FASB Pension Change: Nudging Sponsors Towards Additional De-Risking?

Earlier this year, the Financial Accounting Standards Board (FASB or Board) issued a new rule regarding how plan sponsors present net periodic benefit cost in their income statements.[1] In this piece, we discuss the key changes and potential investment implications.

The new guidance changes where pension expense is reflected on the income statement

Pension expense will be disaggregated on the income statement with only service cost reflected within the operating income metric, if one is maintained. This change more closely aligns reporting for pensions under US Generally Accepted Accounting Principles with the reporting requirements under International Financial Reporting Standards.

The benefit of expected return income no longer accrues to operating income

Any expected return income recognized by sponsors, generally the product of a plan's expected return assumption and plan assets, will now be reflected outside the operating income metric if one is maintained. However, that income will still flow to the sponsor's net income and earnings per share.

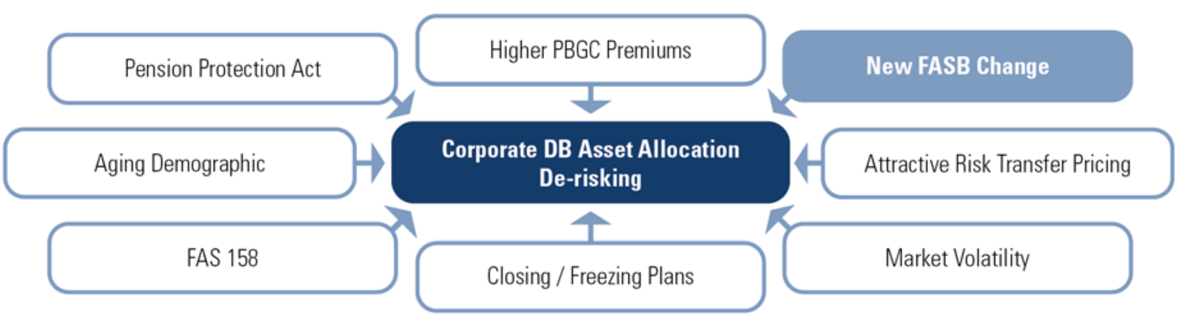
The change could impact views on pension plan asset allocation

Since expected return income will no longer be reflected in operating income, this change may affect how sponsors consider the impact of holding risk-seeking assets such as public equity which may result in a relatively high expected return on asset assumption. For example, this change could affect how some sponsors view moving towards asset allocation de-risking, and in particular more shifts to high-quality, long-duration fixed income.

Most companies will adopt the new rule in early 2018

The new guidance is effective for public entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Private entities will have additional time to adopt the new standard.

EXHIBIT: MULTIPLE FORCES OVER THE PAST DECADE HAVE ENCOURAGED PLAN ASSET DE-RISKING



Source: Goldman Sachs Asset Management.

1 For additional information, please see FASB Accounting Standards Update 2017-07, "Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost," March 2017.

Change in reporting, but not a change in measurement or economics

The new guidance requires an employer to report the service cost component of pension expense in the same line item of the income statement as other compensation costs arising from employee services during the period. Other components of net periodic pension expense, such as interest cost, expected return on asset (EROA) income, amortization of prior service cost, and amortization of actuarial gains and losses, would be reflected separately outside a subtotal of income from operations, if one is presented. In addition, under the new guidance, only the service cost component of net benefit cost is eligible for capitalization.

This rule change was driven in no small part by users of financial information, including investors and creditors. These stakeholders noted that the previous guidance around the presentation of net defined benefit (DB) pension cost combined elements that were unrelated. Consequently, some felt that the previous presentation methodology was less transparent, reduced the decision usefulness of the financial statements, and required users to spend additional time and resources to analyze the impact of a company's pension plan on its income statement.

Specifically, many users noted that they view service cost, the pension benefits earned in a given period, as akin to payroll. Employees provide services during a particular time frame and are compensated for that in various ways, including the salary they are paid during that period and the right to future pension benefits earned during the same period. This linkage leads many to view service cost as an item to be captured within an operating income metric. The other components of pension expense, detailed earlier, are often thought to be unrelated to the operations for the specified period.

The Board's changes to the presentation of benefit costs support the way many users view these expenses. In addition, these changes align reporting for pensions under US Generally Accepted Accounting Principles (GAAP) more closely with International Financial Reporting Standards (IFRS) by requiring disaggregation of service cost from the other components of net benefit cost.[2]

While this change makes a number of important alterations to the way pensions will be reflected on a sponsor's income statement, it is also important to recognize what it does not do. It does not change the measurement of pension obligations and expense. The calculation of the projected benefit obligation and the surplus/deficit to be recognized on the sponsor's balance sheet remains unchanged. It also does not change the calculation of the underlying components of pension expense, such as service and interest cost, expected return on plan assets, or the amortization of unrecognized gains and losses and prior service cost.[3]

In addition, the economics of the plan remain unchanged. The new guidance does not change contribution requirements for the sponsor or benefit payments due to participants. In other words, there is no impact on the amount of cash that needs to go into the plan from the sponsor or the amount of cash coming out every month to pay retirees or other beneficiaries.

