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Pensions and employee benefits

Partially updated December 2023

About the Pensions and employee benefits guide

PwC is pleased to offer our updated *Pensions and employee benefits* guide. This guide addresses the accounting for pensions and employee benefits under US GAAP. It includes guidance on the accounting for pensions, other postretirement benefits, benefits provided during employment, deferred compensation, and termination benefits.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB's Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues.

This guide should be used in combination with a thorough analysis of the relevant facts and circumstances, review of the authoritative accounting literature, and appropriate professional and technical advice.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB's Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC's original content.

References to other PwC guidance

This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- *Business combinations and noncontrolling interests (BCG)*
- *Consolidation (CG)*
- *Financial statement presentation (FSP)*
- *Financing transactions (FG)*
- *Foreign currency (FX)*
- *Income taxes (TX)*
- *Loans and investments (LI)*
- *Stock-based compensation (SC)*

Summary of significant changes

Following is a summary of the noteworthy revisions to the guide since it was last updated. Additional updates may be made to keep pace with significant developments.

Revisions made in December 2023

PEB 4, Amendments, curtailments, and settlements

- Question PEB 4-1 was added to illustrate the accounting for a pension plan amendment resulting from litigation.

Revisions made in October 2023

PEB 3, Net periodic benefit cost

- Content in **PEB 3.2.7.2** was moved to **PEB 3.2.6.4** and updated to clarify the definition of an "inactive" plan participant.

Revisions made in December 2021

PEB 4, Amendments, curtailments, and settlements

- **PEB 4.10** was updated to discuss when a plan should be remeasured upon a plan division.
- **PEB 4.11** was added to include a discussion of the accounting for a pension in a spinoff.

Revisions made in October 2021

PEB 1, Overview of pension and other postretirement benefit plans

- **PEB 1.6.2** was updated to reflect the codification improvements to ASC 715-20 and ASC 715-30 related to cash balance plans.

PEB 2, Overview of pension and other postretirement benefit plans

- The order of certain sections within PEB 2 was rearranged.
- **PEB 2.4.1.5** was added to include discussion of negative interest rates and their impact on the discount rates utilized in measuring a plan's benefit obligation.

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***Chapter 1:
Overview of pension and
other postretirement benefit
plans—updated October 2023***

1.1 Overview of pension and OPEB guide

The guidance in ASC 715, *Compensation—retirement benefits*, applies to an employer's accounting for pension plans, as well as postretirement benefits other than pensions. Specifically, ASC 715-30, *Defined Benefit Plans—Pension*, contains guidance for recognition and measurement of pension costs and obligations. ASC 715-60, *Defined Benefit Plans—Other Postretirement*, prescribes the methodology for measuring and recording other postretirement benefit (OPEB) costs and obligations.

The accounting concept underlying ASC 715 is straightforward: an employer's promise to provide employees with postretirement benefits represents a form of deferred compensation. The cost of those benefits should be recognized systematically over employees' service periods. The methodology for measuring and recording pension and OPEB costs and obligations is similar in many respects, including the accounting for settlements of benefit obligations and curtailments (reductions or terminations) of the accrual of benefits.

Therefore, because of the similarities between accounting for pensions and accounting for other postretirement benefits, the accounting for both have been combined in this guide, and generally referenced collectively as pension plans. When the guidance for OPEB benefits differs from pension benefits, the guidance will refer to OPEB plans specifically.

This guide covers the more significant accounting aspects of ASC 715, including:

- Defined benefit versus defined contribution plans (PEB 1)
- Measurement of benefits and attribution of benefits to past, current, and future service (PEB 2)
- Recognition of net periodic benefit cost (PEB 3)
- Significant events (e.g., settlement and curtailments) (PEB 4)
- Multiemployer and multiple-employer plans (PEB 5)

PEB 6 through PEB 8 cover other types of employee benefit arrangements not subject to ASC 715, including benefits provided during employment, deferred compensation, termination benefits, and other postemployment benefits.

Income tax implications of pension and OPEB plans are discussed in TX 5 and TX 12. Disclosures for pension and OPEB plans are discussed in FSP 13.

PEB 9 covers presentation and disclosure related to financial statements of employee benefit plans, including defined benefit plans, defined contribution plans, and health and welfare plans.

1.2 Scope of ASC 715

ASC 715 applies to all arrangements that are in substance pension plans. It does not provide guidance to determine whether an arrangement constitutes a pension plan. That determination depends on the particular facts and circumstances of each case. A key characteristic of a pension plan is that benefits would be available to all employees or to a group of employees who meet stipulated eligibility criteria that define who may participate in the plan and when they may join.

ASC 715 applies to employers' arrangements to provide pension or other postretirement health and welfare benefits to their employees through defined benefit single employer or multiemployer pension and OPEB plans, as well as defined contribution pension and OPEB plans.

Postretirement benefit plans are not limited to legally enforceable contracts. Any arrangement that is in substance a postretirement benefit plan, regardless of its form, is covered by ASC 715. The plan may be written, or there may be an unwritten promise to provide benefits that arises from a past practice of paying benefits or from oral representations made to employees. In certain instances, the written plan may not embody the entire agreement, but may be supplemented by provisions that exist in substance due to past practice or an employer's intended actions as communicated to participants.

When assessing whether an aggregation of deferred compensation contracts is the equivalent of a pension plan or a postretirement benefit plan, factors to consider include:

- Do the arrangements exist in writing and have the approval of the employer's board of directors?
- How many participants are encompassed by the arrangements?
- Is the benefit provided to each participant identical or does each have a separately negotiated benefit arrangement?
- Is there a reasonable expectation that there will be other employees from the same class (e.g., senior executive, executive, director) that will be provided with the same or similar arrangement in the future?
- Is eligibility to participate discretionary or non-discretionary?

These considerations are important conceptual criteria that should be used in evaluating whether an aggregation of deferred compensation contracts is the equivalent of a pension plan or a postretirement benefit plan. The criteria, however, are not intended to be a checklist. Instead, the determination should be based on the weight of the evidence and a decision about what most accurately reflects the nature of the arrangements.

Questions PEB 1-1 through PEB 1-5 discuss the determination of whether a benefit arrangement is within the scope of ASC 715 or ASC 710.

Question PEB 1-1

PEB Corporation has a supplemental executive retirement plan (SERP) that has one participant, the CEO. No other employees are permitted to participate in the plan. The SERP provides a benefit to be paid to the CEO after retirement that is based on compensation and years of service. PEB Corporation has no other defined benefit plans. Should the SERP be accounted for as a pension plan in accordance with ASC 715?

PwC response

Generally, no. A key characteristic of a pension plan is that benefits would be available to all employees or to a group of employees that meet stipulated eligibility criteria that define who may participate in the plan and when they may join. Benefits that are negotiated individually between a reporting entity and one of its officers or other employees are generally not within the scope of ASC 715.

A SERP with, in essence, only a single participant should be accounted for as a deferred compensation arrangement pursuant to the guidance in ASC 710-10-25-9 through ASC 710-10-25-11. The delayed recognition principles for certain gains and losses in ASC 715 would not apply.

If, however, (a) the SERP contains stipulated eligibility criteria, but the CEO is the only participant because he is the only employee that currently meets those criteria and (b) it is expected that additional employees will become eligible to participate in the SERP in the future and would receive similar benefits, the SERP may be considered a pension plan within the scope of ASC 715.

Question PEB 1-2

PEB Corporation does not have a plan document; however, several executives have individual employment agreements that provide identical postretirement benefits. There is an expectation that future executives will also be provided with the same agreements. Would this group of contracts qualify as a plan accounted for in accordance with ASC 715?

PwC response

Generally, yes. A key characteristic of a pension plan is that benefits would be available to all employees or to a group of employees. In this fact pattern, the same benefit is provided to all executives, and is expected to continue to be offered. Therefore, in substance, the group of arrangements constitutes a postretirement benefit plan subject to the guidance in ASC 715.

Question PEB 1-3

There is no plan document, but several executives of PEB Corporation have individual employment agreements that provide each executive with a differing level of postretirement benefits. Future executives may or may not be provided with similar agreements. Would this group of contracts qualify as a plan accounted for in accordance with ASC 715?

PwC response

Generally, no. These arrangements would be accounted for as individual deferred compensation contracts in accordance with ASC 710. This is because the benefit levels differ, as well as the fact that the benefits may not be consistently offered.

Question PEB 1-4

PEB Corporation has a plan in which eligibility to participate is defined in a non-discretionary manner by class of employee (e.g., senior executive, executive, director). Each class of employee has a separate benefit formula. Would this arrangement qualify as a pension plan?

PwC response

Generally, yes, this would be treated as a pension or postretirement benefit plan subject to ASC 715. This is because the plan is formula driven, and the benefits are consistently offered to eligible members of a group, even though the benefits may vary by employee class. If individual deferred compensation contracts with multiple employees are equivalent to a pension plan when taken together, they should be accounted for in accordance with ASC 715.

Question PEB 1-5

PEB Corporation has a plan document and has approved three executives for participation at different times. However, each participant has been provided with a different benefit level. Future executives who are approved for participation may or may not receive the same level of benefits. Would these arrangements qualify as a plan accounted for in accordance with ASC 715?

PwC response

Generally, no. Even though the benefits are technically covered by the same “plan document,” the plan is not offered consistently, nor is there a consistent benefit formula to determine the level of benefits to be provided (in other words, the benefits are more discretionary). Therefore, the substance of this arrangement is a series of individual deferred compensation contracts that would be accounted for in accordance with ASC 710.

1.3 *Defined benefit plan*

ASC 715-30-20 defines a defined benefit plan.

Excerpt from ASC 715-30-20

Defined benefit plan: A defined benefit plan provides participants with a determinable benefit based on a formula provided for in the plan. ...

- b. Defined benefit pension plan—A pension plan that defines an amount of pension benefit to be provided, usually as a function of one or more factors such as age, years of service, or compensation. Any pension plan that is not a defined contribution pension plan is, for purposes of Subtopic 715-30, a defined benefit pension plan.

As the definition says that a defined benefit pension plan is any pension plan that is not a defined contribution plan, the first step in evaluating the type of plan is to determine if it is a defined contribution plan (see PEB 1.4). If a plan does not meet the criteria of a defined contribution plan, it is a defined benefit plan by default. An example of a defined benefit plan is one in which participants may receive monthly benefits of \$100 for each year of service or annual benefit payments of 1% of the final year's pay for each year of service. Additionally, most “cash balance” plans (see PEB 1.6.2) are also defined benefit plans. PEB 2, PEB 3, and PEB 4 contain further detail on the accounting for defined benefit plans.

1.4 *Defined contribution plan*

ASC 715-30-20 includes a definition of a defined contribution plan.

Excerpt from ASC 715-30-20

Defined contribution plan: A plan that provides an individual account for each participant and provides benefits that are based on all of the following: amounts contributed to the participant's account by the employer or employee; investment experience; and any forfeitures allocated to the account, less any administrative expenses charged to the plan.

...

- b. **Defined contribution postretirement plan**—A plan that provides postretirement benefits in return for services rendered, provides an individual account for each plan participant, and specifies how contributions to the individual's account are to be determined rather than specifies the amount of benefits the individual is to receive.

A profit-sharing plan is a type of defined contribution plan in which, for example, an employer contributes 3% of the entity's annual pre-tax income to a plan, which is allocated to participants in a manner specified in the plan. In a defined contribution plan, investment income and plan expenses are allocated based on participants' individual account balances. The retirement benefits a participant will receive depend on the amount contributed to the participant's account plus any allocated income or expense. Both pension and OPEB plans may be defined contribution plans. A 401(k) plan in which the employer provides a "matching" contribution is also an example of a defined contribution plan.

Some plans contain features of both defined contribution and defined benefit plans. Careful analysis of these plans is required. If, in substance, the plan provides a defined benefit, the accounting and disclosure requirements should be those required for a defined benefit plan. For example, in some plans there may be an unfunded account balance established for each plan participant. Thus, while the form of the plan may look like a defined contribution plan, the substance and employer's commitment may weigh more heavily on the side of a defined benefit plan.

Much of the guidance governing the accounting for pension and postretirement benefits was developed in the context of plan designs that were prevalent in the United States in the late 1980s (when the original guidance that has been codified in ASC 715 was developed) and some of the concepts in the Employee Income Retirement Security Act of 1974 (ERISA). Thus, many times the distinction between a defined benefit plan and defined contribution plan are more difficult to apply to plan designs in non-US jurisdictions. See PEB 1.8 for a discussion of the accounting considerations related to certain plan designs more prevalent outside the US.

1.4.1 Accounting for defined contribution plans

The cost of benefits offered through a defined contribution plan are typically the contribution called for in a period. If, however, a plan provides for contributions in respect of any individual participant to continue into periods after that individual retires or terminates employment based on criteria specific to that employee (e.g., additional amounts are to be contributed for the first 10 years subsequent to retirement), the estimated cost of those postretirement contributions must be accrued during the employee's service period. Disclosure requirements for defined contribution plans are covered in ASC 715-70-50-1 and discussed in FSP 13.

1.5 Pension plans

A pension plan is a retirement benefit plan that specifies a pension benefit based on the plan's formula—typically some combination of salary and years of service. In the US, a pension plan must comply with ERISA. ERISA (1) requires plans to provide participants with plan information, including information about plan features and funding; (2) sets minimum standards for participation, vesting, benefit accrual, and funding; (3) provides fiduciary responsibilities for those who manage and control plan assets; (4) requires plans to establish a grievance and appeals process for participants to get benefits from their plans; (5) gives participants the right to sue for benefits and breaches of fiduciary duty; and (6) guarantees payment of certain benefits through a federally chartered corporation if a defined benefit plan is terminated.

In addition, many plans are tax-qualified defined benefit plans. To be tax-qualified, the employer must pre-fund benefits in a segregated and restricted trust so that the plan meets minimum funding requirements. The pool of funds is typically invested in a variety of assets at the discretion of the plan’s trustees who have a fiduciary obligation to the beneficiaries—the employees or eventual retirees—to steward the fund in order to provide sufficient assets to fund the benefits upon retirement.

In addition to an employer's contributions, some pension plans may allow a worker to contribute part of their current income from wages into the pension fund to provide enhanced benefits, or merely to share the cost of funding the defined plan benefits.

The basic cost recognition premise in ASC 715 is that the cost of benefits provided by these plans should be recognized systematically over the active service period of the employee. A distinguishing characteristic of defined benefit pension plan accounting is that the “cost of benefits” includes not only the actuarial present value of the future benefit payments but also the interest on the obligation reduced by the return on the invested plan assets. Put simply, the entire plan constitutes the unit of account, which also impacts the income statement (components of pension cost) and balance sheet (plan assets and obligations) presentation. Another key feature of defined benefit pension plan accounting is the concept of delayed recognition of certain changes in estimates, namely differences in actuarial experience or investment returns. Thus, another component of pension cost is the subsequent amortization of these initially deferred gains and losses. The components of pension costs and assets and obligations are illustrated in Figure PEB 1-1, and are described in PEB 2, PEB 3, and PEB 4.

Figure PEB 1-1
Components of pension plan reporting

Component	Balance sheet		Comprehensive income	
	Plan assets	Benefit obligation	Net income	Other comprehensive income
Service cost		↑	↓	
Interest cost		↑	↓	
Expected return on plan assets	↑		↑	
Employer contributions	↑			
Benefit payments	↓	↓		
Plan amendments		↑ ↓		↑ ↓
Amortization of prior service cost			↑ ↓	↑ ↓
Gains/losses	↑ ↓	↑ ↓		↑ ↓
Amortization of gains/losses			↑ ↓	↑ ↓
Curtailments		↑ ↓	↑ ↓	↑ ↓
Settlements	↓	↓	↑ ↓	↑ ↓
Acquisitions/disposals	↑ ↓	↑ ↓		

1.5.1 **Qualified and nonqualified plans**

Qualified plans meet Internal Revenue Code Section 401(a) and ERISA requirements. That gives the plans a tax-advantaged status, meaning both employers and employees receive a tax deduction on the contributions they make to the plan. Funds placed in a qualified retirement account then grow on a tax-deferred basis such that no tax is due on the earnings as long as they remain in the account. Upon retirement, when the employee begins to receive funds from the plan, the employee will generally be subject to personal income taxes on the benefits paid by the plan.

To be a tax-qualified plan, a plan sponsor must ensure the plan meets several guidelines regarding participation, vesting, benefit accrual, funding, and availability of plan information. Specific requirements for tax-qualification include:

- Disclosure and reporting – Retirement plans must comply with the reporting requirements of the US Department of Labor and IRS. Participants must receive periodic statements of their account balance/benefits.
- Coverage – A specified portion of employees, but not necessarily all, must be covered.
- Participation – Employees who meet eligibility requirements must be permitted to participate.
- Vesting – After a specified duration of employment, a participant's rights to pension benefits are non-forfeitable.
- Nondiscrimination – Benefits must be proportionately equal in assignment to all participants to prevent excessive weighting in favor of higher paid employees.
- Funding – Plans must comply with certain minimum funding requirements.

Nonqualified plans are those that do not meet the tax requirements. As a result, these plans do not qualify for the favorable tax treatment that is afforded qualified plans. Specifically, contributions to a nonqualified plan are not deductible by the employer until the employee receives the benefits provided by the plan and is taxed on the income. As such, nonqualified plans are most commonly offered only to key executives or other select employees or groups of employees.

1.5.2 **Supplemental plans**

In order to maximize the available tax benefits and also maintain an attractive benefits package for more senior executives, some entities have two defined benefit pension plans covering the same employees—a qualified pension plan and a nonqualified pension plan that pays benefits in excess of the maximum allowed for the qualified pension plan by Section 415 of the Internal Revenue Code. Even though the employees covered by the nonqualified plan overlap with the employees covered by the qualified plan, each plan is its own unit of account under ASC 715. The accounting for the plans may not be combined.

1.5.2.1 **Supplemental executive retirement plans**

A supplemental executive retirement plan (SERP) is a nonqualified retirement plan for key employees, typically executives, that provides benefits above and beyond those provided by other retirement plans. These plans are typically offered selectively to highly compensated executives whose qualified

plan contributions are limited by contribution rules. The reporting entity and the respective executive enters into a formal agreement that promises the executive a certain amount of supplemental retirement income based on vesting and other eligibility conditions the executive must meet. The plan may be funded out of current cash flows, investments held by the reporting entity or through a trust, or through reporting entity funding of a life insurance policy with a cash surrender value, and the deferred benefits are not currently taxable to the executive. However, the income received upon retirement will be taxed as ordinary income.

1.5.3 Nonqualifying excess 401(k) plans and other similar plans

A nonqualifying 401(k) plan provides employees with an opportunity to save beyond the limits of the entity's qualified 401(k) plan. Under such a plan, the employee contribution generally goes into the general assets of the entity (i.e., essentially deferred compensation) and a "phantom account" is established. However, this type of plan would not meet the definition of a defined contribution plan because it does not have individual accounts for participants. In this case, because the benefit is essentially an unfunded defined benefit plan (i.e., a promise to the employee to pay them the value of their "phantom account" in the future) and not a collection of individual deferred compensation contracts, we believe application of the defined benefit plan accounting model would be appropriate. However, consistent with the underlying nature of the obligation, and by analogy to the guidance in ASC 715-30-35-40 through ASC 715-30-35-41 for plans in which the vested benefit obligation at the measurement date may exceed the actuarial present value of the benefits, marking-to-market the account balance would also be acceptable. A full actuarial valuation would be required if regular defined benefit plan accounting is followed.

If a reporting entity follows the "mark-to-market approach," we believe there are two acceptable interpretations to account for the excess 401(k) plan liability. This interpretation should be considered as a policy election to be followed consistently:

- The excess 401(k) plan liability is subject to ASC 820, *Fair Value Measurement*.
- The excess 401(k) plan liability is not subject to ASC 820. The mark-to-market approach is acceptable based on analogy to ASC 715-30-35-40 and ASC 715-30-35-41. Under that guidance, an employer may account for the types of benefit obligations described in ASC 715-30-35-40 by using the "actuarial present value of vested benefits to which the employee is entitled if the employee separates immediately." Technically, even though this is a current "walk-away value," it is not fair value.

1.6 Hybrid plans

Some benefit plans contain features of both a defined contribution plan and a defined benefit plan. These plans should be accounted for based on the substance of the arrangement.

1.6.1 Target benefit plans

A target benefit plan has a benefit formula the employer uses to determine a target benefit. Contributions are made in an amount necessary to fund the benefit without an actual commitment to provide the benefit. Although the form of the plan is a defined contribution plan, the substance and employer's commitment may weigh more heavily on the side of a defined benefit plan. Analysis of the written plan provisions, communication to plan participants, and the history of and reasoning for

updates to the contribution should be made to determine if, in substance, the plan provides a defined benefit, in which case it would be subject to the accounting and disclosure requirements of a defined benefit plan. The following are examples of when consideration should be given to accounting for a plan of this nature as a defined benefit plan:

- The employer effectively controls the plan's investment policy, so that employees do not control how the balances in their individual accounts are to be invested (i.e., no choice exists among investment options, such as an equity fund, a fixed income fund, or a money market fund).
- The employer periodically adjusts the level of contribution rates or takes other actions designed effectively to transfer the risk of investment losses to the employer rather than leaving it with the employees.

When a target benefit plan is established to replace a terminated defined benefit plan, the classification of the target benefit plan should begin with a presumption that it is a defined benefit plan. To overcome this presumption would require strong evidence to the contrary.

1.6.2 Cash balance plans

Arrangements referred to as "hybrid plans," "cash balance plans," "guaranteed individual account plans," or "lump-sum pension plans" typically have the following characteristics:

- Benefits are intended to be paid primarily in lump-sum form, although annuity equivalents of the lump-sum account balance may be paid instead.
- Employer contributions to "separate accounts" and account balances are communicated periodically to employees. However, separate investment accounts are not actually maintained; the "separate accounts" are maintained on paper only, and are "credited" periodically with investment earnings.
- Actual plan earnings below the guaranteed rate of return are required to be made up by the employer; earnings in excess of the guaranteed rate, in effect, serve to reduce the employer's cost.

Legally, and in substance, these types of arrangements are defined benefit plans and should be accounted for as such. While the account-balance-reporting feature may be somewhat similar to a defined contribution plan, like any defined benefit plan, a cash balance plan must be funded on an actuarial basis in accordance with ERISA. The employer, not the employees, bears the investment risks and rewards. Similarly, and as with any other defined benefit plan, ASC 715 requires the accounting to be based on the attribution of benefits earned in each service period under the terms of the plan. With that in mind, the "guaranteed income credit" reported in the "separate accounts" may not be particularly relevant for accounting purposes.

ASC 715-20-25-1

A cash balance plan is a defined benefit plan.

ASC 715-20-25-2

A cash balance plan communicates to employees a pension benefit in the form of a current account balance that is based on principal credits and future interest credits based on those principal credits.

ASC 715-20-25-3

In a cash balance plan, individual account balances are determined by reference to a hypothetical account rather than specific assets, and the benefit is dependent on the employer's promised interest-crediting rate, not the actual return on plan assets. The employer's financial obligation to the plan is not satisfied by making prescribed principal and interest credit contributions—whether in cash or as a hypothetical contribution to participants' accounts—for the period; rather, the employer must fund, over time, amounts that can accumulate to the actuarial present value of the benefit due at the time of distribution to each participant pursuant to the plan's terms. The employer's contributions to a cash balance plan trust and the earnings on the invested plan assets may be unrelated to the principal and interest credits to participants' hypothetical accounts.

ASC 715-20-25-4

The determination of whether a plan is pay-related and the appropriate benefit attribution approach for a cash balance plan with other characteristics or for other types of defined benefit pension plans depend on an evaluation of the specific features of those benefit arrangements.

As noted in ASC 715-20-25-1, a cash balance plan is a defined benefit plan and, therefore, is subject to the guidance in ASC 715-30. The determination of the appropriate benefit attribution approach for a cash balance plan depends on an evaluation of the specific features of those benefit arrangements.

ASC 715-30-55-127A includes an example of a cash balance plan that is not pay-related. In this example, the use of the projected unit credit method is not appropriate for purposes of measuring the benefit obligation and the annual cost of benefits earned. Instead, an entity that has that specific type of plan would apply a traditional unit credit method to determine costs and obligations for that plan. The principal difference between the projected unit credit method and the traditional unit credit method is that future salary increases are not assumed in the traditional unit credit method. See PEB 2.5.1 for discussion of the projected unit credit method.

Because this guidance applies only to the narrowly defined plan described in ASC 715-30-55-127A, entities should not necessarily apply that measurement and attribution guidance to other cash balance plans that have features that are different from the identified cash balance plan in the example. The accounting used should reflect the substantive plan based on its specific facts and circumstances.

Although many cash balance plans provide a minimum interest crediting rate, in many cases by reference to a US government obligation (e.g., treasuries), that interest crediting rate is part of the benefit promise and is not relevant for determining the present value (i.e., discounting) of the benefit obligation. Thus, the discount rate guidance in ASC 715-30-35-44 for “traditional” defined benefit plans equally applies to cash balance plans.

1.6.3 Floor-offset plans

Certain linked pension plan arrangements are known as “floor-offset” or “feeder-floor” plans. These arrangements (henceforth referred to as floor-offset plans) generally consist of two legally separate pension plans (a defined contribution plan and a defined benefit plan) that guarantee a minimum level of benefits. In a floor-offset plan, benefits are generally required to be paid from the defined benefit plan only if the balance in the employee's defined contribution account is insufficient to cover the minimum benefit under the defined benefit plan. Furthermore, the terms of the defined benefit plan may specify that the employer's obligation under that plan is reduced to the extent that a participant's

account balance in the defined contribution plan is used to pay benefits covered by the defined benefit plan.

ASC 715-70-55-2 through ASC 715-70-55-3 indicates that these arrangements should be accounted for as two plans. It would be inappropriate to account for this arrangement as a single plan (either defined benefit or defined contribution) based, for example, on whether benefits will be satisfied primarily from one plan or the other. For example, it would be inappropriate to account for the two plans as a defined contribution plan even if the employer expects that a significant amount of the benefits payable under the arrangement will be satisfied by the defined contribution plan. The unit of accounting under ASC 715 is the individual plan. The dissimilar nature of an employer's obligation under each type of plan, including how those obligations are satisfied, and the fact that plan assets of a defined contribution plan would not be legally available to pay the benefits due under a defined benefit plan (and vice versa), makes it inappropriate to consider the two plans as a single plan for accounting purposes.

Floor-offset plans should be accounted for by determining the projected benefit obligation of the defined benefit plan as the net of (1) the actuarial present value of the defined benefit promised (ignoring the defined contribution offset) less (2) the current balance in the defined contribution plan at the measurement date. An approach in which the balance in the defined contribution plan is projected to retirement and then offset against the expected defined benefit at retirement is not appropriate. Once the projected benefit obligation for the defined benefit plan has been determined in this manner, the two plans should be accounted for separately. The assets of the defined contribution plan should not be combined with those of the defined benefit plan.

1.6.4 Variable annuity plans

A variable annuity plan is a defined benefit pension plan that provides a pension benefit that is adjusted for the actual return on plan assets as compared to an assumed investment (or “hurdle”) rate. A characteristic of this type of plan is that the lump sum value of the benefit will increase or decrease based on the actual return on plan assets. These plans are often communicated as account balance plans. However, the plan assets are commingled and there are no allocated individual account balances. Therefore, the plan does not qualify as a defined contribution plan and should be accounted for as a defined benefit plan.

1.7 Termination indemnities and similar arrangements

Termination indemnities, which are more prevalent outside the US, generally involve unfunded plans that pay benefits for virtually all terminations, including retirement and voluntary and involuntary terminations. These plans are, in substance, defined benefit plans.

In these plans, the actuarial present value of benefits to which the employee is entitled if the employee terminates immediately may exceed the actuarial present value of benefits to which the employee is entitled at the expected date of separation based on service to date (due to the effects of discounting such future payments). If the vested benefit obligation (VBO) is determined assuming employee termination at the measurement date, that VBO could exceed the accumulated benefit obligation if that obligation is measured based on the employee's expected date of termination and related assumptions (such as salary increases) through that date. The accounting issue is whether the VBO is the actuarial present value of the vested benefits to which the employee is entitled if the employee separates immediately (Approach 1) or the actuarial present value of the vested benefits to which the

employee is currently entitled, but based on the employee's expected date of separation or retirement (Approach 2).

Based on the guidance in ASC 715-30-35-41, either approach is acceptable as an accounting policy election, but the method used should be consistently followed and disclosed. Under either approach, the defined benefit plan provisions of ASC 715-30 should be followed. So, for example, the treatment of prior service costs arising from plan amendments and the treatment of gains and losses should be consistent with the requirements of ASC 715-30.

See PEB 8 for guidance on severance and other postemployment benefits not provided through a pension plan.

ASC 715 does not apply to government-established "social security" systems, under which the government pays pensions to retirees and obtains funds through payroll taxes or other levies on employers and employees. ASC 715 does not apply to such systems as employers have no responsibility to make the pension payments and there is no direct relationship between the taxes paid and recorded by the employer and the pensions paid by the government.

1.8 *Foreign plans*

ASC 715 does not include special provisions applicable to pension arrangements outside the US. If those arrangements are in substance similar to pension plans in the US, they are subject to the provisions of ASC 715. ASC 715 applies to any arrangement (written or unwritten) that is similar in substance to a pension plan regardless of the form or means of financing. Pension benefits are defined in ASC 715-30-20 as "periodic (usually monthly) payments made pursuant to the terms of the pension plan to a person who has retired from employment or to that person's beneficiary." Thus, for example, if such an arrangement is in substance a pension plan, such as when severance benefits are paid for virtually all terminations, it is subject to the provisions of ASC 715. ASC 715 does not apply to life insurance benefits provided outside a pension plan or to other postretirement health and welfare benefits. However, ASC 715 would apply to death-in-service or disability benefits provided as part of an overall pension plan (regardless of whether such benefits are covered by insurance policies purchased by the entity or pension trust).

The entity's specific pension and severance arrangements at each foreign location should be clearly understood in order to determine the applicability of ASC 715. See PEB 8 for a discussion of postemployment benefits, which may impact the accounting for these severance arrangements.

Some international plans have been designed that contain features of both defined benefit and defined contribution plans. However, the narrow scope of defined contribution plans under ASC 715, which requires individual accounts for each participant, often prevents such plans from qualifying as defined contribution plans, and therefore these plans would be defined benefit plans for US GAAP reporting.

Because many foreign countries have some form of nationalized health insurance, employer promises to provide retiree healthcare coverage may not be as prevalent among non-US entities. In effect, the cost for non-US operations' postretirement health care is often reflected in local taxes or social security contributions.

There may be other situations when non-US arrangements that are similar in substance to OPEB plans offered in the United States exist. Even in countries with nationalized health insurance, the coverage

provided by such insurance may be limited. As a result, employers may still have OPEB plans, albeit of a more restricted nature. Experience has shown that the liability that results from even restricted coverage plans can be significant. Such plans are required to be accounted for in accordance with the provisions of ASC 715-60 and the appropriate disclosures made in accordance with ASC 715-60-50.

The applicability of ASC 715-60 to these plans should be determined by the nature of the obligation and the terms and conditions that define the amount of benefit payments, not by the funding mechanism, whether the benefits are payable over more than one period or as a lump-sum, or whether the benefits are required by law or custom.

1.9 Other postretirement benefit plans

The most common form of postretirement benefit plan other than pensions (typically referred to as an OPEB plan) is a promise to provide healthcare benefits to retirees. The promise may be either to reimburse retirees for their payments for healthcare services, pay insurance premiums directly, or provide the services to retirees directly. However, OPEB plans are comprised of all forms of benefits other than pensions provided to retirees and their spouses, dependents, and beneficiaries. These include life insurance offered outside of a pension plan, legal and tax services, tuition assistance, daycare services, and housing assistance.

A postretirement benefit plan generally exists whenever an employer promises to provide benefits other than pension benefits to employees after they retire. Those to whom a promise has been made typically include current and former employees (including retirees and disabled employees). The benefits may extend to the employees' spouses, dependents, and beneficiaries. The provisions of ASC 715 do not extend to other postemployment benefits arising from circumstances other than retirement. Such benefits, which are payable after employment ends but before retirement begins (e.g., severance benefits), are covered by ASC 712, *Compensation - Nonretirement Postemployment Benefits* (see PEB 8), and, in some instances, ASC 420, *Exit or Disposal Cost Obligations* (see PEB 8).

An employer may sponsor a health care plan permitting retirees to continue participation on a "pay all" basis (i.e., by requiring a retiree contribution based on the estimated per capita cost of coverage). In some plans, retiree contributions are established based on the average per capita cost of coverage for the entire plan group (i.e., actives and retirees when the plan provides coverage to both), rather than the per capita cost for retirees only. While not readily apparent, this practice provides a postretirement benefit to the extent that the retirees are contributing less than the actual costs someone their age would incur for healthcare because retirees as a group usually incur medical costs that are greater than the average cost for active employees and retirees. The employer's OPEB obligation would be calculated as the portion of the future cost of retiree health care benefits not recovered through retiree contributions, Medicare, or other reimbursements. Refer to ASC 715-60-35-97 and ASC 715-60-55-6.

1.10 Multiemployer plans

A pension or OPEB plan to which two or more unrelated employers contribute, usually pursuant to a collective bargaining agreement, is generally considered to be a multiemployer plan. A common characteristic of a multiemployer plan is that there is no separate accounting for assets contributed by the participating employers. Instead, the assets are commingled and can be used to provide benefits to employees of other participating employers. Contributions to the plan may be on the basis of production, hours worked, or similar criteria. The plan frequently is administered jointly by labor and

management trustees. See PEB 5 for a discussion on the accounting for multiemployer plans, and distinguishing between multiemployer and multiple-employer plans.

1.11 *Determining the substantive benefit plan*

Postretirement benefit plans are not limited to legally enforceable contracts. Any arrangement that is in substance a postretirement benefit plan, regardless of its form, is covered by ASC 715. The plan may be written, based on statutory requirements, or there may be a substantive obligation - an unwritten promise to provide benefits that arises from a past practice of paying benefits or from oral representations made to employees. In certain instances, the written plan may not embody the entire agreement, but may be supplemented by provisions that exist in substance due to past practice or an employer's intended actions as communicated to participants.

An objective of ASC 715 is that the accounting for pension and OPEB plans reflects the substance of the arrangement between the employer and employee rather than its form. Therefore, ASC 715 requires employers to measure the obligation using the provisions that are understood by both the employer and employee to be the operative plan terms (the substantive plan), even when such provisions are not embodied in the written plan.

1.11.1 *Cost sharing between employer and employee*

In some plans the employee contributes to the cost of the benefit obligation. The consideration of certain cost sharing practices (i.e., policies that reduce the employer's cost) that are not embodied in the written plan is described in ASC 715-60-35-51. However, there are certain situations when such practices should not be considered part of the substantive plan, as described in ASC 715-60-35-52 through ASC 715-60-35-54.

ASC 715-60-35-55 discusses collectively bargained plans, noting that, because an employer does not have the unilateral right to change such a plan, the written plan would typically constitute the substantive plan. An exception exists when the employer can demonstrate its ability to maintain a consistent level of cost sharing or a consistent level of increasing or reducing its share of costs in past negotiations without making offsetting changes in other benefits or compensation, or incurring other significant costs. Many companies have added per capita limitations or other types of "caps" on annual OPEB benefits as part of collectively bargained plans. Even if these caps are not expected to come into play during the term of the contract, they form part of the substantive plan in determining the estimated benefit obligation.

In some situations, an employer's past practice in successive union negotiations may provide evidence that the substantive plan is different from the written plan, even in situations when offsetting changes were made to compensation or other benefits. This will result in an accumulated postretirement benefit obligation (APBO) under ASC 715 that may be considerably different (generally higher) than an APBO based on the written plan. All of the relevant facts and circumstances should be considered in assessing whether the substantive plan in those situations differs from the written plan. For example, consistently waiving the caps as part of multiple successive contract negotiations may be an indicator that the plan should be accounted for as if it were an uncapped plan, despite the fact that such waivers are negotiated and are accompanied by offsetting negotiated changes. Further, increases in caps or other plan terms that occur as a result of multiple contract negotiations may be an indicator that the substantive plan includes such increases on an ongoing basis. Regardless of whether offsetting changes in other benefits or compensation have occurred or other significant costs have been incurred

to maintain the cost-sharing arrangement, judgment is required to determine the substantive plan and whether it differs from the written plan.

The term "past practice" is not defined in ASC 715, although ASC 715-60-35-51 states: "Such a past practice would be indicated when the nature of the change and duration of the past practice are sufficient to warrant a presumption that it is understood by the plan participants." Each situation must be considered individually.

1.11.2 *Limitations when determining the substantive plan*

The requirement to consider past practice and communication to participants of intended changes is limited to a plan's cost-sharing provisions. Changes in other plan provisions, such as those that alter the types of benefits covered by the plan or the eligible participants, would not impact what is considered the substantive plan under ASC 715-60-35-51 and therefore, the written plan would govern. For example, an employer may have an established practice of limiting its annual increase in the cost of retiree health coverage to 5%, accomplished by various methods, including limiting hospital room coverage, eliminating surgical benefits for certain procedures, reducing dependent coverage, and changing cost-sharing provisions of the plan. The ability of the employer to maintain this level of cost increase in the future through these means is not reasonably predictable, because reductions in coverage and eligible participants cannot be made indefinitely. Therefore, in calculating the OPEB obligation, a presumption could not be made that the annual increase in the employer's cost of providing retiree health care coverage would always be limited to 5%. However, within the actions taken to achieve the 5% limitation, the cost-sharing actions would be considered part of the substantive plan if the employer has a past practice of cost-sharing (e.g., raising deductibles or retiree contributions, or changing co-insurance provisions) or has the ability (and has communicated to affected plan participants its intent) to institute different cost-sharing provisions.

1.11.3 *Substantive commitment outside of written terms*

ASC 715-30 describes situations when an entity has a history of regular increases of benefits. This or other evidence may indicate that an employer has a present commitment to make future amendments and that the substance of the plan is to provide benefits that are greater than the benefits defined by the written terms of the plan. In those situations, the substantive commitment would be the basis for the accounting. Accounting for substantive commitments is further discussed in PEB 4 with the accounting for plan amendments.

***Chapter 2:
Measurement of defined
benefit plans—updated
October 2023***

2.1 Overview of defined benefit plan measurement

This chapter discusses the measurement of benefit obligations for defined benefit pension and OPEB plans as well as specific considerations relative to the determination and measurement of plan assets. Measuring pension and OPEB obligations includes three key considerations:

- **Projections and assumptions** – As the amount of pension and OPEB benefits ultimately paid to each employee depends on future events, such as length of service, future compensation levels or future health care costs, employee turnover, and mortality, it is necessary to make estimates and assumptions about those future events.
- **Interest rates** – The current measure of the pension and OPEB benefit obligation is the discounted present value of the expected future benefit payments; consequently, the expected gross benefit payments in the future must be discounted to present value at an appropriate discount rate.
- **Attribution** – The projected benefit obligation (PBO) or accumulated postretirement benefit obligation (APBO) at any point in time only reflects the value of benefits that are attributable to an employee's past service (present obligation). As a result, plans that do not provide for an equal amount of benefit for each service year need to develop an attribution approach to determine the benefits attributable to past service and those attributable to future service.

Sections in this chapter will cover measurement timing (i.e., measurement date), and, specific to pension plans, the distinction between the accumulated benefit obligation (ABO) and PBO. Assumptions, including key actuarial inputs and interest rates, will also be covered. Lastly, the chapter covers relevant health care legislation and reform, and how such regulation impacts the measurement of relevant costs and obligations.

2.2 Measurement of the defined benefit obligation

The projected benefit obligation and accumulated benefit obligation are measures of the obligation of a pension plan and the expected postretirement benefit obligation is a measure of the obligation of an OPEB plan.

2.2.1 Pension – Projected benefit obligation

The projected benefit obligation, or PBO, is the actuarial present value of all expected future benefit payments attributed by the pension benefit formula to employee service rendered to date. Measurement of the PBO should reflect future compensation levels to the extent that defined benefits are compensation-related, in accordance with the projected unit credit method (see PEB 2.5.1). Future compensation levels should be consistent with the formula defining the pension benefit and include an estimate of future compensation levels of individual employees covered by the plan, including changes attributed to general price levels, productivity, seniority, and promotion, depending upon the pension benefit formula. All assumptions should reflect consistent expectations of future economic conditions, such as future rates of inflation. See ASC 715-30-55-20 for information on the interplay between assumed increases in salary levels and the selection of discount rates.

Other factors, such as changes under existing law in expected social security benefits (or similar national welfare program) that, pursuant to the terms of the plan, will offset the benefits payable by

the pension plan, including benefit and salary limitations, should also be estimated. As noted in ASC 715-30-55-21, if existing law provides for indexing or has a schedule of changes inherent in it, those effects should be considered; however, possible amendments of the law should not be considered.

2.2.2 Substantive pension plans

ASC 715 requires employers to account for the substantive plan, which is the substantive commitment made to employees for future benefits, which may differ from the written provisions or there may be no written provisions.

Excerpt from ASC 715-60-35-56

A past practice of regular increases in postretirement benefits defined in terms of monetary amounts may indicate that the employer has a present commitment to make future improvements to the plan and that the plan will provide monetary benefits attributable to prior service that are greater than the monetary benefits defined by the extant written plan. In those situations, the substantive commitment to increase those benefits shall be the basis for the accounting.

This is a critical aspect of defined benefit plan accounting as many arrangements are not legally protected or contractual. The objective is to account for the promise that the employer has made to provide postretirement benefits in return for current employee service.

If evidence indicates the plan sponsor has made a substantive commitment to make future plan amendments, such amendments should be included in the projected benefit obligation. A substantive commitment might be a benefit increase announced to employees, a plan amendment approved by the Board of Directors, or an unwritten policy to increase benefits. This latter situation relates primarily to non-pay-related plans when, for example, it is the entity's policy or practice to increase retirement benefits by a cost-of-living adjustment. However, a history of retroactive plan amendments does not, in and of itself, represent a "substantive commitment." See ASC 715-30-55-16 through ASC 715-30-55-19 for additional guidance in this area.

2.2.3 Pension — accumulated benefit obligation definition

The accumulated benefit obligation (ABO) is the actuarial present value of expected future benefit payments attributed by the pension benefit formula based only on the employees' accumulated service to the measurement date. The ABO is based on the assumption that no future pension benefits, or increases in benefits based on future salary increases, will accrue in the future. The measurement technique for the ABO is the same as for the PBO, except that it focuses on past and current compensation levels, and does not incorporate assumed salary increases. It does, however, similar to the requirement to consider the substantive commitment in measuring the PBO, include automatic benefit increases specified by the plan (e.g., cost-of-living increases) that are expected to occur. In addition, contractually agreed-upon retroactive plan amendments should be included in the ABO, even if some of the provisions are not yet effective.

