Pension and Other Postretirement Benefits Affected by Turmoil in the Credit Markets

Financial Reporting Alert 08-19

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This Financial Reporting Alert highlights the impact that the volatile financial markets and the broadening market decline may have had, and could have, on an entity's pension and other postretirement benefit calculations and disclosures.

Considerations for This Financial Reporting Season

Balance Sheet Impact

In response to the broad market declines, coupled with the requirements in Statement 158[1] that an entity record the funded status of its defined benefit postretirement plan(s) as an asset or liability on its balance sheet, financial statement preparers should focus on the value of an entity's plan assets this year-end. Because funded status is computed as the difference between plan assets and the postretirement benefit obligation, a decrease in a plan's assets will result in a dollar-for-dollar pretax decline in funded status. On the other hand, an increase in the discount rate would result in a decrease in the benefit obligation and an improvement in funded status. Accordingly, reductions in the fair value of pension assets and broadening market declines could have a significant effect on an entity's pension asset or liability. Entities should understand and evaluate the potential effect that an increasing postretirement benefit liability (or decreasing postretirement benefit asset) may have on their debt covenant calculations or capital requirements.

Underlying Assumptions

In measuring the pension[2] obligation and recording the net periodic benefit cost, financial statement preparers should understand, evaluate, and conclude on the reasonableness of the underlying assumptions that could be affected by the credit market turmoil and broadening market declines. Paragraph 43 of Statement 87[3] requires that "[e]ach significant assumption used shall reflect the best estimate solely with respect to that individual assumption [as of the measurement date]." Because of the current market conditions, entities should particularly understand, evaluate, and conclude on the reasonableness of the discount rate and the expected long-term return on plan assets.

Discount Rate

To support their discount rate, some companies seek advisors for assistance in constructing hypothetical bond portfolios rather than using a yield curve constructed by a third party (e.g., Citigroup or an actuarial firm). Companies that use hypothetical bond portfolios to support the discount rate to measure their postretirement benefit obligations should evaluate the impact of current market conditions on both bond pricing and bond selection.

Hypothetical Bond Portfolios — Bond Yield Considerations[4]

The discount rate used to measure postretirement benefit obligations should reflect the rate at which pension benefits could be effectively settled. Use of a model that reflects rates of zero-coupon, high-quality corporate bonds is an acceptable method of deriving the assumed discount rate. 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.

Paragraph 44A of Statement 87 states, in part:

> [A]n employer may look to rates of return on high-quality fixed-income investments in determining assumed discount rates. The objective of selecting assumed discount rates using that method is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the pension benefits when due. Notionally, that single amount, the projected benefit obligation, would equal the current market value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments.

Constructing a hypothetical portfolio of high-quality instruments with maturities that mirror the pension obligation is one method that can be used to achieve this objective; other methods that can be expected to produce results not materially different are also acceptable.

Current market conditions have affected the level of trading activity for some bonds, resulting in large spreads between the bid and ask prices. Pricing should reflect the amount at which the pension benefit obligation could be settled. In the current market, bid price (which is often used because of the availability of data) may not necessarily be representative of the cost of acquiring a hypothetical portfolio. Paragraph 31 of Statement 157[5] may assist companies in evaluating the appropriateness of bond pricing used in developing their models:

> If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). This Statement

> does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

Hypothetical Bond Portfolios — Bond Selection[6]

In developing a hypothetical portfolio, companies are required to exclude certain bonds, known as "outliers," and must also consider whether there is a sufficient quantity of the selected bonds ("capacity") in the market to cover their pension obligations. In other words, the value of the bonds in the hypothetical portfolio must be sufficient to effectively settle the pension obligation.

The discount rate may be affected by the credit market turmoil and broadening market declines as a result of downgrades in the bond instruments that are used to develop the rate. Entities should exclude outliers from the hypothetical bond portfolio when developing their postretirement plan discount rates; discount rates derived from hypothetical bond portfolios, which generally include fewer bonds, are more greatly affected than third party yield curves if outliers are inappropriately included.

Outliers would include bonds that have high yields because:

- The issuer is on review for possible downgrade by one of the major rating agencies.[7]
- Recent events have caused significant price volatility and the rating agencies have not yet reacted.

We are currently observing a widening of the range of yields on high-quality bonds at all maturities. Companies should understand and evaluate the bonds in their hypothetical bond portfolios to ensure that all outliers have been identified and excluded. Rating agencies have recently downgraded a number of bonds, including those in the finance sector, and more downgrades may occur. Downgrades from high-quality to less-than-high-quality that occur shortly after the balance sheet date may indicate that a bond was an outlier on the balance sheet date, particularly if the bond was subject to a downgrade watch. Even after identifying and excluding outliers, entities should select a discount rate that is appropriate. Use of an inappropriately high discount rate could result in an understatement of the benefit obligation and, consequently, an understatement of the pension liability (or overstatement of the pension asset).

