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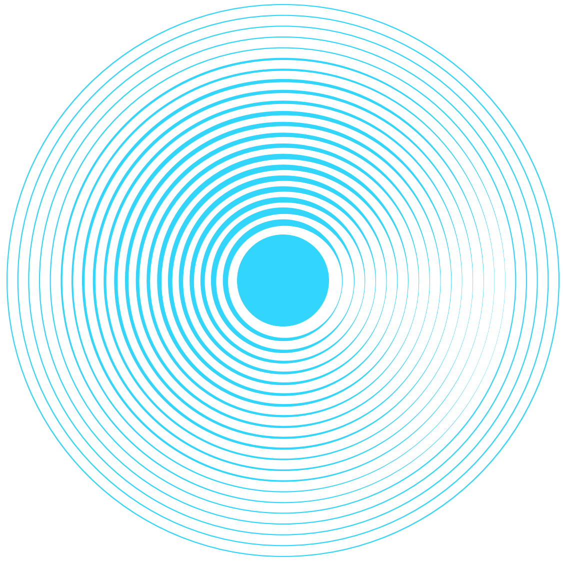

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Financial Reporting Considerations Related to Pension and Other Postretirement Benefits

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) the current macroeconomic environment, (2) "buy-in" and "buy-out" transactions, (3) the Inflation Reduction Act of 2022 (IRA), and (4) certain defined benefit pension plans in the Netherlands and the United Kingdom.

Background

Current Macroeconomic Environment

The current macroeconomic environment is marked by a combination of moderated inflation, heightened interest rates, and geopolitical uncertainty. Global central banks have adopted a cautious approach to adjusting rates in response to mixed economic signals, aiming to balance inflation with economic stability. Therefore, entities with pension and other postretirement benefit plans may still 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 would reflect the known and actual impact of all relevant macroeconomic factors in

[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.

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

In August 2018, the FASB issued ASU 2018-14,[2] which amended ASC 715[3] to add, remove, or clarify disclosure requirements related to defined benefit pension and other postretirement plans. As a result, ASC 715-20-50-1 requires enhanced disclosures about (1) the funded status of defined benefit plans, (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), and (3) the reasons for significant gains and losses related to changes in the defined benefit obligation for the period. Accordingly, entities should consider including enhanced disclosures related to (1) significant concentrations of risk within plan assets in accordance with ASC 715-20-50-1(d)(5) and (2) reasons for significant gains and losses arising from demographic experience or assumption changes affecting the benefit obligation in accordance with ASC 715-20-50-1(r)(1). Entities should also consider whether they have appropriately assessed and disclosed (1) the risks related to their plan assets (particularly if their plans hold Level 3 investments) and (2) the reasons for significant changes in plan benefit obligations.

Rollforward Method

Many entities use a rollforward approach in accordance with ASC 715. Under this approach, benefit obligations are measured by using census data prepared before the entity's fiscal year-end and are projected forward to the measurement date. Entities that elect to apply this approach should use judgment in determining whether any adjustments are needed in cases in which inflation and interest rate projections fluctuate within the fiscal year. For example, if the actual compensation growth for the fiscal year is lower than that assumed in the calculation as of the beginning of the year because of wage inflation moderation, the actual benefit obligation at the end of the fiscal year should reflect such change if significant. Entities should thoroughly document the judgment process used to determine whether adjustments are needed for rollforward methods and assumptions. In addition, entities should consider disclosing material changes made in the rollforward. See the Presentation and Disclosure section for more information.

Risk-Mitigating Activities

Entities with defined benefit pension plans may consider purchasing insurance contracts to manage risks associated with plan benefits. Purchasing a nonparticipating annuity involves the transfer of significant risk from the employer to the insurance entity (commonly referred to as "buy-out") and will typically trigger plan settlement.[4] 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. Entities that are considering risk-mitigating activities should evaluate the nature of the insurance contracts and determine the appropriate accounting treatment. See the Buy-In and Buy-Out Transactions section for more information.