The ABO should be measured based on the employees' history of service and compensation. Projected years of service may be a factor if, for example, benefits earned per year increase based on achieving a specified number of years of service.

2.2.4 OPEB — expected postretirement benefit obligation definition

The expected postretirement benefit obligation (EPBO) is the actuarial present value at a particular date of the total postretirement benefits expected to be paid to employees and their dependents and beneficiaries for an OPEB plan—essentially the projected total costs of benefits to be provided in retirement. The EPBO is the basis for calculating the service cost component—the portion considered compensation—of net periodic postretirement cost and is the key estimate underlying the reported liability for an OPEB plan—the accumulated postretirement benefit obligation (APBO).

The APBO is the portion of the EPBO earned to date and not yet paid (i.e., the aggregation of the EPBO attributed to plan participants' prior service periods, together with accumulated interest thereon, less benefits paid). The portion is based on the years of service in relation to total expected years of service to the full eligibility date under the plan (see PEB 2.5.3).

2.3 Demographic assumptions in pension and OPEB plans

The calculation of expected benefits for plan participants of pension and OPEB plans requires the use of assumptions about the demographics of plan participants. Because the nature of benefits provided under pension plans differs from that of benefits provided under OPEB plans, the data needed may be slightly different between the two types of plans; however, many data points will be consistent. Examples of such demographic assumptions include estimates of:

- Life expectancy or mortality
- Expected retirement age
- Employee turnover
- Other factors such as probability of disability, marital status, and dependency status.

ASC 715 requires each significant assumption to reflect the best estimate of that particular future event (an "explicit" approach). Thus, employers may not apply an approach that looks to the aggregate effect of two or more assumptions, even if their aggregate effect may be approximately the same as that of an explicit approach.

2.3.1 Demographic data used in plan assumptions

The demographic assumptions of plan participants rely on categorical employee information. Therefore, employers will typically accumulate various information about individuals expected to be eligible for benefits under the plan, including active employees eligible or expected to become eligible, former employees who are eligible for benefits under the retiree plan (including disabled individuals), and retirees. Some of this so-called "census" data may include:

- Date of birth
- Gender
- Date of hire

- Business unit
- Hourly/salaried employee
- Marital status and spouse's date of birth (if spousal coverage is provided)
- Retirement date
- Salary (if plan is pay-related)

Data that may be required and would be unique to OPEB include:

- Plan option selected (e.g., indemnity plan, HMO, or PPO)
- Coverage offered through spouse's or other plan, including Medicare
- Dependents and their dates of birth (if dependent coverage is provided)
- Geographic location of employees and retirees

Some of the OPEB census data may not be available. For example, companies may not have updated information on dependents or their birth dates, or the existence of coverage through a spouse's plan. Depending on the nature and level of OPEB coverage, such data could be significant to the OPEB calculation. If not currently accessible, actuarial estimates of this data should be made.

2.3.2 *Life expectancy or mortality assumptions*

A key assumption in the calculation of expected plan costs is life expectancy or mortality—i.e., for how long will the plan be required to pay benefits as most arrangements provide benefits for life. As with any other assumption underlying an accounting estimate, employers should use the best available information to inform their selection of a mortality assumption. Generally, the most current published mortality tables should be used unless (1) an employer can demonstrate through an analysis of actual experience the need for higher mortality rates (shorter life expectancy) that may be reflected in older tables or (2) appropriate actuarial adjustments are made to the older tables to reflect trends towards the more current (generally lower) mortality rates. The expected mortality rates reflected in published mortality tables are based on historical mortality experience through the year of the mortality study (i.e., the base year). Adjustments to these tables are typically needed to reflect projections of expected future mortality improvements after the base year. Examples of typical adjustments made to a base mortality table include (1) projecting future mortality improvements after the base year and (2) blending separate male and female mortality tables into a unisex table in proportion to the male and female percentages of a company's plan participant population.

ASC 715 does not prescribe use of a specific mortality table or mortality improvement scale. The mortality assumption should represent management's best estimate of the expected duration of future benefit payments at the measurement date. Employers can consider using mortality tables that reflect the nature of their respective industries. For example, it would generally be inappropriate for an employer in a service-based industry to use mortality tables that were developed from employee data derived from the manufacturing industry. The estimate should be based on the facts and circumstances for each plan (e.g., population, demographics) and consider all available and relevant information at the date the reporting entity's financial statements are available to be issued. The

mortality assumptions for measuring defined benefit obligations under GAAP should be assessed independent of those specified for pension funding requirements as set by the IRS (for tax-qualified plans in the US).

Actuarial Standards of Practice 35, *Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations*, requires actuaries to consider mortality improvements since the mortality table's base year through the measurement date as well as projected improvements beyond the measurement date.

The Society of Actuaries (SOA) publishes mortality tables from time to time, which are generally considered to be reliable sources for developing mortality assumptions. These tables are based on observed experience over a defined study period and considering past trends, and reflect more recent data and the latest actuarial techniques.

The SOA also issues mortality improvement scales to reflect additional years of mortality data from the Social Security Administration between full studies leading to new mortality tables. Since 2015, mortality data shows a continued (although smaller) downward trend in mortality—i.e., increases (or improvements) in life expectancy. Companies should consider any published new mortality data for their plans in relation to their plan-specific mortality experience and future expectations.

Mortality assumptions are a long-term estimate of future experience, so we would not expect mortality improvements to be projected only through the current measurement date each year. That would be, in effect, phasing in a long-term assumption in annual increments over a long period of time, and inconsistent with the use of the current best estimate of future mortality experience. Further projections of mortality should reflect improvements (both from the base year of the mortality study to the measurement date and for periods after the measurement date) on a generational basis rather than using a static table projection (although a static projected table may be acceptable with significant additional support and analysis). Alternative custom-base tables may be supportable, for example, adjusting a standard published Society of Actuaries table based on company-specific recent historical mortality experience, to the extent there is sufficient data to be statistically credible. Regardless of base tables used, the improvement scale applied should generally be in line with most recent improvement scales available.

In addition to the published SOA standard improvement scales, other custom-designed mortality improvement scales may be supportable, such as those that incorporate data published by the Social Security Administration.

2.3.2.1 Mortality tables for use in lump sum pension calculations

For qualified pension plans in the US that offer a lump sum benefit payment rather than an annuity, the IRS prescribes the actuarially equivalent interest rate and mortality table for determining the minimum statutory required lump sum payment. Pension plans typically require the use of the then-current IRS tables (or the "greater of" the amount calculated using such tables and the amount calculated using another specified set of tables) to convert the participant's stream of future benefits into a lump sum amount. For actuarial valuations of pension plans that offer lump sum payments, management is required to choose a mortality table and projection scale assumption for accounting purposes to determine the lump sum amounts expected to be paid at each expected payment date in the future.

Under current law, for payment of lump sums, mortality is required to be based on US retirement plan experience, and the Secretary of the Treasury is required to consider updating the lump sum tables at least every 10 years. However, there are no formulaic or automatic provisions required as part of that consideration, and the Secretary of the Treasury has latitude in implementing the updates. Thus, applicable mortality tables for subsequent years will be determined in the future based on the IRS' approach of updating the tables when considered appropriate.

This discretion by Treasury gives rise to a question of how to project future lump sum payments over the life of the plan. We believe there are two acceptable approaches under ASC 715:

- **View 1:** Future anticipated updates by the IRS to its lump sum mortality tables can be anticipated and reasonably estimated prior to future IRS regulations being promulgated (much like annual cost of living increases). This would be consistent with the general approach in ASC 715 to reflect the employer's best estimate of future benefit payments, incorporating a wide variety of projections of future events. Management should reflect its best estimate of what it believes the IRS-prescribed mortality table will be in future years when the expected lump sum amounts are to be calculated and paid.
- **View 2:** Future updates by the IRS to lump sum mortality tables is equivalent to a change in law, which should not be anticipated under ASC 715-30-35-31 and ASC 715-60-35-102. Management should assume that mortality rates used to calculate lump sum amounts paid in all future years will be based on the currently promulgated IRS tables. When the IRS updates their lump sum mortality tables, the impact on the projection of future lump sum payments would be reflected in the measurement of the obligation at the next measurement date following the IRS update.

2.3.2.2 *Mortality tables for promised future annuity purchases*

Rather than paying benefits directly, some pension plans may promise to purchase annuities from an insurance company to provide the retirement benefit. In those cases, the mortality tables expected to be inherent in insurance companies' rates should be incorporated into the measurement of the plan's benefit obligation. That would be true not only for special valuations, such as lump sum windows, retiree annuity purchases, and plan terminations, but also for ongoing annual valuations when lump sums or annuity purchases are assumed in the future.

2.3.3 *Expected retirement age assumption in pensions*

The assumption of retirement age—i.e., when benefits will begin versus when they will end (mortality)—can be more critical to the measurement of an OPEB obligation than to a pension obligation. Pension plans often provide for a reduced benefit if early retirement is elected to reflect the longer period over which the retiree is expected to receive a defined benefit. OPEB plans often do not have a similar provision. In addition, prior to age 65, there would generally be no Medicare reimbursement, resulting in a substantially higher annual per capita cost for OPEB plans. In general, the expected retirement age assumption should reflect an employer's historical experience relative to its plan's demographics and general economic trends.

2.3.4 *Employee turnover assumption in pensions*

Turnover represents the rate at which employees participating in the plan are expected to leave before becoming eligible for benefits (i.e., forfeiture rate). This assumption will have a significant impact in OPEB plans that specify that employees who terminate before the date they are eligible for benefits

lose all OPEB benefits earned to date. Because pension plans may provide for vesting of benefits over relatively short periods of service, the measurement of costs and obligations for pension purposes is generally less sensitive to the turnover assumption than they are for OPEB purposes. See PEB 2.5 for a discussion of the impact of vesting provisions on the attribution period of service cost.

2.3.5 *Disability assumption in pensions*

Many employers provide lifetime health care coverage to employees who retire due to disability. For such plans, rates of disability and recovery are required to project benefit payouts. It may also be necessary to use per capita claims costs specific to disabled retirees if they are greater than for other retirees.

2.3.6 *Marital and dependency status assumption in pensions*

In addition to providing benefits to retirees, many OPEB plans provide health care benefits to retirees' spouses and dependents, often with no reduction in benefit levels. For these plans, spousal and dependent coverage can significantly increase the OPEB obligation otherwise payable for retiree-only coverage. In contrast, although pension plans may also provide for spousal benefits, they generally do so through a surviving spouse option, which typically provides reduced benefits to the retirees to take into account the additional payments expected to be made to the spouse subsequent to the retiree's death. Regardless, ASC 715 requires that an actuarial assumption be made about employees' expected marital status and number of dependents during retirement. The starting point for any such assumption is the accumulation of demographic data for current spouses and dependents.

2.3.7 *OPEB plan assumptions*

Additional assumptions used in the calculation of expected benefits for plan participants specific to OPEB plans may include:

- Opting into Medicare coverage
- Per capita medical claims costs
- Healthcare cost trend rates

2.3.7.1 *Opting into Medicare*

Under existing law, prescription drug benefits and certain health care benefits are available to individuals age 65 and older through the federal Medicare program. The estimation of the employer's future cost, therefore, includes a reduction of the assumed gross per capita claims cost to the extent that plan benefits are reduced for amounts expected to be either paid through Medicare or subsidized by a federal government program when determined to be "actuarially equivalent" to Medicare. Similarly, the assumed gross per capita claims cost is reduced by expected reimbursements of costs by others, for example, by a retiree's spouse's OPEB plan sponsored by another enterprise. The Medicare and other provider reimbursement amounts must be estimated for each future year using the level of benefit coverage provided under the present law and/or existing provisions of the other plan. Only enacted changes in the law or the existing terms of other providers' plans, including amendments that are approved and that take effect in future periods, are to be considered in current period measurements for benefits expected to be provided in those future periods. Future changes in the law or other provider plans cannot be anticipated.

2.3.7.2 Per capita medical claims costs

For benefits defined in terms of health care coverage, future benefit payments to be made by an employer to or on behalf of each plan participant must be estimated. These future benefit payments are referred to in ASC 715-60 as the assumed "net incurred claims cost at each age" and are derived by estimating the assumed (gross) per capita claims costs by age and reducing it by the effects of Medicare and coverage by other providers and the effects of the plan's cost-sharing provisions (i.e., employee/retiree contributions, co-payments, deductibles).

Separate base period gross per capita claims costs should be developed at each age, and possibly also by gender, geographic location, and type of medical service (e.g., hospital care, physician services, prescription drugs).

Trend rates (see PEB 2.3.7.3) are estimated for each future year through the last year the youngest current plan participant or dependent is expected to receive benefits. These rates are then applied to the base period cost for each of the applicable years during retirement to estimate the aggregate future claims cost during retirement. For example, to estimate the future cost of retiree health care coverage at age 70 for an employee who is 45 years old in 2019, the annual trend rates for 2019 through 2044 would be applied to the base period 2019 cost to estimate the cost for a 70-year-old retiree. Some plans incorporate "caps" that limit the maximum OPEB benefit payable. See discussion of capped plans in PEB 2.4.4.

Participant cost-sharing amounts would also reduce the assumed gross per capita claims cost. These components of per capita claims cost are calculated by applying the cost-sharing provisions embodied in the employer's substantive plan to each year's projected assumed gross per capita claims cost. Certain plans require contributions by active employees toward their postretirement benefit coverage. In those cases, the actuarial present value of such contributions would reduce the actuarial present value of the aggregate assumed incurred claims cost.

The assumed net incurred claims cost at each age during the retirement period is estimated for each employee/retiree participating in the plan and is then applied, along with actuarial assumptions similar to those used in pension calculations, to estimate benefit payments for the entire participant group.

Internal and external costs directly associated with administering the plan would also be included as a component of the estimated gross claims cost, if significant. ASC 715 does not elaborate on the types of direct costs to be considered, but we believe they should be limited to incremental costs. Therefore, employee salaries and general and administrative expenses that would have been incurred even if no OPEB plan existed should not be included in assumed gross claims cost.

2.3.7.3 Health care cost trend rates

The health care cost trend rates to be applied to the base period gross per capita claims costs represent the expected annual rates of change in the gross cost of the specific health care benefits provided under the plan. The health care cost trend rate assumption generally contains three components:

- The initial trend rate, which is used to project current per capita claims costs to the next year
- The ultimate rate, which is the rate at which health care cost trends will level off in some future year

- The number of years and pattern of change between the initial and ultimate rates

ASC 715 requires that these rates be developed using past and present health care cost trends, which would implicitly consider estimates of health care inflation, changes in health care utilization and delivery patterns, technological advances, and changes in the health status of plan participants. It also notes that different types of services, for example, hospital and dental care, may require different trend rates.

The initial trend rate assumption should reflect the employer's recent retiree-specific health care cost experience, adjusted as appropriate for expectations of next year's costs. The ultimate trend rate assumption should reflect long-term expectations of future general inflation, plus some additional amount to reflect that retiree health care costs are expected to continue to rise at a greater rate than general inflation. The ultimate rate is limited by the general expectation that health care spending will not continue to rise at current levels forever. The pattern of decline in inflation rates and the number of years between the initial and ultimate rates is generally the most subjective component of the health care cost trend rate assumption.

Developing future trend rates begins with an analysis of past years' actual experience. If estimates of the assumed per capita claims costs are made for various categories of health care services, for example, hospital care and dental care, separate trend rates would be developed for each such category. This historical analysis would typically be developed from the same source as the data used for developing the base period gross per capita claims cost discussed in PEB 2.3.7.2. The extent of the historical periods necessary to develop an appropriate estimate is a matter of judgment. It is also important to consider any recent plan changes that may reduce the usefulness of historical data.

When historical data is not available, or is not considered reliable or indicative of the plan's expected experience, trend rates can be developed from per capita costs of other employers, adjusted to best reflect the terms of the employer's plan and the demographics of the participants.

Estimates of future health care trends should not rely on history alone. The analysis of past trends is supplemented by assumptions about the magnitude and direction of changes in future trend rates from present rates. In developing estimates of future trends, it is important that preliminary estimates be tested against general inflation and productivity estimates to ensure that health care remains logically correlated to other economic factors. This approach is similar to that used in developing projections of the Consumer Price Index.

ASC 715-60-35-99 through ASC 715-60-35-101 provides general guidance for developing the trend rates assumption.

ASC 715-60-35-99

The assumption about health care cost trend rates represents the expected annual rates of change in the cost of health care benefits currently provided by the postretirement benefit plan, due to factors other than changes in the demographics of the plan participants, for each year from the measurement date until the end of the period in which benefits are expected to be paid. Past and current health care cost trends shall be used in developing an employer's assumed health care cost trend rates, which implicitly consider estimates of health care inflation, changes in health care utilization or delivery patterns, technological advances, and changes in the health status of plan participants.

ASC 715-60-35-100

Differing services, such as hospital care and dental care, may require the use of different health care cost trend rates. It is appropriate for that assumption to reflect changes in health care cost trend rates over time. For example, the health care cost trend rates may be assumed to continue at the present level for the near term, or increase for a period of time, and then grade down over time to an estimated health care cost trend rate ultimately expected to prevail.

ASC 715-60-35-101

An assumption about changes in the health status of plan participants considers, for example, the probability that certain claims costs will be incurred based on expectations of future events, such as the likelihood that some retirees will incur claims requiring technology currently being developed or that historical claims experience for certain medical needs may be reduced as a result of participation in a wellness program.

As in any actuarial valuation, a number of alternative scenarios may need to be considered before the most probable assumptions are identified. These may vary by the length of time the near-term trend pattern is expected to continue and the timing and degree of the grading down to the ultimate trend rate. It may not be unrealistic to assume that, at some point, the trend rate would approach the forecasted general inflation rate.

In the periodic reporting of OPEB cost, the difference between actual versus estimated rates of change in per capita claims cost, and between actual versus expected benefit payments in the year just completed, will result in actuarial gains or losses, as discussed in PEB 3. Accounting for these gains or losses is discussed at PEB 3.2.7. In addition, the most recent trend rate experience should be considered in the development of the trend rate estimates to be used in measurement of the following period's OPEB cost and obligation.

Rates of increase in health care costs experienced in the past and estimated to occur in the future will vary from employer to employer, and even from plan to plan within each reporting entity, depending on a number of factors:

- Actual retiree health care inflation experienced in prior years
- Expected cost increases—e.g., premium increases on the part of the insurance carrier
- Type of health care coverage offered—traditional indemnity, health maintenance organization (HMO), or preferred provider organization (PPO)
- Specific categories of services covered—major medical or basic medical, prescription drugs, etc.
- Demographics of the covered group—age, gender, and geography
- Effectiveness of cost and utilization controls, such as contracts with specified providers, catastrophic case management, and hospital pre-admission reviews
- Regulatory changes that may affect the cost of providing health care (e.g., the Affordable Care Act)

Accordingly, and consistent with the base period per capita claims cost assumption, the health care cost trend rates assumption must be developed on a plan-specific basis.

As health care costs continue to rise, assumed health care cost trend rates have a significant impact on postretirement benefit obligations and the periodic expense related to those obligations. Employers should reevaluate the health care cost trends rates as part of each actuarial valuation to ensure they reflect the best available information as of the measurement date.

2.4 Financial assumptions when measuring the plan obligation

In addition to the demographic and actuarial/economic assumptions discussed in the previous section, pension and OPEB plans require financial assumptions to be made to value the plan obligations. These assumptions include the discount rate and estimate of future salary and benefits levels. Additionally, the expected long-term rate of return on plan assets is an important component when determining the net benefit cost each reporting period. Similar to the demographic information discussed in PEB 2.3, the financial assumptions require estimation, and using the most relevant source information available to preparers. As noted in PEB 2.3, each significant assumption should reflect the best estimate of that particular future event, and employers may not apply an approach that looks to the aggregate effect of two or more assumptions, even if their aggregate effect may be approximately the same as that of an explicit approach.

2.4.1 Discount rate used to measure the plan obligation

ASC 715-30-35-43 and ASC 715-30-35-44 describe the objective of selecting assumed discount rates, which is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the accumulated benefits when due. Generally, government regulations specify discount rates for purposes of calculating tax-deductible contribution levels or minimum funding or benefit levels under social welfare regulations. Those discount rates are generally not based on this financial reporting measurement objective and would therefore not be acceptable for determining the assumed discount rate for US GAAP purposes.

ASC 715-30-35-43

Assumed discount rates shall reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement of the obligation (including information about available annuity rates published by the Pension Benefit Guaranty Corporation). In making those estimates, employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits. Assumed discount rates are used in measurements of the projected, accumulated, and vested benefit obligations and the service and interest cost components of net periodic pension cost.

ASC 715-30-35-44

The preceding paragraph permits an employer to look to rates of return on high-quality fixed-income investments in determining assumed discount rates. The objective of selecting assumed discount rates using that method is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay the pension benefits when due. Notionally, that single amount, the projected benefit obligation, would equal the fair value of a portfolio of high-quality zero coupon bonds whose maturity dates and amounts would be the same as the timing and amount of the expected future benefit payments. Because cash inflows would equal cash outflows in timing and amount, there would be no reinvestment risk in the yields to maturity of the portfolio. However, in other than a zero coupon portfolio, such as a portfolio of long-term debt instruments that pay semiannual interest payments or whose maturities do not extend far enough into the future to meet expected benefit payments, the assumed discount rates (the yield to maturity) need to incorporate expected reinvestment rates available in the future. Those rates shall be extrapolated from the existing yield curve at the measurement date. The determination of the assumed discount rate is separate from the determination of the expected rate of return on plan assets whenever the actual portfolio differs from the hypothetical portfolio described in this paragraph. Assumed discount rates shall be reevaluated at each measurement date. If the general level of interest rates rises or declines, the assumed discount rates shall change in a similar manner.

As noted in ASC 715-30-35-44, conceptually, the PBO represents the single amount that needs to be invested in a portfolio of high quality, zero-coupon bonds whose maturities exactly match the timing and amount of the plan's expected benefit payments. However, that exact portfolio cannot typically be constructed and, therefore, amounts must be extrapolated. Many actuarial and financial firms publish pension discount rate curves that are specifically developed to assist plan sponsors in meeting the requirements of the guidance in ASC 715-30-35-43 and ASC 715-30-35-44. These curves are generally updated monthly and include spot rate yields (zero coupon bond yield estimates) in half year increments for use in tailoring a discount rate to a particular plan's projected benefit cash flows. There are also published pension liability indices and discount yield curves in which the discount rates are developed from these spot rate yields based on the pattern and duration of the benefit payments of pension plans of varying durations (e.g., long, intermediate, short). Other indices are available that have not been specifically designed to match the benefit payment stream of a pension plan and would only give an indication of the yields produced by high-quality bonds at a certain point in time.

The assumed discount rates should be reevaluated at each measurement date (including interim remeasurements required in connection with accounting for plan amendments, curtailments, and settlements) to determine whether they continue to reflect the best estimates of then-current rates (see ASC 715-60-35-79). Specifically, ASC 715 requires that the discount rate reflect bond yields at the measurement date. Given the volatility in the financial markets and the potential for significant movements in interest rates from period to period, the discount rate assumption should be based on current market information. Generally, developing a portfolio of bonds at an earlier date and then attempting to "roll-forward" that data to the measurement date would not be appropriate.

The SEC staff provided guidance on the selection of discount rates in ASC 715-20-S99-1.

Excerpt from ASC 715-20-S99-1

...the SEC staff expects registrants to use discount rates to measure obligations for pension benefits and postretirement benefits other than pensions that reflect the 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.).

The FASB concluded that, conceptually, the basis for determining the assumed discount rates for measuring the expected postretirement benefit obligation (EPBO) and the service cost component for OPEB plans should be the same as the basis for determining the assumed discount rates for pension measurements. The weighted average of the assumed discount rates disclosed for OPEB may be different from the ones disclosed for pensions due to the effect of the differences in the expected timing of cash outflows of each plan.

The service cost component of net periodic benefit cost could be volatile from year to year as a result of using current discount rates because the changes in discount rates will immediately affect the PBO and EPBO, which is the basis for determining service cost. In concept, notwithstanding the long-term nature of pension and OPEB arrangements, this period-to-period volatility is an appropriate reflection of the current cost of services—i.e., the cost of services purchased in the current period should reflect current period prices. The PBO and APBO will also be immediately affected by discount rate changes. Those changes are classified as actuarial gains or losses. Changes in the discount rate also affect the interest cost component of net periodic benefit cost, although the effect of an increase (or decrease) in the rate will be offset to some degree by the effect of the corresponding decrease (or increase) in the PBO or APBO to which the interest rate is applied.

Interest rates (sometimes referred to as yields or yields to maturity) generally vary depending on the remaining maturity or duration of the obligation. Consequently, the discount rate for a plan covering only retired employees would be expected to differ from the discount rate used for a plan covering a relatively young work force. Therefore, a weighted-average or "blended" discount rate, based on individual discount rates applicable to the varying periods until the benefits are due, should be used for discounting the pension benefit obligation and related pension cost components (i.e., service cost and interest cost).

2.4.1.1 Considerations in selecting discount rates

Assumed discount rates should be reevaluated at each measurement date, including interim remeasurements required in connection with accounting for plan amendments, settlements, curtailments or other significant events. Although there is some latitude regarding the methodology that may be selected to determine the discount rate, the approach selected should be followed consistently. A change in facts and circumstances may, however, warrant a change in the approach for determining the discount rate. Changes in the approach should generally be limited to changes that produce a more refined estimate of the discount rate, such as changing from a benchmark approach (see PEB 2.4.1.2) to a specific bond matching or spot-rate yield curve approach. This would represent a change in accounting estimate that is accounted for prospectively, not a change in accounting principle, as described in ASC 250, *Accounting Changes and Error Corrections*.

For example, employers that determine their discount rates by matching a plan's specific cash flows to a spot-rate yield curve or individual high-quality bonds may switch from one acceptable spot-rate yield

curve to another acceptable curve, or switch from an acceptable curve to an acceptable bond match. In these cases, we believe there is no change in methodology because the methodology in use continues to be based on a cash flow matching approach. Nonetheless, such a change should be accompanied by a sound rationale in support of the change. This might be the case when the employer has changed actuarial firms and the previously used spot-rate yield curve is no longer available, or the employer's actuary or an outside vendor develops a new curve that produces a discount rate that the client believes more appropriately reflects the characteristics of its benefit obligation. It is not appropriate to make a change solely for the purpose of achieving a higher discount rate or avoiding a change in the assumed discount rate.

Mergers periodically occur between certain actuarial firms that had their own proprietary methods for developing assumed discount rates. Thus, subsequent to the mergers, companies served by those actuarial firms have access to new discount rate methodologies. Having access to a new methodology would not, by itself, be considered a change in facts or circumstances that supports switching to the use of that methodology. Such a switch would have to be supported by an appropriate rationale as to why the new methodology would provide a better estimate under the circumstances.

2.4.1.2 Benchmark approach

Under a benchmark approach, entities start with a rate from a published bond index and make certain adjustments, either upward or downward, to reflect the individual facts and circumstances of their plans. The rate selected from the index or indices, as well as the adjustments made to that rate, should be supported. The following should be considered as appropriate adjustments to the indices:

- An upward adjustment to certain published bond indices to restate them from a semi-annual coupon basis to an annual discount rate basis (some indices are already annualized)
- An upward or downward adjustment to the yield of the index when the duration of the benefit stream is either significantly longer or shorter, respectively, than the duration of the bonds in the index. Two scenarios when these duration adjustments might be made are: (1) when the population of participants is comprised primarily of retirees, thus causing the plan's expected benefit payment stream to have a relatively short duration, or (2) when the population of participants is comprised of very few retirees and a relatively young active workforce, thus causing the plan's expected benefit payment stream to have a relatively long duration.
- A downward adjustment to the yield of the index to reflect the removal of the effect of call features of callable bonds in the index, if necessary
- Once the published yield is adjusted based on the considerations listed above, it is acceptable to round to the next 25 basis point interval, if the employer's policy is to do so. For example, if the published yield as of the measurement date of 5.66% is adjusted by eight basis points to reflect annual versus semi-annual interest payments (so 5.74%), it could then be rounded to 5.75%.

Other adjustments to the index (e.g., to replace the bonds in the index with lower quality bonds to obtain a higher yield) are not generally appropriate. If an entity sponsors more than one pension or postretirement benefit plan, it may be appropriate to choose different discount rates for different plans on the same measurement date because of differing average durations until benefit payments are made and differing patterns of cash flow requirements.

Given the availability of other yield curve and bond-matching approaches, use of a benchmark approach to develop discount rates is increasingly uncommon. For an employer using a benchmark approach, the following information should be maintained or updated/re-evaluated each period to support the discount rate:

- Information regarding the constituent bonds in the related bond index. Obtaining this information may require the employer to acquire a subscription from the organization that produced the bond index or from a financial information service.
- Comparing the timing and amount of cash outflows of the bonds in the index to the defined benefit plan's expected cash outflows for benefits, and quantifying/documenting the basis for any positive or negative adjustments to the bond index yield relative to the cash flow analysis
- Considering, quantifying, and documenting any negative adjustments to the bond index yield for callable bonds included in the index. Specific expertise may be needed to compute and support an appropriate adjustment.
- Considering, quantifying, and documenting any other adjustments to the bond index yield. The two most typical are (1) converting the rates from certain published bond indices from a reported semi-annual compound rate basis to an annual discount rate basis and (2) arithmetic rounding.

2.4.1.3 Bond matching and spot-rate yield curve approaches

A plan's benefit cash flows are often such that the employer's discount rate can be supported more consistently by using spot-rate yield curves or a specific bond matching approach rather than a benchmark approach. Some large actuarial firms have developed specific bond matching models and nearly all of the largest actuarial firms and other organizations have developed spot-rate yield curves to assist employers in developing their discount rate assumptions.

Although a helpful starting point, these approaches should be carefully reviewed to assess whether they incorporate appropriate bonds and bond pricing, effectively match the specific plan's expected benefit cash flow stream, and incorporate reasonable assumptions about reinvestment of excess bond cash flows and yields for bond maturities in years in which no bonds exist (e.g., beyond 30 years). Some specific points to consider include:

- Callable bonds should not be included in any bond matching (or included using the yield to the call date).
- It is generally inappropriate to use the yield on a single issuer's bond as the discount rate even if it is of equal duration and sufficient magnitude to the benefit obligation.
- The objective in determining an appropriate discount rate using a bond-matching approach is to match cash flows of the plan to principal redemptions on zero coupon bonds. Because most publicly traded bonds included in the various models bear interest at a stated coupon, it would generally be appropriate to adjust the yields in the model (most likely upward) to reflect this difference.

2.4.1.4 Use of multiple discount rates

In recent years, some actuarial firms have proposed various approaches to change the calculation of an entity's service cost and/or interest cost by using multiple (e.g., disaggregated) discount rates or spot rates reflective of varying employee demographics and timing of benefit payments. For companies that currently utilize a yield curve approach to calculate discount rates and the projected benefit obligation, assuming management believes it produces a better estimate of their benefit costs, a change to such an approach would be treated as a change in estimate under ASC 250, *Accounting Changes and Error Corrections*. To the extent that such a change produces a meaningful impact on interest cost in periods subsequent to the change, the financial statements or MD&A should include appropriate disclosure of the change and its impact on interest cost. Additionally, there are a number of potential calculation complexities to this approach to consider, including the impact on plans that allow lump-sum payouts.

For a reporting entity that currently utilizes the bond matching approach to calculate discount rates and determine its projected benefit obligation, it would likely be difficult to justify changing to a yield curve approach in order to utilize disaggregated spot rates to develop interest cost and service cost.

Regardless of the approach used – traditional bond matching or yield curve approach or a disaggregated yield curve approach – the measurement of the projected benefit obligation and the measurement of the ensuing period's service and interest cost must be based on the same discount rate methodology. Said differently, it would not be appropriate for a reporting entity to use a bond matching approach to calculate the projected benefit obligation and a disaggregated yield curve approach to determine service and interest cost in the following period.

2.4.1.5 Negative interest rates

In some cases, particularly in certain non-US territories, observed yields on certain high-quality corporate bonds can be negative for certain bond durations. Depending on the magnitude and duration of benefit payments for a particular plan, these negative yields could meaningfully reduce the overall discount rate for a benefit plan or even lead to an overall negative discount rate, particularly for plans with primarily shorter-duration payments. While this is an unusual situation that was not specifically contemplated in the accounting guidance, we believe that the actual observed market rates should be utilized.

The objective when selecting assumed discount rates for purposes of measuring a plan's benefit obligations is to determine the single amount that, if invested at the measurement date in a portfolio of high-quality corporate debt instruments, would provide the necessary future cash flows to pay the benefits when due. If high-quality corporate bonds available in the marketplace are trading at negative yields (i.e., their present value is greater than their nominal future cash flows), an employer would need to purchase an amount of bonds that exceeds the notional undiscounted future benefit payments to generate a stream of future cash flows to pay the benefits when due. In spite of the counterintuitive outcome, that is the economic reality of a negative interest rate environment. Therefore, we believe employers should use the actual yields, even if negative, on high-quality corporate bonds throughout the yield curve to measure their benefit obligations.

2.4.2 Expected long-term rate of return on plan assets

The expected long-term rate of return on plan assets is determined as of the measurement date and should reflect the average rate of return expected to be earned on the funds invested over the period until the benefits are expected to be paid. It is used in conjunction with the market-related value of

plan assets (see PEB 2.6.5) to compute the expected return on plan assets component of periodic pension expense, discussed in PEB 3.

The expected long-term rate of return on plan assets should generally be based on the investment portfolio that existed as of the measurement date without consideration of proposed changes to the portfolio subsequent to the measurement date. We believe, however, that it may be acceptable for employers to consider probable changes in the portfolio mix (e.g., to bring it back in line with the target mix or to align with a new target mix), provided the changes will occur in a reasonable period of time and have been approved by the appropriate level of management. Judgment should be applied to determine whether a planned change is probable. The expected long-term rate of return on plan assets should also reflect the long-term earnings expectations on contributions to the plan expected to be received during the current year. Contributions expected to be made in future years should not be considered in determining the expected long-term rate of return on plan assets.

The most common approach to determining the expected long-term rate of return on plan assets is to develop a weighted average based on the mix of plan assets. Under this approach, the percentage of total plan assets of each component of the plan asset mix is multiplied by the expected asset return for that component. The sum of those asset mix weighted expected rates of return for each component are then added together to determine the total expected rate of return.

Figure PEB 2-1 illustrates the calculation of the expected long-term rate of return using a weighted average approach.

Figure PEB 2-1
Estimating the rate of return of plan assets

Component of the plan asset mix:	Percentage of total assets	Expected asset return	Expected rates of return for the component
Domestic equities	35%	9.0%	3.15%
Fixed income	32%	5.5%	1.76%
International equities	15%	9.0%	1.35%
Real estate	10%	7.0%	0.70%
Cash	3%	3.0%	0.09%
Private equity	5%	12.0%	0.60%
Impact of active management (if applicable)			0.35%
Total adjusted rate of return			8.00%

Under this approach in Figure PEB 2-1, it is appropriate to consider the following:

- Estimating the projection horizons for the expected returns. ASC 715 indicates that the rate of return should reflect the average rate of earnings expected on the funds invested to provide for the benefits in the PBO. Thus, the rate of return should be the rate to be earned over the period until the benefits are paid. Accordingly, it is necessary to consider the expected duration of the current PBO (i.e., without new entrants into the plan) in evaluating the time horizon for future expected earnings.
- Assessing forward-looking capital markets returns for the individual asset classes. Using solely historical returns as an approximation of the rate of return may not produce an appropriate rate, particularly if the market has moved significantly in one direction in recent years. Accordingly, it may be more appropriate to consider forward-looking capital markets returns for the plan's investments.
- Projected returns should be reduced by any outflows associated with generating those returns. For example, if the benefit fund must pay taxes on its investment earnings, such taxes should be included in the projection of expected returns. Similarly, if investment management fees are charged against the actual return on assets, such outflows should be included in the expected return projection.
- Considering the inflation component. The assumed long-term inflation assumption underlying the expected rate of return should be consistent with the inflation assumption underlying the salary increase and discount rate assumptions.
- Determining the best estimate. The rate of return should be management's "best estimate." Even if there is likely a range of potential returns, using either the most optimistic or most pessimistic assumptions is likely not reflective of the most likely scenario (best estimate).

2.4.3 *Future salary and benefits levels*

Many pension plans, and some OPEB plans, are pay related, requiring an assumption as to future salary increases. For example, an OPEB life insurance plan may define the amount of death benefit to be received based on the employee's average or final level of annual compensation. Although less common, an OPEB health care plan may define the retiree's deductible or contribution based on similar criteria. For pay-related plans, the calculation of the benefit obligation would reflect expected compensation levels, including changes attributable to inflation, seniority, promotion, and other factors. All assumptions should reflect consistent expectations of future economic conditions, such as future rates of inflation. ASC 715-30-55-20 addresses the interplay between assumed increases in salary levels and the selection of discount rates. See PEB 2.2 for additional discussion of salary and healthcare cost increase assumptions.

2.4.4 *Caps or limitations in OPEB plans*

An employer is required to measure its share of costs for health care services by projecting future costs. However, an employer's plan may have a limit or "cap" on the dollar amount of health care coverage it promises to pay. For these plans, the employer would measure its obligation for all years in which the cap is expected to be operative by estimating the future dollar amount of the annual cap. Only in those years in which the cap is not expected to be reached would the employer's obligation need to be calculated by making projections of future per capita health care costs. The cap may be

defined in the aggregate for the retiree group. For example, an employer may agree to bear annual costs equal to a specified dollar amount multiplied by the number of plan participants in each future year. Alternatively, the cap may be defined on an individual participant basis. In these situations, if per capita claims cost estimates indicate that the cap will not be reached in certain years for at least some participants, projections of future health care coverage (rather than only the dollar-defined cap) would be required for those years.

Under these plans, the dollar-denominated cap can be fixed, increased automatically (indexed), or redetermined on an ad hoc basis. Therefore, the substantive plan approach (see PEB 2.2.2) may require an employer to anticipate increases in the dollar-denominated amount, or ignore the caps for purposes of calculating obligation and expense amounts, if:

- The employer communicates its intent to raise the dollar-denominated amount (i.e., the cap) in the future (e.g., to keep pace with inflation), or
- The actual increases in the dollar-denominated amount reflect a consistent past practice.

Judgment will be necessary to determine what constitutes a consistent past practice of increases.

2.4.4.1 Capped plans in collective bargaining arrangements

If the dollar-denominated caps are based on the results of collective bargaining with a labor union, there is a general presumption under ASC 715-60-35-55 that the caps should be included in the measurement (i.e., an increase in the caps included in the written plan should not be anticipated), even after a past practice of increases is established, because employers usually do not have the unilateral right to determine the magnitude of increases to a collectively bargained plan when each change in the plan must be bargained. Accordingly, if the plan is subject to union negotiation, employers should not anticipate future increases to the dollar-denominated caps. However, in some situations, an employer's past practice in successive union negotiations may provide evidence that the substantive plan is different from the written plan, even in situations when offsetting changes were made to compensation or other benefits. All of the relevant facts and circumstances should be considered in assessing whether the substantive plan in those situations differs from the written plan. When an employer consistently waives the caps as part of multiple successive contract negotiations, this may be an indicator that the plan should be accounted for as if it were an uncapped plan, despite the fact that such waivers are negotiated and are accompanied by offsetting negotiated changes. Further, increases in caps or other plan terms that occur as a result of multiple contract negotiations may be an indicator that the substantive plan includes such increases on an ongoing basis. Even in situations when offsetting changes in other benefits or compensation have occurred or other significant costs have been incurred to maintain the cost-sharing arrangement, judgment still must be applied in determining the substantive plan and whether it differs from the written plan.

In some companies, the nonbargained employee group receives the same retiree health benefits as the collectively bargained employee group, and changes to the bargained plan have historically been made to the nonbargained plan at the same time. In that case, the facts and circumstances of each plan will need to be assessed, including past practices and cost sharing arrangements, in order to determine the substantive plan of each employee group.

2.5 Attribution of benefits to periods of service

The only acceptable attribution approach in ASC 715 is the benefit approach. Under this approach, discounting of the cost of benefits earned in a period is performed after an equal amount of the projected benefits are attributed to each period. For example, assume the plan specifies that \$500 of future benefit is earned for each year of service and it is expected that the employee's expected service life is 20 years; at retirement, the employee will be entitled to a lump-sum cash payment of \$10,000. Using the benefit approach, each year is charged with a service cost equal to the then-present value of \$500 due at the end of year 20. Unlike stock compensation accounting under ASC 718, vesting provisions associated with pension benefits do not affect the period of attribution of expense. See PEB 2.5.3 for discussion of the attribution period for OPEB plans.

Accordingly, a benefit approach assigns a service cost to the early period of an employee's active service that is less than that assigned during later years. Put simply, the present value of a dollar of benefit promised to a 60-year-old is greater than that of a dollar of benefit promised to a 25-year-old, if both are payable at age 65. While the total benefit promised is the same, the benefit approach results in lower charges for service cost in early periods offset by higher charges for service cost in later periods compared with a straight-line approach (cost approach) based on the aggregate present value of the retirement benefits. The benefit approach invariably results in a lower accumulated and projected benefit obligation at any point in time prior to retirement compared with the cost approach, with interest cost recognized over the service period to accrete the previously accrued benefits to the amount payable in retirement.

ASC 715 requires the use of a single actuarial method based on the plan's benefit formula to the extent the plan states or implies attribution. For plans that define benefits similarly for all years of service (e.g., \$500 for each year of service), the actuarial method to be used is "benefit/years of service" (unit credit actuarial cost method). When benefits are "salary" related, that is, defined based on final pay or career average pay (e.g., 1% of final pay for each year of service), a projected unit credit method is used. All career-average-pay plans and final-pay plans are accounted for similarly. See PEB 2.5.2.2 for discussion of attribution of benefits to service periods when it is not apparent from the benefit formula.

2.5.1 Projected unit credit method

The projected unit credit method is an actuarial valuation method that views each period of service as giving rise to an additional "unit" of benefit entitlement and measures each unit separately to build up the final obligation. This method will consider expected future pay increases in the calculation of liability and normal cost. The normal cost is the estimated present value of projected benefits current plan members will earn in the year following the valuation date. It represents today's value of one year of earned benefits.

Example PEB 2-1 demonstrates a basic calculation using the projected unit credit method.

EXAMPLE PEB 2-1

Projected unit credit method

PEB Corporation provides a pension plan that pays participants an annual benefit in retirement of 1% of final salary for each year of service earned under the plan. Assume a plan participant is currently age 55, has worked for 20 years for PEB Corporation, and has a current salary of \$50,000. The actuary

assumes the participant will retire at 65, after working 30 years for PEB Corporation, with an estimated future salary of \$75,000.

How is the PBO calculated using the projected unit credit method?

