incorporate into the measurement of the pension obligation that reflect the entity's best estimates as of the applicable plan measurement date.

Accounting Implications

Initial Recognition and Remeasurement Considerations

Under U.S. GAAP, defined benefit pension plan changes (including changes attributable to legislation or court rulings) that result in a retroactive increase or decrease in benefit levels for plan participants are viewed as prior service cost under ASC 715.[1] Since the Court Ruling requires retroactive changes in the level of benefits accrued during the period from 1990 to 1997 to equalize the level of pension benefits accrued for men and women participants, the equalization adjustment should be treated as a prior service cost.

Generally, plan amendments required by legislation or court rulings are accounted for upon enactment of the legislation or finalization of the court rulings. As noted above, the Court Ruling was issued on October 26, 2018. An entity will need to determine with its legal advisers whether the ruling is applicable and requires plan amendments to address benefit equalization and, if so, whether the entity intends to comply with the ruling and make the necessary plan amendments. The Court Ruling may be subject to an appeal, but it is unknown at this time whether that will occur.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

ASC 715-30-35-66 states that "sometimes, an entity remeasures both plan assets and benefit obligations during the fiscal year, for example, when a significant event such as a plan amendment, settlement, or curtailment occurs that calls for a remeasurement." An entity will need to assess whether the Court Ruling is considered a significant event for a plan and triggers a remeasurement. This assessment is performed on a plan-by-plan basis. Because ASC 715 does not define the term "significant event," an entity will need to use judgment in determining whether a significant event has occurred. When making this determination, the entity may consider (1) any current or future effect on the projected benefit obligation, net periodic pension cost, or other comprehensive income and (2) qualitative factors.

An entity is not permitted to adjust just one assumption in an interim-period remeasurement. An entity that determines that the Court Ruling is a significant event must perform a complete remeasurement. A remeasurement of the obligation and plan assets may be performed at any time as long as both are remeasured (i.e., it is not acceptable to remeasure just the obligation or just plan assets). ASC 715-30-35-68 states, in part:

> Measurements of net periodic pension cost for both interim and annual financial statements shall be based on the assumptions used for the previous year-end measurements unless more recent measurements of **both** plan assets and obligations are available or a significant event occurs. [Emphasis added]

If an entity concludes that the Court Ruling is applicable to its plans but is not a significant event, the entity will include the effect of the ruling in its next annual year-end remeasurement. The resulting increase in the projected benefit obligation when the effect of the Court Ruling is included in remeasurement of the projected benefit obligation should be treated as prior service cost regardless of whether the effect of the ruling is initially recognized as a result of a significant-event interim remeasurement or as part of the next year-end measurement of the pension plan. Under ASC 715-30-35-16, prior service cost is generally "recognized immediately in other comprehensive income." Accordingly, the prior service cost is recognized in other comprehensive income on the measurement date.

Subsequent Recognition

After initial recognition of the prior service cost, ASC 715-30-35-11 requires that **"prior service cost shall be amortized as a component of net periodic pension cost"** (emphasis added). An entity should review the considerations in ASC 715-30-35-10 through 35-17 to determine the method and period of the amortization of the prior service cost from other comprehensive income to recognize as a component of net periodic pension cost.

Changes in Estimates in Future Periods

Given the difficulty of obtaining the information needed to measure the effect of the Court Ruling, combined with the complexity and uncertainty associated with implementing the several acceptable alternative methods of equalizing pension benefits, reporting entities will most likely be required to make estimates and assumptions as part of the measurement and initial recognition of the effect of the Court Ruling that will be treated as prior service cost. Over time, improved availability of information supporting the estimates and measurement assumptions as well as further clarity regarding application of the equalization methods will most likely give rise to actuarial gains or losses in future remeasurements of the pension obligation. Subsequent gains and losses in measurements of the projected benefit obligation (after initial recognition of the prior service cost related to the Court Ruling) that are related to equalization and that arise from experience different from that assumed or from a change in an actuarial assumption should generally be recorded as gains and losses in accordance with ASC 715-30-35-18 through 35-27. However, the guidance therein **"does not require recognition of gains and losses as components of net pension cost of the period in which they arise"**[2] (emphasis added).

Other Considerations

It is possible, although expected to be rare in practice, that reporting entities have already recognized an equalization adjustment in the projected benefit obligation in a reporting period before the Court Ruling in October 2018. Entities in such cases should consider consulting with their independent accountants regarding how to account for and disclose the effects of the Court Ruling. Depending on the facts and circumstances, entities that have previously recognized the effect of equalization may determine that the accounting effect of the Court Ruling may result in an adjustment to actuarial assumptions that will give rise to gain or loss recognition under ASC 715-30-35-18 through 35-27. Further, depending on the timing of interim or annual remeasurements of the pension plan obligation and the related timing of issuance of the financial statements that include the remeasurement, the effect of the Court Ruling may be expected to be reflected in the actuarial assumptions. For example, if a reporting entity with a September 30 year-end previously recognized the effect of equalization in measuring its pension obligation and therefore treats the effect of the Court Ruling as an actuarial gain or loss, the annual remeasurement of the pension obligation on September 30, 2018, should include the revised actuarial assumptions reflecting the effect of the Court Ruling if the financial statements are issued after the date of the Court Ruling.

Disclosures

Entities should consider the following when determining the nature and extent of their disclosures about the Court Ruling and the ruling's effect on their pension liabilities as part of their annual and quarterly reports:

- The size and materiality of the U.K. pension benefit plan and related equalization adjustment.
- Any significant judgments or estimates used as part of the calculation of the equalization adjustment.
- Any required disclosures under ASC 715-20-50, including, but not limited to:
  - Disclosure of the effect of plan amendments in the reconciliation of the beginning and ending projected benefit obligation.
  - If applicable, an explanation of any significant change in the benefit obligation not otherwise apparent in the other disclosures already required.
- Any required SEC disclosures, including, but not limited to, identification and discussion in MD&A of any known trends or uncertainties that are reasonably likely to have a material effect on liquidity, capital resources, or operating results. Entities must assess and disclose whether the Court Ruling is reasonably likely to have a material effect on their liquidity, capital resources, or operating results and, if so, provide appropriate disclosures in MD&A.

[2] Quoted from ASC 715-30-35-19.

IFRS Considerations

For entities that report under IFRS Standards, there are two key differences between the U.S. GAAP requirements discussed above under ASC 715 and the IFRS requirements under IAS 19:[3]

- *Plan amendments* — Under U.S. GAAP, prior service costs are recorded in other comprehensive income on the measurement date and amortized as a component of net periodic pension cost in accordance with ASC 715. Under IAS 19, immediate recognition of profit or loss for the past service cost adjustment is required.
- *Actuarial gains or losses* — Under IAS 19, any subsequent gains or losses related to the equalization adjustment, including actuarial gains or losses in future periods, are recognized immediately in other comprehensive income and are not subsequently amortized in the income statement as they are under U.S. GAAP.

[3] IAS 19, *Employee Benefits*.