Lump Sum Settlements

Some entities may consider the use of restructuring programs involving a reduction in workforce that may include early retirements; the use of these programs has been more

[2] FASB Accounting Standards Update (ASU) No. 2018-14, *Compensation — Retirement Benefits — Defined Benefit Plans — General (Subtopic 715-20): Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans.*

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

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

common in recent years because of the current macroeconomic environment. Such entities may have pension plans that permit plan participants to elect to receive their pension benefit in a lump sum, or they may amend their pension plans to offer a lump sum option to retiring and/or vested terminated participants; as a result, there could be multiple lump sum payments over the course of the year, which may lead to requiring settlement accounting. In accordance with ASC 715-30-35-79 through 35-83, if the cost of all settlements in a year exceeds the service cost plus interest cost threshold, a pro rata portion of the gain or loss recorded in accumulated other comprehensive income equal to the percentage reduction in projected benefit obligation must be recognized immediately in earnings. Entities should closely monitor their cumulative annual settlements to determine whether the threshold is exceeded.

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 cost plus 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 cost plus 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 (i.e., 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.

Buy-In and Buy-Out Transactions

In response to a higher interest rate environment, entities with pension plans may consider purchasing annuity contracts to manage financial risks associated with plan benefits. ASC 715-30-20 defines an annuity contract as a "contract in which an insurance entity unconditionally undertakes a legal obligation to provide specified pension benefits to specific individuals in return for a fixed consideration or premium." This is often referred to as a buy-out transaction. By entering into a buy-out transaction with an insurer, an entity with a pension plan will eliminate or reduce the risk associated with future benefit payments to plan participants since the insurer will take over the legal obligation of the future payments. In a buy-out transaction, the entity with a pension plan is completely relieved of its legal obligation to make future payments, and the responsibility for making those payments rests solely on the insurer. Accordingly, the insurer in a buy-out transaction will make the payments directly to the beneficiaries and participants.

There are also scenarios in which an entity with a pension plan buys an annuity contract but retains the legal obligation to the beneficiaries and participants and is reimbursed by the insurer for the amount paid out every month. Such a transaction is commonly known as a buy-in transaction. Although a buy-in transaction reduces the risk associated with future benefit payments, its accounting implications differ from those of a buy-out transaction.

When an entity purchases an annuity contract to provide specified pension benefits to specific individuals, it needs to consider whether settlement accounting has been triggered. ASC 715-30-20 defines a settlement of a pension or postretirement 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." In assessing whether a buy-out or buy-in transaction would trigger settlement accounting, an entity should consider (1) each of the three criteria in that definition and (2) the implementation guidance in ASC 715-30.[5]

In general, buy-out transactions are considered to trigger settlement accounting, provided that all of the above conditions are met. However, buy-in transactions would not generally trigger settlement accounting because they do not relieve entities with pension plans of primary responsibility for the pension obligation (i.e., an entity with a pension plan would still be responsible for making the benefit payments and would only get reimbursed by the third-party annuity provider). Further, a buy-in transaction may include a feature that converts to a buy-out transaction at a later date. In such a case, because the entity is not relieved of primary responsibility for the pension obligation until the buy-out transaction occurs, the criteria for recognizing a settlement of the obligation are not met in the absence of that event.

To determine whether settlement accounting is appropriate, entities with pension plans that have entered into annuity contracts to provide benefits should evaluate their specific facts and circumstances under the relevant guidance of ASC 715-30. Entities are encouraged to consult with their accounting advisers when making this determination.

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 be 10 in 2026, 15 in 2027 and 2028, and 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 is being phased in starting in 2024 by capping the out-of-pocket costs at approximately $3,250.

[5] See ASC 715-30-35-84 through 35-91 and ASC 715-30-55-140 through 55-159 for guidance on using annuity contracts in settlement transactions and meeting the criteria for settlement accounting.

Since the above changes are being 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 the RDS will affect projections of the cost of health care over the period for which the plan provides benefits to its participants.

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 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. Typically, yield curves are also supported by a white paper or other documentation that discusses how the yield curves are constructed.

Management should understand how the yield curve that it 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)[6] 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

[6] 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.