Analysis

Using the projected unit credit method, the projected benefit obligation is based on the participant's expected future salary, but only takes into account the service earned to date. In other words, the projected benefit obligation would be the actuarial present value of a stream of annual payments of 1% times the projected salary at 65 multiplied by the years of service to date (20 at age 55) for the person's expected lifetime (assume 80 years), commencing upon expected retirement at age 65 as follows:

Expected future salary	\$75,000
Benefit rate	× 1%
Years of service rendered to date	× 20 yrs
Accumulated annual benefit	\$15,000
Life expectancy	<u>× 15 yrs</u>
Gross projected benefit	\$225,000

The projected benefit obligation would then be the actuarial present value of a \$15,000 annuity payable for 15 years beginning in 10 years.

2.5.2 Backloaded plans

In some cases, a plan's benefit formula may not reflect the substance of the arrangement. For example, a plan that defines different rates of benefit accrual for different years of service (i.e., a "step-rate plan") may backload benefits; that is, it may provide for deferred earning of benefits. ASC 715-30-35-36 through ASC 715-30-35-38 requires that the projected benefit obligation be accounted for according to the terms of the plan unless there is significant backloading of benefits, in which case the projected benefit obligation should be attributed on a straight-line basis over the expected service period.

Consider the following terms of five plans, including three "step-rate" plans, all of which provide a benefit of \$10,000 to participants with 20 or more years of service.

- Plan A \$10,000 earned in year 2
- Plan B \$500 per year, earned annually in years 1-20
- Plan C \$500 per year for each year of service, earned in year 20
- Plan D \$1 per year, earned annually in years 1-19, \$9,981 earned in year 20

- Plan E \$400 per year, earned annually in years 1-10, \$600 per year, earned annually in years 11-20

Backloaded plans (Plans C and D) and frontloaded plans (Plan A) are accounted for differently. Backloading results in straight-line attribution over the expected service period; frontloading follows the terms of the plan. Thus, the present value of the entire benefit due under Plan A would be attributed over two years.

Plan D is an extreme example of backloading benefits to year 20, although the substance of the plan is that over a 20-year service period a benefit of \$10,000 will accumulate. The benefits earned under Plans B, C, and D would be accounted for similarly, although the total cost may differ because of turnover assumptions; each year in the 20-year period would be charged with the actuarial present value of a \$500 benefit payable at retirement.

Judgment is required in determining whether benefits are backloaded. When step-rate benefits reflect the increased value of an employee's continued service (Plan E), the benefit formula should be followed. Under Plan E, years 1-10 would be charged with the actuarial present value of a \$400 benefit payable at retirement and years 11-20 with the present value of a \$600 benefit.

If an employee's service period is expected to extend beyond 20 years in this example, but no additional benefits are earned, the subsequent years' charges would be for interest only, to accrete the previous compensation charges to the then present value of the plan benefit. It would not be appropriate to amortize the service cost over the longer expected service period because the terms of the plan specify otherwise.

2.5.2.1 Attribution of OPEB plans

ASC 715-60-35-61 through ASC 715-60-35-70 generally prescribes that an equal amount of the EPBO be attributed to each year of service in the attribution period for OPEB plans, regardless of the existence of a benefit formula that specifies the benefits earned for individual periods of service. There is an exception in the rare situation when the benefit formula attributes a disproportionate share of the EPBO to early years of service. In that situation, the benefit formula is followed. This methodology is different from that required under pension accounting by ASC 715-30, under which benefits are attributed ratably only in the absence of a plan formula (see ASC 715-60-55-13 for further guidance). The FASB concluded that ratable allocation would be less complex, especially in situations when the benefit formula grants differing levels of benefits depending on years of service and when it is supplemented by other eligibility criteria. Ratable allocation avoids the need for interpreting plan terms to determine specific benefits provided in exchange for each year of service.

2.5.2.2 Attribution - plans with no specified earning of benefits

In accordance with ASC 715-30-35-38, if a pension plan's benefit formula does not specify how benefits are earned relative to years of service, the benefits are deemed to accumulate in either of the following manners:

- Benefits of a type includable in vested benefits (for example, a supplemental early retirement benefit that is a vested benefit after a stated number of years) are included in the benefit obligation in proportion to the ratio of the number of completed years of service to the number that will have been completed when the benefit is first fully vested.

- Benefits of a type not includable in vested benefits (for example, a death or disability benefit under the pension plan that is payable only if death or disability occurs during active service) are included in the benefit obligation in proportion to the ratio of completed years of service to total projected years of service.

2.5.3 OPEB plans - full eligibility date

For OPEB plans, the end of the attribution period is the full eligibility date. At that date, an employee's APBO and EPBO are equal. The full eligibility date is the date on which an employee has rendered all the service necessary to receive all the benefits expected to be received by that employee (including any beneficiaries and dependents expected to receive benefits). This date could precede the employee's expected retirement date, depending on the terms of the plan.

While the full eligibility date is used for attribution, the expected retirement date is used for measurement (expected timing of when benefit payments will commence) of the expected benefits.

In determining the full eligibility date, plan terms that provide incremental benefits expected to be received by an employee for additional years of service extend the attribution period, unless those incremental benefits are trivial. Salary progression and benefit indexation formulas are examples of plan provisions providing incremental benefits. To illustrate, assume an employee is eligible for postretirement life insurance benefits after rendering 10 years of service and attaining age 55, but the amount of insurance benefits earned under the plan are indexed until retirement (e.g., based on final salary at retirement). Even though an employee has met the age and service requirements, the full eligibility date has not yet been reached because the employee earns additional non-trivial benefits each year for salary increases until retirement (see ASC 715-60-55-11 through ASC 715-60-55-13).

Question PEB 2-1 addresses measurement and attribution at the full eligibility date.

Question PEB 2-1

An employee is fully eligible for a benefit payable under an OPEB plan at age 55, but his expected retirement date is at age 65. What is the appropriate age to use to calculate the EPBO and what is the appropriate attribution period?

PwC response

The EPBO should be calculated as the actuarial present value of benefits to be provided beginning at age 65. However, because the employee will be fully eligible for the OPEB benefits at age 55, that is the age that would be used in the calculation of the EPBO (i.e., the actuarial present value as of age 55 of the benefits payable beginning at age 65) and the period to which benefits (service cost) would be attributed. While there would be no additional service cost for an employee beyond age 55, there will be interest cost and potential gains and losses. In other words, all of the service cost component would be recognized by the time the employee is age 55. From age 55 to 65, interest cost would be recognized to accrete the liability to its full balance at the time the employee reaches age 65.

Question PEB 2-2 addresses a question regarding determination of the full eligibility date when there is incremental benefit provided for additional years of service.

Question PEB 2-2

A plan provides single coverage to employees who work for 10 years and attain age 55 while in service and dependent coverage for employees who work 20 years and attain age 65 while in service. For an employee expected to meet the necessary age and service requirements and also expected to have dependents during retirement (even though none may exist today), what is the full eligibility date?

PwC response

The full eligibility date is the date that employee has rendered 20 years of service and attained age 65.

Example PEB 2-2 addresses the determination of the full eligibility date when there is a graded benefit formula.

EXAMPLE PEB 2-2

Determination of the full eligibility date when there is a graded benefit formula

Consider an OPEB plan with the following benefits:

- 25% of eligible healthcare costs if an employee provides at least 10 years of service
- 50% of eligible healthcare costs if an employee provides at least 20 years of service
- 80% of eligible healthcare costs if an employee provides at least 30 years of service

Employee A was hired at age 32 and is expected to retire at age 60 (with 28 years of service).

Employee B was also hired at age 32 but is expected to retire at age 65 (with 33 years of service).

What is the full eligibility date and attribution period for each employee?

Analysis

Employee A would be fully eligible for the expected level of benefits (50% of eligible costs) at age 52; that is, when 20 years of service have been rendered. Thus, the attribution period is 20 years, even though the expected service period is 28 years.

Employee B would be fully eligible for the expected level of benefits (80% of eligible costs) at age 62 when 30 years of service have been rendered. The attribution period would be 30 years, even though the expected service period is 33 years.

2.6 Plan assets

ASC 715-30-20 defines plan assets.

Excerpt from ASC 715-30-20

Plan assets: Assets—usually stocks, bonds, and other investments—that have been segregated and restricted, usually in a trust, to provide for pension benefits. The amount of plan assets includes amounts contributed by the employer, and by employees for a contributory plan, and amounts earned from investing the contributions, less benefits paid.

Plan assets ordinarily cannot be withdrawn by the employer except under certain circumstances when a plan has assets in excess of obligations and the employer has taken certain steps to satisfy existing obligations.

Assets not segregated in a trust or otherwise effectively restricted so that they cannot be used by the employer for other purposes are not plan assets even though it may be intended that such assets be used to provide pensions. If a plan has liabilities other than for benefits, those nonbenefit obligations may be considered as reductions of plan assets.

Amounts accrued by the employer but not yet paid to the plan are not plan assets. Securities of the employer held by the plan are includable in plan assets provided they are transferable.

Plan assets are assets that have been contributed to the plan by the employer, or by plan participants in a contributory plan, and may be sold or transferred by the plan (i.e., the employer no longer directly controls the assets). Thus, transferable employer securities held by the plan are included in plan assets, but plan receivables for contributions due from the employer, and securities that are restricted as to transfer, are excluded. The securities held by the plan should be transferable in their present state—not, for example, upon conversion into another security. Similar considerations would also apply to nonfinancial assets contributed by the employer to the plan (e.g., real estate).

Plan assets generally cannot be withdrawn by an employer except in situations when they exceed plan obligations and the employer has taken certain steps to satisfy those obligations. The issue of whether assets must be segregated in a manner that makes them "bankruptcy proof" to qualify as plan assets is addressed in ASC 715-60-55-26. The guidance indicates it is not necessary to determine that a trust is bankruptcy proof for the assets in the trust to qualify as plan assets; however, assets held in a trust that explicitly provides that such assets are available to the general creditors of the employer in the event of the employer's bankruptcy (e.g., rabbi trusts) do not qualify as plan assets.

2.6.1 Measurement of plan assets

Plan assets should be measured at fair value in accordance with ASC 820, *Fair Value Measurement*. These values should be reduced by brokerage commissions and other costs normally incurred in a sale if those costs are significant (similar to fair value less cost to sell).

ASC 715 permits the use of a calculated "market-related value" of plan assets to be used in developing the expected return on plan assets (see PEB 3.2.5) and for determining the amount of gains and losses subject to recognition (see PEB 3.2.7). This approach can mitigate volatility in expected asset returns and gains/losses because it delays the impact of asset-related gains and losses on the calculation of the

expected return assumption. Use of the calculated market-related value for purposes of determining the expected return on plan assets is an accounting policy election. See further discussion of market-related value in PEB 2.6.5. Importantly, regardless of whether a calculated market-related value of plan assets is used for determining benefit costs, the funded status of the plan is still measured based on the fair value of plan assets determined under ASC 820.

2.6.2 OPEB plan assets

Unlike pension plans, which, subject to IRS qualification requirements, provide the opportunity for employers to deduct contributions to the plan currently and are subject to minimum funding requirements under ERISA, most employers do not prefund their other postretirement benefit plans. However, some employers may set aside some assets for OPEB benefits. ASC 715-60-55-26 through ASC 715-60-55-28 provides guidance to assess whether those assets should be considered “plan assets” and included in the determination of the plan’s funded status and benefits cost.

Investments that are intended to fund postretirement benefits but that are not segregated in a trust or otherwise effectively restricted to pay only postretirement benefits are not plan assets. For example, a voluntary employees’ beneficiary association (VEBA) may exist to pay benefits of both active and retiree health care plans. Unless the VEBA assets are legally segregated only for retiree benefits, those assets would not be considered plan assets, but instead would be accounted for as other employer assets of a similar nature and with similar restrictions (generally accounted for as reporting entity assets under ASC 320, *Investments - Debt and Equity Securities* or ASC 321, *Investments - Equity Securities*) (see PEB 6.7). Assets held in a rabbi trust (see PEB 7.5) and the cash surrender value of corporate-owned life insurance (COLI or BOLI) are also excluded from plan assets, as both are not restricted solely for the payment of OPEB benefits. Rabbi trust assets revert to the sponsoring entity in the event of bankruptcy and the employer is the owner or beneficiary of a COLI policy.

2.6.3 Fair value

ASC 820-10-20 defines fair value.

Excerpt from ASC 820-10-20

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair value is considered to be the most relevant information for assessing the plan's ability to pay benefits as they become due and the future contributions necessary to provide benefits promised.

See PwC’s *Fair value measurements* guide for additional information regarding fair value.

2.6.4 Insurance contracts

A plan may purchase insurance contracts. Some contracts may be accounted for as the settlement of benefit obligations (see PEB 4.3); others are reported as plan assets.

2.6.4.1 *Insurance contracts as assets in a pension plan*

ASC 715-30-35-60 addresses the valuation of insurance contracts that are not purchased annuities that qualify as a settlement (see PEB 4.3), but rather are held as investments of the plan.

ASC 715-30-55-36 addresses the treatment of life insurance policies owned by the employer that are used to fund pension benefits. We believe that, for cash surrender value to be included as plan assets, the policy should designate the plan as owner and beneficiary.

For ASC 715 purposes, the best evidence of fair value of such investments may be the "contract value," "cash surrender value," or "conversion value." Such values are typically quantified by insurance companies. Although a cash surrender value may be available, it is important to consider the presence of any penalty provisions associated with the termination of such contracts. When there is a significant penalty for termination, the cash surrender value may not serve as a proxy for fair value. In these instances, it is necessary to consider any available conversion value (for example, into annuities), or fair value can be estimated based on the amount at which the contract could be sold to a willing third-party buyer. A third-party buyer price will likely include similar considerations as were used by the insurer when originally pricing the insurance contract, including factors based on assumptions about the plan participants covered under the contract, such as expected mortality. This value would be based on the current discount rate inherent in the contract.

2.6.4.2 *Insurance contracts as assets in an OPEB plan*

Insurance contracts may also be used in OPEB plans. An insurance contract is defined in ASC 715-60-20.

Excerpt from ASC 715-60-20

Insurance contracts: A contract in which an insurance entity unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium. An insurance contract is irrevocable and involves the transfer of significant risk from the employer (or the plan) to the insurance entity

Benefits covered by insurance contracts that meet the glossary definition are excluded from the APBO and the contract is excluded from plan assets, except for any participation right (as described in PEB 2.6.4.3).

There may be some situations when employers could have significant contingent liabilities as a result of employee benefit plan investments in instruments of financially troubled insurance companies. Consideration of reporting issues applicable to employer financial statements may be necessary under ASC 450-20, *Loss Contingencies*. These contingencies could include the following:

- Because selection of an insurance carrier is a fiduciary decision, participants, unions, and/or the Department of Labor (DOL) may attempt to charge plan trustees with violation of their fiduciary duties. This may be more likely to occur in situations involving defined contribution plans and annuities purchased in settlement of a defined benefit plan liability.
- Employers may decide to subsidize defined contribution plan participants or defined benefit pension plan annuitants for some or all of any loss in value resulting from investments made in

financially troubled insurance companies. This is technically a prohibited transaction and may require DOL approval.

2.6.4.3 *Participating and nonparticipating insurance contracts*

Insurance contracts may be either participating or nonparticipating. Participating arrangements allow the purchaser (the employer or plan) to participate in the investment performance or other experience of the insurer. If the substance of the participating arrangement causes the employer or plan to remain subject to most or all of the risks and rewards of ownership of the obligation or assets transferred to the insurer, the insurance contract would be considered a plan asset, and the related promise to provide benefits would be included in the APBO. ASC 715-60 does not provide specific quantitative criteria for determining whether significant risks and rewards of ownership have effectively been transferred. As a general rule, we believe that, if the cost of the participation right (the difference between the cost of a participating and nonparticipating contract for otherwise equivalent underlying coverage) exceeds 10% of the nonparticipating contract premium, a significant portion of the risks and rewards have not been transferred.

For participating contracts in which a significant portion of the risks and rewards of ownership have been transferred, the cost of the participation right (not the entire contract), measured as the difference between the purchase price of the participating insurance contract and the price of an equivalent insurance contract without a participation right, is established as an asset on the date of purchase and remeasured subsequently at its fair value, if fair value is reasonably estimable. If the fair value of the participation right cannot be reasonably estimated, it would be measured at its amortized cost (not in excess of its net realizable value), and the cost amortized systematically over the expected dividend period under the contract. The carrying value should be assessed for recoverability on an ongoing basis. Dividends paid on such contracts are accounted for as a return on plan assets.

The purchase of a nonparticipating insurance contract results in a settlement (see settlement accounting discussion in PEB 4.3.4). The purchase of a participating contract may also result in a settlement if the substance of the contract allows the employer (or plan) to transfer a significant portion of the risks and rewards associated with the PBO and plan assets to the insurer. However, ASC 715-60-35-156 requires that the settlement gain that is otherwise recognizable must be reduced. Since the enterprise is still at risk for the participation right, an unrecognized net gain (but not an unrecognized net loss) must first be reduced by the cost of the participation right before calculating the amount to be recognized in income.

Some employers enter into agreements whereby benefits earned in the current period are covered by the annual purchase of an insurance annuity contract. The premium cost of those benefits is the service cost component of the net periodic pension or OPEB cost, except as described above for the cost of any participation right (see ASC 715-60-55-7 and ASC 715-60-55-8). Annuity contracts may also be purchased to provide for benefits earned for past years' services (i.e., to settle the PBO).

2.6.4.4 *Annuity contracts*

An annuity contract is an irrevocable contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium. The insurer should be a company authorized to do business as an insurance carrier under state law or under comparable laws outside the United States.

Once the premium is paid, the insurance company assumes a legal obligation to pay the benefits to retired employees on behalf of the employer; accordingly, the employer no longer bears significant risk. Therefore, if benefits earned in the current period pursuant to the plan's benefit formula are covered by annuity contracts, the premium cost of such annuity contracts generally is the service cost component of net periodic pension cost. Annuities purchased for previously accumulated benefits may reflect a settlement of such benefits (see PEB 4.3).

Participating annuity contracts cause the purchaser (employer or plan) to share in the experience of the insurance company, generally by way of a dividend. The annuity cost should be reduced by the cost of the participation right, which should be recognized as an asset of the participation right beneficiary (either the plan or the employer). Dividends actually received by the plan are considered to be a return on plan assets and are accounted for like any other fund earnings.

Benefits covered by annuity contracts should be excluded from the projected and accumulated benefit obligations because the obligation has been assumed and the risk has been transferred to the insurer; annuity contracts should also be excluded from the determination of plan assets. The only exception arises when an annuity contract has been purchased from a captive insurance company, or if there is reasonable doubt of the insurer's ability to meet its annuity payment obligations under the contract. In these situations, the contract is not deemed to be an annuity contract; it is considered a plan investment.

2.6.5 Market-related value of assets

Market-related value can be either fair value or a calculated value that defers recognition (for certain purposes) of changes in fair value over not more than five years through a systematic and rational amortization method. This delayed recognition concept can be applied for either pension or OPEB plan assets. The market-related value can be determined using different methods for different classes of assets (e.g., stocks, bonds, real estate). As noted in ASC 715-30-55-37, the classes of assets identified and approach utilized should be consistently applied from period to period both within and across plans. In situations when the employer has several plans with similar investments, it would typically use the same asset valuation methods for each class of asset, unless facts and circumstances warrant use of a different method.

Example 3 in ASC 715-60-55-79 through ASC 715-60-55-95 depicts an approach for calculating the market-related value of plan assets. ASC 715-30-55-37 through ASC 715-30-55-40 provides additional guidance on the application of the market-related value technique for measuring plan assets.

The market-related value is used in calculating expected return on plan assets (see PEB 3.2.5), which impacts the net gain or loss to be amortized (see PEB 3.2.7), as that in turn incorporates the difference between the expected return on the market-related value of plan assets and the actual return on plan assets. Further, asset gains and losses not yet reflected in market-related value are not required to be amortized (see PEB 3.2.7).

The illustration in ASC 715-30-55-101 through ASC 715-30-55-107 demonstrates the accounting for gains and losses, including the interplay of actual return (based on fair value) and expected return (based on market-related value) on plan assets. It also illustrates one approach for computing market-related value that has been widely used by employers under ASC 715, although other approaches may also be acceptable.

2.6.5.1 *Changes to the method of determining market-related value*

The specific market-related value methodology (i.e., fair value or a calculated value method) is an accounting policy that the employer should consistently follow. Any change in method is a change in accounting principle under ASC 250, *Accounting Changes and Error Corrections*, subject to preferability requirements and retrospective application to prior periods.

We generally believe it is preferable to use fair value as the market-related value of plan assets rather than a calculated value, which delays the recognition of changes in fair value over a period of up to five years. Accordingly, we believe it is difficult for an employer that uses fair value to justify switching to a calculated value. Making such a change solely or primarily to avoid the effect that volatility in the financial markets would have on the employer's reported earnings would not be sufficient to justify such a change.

2.6.6 *Transfers of plan assets between defined benefit plans*

An asset transfer from a pension plan can occur for a number of reasons, including a sale or other transfer of a business, a merger or amalgamation as part of a business rearrangement of pension plans or as a result of a transfer of individual participants or participating employers between plans. An asset transfer occurs when all or any part of the assets of a pension plan are transferred to another pension plan. If the transfer is between unrelated employers, it will likely trigger settlement accounting as discussed in PEB 4.3. The accounting within this section is for transfers of assets between pension plans established for the same employer.

Question PEB 2-3 discusses the appropriate accounting treatment when plan assets are transferred from one defined benefit plan to another defined benefit plan within the same entity.

Question PEB 2-3

PEB Corporation has a defined benefit pension plan that is overfunded by \$1,500,000 and a defined benefit postretirement health and welfare plan that is underfunded by \$700,000.

In light of the plans' funded positions, PEB Corporation is transferring \$700,000 of the plan assets from the pension plan to the postretirement benefit plan in accordance with Section 420 of the Internal Revenue Code. Section 420 permits the transfer of excess assets of a defined benefit pension plan to a retiree healthcare account in another plan. In the pension and postretirement footnote disclosures, the transfer would be shown as a reconciling item in the funded status for each of the plans.

In accounting for this transfer of plan assets in the financial statements, should this be recorded as a balance sheet entry between the prepaid pension asset and the accrued postretirement benefit liability, or should an unrecognized actuarial gain/loss in each of the plans be created (a loss in the pension plan and a gain in the postretirement plan)?

PwC response

PEB Corporation should record the \$700,000 transfer of plan assets from the defined benefit plan to the postretirement benefit plan as a balance sheet entry with a debit to the postretirement benefit liability and a credit to the pension asset.

Dr. Accrued Postretirement Liability	\$700,000
Cr. Prepaid Pension Asset	\$700,000

The transfer would not be recorded as an unrecognized gain/loss, but rather as a direct contribution into the postretirement plan assets and direct distribution from the pension plan assets.

PEB Corporation would still have to calculate, at its next measurement date, an unrecognized gain/loss based on the original expected return on plan assets.

2.7 Measurement date – defined benefit plans

Pension and OPEB plan assets and obligations must be measured at the end of the annual reporting period. The measurement date should be the same date as the entity's fiscal year end. Employers with fiscal year-end dates that do not fall on a calendar month-end (e.g., companies with a 52/53 week fiscal year) may make a policy election to measure plan assets and obligations as of the calendar month-end closest to the fiscal year-end. If the nearest month-end date is used, this would be considered the alternative measurement date and an employer choosing this option must apply it consistently from year to year to all of its defined benefit plans as an accounting policy election and disclose its use accordingly.

Adjustment to the funded status and disclosures for transactions that occur between the alternative measurement date and the fiscal year-end date are limited to adjusting for contributions and other significant events (as defined in ASC 715-30-35-66) which occur. A significant event is defined as a "plan amendment, settlement, or curtailment...that calls for a remeasurement."

2.7.1 Exceptions to the measurement date requirement

Equity-method investees and subsidiaries are required to measure plan assets and obligations as of their own fiscal year-ends for purposes of their stand-alone financial statements. However, they are not required to remeasure their plan assets and obligations using their investor's/parent's measurement date or to change their measurement date to the date used by their investor/parent. Accordingly, an entity that has a subsidiary that sponsors a defined benefit plan is not required to switch the subsidiary's measurement date to the year-end measurement date for consolidation purposes if the subsidiary is consolidated using a different fiscal year-end than the entity's.

An entity that has an equity-method investee that sponsors a defined benefit plan also is not required to switch the investee's measurement date to the year-end measurement date for equity-method accounting purposes if the investee's fiscal period is different from the entity's.

In these cases, the investor/parent would measure the subsidiary's or investee's plan assets and benefit obligations as of the same date used to consolidate the subsidiary, or as of the date of the investee's financial statements that are used to apply the equity method of accounting, based on the subsidiary's or investee's reported balances at those dates (which would effectively reflect an interim reporting date for those entities, utilizing the guidance in PEB 2.7.2). See CG 4.5.7 for guidance on accounting for a lag in investee reporting.

2.7.2 *Interim reporting — defined benefit plans*

Employers are not required to remeasure plan assets and obligations for interim reporting purposes. Rather, under ASC 715-30-35-68 and ASC 715-60-35-125, measurements of net periodic benefit cost for interim financial statements should be based on the assumptions used for the previous year-end measurement of both plan assets and obligations, unless more recent measurements are available, such as when a significant event occurs (e.g., a curtailment, settlement, significant plan amendment) that would ordinarily call for such remeasurements. In this case, an employer would remeasure at an interim date. If there is an interim remeasurement, the subsequent interim balance sheet and amounts reflected in AOCI would be adjusted to reflect the remeasurement.

When there is no interim period remeasurement, a reporting entity will report in its interim balance sheet an amount that is based on the asset or liability recognized in the previous year-end balance sheet, adjusted for (1) subsequent accruals of net benefit cost (service cost, interest cost, and expected return on plan assets), excluding amortization of amounts previously recognized in AOCI (those amounts are charged/credited to the AOCI balance and do not affect the prepaid or accrued benefit liability account), and (2) contributions to a funded plan or benefit payments from an unfunded plan.

For each period that a reporting entity presents interim financial statements, the net periodic benefit cost and OCI would reflect the effect of amortizing amounts out of AOCI into net periodic benefit cost in accordance with the expense recognition guidance in ASC 715. See PEB 3.2.6 and PEB 3.2.7.

Example PEB 2-3 illustrates the quarterly amortization of amounts from AOCI to net periodic benefit cost. See PEB 3.2 for a discussion of pension cost components.

EXAMPLE PEB 2-3

Recording quarterly net periodic benefit cost

PEB Corporation has \$4,000 of annual net periodic benefit cost with quarterly cost of \$1,000 comprised of the following (each amount is 25% of the annual amount computed at the beginning of the year):

Service cost	\$500
Interest cost	350
Expected return on assets	(200)
Amortization of prior service cost	150
Amortization of net loss	200

How would PEB Corporation record the net periodic benefit cost each quarter?

Analysis

The journal entry for each quarter would be as follows (ignoring the effects of any contributions to the plan):

Dr.	Service cost	\$500	
Dr.	Non-service pension cost	500	
Cr.	Net pension liability		650
Cr.	AOCI – prior service cost		150
Cr.	AOCI – net loss		200

2.7.3 Remeasurement date for significant events

The remeasurement of plan assets and obligations for a significant event should occur as of the date of the significant event. However, employers can apply a practical expedient to remeasure the plan assets and obligations as of the nearest calendar month-end date. The decision to apply the practical expedient to interim remeasurements for significant events is not an accounting policy election and can be made independently for each individual event. Disclosure of the election to use the practical expedient and the date which the defined benefit plan assets and obligations were remeasured is required. This expedient does not apply to business combinations, which must be valued as of the acquisition date, as discussed in BCG 2.5.10.

2.7.4 Voluntary interim remeasurement of plan asset and obligation

A voluntary remeasurement of both the asset and obligation at an interim date is not prohibited, provided both are measured at the same date. However, a voluntary remeasurement at an interim date (i.e., one that is not done because of a significant plan amendment, curtailment, or settlement) may establish an accounting policy of remeasuring whenever a similar set of circumstances arises, such as the situations involving discount rate changes discussed below.

A change in the general level of interest rates is not the type of event contemplated by ASC 715-60-35-126 that would require an employer to remeasure its costs and obligations at an interim date. However, an employer is not prohibited from doing so, and may choose to perform an interim remeasurement to prospectively reflect the impact of a change in rates on costs and obligations prior to its regular annual measurement. Regular interim remeasurements that are performed because interest rates have changed since the last measurement date would be indicative of a policy of performing interim remeasurements whenever interest rates subsequently fall or rise by the same or a greater margin. For example, if an employer regularly performs an interim remeasurement when interest rates rise by 100 basis points, the employer would be deemed to have adopted a policy of performing interim remeasurements whenever there is a change in interest rates (i.e., an increase or decrease) of 100 basis points or more. This policy would then need to be consistently followed, and would require the reporting entity to demonstrate preferability, as required by ASC 250, in order to change the policy for remeasurement.

When performing interim remeasurements, employers should obtain new asset values, roll forward the obligation to reflect population changes, and review the appropriateness of all assumptions, regardless of the reason for performing the interim remeasurement (i.e., this applies to interim remeasurements performed because of changes in interest rates or expected rates of return, as well as plan amendments, curtailments, or settlements).

2.7.5 Rollforward of plan balances

ASC 715 states that requiring plan measurements to be as of a particular date is not intended to require that all procedures be performed on that date, and that much of the information can be prepared as of an earlier date and projected forward to account for subsequent events. Further, ASC 715-30-35-1 states, "this Statement is intended to specify accounting objectives and results rather than specific computational means of obtaining those results. If estimates, averages, or computational shortcuts can reduce the cost of applying this Statement, their use is appropriate, provided the results are reasonably expected not to be materially different from the results of a detailed application."

Over time, a common practice by employers and their actuaries in developing pension plan measurements has been to estimate year-end plan obligations using a "rollforward" technique. This technique generally starts with a beginning-of-year obligation determined by an actuarial valuation using actual beginning-of-year census data, then (a) adds service cost and interest cost for the year, which were estimated as part of the beginning-of-year valuation, (b) subtracts benefit payments made during the year, (c) adjusts for significant activity during the year that was not anticipated (e.g., a major reduction in force or a plan amendment) that was below the employer's threshold for performing an interim remeasurement, and (d) adjusts for the change to an end-of-year discount rate, to produce a projected (rolled forward) year-end obligation. This rollforward technique does not use year-end census data estimates.

In the subsequent year (generally in the second or third quarter), typically in connection with the IRS requirement that a new beginning-of-year valuation be performed annually for funding purposes for qualified US pension plans, a new beginning-of-year ASC 715 valuation is performed using new beginning-of-year census data and updated demographic assumptions reflecting new experience studies (if available). The net benefit cost being recognized in the subsequent year that was originally estimated based on the prior year-end rollforward obligation is then "trued-up" in the current period based on this new beginning-of-year valuation. In other words, there may be additional expense in the period of valuation to catch up for the periods that were rolled forward.

Employers need to satisfy themselves that any rollforward techniques they use in developing year-end pension measurements produce a reasonable estimate of the year-end measurements. Accordingly, consideration should be given to whether there have been significant changes in such items as plan demographics that would affect the year-end obligation. Employers might compare actual benefit payments during the year to expected payments per the valuation and obtain information about unusual termination activity and other items impacting the demographics of the population. Also, a comparison of previous years' estimates to actual measurements can be used to identify the extent of differences due to the use of rollforwards.

A material difference in the results of the beginning-of-year valuation versus the results using the rollforward technique to derive the prior-year's end-of-year measurement may be indicative of an error in the prior year's end-of-year measurement, and should be assessed under ASC 250, *Accounting Changes and Error Corrections*. The employer should understand the reasons why the numbers are materially different, including whether the difference is attributable to information that was not available when the year-end rollforward measurement was performed.

Chapter 3:
Net periodic benefit cost—
updated October 2023

3.1 Overview of net periodic benefit cost

This chapter discusses the recognition of cost for defined benefit pension and postretirement benefit plans. It covers the various components of net periodic benefit cost as well as the recognition of that cost both in net income and other comprehensive income.

This chapter also addresses foreign currency considerations for pension and postretirement benefit plans.

3.2 Composition of net periodic benefit cost

The amount to be recognized in an employer's financial statements as the cost of a defined benefit plan is comprised of the following components:

- Service cost – the cost of benefits earned during the period
- Interest cost – interest on the benefit obligation (PBO or APBO)
- Expected return on plan assets – expected long-term rate of return applied to plan assets
- Amortization of prior service cost/credit – amortization of the cost or benefit of previous plan amendments that are initially recognized in other comprehensive income
- Amortization of gains and losses – amortization of gains and losses arising from the annual rereasurement of the plan that are initially recognized in other comprehensive income
- Amortization of transition obligation or asset – net funded status at the time of the initial adoption of FAS 87 (circa 1987, which is now codified in ASC 715). Relatively few plans have any remaining unamortized transition asset.

3.2.1 Presentation of net periodic benefit cost

The service cost component is considered employee compensation and should be presented within income from operations in the same financial statement line items as other compensation. This is also the portion of net periodic benefit cost that is eligible for capitalization as part of the cost of inventory or self-constructed assets if the entity capitalizes labor costs for those purposes. The remaining components of net periodic pension cost are reported separately (in one or more line items) outside of operating income, if a subtotal is presented for income from operations.

3.2.2 Net periodic benefit cost and gains and losses

Net periodic benefit cost is determined at the beginning of the year, based on beginning-of-the-year plan balances (end-of-prior-year valuation) and the expected value of benefits to be accrued in the current year. In theory, if interest rates do not change, there is no change in employee demographics or other actuarial assumptions and assets perform exactly as expected, the accrual of net benefit cost for the period would produce the necessary net benefit asset or obligation at the end of the period. For example, an entity may estimate that \$100 of pension cost should be recognized during the year to arrive at the expected balance of the plan's net obligation at the end of the year. This \$100 would be recognized as pension cost over the course of the year.

Inevitably, actual experience will differ from the estimates and assumptions included in the net periodic benefit cost determined at the beginning of the year. Thus, at the end of the year when the annual measurement of the plan is performed, any difference between the net funded status (net asset or liability) of the plan and the amount accrued via net periodic benefit cost is a gain or loss. For example, if net periodic benefit cost was determined to be \$100 at the beginning of the year but the net liability of the plan actually increases by \$110 during the year, the \$10 difference is an "experience loss," because actual experience differs from the original estimate.

Under the delayed recognition principles of ASC 715, that experience loss is not required to be recognized immediately. Most employers initially defer these losses and amortize them in subsequent periods (see PEB 3.2.7). However, some employers have adopted a policy of immediate recognition of gains and losses, in which case the difference arising on the annual remeasurement would be immediately charged to income in the period of the remeasurement (annual or otherwise).

Cost recognition is independent of cash flows related to the plan. Contributions to the plan by the employer and payment of benefits by the plan impact the net obligation or asset but do not directly affect the determination of net periodic benefit cost.

3.2.3 Service cost

Service cost represents the cost of benefits attributable to service performed by employees for the entity during the year. The measurement of service cost is based on the same assumptions and concepts as the projected benefit obligation (PBO) or expected postretirement benefit obligation (EPBO) and generally requires the use of a benefit/years-of-service attribution approach (see PEB 2.5). Service cost is the actuarial present value of projected benefits attributed to the current period based on the pension benefit formula, including the effect of a substantive commitment to amend the plan, if any (see PEB 2.2.2).

3.2.4 Interest cost

Interest cost represents the portion of net benefit cost attributable to the cost of "carrying" the pension obligation from one period to the next. The projected benefit obligation is measured at present value, using a discount rate representing the time value of money (see PEB 2.4.1). Thus, the interest cost component of pension cost is the increase in the projected benefit obligation due to the passage of time. Stated another way, interest cost represents accretion of interest on the projected benefit obligation using the discount rate.

The interest cost component is not considered to be interest under ASC 835-20, *Capitalization of Interest*, for purposes of interest capitalization on self-constructed assets.

3.2.5 Expected return on plan assets

Pension plans may be funded or unfunded and most postretirement benefit plans are unfunded. For plans that are funded—i.e., investments set aside to fund benefit payments meet the definition of plan assets—the expected return on those assets is a component of net periodic pension cost.

Expected return on plan assets represents the portion of net benefit cost attributable to the expected increase in the value of plan assets over the course of the year. The expected return on plan assets is the product of the expected long-term rate of return on plan assets and the market-related value of plan assets (see PEB 2.6.5). The expected rate of return is estimated based on market conditions and

the nature of the assets (see PEB 2.4.2). Estimates typically incorporate considerations of financial markets, which can be volatile, changes in the macroeconomic environment, and the entity's overall investment strategy for postretirement benefit plans. If the return on plan assets is taxable to the plan trust or other holder of those assets, the expected long-term rate of return should be reduced to reflect the related income taxes expected to be paid under existing tax law. A similar reduction should be made for the cost of managing the assets. Calculation of the expected return on plan assets should take into account changes in the level of plan assets expected to occur throughout the year due to expected contributions and benefit payments. For example, if the employer's contribution for the year is expected to be made two months before the next measurement date, then the expected return on plan assets should include an amount related to the expected return on that contribution only for those two months.

The actual return on plan assets—i.e., the actual investment performance during the year—is based on the fair value of the plan assets at the end of the year, compared to the fair value of plan assets at the beginning of the year, adjusted for contributions and benefit payments during the year. The difference between the expected return accrued as part of net periodic benefit cost and the actual return determined upon remeasurement is a gain or loss. Unless an employer has elected a policy of immediate recognition of gains and losses (see PEB 3.2.7), any gain or loss arising on remeasurement is reflected as a change in the net pension asset or obligation and an offsetting increase or decrease in OCI. Gains and losses accumulated in OCI are subject to amortization in future periods as described in PEB 3.2.7.

3.2.6 Amortization of prior service cost

Prior service cost arises from a plan amendment (including initiation of a plan) that grants increased benefits for service rendered in prior periods. It is measured by the increase in the projected benefit obligation at the date the amendment is adopted (generally the approval date, not the effective date, of the amendment). If the amendment is deemed significant, the employer should perform an interim remeasurement of the benefit obligation and plan assets and would also develop a new measure of net periodic benefit cost for the period from the remeasurement through the end of the fiscal year. If an amendment is not deemed to be significant, the effects of the amendment would be determined as of the date of the next annual measurement date. ASC 715 does not define the term "significant." The determination of whether an event is significant is often a highly judgmental matter. Employers should consider the specific facts and circumstances surrounding the event and their past practice of defining significance for previous events.

Pursuant to ASC 715-30-35-11 and ASC 715-60-35-15 prior service cost must be initially deferred and subsequently amortized as a component of net periodic pension cost, generally by assigning an equal amount of the cost to each remaining year of service for the plan participants continuing to render service to the employer (active plan participants). Importantly, a policy of immediate recognition of the cost of plan amendments is prohibited by ASC 715-30-35-16. If all, or substantially all, of a plan's participants are inactive at the time of the amendment, the prior service cost should be amortized over the remaining life expectancy of plan participants (see PEB 3.2.6.4 for additional discussion of inactive plan participants).

The guidance in ASC 715-30-35-13 for defined benefit pension plans allows amortization of prior service cost over the average remaining service periods of active employees, while the guidance in ASC 715-60-35-15 through ASC 715-60-35-17 for OPEB plans requires that prior service cost be amortized over the period benefited, which is generally the average remaining years of service to the full eligibility date (see PEB 2.5.3) for active employees expected to receive benefits. More rapid

amortization is permitted depending on the facts and circumstances and in some circumstances may be required, as discussed in PEB 3.2.6.1. Amortization of prior service cost should begin immediately after the date the plan amendment is adopted (see PEB 4.6.2 for a discussion of when a plan amendment is considered to be adopted). The amortization schedule for prior service cost is developed at the time of each plan amendment so prior service cost arising from different plan amendments will have different amortization schedules. Sometimes plan amendments can reduce benefits attributable to prior service. See PEB 3.2.6.5 for the impact on amortization of prior service cost in such cases.

ASC 715-30-55-97 shows the amortization of prior service cost and provides one example of a systematic determination of the amount of prior service cost to assign to each expected future year of service. Following that approach results in a declining pattern of amortization of the prior service cost from a particular plan amendment because some employees have shorter remaining service lives than the overall average remaining service period. As noted in ASC 715-30-55-13, alternative approaches that mathematically will result in more rapid amortization (for example, straight-line amortization of prior service cost over the average remaining service periods of active employees) is acceptable. ASC 715-30-55-100 illustrates the application of the straight-line amortization method.

While employers have some latitude in selecting an amortization method, once adopted, the method should be used consistently for all plan amendments and constitutes an accounting policy. ASC 715-30-35-15 indicates that, once an amortization period has been established for a particular plan amendment, it may be revised only if a curtailment occurs or if events indicate that (a) the period benefited is shorter than originally estimated or (b) the future economic benefits of the plan amendment have been impaired. In practice, both of those conditions are uncommon. The amortization period would not necessarily be revised because of ordinary variances in the expected future service period of employees.

Example PEB 3-1 addresses the amortization period for prior service cost affecting both active and retired employees.

EXAMPLE PEB 3-1

Amortization period for prior service cost affecting both active and retired employees

PEB Corporation has a pension plan in which 90% of the participants are active employees and the remaining 10% are retirees. PEB Corporation amends its plan to provide increased benefits, which results in prior service cost. The plan amendment impacts both active employees and retirees. The retiree population has an average remaining life expectancy of 15 years. The active employee population has an average remaining service period of 8 years.

Should the prior service cost associated with the retirees be recognized over their average remaining life expectancy (15 years) or the average remaining future service period of active plan participants (8 years)?

Analysis

All of the prior service cost for this amendment should be amortized over the average remaining future service period of active plan participants (8 years).

A fundamental tenet of defined benefit plan accounting is that the plan is a single unit of account—a single net asset or liability is recognized and a single aggregate net periodic benefit cost is determined.

Thus, an amendment to the plan, even if it only affects a certain subset of the plan participants, should be accounted for following the guidance in ASC 715-30-35-10 and ASC 715-30-35-11 (i.e., recognized during the future service periods of those employees active at the date of the amendment who are expected to receive benefits under the plan). Only when all or almost all of a plan's participants are inactive (see PEB 3.2.6.4 for further discussion), should the cost of retroactive plan amendments be amortized based on the remaining life expectancy instead of the remaining service period, as described in ASC 715-30-35-11. Accordingly, unless all or almost all of a plan's participants are inactive (not just those impacted by the amendment), the costs of retroactive plan amendments are to be amortized over the future service periods of active plan participants.

3.2.6.1 *Collective bargaining arrangements*

An exception to amortization over remaining service periods occurs in situations when a history of regular plan amendments and other evidence may indicate that the period during which the employer expects to realize economic benefits from an amendment granting retroactive benefits is shorter than the entire remaining service period of the active employees. For example, in many collective bargaining arrangements, pension or healthcare benefits are typically a feature of each contract negotiation and the period between contracts may be relatively short. In those situations, the amortization of prior service cost should reflect the period benefited (a more rapid rate of amortization). However, ASC 715-30-35-16 prohibits an accounting policy to recognize the cost of all plan amendments immediately in net periodic pension costs.

