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FASB Update to Accounting Pension Expense Creates Opportunities

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The Financial Accounting Standards Board (FASB) released Update 2017-07, which changes the accounting procedures for sponsors of corporate pension plans (not Taft-Hartley plans). The new changes will bring about much needed simplicity and dampen some of the volatility often associated with these types of plans.

Under FASB Update 2017-07, pension expense will still consist of the same (usually) five components.

The first component is *service cost*, which is the value of benefits being earned by employees during the fiscal year. (With a completely frozen pension plan, the service cost is zero.) This piece of expense is the only one not changing shape, and it will continue to be counted as an element of compensation.

The remaining four items will continue to be calculated by the plan's actuary, but these items are being moved out of operating expense into "below the line" expense. Two of these items are the yin and yang of the *interest cost,* which is the increase in the plan's benefit liability due to the passage of time, and the expected rate of return on assets (for funded defined benefit pension plans). The last two components are amortizations of any prior service costs and accumulated gains or losses above a certain threshold.

We suspect that many investment advisors will want to revisit asset allocations with plan sponsors to make sure the investment mix aligns with the plan sponsor's investment strategy. How might FASB Update 2017-07 change a plan sponsor's thinking?

Liability-Driven Investing (LDI) techniques designed to limit downside risk for the plan sponsor generally results in the plan's actuary lowering the expected rate of return as plan investments become more conservative. Under the new accounting treatment, however, the expected rate of return is no longer an operating expense and thus is de-emphasized. Hence, there is one school of thought that this change will result in more plans moving to a more conservative investment approach.

A counterargument can be made to invest more aggressively. For plan sponsors that are trying to minimize GAAP pension expense, often the plan will invest aggressively, thus pushing up the expected rate of return. With service cost now being the only operating expense and independent of the actual return on assets, a plan sponsor could invest more aggressively without experiencing a sharp increase in pension expense in the event of a recession. However, the balance sheet would continue to reflect the lower funded status of the plan if a recession occurs.

Update 2017-07 is effective for fiscal years after December 15, 2017 for public companies and December 15, 2018 for nonpublic companies. The changes also apply to sponsors of postretirement health and welfare plans. Unlike most changes in FASB, however, because of the anticipated volatility reduction, we are seeing early adoption by plan sponsors.

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