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 and 2024, the SOA again elected not to release a new mortality improvement scale. However, in a manner similar to what it had done in 2022, the SOA issued annual reports in October of 2023 and 2024, respectively (*RPEC 2023 Mortality Improvement Update* [the "2023 report"] and *RPEC 2024 Mortality Improvement Update* [the "2024 report"]), to discuss the relevant research from the current year. In conjunction with the 2023 report, the SOA released MIM-2021-v4, a new version of its mortality improvement model, which a separate report on the updated model describes as being "the same as MIM-2021-v3 with the exception of changing the individual life insurance and individual/group annuity preselected historical [National Center for Health Statistics] decile dataset for mortality improvement projection."

The 2024 report notes the following about mortality rates in the United States during and since the COVID-19 pandemic:

> The COVID-19 pandemic — which began in 2020 — led to a sharp increase in mortality rates. These mortality rates have declined significantly since the onset of the pandemic, but emerging data reflecting U.S. mortality through June of 2024 suggests that there is still a small amount of excess mortality for the 65+ population — around 2.5%, according to RPEC's updated analysis.

In a manner consistent with the 2022 and 2023 reports, the 2024 report also expresses the SOA's view that publishing revised mortality tables with updated data capturing the impacts of COVID-19 would not be appropriate because the effects of the pandemic on future mortality rates are uncertain. However, the 2024 report further states that actuaries could use COVID-19 data from the report or other sources to create their own COVID-19 adjustments to 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.

To support plan-specific mortality assumptions, certain actuarial firms have developed enhanced mortality models that use more granular and client-specific underlying data such as geospatial information, nine-digit zip codes, and other disaggregated demographic information related to individual plan participants. Certain entities may elect to use these models to select a more accurate and client-specific mortality assumption for their benefit obligation calculations.

Regardless of how entities select their mortality assumption, they should document the factors used in selecting this year's mortality assumption for their defined benefit plan, including actuarial recommendations, client-specific demographic data, and any adjustments made as a result of events such as the COVID-19 pandemic that may have long-term effects on the mortality assumption.

Expected Long-Term Rate of Return

The expected long-term rate of return on plan assets[7] 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, 2024, 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, or if capital market return expectations have changed, 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.

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. Under ASOP 27,[8] an actuary is required to assess the reasonableness of each economic assumption that was not selected by the actuary.[9] Accordingly, actuaries are 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 as they could before the June 2020 amendments to ASOP 27 became effective in August 2021. 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 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 have risen over the past few years, the discount rate for some plans may still be below the ultimate health care cost trend rate. 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

7 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."

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

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

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 recent high rate of inflation, initial and short-term trend rates have also been 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 relevance 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 verify 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, 2028:

- 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. The solidarity scheme is expected to be the primary scheme among employees and employers, mainly because of its collective risk-sharing structure and stability features that help mitigate financial volatility.

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.[10] 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 Conference on Current SEC and PCAOB Developments, Joseph Ucuzoglu, then a 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.

Transition

The Dutch Pension Act requires employers to prepare a transition plan, which must be submitted to the pension fund by January 1, 2025, and then submitted to the Dutch central bank (the Dutch National Bank) by July 1, 2025. The transition plan will explain 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.

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

[10] International Accounting Standard (IAS) 19, *Employee Benefits*.

> 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 when the plan amendment is approved and communicated to the plan participants. 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 if employers elect to switch to the solidarity scheme, settlement accounting may not apply.

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

Background

On June 16, 2023, the High Court of Justice in London (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 confirmations for amendments to Section 9(2B) rights.[11] Before April 6, 1997, members of salary-related contracted-out schemes accrued rights to a guaranteed minimum pension. From April 6, 1997, until April 6, 2016[12] (the "applicable period"), such contracted-out schemes had to pass 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.

[11] Rights that accrue under Section 9(2B) of the Pension Schemes Act 1993.
[12] The date on which contracting-out schemes were abolished.

- The requirement to obtain an actuarial confirmation for an amendment to Section 9(2B) rights applies not only to changes to rights attributable to service before the date of amendment (past service rights), but also 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.