Notwithstanding the guidance to consider a shorter period of benefit, ASC 715-30-55-51 does not require the presumption that prior service costs arising from plan amendments negotiated in a collective bargaining environment be amortized over the period between each contract. Rather, each specific situation should be evaluated as to the economic period benefited. The plan's history and other evidence should be evaluated to determine the period during which the employer expects to receive economic benefit. For example, uncertainty may exist regarding the entity's ability and/or intent to continue its past practice of regular plan amendments because of changed economic conditions. The shorter the period expected to be benefited, the more appropriate straight-line amortization may be; for longer periods, a method that allocates a greater proportion of cost to earlier periods using an expected years of future service concept is likely more appropriate.

3.2.6.2 *Amendments that replace other accrued employee benefits*

Not all pension benefit increases are subject to amortization. ASC 715-60-55-111 indicates that pension benefit increases provided to compensate for the elimination of postretirement benefits other than pensions represent a cost of settling the postretirement benefit obligation. Therefore, that cost should be accounted for as an increase in accrued pension liability or a decrease in prepaid pension asset with an offsetting reduction in the obligation for other postretirement benefits.

3.2.6.3 *Amendments that do not give rise to prior service cost*

Plan amendments would not give rise to prior service cost if they are previously anticipated as part of a substantive commitment (see ASC 715-30-55-19). Plan amendments that increase benefits only for future services also do not give rise to prior service cost; the increased benefits will be accrued as future service is rendered.

3.2.6.4 Amortization of prior service cost – inactive participants

If all or almost all participants are inactive at the time of a plan amendment, amortization of the newly arising prior service cost is based on the average remaining life expectancy of the inactive participants rather than on the future service periods of the active participants. A question arises in this context as to what constitutes an “inactive” plan participant.

One interpretation is based solely on employment status. This interpretation is based on a common use of the word “inactive,” suggesting that a plan participant who is working for the reporting entity is active and a plan participant who is no longer working for the reporting entity is inactive. Under another interpretation, participants are considered inactive if they are no longer earning additional defined benefits under the plan. This would include participants who are retired or are otherwise no longer working for the reporting entity (i.e., former employees), since their lack of current service to the reporting entity generally means they are not able to earn additional defined benefits under the plan. In addition, this interpretation would include current employees who are participants in the plan, but for whom future services do not earn them additional defined benefits under the plan (e.g., as the result of a permanent hard freeze of benefits under the plan). This interpretation is supported by ASC 715-30-55-49, which implies that the determination of whether a plan participant who is currently employed by and working for the reporting entity is inactive would be made by reference to whether the participant is earning additional defined benefits under the plan. This guidance uses the phrase “inactive” even though participants are still working for the reporting entity, which suggests that the determination of inactive may depend on whether the participants will earn additional benefits under the plan, not whether the participants are providing services to the reporting entity (i.e., employed by and working for the reporting entity). Whichever interpretation a reporting entity chooses should be consistently applied to each plan sponsored by the reporting entity.

In the context of a defined benefit OPEB plan, the equivalent of an “inactive” participant is a participant who is already fully eligible for benefits (i.e., future service does not affect the amount of their benefit).

ASC 715-30-55-48 indicates that there is no specific quantitative threshold that constitutes “all or almost all” participants. We generally expect that at least 90% of plan participants would need to be inactive in order to use this alternative amortization period.

3.2.6.5 Negative plan amendments

There can be situations when a plan amendment will reduce the projected benefit obligation (resulting in what is often called negative prior service cost or a prior service credit). In those cases, the reduction should be used to first reduce any existing prior service cost included in accumulated other comprehensive income. The excess should be amortized to net periodic pension cost on the same basis as the cost of benefit increases (prior service cost). If a plan amendment eliminates defined benefits for future services for a significant number of employees, it would be considered a curtailment, and all prior service cost included in accumulated other comprehensive income related to years of service no longer expected to be rendered would be recognized in computing the gain or loss on curtailment. See PEB 4.4 for further discussion relating to curtailments.

ASC 715 does not provide guidance on the ordering assumption (e.g., LIFO, FIFO, or pro rata) to be used to reduce prior service cost included in AOCI when the aggregate amount accumulated in AOCI exceeds the reduction in the projected benefit obligation resulting from the negative plan amendment. Since amortization of prior service cost from plan amendments is determined for each amendment at

the date of the amendment, at any point in time each plan amendment will be amortized over a different period and in differing proportions. Thus, the order in which the reduction in the PBO arising from the negative plan amendment is applied to prior service cost from prior plan amendments will directly affect the amount of prior service cost amortized in each future period. Unless the plan amendment reducing the pension obligation is specifically related to a prior amendment (i.e., essentially reversing that plan amendment or a portion of it), ASC 715-30-55-54 states that any systematic method, applied on a consistent basis, would be acceptable.

3.2.6.6 Initial recognition and reporting in OCI

Prior service costs and credits that arise during the year are recognized as a component of other comprehensive income (OCI). These amounts are subsequently amortized out of accumulated other comprehensive income (AOCI) and become a component of net benefit cost using the recognition provisions in ASC 715. As the prior service cost or credit is amortized into net periodic benefit cost, a reclassification adjustment is recognized in other comprehensive income, as described in ASC 220-10-45-15. Therefore, total comprehensive income (which is comprised of net income and other comprehensive income) should reflect no net impact from the amortization of the prior service cost or credit. Similarly, the amortization of prior service cost or credit has no impact on the accrued benefit liability as the effects of the underlying plan amendments have already been recognized on the balance sheet.

3.2.7 Amortization of gains and losses

A gain or loss can result from a change in either the value of plan assets different from that assumed (i.e., the expected return on plan assets) or the projected benefit obligation resulting from actuarial experience different from that assumed, as well as changes in discount rates or healthcare cost trend rates. ASC 715 does not make a distinction between gains and losses arising from investment activities related to plan assets and those arising from changes in actuarial assumptions and experience different from what was assumed. Gains and losses arise at the time a remeasurement of the plan occurs. Unless a reporting entity has chosen to immediately recognize those gains and losses (see PEB 3.2.7.1 below), they are charged or credited directly to accumulated other comprehensive income (AOCI).

Gains and losses accumulated in AOCI are required, at a minimum, to be amortized as a component of net periodic pension cost if they exceed a defined "corridor." Unlike prior service cost, the amount of net gain or loss to be amortized as part of net periodic benefit cost and their amortization period is recalculated at each measurement date. The "corridor" is defined as the greater of 10% of the projected benefit obligation or 10% of the market-related value of plan assets as of the beginning of the year. If the amount of a net gain or loss does not exceed the corridor amount, it will never become a component of net periodic pension cost unless the corridor itself narrows because the balances it is based on decline.

The concept of a corridor was originally intended to acknowledge the long-term nature of pension and postretirement benefit obligations and the likelihood that net assets or liabilities could move significantly from period to period given the leverage of some of the long-term assumptions. Thus, it is intended to reduce period-to-period volatility in pension cost resulting from short-term market swings by providing a reasonable opportunity for gains and losses to offset over time without affecting pension cost. If, however, the gains and losses accumulate to an absolute value that exceeds 10% of the greater of the PBO or plan assets (i.e., outside the corridor), some amortization (recognition in net benefit cost) is required. In those cases, the minimum amortization is the net gain or loss in excess of

the corridor divided by the average remaining service period of active employees expected to receive benefits. See PEB 3.2.7.2 for a discussion of the amortization period when all or almost all plan participants are "inactive." Additionally, as discussed in PEB 2.6.5, asset gains and losses not yet reflected in market-related value are not included in the amount subject to amortization.

As the net gain or loss is amortized, a reclassification adjustment is recognized in other comprehensive income, as described in ASC 220-10-45-15. Therefore, there is no net impact on total comprehensive income (which comprises net income and other comprehensive income) from the amortization of the net gain or loss.

3.2.7.1 Changes to the method of recognizing gains and losses

As an alternative to the minimum amortization (excess outside the 10% corridor; see PEB 3.2.7), ASC 715 provides that any systematic method of amortization may be used in lieu of the minimum amortization method if the following criteria are met:

- The minimum amortization is used in any period in which it is greater than the amount determined by the alternative method
- The alternative method is applied consistently
- The alternative method is applied similarly to both gains and losses
- The alternative method is disclosed

Some common alternative methods for the recognition of gains and losses in excess of the minimum amortization required by ASC 715 that we have seen in practice include:

- Immediate recognition of the full net gain or loss in the income statement,
- Immediate recognition of amounts in excess of the corridor in the income statement, or
- Recognition over periods shorter than the average remaining service period or average remaining life expectancy, as applicable.

Any change in the method of recognizing gains and losses is considered to be a change in accounting principle under ASC 250, *Accounting Changes and Error Corrections*, that must be justified on the basis of preferability and applied retrospectively to all periods presented. We generally believe that any method that results in recognizing gains and losses in net income sooner (i.e., moves the recognition of gains and losses closer to immediate recognition) is preferable. Conversely, we believe it is difficult to support the preferability of any change that further delays the recognition of gains and losses in net income, including the change to a longer amortization period.

An employer that implements an immediate recognition approach generally would recognize in net income the full amount of the net gain or loss that is measured at the time the benefit obligation and plan assets are remeasured. As such, when the annual measurement is performed at year-end, the full amount of the net gain or loss would be recognized in the fourth quarter. If the employer remeasures the benefit obligation and plan assets at an interim period (e.g., due to a significant plan event), it would recognize in that period the full amount of the net gain or loss measured.

A policy of immediately recognizing gains and losses upon remeasurement does not require a quarterly "mark to market" adjustment (i.e., the plan assets and obligation are not remeasured each quarter outside of significant plan events). Public companies, however, should provide appropriate "early warning" disclosures in the MD&A of earlier quarterly filings to the extent the fourth quarter adjustment is expected to be material. ASC 715 indicates that the corridor should be calculated as of the beginning of the year for purposes of amortizing the net gain or loss in AOCI. For employers that immediately recognize gains and losses outside the corridor, we believe it would be appropriate to use the corridor determined as of the measurement date since it would be based on the most recent measurements available.

See PEB 3.2.10 for further discussion of pension accounting changes under ASC 250.

Example PEB 3-2 addresses the interplay of an interim remeasurement for a plan amendment with a reporting entity's accounting policy to immediately recognize gains and losses outside of the corridor.

EXAMPLE PEB 3-2

Interplay of an interim remeasurement with a reporting entity's accounting policy to immediately recognize gains and losses outside of the corridor

PEB Corporation maintains a defined benefit pension plan for its employees. PEB Corporation has elected an accounting policy to immediately recognize all pension gains and losses in excess of the corridor.

On December 8, 20X1 PEB Corporation's Board of Directors amended the plan so that PEB Corporation's defined benefit plan would be frozen in March 20X2 and no additional benefits would accrue after that time. This was communicated to the employees and the plan amendment is therefore considered adopted on December 8, 20X1.

Ordinarily, PEB Corporation measures their plan assets and obligations as of the date of the financial statements (December 31) in accordance with ASC 715-30-35-62. However, management determined that the amendment is a significant event that requires a remeasurement at the date of the amendment. Since the previous year-end measurement date, discount rates have decreased and asset returns have underperformed expectations.

How should PEB Corporation account for the gain or loss arising upon remeasurement at the date of the amendment?

Analysis

Freezing a defined benefit plan constitutes a curtailment under ASC 715 (see PEB 4.4). In order to determine the effects of the curtailment, the plan first needs to be remeasured as of the date of the event with current actuarial assumptions updated for current circumstances (prior to incorporating the effects of the amendment) and the current fair value of plan assets. Once that remeasurement is complete, PEB Corporation can remeasure the plan's obligations considering the amendment to the plan and determine the effects of the curtailment on the plan (the difference between the PBO arising from those two measurements).

The remeasurement (prior to considering the amendment) will likely result in an unrecognized net loss in excess of the corridor given the negative market developments. The curtailment is expected to

result in a gain from the reduction in the projected benefit obligation (the elimination of the value of projected future salary increases on the benefits accrued to date). Any gain arising from the curtailment is first offset against any unrecognized net loss and could result in the remaining unrecognized net loss being within the corridor and not subject to recognition under PEB Corporation's policy.

Thus, the sequencing of accounting events here is critical. Under PEB Corporation's accounting policy of immediate recognition of gains and losses outside the corridor, which must be applied consistently to all remeasurement events, the loss arising from the interim remeasurement prior to determining the effects of the curtailment would be recognized to the extent it exceeded the corridor. Any curtailment gain would first be offset against any remaining net loss (reflecting amounts within the corridor in this fact pattern) and then the remainder would be recognized in net income as a curtailment gain.

3.2.7.2 *Amortization of gains and losses – inactive participants*

When all or almost all plan participants are inactive, gains and losses subject to amortization should be amortized over the average remaining life expectancy of the inactive participants rather than the average remaining service period of active participants. ASC 715-30-55-48 indicates that there is no specific threshold for determining "all or almost all" and that judgment is required based on the facts and circumstances of the particular plan. However, the analysis should be based on the number of participants, not another unit of measure. We expect that at least 90% of participants would be inactive in order to use this alternative amortization period.

Question PEB 3-1 addresses the definition of an "inactive" participant.

Question PEB 3-1

PEB Corporation adopts an amendment to freeze the benefits provided under its defined benefit plan. The result of this amendment is that no participants in PEB Corporation's plan will accrue additional pension benefits for service provided in future years. However, a substantial majority of the plan participants are active employees; retirees currently make up a minority of the plan's population.

For purposes of determining the amortization period for gains and losses subject to amortization, are all or substantially all of PEB's plan participants inactive?

PwC response

As described in PEB 3.2.6.4, we believe that there are two acceptable interpretations of "inactive" in this context.

One interpretation is based solely on employment status. This interpretation is also supported by ASC 715-30-55-50, which indicates that, in the event all employees covered by a plan are terminated but not retired, the minimum amortization of a net gain or loss included in AOCI should be determined based on the average remaining life expectancy of the inactive participants. This indicates that a participant who is no longer working for the reporting entity is considered to be inactive. Under this interpretation, PEB Corporation would use the average remaining service period to determine the amount of gain or loss to amortize.

Under another interpretation, participants are considered inactive if they are no longer earning additional defined benefits under the plan.

Whichever interpretation a reporting entity chooses should be consistently applied to each plan sponsored by the reporting entity.

Question PEB 3-2 addresses when the amortization period for gains and losses should be changed when all or almost all participants become inactive.

Question PEB 3-2

PEB Corporation adopted an amendment of its pension plan during FY20X1. As a result of this amendment, all plan participants ceased accruing additional benefits under the plan effective June 20X2 (i.e., a plan freeze). PEB Corporation defines an inactive participant as a participant who is no longer accruing benefits for future service under the plan. Consequently, all plan participants became inactive in June 20X2. PEB Corporation's annual measurement date for its pension plan is December 31.

When should PEB Corporation reassess the amortization period for unrecognized gains or losses as a result of all of its participants becoming inactive in June 20X2?

PwC response

At the next measurement date following June 20X2. The amortization period is determined as part of the overall process of calculating and assessing the overall actuarial gain/loss, which is only done in conjunction with a measurement of the plan assets and obligations. At December 31, 20X1, the participants are active. Therefore, the amortization period would be based on their average remaining service period as employees. The change in status from active to inactive of a group of participants through the ordinary operation of the plan is not considered a significant event that would require a remeasurement. As such, the change in participants' status during 20X2 would neither require nor permit (absent a policy of more frequent interim remeasurements) a reassessment of the amortization period for deferred gains and losses. Accordingly, the amortization established at the most recent measurement date of December 31, 20X1 should continue for the remainder of the year. At the measurement date of the plan following June 20X2, the amortization period for gains and losses would be based on the remaining life expectancy of the plan participants. If there is no significant event between June 20X2 and the end of the year, the next measurement of the plan would be December 31, 20X2.

If, however, PEB Corporation had a policy of remeasuring their defined benefit plans on an interim basis or in the event of other similar events, the amortization period would be reassessed in conjunction with that full remeasurement of all of the plan assets and obligations.

3.2.8 *Mandatory changes: plan amendment vs. actuarial gain/loss*

The effect of changes to a plan's terms made in response to new laws or regulations need to be carefully considered to determine whether they constitute a plan amendment, which would result in prior service cost or credit, or an actuarial gain/loss. See PEB 3.2.6 for amortization of prior service cost and PEB 3.2.7 for amortization of gains and losses. To determine the appropriate accounting, the consequences of a plan sponsor electing not to amend its plans to reflect the changes required should be assessed. For example, the consequences of not amending a plan to incorporate the changes

required by the Pension Protection Act of 2006 were determined to be severe; they included a disqualification of the plan's tax-advantaged status. Such negative consequences may essentially compel the plan sponsor to modify its plans as necessary to conform to the law. In that circumstance, we concluded that changes to the terms of the plan in response to the Pension Protection Act could be considered mandatory and the resulting impact on the plan treated as an experience gain or loss. That treatment was consistent with the guidance in ASC 715-60-35-137, which calls for the effect of the Medicare Prescription Drug, Improvement, and Modernization Act to be accounted for as a gain/loss.

However, we would not object to an employer accounting for changes to a plan due to changes in laws or regulations as a plan amendment (i.e., treating the change in the PBO as prior service cost) since, technically, the employer could choose not to modify its plans to conform to the new law and simply accept the consequences of not doing so.

3.2.9 Net periodic benefit cost — change in estimate

A change in the discount rate, the expected rate of return on plan assets, or any other actuarial assumption due to changed circumstances is considered to be a change in estimate rather than a change in accounting principle. For example, if changing market conditions indicate that the expected rate of return on plan assets should be 5% rather than 6%, the change is considered a change in accounting estimate. Additionally, changes in the approach to determining the discount rate, such as changing from a benchmark approach to a specific bond matching approach, would also be considered a change in accounting estimate as described in PEB 2.4.1.1. The effect of all changes in assumptions are reflected as actuarial gains and losses.

3.2.10 Net periodic benefit cost — change in accounting principle

There are two significant areas in ASC 715 in which acceptable alternatives are available:

- The approach to determining the market-related value of plan assets (see PEB 2.6.5)
- The gain/loss recognition approach (see PEB 3.2.7).

A change in either of these is a change in accounting principle subject to the requirements of ASC 250, *Accounting Changes and Error Corrections*. For example, a change in the method of computing the market-related value of plan assets from a five-year average to a three-year average would be considered a change in the method of applying an accounting principle.

To change an accounting principle not mandated by the issuance of an authoritative accounting pronouncement, the new accounting policy must be considered preferable to the existing policy. Refer to FSP 30.4 for the general requirements for justifying a change in accounting principle.

With respect to pension and OPEB accounting changes, the Basis for Conclusions in Statement of Financial Accounting Standards No. 87, *Employer's Accounting for Pensions* (which is the principal source of the guidance in ASC 715-30, *Compensation-Retirement Benefits—Defined benefit plans--pension*), indicates that the FASB believed at the time that (1) the fair value of plan assets is preferable to a calculated market-related value (MRV), and (2) immediate recognition of gains and losses is preferable to delayed recognition.

Based on these views, any method that moves MRV closer to fair value or moves the recognition of gains and losses closer to immediate recognition is usually considered preferable. For example, the following changes would generally be considered preferable:

- Changing from a five-year calculated MRV to a three-year calculated MRV or to fair value.
- Changing from the minimum amortization of gains/losses outside the 10% corridor to immediate recognition of gains/losses outside the 10% corridor
- Changing to immediate recognition of the full amount of gains and losses determined at each measurement date (i.e., eliminate use of the corridor).

Other changes may be more difficult to justify as preferable. For example, it is generally difficult to support the preferability of any change that further defers recognition of gains and losses (e.g., switching from amortization of all gains and losses to a 10% corridor approach) or that further defers the recognition of changes in the value of plan assets (e.g., changing from fair value to a calculated value for determining the market-related value of plan assets). Refer to PEB 3.2.7 for further discussion of changes to the recognition of gains and losses and to PEB 2.6.5 for changes to the determination of the market-related value of plan assets.

Pursuant to ASC 250, a change in accounting principle is reported through retrospective application of the new accounting principle to all prior periods, unless doing so is impracticable. Because of the long-term deferral mechanisms in pension accounting, in order to determine the retrospective impact and the cumulative effect on the opening balances of the earliest period presented, it may be necessary to retrospectively apply the new accounting principle to the year the current pension accounting rules (ASC 715-30) or postretirement benefit accounting rules (ASC 715-60) were initially applied and to each year thereafter. For example, for a reporting entity that adopted FAS 87 (the primary source of ASC 715-30) in 1987, a change in determining the market-related value of plan assets would conceptually be applied retroactively starting in 1987 and pension cost for each year thereafter would be recomputed under the new method up to the beginning of the year that the new method is adopted. This computation would not only result in an adjustment to the expected return on assets, but also to the amortization of gains and losses, as well as to any curtailments or settlements recorded since adoption in 1987. Similarly, a change to immediately recognize amounts in excess of the 10% corridor would require a recomputation of benefit expense since adoption of the current pension and OPEB accounting rules.

Although the need to reproduce information from many years ago could be challenging and time-consuming, it may be difficult to assert that is impracticable.

3.2.11 *Amortization of transition obligation or asset*

The transition obligation or asset essentially represented the initial funded status of defined benefit plans at the time of initial adoption of the guidance in ASC 715-30 and ASC 715-60. Rather than requiring that amount to be charged to retained earnings, the transition guidance permitted delayed recognition. For employers that elected the delayed recognition method, the transition amount is amortized on a straight-line basis as a component of net periodic benefit cost. Remaining unamortized amounts are included in AOCI. The amortization period is generally the average remaining service period of active plan participants at the time of adoption, but if the average remaining service period at transition was less than 20 years, ASC 715 allowed the amortization to take place over 20 years. Based on the original effective dates of ASC 715-30 and ASC 715-60, only plans with average remaining

service periods greater than 30 years should have any remaining unamortized transition amount. Certain plan events could accelerate the recognition of the unamortized transition amount.

3.3 Net periodic benefit cost – other elements of income or expense

Other elements of income or expense include accounting for deviations from the substantive OPEB plan and employer contribution taxes.

3.3.1 Deviations from the substantive OPEB plan

Under ASC 715-60, the impact of an employer's temporary deviation from the provisions of a substantive OPEB plan are recognized immediately rather than deferred and amortized. This provision does not apply to pension plans. For example, some OPEB plans include terms (either written or substantive) that provide that shortfalls resulting from benefit payments in excess of the employer's share of incurred claims cost and participant contributions for a year are to be recovered through the subsequent year's participant contributions (i.e., a retrospective adjustment). If an employer forgives that retrospective charge on a one-time basis, that decision is required to be recognized as a current period loss rather than be deferred and amortized. If, however, the facts and circumstances indicate that the employer had in substance made a decision to continue to bear the shortfall in future years as well, the effect of that change on the APBO would be calculated and accounted for as a plan amendment.

The theory behind the requirement for immediate recognition is that the change results from a temporary change in intent rather than a change in estimate or permanent plan change.

3.3.2 Accounting for employer contribution taxes

In certain jurisdictions, the tax authority imposes a tax on contributions made by the employer to the pension plan. ASC 715 does not directly address the accounting for this type of tax.

Example PEB 3-3 describes the treatment of taxes paid on employer contributions to a pension plan.

EXAMPLE PEB 3-3

Taxes paid on employer contributions to a pension plan.

PEB Corporation sponsors a defined benefit pension plan. The local tax jurisdiction imposes a 16% tax on the pension plan on all tax-deductible contributions paid by the employer. In other words, for a contribution of \$100, the pension plan incurs a \$16 tax; therefore, an employer needs to contribute \$119 to the plan so the plan can pay \$100 in pension benefits, net of the 16% tax (\$19).

How should PEB Corporation account for the contribution tax?

Analysis

The contribution tax should be recognized as a component of net periodic pension cost in the period in which the contribution is made. ASC 715 does not directly address the accounting for this type of tax; however, ASC 715-60 contains guidance on the accounting for internal and external costs directly associated with administering a non-pension postretirement benefit plan.

ASC 715-60-35-90 states that several assumptions are required to be used in measuring an employer's postretirement health care obligation. According to ASC 715-60-35-93, the assumed per capita claims cost, one of the key assumptions affecting the amount and timing of future benefit payments, is the best estimate of the expected future cost of the benefits covered by the plan. ASC 715-60-35-98 further indicates that, if significant, the internal and external costs directly associated with administering the postretirement benefit plan is also considered a component of assumed per capita claims cost.

The employer contribution tax is not a direct cost of providing or administering the benefits as contemplated by ASC 715-60 because additional contributions can be avoided if the fair value of the plan assets increases, for example, and the plan becomes fully funded or overfunded. If the additional contributions can be avoided, the tax on these contributions is also avoidable. Therefore, the employer contribution tax should not affect the value of the benefit obligation or service cost, nor should the service cost be grossed up for the effects of the tax. PEB Corporation should account for the contribution tax on a "pay-as-you-go basis," and should include the tax as part of pension cost in the income statement.

3.4 *Foreign plans*

ASC 715 does not include special provisions applicable to pension arrangements outside the US. If those arrangements are in substance similar to pension plans in the US, they are subject to the provisions of ASC 715.

ASC 715 establishes standards of financial reporting and accounting for an employer that offers pension benefits to its employees in the form of a plan (as described at PEB 1.2). Pension benefits are defined in ASC 715-30-20 as "periodic (usually monthly) payments made pursuant to the terms of the pension plan to a person who has retired from employment or to that person's beneficiary."

ASC 715 applies to any arrangement (written or unwritten) that is similar in substance to a pension plan regardless of the form or means of financing.

3.4.1 *Foreign plans – foreign currency translation*

Companies with foreign pension plans where the local currency is the sponsor's functional currency need to account for foreign currency translations of pension and pension-related amounts in AOCI that are reclassified to net income.

ASC 830, *Foreign Currency Matters*, governs foreign currency translation. Refer to FSP 21 and our *Foreign currency* guide for guidance on foreign currency translation.

The guidance in ASC 830, *Foreign Currency*, predates the guidance in ASC 220, *Comprehensive Income*, and does not contain explicit guidance for the translation of amounts of other comprehensive income. Conceptually, AOCI can be likened to a separate category of retained earnings, but existing accounting guidance is unclear concerning the exchange rate that an enterprise would use to translate the activity in other comprehensive income for a particular period arising from the reclassification of amounts from AOCI into net income (see FX 5.3).

We believe there are two acceptable approaches to accounting for the foreign currency translation under ASC 830 when pension items are reclassified from AOCI to net income: (1) the historical rate approach and (2) the current rate approach. Selection of an approach is an accounting policy decision that should be applied consistently.

Although we believe both the historical rate approach (described in PEB 3.4.1.1) and the current rate approach (described in PEB 3.4.1.2) are acceptable under GAAP, we believe the historical rate approach is preferable. The arguments in support of the historical rate approach appear to be more conceptually sound (i.e., that AOCI is analogous to retained earnings and that reclassification adjustments are not "recognition" events). However, we acknowledge that the use of the historical rate approach gives rise to practical challenges in tracking the historical exchange rates associated with the AOCI amounts that are subject to reclassification to net income. We believe that a number of approaches (averaging, first-in, first-out, etc.) to simplify that process could be acceptable (see PEB 3.4.1.1).

3.4.1.1 Foreign plans — the historical rate approach

Under the historical rate approach, the amount of AOCI reclassified to net income each period would be translated from the functional currency of the foreign operation to the reporting currency at the historical exchange rate in effect at the time the prior service costs/credits, net gain or loss, and transition asset/obligation were initially recognized in OCI.

This approach is consistent with the principles in ASC 220, which defines OCI as revenues, expenses, gains, and losses that under GAAP are included in comprehensive income but excluded from net income. In the context of ASC 220, the initial recognition of pension-related amounts in OCI (i.e., the change in equity — or net assets —not arising from owner transactions), and not the reclassification adjustment, is the income recognition event that triggers translation into the reporting currency.

Based on this view, a reclassification from one component of income (OCI) to another (net income, and, in turn, retained earnings) is merely a recycling of amounts previously recognized and translated at the exchange rate in effect at the time those amounts were previously recognized. Therefore, the exchange rate used to translate an item recognized in OCI should not change when that item is later reclassified to net income.

This approach is also consistent with the treatment of retained earnings under ASC 830. The amount of net income that an entity reports each period is translated at the exchange rates in effect during that period. Once translated, that net income accumulates in retained earnings and is not subsequently retranslated at a current rate (i.e., retained earnings balances do not fluctuate from period to period based on changes in exchange rates). Similarly, amounts accumulated in AOCI are not retranslated. Therefore, AOCI amounts that are reclassified to net income should not be retranslated in the period they are recorded in net income.

Implementation and tracking—historical rate approach

Amounts in AOCI may be amortized and recognized in net periodic benefit expense over many future years. As a result, entities that adopt the historical rate approach will need to develop processes to track the foreign currency rates in effect in each period when prior service costs/credits and gains or losses are added to AOCI. Entities will also need to develop policies to determine the "layer" of AOCI that is reclassified into the income statement.

We believe that there are many reasonable approaches that entities might adopt to track the historical rates to be used when reclassifying amounts from AOCI to net income. For example, an entity might adopt a policy of reclassifying AOCI amortization on a FIFO basis, such that the first dollar of AOCI loss reclassified would be translated at the exchange rate in effect when the first dollar of loss was recognized in AOCI. Alternatively, an entity might adopt a policy of developing a blended historical average rate for all amounts in AOCI, and this rate would be updated each time new amounts are added to AOCI. Entities should elect an approach and consistently follow it.

3.4.1.2 Foreign plans — the current rate approach

Under the current rate approach, the amount of AOCI reclassified to net income each period would be translated from the functional currency of the foreign operation to the reporting currency at the current exchange rate in effect for the period in which the reclassification adjustment is reflected in net income (typically the average exchange rate for the period, since pension expense is reflected ratably over the period). As an underlying concept in ASC 830 is for the foreign operation to determine its components of income and expense using its functional currency, and then for those amounts to be translated to the reporting currency, this approach would reflect all components of the foreign operation's net pension costs at the same current period average rates.

When applying the current rate approach, differences arise from applying the historical rate to the pension-related AOCI balance and the current rate for the related amortization. Although there is no specific accounting guidance for the differences that arise when applying the current rate approach, we believe the difference should be recorded in the AOCI balance as part of the cumulative foreign currency translation adjustment (CTA) and tracked separate from the pension-related AOCI balances.

ASC 830-30-40-1 requires the CTA balance in AOCI to be recognized in income only upon sale of the foreign entity to which it relates or when actions result in the complete or substantially complete liquidation of the investment. As such, it would not be appropriate to amortize the difference that arises from applying the current rate approach into the income statement the way that the deferred gains/losses and prior service costs/credits are amortized out of AOCI and into income.

3.4.2 Foreign plans — foreign currency remeasurement

If an entity's local books of record are not maintained in its functional currency, ASC 830, *Foreign Currency Matters*, requires remeasurement into the functional currency prior to translation of the financial statements into the reporting currency (if different than the functional currency). See FX 5.4. The intent is to produce the same result as if the entity's records were initially maintained in the functional currency. As a result, entities with pension plans denominated in a currency that differs from their functional currency should remeasure the net pension plan asset or obligation into the functional currency. Fluctuations in exchange rates from one pension measurement date to the next will affect the overall change in the net pension asset or obligation (which is considered a foreign currency-denominated payable or receivable from the perspective of the functional currency) due to foreign exchange movements. However, existing guidance is not explicit on how to account for these foreign exchange movements on the net pension asset or obligation balances. We believe those exchange rate movements can either be reflected in current earnings consistent with the broad guidance in FX 5.4 (see PEB 3.4.2.2) or recognized as a component of experience gains and losses under ASC 715 (see PEB 3.4.2.1).

Under either approach, for purposes of measuring a pension obligation, the remeasurement should generally be performed using the current exchange rate in order to produce the same result as if the

entity's local books of record had initially been recorded in the functional currency. However, we are also aware that some entities perform this remeasurement using historical exchange rates because they consider pension obligations to be nonmonetary for purposes of ASC 830-10-45-18. This interpretation is based, in part, on analogy to ASC 255-10-55-1, which describes pension obligations (other than fixed amounts payable to a fund) as nonmonetary liabilities. We would not take exception to use of this historical rate interpretation for purposes of the remeasurement process.

3.4.2.1 Foreign currency remeasurement — OCI approach

Under ASC 830, it is necessary to recognize currently in income all exchange gains and losses from remeasurement of monetary assets and liabilities that are not denominated in the functional currency. However, ASC 830 does not include detailed guidance on determining whether an asset or liability is considered monetary or nonmonetary. To assist in making this determination for pension assets and obligations, proponents of this approach analogize to ASC 255-10-55-1, which lists many common balance sheet accounts and denotes each as being either monetary or nonmonetary. That listing includes accrued pension obligations and notes that fixed amounts payable to a pension fund are monetary and all other amounts are nonmonetary.

For the portion of the pension obligation that is nonmonetary, it is not appropriate to recognize exchange gains and losses from remeasurement in income under ASC 830. Instead, they should be treated as part of the adjustment to other comprehensive income under ASC 715.

In addition, the remeasurement of the net pension asset or obligation into the functional currency is not fundamentally different from a situation in which a US employer's pension plan holds foreign currency-denominated investments. In that situation, the employer would be required under ASC 715 to treat all movements in the value of the investment as net pension gain or loss in other comprehensive income, and would not be permitted to strip out any gain or loss associated with foreign currency movements and recognize those currently in income.

ASC 320-10-35-36 addresses an analogous situation with respect to available-for-sale (AFS) debt securities that are denominated in a foreign currency. The guidance addresses whether the entire change in the fair value of foreign currency-denominated AFS debt securities should be reported in other comprehensive income, or whether the portion attributable to changes in foreign exchange rates should be reported currently in earnings. The guidance states that the entire change in value of the securities, other than the amount recorded in the allowance for credit losses, should be reflected in other comprehensive income. The exchange rate movements are just one component of the overall change in fair value of the security in functional currency terms and, therefore, should be treated as similar to other changes in fair value.

3.4.2.2 Foreign currency remeasurement — income statement approach

ASC 830 does not provide explicit guidance on how to determine whether an asset or liability is considered monetary or nonmonetary. ASC 255-10-55-1 should not be considered binding in making this determination because this guidance was not written to interpret ASC 830 and did not amend ASC 830. Further, ASC 255-10-55-1 says that not all of the accrued pension obligation would be considered to be nonmonetary. This would seem to necessitate an allocation of the obligation between monetary and nonmonetary. Based on the definition of a monetary liability in ASC 255, the nonmonetary portion might reasonably be the portion of the obligation that was determined with reference to future salaries. That portion may be insignificant, depending on the demographics of the plan's participants. Accordingly, a practical approach is to consider the entire obligation to be monetary. This would be

consistent with IFRS. IAS 21, *The Effects of Changes in Foreign Exchange Rates*, explicitly states in IAS 21.16 that pensions and other employee benefits to be paid in cash are monetary items. There is no discussion in IAS 21 that suggests the need to bifurcate the item into monetary and nonmonetary portions.

It is reasonable to consider pension obligations as monetary liabilities under ASC 830 because:

- ASC 830 does not provide guidance for determining whether an asset or liability is monetary or nonmonetary
- IFRS is clear that pension and other employee benefits are monetary items
- There are practical issues associated with applying an ASC 255 approach

Thus, any foreign currency movements associated with the net pension asset or obligation should be reflected currently in income.

3.4.2.3 Foreign currency remeasurement – AOCI

Unlike the net pension asset or obligation, the AOCI balances associated with a pension plan sponsored by a foreign subsidiary whose functional currency is not the local currency should not be remeasured to current exchange rates each period. Rather, they should be maintained at the historical exchange rates as if the local books were maintained in the functional currency. These balances do not reflect amounts actually owed to participants (or due from the plan), but rather are just deferrals of historical activity. As remeasurement treats these amounts as if they were always recorded in the functional currency, there is no need to adjust the amounts recorded historically in that currency. Similarly, amortization of amounts out of AOCI into income should be calculated at the historical rates.

***Chapter 4:
Amendments, curtailments,
and settlements—updated
December 2023***

4.1 Overview of amendments, settlements, and curtailments chapter

This chapter discusses the employer's accounting for significant events related to defined benefit pension and postretirement benefit plans, including a plan amendment, settlement, or curtailment.

As described in PEB 1, throughout this guide we refer to "pension plans" to describe both pension and postretirement benefit plans, unless the context requires otherwise to highlight differences.

4.2 Significant events impacting pension plans

The concept of delayed recognition of many gains and losses arising during the ordinary operation of a pension plan is a foundational concept in pension accounting. In addition, ASC 715 provides for delayed recognition of the cost of retroactive plan amendments (prior service cost). However, there are limits to delayed recognition and the guidance prescribes the minimum amortization into earnings of the various types of gains, losses, and prior service costs. Importantly, in the context of significant events, ASC 715 provides for proportionate recognition of unrecognized balances when all or a portion of a plan's obligation is settled (a settlement), or if benefits under a plan are eliminated or significantly reduced (a curtailment).

Outside of significant events that affect ongoing benefit plans, unamortized net gains or losses and prior service cost/credit accumulated in other comprehensive income are only reclassified from accumulated other comprehensive income to net income when all of the following conditions are met:

- All pension obligations are settled
- Defined benefits are no longer earned under the plan and the plan is not replaced by another defined benefit plan
- There are no remaining plan assets
- The plan ceases to exist

4.2.1 Definition of a settlement

A settlement is a transaction that (a) is an irrevocable action, (b) relieves the employer (or plan) of primary responsibility for a pension obligation, and (c) eliminates significant risk related to the obligation and the assets used to effect the settlement. For example, a pension benefit obligation may be settled by making lump-sum cash payments to participants, or by purchasing nonparticipating (and certain participating) annuity contracts for vested benefits. A settlement can also occur by transferring certain plan assets and obligations to the buyer of a part of a business. Thus, the employer's risk (e.g., mortality and investment risk) is transferred to the participant, insurer, or acquirer depending on the form of discharge, and the possibility of the employer experiencing future gains or losses related to that obligation and to the assets used to effect the settlement is eliminated. Settlements are discussed further in PEB 4.3.

4.2.2 **Definition of a curtailment**

A curtailment is an event that either (a) significantly reduces the expected years of future service of current employees (for example, employee terminations) or (b) eliminates the accrual of defined benefits for some or all future services of a significant number of employees (for example, a negative plan amendment). Examples of such situations are plant closings or partial shutdowns, whereby employees' service is terminated earlier than expected. Another example would be the termination of a pension plan. The suspension of a plan (i.e., a plan "freeze") pursuant to which employees no longer earn additional defined benefits for future service to the employer, but when future service counts toward vesting of benefits accumulated based on past service, may or may not result in a curtailment depending on the nature of the specific terms of the freeze. See PEB 4.4.3 for further guidance on the accounting for a plan freeze.

The disposal of part of a business, even if not resulting in a *significant* reduction in expected years of future service, may still require accounting similar to a curtailment. ASC 715-30-55-134 indicates that when a disposal does not result in an actual curtailment, the effects of the reduction in workforce on the plan's obligation should be measured in the same manner as a curtailment (sometimes referred to as "curtailment-like" accounting) for purposes of determining the gain or loss on the disposal.

Judgment will be required to determine what constitutes a significant portion of expected years of future service or a significant number of employees; ASC 715 does not provide quantitative guidelines. In practice, a reduction in future years of service of 10% or greater, or elimination of the accrual of defined benefits for some or all of the future services of 10% or more of the employees, are generally considered to be significant; reductions of 5% or less generally would not be considered significant. Reductions between 5 and 10% should be evaluated based on specific facts and circumstances. Importantly, the significance determination for this purpose is based on plan-related employee information, not on the potential impact of the event on net income. As the unit of account for pension accounting is the plan, the significance determination should be evaluated separately for each plan.

Judgment may also be required when assessing whether layoffs are temporary. A curtailment only occurs when it is no longer probable that the specific employees will be rehired. For example, if a significant number of workers are furloughed for a period of months and others are hired to replace them, a curtailment has occurred. However, if the reporting entity has not replaced the workers, and, based on present intentions, it is reasonable to expect the furloughed employees to return to the work force, a curtailment has not occurred. A temporary layoff may still result in a curtailment if it is long enough in duration or affects enough of the plan participants that it significantly reduces the expected years of future service of present employees covered by the pension plan.

Curtailments are discussed further in PEB 4.4.

4.2.3 **Definition of a plan amendment**

Although most of the accounting for "significant events" revolves around settlements and curtailments, a plan amendment may also be considered a significant event. A plan amendment is a change in the terms of an existing plan, or, in some cases, the initiation of a new plan. Plan amendments can either increase benefits—a positive plan amendment resulting in prior service cost—or reduce or eliminate benefits—a negative plan amendment. In some cases, a plan amendment may even affect benefits attributed to years of service already rendered.

In some cases, plan amendments can lead to curtailments, but in other cases, they are just a significant event requiring an interim remeasurement of the plan. Plan amendments are discussed further in PEB 4.6.

4.3 Settlement accounting

Settlement of all or a portion of an employer's projected benefit obligation results in the elimination of significant risks related to the portion of the pension obligation settled and the assets transferred. Thus, settlement also results in the ultimate realization of gains or losses (including any remaining transition obligation or asset) previously reported as unrealized in accumulated other comprehensive income. Because a settlement requires a transfer of assets and legal satisfaction of all or the respective portion of the benefit obligation, a separate concurrent or subsequent decision to continue the plan or adopt another defined benefit plan does not affect the gain or loss realization of the current settlement.

4.3.1 Settlement mechanics

Settlements can be accomplished in a number of ways, including, but not limited to:

- Lump-sum payment to employees (either as the normal form of benefit payment under the plan upon termination or retirement, or as a special offer),
- Purchase of nonparticipating annuity contracts,
- Purchase of participating annuity contracts, in some instances, or
- Transfer of plan assets and obligations to another entity in connection with the sale of a business.

The value of the payment or transfer of plan assets required to settle a pension obligation may indicate that the discount rate and other assumptions as of the most recent measurement date for ASC 715 purposes was not reflective of the actual discount rate and other assumptions upon which the pension obligation could be settled in the marketplace. Consequently, ASC 715 requires that the entire pension obligation (not just the portion being settled) and plan assets to be remeasured at their current value as of the date the settlement, prior to accounting for the settlement transaction. The results of that remeasurement—the increase or decrease in the pension benefit obligation and plan assets—increases or decreases the net unamortized actuarial gain or loss that will be subject to the guidance for settlement accounting. See PEB 4.3.5 through PEB 4.3.6 for further details about settlement accounting.

4.3.2 Settlement timing

A settlement is recognized when the event of settlement occurs, which is the point at which:

- the employer's action is irrevocable,
- the employer (or plan) is relieved of primary responsibility for the pension benefit obligation, and
- significant risk related to the obligation and the assets used to effect the settlement is eliminated.

