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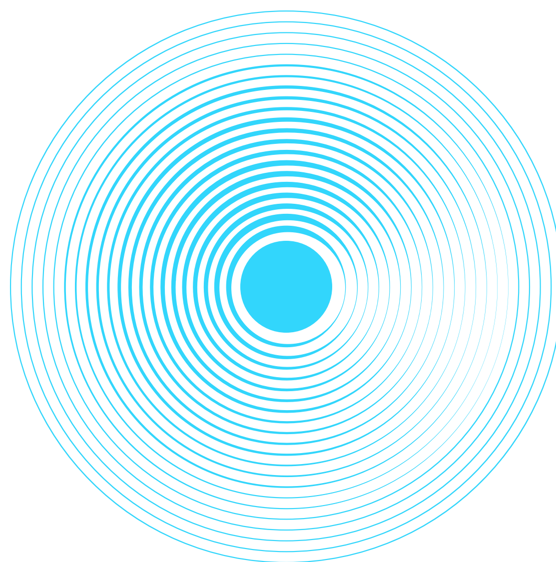

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Financial Reporting Considerations Related to Pension and Other Postretirement Benefits

Introduction

This publication highlights some of the important accounting considerations related to the calculations and disclosures entities provide under U.S. GAAP[1] in connection with their defined benefit pension and other postretirement benefit plans. Many of these considerations have been addressed in prior editions of this publication and are summarized below. The discussion in the current edition also reflects matters related to (1) inflation and rising interest rates, (2) the Inflation Reduction Act of 2022 (IRA), and (3) the ongoing effects of the COVID-19 pandemic.

Background

Inflation and Rising Interest Rates

The volatility in the global economy over the past few years has been accompanied by pressures such as the lingering effects of the COVID-19 pandemic, supply-chain disruptions, and geopolitical tensions. Faced with an extraordinarily high rate of inflation, global central banks have been raising interest rates in an effort to temper it.

Given the inflationary environment and the high level of uncertainty, entities with pension and other postretirement benefit plans may find it challenging to consider all relevant factors and develop assumptions for those plans. Entities are advised to consult with their actuaries to evaluate the approaches they should take to establish assumptions. We expect that entities

[1] The views presented in this publication are specific to U.S. GAAP. For entities that use another reporting framework, such as IFRS® Accounting Standards, preparers are encouraged to discuss the accounting implications with their advisers as appropriate.

would reflect the known and actual impact of inflation and other macroeconomic factors in the relevant short- and long-term assumptions. Even if some of the factors have offsetting effects and the assumptions do not fluctuate year over year, entities should document the considerations and provide related disclosures in their periodic filings.

Connecting the Dots

ASC 715-20-50-1[2] requires enhanced disclosures about (1) the funded status of defined benefit plans and (2) the key considerations of events during the annual period that affect plan assets (particularly when Level 3 investments or derivative instruments are held by the plans). Accordingly, in issuing comments to SEC registrants, the SEC staff has asked questions related to significant concentrations of risk within plan assets and has required enhanced disclosure in accordance with ASC 715-20-50-1(d)(5) related to significant concentrations of risk within plan assets. Entities should consider whether they have properly assessed and disclosed the risks related to their plan assets, particularly if their plans hold Level 3 investments.

Rollforward Method

Many entities use census data prepared before their fiscal year-end and project forward any changes to measure their benefit obligation, as allowable under ASC 715. Entities that elect to do so should use judgment in determining whether any adjustments are necessary as a result of inflation and rising interest rates when rolling forward their benefit obligation and should document the judgments they made, as applicable. For example, if the actual compensation paid for the fiscal year is higher than that assumed in the calculation as of the beginning of the year because of inflation, the actual benefit obligation at the end of the fiscal year should reflect such change if significant. In addition, entities should consider disclosing material changes made in the rollforward. See the Presentation and Disclosure section for more information.

Risk-Mitigating Activities

In response to inflation and macroeconomic uncertainties, entities with pension plans may consider purchasing insurance contracts to cover plan benefits. Purchasing a nonparticipating annuity involves the transfer of significant risk from the employer to the insurance entity (commonly referred to as "buyout") and will typically trigger plan settlement.[3] Entities with pension plans may also purchase insurance contracts that do not transfer the benefit obligation to the insurer (commonly referred to as "buy-in"), under which the pension plans receive periodic payments from the insurer to cover the pension obligation. A buy-in contract typically does not trigger settlement accounting since the employer retains the primary responsibility for the pension obligation. Further, insurance contracts in a buy-in arrangement typically qualify as plan assets. Entities that are considering risk-mitigating activities should evaluate the nature of the insurance contracts and determine the appropriate accounting treatment.