Nonetheless, the particular way an item is accounted for and reported in the financial statements can influence how sponsors view the impact of maintaining or changing that item. This effect can be even more acute when there is a change in the accounting or reporting guidance. We explore this topic later in this note.

Operating income could be better or worse off

It is quite clear that disaggregating pension expense components on the income statement and only including service cost in an operating income total will change that metric. Below we have outlined a generic example that reviews how this would work in practice. The example details the different components of net periodic pension expense, as typically presented by a company in its 10-K and 10-Q filings with the Securities and Exchange Commission, and indicates where they would be reflected on the sponsor's consolidated income statement under the new guidance.

2 IAS 19(R), Employee Benefits, allows for the service cost and net interest cost components to be recognized in the income statement as either a combined amount or as separate line items while the new US GAAP guidance will require the disaggregation of the service cost component from all other components of net benefit cost.

3 This change may, however, impact the timing of when certain elements of pension expense are actually recognized through the income statement since only service cost will now be eligible for capitalization. In short, companies that may have previously capitalized certain pension costs may no longer be able to do so, resulting in a more immediate recognition of those expenses through their income statements.

EXHIBIT 1: GENERIC EXAMPLE OF APPLICATION OF NEW GUIDANCE

Service cost	15	Included in operating income
Interest cost	40	
Expected return income	(56)	Net amount excluded from operating income
Amortization of gains/losses	25	
Amortization of prior svc cost	5	
Net pension expense	29	

Source: Financial Accounting Standards Board, Goldman Sachs Asset Management.

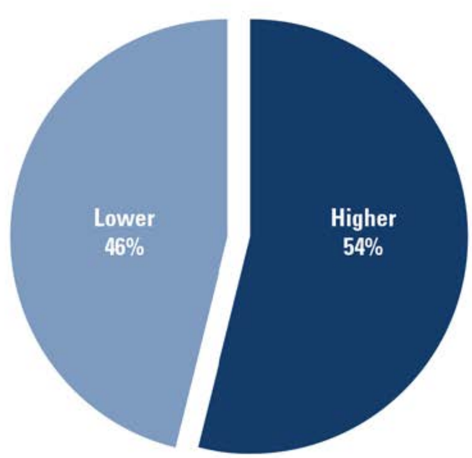
The determination of whether this change will result in higher or lower operating income for a sponsor will be driven by the relationship between service cost and total net pension expense. If service cost is less than total net pension expense, then operating income will be higher, and vice versa. In the generic example in Exhibit 1, because service cost is less than total net pension expense, the sponsoring organization, holding all else constant, would experience an increase in operating income, if it maintains such a metric.

Over the past several years, given increases in projected benefit obligations due to, primarily, lower interest rates, many companies have amortized actuarial losses as part of their pension expense calculations. Consequently, excluding those losses from operating income may result in an upward boost to that metric.

At first blush, one may conclude that if a company's plans are completely closed and frozen, and therefore have zero service cost, the sponsor will have higher operating income under the new rule. After all, the only pension-related expense running through operating income would be a zero for service cost. Even here, however, it may not be clear cut. For example, if the plan is generating net pension income due to expected return on asset income that exceeds the sum of interest cost and any amortization items, then removing that net pension income from operating income could result in a reduction of operating income.

Using 2016 data for US plans of the S&P 500 universe, we compared service cost to total net periodic pension cost in order to gain a sense of how this change would have impacted last year's results had the rule change been in place at that time. As seen in Exhibit 2, slightly more than half of the companies in the S&P 500 with US DB plans would have seen an increase to operating income in 2016, assuming they maintained such a metric, had the rule been effective last year.

EXHIBIT 2: PRO FORMA IMPACT TO 2016 OPERATING RESULTS FROM RULE CHANGE



Source: Goldman Sachs Asset Management, company reports, population based on US plans (when specified) of S&P 500 companies.

Change could affect sponsor views on the impact of asset allocation and investment strategy decisions

While the new guidance does not change the economics of a plan, it could influence the way a sponsor considers the impact of a pension plan's asset allocation and investment strategy. There are a number of factors that may influence a sponsor's views around asset allocation, including its views on the relative attractiveness of different asset classes, the funded status of the plan, and whether or not the plan is still accruing new benefits for employees. The way companies account for and report their pension in their financial statements may also affect how sponsors view the impact of a plan's asset allocation.