A settlement generally occurs when the employer (or plan) pays the premium to purchase an annuity contract, makes a lump-sum cash distribution to employees to settle the obligation, or closes on the sale of a business (assuming the three settlement criteria are met based on the terms of the sale).

When settlement is to be achieved by use of an annuity contract, all elements of the contract should be irrevocable and not subject to any additional actions, particularly regulatory approvals by the Department of Labor, IRS, or Pension Benefit Guaranty Corporation. Otherwise, a contract, by its terms, may be modified. However, there are instances when an annuity is purchased, but the annuity price may be subject to adjustment to reflect finalization of the participant data. We believe that the settlement may be recognized upon the purchase as long as the three criteria for settlement are met (the action is irrevocable, primary responsibility for the obligation is relieved, and significant risk related to the obligation and assets effecting the settlement are eliminated).

4.3.3 Service cost and interest cost threshold

Through the normal operation of a plan, some beneficiaries may be paid in a lump sum at the conclusion of employment. Technically, that “normal” benefit payment is a settlement. However, in accordance with ASC 715-30-35-82, settlement accounting is not required for individual lump sum payouts if the cost (e.g., the lump sum payment or price of the annuity contract) of all settlements in a year is less than or equal to the sum of the service cost and interest cost components of net periodic pension cost for the plan for the year (see PEB 3.2 for elements of pension cost). Notwithstanding that exception, a reporting entity may adopt a policy of recognizing the gain/loss on all settlements when they occur, or a reporting entity may adopt a policy to recognize the gain/loss on all settlements if the cost of the settlements exceeds some other defined threshold less than the sum of service and interest cost. Whichever policy is adopted should be applied consistently from year to year.

If an employer determines that it is probable that during the fiscal year the criteria for settlement accounting will be met, the employer should recognize settlements immediately when they occur, rather than wait for the threshold to be met. In practice, it may be acceptable to perform the settlement calculations as of the end of each quarter in situations when lump sums are paid throughout the year as a “normal” form of benefit payment.

If, at the beginning of the year, an employer determines that it is not probable that the criteria for recognition of settlement accounting will be met during the fiscal year, but then later in the year the cost of settlements exceed the threshold for settlement accounting, then the employer should recognize the gain or loss for all settlements that have occurred (not just those that exceed the threshold) in the period when it becomes probable that the threshold will be met, consistent with the guidance in ASC 715-30-55-168 and the guidance in ASC 250 for a change in an accounting estimate.

4.3.4 Settlement cost

For purposes of applying the thresholds described in PEB 4.3.3, the “cost” of settlements is determined in accordance with the guidance in ASC 715-30-35-83.

ASC 715-30-35-83

The cost of a settlement is determined as follows for each of the different settlement types:

- a. For a cash settlement, the amount of cash paid to employees

- b. For a settlement using nonparticipating annuity contracts, the cost of the contracts
- c. For a settlement using participating annuity contracts, the cost of the contracts less the amount attributed to the participation rights. See paragraph 715-30-35-57.

Because of the nature of OPEB obligations, settlements are unusual in OPEB plans. Typically, settlements of OPEB obligations arise only from the sale of a business when the buyer assumes the OPEB obligation for the employees of the sold component (see Example 3 in ASC 715-60-55-130 through ASC 715-60-55-134). A key characteristic of a settlement is the transfer of cash or plan assets to a third party (e.g., employer pays lump sums to participants in exchange for the participant's right to receive retiree medical benefits). Accordingly, a plan amendment that merely eliminates OPEB benefits for a subset of the plan's population is not a settlement; it would be a negative plan amendment (see PEB 4.6.1).

4.3.5 Full settlement of a pension plan

A full settlement of the entire plan can occur only when the accumulated and projected benefit obligations (PBO) are equal (i.e., a flat-benefit or frozen plan). It is unlikely that an annuity contract could be purchased to settle the entire projected benefit obligation for a pay-related plan when there are still active employees because the insurer would be assuming a liability for benefits based on unknown salary progression. However, the plan may first be frozen, eliminating the salary progression component of the PBO, which generally would result in a curtailment when the freeze is adopted. See PEB 4.4.3.1 for information on hard freezes. Once the salary progression component of the PBO is eliminated, annuity contracts could be purchased to fully settle the PBO.

In a full settlement, the employer recognizes the balance of any unamortized net gain or loss and any unamortized transition asset arising from adoption of ASC 715.

4.3.6 Partial settlement of a pension plan

When only a portion of the benefit obligation is settled, the employer should recognize in income a pro rata portion of the aggregate unamortized net gain or loss and a pro rata portion of the unamortized transition asset determined upon adoption of ASC 715. The pro rata factor is based on the percentage reduction in the projected benefit obligation from the settlement. The unamortized gain or loss subject to recognition is for the entire plan (not just the portion being settled) and includes the effect of the remeasurement of the entire plan assets and pension obligation immediately prior to settlement. Note that prior service cost (including any transition obligation) does not enter into the calculated gain or loss on settlement; it continues to be amortized over the estimated future service period of the employees, assuming those employees are expected to provide future service to the employer pursuant to the continuing pension plan.

As described in PEB 4.3.3, the gain or loss on a partial settlement of the projected benefit obligation need not be recognized when the cost of all settlements in the year equals or is less than the sum of the current year's service and interest cost for that particular plan. Accordingly, the employer may view the action (e.g., the payment of lump-sum benefits) as a normal part of operating the plan, and may elect not to recognize a portion of the gains and losses in connection with each lump-sum payment. Other employers who purchase annuity contracts for employees upon retirement may view the action as a settlement and elect to recognize a portion of the gains and losses in connection with each

transaction. The approach taken by the employer is an accounting policy election and should be consistently followed.

In general, a partial settlement refers to a transaction where the employer settles the full amount of its obligation for vested benefits with respect to a portion of the plan's participants so that significant risks related to the obligation for those participants is eliminated. On the other hand, a settlement of only a portion of the obligation for a given participant or group of participants' vested benefits where the employer remains liable for the balance of the benefit obligation for those same participants' vested benefits may not constitute a settlement because it does not eliminate significant risks related to the pension benefit obligation for the participants as described in ASC 715-30-55-149.

4.3.7 *Annuity contracts that do not result in settlement*

The critical factor in determining whether settlement has occurred is the transfer of risk. Transfer of risk within a controlled group does not constitute settlement; risk transferred outside the group does. Risk has also not been transferred if there is reasonable doubt that the insurer will meet its obligations under an annuity contract. Therefore, the purchase of the contract from such an insurer does not constitute settlement (see PEB 2.6.4.4).

Annuities purchased from an insurance company controlled by the employer do not constitute a settlement since the risk has not been eliminated, but merely transferred within the group. When annuities are purchased from an affiliated insurance company not controlled by the employer (e.g., subsidiary A purchases an annuity from subsidiary B), settlement accounting should be reflected in the separate reporting entity financial statements of the employer; however, for consolidated financial statement purposes, no settlement is deemed to have occurred.

If a nonparticipating annuity contract is purchased from an insurance company that is an investee not controlled by the employer, the entire settlement gain or loss should be recognized by the employer if all settlement criteria are met.

ASC 715-30-35-89 through ASC 715-30-35-91 address the accounting for pension benefits paid by an employer after an insurance company fails to meet its obligation to pay annuity benefits. The employer should recognize a loss at the time the deficiency was assumed if any gain was recognized on the original settlement. The loss recognized would be the lesser of (a) any gain recognized on the original settlement and (b) the amount of the benefit obligation assumed by the employer. Any excess of the obligation assumed by the employer over the loss recognized should be accounted for as a plan amendment or plan initiation (i.e., prior service cost).

4.3.7.1 *Participating annuity contracts*

A participating annuity contract is one in which the purchaser participates, by way of a dividend, in the insurer's experience subsequent to purchasing the contract. The participation may relate to a return on investment better or worse than anticipated, or to mortality or other actuarial experience deviating from expectations. The insurer's experience will affect the dividend amount. Thus, the purchaser is still exposed, to some degree, to the same risks and rewards related to future experience that existed prior to purchasing the contract.

If the substance of the participating annuity contract causes the employer (or plan) to remain subject to more than insignificant risks and rewards associated with the pension benefit obligation or plan

assets used to purchase the annuity contract, the purchase of the participating annuity contract does not constitute a settlement.

When the purchaser of the participating annuity contract does not retain significant risk, a settlement has occurred. However, because of the participation interest, ASC 715 requires that a net gain (but not a net loss) first be reduced by the cost of the participation right before calculating and recognizing a settlement gain or loss. The cost of the participation right, which is measured as the difference between the cost of the participating annuity contract and the estimated cost of a nonparticipating annuity contract providing the same benefit payment stream, represents a plan asset. Dividends on the annuity contract are, therefore, included in the return on plan assets.

In ASC 715-30-55-157, the FASB took the view that there are no specific quantitative thresholds for assessing whether a participation interest is “significant.” In practice, if the value of the participation right exceeds 10% of the premium for a nonparticipating annuity contract, the participation interest is generally considered significant and settlement accounting would be precluded.

One of the criteria required for a settlement is that the transaction “eliminates significant risks related to the obligation and the assets used to effect the settlement.” Further, if the employer remains subject to all or most of the risks and rewards associated with the benefit obligation covered or the assets transferred to the insurance company, the purchase of the contract does not constitute a settlement. Thus, when the participation right is significant, the employer or plan has not met the criteria for settlement accounting, and the participating annuity contracts should be accounted for as plan assets in their entirety.

For purposes of calculating the premium differential between a participating and nonparticipating annuity contract, it is necessary to obtain a bona fide written bid for a nonparticipating annuity from the same insurance company being considered for purchase of the participating annuity.

4.3.8 Pension buy-in arrangements

A pension buy-in arrangement is similar to a traditional nonparticipating annuity (also known as a buy-out, see PEB 4.3.2), when a plan transfers future responsibility for some portion of promised employee retirement benefits to an insurance company. Under the buy-in arrangement, however, the benefit obligation is not transferred to the insurer. Instead, the plan remains responsible for paying the benefits, but purchases a contract from the insurer that generates returns designed to equal all future designated contractual benefits payments to covered participants.

While the purchase of a traditional buy-out annuity contract generally triggers settlement accounting, the purchase of a buy-in contract typically results in no settlement accounting because the employer has not been relieved of primary responsibility for the benefit obligation. The buy-in contract is effectively an investment by which the plan can receive payments from the insurer corresponding to the benefits due to the covered participants, but ultimately the primary obligation to pay benefits has not been transferred. In the event the insurer is unable to make payment under the buy-in (for example, due to bankruptcy), the employer would still be obligated to provide the promised retirement benefits.

4.3.8.1 Ongoing accounting for the buy-in asset

Since settlement accounting is not applied and the contract is not considered an annuity, the buy-in contract represents a plan asset. Plan assets are remeasured to fair value at each measurement date. In

determining the appropriate fair value for buy-in assets, we believe the accounting literature supports the following two approaches.

□ Fair value

The fair value of the buy-in contract is directly measured at each plan measurement date. Initially, this fair value would be based on the purchase price of the contract. In subsequent measurements, fair value would be estimated based on the contract's exit price (the amount at which the contract could be sold to a willing third-party buyer) pursuant to ASC 820, *Fair Value Measurements and Disclosures*.

Estimating the exit price value would likely include similar considerations as were used by the insurer when originally pricing the buy-in contract, including assumptions about expected mortality and current discount rates. The current discount rate would likely reflect the same rate that would be used by an insurer in determining the current price of a buy-out annuity, and generally be consistent with the Pension Benefit Guaranty Corporation (PBGC) published rates for single-employer pension annuities (although some adjustment may be necessary to take into account any lag relative to when the American Council of Life Insurers gathered information from large insurance companies that was considered by the PBGC in developing the published rates).

□ Contract value

ASC 715-30-35-60 addresses the valuation of insurance contracts that are not annuities. This guidance notes that such contracts should be reflected at fair value, but indicates that a stated cash surrender value, if there is one, can be used as a proxy for fair value. For many insurance contracts held in a pension trust, cash surrender value is considered to reflect fair value and thus is used for reporting purposes. In the case of buy-in arrangements, however, while a cash-out formula may exist, this value may incorporate a significant termination penalty. Based on this, while use of the surrender value would be acceptable, we believe it is not required since the surrender value may not be a good proxy for fair value due to the penalty provision.

4.3.8.2 Ongoing accounting for the buy-in portion of the PBO

Because the buy-in contract does not constitute a settlement, it may be appropriate to consider the pricing of the buy-in contract in measuring the obligation associated with the relevant participants. We believe the accounting literature supports the following two approaches.

□ Disregard the buy-in contract

Since the buy-in contract does not constitute a settlement, the benefit obligation covered by the buy-in contract would continue to be measured with the traditional discount rate and mortality assumptions used by the employer for the balance of the plan. Because the discount rate used in measuring the benefit obligation is based on yields of high quality corporate bonds, the value of the buy-in contract asset will likely exceed the value of the related benefit obligation. While the asset and obligation would be based on similar participant demographics, the discount rate implicit in the buy-in contract would likely be lower (as discussed in PEB 4.3.8.1, reflective of PBGC annuity rates). In addition, the value of the buy-in contract may be based on different mortality assumptions.

□ Buy-in contract value

The value of the benefit obligation associated with the participants covered by the contract would be set equal to the fair value of the buy-in contract at each measurement date. This approach is considered supportable because the guidance on establishing discount rates in ASC 715-30-35-43 calls for the rate at which the obligation could be effectively settled.

While purchase of the buy-in contract does not result in an actual settlement, it can be viewed as financially equivalent to an effective settlement since the majority of the risks and rewards associated with the benefit obligation and related assets have been eliminated (especially if there has been no downgrade in the ratings of the insurance company that wrote the contract). As a result, the discount rate used in pricing the buy-in contract also represents the rate at which the obligation can be effectively settled.

If this alternative is followed, an actuarial loss will arise at the next plan measurement date following the purchase of the buy-in contract since the benefit obligation will be increased to match the purchase price of the buy-in contract. For example, if the benefit obligation was \$100 before purchasing a buy-in contract for \$105, the obligation would be remeasured to \$105, and a \$5 actuarial loss would be reflected in accumulated other comprehensive income.

After this initial remeasurement, the fair value of the buy-in asset and the associated benefit obligation should be equal, other than due to changes in the credit quality of the insurer. The expected return on plan assets related to the buy-in contract and the related interest cost on the associated benefit obligation recognized as components of net periodic benefit cost should be equal and offsetting. If the buy-in contract covers only a portion of the plan obligation and participants, determination of the appropriate discount rate and expected return on assets may be more complex.

4.3.9 Pension asset reversions

ERISA generally precludes an employer from withdrawing excess plan assets from a pension plan without first settling the obligation. Limited exceptions exist for the transfer of excess plan assets to an ESOP or a postretirement medical benefit plan. However, in some jurisdictions (e.g., Canada and the United Kingdom), employers may withdraw excess funds from a defined benefit pension trust when certain conditions are met. As noted in ASC 715-30-55-6, if an employer merely withdraws excess plan assets (cash) from a pension plan but is not required to settle the pension obligation as part of the asset reversion, no gain or loss should be recognized. The withdrawal would be recorded as a negative contribution.

4.4 Curtailment accounting

The effect of a curtailment can be either a gain or a loss. The gain or loss is the sum of two elements. The first element is the prior service cost accumulated in other comprehensive income associated with years of service no longer expected to be rendered. For purposes of the curtailment calculation, prior service cost includes (a) the cost of retroactive plan amendments and (b) any remaining transition obligation (see PEB 4.4.1). The second element is the change in the projected benefit obligation, in some cases offset by the amount of unrecognized gains and losses (see PEB 4.4.2.2).

Depending on whether the combined effect of these measurements is a gain or loss affects the timing of recognition. A net curtailment loss is recorded when it is probable that a curtailment will occur and the effect of the curtailment is reasonably estimable. A net curtailment gain is deferred until realized (e.g., when the plan amendment is adopted or the employee terminations occur). If an employer cannot unilaterally terminate its plan because PBGC or other oversight entity approval is required, the net gain should be recognized when approval is received rather than when the amendment is adopted. Refer to PEB 4.4.4 for further discussion about the timing of recognition for curtailments. Also see several illustrations in ASC 715-30-55 that demonstrate curtailment accounting.

See PEB 2.7.2 for a discussion of when to remeasure the plan's obligations and assets in connection with a curtailment.

4.4.1 Prior service cost to be recognized in a curtailment

The theory behind recognition of prior service cost when a curtailment occurs is because the work force has been reduced or the accrual of benefits for some or all future services has been eliminated. Therefore, the employer will not realize all of the expected future economic benefits of prior plan amendments. Consequently, the unamortized prior service cost relating to the affected employees or years of service should be recognized immediately.

The prior service cost to be recognized is computed as follows:

$$\frac{\text{Reduction in expected years of future service}}{\text{Expected years of future service (prior to curtailment)}} \times \text{Prior service cost (including transition obligation) (prior to curtailment)}$$

The determination of the percentage reduction should only include the expected future service years for those active participants who were included in the original determination of the prior service cost amortization. For example, if an employer's pension plan includes both union and salaried employees, and a prior plan amendment affecting only salaried employees was being amortized over the expected future years of service of the salaried employees, a curtailment that affects only the union employees would not result in immediate recognition of the prior service cost associated with the salaried employees. Any existing prior service cost that is not immediately recognized due to the curtailment is generally amortized over the remainder of the original amortization period.

A curtailment may result in all or almost all of a plan's participants becoming inactive, in which case prior service cost amortization would subsequently be based on the remaining life expectancy of the inactive participants. See PEB 3.2.6.4 for further discussion of this topic.

Acceleration of negative prior service cost in a curtailment is handled in a similar fashion. See further discussion of negative plan amendments in PEB 4.6.1).

4.4.2 Net gain/loss from change in projected benefit obligation

Calculating the second element of gain or loss from a curtailment involves two steps: (1) calculate the change in the projected benefit obligation arising from the event causing the curtailment and (2) compare that change to the unrecognized net gain or loss accumulated in other comprehensive income.

4.4.2.1 *Change in projected benefit obligation*

The projected benefit obligation should first be remeasured using the current discount rate and reflect any other changes in assumptions or the plan's participant population, if significant, before considering the event causing the curtailment. Any gain or loss arising on that remeasurement will become part of the unrecognized net gain or loss that will be used in step 2 of the calculation.

A curtailment may cause the projected benefit obligation to decrease (a gain) or increase (a loss). For example, in a plan when pension benefits are based on final compensation levels, a curtailment caused by a reduction in force will generally reduce the projected benefit obligation because projected future salary increases will no longer materialize. On the other hand, if employees' services are terminated, acceptance of early retirement benefits provided by the plan may exceed estimated rates of acceptance anticipated prior to the curtailment. If the benefits are not actuarially reduced for other reasons, the projected benefit obligation will increase. In this type of arrangement, usually called "subsidized early retirement benefits," the actuarial present value of early retirement benefits exceeds the actuarial present value of normal retirement benefits (at current salary levels). The remeasurement of the projected benefit obligation should reflect the net effect on the projected benefit obligation of all of the elements of the curtailment, both the reductions and increases, as applicable.

4.4.2.2 *Comparison of change in PBO to unrecognized gain/loss*

Once the change in the projected benefit obligation arising from the curtailment event is determined, it is evaluated for potential recognition in the income statement by comparing it against the unamortized gain or loss in AOCI, as follows (for this purpose, any remaining transition asset is considered a gain):

		Effect of curtailment on PBO	
		Decrease	Increase
Net gain/loss in AOCI pre-curtailment	Loss	<input type="checkbox"/> Potential curtailment gain <input type="checkbox"/> Offset against net loss. <input type="checkbox"/> Excess, if any, recognized as curtailment gain	<input type="checkbox"/> Curtailment loss <input type="checkbox"/> Recognized in full
	Gain	<input type="checkbox"/> Curtailment gain <input type="checkbox"/> Recognized in full	<input type="checkbox"/> Potential curtailment loss <input type="checkbox"/> Offset against net gain <input type="checkbox"/> Excess, if any, recognized as curtailment loss

4.4.3 *Pension plan freezes*

Plan freezes occur when an employer amends the plan to eliminate benefit accruals related to future service. An amendment to a defined benefit pension plan to permanently eliminate all future benefit accruals is considered a "hard freeze." In other situations, employers may eliminate benefits for future service, but continue to consider salary increases in determining the defined benefit related to past service, which is considered a "soft freeze." Whether the plan freeze results in a curtailment depends in part on the type of freeze. It also depends on whether the freeze is temporary (for example, an employer may choose to suspend benefit accruals only until the employer's financial condition

improves) or permanent (the employer may amend the plan to permanently eliminate all future benefit accruals). In other situations, the employer may announce a freeze that will become effective in a future year, with additional benefits continuing to accrue up to the effective date of the freeze.

4.4.3.1 *Hard pension plan freeze*

Since a curtailment occurs when an event eliminates the accrual of defined benefits for some or all future service for a significant number of employees, a permanent hard freeze will generally require curtailment accounting.

4.4.3.2 *Soft pension plan freeze*

ASC 715 does not provide guidance on whether a soft freeze should result in a curtailment; specifically, it does not address whether the increase in the accumulated benefit obligation as a result of future salary increases constitutes the accrual of benefits for future service. As such, employers may elect an accounting policy as to whether a soft freeze constitutes the elimination of the accrual of defined benefits.

If an employer adopts a policy to consider a soft freeze as a curtailment, it would also need to evaluate whether a soft freeze meets the significance threshold described in PEB 4.2.2 for curtailment accounting. Because participants' accrued benefits continue to increase in relation to future salary levels, a soft freeze will generally not result in a change in the PBO. Thus, the only effect of curtailment accounting for a soft freeze is the immediate recognition of the relevant portion of unamortized prior service costs.

If the employer adopts a policy to consider a soft freeze merely a modification to the benefit arrangement (i.e., view the right to continued salary increases as continuing to accrue benefits for future services), curtailment accounting would not apply, and the existing balance of unamortized prior service costs would continue to be amortized over its existing amortization period. In addition, because the PBO has not changed, there would be no prior service cost or credit arising from the plan amendment that gave rise to the soft freeze. The only immediate accounting impact would be a reduction in service cost, but only prospectively from the next measurement date, which, if not considered a curtailment or significant event, would not occur until the next annual remeasurement.

4.4.3.3 *Temporary pension plan freeze*

A temporary freeze may require curtailment accounting if the freeze eliminates the accrual of defined benefits for some or all future service for a significant number of employees. ASC 715-30-55-171 and ASC 715-30-55-172 provide that even a temporary suspension of benefit accruals would meet the definition of a curtailment if the suspension eliminates significant pension accruals for some or all of present employees' future service. The probable duration of a temporary freeze should be considered when determining whether the event is significant (see PEB 4.2.2) and, thus, requires curtailment accounting. If the estimated duration of the freeze is a range of years and no single duration in that range is a better estimate than any other, then the determination of significance should be based on the estimated duration of the freeze within the range that results in the minimum net gain or loss from curtailment accounting.

4.4.3.4 *Post-freeze pension accounting*

Once an amendment that results in a hard freeze is adopted, pension benefits will cease to accrue as of the effective date of the freeze. If an employer considers all or almost all of the participants to be "inactive" (based on the policy choice described in PEB 3.2.7.2 because they are no longer earning additional defined benefits under the plan as a result of the hard freeze, the employer may change the period over which gains and losses are subsequently amortized and the period over which any prior service credit that may have arisen from the plan amendment that led to the freeze is amortized. At the next measurement date after the effective date of the hard freeze, employers could begin to use the new amortization period equal to the average remaining life expectancy of the participants instead of the average remaining service period.

Once a plan is frozen, such that the accrual of future defined benefits cease, no further curtailments can occur because the definition of a curtailment is the elimination of the accrual of benefits for future service. For example, the layoff of employees who participate in a frozen plan may lead to an earlier than expected payment of benefits by the plan (e.g., lump sum payouts, early retirements), which could result in an increase in the present value of the PBO. Nevertheless, because the plan is already frozen and no benefits are being earned, curtailment accounting would not apply and the increase in the PBO would be treated as an actuarial loss at the next remeasurement.

Figure PEB 4-1 summarizes the appropriate accounting for pension plan freezes

Figure PEB 4-1
Accounting for pension plan freezes

Type of freeze	Curtailment	Post-freeze amortization period
Hard freeze – Immediately effective	Yes	Remaining life expectancy
Hard freeze – Delayed effective date	Yes	Prior to effective date: remaining service period Next remeasurement after effective date: Remaining life expectancy
Temporary freeze	Maybe, depending on whether the probable duration of the freeze results in a significant reduction in future years of service for which benefits are earned	Remaining service period
Soft freeze – Immediately effective	Depends on policy; see PEB 4.4.3.2	Curtailment: remaining life expectancy No curtailment: remaining service period

Type of freeze	Curtailment	Post-freeze amortization period
Soft freeze – Delayed effective date	Depends on policy; see PEB 4.4.3.2	Curtailment: <ul style="list-style-type: none"> <li data-bbox="1105 354 1446 413">□ Prior to effective date: remaining service period <li data-bbox="1105 432 1503 520">□ Next remeasurement after effective date: remaining life expectancy No curtailment: remaining service period

4.4.4 *Timing of recognition of curtailments*

The timing of recognition of a curtailment depends on the reason for the curtailment and will differ if it is the result of a plan termination or amendment versus the result of employee terminations. In any circumstance, however, a curtailment is a "significant event" and significant events require a remeasurement of plan obligations and assets. Thus, immediately prior to measuring the effect of a curtailment, the projected benefit obligation and fair value of plan assets should be remeasured based on the pre-existing plan terms and demographics (i.e., prior to curtailment). In performing such remeasurements, current discount rates and the fair value of plan assets should be obtained as of the remeasurement date, and other assumptions and significant changes in the plan's population prior to the curtailment should be reconsidered as of that date. That remeasurement will change the amount of gains and losses in accumulated other comprehensive income, which will be relevant when the effects of the curtailment event itself are measured.

4.4.4.1 *Curtailment resulting from plan termination or amendment*

When a curtailment is a result of a change to the plan—a plan amendment or, in the more extreme case, a plan termination—the gain or loss is generally recognized at the date the amendment is adopted. ASC 715-30-55-184 indicates that the effects of a curtailment that will result in a net gain should be measured and recognized when an employer amends its plan, and not when the plan termination or freeze is effective. Thus, the timing of recognition in these situations is generally the same regardless of whether the curtailment results in a gain or loss. Even if the result (or expected result) of the curtailment is a loss, it should not be recognized prior to when the employer actually amends the plan, even if it is probable that the plan will be amended. The date a plan amendment is adopted often precedes the date at which the amendment will become effective, which sometimes is months or even years later. See PEB 4.6.2 for additional discussion of the timing of plan amendments.

4.4.4.2 *Curtailments resulting from employee terminations*

When a curtailment is a result of employee terminations (e.g., closing of a plant or a significant reduction in force), the timing of recognition depends on whether the curtailment will result in a gain or a loss. A curtailment loss should be recognized when it is probable that a curtailment will occur and the amount of the loss is reasonably estimable. Conversely, recognition of a curtailment gain should be deferred until the related employees terminate. Thus, even for a single restructuring event, curtailments in multiple plans may be recognized in different periods depending on the circumstances of each plan.

At the date a decision is made to terminate employees, an estimate should be made of whether there will be a curtailment gain or loss. If the estimate indicates a curtailment loss is expected, measurement and recognition of the loss should occur when the curtailment is probable of occurring and its effects are reasonably estimable. This often precedes the period in which the actual employee terminations occur. For example, if a curtailment will result from a disposal of a component of an entity, a curtailment loss would be measured and recognized in earnings when the disposal is probable of occurring and the curtailment effects are reasonably estimable. The assessment of probable in this context is independent of the assessment of whether any related property, plant, and equipment has met all the criteria to be classified as held for sale under ASC 360-10-45-9, *Property, Plant and Equipment*. However, if the curtailment is expected to result in a gain, measurement and recognition of the gain would be deferred until the employees are terminated (typically when the disposal occurs).

4.4.4.3 Methods of recognizing curtailment gains

When a gain is expected from a curtailment resulting from employee terminations, it should not be recognized until those employees terminate. In some situations, employees may be terminated over a period of time pursuant to a single overall restructuring program, and those aggregate terminations may be sufficient to result in a curtailment.

Employers can elect to recognize the curtailment gains in this situation in one of two ways:

- a) measure and record the curtailment gain based on the cumulative terminations at the end of each interim reporting period, even if the terminations up to that date would not by themselves meet the significance threshold for a curtailment event, or
- b) postpone any curtailment gain recognition until the aggregate terminations result in a sufficient reduction in expected years of future service to meet the significance threshold.

Whichever approach is selected would constitute an accounting policy election and should be followed consistently for future termination events.

Example PEB 4-1 addresses the timing of recognition of curtailment gains and losses related to a plan amendment when the full impact of the curtailment may not be known until a later period.

EXAMPLE PEB 4-1

Recognition of curtailment gains and losses when the impact of the curtailment is not yet known

On October 31, 20X1, PEB Corporation's board of directors approved freezing PEB Corporation's defined benefit plan effective immediately. In conjunction with freezing the plan, affected employees will need to make certain one-time irrevocable elections regarding matters such as early retirement, joint and survivor annuities, and the treatment of a companion profit sharing defined contribution account that the reporting entity allows to be annuitized through the pension plan. The participants of the plan are to be provided with detailed information about their elections during a specified time period in early 20X2 and will need to make their final elections by June 30, 20X2. PEB Corporation's action to freeze the pension plan eliminates the accrual of defined benefits for future years of service and, thus, results in a curtailment of the plan.

When should PEB Corporation record the curtailment?

Analysis

The curtailment gain or loss should be calculated in the fourth quarter of 20X1 using management's best estimate about how the PBO will be affected by the plan changes and employee elections. If the final impact of the employee elections in June 20X2 is different from their original estimates, these differences should be treated as an actuarial gain or loss at the next measurement date and accounted for in accordance with PEB Corporation's policy (i.e., amortization or immediate recognition).

PEB Corporation should not wait until the employee elections are finalized in June 20x2 to record the curtailment gain or loss, nor should the amount of curtailment gain or loss recognized in 20x1 be adjusted when the final elections are known in 20X2. The rationale for this approach is that the effects of the curtailment should be recognized when the amendment is effective. Even though the exact measurement of the ultimate effect will depend on the employee elections, the need to estimate those elections is no different than many of the actuarial assumptions developed during the normal measurement of the plan.

Example PEB 4-2 illustrates the accounting for a net curtailment gain in one plan and a net curtailment loss in another plan as a result of the same restructuring event.

EXAMPLE PEB 4-2

Restructuring event causes a net curtailment gain in one plan and a net curtailment loss in another plan

On December 31, 20X1, PEB Corporation decided to restructure its operations, resulting in the layoff of 10,000 employees. The employees that will be affected by the layoff are covered by two separate pension plans, one for hourly workers (Hourly Plan) and one for salaried workers (Salaried Plan). At the time PEB Corporation determined that the layoff was probable, management evaluated the two plans for curtailment. Upon doing so, they determined that the curtailment in the Hourly Plan would result in a net loss, while the curtailment in the Salaried Plan would result in a net gain. The employees will be terminated during 20X2.

Can PEB Corporation record the effects of both plan curtailments in 20X1?

Analysis

No. ASC 715-30-35-69 requires pension accounting to be applied at the individual plan level (i.e., the determination of whether a curtailment has occurred is a plan-by-plan assessment). Thus, the curtailment of the Hourly Plan is a separate accounting event from the curtailment of the Salaried Plan. In addition, ASC 715-30-35-94 indicates that a net curtailment loss "shall be recognized in earnings when it is probable that a curtailment will occur and the effects described are reasonably estimable." It further states that a net curtailment gain "shall be recognized in earnings when the related employees terminate." Because the net result of the curtailment of the Hourly Plan is a loss, PEB Corporation should record the loss when it is probable and reasonably estimable (i.e., on December 31, 20X1). On the other hand, because the net result of the curtailment of the Salaried Plan is a gain, PEB Corporation should record the gain when the salaried employees are terminated in 20X2.

Example PEB 4-3 illustrates the recognition of a curtailment from a phased restructuring event.

EXAMPLE PEB 4-3

Recognition of a curtailment from a phased restructuring event

On January 1, 20X1, PEB Corporation decided to restructure its operations, resulting in a layoff of employees. The layoffs will occur in phases as each phase is determined by management, but are clearly part of a single restructuring plan. The employees that will be affected by the layoff are covered by a single pension plan. The plan of restructuring represents a curtailment event because it will significantly reduce the expected years of future service of present employees in the pension plan.

During the first quarter of 20X1, PEB Corporation determined that the layoffs as a result of Phase 1 were probable and the number and demographic characteristics of the affected employees were estimable. In turn, management determined that Phase 1 would result in a curtailment loss of \$100 million, which was recorded in the first quarter of 20X1. In the third quarter of 20X1, PEB Corporation finalized Phase 2 of the employee terminations, the amount and nature of which were not identified (i.e., not reasonably estimable) prior to that point. The employees from Phase 2 will not be terminated until 20X2. Management determined that the Phase 2 layoffs would result in a curtailment gain of \$60 million.

When should PEB Corporation account for the curtailment gain resulting from Phase 2?

Analysis

The curtailment gain from Phase 2 should be recorded in the third quarter when it becomes probable and estimable, as it reduces the overall curtailment loss on the single restructuring action. Normally, a curtailment gain would not be recorded until the related employees are actually terminated. However, in this example, the employees affected by Phase 1 and Phase 2 participate in the same pension plan and the curtailment arises as a result of a single overall restructuring plan.

ASC 715-30-55-172 indicates that when there are individually insignificant reductions of expected future years of service of employees covered by a pension plan that are caused by one event (such as related to a single plan of reorganization), and those reductions accumulate to a significant reduction, the fact that the reductions occur over a period of time does not affect the determination that an event giving rise to a curtailment has occurred. This literature suggests that if there are multiple phases of employee reductions that relate to a single event, the phases should be aggregated to determine whether a curtailment has occurred.

Had PEB Corporation been able to determine that Phase 2 was probable and been able to estimate its impact when PEB Corporation recorded the initial curtailment loss from Phase 1, the amount PEB Corporation would have recorded would have been the combined curtailment loss of \$40 million.

Example PEB 4-4 addresses the timing of recognition of curtailment gains for phased terminations.

EXAMPLE PEB 4-4

Timing of recognition of curtailment gains for phased terminations

On December 15, 20X1, PEB Corporation, a calendar year end reporting entity with an OPEB plan, announced a plant closing. As a result, 200 employees will be terminated on or before January 31, 20X2. An additional 200 will be terminated on or before April 15, 20X2 and an additional 200 will be terminated on or before August 1, 20X2. In accordance with ASC 715-30-55-172, PEB Corporation aggregates the terminations that will occur in January, April, and August to determine whether the plant closing results in a curtailment (i.e., whether the combined effect of all three tranches of terminations as part of a single plant closing constitute a significant reduction in future years of service). Based on PEB Corporation's policy for determining significance, it has concluded that the terminations expected to occur as a result of the plant closing will result in a curtailment and that the curtailment will result in a gain. However, the termination of the first 200 employees on January 31 will not constitute a significant reduction; a significant reduction will occur only when the termination of an additional 200 employees occurs on April 15 for an aggregate termination of 400 employees at that date.

When should PEB Corporation measure and record the curtailment gain?

Analysis

In accordance with ASC 715-30-35-94, a curtailment gain should be recognized in earnings when the related employees terminate, not when the plant closing is announced. Since the employees will be terminated on three separate dates, PEB Corporation may recognize a portion of the gain in the first quarter (for January 31 terminations), in the second quarter (for April 15 terminations), and in the third quarter (for August 1 terminations). A full remeasurement of the obligation and plan assets should be performed immediately prior to determining the gain to be recognized in each quarter.

Alternatively, PEB Corporation can choose to recognize the gain when the number of employees that have been terminated constitutes a significant reduction of future years of expected service and therefore meets the definition of a curtailment. In that case, PEB Corporation would recognize no effect of the curtailment in the first quarter. Then, in the second quarter, the portion of the gain for the 400 employees that are terminated in both the January and April timeframes would be recognized. In the third quarter, the gain associated with the August terminations would be recognized. This treatment is consistent with the guidance in ASC 715-30-55-167 and ASC 715-30-55-168 in which a settlement gain or loss is recognized once the individual settlement amounts are expected to exceed the threshold amount of service and interest and cost for the year. A full remeasurement of the obligation and plan assets should be performed immediately prior to determining the gain to be recognized in the second and third quarters.

Once either method is selected, it would constitute an accounting policy that would need to be applied to similar events in the future.

Importantly, if the effect on the plan from the employee terminations was a curtailment loss, PEB Corporation would have no choice other than to recognize the full amount of the loss in December 20X1, when the curtailment event would have been deemed probable and estimable.

4.5 Settlement and curtailment combined

Settlements and curtailments are very different events. Management's decision to settle a pension obligation is a separate, discrete decision from one to reduce its work force or reduce future benefit accruals. Therefore, even when they occur contemporaneously or are related to the same event—for example the sale of a business (curtailment) along with a transfer of a portion of a pension plan to the buyer (settlement)—it is not appropriate to net the gain from one against the loss from the other. The timing of recognition for both may differ in any event and, importantly, the order in which the accounting for each event occurs may affect the ultimate net gain or loss recognized.

When a related series of transactions involves both a curtailment and a partial settlement, and the projected benefit obligation changes as a result of the curtailment, gain or loss recognition may differ depending on the order of applying settlement and curtailment accounting. This is because the pro rata factor for recognition of gains and losses in a settlement is based on the portion of the projected benefit obligation settled, and the amount of potential curtailment gain or loss depends on the amount of any unamortized gain or loss. The order of recording curtailment and settlement events is not specified by ASC 715. ASC 715-30-35-75 indicates that neither order is demonstrably superior, although the approach selected should be consistently followed.

Example PEB 4-5 illustrates the impact of the order of accounting for a curtailment and a settlement.

EXAMPLE PEB 4-5

Interaction of settlement accounting and curtailment accounting

Facts

PEB Corporation sponsors a defined benefit pension plan for all employees. PEB Corporation decides to sell one of its five manufacturing plants to a strategic buyer who will assume the pension benefit obligation for the employees of the disposed plant. The effective termination of the employees participating in the plan in connection with the sale constitutes a curtailment. The transfer of plan assets to the buyer in the sale also settles the pension benefit obligation for those employees.

Assume the demographic profile of the employees at all five manufacturing plants is essentially equal and the following facts about the status of the plan prior to any settlement or curtailment accounting (but after remeasurement of the plan using current assumptions):

- Projected benefit obligation of \$2,000,000
- Unrecognized prior service cost of \$250,000
- Unrecognized net gain of \$250,000
- Curtailment causes a \$200,000 reduction in the projected benefit obligation
- Benefits of \$300,000 are settled

How does the calculation differ if the curtailment or settlement is calculated first?

Analysis

If curtailment accounting is applied first, \$50,000 of unrecognized prior service cost (1/5 of the remaining years of expected service have been eliminated) represents one component of the curtailment. Because the curtailment causes a \$200,000 reduction in the PBO, the remaining PBO is \$1,800,000. The \$200,000 reduction in the PBO (a potential gain) is recognized in full as there was an unrecognized net gain at the time of the curtailment. Therefore, the net curtailment gain is \$150,000 (\$200,000 PBO gain less \$50,000 prior service cost recognition). For the settlement calculation, 16.7% (\$300,000 benefits settled divided by \$1,800,000 of remaining PBO) of the unrecognized net gain of \$250,000, or \$41,667, would be recognized on settlement. As a result, the combined net result of the curtailment and settlement accounting would be a gain of \$191,667.

If settlement accounting is applied first, 15% (\$300,000 benefits settled divided by \$2,000,000 of remaining PBO) of the unrecognized net gain of \$250,000, or \$37,500, would be recognized as a settlement gain. For the curtailment calculation, \$50,000 of unrecognized prior service cost (1/5 of the remaining years of expected service have been eliminated) represents one component of the curtailment. The \$200,000 reduction in the PBO (a potential gain) would be recognized in full as there was still an unrecognized net gain after considering the settlement gain recognized. Therefore, the net curtailment gain is \$150,000 (\$200,000 PBO gain less \$50,000 prior service cost recognition). As a result, the combined net result of the curtailment and settlement accounting would be a gain of \$187,500.

4.6 Plan amendments

Plan amendment accounting is to be followed when benefits are increased or decreased. See PEB 3.2.6 for the accounting for prior service cost that arises from plan amendments. If an amendment is deemed significant, the employer should perform an interim remeasurement of the benefit obligation and plan assets and would also develop a new measure of net periodic benefit cost for the period from the remeasurement to the next annual measurement date. If an amendment is not deemed to be significant, the effects of the amendment would be determined as of the date of the next annual measurement date. ASC 715 does not define the term "significant." The determination of whether an event is significant requires judgment. Employers should consider the specific facts and circumstances surrounding the event and their past practice of defining significance for previous events.

4.6.1 Negative plan amendments

A negative plan amendment occurs when a plan sponsor reduces or eliminates benefits already earned (or being earned) by plan participants for past services. ERISA and other retirement welfare laws often prohibit the reduction of retirement welfare benefits already earned by employees. However, there are no US federal laws prohibiting a reduction in postretirement healthcare benefits. The significant increase in the cost of healthcare has prompted many companies to amend the terms of their OPEB plans by reducing or eliminating benefits, which may be considered a "negative plan amendment."

However, reductions in benefits have sometimes resulted in litigation against the enterprise on behalf of the retirees. Such litigation may seek to retroactively reinstate the prior level of benefits. The possibility that negative plan amendments might be later reversed as a result of litigation or the threat thereof should be carefully considered. If it is probable (as used in ASC 450) that the negative plan

amendment will be rescinded, the OPEB obligation should not be reduced by the effects of the negative plan amendment. Even if rescission is not probable, the possibility that a rescission could be compelled may, depending on specific facts and circumstances, represent a contingent liability requiring disclosure pursuant to ASC 450.

Negative plan amendments in OPEB plans could include increases in required participant contributions or deductibles not already part of the substantive plan, the institution of a dollar-defined cap on the employer's share of costs, reductions in benefit coverage, or total elimination of eligibility for benefits (e.g., a plan amendment that provides that all employees not currently eligible to retire will no longer be entitled to plan benefits).

Question PEB 4-1 illustrates the accounting for a pension plan amendment resulting from litigation.

Question PEB 4-1

Company A sponsors a defined benefit plan. In the prior year, Company A was sued by participants in the plan. The participants claimed the pension benefits promised were insufficient and requested additional benefits under the plan. The case went to trial, and in the current accounting period, the court decided in favor of the plaintiffs and ordered Company A to amend its plan to increase the benefits. How should Company A account for this increase in pension benefits?