Final Ruling of the Court of Appeal

On appeal to the Court of Appeal in London (the "Court of Appeal"), Virgin Media Limited challenged the second of the High Court's determinations described above, arguing that the requirement to obtain an actuarial confirmation for an amendment to Section 9(2B) rights should apply only to changes to past service rights. In a ruling issued on July 25, 2024 (the "Final Ruling"), the Court of Appeal upheld the High Court's determination that the requirement to obtain an actuarial confirmation applies to changes to future as well as past service rights.

All entities in the United Kingdom that amended Section 9(2B) rights at any time during the applicable period should consider the applicability of the Final Ruling to their U.K. contracted-out defined benefit pension plans for financial reporting purposes in the current year, particularly regarding whether they have satisfied the Section 37 and Regulation 42 requirements to obtain actuarial confirmation for any relevant amendments made. Evaluating the extent to which the Final Ruling applies will require coordination with the trustees of the pension schemes and consultation with legal advisers. Note that the Final Ruling was based on the assumption that a Section 37 actuarial confirmation was never issued; the Court of Appeal did not rule on whether other forms of actuarial confirmation would satisfy the requirements of Regulation 42 and Section 37, or whether there was alternative evidence that could prove that an actuarial confirmation was obtained. However, because of the Final Ruling, entities with invalid plan amendments from the applicable period need to account for them in the current year as they calculate their year-end or interim benefit obligations by including assumptions in the actuarial analysis related to the invalid amendments.

Potential Accounting Implications of the Final Ruling

Ultimately, the accounting impact of the Final Ruling on an entity's financial statements depends on the entity's ability to (1) determine whether an actuarial valuation was available at the time of the previous plan amendment and, consequently, (2) assess the potential invalidity of the amendment. If the entity determines that a qualifying valuation was available for a previous plan amendment that is subject to the Final Ruling, there is no expected accounting impact on the entity's financial statements, provided that the amendment is deemed to be valid. If the entity is currently unable to determine whether a qualifying valuation was available at the time a plan amendment was adopted, the entity should evaluate whether the plan amendment is rendered invalid.

Initial Recognition and Remeasurement

Under U.S. GAAP, defined benefit pension plan changes (including changes attributable to legislation or court rulings) that result in a retroactive increase or decrease in benefit levels for plan participants are viewed as prior service cost in accordance with ASC 715. Since the Final Ruling may require retroactive changes in the level of benefits accrued during the applicable period for any invalid plan amendments that should now be treated as void, the potential adjustments to be booked should be treated as a prior service cost.

Generally, plan amendments required by legislation or court rulings are accounted for upon enactment of the legislation or finalization of the court rulings. As noted above, the High Court's ruling was issued on June 16, 2023, and the Court of Appeal issued its Final Ruling rejecting Virgin Media Limited's legal challenge on July 25, 2024. An entity will need to perform a diligent investigation of its previous plan amendments from the applicable period to determine, in consultation with its legal and accounting advisers, whether the Final Ruling affects the accounting for its benefit obligation. If the entity determines that any of those amendments are invalid, it will need to comply with the Final Ruling and make the required adjustments to its benefit obligation and prior service cost.

ASC 715-30-35-66 states, in part, that "sometimes, an entity remeasures both plan assets and benefit obligations during the fiscal year, for example, when a significant event such as a plan amendment, settlement, or curtailment occurs that calls for a remeasurement." Accordingly, the Final Ruling may be considered a significant event for a plan and trigger an interim remeasurement.

However, if an entity concludes that the Final Ruling is applicable to its plans but is not a significant event, the entity should include the effect of the Final Ruling in its next annual year-end remeasurement (which may be as soon as December 31, 2024). The resulting increase in the projected benefit obligation when the effect of the Final Ruling is included in remeasurement of the projected benefit obligation should be treated as prior service cost regardless of whether the effect of the ruling is initially recognized as a result of a significant-event interim remeasurement or as part of the next year-end measurement of the pension plan. Under ASC 715-30-35-16, prior service cost is generally "recognized immediately in other comprehensive income." Accordingly, the prior service cost is recognized in other comprehensive income on the measurement date.