Lump-Sum Settlements

In response to current macroeconomic uncertainties, some entities may consider the use of restructuring programs involving a reduction in workforce that may include early retirements. Such entities may have pension plans that permit employees to elect to receive their pension benefit in a lump sum, which could result in multiple lump-sum payments over the course of the year. Further, as a result of rising interest rates, more pension participants may elect to receive lump-sum payments sooner, before such rates increase. Entities should consider whether the cost of all settlements in a year exceeds the service-and-interest-cost threshold and, if so, recognize a settlement gain or loss in accordance with ASC 715-30-35-79.

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

[3] See ASC 715-30-15-6.

Connecting the Dots

The ASC master glossary defines a settlement of a pension or other postemployment benefit obligation as a "transaction that is an irrevocable action, relieves the employer (or the plan) of primary responsibility for a pension or postretirement benefit obligation, and eliminates significant risks related to the obligation and the assets used to effect the settlement."

Under ASC 715-30-35-82, any gain or loss from a settlement must be recognized in earnings "if the cost of all settlements during a year is greater than the sum of the service cost and interest cost components of net periodic pension cost for the pension plan for the year." An entity that adopts an accounting policy of applying settlement accounting to one or more settlements that are below the service-and-interest-cost threshold must apply this policy to all settlements.

When settlements occur in an interim period during a year in which it is probable that the cumulative settlements for the year will exceed the service-and-interest-cost threshold, an entity should assess, on at least a quarterly basis, whether it is probable that the criteria for settlement accounting will be met (e.g., whether the total settlements will exceed the threshold). If the entity concludes that it is probable that the threshold will be exceeded during the year, the entity should apply settlement accounting on at least a quarterly basis rather than wait for the threshold to be exceeded on a year-to-date basis. Accordingly, as the settlements occur, and at least quarterly, the entity should complete a full remeasurement of its pension obligations and plan assets in accordance with ASC 715-30-35. Recognizing settlement accounting at quarter-end would be an acceptable practical accommodation unless, under the circumstances, the assumptions and resulting calculations indicate that use of the exact date within the quarter would result in a materially different outcome.

Inflation Reduction Act of 2022

On August 16, 2022, the IRA was signed into law. The IRA contains a tax and spending package of roughly $740 billion that includes provisions related to climate, clean energy, and health care affordability. The following key provisions of the IRA may affect entities' other postretirement benefit plans:

- *Drug price negotiation* — Selected drugs covered by Medicare Parts B and D will be subject to mandatory price negotiations with Medicare beginning in 2026, with negotiated prices subject to a cap. The number of drugs selected for negotiation will increase from 10 in 2026 to 20 in 2029 and subsequent years.
- *Inflation rebate* — Certain drugs covered by Medicare Parts B and D for which prices are rising at a higher rate than that of inflation are subject to rebates. Under Medicare Part B, the rebate became due beginning in the first quarter of 2023. Under Medicare Part D, the rebate first became due during the period from October 1, 2022, to September 30, 2023. In addition, the government is permitted to delay rebate invoices until 2025 for initial periods, which could defer the timing of the first rebate payment by the manufacturers.
- *Medicare Part D benefit redesign* — The coverage gap under Medicare Part D will be eliminated, and as of January 1, 2025, manufacturers will be subject to mandatory discounts on brand drugs in the initial coverage and catastrophic coverage phases. In effect, the change will cap the out-of-pocket spending for Medicare Part D costs at $2,000 per year starting in 2025. The change will be phased in starting in 2024 by capping the out-of-pocket costs at approximately $3,250 in that year.

Since the above changes will be implemented in phases over the next several years, estimating the potential impact of these provisions on other postretirement benefit plan prescription drug benefits may be challenging. Although the changes are designed to lower costs overall, entities should continue to monitor their impact and consider all relevant facts. In addition, for other postretirement benefit plans that apply for the Retiree Drug Subsidy (RDS), qualifying for the RDS has become more difficult since the plans cannot qualify unless the prescription drug benefits they offer are at least actuarially equivalent to the now improved Medicare Part D benefits. It may be that some plans no longer qualify for the RDS or are expected to still qualify but for fewer years of subsidy payments. Entities should consider whether any changes in qualification status for RDS will affect projections of the cost of health care over the period for which the plan provides benefits to its participants.

