NEW ACCOUNTING STANDARD MAY ACCELERATE U.S. PENSION DE-RISKING

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FASB'S NEW ACCOUNTING STANDARD

FASB's newly-issued Accounting Standards Update No. 2017-07 (ASU2017-07) changes the presentation of net benefit cost, i.e. pension expense, in a company's financial statement. This new standard simplifies the pension expense disclosure by removing the Expected Return on Pension Assets (EROA) and Actuarial Gain and Loss components from the calculation of operating earnings. Many analysts have been spending a great deal of time making adjustments to the reported earnings in the financial statements to better represent how the current compensation component of a pension plan was affecting the company's performance. This change was made to improve the transparency and usefulness of pension expense information for analysts and other stakeholders.

Operating income will change for all companies with a defined benefit pension plan. The change will reduce operating income for some companies and increase it for others. It will also likely accelerate the increase in liability driven investments (LDI) as more companies move to de-risk their plans.

PENSION EXPENSE – POST ASU2017-07

Service Cost is a measure of benefits which are currently accruing for active employees. It is the only component of pension expense related to an employee's service to the company during the current period. The current required pension expense calculation includes several elements that are unrelated to current compensation cost. ASU2017-07 will require companies to include <u>only</u> the service cost component in the operating income statement. The other prior pension expense components will be reported outside the operating income determination, i.e. "below-the-line." The new accounting standard will require the following presentation of items currently included in net pension expense.

Exhibit 1: Pension expense – post ASU2017-07

Operating Income	Below-the-Line
Service Cost	Interest Cost
	Expected Return on Assets
	Amortizations (plan amendments & gains & losses)

EFFECT ON OPERATING EARNINGS

The pension expense effect on operating earnings will generally be less volatile because investment experience and other actuarial gains and losses will not be included. Most analysts think this change is an improvement in measuring the effect of the pension plan on operating earnings.

Companies with better funded pension plans will likely have reduced operating earnings because the expected return on assets component currently has a significant positive effect of lowering pension expense. Conversely, companies with less well funded plans may experience an increase in operating earnings.

Consider a pension plan with $300M of Pension Obligation and Service Cost of $7,100,000. The impact of ASU2017-07 is shown below for alternative funded percentages of 70%, 85%, or 100% with 7.5% expected return on asset assumption. The current expense varies by the pension assets; it is lowest when the plan is fully funded. In contrast, the ASU 2017-07 expense is not affected by the value of the pension assets.

Exhibit 2: Hypothetical Pension Plan

	Funded Percent		
	70%	85%	100%
Assets	$210,000,000	$255,000,000	$300,000,000
Current Expense	$9,000,000	$5,600,000	$2,200,000
ASU2017-07 Expense	$7,100,000	$7,100,000	$7,100,000
Effect on Operating Earnings	$1,900,000	($1,500,000)	($4,900,000)

ACCELERATION OF PENSION DE-RISKING

Many plan sponsors have been reluctant to increase the fixed income allocation or adopt LDI strategies to reduce risk in their pension portfolio. The change in asset allocation would have reduced the expected asset return component in the pension expense calculation with a resulting reduction in operating earnings. Companies can now focus on the benefits of reduced volatility in funded status and contributions by de-risking their pension plan -- without concern about the resultant effect on operating earnings.

The usual first step for companies who choose to de-risk their plans is to increase the allocation to long duration bonds which match the duration of the plan’s liabilities. This liability driven investment (LDI) approach is usually adopted in phases. The initial LDI investment might be 40% or so, increasing to 90%-100% as the plan becomes well-funded.

EFFECTIVE DATE OF ASU2017-07

ASU2017-07 takes effect for public business entities for annual periods beginning after Dec. 15, 2017. For other entities, the amendments take effect for annual periods beginning after Dec. 15, 2018.

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