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Contents

Financial Reporting Considerations Related to Pension and Other Postretirement Benefits

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 included in prior *Financial Reporting Alerts* and are summarized below. In the current year, emerging issues and disclosure items include (1) refinements to discount rate selection methods; (2) the effective dates for ASU 2017-07,[2] which addresses income statement presentation of the components of net periodic benefit cost; and (3) the effective dates for ASU 2018-14,[3] which addresses disclosure requirements related to defined benefit plans.

Overview

Refinements to Discount Rate Selection Methods

We have been advised by some third parties, particularly those developing hypothetical bond portfolios for U.S. markets, that they have made refinements to discount rate methodologies. We discuss entities' evaluation of such refinements, including accounting and disclosure considerations, in the Discount Rate section.

[1] The views presented in this publication are specific to U.S. GAAP. For entities that use another reporting framework, such as IFRS® Standards, preparers are encouraged to discuss the accounting implications with their advisers as appropriate.
[2] FASB Accounting Standards Update (ASU) No. 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.*
[3] FASB Accounting Standards Update No. 2018-14, *Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans.*

Effective Dates for ASU 2017-07

ASU 2017-07 amends the requirements in ASC 715[4] related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension and other postretirement plans. For entities other than public business entities (PBEs), the ASU's amendments are effective for annual periods beginning after December 15, 2018, and interim periods in subsequent annual periods. For PBEs, the ASU's amendments became effective for interim and annual periods beginning after December 15, 2017. The ASU's provisions are further discussed in the Presentation and Disclosure section.

Effective Dates for ASU 2018-14

ASU 2018-14 amends ASC 715 to add, remove, and clarify disclosure requirements related to defined benefit pension and other postretirement plans. The ASU's amendments are effective for PBEs for fiscal years ending after December 15, 2020. For all other entities, the ASU is effective for fiscal years ending after December 15, 2021. Early adoption is permitted. The ASU's provisions are further discussed in the Presentation and Disclosure section.

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. Recently, we have become aware of certain refinements to hypothetical bond portfolio construction methods. Considerations related to an entity's discount rate selection method, its use of a hypothetical bond portfolio, its use of a yield curve, and its measurement of components of benefit cost 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 also be acceptable.

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

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 the availability of new technology or modeling techniques. Entities and their auditors, with the assistance of employee benefits specialists, should understand the nature of and the reason for 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 50-1(r), under which an entity must disclose both (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.

Measurement of Benefit Cost Components

Since 2015, a frequently discussed topic has been the alternatives for applying discount rates to measure the components of net periodic benefit cost for a defined benefit retirement plan obligation under ASC 715. That year, the SEC staff accepted the use of a spot rate approach for measuring the service cost and interest cost components of net periodic benefit cost by entities that develop their discount rate assumption by using a yield curve approach (referred to as the granular approach). However, in 2016, the staff stated that it objected to the use of a similar granular approach for SEC registrants that use a bond-matching approach to support the discount rate.

For further background on a change in approach to determining discount rates, see Deloitte's August 24, 2016, and December 21, 2015, *Financial Reporting Alert* newsletters.

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 of the Society of Actuaries (SOA)[5] released a new set of mortality base tables (RP-2014) and a new companion mortality improvement scale (MP-2014). Further, the SOA released updated mortality improvement scales MP-2015, MP-2016, MP-2017, MP-2018, and, most recently, MP-2019,[6] which reflect a continuing decline in the observed longevity improvements since 2006.

In addition, in 2019, the SOA released a new set of mortality base tables (PRI-2012[7]) that include more current data than the RP-2014 tables. The selection of mortality base tables and improvement scales requires judgment. 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. 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 the new base tables and mortality improvement scales.

Expected Long-Term Rate of Return

The expected long-term rate of return on plan assets[8] 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, 2019, 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.

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 trend of health care cost increases, (2) gradually decreasing trend rates for each of the next several years, and (3) an ultimate trend rate that is used for all remaining years.