COVID-19

The COVID-19 pandemic continues to affect major economic and financial markets, and entities are facing challenges associated with the economic disruptions of adjusting to what appears to be an uncertain "new normal." Since the outbreak of the pandemic, many entities have considered (1) the impact of their own actions on defined benefit plans (e.g., plan amendments) and (2) the potential impact of COVID-19 on certain significant actuarial assumptions that affect the measurement of defined benefit obligations. Nevertheless, the potential long-term economic effects associated with the COVID-19 pandemic can vary depending on a reporting entity's particular facts and circumstances, thereby introducing additional uncertainty to ongoing estimates related to pension and other postretirement benefits. However, the requirement in ASC 715 that entities use the "best estimate" for each assumption as of the current measurement date remains unchanged. Therefore, entities should consider whether COVID-19 may have an impact on actuarial assumptions and document what factors they considered (including any recommendation by their actuaries) in selecting this year's assumptions for their pension and other postretirement benefits, as applicable.

Entities that elect to use the rollforward method to measure the benefit obligation should use judgment in determining whether any experience adjustments related to COVID-19 are necessary when rolling forward their benefit obligation and should document the judgments they made, as applicable.

Further, entities may hold significant amounts of assets that do not have an active market, such as investments in hedge funds, structured products, and real estate assets that may have become more illiquid, making their valuation more complex. Appropriately determining the fair value of such assets is important in the determination of the funded status of a defined benefit plan.

Discount Rate

Over the past few years, we have provided insights into approaches used to support discount rates for defined benefit plans (e.g., hypothetical bond portfolio, yield curve, index-based discount rate), considerations related to the application of discount rates when an entity measures its benefit obligation, and considerations related to the use of a more granular approach to measure components of benefit cost. Entities should discuss with their employee benefits specialists whether certain refinements to hypothetical bond portfolio and yield curve construction methods occurred in the current period. Considerations related to an entity's discount rate selection method, its use of a hypothetical bond portfolio, and its use of a yield curve are addressed below.

Discount Rate Selection Method

ASC 715-30-35-43 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 (also referred to as bond matching) 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 be acceptable as well.

Connecting the Dots

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.).

Entity's Use of a Hypothetical Bond Portfolio

To support its discount rate, an entity may elect to use a hypothetical bond portfolio developed with the assistance of an actuarial firm or other third party. Many hypothetical bond portfolios developed by actuarial firms or other third parties are supported by a white paper or other documentation that discusses how the hypothetical bond portfolios are constructed. It is advisable for management to understand how the hypothetical bond portfolio it has used to develop its discount rate was constructed, including the universe of bonds used in the analysis. In particular, management should consider evaluating how bonds included in the bond universe are assessed for reliability and quality of pricing and the criteria used to evaluate and eliminate outliers.

We have been advised by some third parties, particularly those involved in developing hypothetical bond portfolios in the U.S. markets, of refinements to the bond-matching method resulting from advances in technology and modeling techniques. Such refinements may require management to exercise additional judgment when evaluating the reliability and quality of pricing of bonds selected from the revised bond universe for inclusion in the hypothetical bond portfolio. If applicable, management should consider the reasonableness of adjustments or changes to the bond universe that is used to develop the hypothetical bond portfolio and evaluate whether the changes made are appropriate for the plan.

Connecting the Dots

Refinements in discount rate models occur from time to time and may be driven by (1) the availability of new technology or modeling techniques or (2) changes in available market information. Entities and their auditors, with the assistance of

employee benefits specialists, should understand the nature of, the reason for, and the appropriateness of the change(s). Entities should also consider 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. Changes in the method used to determine that best estimate should be made when facts or circumstances change. If the facts or circumstances do not change from year to year, it would generally be inappropriate for an entity to change the basis of selection. Changes to an entity's choice of discount rate selection method, as well as refinements to a given discount rate selection method, are viewed as changes 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.

It is important for entities that make refinements to the discount rate selection method to consider the impact of the change in estimate on disclosures. Specifically, entities should consider the disclosure requirements in ASC 250-10-50-4, under which an entity must disclose the material effect of changes in accounting estimates on income statement and earnings-per-share measures, and ASC 715-20-50-1(k) and (r), under which an entity must disclose (1) the discount rate used to determine the benefit obligation and net periodic benefit cost as well as (2) an explanation for any significant change in the benefit plan obligation not otherwise apparent in the other required disclosures of ASC 715.

Entity's Use of a Yield Curve

To support its discount rate, an entity may elect to use a yield curve constructed by an actuarial firm or other third party. Many such yield curves 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 consider evaluating and reaching 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, particularly those constructing yield curves for non-U.S. markets (e.g., the 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.