In the past, some plan sponsors may have maintained exposure to equities or other asset classes with high long-term expected returns in their pensions, even if there may have been other factors supporting an asset/liability matched allocation, to support a relatively high EROA assumption. Under US GAAP, that assumption is then applied to the market-related value of plan assets to derive expected return income which can offset other components of pension expense, as seen in the previous example in Exhibit 1.[4]

In other words, the higher the EROA assumption, the greater the expected return income that will be recognized and, therefore, the lower total pension expense to be recognized through the sponsor's income statement. Maintaining a high EROA assumption may, at times, result in an increase in the company's net income and earnings per share (EPS). Although the quality of expected return income may be considered low by investors and creditors, it is, nonetheless, GAAP income.

Under this rule change, expected return income will no longer be reflected in operating income. A sponsor can raise or lower the EROA assumption and there would be no change to the total amount of pension expense recognized through operating income. Consequently, some plan sponsors that may have been considering shifts in their asset allocation to more fixed income from equity as part of a de-risking program might be more inclined to enact such changes.

For other plan sponsors, however, the rule change may not influence their views on asset allocation and investment strategy. There may be several reasons for this:

- First, EROA income still flows through to net income and EPS. For some organizations where these may be the most important metrics, this change may not affect how sponsors view maintaining exposure to equities or other asset classes with relatively high expected returns.
- Second, some sponsors already adjust any operating income measure they maintain for all components of pension expense except service cost. In this regard, the actual US GAAP accounting is simply catching up to what some plan sponsors have already been doing in practice through pro forma adjustments to their financial results.
- Third, there is no requirement in US GAAP to maintain an operating income metric, and, consequently, some companies do not do so.
- Finally, as with most things pension-related, materiality can be key. For some organizations the amount of EROA income generated by its plan(s) may not be large enough to significantly influence metrics like operating income, net income, or EPS. In these cases, sponsors' views on their plans may not be impacted by the changes around where various pension expense components are reflected on the income statement.

For these reasons, this may not be a transformative change for the entire corporate DB pension industry. Actually disconnecting the EROA assumption from a plan's asset allocation, as has been done under IFRS, could have a much larger impact since there is no longer a direct linkage between bottom line financial reporting and exposure to riskier assets.

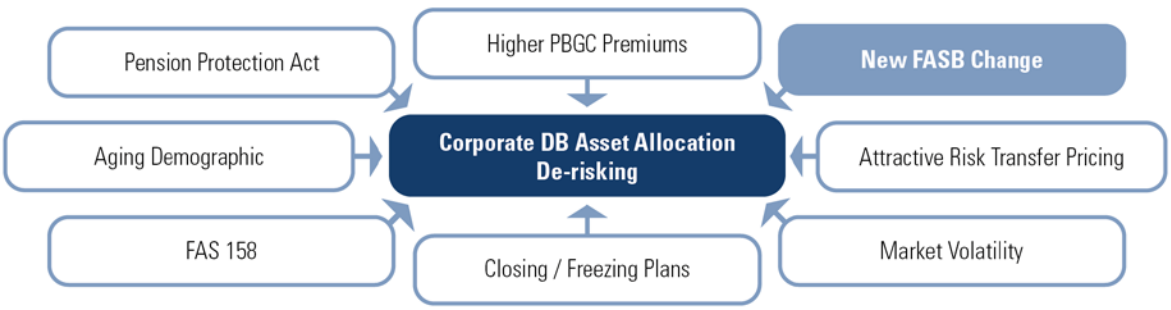
Nevertheless, the rule change could influence sponsors to reconsider asset allocation de-risking actions in light of the fact that the financial reporting benefit of maintaining exposure to riskier assets like equities would no longer accrue

4 The market-related value of plan assets can either be the fair value of plan assets or a value that smooths actual gains and losses over a period of several years.

to operating income. Whether and how this change is considered by a sponsor may depend on, as with everything, the specific facts and circumstances for each sponsor.

Over the past ten plus years, there have been a number of factors that have nudged sponsors to engage in de-risking actions with respect to their asset allocation and investment strategy. These include the issuance of the Pension Protection Act and Financial Accounting Standard 158 in 2006, the ongoing increases to Pension Benefit Guaranty Corporation premiums, market volatility such as that experienced during the financial crisis, and decisions by sponsors to close or freeze their plans (see Exhibit 3). This new accounting rule change could be another factor guiding some plan sponsors to consider de-risking actions, in particular with respect to their asset allocation and investment strategy.

EXHIBIT 3: FORCES AT WORK: FASB CHANGE POTENTIALLY ANOTHER FACTOR GUIDING CORPORATE DB PLANS TO DE-RISK



Source: Goldman Sachs Asset Management.

Rule generally effective in 2018, but some have adopted early

The new guidance is effective for public entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. In other words, a company with a fiscal year that matches the calendar year would need to adopt on January 1, 2018. Private entities will have additional time to adopt the new standard.

Early adoption was permitted and some companies, including Ford, Ingersoll Rand, and Tegna, elected to do so. However, it appears that the vast majority of plan sponsors did not elect to adopt early. We expect many organizations to continue to evaluate the impact of this new rule over the next few months as they prepare for mandatory adoption in 2018, particularly with respect to their views on any impact on their overall investment strategy.

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