Historically, the ultimate health care cost trend rate had been less than the discount rate. With discount rates continuing to be at or near record lows, the discount rate for some plans is 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 rate below that) are reasonable. Entities should also remember that (1) the discount rate reflects

[5] 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.

[6] The most recent mortality improvement scale released by the SOA is available at https://www.soa.org/resources/experience-studies/2019/mortality-improvement-scale-mp-2019/.

[7] The PRI-2012 tables released by the SOA are available at https://www.soa.org/resources/experience-studies/2019/pri-2012-private-mortality-tables/.

[8] 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."

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).

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 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). Management should consider establishing 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 key 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 (1) the basis for each important assumption used and (2) how management determined which assumptions were important.

U.K. Pension Benefits — High Court of Justice Ruling on Equalization

On October 26, 2018, the High Court of Justice in the United Kingdom (the "High Court") ruled that Lloyds Bank plc was required to equalize benefits payable to men and women under its U.K. defined benefit pension plans by amending those plans to increase the pension benefits payable to participants that accrued such benefits during the period from 1990 to 1997. The inequalities arose from statutory differences in the retirement ages and rates of accrual of benefits for men and women related to Guaranteed Minimum Pension (GMP) benefits that are included in most U.K. defined benefit pension plans. In its ruling, and in a supplementary ruling on December 6, 2018, the High Court also provided details on acceptable alternative methods of amending plans to equalize the pension benefits. A second case, this one about how to address obligations for employees who transferred out of a pension scheme, which was not addressed in the 2018 rulings, is expected to be heard by the High Court in 2020.

All entities in the United Kingdom that offered GMP benefits during this period will need to consider the applicability of the High Court's ruling to their U.K. defined benefit pension plans. On January 23, 2019, the U.K. government published guidance on GMP conversion and equalization that is applicable to all entities. Although the potential impact of the 2018 rulings on any individual pension scheme will vary, current preliminary estimates of the potential increase in the projected benefit obligation of a pension plan are from 0 percent to 3 percent.

As entities begin to implement these changes, those with U.K. pension obligations should consider which approach or method to adopt. Certain approaches and methods have potentially significant accounting and financial reporting impacts beyond preliminary estimates with regard to the 2018 rulings. Entities should also consider consulting with their legal advisers, actuaries, and independent accountants.

For more information, see Deloitte's November 26, 2018, *Financial Reporting Alert*.

Presentation and Disclosure

Disclosures Related to Defined Benefit Plans

In August 2018, the FASB issued ASU 2018-14, which amends ASC 715 to add, remove, and clarify disclosure requirements related to defined benefit pension and other postretirement plans. The ASU's changes related to disclosures 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.

ASU 2018-14 adds requirements for an entity to disclose the following:

- 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.
- 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.

Further, ASU 2018-14 removes guidance that currently requires the following disclosures:

- The amounts in accumulated other comprehensive income expected to be recognized as part of net periodic benefit cost over the next year.
- Information about plan assets to be returned to the entity, including amounts and expected timing.
- Transactions resulting from the June 2001 amendments to the Japanese Welfare Pension Insurance Law.
- Information about (1) benefits covered by related-party insurance and annuity contracts and (2) significant transactions between the plan and related parties. (Entities separately need to provide the related-party disclosures required under ASC 850.)
- For nonpublic entities with Level 3 plan assets in the fair value hierarchy measured on a recurring basis, a reconciliation of the opening balances to the closing balances. (However, those entities would still need to disclose transfers of plan assets into and out of Level 3 and any purchases of Level 3 assets by the plan.)
- For public entities, the effects of a one-percentage-point change on the assumed health care costs and the effect of this change in rates on service cost, interest cost, and the benefit obligation for postretirement health care benefits.

The ASU's amendments are effective for PBEs for fiscal years ending after December 15, 2020. For all other entities, the ASU is effective for fiscal years ending after December 15, 2021. Early adoption is permitted; however, all provisions of ASU 2018-14 must be adopted if early adoption is elected. A retrospective transition method is required.