In recent years, we have held discussions with actuarial firms regarding the incorporation of longer-duration bonds (bonds with stated maturities in the range of up to 80–100 years) in the development of the yield curve. There is significant judgment involved in the development of yield curves, particularly when longer-duration bonds are used, since there often are no observable market rates across the full spectrum of maturities. Management should understand and consider evaluating the reasonableness of how the additional bonds included in the bond universe are evaluated for reliability of pricing by considering parameters such as screening for potential outliers. In a manner similar to the discussion of hypothetical bond portfolios above, management should consider the reasonableness of any revisions to the yield curve construction method in such circumstances and decide whether the changes made are appropriate for the plan.

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. Entities should consider whether the mortality tables used and adjustments made (e.g., for longevity improvements) are appropriate for the employee base covered under the plan.

In 2014, the Retirement Plans Experience Committee (RPEC) of the Society of Actuaries (SOA)[4] released a new set of mortality base tables (RP-2014) and a new companion mortality improvement scale (Scale MP-2014). In 2019, the SOA released a new set of mortality base tables (Pri-2012) that include more current data than the RP-2014 tables. Generally, we would expect an entity to use the Pri-2012 mortality tables because they are based on experience more current than that reflected in the RP-2014 tables. However, the selection of a mortality assumption should take into consideration an entity's specific facts and circumstances, including actual plan mortality experience to the extent credible.

Annually from 2015 through 2021, the SOA released an updated mortality improvement scale that incorporates the latest available historical data. In 2021, the SOA released Scale MP-2021, which reflects the historical U.S. population mortality experience through 2019. Therefore, MP-2021 does not reflect any historical or potential future effects of COVID-19, as explained in the SOA's October 2021 report *Mortality Improvement Scale MP-2021*. The SOA elected not to release a new mortality improvement scale for 2022 but in October of that year issued *RPEC 2022 Mortality Improvement Update* (the "2022 report"), which discusses the relevant research. The 2022 report shows that the newest mortality data available from 2020 were severely affected by COVID-19; however, as noted in the report, the "impact of COVID-19 on mortality rates . . . has not been evenly dispersed by geography, race, sex, or socio-economic level," and the "excess death rates have also varied substantially from period to period with pronounced peaks and less-elevated valleys." Therefore, the SOA believes that it would not be appropriate to incorporate the higher rates of mortality experienced from 2020 without adjustments.

As further noted in the 2022 report, the SOA in April 2021 "released MIM-2021 (SOA 2021), a new mortality improvement model that is a single structure for actuarial practitioners across different practice areas to create mortality improvement projections." Concurrently with its release of the 2022 report, the SOA released MIM-2021-v3, an updated version of this model. The 2022 report observes that the "functionality [of MIM-2021-v3] enables practitioners to model their selected assumption for the effects of the pandemic on mortality."

In 2023, the SOA again elected not to release a new mortality improvement scale. However, in October 2023, it issued *RPEC 2023 Mortality Improvement Update* (the "2023 report"), which discusses the relevant research in the current year. The 2023 report notes that "COVID-19 has greatly affected mortality rates in the U.S. since March 2020" and further states:

> Excess mortality relative to pre-pandemic trends began to significantly abate after the first quarter of 2022. The first half of 2023 has shown population mortality levels that are close to pre-pandemic trends in aggregate, with significant differences by age group. While there is still considerable excess mortality among working-aged adults during this period, mortality rates for ages over 65 have been below projections based on pre-pandemic trends.

In a manner consistent with the 2022 report, the 2023 report also reiterates that the SOA believes that without adjustments, it would not be appropriate to incorporate the higher rates of mortality experienced since 2020.

[4] The SOA is a leading provider of actuarial research, and its mortality tables and mortality improvement scales are considered by many plan sponsors as a starting point for developing their mortality assumptions.

While entities should consider the most recent mortality information available when determining their mortality assumptions for the fiscal year-end pension accounting and any applicable remeasurement dates, the selection of mortality base tables and improvement scales requires judgment and should take into account an entity's specific facts and circumstances. It is advisable for entities, with the help of their actuaries, to (1) continue monitoring the availability of updates to mortality tables, longevity improvement scales, and related experience studies and (2) consider reflecting these updates in the current-year mortality assumption, including whether the COVID-19 pandemic may affect the potential mortality trends.

Entities should consider documenting the factors used (including any recommendation by their actuaries) in selecting this year's mortality assumption for their defined benefit plan, including how they evaluated (1) the currently available base tables and mortality improvement scales and (2) subsequent information.

Expected Long-Term Rate of Return

The expected long-term rate of return on plan assets[5] 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, 2023, for a calendar-year-end entity). If the target allocation of plan assets to different investment categories has changed from the prior year or is expected to change during the coming year, an entity should consider discussing with its actuaries and independent auditors whether an adjustment to its assumption about the long-term rate of return is warranted.