PwC response

Generally, we believe the increase in the pension benefit obligation resulting from this type of change in pension benefits should be recognized immediately in net income in the current period.

Unlike a typical plan amendment that increases (or decreases) promised pension benefits, which would be deferred as “prior service cost” in AOCI and amortized as a component of pension expense over future periods, we believe the increase in the benefit obligation in this scenario is more akin to a loss contingency subject to ASC 450-20, *Loss Contingencies*, rather than a discretionary plan amendment under ASC 715. This is because the amendment of the plan was not a discretionary action taken by the plan sponsor but, instead, was a required action ordered by the court. Thus, the amendment is not motivated by the employer’s desire to realize an economic benefit by granting the amendment, which is the underlying concept for amortization of prior service cost over future periods. Therefore, the resultant accounting should reflect this fundamental difference in the substance of this event (court ordered action / litigation settlement) compared to a discretionary plan amendment, notwithstanding the legal form as a plan amendment.

However, facts and circumstances in other fact patterns could yield different answers. For example, consider a situation in which the participants sued for benefits that were previously provided by the company, but taken away in a negative plan amendment, and the court ordered the company to reinstate the previous benefits. This may potentially be viewed as a rescission of the previous plan amendment and an adjustment to prior service cost (or negative prior service cost) recorded for the previous amendment(s).

4.6.1.1 Negative plan amendment - curtailment accounting

In the context of a postretirement healthcare plan, a curtailment could occur if an employer suspends or terminates an OPEB plan pursuant to which employees no longer earn defined benefits for future service to the employer but future service counts toward vesting of benefits accumulated based on past

service (e.g., if a plan with a five-year vesting requirement is terminated, an employee with four years of service may vest with respect to the benefits accumulated to that date upon completing one more year of service). Such an amendment reduces or eliminates the accrual of defined benefits for some or all future years of service and could, therefore, also cause a curtailment. It is important to distinguish between a reduction in the APBO caused by a negative plan amendment and a reduction caused by a curtailment. See ASC 715-60-55-140 through ASC 715-60-55-160 for illustrations of the differences between a negative plan amendment and a curtailment.

In situations when a negative plan amendment reduces or eliminates benefits accumulated for past service, the reduction in the APBO would first be used to reduce any unrecognized prior service cost from previous plan benefit improvements and then to reduce any remaining transition obligation. The excess, if any, would be amortized to net periodic OPEB cost on the same basis as prior service cost arising from benefit increases. Even if the event also gives rise to a full or partial curtailment, only previously unrecognized prior service cost/negative prior service cost (i.e., from previous plan amendments) is accelerated in the curtailment and not the negative prior service cost arising from the current negative plan amendment.

Example 6 in ASC 715-60-55-146 through ASC 715-60-55-160 (Cases A through C) outlines the guidance for accounting for a negative plan amendment that causes a curtailment. These examples indicate that:

- the effects of the negative plan amendment should be determined first,
- after the effects of the negative plan amendment are recorded, the determination of any gain/loss on the curtailment should be made, and any negative prior service cost that results from the current negative plan amendment should not be included in the prior service cost recognized in the curtailment gain/loss calculation, unless the plan is simultaneously being terminated completely (see PEB 4.9 for further discussion of plan terminations).

ASC 715 does not provide guidance on the method (e.g., LIFO, FIFO, pro rata) to be used to reduce prior service cost when there have been several prior amendments that, in the aggregate, resulted in unamortized prior service cost exceeding the reduction in the APBO resulting from a negative plan amendment. Since prior service cost is amortized over the estimated remaining years of future service to full eligibility at the date of the amendment, each plan amendment will be amortized over a different period. Accordingly, the order of reducing the prior service cost will directly affect the amount of prior service cost amortized in each future period. Unless the negative plan amendment is related to a specific prior amendment, ASC 715-30-55-54 states that any systematic method, applied on a consistent basis, would be acceptable.

4.6.2 *Timing of recognition of a plan amendment*

The effects of a plan amendment, whether positive or negative, should be considered when measuring the benefit obligation only if it has been communicated to plan participants at the date the amendment is adopted or within a reasonable period of time thereafter (i.e., within the time period that would ordinarily be required to prepare information about the amendment and disseminate it to employees and retirees). Neither ASC 715-60-35-21 nor ASC 715-60-55-19 define "a reasonable period of time." They do, however, indicate that one year after the date of amendment is not a reasonable period of time. We believe that recognition of the amendment at adoption is appropriate if management's actions demonstrate that it intends to communicate the changes in the normal time period typical for communications of other amendments of a similar nature or magnitude. Deferring the communication

to the annual date on which plan changes and other information are communicated would generally not meet the "reasonable period of time" condition. As indicated in ASC 715-60-55-19, if the delay in communication is unreasonable, the existing written plan continues to be the substantive plan that would be accounted for because it represents the last plan whose terms were mutually understood by the employer and plan participants.

ASC 715-60-35-54 also states that an employer's communication of its intent to institute cost-sharing provisions that differ from the written plan or prior practice do not constitute the substantive plan if the plan participants would be unwilling to accept the change without adverse consequences to operations or if other modifications to the plan or offsetting benefits would be required to gain participants' acceptance.

Example PEB 4-6 provides an example of the timing of the accounting for negative plan amendments.

EXAMPLE PEB 4-6

Timing of the accounting for negative plan amendments when communication is delayed

During the third quarter of 20X1, the Compensation Committee of the Board of Directors of PEB Corporation, a calendar year-end reporting entity, approves changes to PEB Corporation's defined benefit OPEB plan that will reduce the benefits provided to participants. The effect of the changes will be accounted for as a negative plan amendment and a curtailment that will result in a gain.

PEB Corporation's human resources department intends to communicate the changes to plan participants through the normal course of its annual benefits enrollment cycle, which will occur in the first quarter of 20X2. If PEB Corporation had chosen to communicate this change following the adoption of the resolution by the Compensation Committee, under its normal communication processes, it ordinarily would have taken approximately two to three weeks to prepare and distribute a communication to the active and retired plan participants.

When should PEB Corporation recognize the effects of the negative plan amendment?

Analysis

PEB Corporation should account for the negative plan amendment and curtailment in the first quarter of 20X2. Under the guidance in ASC 715-60, the effects of the plan changes should generally be incorporated into the measurement of the plans' obligations in the period that the amendments are adopted (ASC 715-60-35-171). However, ASC 715-60-35-21 clarifies that the effects of the plan amendment should be considered at the date the amendment is adopted only if it is communicated to plan participants at that time or within a reasonable period of time thereafter. A reasonable period of time is described as "the time period that would ordinarily be required to prepare information about the amendment and disseminate it to employees and retirees." Under PEB Corporation's normal process, it would take approximately two to three weeks from the date the Compensation Committee approved the changes to prepare and distribute a communication to the plan participants. Thus, communication of the changes two quarters later would not be deemed to occur within a reasonable period of time. Consequently, the effects of the amendments, including the curtailment gain, should only be recognized when the terms of the plan amendment are mutually understood by the employer and the employees (i.e., when communicated by PEB Corporation to the plan participants). This will occur during the first quarter of 20X2, once the benefits enrollment package is disseminated to active employees and retirees.

4.6.3 *Series of interrelated benefit plan changes*

It is not unusual for an entity to make amendments or other changes to multiple benefit plans or other employee compensation arrangements simultaneously (or within a relatively short period of time). Often, a benefit will be reduced under one arrangement, but the reduction may be compensated for, in whole or in part, under another arrangement. For example, an entity may eliminate benefits under a postretirement medical arrangement, but increase benefits under a pension plan to mitigate the reduction.

In these situations, we believe it is important to understand the economic substance of the entire series of interrelated changes in employee benefit arrangements. This is important in order to ensure that financial statement recognition is not distorted due to the different recognition models that exist under the various employee compensation standards. For example, the income statement impact of amendments to a defined benefit pension plan are generally deferred and amortized, while a change to a cash bonus arrangement would typically be reflected immediately in the income statement.

As a simple example, a reporting entity may reach an agreement with its employees to forgo paying a presently due bonus that the employees have earned, and in return will increase the benefits payable under its pension plan by an equal amount. If one were to view the two actions in isolation, the elimination of the bonus accrual would be reflected as a gain in the income statement immediately, while the benefit enhancement in the pension plan would be reflected as prior service cost and amortized over a future period. That accounting would not reflect the underlying economic substance of the exchange. ASC 715 contains several examples of concurrently negotiated changes in various benefit plans. Consistent with that guidance, in some circumstances, it may be appropriate to immediately recognize in income part or all of the change in the obligation under a defined benefit plan rather than reflecting such change as a positive or negative plan amendment that is amortized into income over future periods.

In another example from practice, the Pension Protection Act of 2006 caused situations affecting both qualified and non-qualified pension plans. For example, increasing the benefit and compensation limits that were scheduled to expire under the Economic Growth and Tax Reconciliation Relief Act of 2001 increased the PBO. However, since most entities have nonqualified excess benefit plans or Supplemental Executive Retirement Plans (SERPs), the increase in the PBO of the qualified plan was generally offset by a decrease in the PBO of the SERP. Accordingly, those entities found that the overall effect on total pension obligations was neutral. In that case, we generally concluded that the appropriate accounting treatment was to transfer the accrued liability from the SERP to the PBO of the qualified plan, along with a pro rata share of deferred items (prior service cost, gains and losses, and transition amount). Thus, rather than treat the events as separate events within each plan, the underlying economics were that the overall benefit to the individual was not changing; the source of the payment was merely shifting from one plan to the other.

Example PEB 4-7 illustrates how to account for the interrelated benefit changes resulting from an early retirement offer.

EXAMPLE PEB 4-7

Accounting for the interrelated benefit changes resulting from an early retirement offer

Medical benefits are provided to long-term disabled employees under a long-term disability (LTD) plan that is accounted for under ASC 712, *Compensation—Nonretirement Postemployment Benefits*.

When the employee retires, the medical benefits are provided under the employer's postretirement medical plan, which is accounted for under ASC 715. Because the reporting entity assumes that employees will retire at age 65, its ASC 712 obligation includes benefits for employees through age 64, and its ASC 715 obligation includes benefits for retired employees, age 65 and older. As a result of an employer-provided incentive to retire early, 55% of the long-term disabled employees elected to retire in the current year. Because many of these employees are under age 65, this event results in a decrease in the ASC 712 obligation and an increase in the ASC 715 obligation for the cost of benefits from the employee's age at retirement (e.g., age 60) to age 65.

Should the decrease in the ASC 712 obligation be recognized as a gain and the increase in the ASC 715 obligation recognized as an actuarial loss?

Analysis

No. Although unanticipated early retirements can give rise to an actuarial loss under ASC 715 (and gain recognition under ASC 712), the early retirements in this case resulted from the overt actions of the employer to cause the employees to retire early. Further, the employees did not lose any benefits as a result of their decision to retire early. The employer's obligation to pay their medical benefits remains unchanged; merely the source of funding changes. Because the economic substance of the employer's obligation has not changed, any gain recognition under this fact pattern would cause the financial statements to be misleading. Accordingly, the portion of the ASC 712 liability that decreased due to the early retirement of the disabled employees should simply be transferred to the accumulated postretirement benefit obligation and included in the accrued postretirement benefit liability in the balance sheet. This is consistent with the conclusions in ASC 715-60-55-111.

4.7 Termination benefits

ASC 715 covers the accounting for two types of termination benefits, special termination benefits and contractual termination benefits provided under an ongoing defined benefit pension arrangement. The cost of the termination benefits is determined by the amount of the lump-sum payments or the present value of expected future payments (or increases to future benefit payments as a result of the termination). The portion of a non-vested benefit that becomes vested as part of the termination is included in the cost of the termination benefit. For example, if a non-vested employee becomes 100% vested as a result of the termination, the entire present value of the employee's vested benefit is included in the cost of the termination benefit.

4.7.1 Special termination benefits

Special termination benefits arise when the employer offers to provide, for a short period of time, certain additional benefits to employees electing voluntary termination, including early retirement. A liability should be recorded and an expense recognized in the period the employees irrevocably accept the offer and the amount of the termination liability is reasonably estimable. Once the employees irrevocably accept the offer, it would likely be difficult for an employer to assert that the termination liability is not reasonably estimable. PEB 8.2 covers specific situations involving special termination benefits that require a minimum service period after an employee accepts the offer, or when acceptance by the reporting entity of the employee's decision is required.

There may be situations when a special termination benefits offer extends beyond the end of a reporting period. Irrevocable acceptances by the period-end date should be recorded as a termination

liability; however, revocable acceptances at that date or irrevocable acceptances that occur after the balance sheet date but before the financial statements are issued (or available for issuance) would not be accrued and recorded at the balance sheet date (i.e., a non-recognized subsequent event under ASC 855). The contingent liability for offers still outstanding and offers that have not yet been irrevocably accepted should be disclosed, if significant, pursuant to ASC 450-20, *Loss Contingencies*.

There also may be situations when, in connection with a downsizing action, employees may elect either a cash severance package or a special termination pension benefit. For example, eligible employees may be given a choice between special termination pension benefits with a present value of \$15,000 or a cash payment of \$12,000. As it is clear that the reporting entity's minimum liability is \$12,000 per terminated employee, a loss should be recorded on that basis as part of the restructuring in accordance with ASC 420, *Exit or Disposal Cost Obligations*. The additional amount (\$3,000) should be accrued at the date of acceptance by employees who irrevocably elect the higher benefit. See PEB 8.5.)

4.7.2 Contractual termination benefits

Contractual termination benefits are provided to employees when employment is terminated due to an event specified in the provisions of an existing plan or agreement (e.g., a labor contract). For example, an agreement may provide that, in the case of a plant closing, the employer will provide stated benefits to affected employees. A liability should be recorded for contractual termination benefits and the expense recognized when it is probable that employees will be entitled to the benefits and the amount is reasonably estimable pursuant to ASC 715-30-25-10. See BCG 2.5.10 for a discussion related to business combinations.

4.7.3 Applicable guidance and timing of recognition

The timing of recognition differs for special termination benefits and contractual termination benefits. Timing of recognition of special termination benefits is based on employee acceptance; timing of recognition of contractual termination benefits depends on the employer's assessment of probability. The FASB's guidance is explicit and intentional in this regard and is based on a view that the nature of the two types of benefits are different, thus justifying different accounting treatment. In the case of special termination benefits, it is the employees, not the reporting entity, who elect termination, and no obligation arises until the employees make that irrevocable election. However, an employer is legally bound to pay contractual termination benefits whenever the specified event occurs, which is generally within the control of the employer, and the cost of those benefits should be accrued when the decision causing the event is made if the decision makes it probable that benefits will be paid.

ASC 420, *Exit or Disposal Cost Obligations*, addresses the accounting for costs associated with exit or disposal activities. Although it prescribes the accounting for one-time termination benefits, which it defines as benefits that are established by a plan of termination that applies for a specified termination event or for a specified future period, it does not amend the accounting for termination benefits paid through a preexisting plan, including contractual termination benefits currently accounted for under ASC 715. Refer to FSP 13 and PEB 8 for a more detailed discussion of ASC 420.

Events that give rise to termination benefits may also result in a curtailment if sufficient terminations take place to meet the employer's significance threshold for reductions of future years of service. ASC 715-30-55-222 through ASC 715-30-55-230 provides examples of accounting for a plan curtailment involving special termination benefits. Termination benefits may also give rise to a settlement in plans that allow the pension benefit to be paid as a lump sum at retirement.

4.8 Accounting for successor plans

A successor plan is a new pension plan that is established by an employer (or an existing plan that is amended) to provide for the accrual of defined pension benefits for the future services of employees that were previously covered by an old plan.

It is important to understand whether a successor plan has been established when an existing plan is terminated because, if so, recognition of a curtailment gain or loss would generally not be appropriate. As discussed in ASC 715-30-55-132, although employees no longer accrue pension benefits under the terminated pension plan, which would typically indicate a curtailment event has occurred, they do accrue pension benefits under the successor pension plan.

From an accounting viewpoint, the two pension plans are viewed as one pension plan because, in substance, the pension plan has not been terminated. If the successor pension plan provides reduced or increased pension benefits for employees' future service, that change in the benefit formula is accounted for as a plan amendment and, if the reduction in benefits for future service is significant, potentially a curtailment. See PEB 3.2.6 for a discussion of the accounting for plan amendments and PEB 4.4 for a discussion of the accounting for curtailments.

Importantly, a defined contribution plan is not considered a successor plan in this context because it does not provide for the accrual of defined benefits. Similarly, a multiemployer plan would not be considered a successor plan for a single employer plan, but careful consideration of the nature of the multiemployer arrangement is warranted prior to concluding that curtailment or plan termination accounting is appropriate.

4.9 Accounting for a plan termination

A plan termination is an event in which the benefit plan ceases to exist and all benefits are settled by the purchase of annuity contracts, the payment of lump-sum benefits, or by other means (see PEB 4.3 for a discussion of settlements). The plan may or may not be replaced by another plan (i.e., a successor plan as described in PEB 4.8). At the point of final plan termination, all deferred amounts in accumulated other comprehensive income should be recognized in the income statement. Settlement accounting is not appropriate until all the criteria for settlement have occurred (as described in PEB 4.3). However, if a reporting entity decides to terminate a plan at a future date, it may be appropriate at the next measurement date for the assumptions to incorporate certain estimates that reflect the pending settlement.

For example, if the plan termination is assessed to be probable, the measurement of the obligation should reflect the settlement rate at termination and the discount rate prior to termination should reflect the shorter duration until the termination date. Similarly, assumptions impacted by the decision to terminate the plan should be updated and reflected in the PBO if known. For example, lump sum versus annuity elections, other assumptions implicit in annuity purchase rates (e.g., mortality, administrative costs), retirement rates, increased utilization, opt-in rates (if applicable, for OPEB plans) and other assumptions (e.g., salary scale, turnover, COBRA) should be updated.

In addition, the amortization periods for gains and losses, as well as for new prior service cost (or negative prior service cost) arising from plan amendments, should be assessed to consider whether the amortization period should end at the planned termination date or should continue over the relevant average life expectancy or service period. In certain cases, it may be reasonable to amortize remaining

amounts over the period until the plan is to be terminated. The underlying basis in the original guidance for pension and OPEB accounting to defer and amortize gains and losses and prior service cost is to acknowledge that gains and losses can offset over the lifetime of a plan during which benefits will be paid, making it more appropriate to spread the cost over the period that the participants will receive benefits. If a plan is anticipated to terminate, that period may now be shorter than previously anticipated if the payment of benefits will cease at that time.

Consider the case of an unfunded OPEB plan for which the reporting entity may unilaterally terminate the plan and there is no obligation to settle any accumulated benefits upon termination. In this case, it may be reasonable to view the remaining period of time until the plan is terminated as the only period during which benefit payments will be made and that gains and losses could offset. Assuming that the ability to terminate the plan and cease paying any benefits is solely within the control of the reporting entity, and termination is reasonably assured based on the planned timetable and surrounding circumstances, it may be appropriate to amortize remaining amounts in accumulated other comprehensive income over the period of time until the plan terminates and the benefit payments will cease. Alternatively, we believe it would also be appropriate to continue to follow the amortization model in ASC 715 as described in PEB 3.2.7.

Example PEB 4-8 provides an example of the timing of the accounting for an amendment to terminate a plan with a future effective date.

EXAMPLE PEB 4-8

Timing of the accounting for an amendment to terminate a plan with a future effective date

PEB Corporation sponsors a postretirement healthcare plan that has no active employee participants, only retirees (i.e., all of the plan's participants are inactive). The accumulated postretirement benefit obligation is approximately \$100 million. On December 1, 20X1, PEB Corporation amended the plan to terminate all health care benefits effective April 1, 20X2, and also communicated that change to the participants in December 20X1. PEB Corporation has the authority to amend the plan at any time.

How should PEB Corporation account for the amendment to terminate the plan with a future effective date?

Analysis

PEB Corporation should account for the amendment to terminate the plan as a negative plan amendment as of the date of the amendment (December 1, 20X1), which would require PEB Corporation to recognize the reduction in the liability as a prior service credit in accumulated other comprehensive income on December 1, 20X1. Because the plan has only inactive participants, the prior service credit would ordinarily be amortized over the average life expectancy of participants; however, as the plan will terminate on April 1, 20X2, with no further payments to be made to participants after that date, it would likely be acceptable to amortize the prior service cost over the period from December 1, 20X1 through March 31, 20X2.

For other plans that would require payment of accumulated benefits, such as via purchase of annuities or lump sum payments, the decision to terminate the plan in the future has not yet eliminated the obligation to pay benefits over an extended period of time, and so there has not yet been a reduction in the period of time over which benefit payments will occur. The reporting entity will still need to

negotiate the settlement of accumulated benefits in the future. As settlement gains and losses should not be reflected until the actual settlement of the benefits occurs, it should not be anticipated and, therefore, the amortization period should not be adjusted from the base model under ASC 715 (average remaining service period or average remaining life expectancy).

4.10 *Accounting for plan division or merger*

When an employer divides one plan into two or more pension plans, the employer should first remeasure the plan based on current assumptions at the time of the plan division if it is determined to be a significant event of the plan. ASC 715 requires interim remeasurement of a plan if there has been a significant event associated with the plan. While "significant" is not defined in ASC 715 or other benefits literature, the significance determination for this purpose is based on the impact to the plan in question, not on the potential impact of the event on the financial statements. As the unit of account for pension accounting is the plan, the significance determination should be evaluated separately for each plan. The framework for evaluating whether a curtailment is significant as described in PEB 4.2.2 may be appropriate to consider in assessing whether the division of the plan is significant. This would generally be applied only to the overall impact on the benefit obligation.

If the portion of the plan that will be separated from the remaining plan is determined not to be significant, the plan assets and obligations would not need to be remeasured at the date of the division. However, the plan assets and obligations will still need to be divided on the date of the division. In this case, the funded status, plan assets, and amounts in AOCI should be allocated using a systematic and rational approach, based on the balances at the previous measurement date adjusted for activity through the date of plan division (for example, benefit payments and contributions).

The employer would then allocate the net gain or loss included in AOCI in proportion to the projected benefit obligations of the two surviving plans. Prior service cost included in AOCI should be allocated to the surviving plans based on the applicable individuals included in the employee groups covered. See additional guidance in ASC 715-30-55-90 through ASC 715-30-55-92 and ASC 715-30-55-124 through ASC 715-30-55-127.

In a plan merger, similar amounts of the predecessor pension plans are aggregated and a single amortization schedule for each of the combined amounts is used. For example, total net gain or loss in accumulated other comprehensive income is amortized using the average remaining service period of the combined employee group. However, the prior service cost included in accumulated other comprehensive income of each pension plan at the time of the combination would continue to be amortized as previously determined based on specific employee groups covered. See additional guidance in ASC 715-30-55-88 and ASC 715-30-55-89 and ASC 715-30-55-122 and ASC 715-30-55-123.

4.11 *Accounting for pensions in a spinoff*

In a spinoff, a reporting entity distributes shares of a subsidiary pro-rata to its shareholders. Generally, the distributing company (spinnor) does not recognize a gain or loss on the distribution in accordance with ASC 845-10-30-10 and ASC 505-60-25-2. If the subsidiary being spun off (spinnee) has employees that participate in pension plans, the spinnor will need to determine how the plans will be treated in connection with the spinoff. The following are some of the more common situations encountered.

4.11.1 Standalone spinnee plan

If the employees or retirees of the spinnee participate in a separate pension plan from the employees and retirees of the spinnor, no additional accounting is needed. The spinoff would not result in any change to the benefits or future years of service of the parent's pension plan; therefore, no curtailment or settlement would occur in connection with the spinoff. Upon the consummation of the spinoff, the net asset or liability (funded status) of the plan of the spinnee would be removed from the spinnor's balance sheet and included as part of the distribution charged against retained earnings. In addition, any amounts of accumulated other comprehensive income related to the spinnee's pension plan would be charged or credited to retained earnings of the spinnor at the time of the spinoff, and those balances would be "assumed" by the spinnee for purposes of its post-spin accounting for the plan.

4.11.2 Plan division

When the entity has plans that include employees and retirees of both the spinnor and spinnee, and the entity will be separating the pension plan(s) (e.g., a "mirror" plan will be established for the employees and retirees of the spinnee), the separation would be treated as a plan division in accordance with the guidance discussed in PEB 4.10. That guidance indicates that the plan should be remeasured immediately before the division in order to determine the amounts of unrecognized net gain or loss or prior service cost to be allocated among the two plans. After the plan division, all of the balances—funded status and AOCI—asccribed to the plan of the spinnee should be charged against retained earnings of the spinnor as part of the distribution to shareholders in the spinoff.

4.11.3 Plan remains with spinnor

In some cases, an entity has plans that include employees and retirees of both the spinnor and spinnee, and the entire plan (including the benefit obligation and plan assets) will be retained by the spinnor. The employees and retirees of the spinnee may remain participants in the plan (for any vested and accrued benefits earned to-date), but will typically not accrue additional benefits under the plan. Instead, alternative benefits for future service may be provided by the spinnee (for example, an enhanced defined contribution plan).

As discussed in PEB 4.2, a curtailment occurs when an event significantly reduces the expected years of future service of present employees covered by the employer's pension plan or eliminates the accrual of defined benefits for some or all future services of a significant number of employees. As a result of the spin transaction and the elimination of the spinnee employees from the plan retained by the spinnor, a curtailment of the plan may be triggered if it has not been frozen previously. A gain or loss may need to be recognized as a result of the curtailment.

If the spinoff does not result in a curtailment (i.e., the reduction in expected years of future service or plan participants is not significant) the effects of the spinoff would merely represent experience of the plan that would be captured in the next measurement of the plan. Unlike a disposal of a component resulting in a gain or loss, when "curtailment-like" accounting is applied, as discussed in PEB 4.2.2, a spinoff is not a "realization event."

***Chapter 5:
Multiemployer and multiple-
employer plans—updated
October 2023***

5.1 *Multi- and multiple-employer plans overview*

This chapter discusses what qualifies as a multiemployer plan, and differentiates them from multiple-employer plans. The accounting for each type of plan is also discussed, including withdrawal liabilities. Lastly, the reporting by subsidiaries participating in their parent's plan is discussed.

5.2 *Multiemployer plans*

ASC 715-80 defines a multiemployer plan as a pension or postretirement benefit plan to which two or more unrelated employers contribute, usually pursuant to one or more collective-bargaining agreements. A characteristic of multiemployer plans is that assets contributed by one participating employer may be used to provide benefits to employees of other participating employers since assets contributed by an employer are not segregated in a separate account or restricted to provide benefits only to employees of that employer. A multiemployer plan is usually administered by a board of trustees composed of management and labor representatives and may also be referred to as a "joint trust" or "union plan." Generally, many employers participate in a multiemployer plan, and an employer may participate in more than one plan. The employers participating in multiemployer plans usually have a common industry bond, but for some plans the employers are in different industries and the labor union may be their only common bond. Some multiemployer plans do not involve a union. For example, local chapters of a not-for-profit entity may participate in a plan established by the related national organization.

A key characteristic of a multiemployer plan is that the plan's obligation to retirees continues even if a former employer discontinues its participation in the plan.

5.2.1 *Accounting for multiemployer plans*

ASC 715-80-35-1 requires expensing the required contribution for all multiemployer plans, similar to the accounting for defined contribution plans. An employer accounts for its participation in a defined benefit multiemployer plan generally as if it were a defined contribution plan. As a result, a participating employer recognizes as net pension cost its required contribution for the period and generally recognizes a liability for any required contributions that are due and unpaid. There is generally no accrual for future contributions. As the guidance on classification of benefit costs (described in PEB 3.2) only applies to plans subject to ASC 715-30 and ASC 715-60, the entire net pension cost for a multiemployer plan is viewed as an employee benefit cost and classified with other similar costs.

When an employer enters a multiemployer plan or improves the benefits under the plan, it unconditionally promises to pay specified future contributions to the plan. In return, the plan unconditionally promises to pay retirement benefits to the employer's covered participants in the plan. ASC 715-80-55-2 indicates that, under an arrangement of this nature, an employer is not required to report a liability beyond the contributions currently due and unpaid. This guidance does not, however, preclude an employer from recording a liability for specified future contributions (a) it promised to make upon entering a multiemployer plan or (b) to cover the cost of improved benefits under the plan.

Employers occasionally receive notices from the multiemployer plan describing future increases (or potential increases) in the employer's contributions. In some cases, these increases may be due to funding rules under the Pension Protection Act of 2006 that require automatic surcharges on

employer contributions for plans in "critical status." In other cases, the plan may be notifying the participating employers that additional funding related to past or future service will or may be required to make up a funding deficit. Whether a liability should be recognized for an increase in future contributions should be determined based on the specific facts and circumstances. The employer is generally required to record a liability under ASC 715 and ASC 450, *Contingencies*, only if the increased future contributions are probable and relate to periods covered by the financial statements (or earlier periods). For example, if the plan notifies an employer of an increase representing a "catch-up" adjustment of amounts previously paid, the employer should record a liability for the increase. Even if the employer is not required to recognize a liability, increases in future employer contributions that are reasonably possible should be disclosed under ASC 450.

5.2.2 *Multiemployer plans – withdrawal liabilities*

A characteristic of a multiemployer plan is that its obligation to retirees continues even if a particular employer discontinues its participation in the plan. When an employer stops actively participating in a multiemployer plan, the employer is said to withdraw from the plan. This may occur as a complete or a partial withdrawal. A "complete withdrawal" occurs when the employer (including all controlled group members) permanently ceases to have an obligation to contribute to the plan or permanently ceases all covered operations under the plan. A partial withdrawal occurs when there is only a partial cessation of the employer's obligation to contribute. This may occur in instances when there is a substantial headcount reduction, such that the number of employees that are the basis for contribution are ultimately reduced, resulting in less contribution obligation.

An employer that withdraws from a multiemployer plan typically must continue payments to the plan to complete funding of the plan's liability for vested benefits. If the plan has an unfunded liability, the withdrawing employer may be charged for the unfunded liability that it leaves behind—the withdrawal liability. In general, a withdrawal liability is the withdrawing employer's share of the plan's unfunded liability, although the calculations are determined based on the terms of the plan and regulatory requirements, and are often complex. If withdrawal from the plan would give rise to a liability, that liability is accounted for following ASC 450, meaning it is recorded when withdrawal is probable and the amount of the liability is reasonably estimable. If withdrawal is reasonably possible, disclosure of the possible withdrawal liability should be made.

Question PEB 5-1 addresses the measurement for a withdrawal liability to be paid over time.

Question PEB 5-1

PEB Corporation withdraws from its participation in a multiemployer plan and must pay a withdrawal liability; however, payment may be spread over a period of time not to exceed 20 years. Should the withdrawal liability be discounted and, if so, at what rate?

PwC response

It depends. The guidance in ASC 715-80 indicates that when withdrawal from a multiemployer plan gives rise to an obligation, the provisions of ASC 450 apply. Therefore, recording the obligation at the gross amounts that will be paid, without considering the time value of those payments, would be acceptable. Discounting the obligation to its present value and then accreting this balance to the ultimate settlement amount may also be acceptable if the amount of the liability and the timing of the cash payments are fixed or reliably determinable. Depending on the facts and circumstances,

discounting at a risk-free rate or an effective settlement rate incorporating a credit adjusted rate may be most appropriate.

5.3 *Subsidiaries participating in parent company plans*

When an entity participates in a pension or retirement benefit plan sponsored by an affiliated entity (e.g., parent company, sister subsidiary), the accounting in standalone financial statements of that entity should generally follow the "multiemployer" guidance in ASC 715-80. This guidance also applies to other affiliated entities in addition to parent/subsidiary relationships. It is not uncommon for actuaries to perform allocations of plan obligations and assets to the various subsidiaries participating in a parent-sponsored plan. Based on this allocation, it might appear that the subsidiary has sufficient information to account for its participation in the plan following the single-employer guidance of ASC 715. However, based on the guidance in ASC 715-30-55-63 and ASC 715-30-55-64, the subsidiary should generally continue to follow the multiemployer guidance in ASC 715-80.

The multiemployer guidance differs significantly from the traditional "single employer" accounting guidance in ASC 715. Under multiemployer accounting, an employer would typically recognize expense based on the required contribution to the plan for the period, and the employer would only recognize a liability to the extent that the required contribution had not been paid at the end of the period. When the employers are affiliated entities, other expense allocation approaches may also be appropriate, such as an allocation of parent expense based on headcount, total salaries, etc. When preparing carve-out financial statements, the allocation of costs should be reasonable. The amount of expense recognized in the carve-out financial statements may be different from any required contributions. Refer to SAB Topic 1.B for further discussion of allocation of costs in carve-out financial statements.

A subsidiary participating in its parent's single employer plan or a non-profit agency participating in its national organization's plan is not required to provide the multiemployer plan disclosures described in FSP 13. Instead, the subsidiary/non-profit agency is required only to disclose the amount of contributions to the plan and to disclose the name of the plan.

Some pension plans may be structured as master trust arrangements in which the master trust is sponsored by the parent company and the underlying assets are legally segregated in sub-trusts by subsidiary. Such arrangements may in fact be "multiple-employer" plans (as opposed to "multiemployer" plans) and, if so, may be accounted for as separate defined benefit plans under ASC 715.

5.4 *Multiple-employer plans*

Multiple-employer plans are defined under ASC 715 as aggregations of single-employer plans (other than plans adopted by employers under common control) that are combined to permit participating employers to pool pension fund assets for investment purposes and reduce plan administration costs. These arrangements may allow employers to have different benefit formulas, with each employer's contribution to the plan based on the benefit formula it selects. Typically, multiple-employer plans do not involve collective bargaining agreements. Such plans are considered to be single-employer plans, and each employer is to account for its respective interest in the pooled assets and record pension costs in accordance with ASC 715-30. Some plans that are called multiple-employer plans under ERISA may in certain cases be multiemployer plans for accounting purposes under ASC 715-80. Careful consideration of the substance of the arrangement is necessary to distinguish between a multiemployer plan and a multiple-employer plan for accounting purposes.

Question PEB 5-2 addresses the distinguishing characteristics of multiemployer versus multiple-employer plans.

Question PEB 5-2

What are the key differences between multiemployer and multiple-employer plans?

PwC response

A key characteristic of multiple-employer plans is that the assets are not commingled, and can only be used to pay benefits for the contributing employer. They may involve features that allow participating employers to select different benefit formulas, with each employer's contributions to the plan based on their respective benefit formula and beneficiaries. The main purpose of multiple-employer plans is to reduce the cost of plan administration by pooling together the plan assets of multiple employers.

As described in ASC 715-80, a multiemployer plan is a postretirement benefit plan in which two or more employers contribute to a fund. This fund is then used to provide benefits to plan participants who were employed by the participating employers. A common characteristic of this type of plan is that the contributions of one employer can be utilized to provide benefits to another employer's employees (i.e., contributed assets from each employer are commingled, not kept separate, and are not restricted to provide benefits only to employees of that employer).

***Chapter 6:
Benefits payable during
employment—updated June
2022***

6.1 Overview of benefits payable during employment

This chapter discusses employee benefits payable while the employee is providing services. This includes wages and salaries, cash bonuses, compensated absences, fringe benefits, non-monetary benefits, and benefits funded through a voluntary employees' beneficiary associations (VEBAs). Deferred compensation arrangements are addressed in PEB 7, while pension and OPEB accounting are covered in PEB 1 through PEB 5 and other postemployment and termination benefits are covered in PEB 8.

6.2 Wages and salaries

While there is no specific authoritative literature on wages and salaries paid to an employee during employment, a reporting entity should recognize these costs as services are provided.

In addition, consistent with the guidance in ASC 718-10-15-4 (see SC 1.4), any share-based payments made to employees and service providers on an entity's behalf, whether by a parent of the reporting entity or an economic-interest holder of the reporting entity, which includes any person or entity that has a financial interest in the reporting entity (via equity securities, debt, certain contractual arrangements or otherwise) should also be accounted for as compensation by the reporting entity, unless the payment is clearly for a purpose other than compensation for services to the entity. SAB Topic 5T expands this concept to payments other than share-based payments. While this guidance is technically only applicable to SEC registrants, we believe the underlying concepts apply to all entities.

6.3 Cash bonus plans and cash bonuses

Cash bonuses may be awarded under a formal incentive plan or based on management's decision to grant individual employees or a pool of employees a cash bonus. In either instance, ASC 710 provides the relevant guidance for these contracts. However, if the individual employee cash bonus arrangement is one of a group of individual deferred compensation contracts that possess characteristics of a postretirement benefit plan, then the guidance contained in ASC 715 would apply (see PEB 2). Certain cash bonuses that depend on an entity's share price are subject to the guidance in ASC 718 (see SC 1.3).

6.3.1 Signing bonuses

An employer may enter into an employment agreement with a new employee that includes a "signing bonus," payable upon the employee's commencement of employment. In general, no liability should be recognized for the signing bonus until the employee commences employment, as this is generally the date when the employee is first entitled to the payment and the reporting entity is obligated to pay. Depending on the terms of the employment contract, it may be appropriate to record the entire expense for the signing bonus immediately. If service is required to retain the bonus, it may need to be deferred and amortized over the employee's service period, subject to consideration of the employer's willingness to enforce the repayment features.

Question PEB 6-1

In December 20X1 PEB Corporation signs an employment agreement with a new employee. The agreement includes a cash bonus payable upon the start of employment in January 20X2. There are no vesting or clawback provisions associated with the bonus indicating a future service requirement. Should PEB Corporation accrue a liability for the cash bonus in December 20X1 when the employment agreement was signed?

PwC response

No. PEB should not accrue the cash bonus in 20X1. The bonus should be recognized on the date the employee starts employment with PEB Corporation in January 20X2, as this is the date when the employee has earned the bonus and PEB Corporation is obligated to pay it (i.e., if the individual never commences employment, he will not receive the bonus).

6.3.2 Lump-sum payments under union contracts

ASC 710-10-25-12 through ASC 710-10-25-14 provides that all or a portion of a lump-sum payment made in connection with the signing of a new union contract may be deferred and amortized over a period not to extend beyond the contract period. This guidance is applicable only when it is clear that the payment will benefit a future period in the form of a lower base wage rate than otherwise would have existed. If the lump-sum payment does not benefit a future period, it is recognized as a one-time expense. This guidance relates solely to union contracts and not to individual employment contracts or any other situation involving compensation payments to individual employees. The SEC observer (see ASC 710-10-S99-1) noted that deferral of a lump-sum payment is appropriate only when there is no evidence whatsoever that the payment might be related to past services.

6.3.3 Multi-year bonus arrangements

When a cash bonus contract provides benefits that cover a service period greater than one year, ASC 710-10-25-9 states that "...the cost of those benefits shall be accrued over that period of the employee's service in a systematic and rational manner." It would not be appropriate, for example, to record all of the expense in one year if additional years of service are required to be rendered in order to earn that bonus, even if the amount is based on the initial year's financial performance. In addition, the cumulative expense recognized should not be less than the expense associated with vested amounts, and, generally, should not result in back-loading of expense. Further, whatever method of attribution of cost is utilized should be consistently applied to similar contracts or plans.

ASC 710 does not address whether an entity should estimate forfeitures in cash plans or account for the forfeitures as they occur. However, given the ability to estimate forfeitures under ASC 718 and the fact that estimating forfeitures could be viewed as "systematic and rational" as contemplated by ASC 710, we believe that it would be acceptable to estimate forfeitures in a cash plan as long as management has the ability to make a reasonable estimate. For example, it may be difficult for a start-up enterprise with limited history to estimate forfeitures. A decision to estimate forfeitures in cash awards is an accounting policy election that should be consistently applied to similar arrangements.

Question PEB 6-2 illustrates the accounting for a cash bonus that vests on a graded basis.

Question PEB 6-2

PEB Corporation has established a cash bonus plan for its employees. Employees receiving awards under the plan will be paid cash as follows: 30% in year 1, 30% in year 2, and 40% in year 3. The plan is not stock-based and is therefore not within the scope of ASC 718. How should PEB Corporation recognize the expense associated with this cash bonus plan?

PwC response

Under ASC 710-10-25-9, the cost of benefits attributed to a period or service greater than one year should be accrued over the period of service in a systematic and rational manner. One such manner is the accelerated attribution approach sometimes applied to share-based awards (e.g., compensation cost in the first year of the award would be calculated as 100% of the year 1 tranche, 50% of the year 2 tranche and 33.3% of the year 3 tranche). Another approach is recognition of the entire value of the benefit on a straight-line basis (i.e., 33% per year). Selection of an approach would be an accounting policy election that should be applied to similar arrangements. Other methods of attribution that are systematic and rational may also be acceptable.

6.3.4 Cash bonus plans with performance or market conditions

Cash bonus plans may also include performance or market conditions (see SC 2.5). Cash bonus plans that include performance conditions are subject to the guidance in ASC 710—i.e., the cost of those benefits should be accrued over the period of service when management determines that it is probable that the performance condition will be achieved. In this context, the meaning of probable is consistent with its definition in ASC 450. When the performance condition is not considered probable, no cost is accrued, or previously accrued cost is reversed. If a performance condition is initially considered not probable and the assessment of the probability changes, we believe there are two approaches to account for any adjustments made to the estimated incentive payout.

In the first approach, the reporting entity can increase the accrual to reflect the amount that cumulatively would have been accrued by the end of the reporting period had the performance condition been assessed as probable from the inception of the service period. The remaining balance, thereafter, should be accrued as future services are rendered. The second approach would be for the reporting entity to account for the increased compensation prospectively (i.e., accrue the total estimated compensation assessed as probable over the remaining period with no immediate adjustment to the accrual). Under this approach, the reporting entity would still need to ensure that the accrual recorded at the balance sheet date reflects at least the portion of the bonus in which participants have vested.

Plans that include a market condition that is based, at least in part, on the price of the entity's shares or other equity instruments should be accounted for in accordance with ASC 718. See SC, PwC's *Stock-based compensation* guide, regarding the accounting for awards subject to ASC 718.

Example PEB 6-1 illustrates the accounting for changes in the incentive payout due to reassessment of the probable outcome of the performance condition.

EXAMPLE PEB 6-1

Accounting for changes in the probability assessment of a performance condition

On June 30, 20X1, PEB Corporation set up a long-term incentive plan for certain of its key executives. PEB Corporation has a calendar year end. The plan has a performance condition based on achieving targeted net income levels calculated on a cumulative basis for the two-year period ending June 30, 20X3. Participants vest in the bonus on June 30, 20X3. The estimated payouts are based on reaching the targeted cumulative net income levels are as follows:

- Cumulative income of at least \$25 million but less than \$30 million: payout is \$3 million
- Cumulative income is \$30 million or more: payout is \$5 million

PEB Corporation is accounting for the long-term incentive plan by recognizing the anticipated payout using straight-line attribution over the 24-month vesting period. Bonuses under the incentive plan will be paid out in July 20X3, once results for the cumulative two-year performance period have been determined.