For more information, see Deloitte's August 29, 2018, *Heads Up*.

Presentation of Net Periodic Benefit Cost

In March 2017, the FASB issued ASU 2017-07, which amends the requirements in ASC 715 related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension and other postretirement plans.

Under current U.S. GAAP, net benefit cost (i.e., defined benefit pension cost and postretirement benefit cost) consists of several components that reflect different aspects of an employer's financial arrangements as well as the cost of benefits earned by employees. These components are aggregated and reported net in the financial statements.

ASU 2017-07 requires entities to (1) disaggregate the current-service-cost component from the other components of net benefit cost (the "other components") and present it with other current compensation costs for related employees in the income statement and (2) present the other components elsewhere in the income statement and outside of income from operations if such a subtotal is presented.

The ASU also requires entities to disclose the income statement lines that contain the other components if those components are not presented on appropriately described separate lines.

Connecting the Dots

Although ASU 2017-07 does not require entities to further disaggregate the other components, they may do so if they believe that the information would be helpful to financial statement users. However, entities must disclose which financial statement lines contain the disaggregated components.

In addition, only the service cost component of net benefit cost is eligible for capitalization (e.g., as part of inventory or property, plant, and equipment). This is a change from current practice, under which entities capitalize the aggregate net benefit cost when applicable.

The ASU's amendments are effective for PBEs for interim and annual periods beginning after December 15, 2017. For other entities, the amendments are effective for annual periods beginning after December 15, 2018, and interim periods in the subsequent annual period. Early adoption is permitted.

Entities must use (1) a retrospective transition method to adopt the requirement for separate presentation in the income statement of service costs and other components and (2) a prospective transition method to adopt the requirement to limit the capitalization (e.g., as part of inventory) of benefit costs to the service cost component. Further, entities must disclose the nature of and reason for the change in accounting principle in both the first interim and annual reporting periods in which they adopt the amendments.

The ASU also establishes a practical expedient upon transition that permits entities to use their previously disclosed service cost and other costs from the prior years' pension and other postretirement benefit plan footnotes in the comparative periods as appropriate estimates when retrospectively changing the presentation of these costs in the income statement. Entities that apply the practical expedient need to disclose that they did so.

For more information, see Deloitte's March 14, 2017, *Heads Up*.

Recent SEC Staff Views

The SEC staff continues to emphasize the disclosures related to how registrants account for pension and other postretirement benefit plans and how key 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.

Disclosures About Critical Accounting Estimates

Recent SEC staff comments have focused on inadequate disclosure of critical accounting policies and estimates related to a registrant's benefit plans. The SEC staff expects registrants to provide robust disclosures of their critical accounting policies and estimates in MD&A instead of duplicating documentation from the accounting policy disclosures in the financial statement footnotes. In addition, the 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.

Liquidity and Capital Resources

The SEC staff has encouraged registrants to explain the trends and uncertainties related to pension or other postretirement benefit obligations (e.g., a registrant's funding requirements may be affected by changes in the measurement of its plan obligations and assets). A registrant also may want to disclose in both qualitative and quantitative terms what its plan contributions have been in the past and the expected changes to those contributions.

When commenting on other postretirement benefit plans, which are usually funded as the related benefit payments become due, the SEC staff has noted that the footnote disclosures should include the plan's expected future benefit payments for each of the next five years and in the aggregate for the five years thereafter. This information may provide insight into a registrant's expected liquidity requirements, which could then warrant discussion in the liquidity section of MD&A or in the contractual obligations table.

For more information, see Deloitte's *A Roadmap to SEC Comment Letter Considerations, Including Industry Insights*.

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, and again in April 2018 to provide additional guidance on what it expects from registrants when they use these measures.[9] 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 Deloitte's *A Roadmap to Non-GAAP Financial Measures*.

[9] See Deloitte's May 23, 2016, and July 19, 2016, ***Heads Up*** newsletters for a discussion of the SEC's focus on non-GAAP measures.