In August 2021, changes to ASOP 27[6] became effective. Management generally engages an actuarial specialist to assist in measuring pension obligations for financial reporting purposes. The assumptions used to measure the pension obligation are the responsibility of management. Before the changes in ASOP 27, actuarial specialists often would specifically disclaim any assessment regarding the expected long-term rate of return assumption when management selected the assumption and the actuary was not directly involved in the analysis supporting the selection. Under the new revisions to ASOP 27, an actuary is required to assess the reasonableness of each economic assumption that was not selected by the actuary.[7] Accordingly, actuaries are now expected to assess the reasonableness of the long-term rate of return assumption, and actuarial reports in most cases may no longer disclaim an assessment of that assumption. An actuary's assessment of the reasonableness of the long-term rate of return assumption does not change management's responsibility for the assumption or eliminate the requirement that the independent auditor assess and mitigate any applicable risk of material misstatement associated with the assumption.

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

[5] 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."

[6] Actuarial Standards Board Actuarial Standard of Practice (ASOP) No. 27, *Selection of Economic Assumptions for Measuring Pension Obligations*.

[7] Other than prescribed assumptions or methods set by law, or assumptions disclosed in accordance with Section 4.2(b) of ASOP 27.

after the measurement date that reflects the recent and expected future trend of health care cost increases, (2) gradually decreasing annual trend rates for each of the next several years, and (3) an ultimate trend rate that is used for all remaining years. Entities should consider whether the COVID-19 pandemic may change the health care cost trend rate — specifically, by assessing whether changes in claims between periods correlate with changes in caseloads and corresponding restrictions, thereby altering the timing of employees' health care treatments.

Historically, the ultimate health care cost trend rate had been less than the discount rate. While discount rates started to rise in 2022 and continued to do so in 2023, the discount rate for some plans may still be below the ultimate health care cost trend rate given that discount rates in 2020 and 2021 were at near-record lows. 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 a discount rate below that) 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).

For economic reasons related to the current high rate of inflation, initial and short-term trend rates are also rising. These increases may not have been reflected in recent experience because of the delayed effect of health care cost changes caused by the contractual nature of insurance and provider contracting; therefore, entities should assess the need to adjust recent experience to reflect the best estimate of expected short- and long-term trends.

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 and consider evaluating and reaching 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, in part, that "each significant assumption used shall reflect the best estimate solely with respect to that individual assumption."

Entities should consider comprehensively assessing 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 as well as employees' long-term behavioral changes). 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 consider documenting the significant 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 the following:

- The basis for each significant assumption used.
- How management determined which assumptions were significant from a range of potential assumptions, when applicable.
- The consistency of significant assumptions with relevant industry, regulatory, and other external factors, including (1) economic conditions; (2) the entity's objectives, strategies, and related business risks; (3) existing market information; (4) historical or recent experience; and (5) other significant assumptions used by the entity in other estimates.
- For issuers that identify pension and other postretirement benefit obligations as critical accounting estimates, how management analyzed the sensitivity of its significant assumptions to change.

Netherlands Pension Reform

Effective July 1, 2023, the Dutch Pension Act requires all traditional annuity-based pension plans (i.e., defined benefit plans) to be phased out and to transition to one of the following three schemes by January 1, 2027:

- A solidarity premium agreement (the "solidarity scheme").
- A flexible premium agreement (the "flexible premium scheme").
- A premium benefit agreement (the "premium benefit scheme").

Existing contribution-based plans must also comply with the new requirements; however, the changes are expected to be minor for contribution-based plans compared with those for annuity-based plans. The premium benefit scheme is only available to pension insurers, and the solidarity scheme is expected to be the primary scheme that employers elect.

Solidarity Scheme

Under the Dutch Pension Act's solidarity scheme, the employer makes defined annual contributions that are based on the number of participants in the scheme, and the future pension benefits to be paid to the participants are variable. Although there is an intended pension objective (i.e., a target benefit), there is no guarantee of future benefits to the participants.

Occurring every five years at a minimum, the pension provider calculates the likelihood that the intended pension objective will be achieved with the employer's contributions. Annually, the pension distributions are then estimated on the basis of predetermined employer contributions and expected returns on the plan assets. A solidarity reserve is also required, which can be used to supplement benefit shortfalls in a particular annual period if actual returns on plan assets fall below the expected returns (to achieve the intended pension objective). Under the Dutch Pension Act, future employer contributions cannot be increased because of shortfalls in plan assets; if the solidarity reserve decreases to a certain level, the pension benefits to the participants will decrease.