Subsequent Recognition

After initial recognition of the prior service cost, ASC 715-30-35-11 requires the prior service cost to "be amortized as a component of net periodic pension cost." An entity should review the guidance in ASC 715-30-35-10 through 35-17 to determine the method and period of amortization of the prior service cost from other comprehensive income that is being recognized as a component of net periodic pension cost.

Changes in Estimates in Future Periods

Given the judgment and legal considerations required to measure the effect of the Final Ruling, combined with the complexity and uncertainty associated with determining how an invalid previous plan amendment legally affects an entity's current pension obligation and prior service costs, reporting entities will most likely be required to make estimates and assumptions as part of the measurement and initial recognition of the effect of the Final Ruling that will be treated as prior service cost. Over time, improved availability of information supporting the estimates and measurement assumptions, as well as further clarity regarding how the Final Ruling will apply to other entities and be enforced, will most likely give rise to actuarial gains or losses in future remeasurements of the pension obligation. Subsequent gains and losses in measurements of the projected benefit obligation (after initial recognition of the prior service cost related to the Final Ruling) that are related to adjustments for invalid plan amendments from the applicable period and result either from experience different from that assumed or from a change in an actuarial assumption should generally be recorded as gains and losses in accordance with ASC 715-30-35-18 through 35-27. However, ASC 715-30-35-19 states, in part, that ASC 715-30 "does not require recognition of gains and losses as components of net pension cost of the period in which they arise."

Disclosures

Regardless of the results of an entity's assessment of its previous plan amendments and its conclusion related to the potential financial statement impact of the Final Ruling, the entity should disclose the existence of the Final Ruling and that the accounting impact of the Final Ruling on its financial statements has been assessed on the basis of the materiality of its U.K. pension plans. The entity should also consider the following when determining the nature and extent of its disclosures about the Final Ruling and the effect of the Final Ruling on its pension liabilities as part of its annual and quarterly reports:

- The size and materiality of the U.K. pension benefit plan(s) affected by the Final Ruling.
- If an adjustment related to invalid previous plan amendments has been made to the defined benefit obligation and prior service cost, the nature of the adjustment and its impact on the actuarial assumptions should be disclosed.
- If an adjustment has not been made because the entity concluded through consultation with its legal advisers that sufficient evidence, actuarial confirmations, or both exist for all plan amendments from the applicable period, a disclosure should be made describing the entity's assessment of the Final Ruling and any judgments made.
- Any significant judgments or estimates associated with the assumptions used to calculate the adjustment to the benefit obligation related to the Final Ruling.
- To the extent that adjustments are still subject to significant uncertainty and complexity, the entity may consider disclosing a range or maximum adjustment amount.
- Any required disclosures under ASC 715-20-50, including, but not limited to:
    - Disclosure of the effect of plan amendments in the reconciliation of the beginning and ending projected benefit obligation.
    - If applicable, an explanation of any significant change in the benefit obligation not otherwise apparent in the other disclosures already required.
- Any required SEC disclosures, including, but not limited to, identification and discussion in MD&A of any known trends or uncertainties that are reasonably likely to have a material effect on liquidity, capital resources, or operating results. The entity must assess and disclose whether the Final Ruling is reasonably likely to have a material effect on its liquidity, capital resources, or operating results and, if so, provide appropriate disclosures in MD&A.

Presentation and Disclosure

SEC Staff's Views

In previous years, 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. Registrants may be asked to explain significant differences in actual experience and estimates. They may also receive questions related to specific plan assets and significant concentrations of risk and be required to provide 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

In previous years, the SEC staff has requested more quantitative and qualitative information about the nature of registrants' assumptions, especially 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. Registrants should provide quantitative and qualitative 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, 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. 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 AS 2501,[13] 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 SEC's Division of Corporation Finance 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

[13] PCAOB Auditing Standard (AS) No. 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*.

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 4.15 of Deloitte's Roadmap *Non-GAAP Financial Measures and Metrics*.

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