On June 30, 20X1, PEB Corporation anticipates that the cumulative net income will reach \$27 million by June 30, 20X3 and, therefore, the payout will be \$3 million. PEB Corporation accrues \$375,000 in each of the third and fourth quarters of 20X3. Absent a change in facts and circumstance, PEB Corporation would accrue another \$375,000 in the first quarter of 20X2 for a cumulative total of \$1,125,000 as of March 31, 20X2.

On March 31, 20X2, when the performance measurements are reassessed, management estimates that cumulative net income will be at least \$30 million and, therefore, the estimated payout is projected to be \$5 million.

How should PEB Corporation account for the change in the probable incentive payout from \$3 million to \$5 million?

Analysis

If PEB Corporation had estimated the probable payout to be \$5,000,000 from inception of the plan, it would have accrued \$1,250,000 in the second half of 20X1 (\$625,000 per quarter for two quarters) and another \$625,000 in 20X2 for a total accrual by March 31, 20X2 of \$1,875,000.

Based on the updated assessment of the award at March 31, 20X2, PEB Corporation needs to increase its accrual. It has two options:

- Cumulative catch-up—increase the accrual to the amount it would be if the amount determined upon reassessment had been used all along. To get the current accrual of \$1,125,000 to the new assessment of \$1,875,000, PEB Corporation would record a true-up of \$750,000. Assuming no other changes in expectations in the ensuing periods, PEB Corporation would accrue \$625,000 per quarter for the remaining 5 quarters of the performance period.
- Prospective—accrue the remaining \$4,250,000 (\$5 million less the \$750,000 accrued as of December 31, 20X1) prospectively over the remaining period from January 1, 20X2 until June 30, 20X3. This would be acceptable under the guidance in ASC 710-10-25-9, which states that the cost

of such benefits should be accrued for over the period of the employee's service in a manner that is "systematic and rational." This would result in an accrual of \$708,333 in the remaining quarters of 20X2 compared to the original expectation of \$375,000.

Whichever method is chosen would constitute an accounting policy election that should be applied consistently to similar arrangements.

Example PEB 6-2 illustrates accounting for an additional cash bonus to be paid in a subsequent year.

EXAMPLE PEB 6-2

Accounting for a discretionary cash bonus to be paid in a subsequent year

PEB Corporation had a particularly good year in 20X0 and decides in early 20X1 to set aside an additional amount of bonus money for key executives. The bonuses will be paid out in January 20X2 and require continued employment through that date in order for the executives to be eligible to receive their bonus.

PEB Corporation has an existing annual bonus plan that allows the compensation committee discretion in increasing or decreasing the amount of the final bonus. Such amounts are determined and paid in late January of each year.

When should the amount of the additional bonus be accrued as an expense?

Analysis

The additional bonus expense should be accrued over the period from February 20X1, when the plan is established, through January 20X2, when the amounts become payable to specific executives (i.e., the implied service period for the award). The rationale for this conclusion is as follows:

- The bonus is not part of PEB Corporation's established bonus plan (which employees were familiar with and knew they were working towards throughout 20X0); instead, the plan was established in 20X1.
- Payment of the additional bonus, unlike the 20X0 bonus payable in January 20X1, requires continued employment of the specific employees through January 20X2. This is a substantive employment requirement, not merely an "administrative period" necessary to finalize year-end bonuses pursuant to the plan's normal terms.

If PEB Corporation believes the bonus is attributable to employee service in 20X0, and accrued as an expense in the 20X0 financial statements, we believe those amounts would need to be finalized and paid out concurrent with any other 20X0 annual bonus payments (i.e., as part of the compensation committee's discretionary authority). Accrual of the bonus in 20X0 would also be acceptable if the decision was made in January 20X1 as part of finalizing the 20X0 bonus and the amounts became fixed obligations (notes payable) to be paid in January 20X2 without regard to continued employment.

Example PEB 6-3 illustrates attribution of expense for a cash bonus funded using a trust.

EXAMPLE PEB 6-3

Attribution of expense for a cash bonus funded using a trust

PEB Corporation commits to fund a Retention Trust with \$15 million for the purposes of an annual bonus payout. PEB Corporation will fund the trust in \$5 million increments over the next three years. PEB Corporation will determine the amount of the bonus on an annual basis and that amount will be distributed to employees from the trust annually. The amount paid each year may be more or less than the annual \$5 million in trust funding; however, PEB Corporation is required to distribute the entire \$15 million by the end of the third year. This arrangement is communicated to employees who may participate in the bonus program.

How should compensation cost be attributed over the three-year period?

Analysis

As PEB Corporation is required to distribute the total \$15 million over the three years, regardless of the annual allocation to employees, recognition of compensation cost on a straight-line basis over the three-year period may be an appropriate approach.

PEB Corporation's ability to pay out an amount greater or less than the current year trust contribution is not the predominant factor in the determination of the attribution method. However, if it is probable that PEB Corporation will pay out more than the amount of straight-line compensation expense cumulatively recognized, then PEB Corporation should adjust the amount recognized as compensation to equal the estimated bonus payment that is going to be made. The cumulative compensation expense recognized should not be less than the actual compensation cost paid. That is, delayed recognition of the compensation cost actually paid, with no clawback features, would not be appropriate.

If PEB Corporation did not pay out an annual bonus in the first two years, recognition of the entire \$15 million of compensation expense in year 3 would not be appropriate as the recipients of the bonus were providing service (i.e., earning the bonus) throughout the entire period. Thus, this approach would not be considered "systematic and rational."

6.3.5 *Single year cash bonus paid within months of year end*

Similar to wages and salaries, there is no specific authoritative guidance on annual cash bonuses paid to employees during employment. Generally, annual cash bonus costs should be recognized over the year of employee service, when probable and reasonably estimable.

Question PEB 6-3 considers an annual bonus paid out within a few months of year end.

Question PEB 6-3

PEB Corporation has a calendar year end and provides employees a recurring annual cash bonus. Bonuses are typically paid to employees in March of the year subsequent to the annual period to which the bonus relates, and require continued employment through the date of payment in order for the employees to be eligible to receive their bonus. Can PEB Corporation recognize the estimated bonus cost over the 12-month fiscal year?

PwC response

Yes. Single year bonuses are often paid out after the first quarter after the fiscal year end due to the need to close the books and finalize the total amount and allocation of the bonus pool. In this case, since the time period is considered to be an “administrative period,” and the bonus is an annual and recurring program, accrual of the bonus over the 12-month fiscal year, rather than accruing through the end of the “requisite service period” (i.e., the subsequent March), is acceptable. However, if there is a substantive employment requirement over a period longer than an “administrative period” in order for the bonus to be earned, the bonus should be accrued over the period of the service requirement.

6.4 *Compensated absences*

ASC 710 describes the accounting for compensated absences, such as vacations, holidays, sick pay, and sabbaticals.

Excerpt from ASC 710-10-25-1

An employer shall accrue a liability for employees' compensation for future absences if all of the following conditions are met:

- a. The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered.
- b. The obligation relates to rights that vest or accumulate. Vested rights are those for which the employer has an obligation to make payment even if an employee terminates; thus, they are not contingent on an employee's future service. Accumulate means that earned but unused rights to compensated absences may be carried forward to one or more periods subsequent to that in which they are earned, even though there may be a limit to the amount that can be carried forward.
- c. Payment of the compensation is probable.
- d. The amount can be reasonably estimated.

The estimated cost for compensated absences is recognized in the periods in which the benefits are earned, which would generally precede the date of vesting. ASC 710-10-25-2 provides an example in which a two-week vacation benefit vests at the beginning of the second year of employment with no pro rata payment in the event of termination during the first year. It indicates that the benefit should be considered earned for work performed in the first year (i.e., before vesting). The obligation recognized should consider estimated forfeitures due to turnover, if reasonably estimable. Unlike a pension or OPEB obligation, the resulting liability for compensated absences during employment is generally not discounted. However, if a client elects to discount their obligation, the expected future payments to be discounted should contemplate the rates of pay expected to be in effect when the payments are made.

The criterion in ASC 710-10-25-1(b) that the employer's obligation must relate to rights that vest or accumulate does not mean that vesting must have occurred before an accrual is recorded. Rather, if the employees' rights eventually vest, the liability should be accrued in the periods in which the employees provide service toward earning the benefit. Further, the requirement to accrue a liability for nonvesting rights to compensated absences, such as vacation pay or sick pay, depends on whether the

unused rights expire at the end of the year in which they are earned or can be carried forward to succeeding years. If unused rights accumulate and are available in subsequent years, a liability should be accrued to the extent it is probable employees will be paid and the amount can be reasonably estimated, even if the right never vests (i.e., will become payable upon termination).

6.4.1 Vacation benefits that lapse

If the rights to any unused vacation time expire at the end of the fiscal year, then no accrual is necessary (i.e., the rights neither accumulate nor vest). However, when the vacation entitlement is based on the employee's anniversary date rather than the reporting entity's fiscal year end, vacation earned by employees from their anniversary date but unused as of the reporting entity's fiscal year end should be accrued.

Question PEB 6-4 considers the accounting for a vacation policy under which employees vest in their full year allotment of vacation on the first day of the year.

Question PEB 6-4

Under PEB Corporation's vacation policy, employees fully vest in the current year's vacation on January 1 provided they have been employed during the prior year. If the employee leaves PEB Corporation during the year, the employee is entitled to a payout of the unused vacation on the employee's termination date. The employee must use the vacation during the current year and will lose any unused vacation at the end of the year (December 31). Should PEB Corporation accrue a liability as of December 31 for the cost of employees' vacation pay that vests on January 1?

PwC response

Yes. Under PEB Corporation's policy, vacation that vests on January 1 of year 2 is earned in year 1. Thus, PEB Corporation should accrue for that vacation during year 1 since all of the criteria of ASC 710-10-25-1 are met. This is consistent with the example in ASC 710-10-25-2.

Question PEB 6-5 considers the accounting for vacation pay that can be carried forward.

Question PEB 6-5

PEB Corporation's vacation policy allows employees to carry forward earned and untaken vacation for use in future periods. However, if an employee leaves PEB Corporation, they are not entitled to cash payment for earned but unused vacation. Should PEB Corporation record an accrual for earned but unused vacation?

PwC response

Yes. ASC 710 requires an accrual to be recorded for rights that vest or accumulate. The fact that employees will not be paid for unused vacation if they leave PEB Corporation means the rights do not vest. However, if vacation benefits can be carried forward to be used in future periods, then the rights accumulate. An accrual should be recorded to the extent compensated absences are earned and available for use in future periods. Some may question whether payment is "probable" in this fact pattern, as required by ASC 710. Probability of payment is not merely a function of whether a cash payment will be made to an employee upon departure but also includes a payment made when the

employee is paid his or her regular salary during an absence (i.e., while on vacation). Appropriate estimates of forfeitures can be incorporated in calculating the accrual.

Example PEB 6-4 illustrates the accounting for a vacation pool.

EXAMPLE PEB 6-4

Accounting for a vacation pool

PEB Corporation offers each employee the right to contribute unused vacation time to a "pool." Any vacation time employees do not use, or contribute to the pool, is forfeited at the end of the fiscal year. Time contributed to the pool expires after three years. Eligible employees may apply to draw time from the pool (i.e., take vacation), up to a limit of two weeks per year. A committee of PEB Corporation managers reviews each application, and if the applicant satisfies three criteria, the committee must grant the applicant's request to draw time from the pool. The criteria are (1) completing a minimum tenure at PEB Corporation, (2) exhausting all other paid time off, and (3) achieving a minimum annual performance rating. During the time off, a successful applicant receives his or her normal pay from PEB Corporation, the same as if the applicant were using his or her own vacation. If the applicant leaves PEB Corporation before using the granted time off, it is forfeited, will not be returned to the pool, and will not be paid in cash. PEB Corporation has operated this plan for a number of years as a means to provide employees greater flexibility in taking their vacation and has experienced a high level of utilization of the pooled vacation benefits.

Should PEB Corporation record a liability for vacation time contributed to the pool?

Analysis

Yes. PEB Corporation should accrue a liability for the vacation pool because the benefits meet the criteria in ASC 710-10-25-1, *Compensated Absences*.

- Payment of compensation for the pooled vacation is probable and reasonably estimable based on PEB Corporation's historical experience. PEB Corporation's ability to exercise discretion over granting time from the pool could affect the conclusion as to whether payment of compensation is probable and reasonably estimable. However, in this case, PEB Corporation's committee has no discretion to deny an application that meets the stated criteria.
- The pooled vacation time is attributable to service employees rendered in a period prior to when it will be used (i.e., only earned but unused vacation can be contributed to the pool).
- Although the pool of benefits do not vest (i.e., cannot be converted to cash), the benefits are carried forward from one fiscal year to the next and therefore are deemed to accumulate as described in ASC 710-10-25-1(b).

Accordingly, PEB Corporation should accrue a liability for the time contained in the pool at the balance sheet date, measured based on its estimate of the probable benefit payments.

If the employer has discretion to accept or reject applications based on subjective factors, accrual may not be appropriate until the discretion is exercised. The employer's past practice and all other relevant facts and circumstances should be considered before determining that an accrual should not be made.

Example PEB 6-5 illustrates the accounting for vacation at interim dates.

EXAMPLE PEB 6-5

Accounting for vacation at interim dates

Under PEB Corporation's vacation policy, employees earn their current year's vacation as they provide service during the year and must use the vacation during the current year or will lose any unused amounts at the end of the year (December 31).

Should PEB Corporation record an accrual for the cost of employees' vacation at interim balance sheet dates?

Analysis

The vacation benefits provided by PEB Corporations' policy do not meet the criteria in ASC 710-10-25-1 as the rights do not vest or accumulate. Therefore, PEB Corporation would not accrue a liability for these benefits as of year end. These types of plans are often referred to as "use it or lose it" plans.

Based on the general principles of ASC 270-10-45-1 that the usefulness of interim information rests on the relationship that it has to the annual results of operations, typically, no accrual at an interim balance sheet date will be required in this situation. Specifically, each interim period would be viewed primarily as an integral part of an annual period and can follow the same accounting policies that are used at year end. However, it would also be acceptable to record an accrual as of an interim period based on ASC 270-10-45-7(b) for an estimated expenditure (such as vacation pay) to be made in a later interim period within the same fiscal year.

If, however, the vacation entitlement is based on the employee's anniversary date rather than PEB Corporation's fiscal year end, an accrual for vacation pay is necessary at each interim and annual reporting date reflecting the accumulated vacation time as of the reporting date that can be utilized in a subsequent interim or annual period.

6.4.2 Sick pay benefits

ASC 710-10-25-7 states that an employer is not required to accrue a liability for nonvesting accumulating rights to receive sick pay benefits. In developing ASC 710, the FASB concluded that estimates of future sick pay would be too unreliable and too costly to develop to justify such a requirement. In addition, the Board observed that it would be unlikely that probable payments would be material unless the rights to sick pay vest or are otherwise payable without an illness-related absence. In those cases (i.e., if employees are (a) allowed to take vested accumulated unused sick pay benefits before retirement or (b) routinely paid sick pay benefits without an illness-related absence) a liability should be accrued. ASC 710 does not prohibit an employer from accruing a liability for nonvesting accumulating sick pay benefits, provided the criteria of ASC 710-10-25-1 are met. The way an employer actually administers sick pay benefits should determine the appropriate accounting, regardless of the form of an employer's policy.

The discussion of sick pay in the guidance contemplates a policy that provides pay for occasional sick days (that is, absences that occur for a limited time and on an irregular basis as a result of sickness or similar conditions). Occasional sick days would exclude extended periods of continuous absence due to

sickness (e.g., absences spanning several weeks or more at a time). In addition, the number of days covered by an employer's plan for occasional sick days cannot exceed the total number of days that a person would normally be absent in any given year for periodic illnesses. For example, if an employer compensates employees for up to 15 sick days a year, the accounting for those benefits would be covered by ASC 710-10-25-7 because the arrangement involves benefits for occasional sick days. Thus, an employer in that situation has a choice of either accruing or not accruing a liability for nonvesting accumulating sick pay. On the other hand, if an employer compensates employees for up to six months of sick days a year, that arrangement would provide benefits for more than occasional sick days, and would not be covered by the exception in ASC 710-10-25-6, even if the plan describes the benefit as sick pay. Judgment is needed to determine whether the terms of a plan provide benefits for occasional sick days or something more.

Example PEB 6-6 illustrates the application of the exception to recognition of a liability for a plan that provides benefits for occasional sick days.

EXAMPLE PEB 6-6

Exception from recognition of a liability for a plan that provides benefits for occasional sick days

PEB Corporation provides employees with sick pay benefits for ten sick days per year. Any unused sick days can be carried forward and used for absences caused by illness in subsequent years (they accumulate). However, employees forfeit all unused sick days when they leave PEB Corporation (they do not vest). PEB Corporation does not recognize a liability for nonvesting accumulating sick pay benefits under the exception in ASC 710-10-25-7.

The value of accumulated unused sick days has grown to a significant amount that is material to PEB Corporation's financial statements. Most of the employees now have available accumulated unused sick days that far exceed the number of days an individual would normally be absent in a given year for periodic illnesses. For example, some have as many as 180 days available to them and could take those days all in one year if needed for health-related absences.

Is it appropriate for PEB Corporation to continue to apply the exception in ASC 710-10-25-7?

Analysis

Yes. Even though the number of available sick days exceeds what would be deemed to be occasional sick days, the unused sick days accumulated under a plan that provides benefits each year for occasional sick days. Thus, the plan continues to qualify for the exception in ASC 710-10-25-7, and PEB Corporation is not required to accrue a liability. The fact that employees have not used all of their sick days and the unrecorded liability for accumulated sick days could be considered to be more akin to a short-term disability plan, which would not qualify for the exception, does not change the nature of the underlying plan from one under which employees earn the right to receive benefits for occasional sick days.

6.4.3 Sabbaticals

ASC 710-10-25-4 states that the appropriate accounting for a sabbatical leave depends on its purpose. If the leave is granted to perform some service to benefit the employer, the compensation is not attributable to services already rendered and a liability should not be accrued. However, a liability

should be accrued over the service period required to earn a sabbatical if the leave is granted to provide compensated unrestricted time off for past service and the other accrual conditions are met.

Compensation expense and a liability should be recorded over the period of time the service entitling the employee to the future compensated absence is rendered. If, through the adoption or amendment of a policy, the employee is entitled to additional compensated absences for past services, the expense should be recognized in the period the policy is adopted or amended.

Question PEB 6-6 considers the accounting for a sabbatical.

Question PEB 6-6

An employer provides an employee with a right to a one-year compensated sabbatical after rendering five years of service. The employee is not required to perform any direct or indirect services for or on behalf of the employer during the sabbatical. Does the right to the sabbatical accumulate?

PwC response

Yes. As described in ASC 710-10-25-5, an employee's right to a compensated absence under a sabbatical (a) that requires the completion of a minimum service period and (b) for which the benefit does not increase with additional years of service, is considered accumulating pursuant to ASC 710-10-25-1. Therefore, assuming all of the other conditions of ASC 710-10-25-1 are met, the compensation cost associated with the sabbatical should be accrued over the requisite service period.

6.5 *Fringe benefits*

While not explicitly addressed in the authoritative literature, we believe that the cost of providing other fringe benefits (including medical, life insurance, or other similar plans) to active employees should be recognized as the costs are incurred as a component of employee compensation for the current period. This could either be as insurance premiums are paid for benefits funded by third-party insurers or on an incurred-but-not-recorded basis (see FSP 23.8) for self-insured benefits. Refer to LI 5 for further discussion of the accounting for certain life insurance arrangements provided outside of a pension or OPEB plan. Life insurance benefits provided through a pension or OPEB plan are accounted for under ASC 715.

6.6 *Non-monetary employee benefits*

While not explicitly addressed in the authoritative literature, we believe that the cost of providing non-monetary benefits (including free or subsidized goods or services) should be recognized in the same manner as benefits payable in cash.

6.6.1 *Non-monetary employee benefits measurement*

The taxable benefit of a non-monetary benefit to the employee for personal income tax purposes is only an appropriate measure of the cost to the reporting entity if it approximates the fair value of the benefit. The amount recognized as an expense by the employer should be measured at the cost to the employer of providing the benefit. For example, the cost of providing an employee with a company car

would be the depreciation charge if the car is owned by the reporting entity or it may be the cost the reporting entity pays to a third party for the lease of the vehicle to be used by the employee.

If the reporting entity sold an appreciated asset to an employee at a discounted price (e.g., book value), the reporting entity should record compensation cost for the difference between the fair value and the cash price, and a corresponding gain on disposition.

6.6.2 *Non-monetary employee benefits presentation*

If the cost of in-kind benefits (e.g., company car, company cafeteria) are already being recognized by the employer. There is no need to record a duplicate expense. However, it may be appropriate, depending on the nature of the employee's services and the manner in which the employer presents its income statement, to recharacterize those costs as employee compensation.

6.7 *Voluntary employees' beneficiary associations*

Voluntary employees' beneficiary associations (VEBAs) are tax-exempt organizations, usually irrevocable trusts, which can be used by a business to fund benefits for its employees (e.g., life, health and accident insurance) at a reduced after-tax cost. Generally, the use of a VEBA will enable the business to fund the cost of a future year's benefits (or, under certain circumstances, multiple future years' benefits) in the present year and receive a tax deduction for the amount funded. The VEBA may be used for the accumulation of funds for the purpose of providing postretirement benefits. Tax deductions for contributions to a VEBA are available, subject to certain restrictions, limitations, and reporting requirements. Income earned on qualifying funds held by the VEBA is normally not subject to tax for the employer or the VEBA. Assets of the VEBA cannot be returned to the sponsor (employer) and must be distributed to the beneficiaries of the VEBA in the event it is terminated.

6.7.1 *Timing of funding and cost recognition*

VEBAs are a tax-advantaged means of funding fringe benefits. However, the assets are reported on the sponsor's balance sheet. Consequently, the timing of payments made to VEBAs does not affect the timing of recognition of the costs of the benefits that the VEBA is designed to fund. Rather, the cost of the benefits funded by the VEBA should be recognized on the same basis they would have been under the terms of the benefit plans provided to employees, absent the existence of the VEBA. For example, VEBAs may be used to fund OPEB obligations as well as obligations related to other employee benefit arrangements. Payments to the VEBA should not be recorded as expense in the period made on the basis that they are similar to insurance premiums or that they are nonrefundable to the sponsor under the tax laws.

6.7.2 *Source of funding OPEB benefits*

As noted at PEB 2.6, ASC 715-60 requires specified criteria to be met for assets to qualify as plan assets. Only assets that qualify as plan assets using the criteria specified in ASC 715-60 may be netted for presentation purposes in the balance sheet against plan obligations. Similarly, only earnings on assets that qualify as plan assets may be included in the measurement of net periodic benefit cost for income statement reporting purposes. As the "net" treatment of plan assets (without evaluating other consolidation and/or right of offset guidance) is a unique treatment for pension and postretirement benefit plans, only those assets specifically segregated and restricted to provide pension or

postretirement benefits to retirees (or postemployment benefits under ASC 712 for which the reporting entity applies the principles in ASC 715) can be considered "plan assets" for this purpose.

***Chapter 7:
Deferred compensation
agreements—updated June
2022***

7.1 Overview of deferred compensation agreements

This chapter discusses various types of deferred compensation contracts, and the relevant accounting for these arrangements, which may vary based on the features of the arrangement. Specifically, this chapter discusses the recognition and measurement of deferred compensation obligations, the accounting for changes in estimates, as well as considerations for various methods of funding deferred compensation contracts, including rabbi trusts.

7.2 Scope of deferred compensation guidance

The FASB codification does not define “deferred compensation” in the master glossary. In practice, the term “deferred compensation arrangement” generally refers to an arrangement between a corporation and selected key officers or employees containing a promise by the employer to pay certain amounts at designated future dates, which may include a period after employment. These arrangements may contain certain stipulated requirements of service. The accounting for deferred compensation arrangements depends on the specific features of the arrangement, such as vesting or the accumulation of the benefit, service and performance conditions, as well as others.

The primary sources of existing authoritative guidance that influences the accounting for deferred compensation arrangements include:

- ASC 710, *Compensation—general*
- ASC 712, *Compensation—nonretirement postemployment benefits*
- ASC 715, *Compensation—retirement benefits*

ASC 710 describes compensated absences (vacation and sick time) and sabbatical leave, common sources of deferred compensation. Accounting for compensated absences is discussed in PEB 6.4.

Accounting for deferred compensation contracts associated with a termination event or contractual postemployment benefits provided to former (or inactive) employees is discussed in PEB 8.

Accounting principles for other forms of compensation that have deferred settlement provisions, such as stock compensation plans, are discussed in PwC's *Stock-based compensation* guide.

Accounting for deferred compensation contracts that are the equivalent of a pension plan or a postretirement health or welfare benefit plan is discussed in PEB 1 through PEB 4. Authoritative accounting literature does not formally define what constitutes a pension plan or other postretirement benefit plan. Such an assessment requires substantial judgment and an evaluation of all relevant facts and circumstances associated with the specific arrangement. Criteria to help determine if contracts qualify as a pension plan are discussed in PEB 1.2.

7.3 Accounting for deferred compensation plans

Payments to be made following the period of active employment should be considered additional compensation for services rendered during the period of active employment, unless it is evident that postretirement advisory and consulting services will be substantive.

7.3.1 Substantive postretirement service requirement

An assessment of the substance of postretirement services should consider whether:

- The individual's compensation is reasonable in comparison to the services to be provided,
- There is a clear understanding of the individual's role and responsibilities, and
- There is supervision of the individual's performance and monitoring of hours worked.

If these criteria are met, some or all of the deferred compensation might be attributable to future services and be appropriately charged to income of the future periods. However, assigning a value to postretirement services will usually be very difficult and will often be impracticable. While employment contracts frequently include requirements regarding availability for advisory services and agreement not to compete after retirement, in many cases, those provisions do not impose any substantive obligation on the executive and the reporting entity does not obtain any significant benefits from the requirements. The accounting should reflect the substance of the arrangement.

In some instances, circumstances may indicate that an agreement characterized as a deferred compensation plan may, in substance, be a bonus with deferred settlement. If substantive future service is not required, the cost of such an agreement is generally required to be accrued at the date of grant rather than over the remaining employment or service period. If, however, the future payments require future services by the employee, then the charge to income would be based on the services rendered through the balance sheet date.

7.3.2 Measurement of the deferred compensation liability

ASC 710-10-30 requires the accrual of an employer's obligation under an individual deferred compensation contract in accordance with the terms of the contract, such that the present value of the obligation is fully accrued at the date the employee attains full eligibility for the benefits. The full eligibility date, as defined in ASC 710-10-20, is the date at which an employee has rendered all of the services necessary to have earned the right to receive all of the benefits expected to be received by the employee. This is the earliest date at which the employee has both completed the service required to earn full benefits under the contract and those benefits are 100% vested (nonforfeitable). This accounting is required even if the full eligibility date precedes the expected retirement (payment) date. When full eligibility has been attained, the present value of the benefits expected to be paid should be accrued. If a deferred compensation contract that requires future service is granted shortly before full eligibility, the total amount to be accrued should be recorded over the remaining period to full eligibility or in the year of grant if within the last year of eligibility.

When the amounts to be paid involve more than one individual (for example, employee and spouse) and/or are payable for at least a guaranteed minimum period of time in the event of early death, those features should be included in the actuarial calculations used to determine the present value of the accrued benefit obligation.

Some deferred compensation contracts provide that benefits are payable immediately if an employee dies or becomes disabled during the eligibility period. Unless death or disability during the eligibility period is considered probable, which would be rare, benefits should be accrued over the eligibility period. If death or disability unexpectedly occurs during the eligibility period, the benefit obligation

would be remeasured, and any previously unrecognized amount should be immediately recognized at the date of the event.

7.3.2.1 *Deferred compensation liability – credit for prior service*

An employer may enter into a deferred compensation contract during an employee's period of active employment and grant credit for prior service in determining eligibility for the benefit to be provided. If the benefit is not vested, the employer should accrue the total obligation under the deferred compensation contract in a systematic and rational manner over the employee's future service period to the date full eligibility for the benefits is attained. However, if the credit for prior service results in a vested benefit, the obligation for that vested benefit should be fully accrued at the time the contract is entered into.

Generally, that vested benefit would be determined on the date the contract is entered into, assuming that employment is terminated immediately, with no future service performed and no future salary earned under the contract. The present value of the vested benefit obligation (based on the expected timing of payment) would be recognized at contract inception. Any unvested benefit based on past service and benefits to be earned for future service should be accrued over the period from contract inception to the full eligibility date. If the deferred compensation contract is amended after contract inception, the present value of any change in the vested benefit obligation would be recognized immediately at the amendment date, with any unvested benefit (whether calculated based on past service or for future service) accrued over the future period until full eligibility.

7.3.2.2 *Deferred compensation liability – methods of accrual*

ASC 710-10-25-9 specifies that the cost of benefits should be accrued over the period of the employee's service in a systematic and rational manner.

ASC 710-10-25-9

To the extent the terms of a contract attribute all or a portion of the expected future benefits to an individual year of the employee's service, the cost of those benefits shall be recognized in that year. To the extent the terms of the contract attribute all or a portion of the expected future benefits to a period of service greater than one year, the cost of those benefits shall be accrued over that period of the employee's service in a systematic and rational manner.

ASC 710-10-25-10

If elements of both current and future services are present, only the portion applicable to the current services shall be accrued. Example 1 (see paragraph 710-10-55-4) illustrates this guidance.

Two approaches that are often used are the sinking fund method and the equal annual accrual method.

Sinking fund method

Under the sinking fund method, the periodic accrual is based on a sinking fund calculation to determine fixed "deposits" that, together with interest, will accumulate to the total amount required at the end of the accrual period, the date of full eligibility. The periodic accrual will be the "deposit" plus the theoretical interest cost on the obligation. This method will produce an increasing charge to expense over the accrual period.

In order to develop the sinking fund calculation, management must determine a discount rate. One basis for determining the discount rate is the approach used for purposes of ASC 715, that is, the rates of return on high-quality, fixed-income investments currently available whose cash flows match the timing and amount of expected benefit payments (see ASC 715-60-35-80 through ASC 715-60-35-83). For these purposes, “high quality” is defined as one of the two highest ratings given by a recognized rating agency (e.g., a rating of Aa or higher from Moody’s Investors Service, Inc.). This basis generally would be appropriate for long term arrangements that provide benefits similar to those provided by typical defined benefit pension programs.

For other arrangements when the obligation is more akin to a long-term payable, it would also be appropriate to determine the discount rate using an entity-specific credit adjustment to the risk-free rate of return—i.e., an approximate “fair value” measure of the obligation, as described in ASC 420-10-30-2. In more limited circumstances involving longer term arrangements with potentially highly variable cash flows, it may also be appropriate to use a discount rate that reflects not only the entity’s credit risk but the uncertainty in the underlying cash flows, consistent with the fair value measurement guidance in ASC 820.

Equal annual accrual method

Under the equal annual accrual method, discounting is ignored and the total estimated payment amount is divided by the number of periods through the full eligibility date to obtain the periodic accrual.

7.3.3 *Remeasurement and changes in estimates*

The deferred compensation liability is subject to regular remeasurement at each reporting period. When the deferred compensation is to be paid over a period of years (for example, for life), the obligation would continue to be remeasured after commencement of payments. The remeasurement should reflect current assumptions regarding future compensation levels (if applicable), mortality, discount rate, benefit commencement date, employment termination date, and form of benefit payment, as applicable.

Unlike pension and OPEB arrangements subject to ASC 715, when a deferred compensation obligation subject to ASC 710 is remeasured to reflect emerging experience and updated assumptions, any resulting gains and losses are recognized immediately in income for the portion of the obligation attributable to past service (generally as a component of compensation expense). The impact of the remeasurement of the obligation attributable to future service would be included in compensation expense in future periods using the same accrual convention (sinking fund or equal installment) used prior to the remeasurement.

In certain deferred compensation arrangements, the liability is more akin to a long-term payable. For example, a deferred compensation plan may call for a fixed cash flow stream over a fixed period of time (e.g., 10 years). For such plans, it would also be acceptable to accrete the liability over time at the historical interest rate at which the liability was initially discounted, similar to a note payable carried at amortized cost, rather than remeasuring each period using current interest rates.

Based on the terms of the plans, balances that have been accrued may sometimes be forfeited—for example, due to death, failure of the employee to comply with the contract, or other causes. Forfeited balances should be credited to compensation expense in the same line items as the cost was recognized

and in the appropriate period based on the reporting entity's policy on accounting for forfeitures (see PEB 6.3.3).

7.4 Voluntary deferred compensation arrangements

Some deferred compensation agreements allow employees to elect to participate on a voluntary basis. A typical voluntary deferred compensation arrangement is funded by a company-owned life insurance policy and includes the following features:

- Individual employees voluntarily defer a portion of their annual compensation (e.g., \$10,000)
- The employee receives fixed payments at specified future dates (e.g., \$10,000 in each of years 7 through 10 after the deferral)
- In the event the employee terminates employment before the specified payment dates, the voluntary deferral plus interest accrued at a specified rate is received by the employee
- At the time an employee defers the compensation, the employer typically enters into a key person life insurance contract on the life of the employee, with the employer as the beneficiary
- The employer intends to meet the commitment to the employee by borrowing against the cash value of the policy

From the employee's perspective, the arrangement may be attractive because the employee is able to defer the payment of tax on the compensation deferred. From the employer's perspective, the cash compensation deferred is typically more than the insurance premium and the insurance proceeds are typically not taxable to the employer, making the arrangement attractive from a business standpoint, principally because the inflows equal or exceed the necessary deferred compensation payments.

The accounting for the employer's liability to compensate the employee is unaffected by the employer's decision to fund the arrangement using an insurance contract. The employer's accounting for an investment in a "key-person" life insurance contract used to fund a deferred compensation agreement is discussed in LI 5.1.1.

The voluntarily deferred amount of compensation should be accrued as compensation expense in the period it is earned, which would ordinarily be the period in which the deferral election is made. The deferred compensation liability should be accreted by a charge to earnings throughout the term of the deferred compensation arrangement using the higher of the interest rate implicit in the arrangement or the specified interest-crediting rate.

7.5 Funding of deferred compensation arrangements

Any funding of deferred compensation arrangements should be accounted for separate from the deferred compensation liability. In addition, for balance sheet presentation purposes, any assets "set aside" by management to fund the deferred compensation liability should not be offset (netted) against the liability. The guidance in ASC 715 that requires netting of plan assets and liabilities, including the restrictive rules around which assets qualify as "plan assets," is specific to pension and OPEB plans.

The same is true for income statement presentation. Any assets held to fund the liability would be subject to the other applicable guidance (e.g., ASC 320 or ASC 321) and the “mark-to-market” adjustments would be reported with the reporting entity’s other investment activity. Any changes in the deferred compensation balance should be reflected in compensation expense. By analogy to ASC 710-10-35-4 (Plan D), a deferred compensation liability should be adjusted, with a corresponding debit (or credit) to compensation expense, based on the changes in the amount owed to the employee. Changes in the fair value of securities held related to the agreements should be accounted for and classified in accordance with applicable guidance as noted above.

Employers sometimes choose to fund deferred compensation arrangements with life insurance policies that are payable to the reporting entity in the event of the employee’s death. The deferred compensation liability and the life insurance asset are accounted for separately. Accounting for an investment in a life insurance contract used to fund a deferred compensation agreement is discussed at LI 5.1.1.

7.5.1 *Rabbi trust arrangements*

A form of irrevocable trust (referred to as a “rabbi” trust) is sometimes used to fund deferred compensation arrangements to reduce the risk of non-payment to the executive. Assets are placed in an irrevocable trust established by the employer. Legally, the assets remain those of the employer; however, access to trust assets is severely restricted. The employer or an acquirer cannot revoke the trust, but the assets are subject to the claims of the employer’s general creditors in the event of bankruptcy. The employee has no right to assign or transfer contractual rights in the trust. As a result, no taxable compensation to the employee results at the time these benefits are funded into the rabbi trust.

To qualify as a rabbi trust for income tax purposes, the terms of the trust agreement must explicitly state that the assets of the trust are available to satisfy the claims of general creditors in the event of bankruptcy of the employer. The use of a rabbi trust segregates the assets necessary to satisfy the deferred compensation obligation without causing constructive receipt to the employee for income tax purposes.

7.5.1.1 *Consolidation of rabbi trusts*

A rabbi trust should be assessed under the guidance in ASC 810 to determine if it is a variable interest entity (VIE). If it is, the ASC 810 guidance should be followed to determine if the employer should consolidate the trust. Even if the trust is not a VIE, ASC 710-10-45-1 requires that the assets of a rabbi trust be consolidated with the accounts of the employer. Thus, regardless of the VIE assessment, the trust and related assets will likely end up consolidated with the accounts of the employer in the financial statements of the employer. See ASC 810 for additional disclosure and reassessment guidance related to VIEs.

7.5.1.2 *No offsetting*

Assets of rabbi trusts that are included in the employer’s financial statements should not be offset against the deferred compensation liability, given the fact that the trust assets are explicitly available to general creditors in the event of bankruptcy and remain assets of the reporting entity. While some reporting entities may invest the trust assets to serve as an economic hedge against changes in the deferred compensation liability, earnings on the trust assets should be reported in the employer’s

income statement in the same manner as returns on other investments and should not be offset against the deferred compensation expense.

7.5.1.3 **Balance sheet classification of rabbi trust assets**

ASC 710 addresses the accounting for deferred compensation arrangements when amounts earned by an employee (e.g., bonuses) that are deferred are invested in the stock of the employer and placed in a rabbi trust. There are four types of deferred compensation arrangements involving consolidated assets in rabbi trusts covered within ASC 710-10-25-15 through ASC 710-10-25-18. These types are defined as Plan A through Plan D based on the diversification and settlement features of the rabbi trust. The guidance describes the accounting for plan assets held in the trust and the deferred compensation obligation.

Figure PEB 7-1 summarizes the four plan types and the guidance in ASC 710-10-25-15 through ASC 710-10-25-18.

Figure PEB 7-1
Rabbi trust plan types

Plan	Description	Accounting
A	<ul style="list-style-type: none"> <input type="checkbox"/> Diversification not permitted <input type="checkbox"/> Settlement in a fixed number of employer shares 	<ul style="list-style-type: none"> <input type="checkbox"/> Employer stock held in rabbi trust classified as treasury stock <input type="checkbox"/> Deferred compensation obligation classified in equity
B	<ul style="list-style-type: none"> <input type="checkbox"/> Diversification not permitted <input type="checkbox"/> Settlement in either cash or shares of employer stock 	<ul style="list-style-type: none"> <input type="checkbox"/> Employer stock held in rabbi trust classified as treasury stock <input type="checkbox"/> Deferred compensation obligation measured independently as a liability
C	<ul style="list-style-type: none"> <input type="checkbox"/> Diversification permitted but employee has not diversified <input type="checkbox"/> Settlement in either cash, shares of employer stock, or diversified assets 	<ul style="list-style-type: none"> <input type="checkbox"/> Same as Plan B
D	<ul style="list-style-type: none"> <input type="checkbox"/> Diversification permitted and employee has diversified <input type="checkbox"/> Settlement in either cash, shares of employer stock, or diversified assets 	<ul style="list-style-type: none"> <input type="checkbox"/> Assets held by the rabbi trust subject to applicable GAAP <input type="checkbox"/> Deferred compensation obligation measured independently as a liability

Employer stock held by the rabbi trust is classified as equity in a manner similar to treasury stock, and other assets held in the trust should be accounted for in accordance with generally accepted accounting principles for the particular asset. The deferred compensation is classified as equity if it is required to be settled solely in a fixed number of shares of the employer stock; otherwise, it is classified as a liability.

In a rabbi trust, there is no notion of a "holding period" or "mature shares" as there is in stock compensation. If the employee can receive cash for a deferred compensation arrangement at any time, no matter how far into the future, the arrangement is a liability because it is an unsettled

compensation obligation that may result in cash settlement. As the model in ASC 718 is different than ASC 710 for cash settlement features, it is important to determine how shares that may be held in a rabbi trust arrangement were initially issued and what standard applies to them—i.e., whether the shares were issued for employee services and, therefore, subject to ASC 718, or in exchange for a deferred cash compensation obligation and, therefore, subject to ASC 710. This could influence the accounting for subsequent repurchases or cash settlement of those shares. Refer to Example SC 3-4 for discussion, under ASC 718, of classification of an award that may be deferred upon vesting and placed in a rabbi trust.

See FSP 11.4.3.2 for additional discussion of the classification of deferred compensation arrangements and of assets held by the rabbi trust.

7.5.1.4 *Earnings per share implications of a rabbi trust*

Employer shares held by the rabbi trust should be treated as treasury stock for earnings per share purposes—i.e., not considered outstanding and, therefore, not included in the denominator in the basic and diluted EPS calculations. However, if the obligation under the deferred compensation arrangement may be settled in employer shares, it should be reflected in the denominator of the EPS computation in accordance with the provisions of ASC 260, *Earnings per Share*. ASC 260-10-45-13 provides that, if an obligation is required to be settled by delivery of shares of employer stock, those shares should be included in the calculation of basic and diluted EPS. If the obligation may be settled by delivery of cash, shares of employer stock, or diversified assets, those shares would not be reflected in basic EPS but would be included in the calculation of diluted EPS in accordance with ASC 260-10-45-30 and ASC 260-10-45-45 through ASC 260-10-45-46. If the shares issuable in settlement of the liability are included in the denominator of the diluted EPS calculation, the numerator is not adjusted (as described in ASC 260-10-55-33). See FSP 7 for further discussion of EPS calculations.

7.5.1.5 *Tax effects of dividends on shares in a rabbi trust*

For US Federal income tax purposes, companies may receive a tax deduction for dividends paid on shares held in a rabbi trust that does not permit diversification (i.e., it only holds employer stock). The accounting for the tax benefit in those circumstances is similar to the accounting for tax benefits related to share-based payments under ASC 718. That is, when the tax benefit is recognized, either as a reduction to taxes payable or an increase in deferred tax assets, the tax benefit should be reflected in income tax expense. See TX 17.7 for a further discussion of tax benefits associated with these dividends.

7.5.1.6 *Unit of account for arrangements with a rabbi trust*

It is important to consider the unit of account when analyzing deferred compensation arrangements that utilize a rabbi trust. We believe it may be appropriate to view the unit of account to be at the individual instrument level, at the plan level, or at the trust level.

Example PEB 7-1 highlights the differences in accounting based on different units of account.

EXAMPLE PEB 7-1

Unit of account for a rabbi trust used for deferred compensation

PEB Corporation has one rabbi trust that is used to fund two deferred compensation plans. One plan is a cash bonus arrangement, the other a stock bonus arrangement. The cash bonus arrangement permits diversification within the rabbi trust, while the stock bonus arrangement does not (i.e., it must be settled by the delivery of a fixed number of shares of employer stock). Additionally, dividends on the employer stock are also deferred in the rabbi trust, and will be settled in cash.