The solidarity reserve has a maximum balance equal to 15 percent of the plan assets (including the solidarity reserve assets) and is funded through a portion of the employer contributions and excess returns. For contributions allocated to the solidarity reserve, the contribution cannot exceed 10 percent of the contribution per participant per year. For excess returns on plan assets allocated to the solidarity reserve, the excess returns cannot exceed 10 percent of the positive collective excess return per year. Accordingly, financial windfalls or setbacks are shared collectively in a manner that leads to more stable or higher future pension benefits. The solidarity reserve, however, cannot be used for operational expenses.

The solidarity scheme has a single collective investment policy for each plan, and financial gains and losses of the plan are allocated to participants on the basis of established rules that correspond to the risk attitude per age cohort of the participants. That is, investment returns may be allocated on the basis of the age of each participant (e.g., younger individuals may bear more risk of allocated returns compared with older individuals). At any point in time, participants are able to determine the benefit to which they are entitled; however, there are no individual participant accounts.

In the event of a participant's death, the benefits allocated to that participant are reallocated to the collective plan and are not distributed to a designated beneficiary.

Accounting Implications

Initial Recognition and Measurement Considerations

Under IFRS Accounting Standards, the Dutch Pension Act's solidarity scheme meets the definition of a defined contribution plan in accordance with paragraphs 28 and 29 of IAS 19.[8] However, under U.S. GAAP, the scheme's classification is more complex. ASC 715-70-20 defines a defined contribution plan as one that:

- "[P]rovides postretirement benefits in return for services rendered."
- "[P]rovides an individual account for each plan participant."
- "[S]pecifies how contributions to the individual's account are to be determined rather than specifies the amount of benefits the individual is to receive."
- "[Specifies that] the benefits a plan participant will receive depend solely on the amount contributed to the plan participant's account, the returns earned on investments of those contributions, and the forfeitures of other plan participants' benefits that may be allocated to that plan participant's account."

We considered whether a solidarity scheme that (1) does not have individual accounts for each plan participant and (2) requires fixed contributions by the employer (which, in substance, limits the employer's risk in the plan to its contributions) should be considered a defined contribution plan under ASC 715. At the 2006 AICPA National Conference on Current SEC and PCAOB Developments, Joseph Ucuzoglu, then professional accounting fellow in the SEC's Office of the Chief Accountant, made the following remarks:

> The staff has observed circumstances in which the benefits in a pre-existing defined benefit plan may be reduced or eliminated, in exchange for the creation of a new plan to which the employer will make fixed contributions. Statements 87 and 106 [codified in ASC 715-30 and ASC 715-60, respectively] are clear that a plan shall be considered a defined contribution plan only if several criteria are satisfied, one of which is the existence of an individual account for each participant. [footnotes omitted] Any plan that does not meet the definition of a defined contribution plan is considered a defined benefit plan. In the arrangements brought to the staff, **even though the employer was at risk only for the amounts contributed to the new plan, the absence of individual participant accounts resulted in a conclusion that the new plan should be accounted for as a defined benefit plan**. [Emphasis added]

Given the absence of individual participant accounts in the solidarity scheme and the narrow definition of defined contribution plans under ASC 715, we believe that the scheme should be accounted for as a defined benefit plan under U.S. GAAP. Although there is an acceptable view that the solidarity scheme represents a defined benefit plan, the measurement approach for the benefit obligation for such a plan is currently undetermined.

[8] IAS 19, *Employee Benefits*.

Transition

The Dutch Pension Act requires employers to prepare a transition plan, which must be formally approved by January 1, 2025, that explains which type of plan is desired (solidarity scheme, flexible premium scheme, or premium benefit scheme), how much premium the employer will pay, and the date on which the employer will transfer from the current plan to the new plan.

The effects of the Dutch Pension Act will not be reflected in an entity's financial statements until amendments to existing Dutch pension plans are finalized.

Connecting the Dots

When accounting for the effects of the Dutch Pension Act, entities should consider the guidance in ASC 715-30-35-31, which states, in part:

> The service cost component of net periodic pension cost and the projected benefit obligation shall reflect future compensation levels to the extent that the pension benefit formula defines pension benefits wholly or partially as a function of future compensation levels (that is, for a final-pay plan or a career-average-pay plan). Future increases for which a present commitment exists as described in paragraph 715-30-35-34 shall be similarly considered. Assumed compensation levels shall reflect an estimate of the actual future compensation levels of the individual employees involved, including future changes attributed to general price levels, productivity, seniority, promotion, and other factors. All assumptions shall be consistent to the extent that each reflects expectations of the same future economic conditions, such as future rates of inflation. Measuring service cost and the projected benefit obligation based on estimated future compensation levels entails considering indirect effects, such as changes under existing law in social security benefits or benefit limitations that would affect benefits provided by the plan, for example, those currently imposed by Section 415 of the Internal Revenue Code. However, possible amendments of the law shall not be considered in determining those pension measurements.