A company must consider capacity when assembling a hypothetical portfolio. Paragraph 31 of Statement 106[8] states that discount rate assumptions should reflect "the present value of future cash outflows currently expected to be required to satisfy" the obligation, and that the rates of return should reflect "investments **currently available** whose cash flows match the timing and amount of expected benefit payments" (emphasis added).

In addition, EITF Topic No. D-36,[9] a 1993 SEC staff observer announcement, quoted paragraph 44A of Statement 87 in stating that the "objective of selecting assumed discount rates is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the accumulated benefits when due.

Notionally, that single amount (the accumulated postretirement benefit obligation) would equal the current market value of a portfolio of high-quality zero coupon bonds, whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments."

However, a company need not consider capacity when using a traditional yield-curve approach to selecting discount rates, because though the bonds used in assembling the particular yield curve may not be sufficient to effectively settle the company's benefit obligation, the curve is believed to be representative of the broader market.

Use of Indices in Selecting a Discount Rate

A company may also select a discount rate by referring to index rates as long as the company can demonstrate that the timing and amount of cash flows related to the bonds included in the indices match its estimated defined benefit payments. Companies that use indices to select their discount rate should evaluate and conclude on whether use of the indices is still appropriate. In the current economic environment, companies should consider whether the specific index reflects the market in a manner consistent with other similar indices and whether market conditions have affected the level of trading activity for bonds included in the index (large spreads between the bid and ask prices). As noted above, pricing should reflect the amount at which the pension benefit obligation could be settled.

Expected Long-Term Rate of Return

The expected long-term rate of return on plan assets[10] is another component of an entity's net periodic benefit cost. As with the discount rate, an entity should understand, evaluate and conclude on the reasonableness of the expected rate of return on plan assets.

Companies should evaluate whether there have been changes in a plan's asset allocation that may affect the expected long-term rate of return. A reduction in the expected return would result in an increase in the net periodic benefit cost in future periods. The expected return on plan assets counterbalances the effect of the other components of net periodic benefit cost (e.g., service cost, interest cost). However, as the name implies, the expected long-term rate of return is intended to be the average rate of earnings expected over the long term on the funds invested to provide future benefits.

Fiscal 2009 Pension Cost

Entities should consider the effect that decreases in plan assets and changes in postretirement benefit obligations could have on the computation of the gain or loss amortization component of fiscal 2009 pension cost. Many entities record the minimum amortization amount (the excess outside the "corridor").[11] In the current environment, many entities have experienced a decline in both the benefit obligation and the asset value, resulting in a tighter corridor, and accumulated losses may have increased. Accordingly, this component of fiscal 2009 pension cost may be greater than previously estimated.

Measurement Date for Plan Assets and Benefit Obligations

Effective for fiscal years ending after December 15, 2008, paragraph 5 of Statement 158 requires that entities measure their plan assets and benefit obligations as of the date of their fiscal year-end.

Measurement of Plan Assets

Preparers should ensure that they use actual market values as of the measurement date (e.g., their fiscal year-end) for assets with readily determinable fair market values.

Entities should value assets without readily determinable fair values (e.g., alternative investments) as of the measurement date by using principles from Statement 157 on estimating the fair value of financial assets in inactive markets, such as the following:

- The objective of fair value measurements is to estimate the price that would be received by the holder of the financial asset in an orderly transaction as of the measurement date. Measurements that do not meet this objective (e.g., do not encompass a market participant’s view) would not be considered fair value measurements.
- Fair value measurements should maximize the use of observable market inputs and minimize the use of unobservable inputs. Thus, when an entity has concluded that a single valuation technique yields better fair value hierarchy information than do other techniques (e.g. Level 2 versus Level 3), it should use the higher-level technique. (However, note that observable inputs that require significant adjustment to meet the fair value objective may render such measurement a Level 3 measurement.)
- When using internal assumptions to develop fair value estimates, management must include appropriate risk adjustments that market participants would use when pricing the asset, including risk of nonperformance and liquidity.
- Broker quotes may not be determinative of fair value if they are not based solely or substantially on observable market information for the financial asset being measured, but they should be considered data points. Judgment should be used in determining the appropriate weight to be applied to broker quotes for financial assets based on Level 3 inputs in inactive markets in a fair value measurement.

In addition, on September 30, 2008, the SEC's Office of the Chief Accountant and the FASB staff jointly issued a press release containing questions and answers aimed at clarifying fair value measurement practices in the current environment. On October 3, 2008, the FASB issued FSP FAS 157-3,[12] which clarifies the application of Statement 157 and includes an example illustrating the key principles for determining fair value in a market that is not active.

Measurement of Benefit Obligations

As noted above, effective for fiscal years ending after December 15, 2008, paragraph 5 of Statement 158 requires that entities measure their benefit obligations as of the date of their fiscal year-end. The discount rate used in the calculation of the benefit obligation should be the rate on the measurement date.