Entities should account for the impact of a new law (e.g., the Dutch Pension Act) as a plan amendment. While the enactment of a new law may have the characteristics of both a plan amendment and an actuarial gain or loss, such an enactment is not part of the actuarial assumptions used to estimate plan obligations. If changes made as a result of new laws are significant, a remeasurement of the pension obligation and the fair value of plan assets may be necessary. Upon performing such a remeasurement, an entity should adjust its statement of financial position in a subsequent interim period to reflect the overfunded or underfunded status of the plan as of that measurement date. By contrast, if a current law provides for future increases in compensation or benefit levels, any currently enacted increases should be reflected in actuarial estimates. If the increases deviate from those assumed, the difference would be recognized as an actuarial gain or loss. Such an increase in benefits is also similar to amending a plan to improve the benefits to plan participants.

Given that traditional annuity-based pension plans in the Netherlands are expected to continue to be accounted for as defined benefit plans under U.S. GAAP, settlement accounting may not apply.

U.K. Pension Benefits — High Court of Justice Ruling on Actuarial Confirmations for Section 9(2B) Rights

On June 16, 2023, the High Court of Justice in the United Kingdom (the "High Court") issued a ruling in the case of *Virgin Media Limited v NTL Pension Trustees II Limited and Others* related to obtaining actuarial confirmation for amendments to Section 9(2B) rights.[9] Before April 6, 1997, members of salary-related contracted-out schemes accrued rights to a guaranteed minimum pension. From April 6, 1997, through April 6, 2016,[10] such contracted-out schemes had to pass

[9] Rights that accrue under Section 9(2B) of the Pension Schemes Act 1993.

[10] The date on which contracting-out schemes were abolished.

an overall scheme quality test (the "reference scheme test") related to members' Section 9(2B) rights. Regulation 42 of the Occupational Pension Schemes (Contracting-Out) Regulations 1996 ("Regulation 42") and Section 37 of the Pension Schemes Act 1993 ("Section 37") required that for any amendment to Section 9(2B) rights, written confirmation was needed from the actuary asserting that the scheme would continue to pass the reference scheme test after the amendment's adoption.

On March 8, 1999, Virgin Media Limited's National Transcommunication Limited Pension Plan was amended to reduce the rate of revaluation of benefits accrued after March 8, 1999. However, since Virgin Media Limited was not able to locate an actuarial confirmation related to this amendment, the case was brought to the High Court. On June 16, 2023, the High Court ruled that:

- The failure to obtain an actuarial confirmation required by Section 37 and Regulation 42 renders the amendment invalid and void.
- Any change to Section 9(2B) rights would be invalid and void; the invalidity is not limited to changes to rights attributable to service before the date of amendment (past service rights) and also applies to changes to rights attributable to service after the date of amendment (future service rights).
- The requirement to obtain an actuarial confirmation applies to all amendments to Section 9(2B) rights and not solely to amendments that may adversely affect Section 9(2B) rights.

All entities in the United Kingdom that have amended Section 9(2B) rights should consider the applicability of the High Court's ruling to their U.K. contracted-out defined benefit pension plans, particularly regarding whether they have satisfied the Section 37 and Regulation 42 requirements to obtain actuarial confirmation for any amendments made between April 6, 1997, and April 6, 2016. Note that the High Court's ruling was based on the assumption that a Section 37 actuarial confirmation was never issued; however, the High Court did not rule on whether other forms of actuarial confirmation would satisfy the requirements under Regulation 42 and Section 37. The accounting impact of the High Court's ruling depends on the entity's ability to determine whether an actuarial valuation was available at the time of the previous plan amendment and, consequently, to assess the potential invalidity of the amendment. If an entity determines that a qualifying valuation was available for amendments subject to the ruling, there is no expected accounting impact to the entity's financial statements. If an entity is unable to currently determine the availability of a valuation at the time of the plan amendment, the entity should evaluate whether the plan amendment is rendered invalid; entities should also disclose the existence of the case and that its accounting impact continues to be assessed on the basis of the materiality of the U.K. pension plans that may be affected.

Presentation and Disclosure

In August 2018, the FASB issued ASU 2018-14,[11] which amended ASC 715 to add, remove, or clarify disclosure requirements related to defined benefit pension and other postretirement plans. The amendments are part of the FASB's disclosure framework project, which the Board launched in 2014 to improve the effectiveness of disclosures in notes to financial statements.

Under ASU 2018-14, an entity must disclose:

- The weighted-average interest crediting rates used in the entity's cash balance pension plans and other similar plans.
- A narrative description of the reasons for significant gains and losses affecting the benefit obligation for the period.

[11] FASB Accounting Standards Update (ASU) No. 2018-14, *Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans*.

- An explanation of any other significant changes in the benefit obligation or plan assets that are not otherwise apparent in the other disclosures required by ASC 715.

All calendar-year companies were required to adopt the ASU's guidance no later than December 31, 2021. We have observed diversity in practice related to the format of, and detail provided in, the narrative description of the reasons for significant gains and losses and other significant changes. In terms of format, SEC registrants have (1) added footnotes to the rollforwards of pension obligations and assets, (2) added a separate discussion to narratively describe significant gains and losses, or (3) included discussions of the results. The detail provided has ranged from a short description attributing changes to updated discount rates to detailed discussions that attribute significant gains or losses to each relevant assumption (e.g., discount rate, mortality).

SEC Staff's Views

The SEC staff has commented on disclosures related to how registrants account for pension and other postretirement benefit plans and how significant 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. For example, the SEC's Division of Corporation Finance (the "Division") has requested that registrants explain significant differences in actual experience and estimates. The Division has also raised questions about specific plan assets and significant concentrations of risk and required enhanced disclosures in accordance with ASC 715-20-50-1(d).

For more information, see Section 2.17 of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

Disclosures of Critical Accounting Policies and Estimates

The SEC staff has requested more quantitative and qualitative information about the nature of registrants' assumptions. In particular, the staff has focused on the discount rate and the expected return on plan assets. Further, the staff has asked registrants how their disclosures in the critical accounting estimates section of MD&A align with their accounting policy disclosures in the notes to the financial statements. The staff expects registrants to provide qualitative and quantitative information necessary for investors to understand the estimation uncertainty of the registrants' critical accounting policies and estimates in MD&A, as opposed to merely duplicating documentation from the accounting policy disclosures in the financial statement footnotes.

In addition, the SEC 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.
- How the registrant calculates historical returns to develop its expected rate of return assumption. If use of the arithmetic mean to calculate the historical returns produces results that are materially different from the results produced when the geometric mean is used to perform this calculation, it may be appropriate for the registrant to disclose both calculations.

- The reasons why the expected return has changed or is expected to change in the future.
- The effect of plan asset contributions during the period on profit or loss, when this effect is significant. The SEC staff has indicated that additional plan asset contributions reduce net pension costs even if actual asset returns are negative because the amount included in profit or loss is determined through the use of expected, as opposed to actual, returns. Consequently, such information can provide an understanding of unusual or nonrecurring items or other significant fluctuations so that investors can ascertain the likelihood that past performance is indicative of future performance.

Connecting the Dots

When evaluating critical accounting estimates in accordance with PCAOB Auditing Standard 2501,[12] auditors are required to obtain an understanding of how management analyzed the sensitivity of its significant assumptions to change on the basis of other reasonably likely outcomes that would have a material effect on the registrant's financial condition or operating performance. Therefore, registrants should expect that auditors may continue to expand their audit procedures to better understand how management analyzes the significant assumptions that may affect the measurement of the defined benefit obligation and certain plan assets.

Non-GAAP Measures

In recent years, the SEC renewed its focus on non-GAAP measures resulting from concerns about the increased use and prominence of such measures, the nature of the adjustments, and the increasingly large difference between the amounts reported for GAAP and non-GAAP measures. In response to increasing concerns about the use of non-GAAP measures, the Division updated its Compliance and Disclosure Interpretations in May 2016, October 2017, April 2018, and December 2022 to provide additional guidance on what it expects from registrants when they use these measures. Some registrants present non-GAAP measures that adjust for items related to defined benefit pension plans. For example, a registrant may adjust to remove (1) all non-service-related pension expense, (2) all pension expense in excess of cash contributions, or (3) the amortization of actuarial gains and losses. Some registrants that immediately recognize all actuarial gains and losses in earnings present non-GAAP measures that remove the actuarial gain or loss attributable to the change in the fair value of plan assets from a performance measure and include an expected return. The SEC staff has observed that these pension-related adjustments can be confusing without the appropriate context about the nature of the adjustment. The staff suggested that registrants clearly label such adjustments and avoid the use of confusing or unclear terms in their disclosures.

For more information, see Section 4.16 of Deloitte's Roadmap *Non-GAAP Financial Measures and Metrics*.

[12] PCAOB Auditing Standard No. 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*.

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