Because of the volatility in the current markets, it may be difficult for preparers to demonstrate that an adjusted discount rate based on a rollforward of a discount rate from an earlier date would meet the requirements of paragraph 10. In aligning the measurement date with the year-end date, some companies may have changed their method for estimating the discount rate. Under paragraph 10 of Statement 87, an entity may employ computational shortcuts if the results are "reasonably expected not to be materially different from the results of a detailed application." In addition, Paragraph E57 of Statement 87 states that a company may change its method of selecting discount rates, provided the change results in "the best estimate of the effective settlement rates." Accordingly, preparers should maintain sufficient support to establish that the requirements of paragraph 10 have been met, including a calculation of the benefit obligation, as of the measurement date, that uses a discount rate that reflects inputs as of the measurement date. Any material difference not recorded by the company would be deemed an error.

Disclosures

Entities should consider the need for additional disclosure (i.e., pursuant to paragraph 5(d)(4) of Statement 132(R))[13] about the allocation of a postretirement plan's assets. For instance, entities whose plan asset allocations are heavily weighted in investments affected by the credit market turmoil and broadening market declines should consider disclosing the potential effects on asset values in the notes to the financial statements, management discussion and analysis (MD&A), or both. Such entities should also consider disclosing investments whose fair value has been reduced as an indirect result of the credit market turmoil (e.g., plans that hold investments in entities that are facing liquidity concerns because of their inability to access financing in tight credit markets).

In light of the market's overall effect on plan asset values, companies should consider disclosing how they calculate the market-related value of plan assets (e.g., fair value or a calculated value, which allows asset-related gains and losses to be recognized over a period of no more than five years).

For a broader discussion of the disclosures that an entity should consider regarding the credit market turmoil and the market declines, see Deloitte's Financial Reporting Alerts 08-4, Turmoil in the Credit Markets: The Importance of Comprehensive and Informative Disclosures, and 08-10, SEC Advises Registrants to Further Explain Fair Value in MD&A — An Addendum to the March 2008 SEC Letter.

Future Considerations

After this financial reporting season, entities should continue to focus on (1) any decrease in the fair value of the pension or other postretirement plan's assets, since this will affect the entity's pension or other postretirement asset or liability on the next measurement date and (2) disclosures of a plan's asset portfolio, including whether the asset allocations are heavily weighted in certain categories.

Entities should also continue to scrutinize their underlying assumptions to ensure that such assumptions remain appropriate. If conditions continue to deteriorate, entities will need to challenge whether their assumptions appropriately reflect the impact of a prolonged market decline.

The FASB is expected to issue a proposed FSP shortly that would amend and expand the disclosure requirements for plan assets for defined benefit plans in Statement 132(R). The purpose of the additional disclosures would be to improve transparency regarding (1) investments of plan assets, (2) potential risk concentrations in the investment portfolio, and (3) information about how the fair value of plan assets was determined. The FSP will set forth a principle that entities can apply when categorizing plan assets. It will also incorporate fair value disclosures, including (1) the levels within the fair value hierarchy[14] in which fair value measurements fall and (2) the inputs and valuation techniques used to determine the fair value of plan assets. The FSP is expected to be effective for fiscal years ending after December 15, 2009, with earlier application permitted.

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[1] FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* — an amendment of FASB Statements No. 87, 88, 106, and 132(R).

[2] These principles also apply to obligations measured in accordance with FASB Statements No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions, and No. 112, Employers' Accounting for Postemployment Benefits* — an amendment of FASB Statements No. 5 and 43.

[3] FASB Statement No. 87, *Employers' Accounting for Pensions*.

[4] Discount rates derived from yield curves would not be as sensitive, as they generally include more bonds.

[5] FASB Statement No. 157, *Fair Value Measurements*.

[6] Discount rates derived from yield curves would not be as sensitive, as they generally include more bonds.

[7] Only if the downgrade would result in the bond no longer being considered a high-quality bond.

[8] FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

[9] EITF Topic No. D-36, "Selection of Discount Rates Used for Measuring Defined Benefit Pension Obligations and Obligations of Postretirement Benefit Plans Other Than Pensions."

[10] As defined in Appendix D of Statement 87, 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."

[11] Paragraph 32 of Statement 87 defines the corridor as 10 percent of the greater of (1) the projected benefit obligation (or accumulated postretirement benefit obligation) or (2) the market-related value of plan assets.

[12] FASB Staff Position (FSP) No. FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active."

[13] FASB Statement No. 132(R), *Employers' Disclosures About Pensions and Other Postretirement Benefits* — an amendment of FASB Statements No. 87, 88, and 106.

[14] Statement 157 establishes a fair value hierarchy that "gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest priority

to unobservable inputs (Level 3).”

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