What is the appropriate accounting for the rabbi trust? Does the accounting differ depending on the assessed unit of account?

Analysis

If the unit of account is viewed to be at the trust level, the entire amount in the rabbi trust would need to follow the Plan B through Plan D accounting described in PEB 7.5.1.3 and in ASC 710-10-25-15 through ASC 710-10-25-18. That is, a deferred compensation liability would be recognized at fair value each reporting period (with a corresponding charge to compensation cost) for all amounts (both the cash and employer stock) in the trust.

If the unit of account is viewed to be at the individual deferred compensation plan level, each plan would be analyzed separately to determine the applicable plan type and accounting. The cash bonus arrangement would be considered Plan D because it permits diversification and the liability associated with it would be measured at fair value at each reporting period. The stock bonus arrangement would likely qualify for Plan A accounting, because it requires settlement by delivery of a fixed number of employer shares. However, because the dividends will be settled in cash, the entire stock bonus plan would be subject to Plan B accounting and the obligation would also be marked to fair value each reporting period.

If the unit of account is viewed to be at the individual instrument level, the three components of this arrangement (cash bonus, stock bonus, dividends) would be analyzed separately. The cash bonus component would follow Plan C/D accounting because it can be diversified. The stock bonus component would follow Plan A accounting, because it is settled in a fixed number of shares. The initial payment of the dividend would not require additional compensation expense as it would be viewed as a dividend on an existing equity instrument. Subsequent to the initial payment, the dividends would require Plan B accounting, because they are cash settled. Any change in the value going forward would require additional compensation cost to reflect changes in the fair value; for example, if interest is paid on the cash balance.

Whether a reporting entity evaluates the unit of account at the trust, plan, or instrument level is an accounting policy decision.

***Chapter 8:
Termination and other
postemployment benefits—
updated June 2022***

8.1 Termination and other postemployment benefits overview

Employees may be provided termination benefits for a number of reasons. The accounting for the cost of termination benefits is determined based on the nature of the benefits, specifically if there is a voluntary or involuntary termination, and the arrangements through which the benefits are paid. For accounting purposes, termination benefits are commonly classified in one of four groups:

- Special termination benefits
- Contractual termination benefits
- One-time termination benefits
- Other postemployment benefits

The accounting guidance for special, contractual, and other postemployment benefits is contained in ASC 712, *Compensation - Nonretirement Postemployment Benefits*, while the guidance for one-time termination benefits is included in ASC 420, *Exit or Disposal Cost Obligations*, specifically ASC 420-10-25-4 through ASC 420-10-25-10.

In certain circumstances, employee termination benefits may have characteristics of more than one type. For example, employee termination benefits provided in connection with one management action may include benefits due pursuant to both a written or substantive plan as well as additional one-time termination benefits that are not contemplated under the substantive plan. The timing of expense recognition could be significantly affected by which accounting model applies.

The guidance for employee termination benefits in ASC 712 and ASC 420 generally applies to benefits provided to a group of employees, either under an ongoing benefit arrangement or on a one-time basis. Individually negotiated arrangements are generally in the scope of ASC 710-10, *Compensation -- General*.

A broader termination program may also trigger a curtailment if the reporting entity has a pension or OPEB plan accounted for under ASC 715. For guidance on accounting for curtailments, refer to PEB 4.4.

Figure PEB 8-1 describes the types of termination benefits, the applicable accounting framework and timing of recognition.

Figure PEB 8-1
Applicable accounting framework and timing of recognition

Type of benefit	Applicable guidance	Description of benefits in scope	Timing of liability/expense recognition
Special termination benefits	ASC 712-10-25-1 PEB 8.2	Benefits offered by the employer for a short period of time in exchange for an employee's voluntary termination.	When an employee irrevocably accepts the offer and the amount can be reasonably estimated.

Type of benefit	Applicable guidance	Description of benefits in scope	Timing of liability/expense recognition
Contractual termination benefits	ASC 712-10-25-2 - ASC 712-10-25-3 PEB 8.3	Benefits required by the terms of an existing plan or agreement (or through an enhancement to an ongoing benefit arrangement) only upon the occurrence of a specified event (e.g., a plant closing) that causes employees' services to be terminated involuntarily	When it is probable the employees will be entitled to benefits (i.e., when it is probable that the specified event will occur) and the amount can be reasonably estimated
Other postemployment benefits	ASC 712-10-25-4 - ASC 712-10-25-5 PEB 8.4	Benefits provided in accordance with a mutually understood benefit arrangement between the employer and the employee or former employee A mutually understood benefit arrangement could be achieved through either a written plan or through a consistent past practice that would constitute a "substantive plan"	When the existing situation or set of circumstances indicates that an obligation has been incurred, it is probable the benefits will be paid, and the amount can be reasonably estimated. For benefits that vest or accumulate: <ul style="list-style-type: none"> • as the employees provide the services to earn the benefits, or • when the liability is probable and reasonably estimable (akin to a loss contingency model)
One-time termination benefits	ASC 420-10-25-4 - ASC 420-10-25-10 PEB 8.5	One-time involuntary termination benefits that are not provided under the terms of an ongoing benefit arrangement or enhancements to an ongoing benefit arrangement that would be applicable for future events	When the conditions specified in ASC 420 have been met, including management's commitment to a plan and communication to employees Expense is recognized immediately if future services are not required, or ratably over the period of required future service

8.2 Special termination benefits

ASC 712 addresses the accounting for special and contractual termination benefits that are payable before retirement and are not payable from a pension or other postretirement benefit plan. Refer to PEB 4 for further discussion of termination benefits paid out of a pension or other postretirement benefit plan. Note, however, that the accounting treatment of special and contractual termination benefits, including timing of recognition, is similar whether or not paid from a pension or other postretirement plan.

Special termination benefits arise when the employer offers, for a short period of time, certain additional benefits to employees electing voluntary termination. A liability should be recorded and an expense recognized in the period the employees irrevocably accept the offer and the amount of the termination liability is reasonably estimable. That timing would generally coincide with when the employees irrevocably accept the offer as it would be unlikely that the termination liability would not be reasonably estimable at that time. It would not be appropriate to record an accrual at the time of the offer based on an estimated acceptance rate.

There may be situations when an offer of special termination benefits extends beyond the end of a reporting period. Irrevocable acceptances received prior to the period end give rise to recognition of a termination liability at the balance sheet date. A contingent liability for offers still outstanding and offers that have not yet been irrevocably accepted should not be accrued even if the acceptances are

received prior to issuance of the financial statements. Such amounts should be disclosed, if significant, pursuant to ASC 450-20, *Loss Contingencies*, (i.e., they would be a non-recognized subsequent event).

Question PEB 8-1

A company announces a plan to reduce costs through the phase-out of a particular product line. The employees impacted by this decision were provided an offer to voluntarily terminate their employment with the company. In return, the employees will receive a one-time termination benefit. The employees were notified of this opportunity on December 15, 20X1 and have until January 15, 20X2 to notify the company if they will accept its offer. Management has indicated that it will process all offers that are accepted by employees. Upon termination, no future services will be required of the employees.

What model for termination benefits should be used? When should the liability and related expense be recorded?

PwC response

Based on the fact pattern, the company would account for the termination benefits as a special termination benefit (under ASC 712) based on the fact that the one-time termination benefit is in exchange for an employee's voluntary termination. The liability and related expense for the special termination benefit would be recorded upon irrevocable acceptance of the offer by an employee. Since the company will accept all employee offers to terminate and no future services are required, the liability and expense will be recognized upon employee acceptance.

Only irrevocable acceptances received by December 31, 20X1 would be recorded in the financial statements as of that date. Accordingly, some of the expense for the termination benefits may be recorded in 20X1 and some in 20X2, based on the acceptances in each period.

Question PEB 8-2

On December 1, 20X1, a company offers voluntary termination benefits to employees who meet specified criteria and agree to terminate employment at the end of the following year. To receive the benefit, eligible employees must (a) accept the offer to voluntarily terminate their employment by signing agreements before December 31, 20X1 and (b) be employed at the date of termination (December 31, 20X2).

How should the company account for this voluntary termination benefit?

PwC response

The voluntary termination benefits should be accounted for as a special termination benefit. In order for the employer to have a liability to pay special termination benefits, employees must accept the offer. However, ASC 712 does not address the situation in which the benefits do not vest upon employee acceptance but involve future service requirements. In general, for a newly established arrangement (voluntary or involuntary) that requires future service beyond a nominal period (generally no more than 60 days, by analogy to ASC 420-10-25-7), we believe the cost should be recognized over the period during which that service is rendered. Thus, the cost of the benefits should be accrued ratably over the affected employees' remaining service period (i.e., the period between the acceptance/agreement through the scheduled termination date).

This is consistent with the "stay bonus" concept discussed in ASC 420 for involuntary termination benefits. Under that concept, the cost of incremental compensation that is not part of a pre-existing benefit arrangement is typically recognized over the required future service (vesting) period, as the termination benefits are being provided not solely for the agreement to terminate employment, but also for substantive future services. It is also consistent with other existing accounting models explicitly addressing benefits with future vesting requirements, such as deferred compensation arrangements (ASC 710) and stock-based compensation arrangements (ASC 718).

8.3 Contractual termination benefits

Contractual termination benefits are provided to employees when employment is terminated due to an event specified in the provisions of an existing plan or agreement (e.g., a labor contract). For example, an agreement may provide that, in the case of a plant closing, the employer will provide stated benefits to affected employees. A liability should be recorded for contractual termination benefits and the expense recognized when it is probable that employees will be entitled to the benefits and the amount is reasonably estimable.

Note that the guidance uses the phrase "contractual" in this context to refer to benefits triggered by specifically identified events (such as a plant closure), not just that the benefits are established pursuant to an existing contractual arrangement. Benefits that are payable pursuant to an existing severance plan that do not depend on the occurrence of a specific event are addressed in PEB 8.4.

The FASB recognized the inconsistency between the timing of recognition for special termination benefits (see PEB 8.2) and contractual termination benefits, but concluded the different nature of the two events warrants different treatment. In the case of special termination benefits, it is the employees, not the company, who elect termination, and no obligation arises until the employees make that irrevocable election. However, an employer is legally bound to pay contractual termination benefits whenever the specified event occurs, and the benefits should be accrued when the decision causing the event is made and that decision makes it probable that termination benefits will be paid.

8.4 Other postemployment benefits

ASC 712 prescribes the accounting for the estimated cost of other postemployment benefits provided by an employer to former or inactive employees after employment but before retirement. These benefits include salary continuation, supplemental unemployment benefits, severance benefits, disability related benefits (including workers' compensation), job training and counseling, and continuation of benefits, such as health care benefits and life insurance coverage. These benefits are generally viewed as part of the compensation provided to employees in exchange for service.

Of these benefits, those that vest or accumulate are accounted for using the same model applied when accounting for compensated absences pursuant to ASC 710-10-25-1 through ASC 710-10-25-3 (see PEB 6.4). Other benefits that do not meet these conditions are accounted for using a loss contingency model under ASC 450-20-25-2.

Under a loss contingency model, a liability to pay benefits that is reported in the balance sheet should result from a condition, situation, or set of circumstances that existed at the balance sheet date. A liability should be recorded when it is probable that a liability had been incurred at that date and the amount is reasonably estimable. For example, the existence of a postemployment benefit plan

evidences an employer's promise to provide termination benefits to involuntarily terminated employees. Employers with such a plan have generally communicated it to employees so that they understand the benefits they would be entitled to receive if they are involuntarily terminated. Thus, the employer with such a plan has a mutual understanding with its employees regarding the benefit arrangement and has therefore obligated itself to pay the benefits in the event of their involuntary termination. Accordingly, when it is probable that the employer will involuntarily terminate the employment of employees, and the amount of the termination benefits is reasonably estimable, the "existing condition, situation, or set of circumstances" requirement is met, and a liability for the cost of the benefits would be recognized. The accrued amount should incorporate an estimate of employees that will voluntarily cease employment prior to being involuntarily terminated and not ultimately receive the severance benefits.

An employer's nonretirement postemployment benefit obligation is the sum of:

- the reasonably estimable value of nonvesting/nonaccumulating postemployment benefits that are probable of payment to the current group of former or inactive employees (e.g., those on disability leave); and
- a proportionate amount (based on the portion of the required service period rendered) of the probable and reasonably estimable value of vesting or accumulating postemployment benefits expected to be paid to current employees.

Uncertainty regarding the timing of benefit payments does not preclude the recognition of the obligation.

Question PEB 8-3

A subsidiary is in the process of streamlining its organization in anticipation of being spun-off by its parent. This spin-off will lead to the termination of 100 subsidiary employees. The subsidiary is offering its employees the opportunity to receive one-time incremental termination benefits, in addition to the termination benefits available under the parent's pre-existing severance plan, if they are willing to leave the company. The employees were notified of this opportunity on March 1 and have until March 31 to notify the subsidiary if they will voluntarily leave. The subsidiary will then determine which voluntary terminations to accept. If less than 100 employees voluntarily agree to terminate then the subsidiary will involuntarily terminate sufficient employees to ensure that they eliminate at least 100 employees in total. All decisions will be made on or before April 30 and communicated to the employees on April 30.

Should the voluntary termination benefits be accounted for as a special termination benefit, a contractual termination benefit, and/or as a one-time termination benefit?

PwC response

The voluntary termination benefits being offered to the employees should be accounted for in two pieces. The portion that is provided under the parent's pre-existing severance plan is a postemployment benefit (ASC 712) and the incremental portion is a one-time termination benefit (ASC 420; see PEB 8.5). The benefits should not be accounted for as special termination benefits because the subsidiary can either accept or deny the employee's acceptance of this termination program. Under ASC 712-10-25-1, "special termination benefits to employees shall be recognized as a liability and a loss when the employees accept the offer and the amount can be reasonably estimated." However, this guidance applies when a plan would be binding once the employee accepts the offer. Since the

subsidiary can either accept or deny the employee's acceptance of this termination program, this plan is not considered a special termination benefit as the subsidiary will make the final decision to terminate an employee.

For termination benefits provided under the parent's pre-existing severance plan, a liability should be recognized when it is probable and reasonably estimable (ASC 712-10-25-2). The subsidiary should consider when the decision was made to streamline the operations and eliminate 100 employees as that is the date when it would be probable and reasonably estimable that 100 employees will be entitled to the contractual termination benefits.

For the one-time benefits that are incremental to the parent's pre-existing severance plan, a liability should be recognized when the criteria under ASC 420-10-25-4 are met. Consequently, for the portion subject to ASC 420, the subsidiary would record the liability when they determine which employees' offers of termination they will accept (i.e., sometime in April), as that is the point at which management would have committed to the plan of termination (assuming that the other three criteria of ASC 420-10-25-4 have been met) and communicated the benefit arrangement.

Question PEB 8-4

On December 15, 20X1, a company makes a general announcement that cost-cutting measures are underway and an involuntary work force reduction will occur in the near future. As of December 15, 20X1, the company has identified affected employees, but has not notified them and does not plan to do so until January 20X2. Upon termination, no future services will be required of the employees.

The company has a written plan that specifies that an involuntarily terminated employee receives two weeks of base salary for every year of continuous employment. In connection with this work force reduction, management has decided to provide severed employees with an extra week of base salary for every year of continuous employment. This additional benefit will be communicated in January 20X2 when identified employees are notified. Management does not intend to offer this additional week in future severance events.

What model for termination benefits should be used? When should the liability and related expense be recorded?

PwC response

The company would account for the benefits associated with the three weeks of base salary for each year of service in two pieces. Two of the three weeks would be accounted for under the other postemployment benefit plan (under ASC 712) because the company has a written plan that entitles severed employees to two weeks of base salary for every year of continuous employment. The related liability and expense for those termination benefits would be recorded on December 15, 20X1 for the identified employees, as there is a mutual understanding of benefits that employees will be entitled to receive at that time, and the benefits are both probable and estimable at that time.

The company would account for the benefits associated with the additional one week of base salary for each year of service as one-time employee termination benefits (under ASC 420) because that benefit is an additional one-time benefit and is not covered by an existing written or substantive plan. The related liability and expense for those termination benefits would be recorded in January 20X2 upon communication of these benefits to the impacted employees ("communication date") when the benefit arrangement is mutually understood by the employees. The amount of the benefit would be recognized

immediately, as no future services are required to receive the additional benefit. See PEB 8.5 for further discussion.

8.4.1 Termination benefits that vest or accumulate

When the four conditions in ASC 710-10-25-1 are met, the expense and liability for benefits are accrued as the employees provide the services to earn the benefits. The four conditions are:

- The benefits relate to past service
- The benefits vest or accumulate
- Payment is probable
- Payment can be reasonably estimated

Benefits meeting these conditions should be recognized in the period or periods in which employees render the necessary services to earn the right to the benefit. An employer must continue to assess whether payment is probable and reasonably estimable at each reporting date, and recognize the liability that exists (i.e., based on the portion of the required service period rendered) when those conditions are initially met.

Vested rights are defined as those for which the employer has an obligation to make payment even if an employee voluntarily terminates; thus, they are not contingent on the employee rendering future services. Benefits that accumulate are those for which earned but unused rights are carried forward to one or more subsequent periods, even though there may be a limit to the amount that can be carried forward. Benefits that accumulate generally have been defined as any postemployment benefit that increases with additional employee service.

Question PEB 8-5

If an employer meets the first two conditions in ASC 710-10-25-1 (i.e., that postemployment benefits are attributable to services already rendered and that they either vest or accumulate) but does not meet one or both of the other conditions in that paragraph (i.e., payment of the benefits is not probable or the amount cannot be reasonably estimated), should the employer follow a loss contingency model (ASC 450-20-25) from that point on?

PwC response

No. Since the employer has a plan under which postemployment benefits meet the first two conditions of ASC 710-10-25-1, it must continue to assess whether it meets the probable and reasonably estimable conditions at each reporting date and recognize the liability that exists when those conditions are initially met (and recognize subsequent increases in that liability for additional benefits earned as a result of additional employee service). Uncertainty regarding the timing of benefit payments does not justify not recognizing the obligation.

8.4.1.1 *Determining when termination benefits accumulate*

Benefits that accumulate are any postemployment benefits that increase with additional years of employee service. If an employee with ten years of service receives a larger benefit than an employee with nine years of service (because of the length of service), the benefit accumulates.

Benefits based strictly on compensation levels do not accumulate. For example, if an employee with five years of service earning \$25,000 would receive the same benefit (e.g., defined as a percentage of final pay) as an employee with three years of service who also earns \$25,000, there is no accumulating benefit. Likewise, if the employee with five years of service receives a salary increase in year six, which would increase the amount of benefit but is not directly attributable to working an additional year (i.e., it is not formulaic based on years of service), the larger benefit would not be considered an accumulating benefit.

Assuming all of the other conditions of ASC 710-10-25-1 are met (particularly that the payment is probable and reasonably estimable), the cost of accumulating benefits should be recognized as they are earned by employees through the rendering of service. The period of attribution starts on the date the rights to benefits begin to accumulate and ends on the date the employees are fully eligible to receive the benefits.

Question PEB 8-6

For a postemployment benefit to accumulate, is it necessary that the increase occur more than once (i.e., in a series of increments as more years of service are rendered)?

PwC response

No. The key criterion for an accumulating benefit is that the benefit amount must increase due to length of service. That increase could occur only once. For example, the benefit could increase after five years of service without any further increases for additional years of service.

Question PEB 8-7

An employer provides disability benefits to its employees subject to an eligibility requirement of five years of service. For five to ten years of service, the employee receives 30% of salary; for 10 to 15 years of service, the employee receives 50% of salary; and for over 15 years of service, the employee receives 75% of salary. Do the disability benefits accumulate?

PwC response

Yes. The disability benefits accumulate. Accordingly, the cost of the benefits would be accrued during the relevant service periods of employees based upon anticipated disabilities and the estimated amount of benefits, assuming the amounts are probable and reasonably estimable.

Question PEB 8-8

An employer has a written involuntary termination benefit plan that is distributed to all of its employees at their date of hire. The plan provides that, upon an involuntary termination of employment for other than cause, each terminated employee will receive one week of severance pay for every year of service (i.e., the benefits accumulate). If an employee voluntarily terminates employment, the employee will receive no termination benefit under this arrangement (i.e., benefits are not vested prior to the involuntary termination date).

Would the written plan constitute a postemployment benefit plan?

PwC response

Yes. The employer and its employees have a mutual understanding of the benefits the employees will receive if they are involuntarily terminated. To be mutually understood, employees must know that the benefit arrangement exists and the terms that determine what benefits the plan provides. Accordingly, when payment of benefits under this plan is probable and reasonably estimable, the cost of the benefits should be accrued based on the approach described in ASC 710-10-25-2 (as prescribed by ASC 712-10-25-4) because the benefits accumulate based on years of service.

8.4.2 Common types of postemployment plans

There are various types of postemployment arrangements, including the following:

- Workers' compensation (see PEB 8.4.2.1)
- Severance benefits (see PEB 8.4.2.2)
- Long-term disability (see PEB 8.4.2.3)
- Life insurance benefits (see PEB 8.4.2.4)
- COBRA benefits (see PEB 8.4.2.5)

8.4.2.1 Workers' compensation

Any benefits that result from an existing injury are recorded under the loss contingency model (ASC 450), requiring that an obligation be recognized for the estimated cost of claims filed and those incurred but not reported. In addition, if a benefit meets all of the ASC 710-10-25-1 conditions, an obligation is to be recognized even before any injuries occur if it is probable that accumulating workers' compensation benefits will be paid to current employees covered by the plan. This is because, for that type of benefit, the event that creates a liability and affects the amount of accumulating benefits is the rendering of employee service. However, since workers' compensation benefits generally do not vary with additional years of employee service (i.e., they do not vest or accumulate), the ASC 710-10-25-1 approach is rarely used to account for the cost of such benefits.

8.4.2.2 Severance benefits

Many severance plans provide benefits that vest (i.e., they are payable regardless of who initiates the action that leads to termination of employment) or accumulate (i.e., the benefits increase in amount

based on length of employment) and are, thus, attributable to past services. An employer should accrue a liability when all four of the ASC 710-10-25-1 conditions are met. A benefit that an employee is entitled to upon any termination of service (including voluntary termination), sometimes referred to as a termination indemnity, should generally be accrued over the vesting period. The liability at each reporting date should at least reflect the amount currently vested. Although the timing of the payment may not be known, it would generally be considered probable that the company will pay the benefits at some point in the future. This type of arrangement may be more common in certain foreign countries.

Some companies may have a history of paying severance benefits for involuntary terminations absent a written severance plan. In that case, the history of the severance payments should be analyzed to determine whether a substantive plan exists. A benefit arrangement that is mutually understood by an employer and its employees would constitute a substantive plan even if that arrangement is unwritten. A history of paying special termination benefits, as defined in ASC 712 (see PEB 8.2), would not constitute such a plan, however, because employers have no obligation to pay benefits until employees accept an offer to voluntarily terminate their employment.

For severance benefits that vest or accumulate, companies should accrue a liability when payment of the benefits is probable and reasonably estimable. Generally, three different situations may occur for companies with written or substantive severance plans:

- Severance occurs from time to time, but is not probable and estimable. Companies should record a liability when payment of benefits becomes probable and estimable.
- Some minimum level of probable severance benefits can be predicted and estimated with reasonable accuracy covering normal recurring involuntary terminations. If the severance benefits vest or accumulate, they should be accrued over the related service period under the ASC 710-10-25-2 approach. Unusual levels of severance (e.g., resulting from a restructuring or plant shutdown) would be accrued when probable and reasonably estimable, generally when management has made the decision to initiate the terminations.
- Some very large companies may have so many work locations that the natural evolution of their businesses results in a reasonably predictable pattern of workforce reductions (e.g., through small reorganizations, plant shutdowns, and other actions). In those situations, overall severance costs, including those related to various termination “events,” could be considered probable of payment and reasonably estimable even though a decision has not been made to close any specific plant. As such, the value of severance benefits that vest or accumulate should be accrued over the relevant employee service periods.

If the termination benefits represent contractual termination benefits (see PEB 8.3), a liability for such benefits would be recognized when it is probable that the specified event that would trigger a requirement to pay benefits (e.g., plant closing) will occur.

One-time termination benefits provided to involuntarily terminated employees under the terms of a one-time benefit arrangement (an arrangement established by a plan of termination that applies for a specified termination event or for a specified future period) should be accounted for under ASC 420 if the benefits are not provided in the form of an enhancement to an ongoing benefit plan. See PEB 8.5 for additional discussion of one-time termination benefits.

Question PEB 8-9

On December 15, 20X1, a company makes a general announcement that cost-cutting measures are underway and an involuntary workforce reduction will occur soon. As of December 15, 20X1, the company has identified affected employees, but has not notified them and does not plan to do so until January 20X2. The company does not have a written pre-existing severance plan; however, it has a history of compensating severed employees four weeks of base salary for every year of continuous employment, and plans to do so in this case. Employees understand how their benefits would be calculated if they were to be involuntarily terminated.

What model for termination benefits should be used? When should the liability and related expense be recorded?

PwC response

The company would likely conclude that it has a substantive involuntary termination benefits plan because it has a consistent past practice of providing termination benefits that employees understand. The liability and related expense for the termination benefits would be accrued on December 15, 20X1 for the identified employees, as there is a mutual understanding of benefits that employees will be entitled to receive at that time and the amount is both probable and estimable. Note that the assessment of what constitutes a “consistent past practice” involves considerable judgment, as further described in PEB 8.5.

Question PEB 8-10

To record a liability for one-time termination benefits, ASC 420 requires an employer to, among other things, communicate to its employees the benefits they will be entitled to receive if they are terminated. Must this communication be made for a liability to be recorded for severance benefits pursuant to an ongoing benefit plan?

PwC response

No. ASC 712 addresses the accounting for benefits that are provided under the terms of an ongoing postemployment benefit plan. A plan represents the benefit arrangement that is mutually understood by an employer and its employees. Thus, if an employer has an ongoing benefit plan that provides involuntary termination benefits, employees are already aware of the benefits they will receive if they are terminated involuntarily so the communication of the benefit is not necessary for an obligating event to occur.

Example PEB 8-1 discusses the timing of recognition of a liability related to a reduction in force.

EXAMPLE PEB 8-1

Timing of recognition of liability for severance benefits for a reduction in force

An employer has a written involuntary termination benefit plan that is distributed to all of its employees at their date of hire. The plan provides that, upon an involuntary termination of employment for other than cause, each terminated employee will receive one week of severance pay for every year of service. If an employee voluntarily terminates employment, the employee will receive no termination benefit under this arrangement.

The employer has previously concluded that involuntary terminations were not probable and/or reasonably estimable.

During its fiscal fourth quarter, the company determines that it will initiate a reduction in force (RIF). Management can reliably estimate the expected number of involuntary terminations that will occur. The RIF is expected to occur approximately six months after the fiscal year end and specific affected employees will be notified at that time and terminated immediately.

What accounting would be required under these circumstances?

Analysis

Because the benefits accumulate—i.e., the amount of severance increases based on years of service—the plan is subject to the guidance in ASC 712. Although no benefits were previously accrued because management concluded payment was not probable or reasonably estimable, the decision to initiate a RIF in the fourth quarter and establish the number of terminations expected to occur makes payment probable and reasonably estimable under the plan. Because payment of the benefit is probable and the amount can be reasonably estimated, the company would recognize a liability during the fourth quarter for the cost of benefits earned by employees' services rendered through the end of the fiscal fourth quarter. The amount should be based on expected future payments of benefits earned for service to date, taking into account the possibility that some individuals may voluntarily terminate their employment before being notified of the RIF and will not be entitled to the benefits. The liability would be increased in the first and second quarters of the next fiscal year as employees who will be terminated as part of the RIF render additional service that earns them a larger benefit (i.e., they reach another anniversary date to be eligible for another week of pay).

If the company did not have a written plan or a substantive plan based on a history of paying benefits for past terminations, but rather announced what the severance benefits for this RIF will be in the fourth quarter when it reached the decision to perform a RIF, the benefit arrangement would be accounted for as a one-time termination benefit. In that case, because individuals must be employed on the termination date in order to receive the benefit and the minimum retention period to receive the benefits is greater than 60 days, the cost of the benefits and corresponding liability would be accrued from the date that all of the conditions in ASC 420-10-25-4 are met (management commitment, employee groups identified, terms established in enough detail that employees can determine benefits if they are terminated, unlikely significant changes to plan will be made and communication to affected employees) through the termination date.

Question PEB 8-11

Company A terminated a key employee. The employee has historically been instrumental in Company A's revenue growth, developing and maintaining a significant number of the company's customer relationships. At the time of termination, Company A and the employee negotiated a \$2 million severance payment, as well as a three-year non-compete agreement.

Should Company A expense the \$2 million upon termination or capitalize some or all of the \$2 million and attribute the amount over the three-year term of the non-compete?

PwC response

It depends. The determination of whether some or all of the \$2 million should be expensed or attributed over a future period is dependent on whether the non-compete agreement is considered an asset (i.e., whether there is a probable future economic benefit that is controlled by the company) consistent with the guidance in ASC 350-30-25 regarding the recognition of an intangible asset. This evaluation would consider whether the non-compete agreement is substantive, and whether Company A has the intent and legal ability to enforce the non-compete agreement.

If the non-compete is determined to be substantive and Company A has the intent and ability to enforce it, the fair value of the non-compete, not to exceed the total payment, would be capitalized and amortized over the three-year term of the non-compete. The fair value of the non-compete may be an amount less than the \$2 million total payment. Any amount paid in excess of the fair value of the non-compete would be expensed as a severance payment.

8.4.2.3 *Long-term disability benefits*

If long-term disability-related benefits do not vary with years of service (i.e., do not vest or accumulate), and are separate from a pension or postretirement plan, the employer is required to accrue the cost of the benefits (e.g., wage continuation, health care, life insurance) at the date of the disability. However, disability-related benefits that vary with years of service (i.e., accumulate) will need to be recognized during employees' service period under ASC 710-10-25 when payment of benefits is probable and reasonably estimable. Disability benefits offered to active employees as part of a pension plan are in the scope of ASC 715-30 and should be included in the measurement of the projected benefit obligation. See PEB 2 for additional discussion of these types of benefits in a pension plan.

In general, disability benefits are unlikely to be probable or reasonably estimable prior to the injury or illness of the employee occurring. Thus, accrual for disability benefits typically occurs on an incident-by-incident basis. To measure the liability for disability-related benefits at the date of disablement, an estimate of all wage continuation and health care benefits will have to be developed for each disabled employee (and covered dependents). Depending on the benefit arrangement and the interaction of various plans, this liability may be smaller if the employer is already accruing a significant portion of disability-related costs as a postretirement benefit under ASC 715-60.

8.4.2.4 *Life insurance benefits*

Employee death benefits (employer-provided life insurance that is self-insured) typically vary with an employee's salary rather than with years of service. Therefore, most such benefit arrangements do not vest or accumulate. As a result, an employer will typically record death benefits, future survivor income payments, and health care benefits for a surviving spouse upon the death of an employee if the benefit is only provided to employees who die while in active service. If the benefit is provided as part of a pension or postretirement plan, or is also provided to former or retired employees, it would be a postretirement benefit accounted for under ASC 715 (see PEB 2). In some cases, employers may purchase life insurance contracts to fund these benefits. See LI 5 for some of the more common types of life insurance contracts, such as, key-person life insurance and split-dollar life insurance, and the reporting entity's accounting for its investment in these contracts.

8.4.2.5 COBRA benefits

The continuation of health care benefits under COBRA (Consolidated Omnibus Budget Reconciliation Act) is a postemployment benefit. Any difference between the actual cost of healthcare benefits and the COBRA contribution collected from the employee is the amount of the postemployment benefit and should be reflected in the measure of the benefit obligation. All employees are entitled by law to elect continuation of healthcare coverage under COBRA. However, the benefit typically does not vest or accumulate and, thus, should be accounted for using a loss contingency model. Because this benefit is provided for a limited period of time, and terminated employees often pay a large portion of the cost of continuing coverage, an employer's obligation for COBRA benefits may not be material. However, employers who voluntarily provide health care continuation on more favorable terms than COBRA may have a more significant obligation.

8.4.3 Subsequent events affecting postemployment benefits

If an event after the balance sheet date confirms that, at the balance sheet date, payment of a benefit covered by ASC 712 was probable, a reasonable estimate of the amount should be accrued at the balance sheet date. The estimate should take into account all information available as of the date the financial statements are issued or available to be issued to the extent the information reflects facts that existed at the balance sheet date. Conversely, if the post-balance sheet date event indicates that the payment of benefits became probable only after the balance sheet date, and all other evidence similarly supports that the payment of benefits was not probable at the balance sheet date, the post-balance sheet date event should not be reflected in an accrual at the balance sheet date.

It would be inappropriate to presume that, once the probability condition is met for any reason, any and all subsequent events that give rise to the payment of benefits should result in an adjustment to the accrual at the balance sheet date. Judgment is required to determine whether payment of benefits is probable at the balance sheet date and, accordingly, the specific facts and circumstances will need to be considered.

Question PEB 8-12

A calendar year-end company has a severance plan under which benefits do not accumulate or vest. The plan provides \$5,000 to each employee who is involuntarily terminated without cause. At December 31, 20X1, the company determined that it was not probable that severance benefits under the plan would be paid. On January 13, 20X2, one of the company's facilities was destroyed by a tornado. On February 5, 20X2, the company's board of directors decided not to rebuild the facility and management decided to terminate the employees that worked at the site. The company intends to file its 20X1 Form 10-K on February 15, 20X2.

Should the company recognize a liability for severance benefits in its 20X1 financial statements?

PwC response

No. The tornado and subsequent decision by management to terminate the employees are not events that provide new information about conditions that existed at the balance sheet date. Payment of severance benefits was not probable at the balance sheet date (December 31, 20X1). Accordingly, the liability for severance benefits would be accrued in the first quarter of 20X2. Depending on the materiality of the severance benefits or the destruction of the facility, disclosure of the event is likely warranted in the 20X1 financial statements.

8.4.4 Recognition of postemployment benefits provided under a plan

The existence of a plan means that employees understand the terms of postemployment benefits to which they are entitled. The compensation accounting framework presumes, therefore, that the employees have been providing service to the company with the understanding that they are earning those benefits. Thus, once payment of benefits under the plan are considered probable and reasonably estimable, they should be recognized in full for past services rendered. Even if future service is required in order to receive the benefit (e.g., an employee identified for involuntary termination must work through the scheduled termination date in order to receive the severance benefits provided for under the plan), any amounts attributable to past service should be recorded immediately.

The approach under ASC 712 for benefits provided pursuant to a pre-existing plan is different than the requirements of ASC 420 for one-time termination benefits (see PEB 8.5.3), which treat the one-time benefits as a stay bonus. Under ASC 420, because the employee did not previously know about the potential severance benefit and therefore could not have been providing services in the past in return for that benefit, the benefit is attributed entirely to future service provided by the employee from the communication date to the termination date.

8.4.5 Measurement of postemployment benefits provided under a plan

ASC 712 does not provide specific guidance on measuring the obligation for postemployment benefits. ASC 712-10-35-1 indicates that "to the extent that similar issues apply to postemployment benefit plans, employers may refer to ASC 715-30 and ASC 715-60 for guidance in measuring their other postemployment obligations in compliance with the requirements of this Subtopic." As ASC 712 does not require employers to follow the guidance in ASC 715, we believe other methodologies that reasonably estimate the obligation can be used.

To the extent that a reporting entity chooses to employ the measurement framework under ASC 715-30 (pensions) or ASC 715-60 (other postretirement benefits), it should apply all of the measurement and recognition provisions of ASC 715, including those that provide for delayed recognition in net income of remeasurement adjustments and plan amendments. It would be inappropriate to apply the guidance selectively. If a company does not apply the provisions of ASC 715 to benefits in the scope of ASC 712, then any changes in the estimated amount of the benefits payable is recorded immediately through compensation cost in the period of change.

ASC 712-10-35-1 permits, but does not require, the use of discounting in measuring postemployment benefit obligations. Outside the context of applying the ASC 715 measurement framework, the parameters for discounting a liability are less well defined. In general, discounting is likely only appropriate when measuring accumulating benefits.

For nonaccumulating benefits, the SEC staff has published interpretive guidance in SAB Topic 5, which prescribes the use of a settlement rate (i.e., a rate that would result in an amount that could be paid currently to settle the liability) and states that the rate should not exceed a risk-free rate (i.e., a rate that reflects no risk of default) on assets with maturities comparable to that of the liability. The use of a risk-free rate (versus a rate based on high-quality bonds under an ASC 715 approach) could have a significant effect on the measurement of the postemployment benefit obligation.

Question PEB 8-13

ASC 712-10-35-1 indicates that, to the extent employers face issues similar to those faced in applying ASC 715, they may refer to ASC 715-30 and ASC 715-60 for guidance in measuring their postemployment obligations. What are some examples of similar issues?

PwC response

Measuring the obligation for disability medical benefits would require an assumption about future health care costs, similar to the judgment required when measuring retiree medical costs. The need to make mortality and morbidity assumptions and other assumptions, such as those concerning turnover, dependents, and beneficiaries, could be considered similar issues. In addition, making discount rates assumptions and accounting for differences between expected and actual outcomes related to benefit payments may be considered similar issues.

Question PEB 8-14

An employer that provides accumulating disability benefits to its employees records an estimated liability pursuant to ASC 710. In subsequent periods, the estimated liability is re-evaluated and adjusted to reflect the actual experience of the employer. Can the employer defer recognition of these adjustments by applying the delayed recognition approach set forth in ASC 715?

PwC response

It depends. Treatment would depend on whether the employer is applying the ASC 715 framework in measuring its postemployment obligations. If it is, remeasurement adjustments would be subject to the employer's accounting policy under ASC 715—either deferral initially in other comprehensive income or immediate recognition in net income. If the employer is not applying the provisions of ASC 715, any change in the liability would be recognized as a change in estimate through net income in the period of change in accordance with ASC 250.

8.4.5.1 *Plan assets of a postemployment plan*

To the extent an employer has set aside assets to fund a postemployment benefit obligation, they would generally be considered assets of the company independent of the benefit obligation, unless the employer is applying the ASC 715 framework. In that case, plan assets would be subject to the parameters in ASC 715 (see PEB 2.6), requiring that they be segregated and restricted (usually in a trust) solely for the purpose of paying postemployment benefits. If the assets are explicitly available to creditors in the event of the company's bankruptcy, they would not qualify as plan assets. See also PEB 7.5.1 for a discussion of rabbi trusts.

8.4.5.2 *Insurance arrangements used to fund postemployment benefits*

There are no specific rules governing the accounting for postemployment benefits that are covered by insurance arrangements. However, regardless of the funding mechanism, employers will need to account for the postemployment benefit obligation pursuant to ASC 712. In particular, postemployment benefits (e.g., long-term disability benefits) that an employer self-insures or that are covered under an experience-rated insurance arrangement will generally be subject to ASC 712 as though they were not insured. In cases when an insurance company has assumed the entire risk of

paying benefits, it may be appropriate to measure the benefit cost as the cost of the insurance (i.e., the amount of the annual insurance premiums). See LI 5 for a discussion of the accounting for certain life insurance arrangements provided outside of pension and OPEB plans.

8.4.5.3 Gains and losses from changes in estimates (postemployment plans)

ASC 712 is silent as to the treatment of gains and losses that result from changes in estimates. As a general matter, the effects of changes in estimates are recognized currently. However, employers may elect to defer the current recognition of gains and losses in net income if other aspects of the ASC 715 model are also applied. Deferral of gains and losses, however, is not appropriate for postemployment benefit obligations accrued under a loss contingency model (ASC 450).

Question PEB 8-15

Medical benefits are provided to long-term disabled employees under a long-term disability plan that is accounted for under ASC 712. When the employee retires, the medical benefits are provided under the employer's postretirement medical plan, which is accounted for under ASC 715. Because the company assumes that employees will retire at age 65, its ASC 712 obligation includes benefits for employees through age 64, and its ASC 715 obligation includes benefits for retired employees age 65 and older. As a result of an employer-provided incentive to retire early, 55% of the long-term disabled employees elected to retire in the current year. Because many of these employees are under age 65, this event results in a decrease in the ASC 712 obligation and an increase in the ASC 715 obligation for the cost of benefits from the employee's age at retirement (e.g., age 60) to age 65.

Should the decrease in the ASC 712 obligation be recognized as a gain and the increase in the ASC 715 obligation recognized as an actuarial loss?

PwC response

No. Although unanticipated early retirements can give rise to an actuarial loss under ASC 715 and, if the employer has not elected to apply the ASC 715 measurement framework to the ASC 712 benefits, a gain for the change in estimate under ASC 712, the two effects are linked to the same event and, in substance, have no impact on the employer's overall obligation. The employees did not lose any benefits as a result of their decision to early retire. The employer's obligation to pay their medical benefits remains unchanged; the employer will merely pay those benefits from a different plan. Because the economic substance of the employer's obligation has not changed, any gain recognition under this fact pattern would be inconsistent with the underlying economics. Accordingly, the portion of the ASC 712 liability that decreased due to the early retirement of the disabled employees should be reclassified to the ASC 715 liability. This treatment is consistent with the example in ASC 715-60-55-11 when increased pension benefits are provided to retirees to partially offset the elimination of their postretirement medical benefits.

8.4.5.4 Amendments to postemployment benefit plans

Plan amendments (including initiation of a plan) affecting postemployment benefits may grant employees credit for past service. The accounting for this "prior service cost" (see PEB 3.2.6) will depend on which approach the employer uses in accounting for the postemployment benefits. If the employer follows the methodology in ASC 715 and the benefit is an accumulating benefit, the prior service cost should be initially deferred in other comprehensive income and recognized over the future service periods of the affected employees. If the employer does not follow the methodology in ASC 715,

the vested prior service cost should be recognized in full in the current period. Similarly, if a loss contingency approach is followed because the benefit does not accumulate (and, therefore, there is no service period), the liability for vested prior service cost should be recognized in full in the period of the amendment.

8.5 Restructurings and one-time termination benefits

ASC 420 addresses the accounting for involuntary termination benefits that are provided pursuant to a one-time benefit arrangement, and not part of an ongoing written or substantive plan. The distinction is important as it can have a significant effect on the timing of recognition of the cost of those benefits. As a general rule, severance benefits provided pursuant to an ongoing plan will be accrued when probable and reasonably estimable, whereas one-time termination benefits cannot be accrued until the terms of the benefit arrangement have been communicated to the affected employees and may need to be spread over a future service period through the termination date.

8.5.1 Requirements for recognition of one-time termination benefits

For one-time termination benefits, a liability is required to be recognized when all of the conditions in ASC 420-10-25-4 are met and the benefit arrangement has been communicated to employees.

ASC 420-10-25-4

An arrangement for one-time employee termination benefits exists at the date the plan of termination meets all of the following criteria and has been communicated to employees (referred to as the communication date):

- a. Management, having the authority to approve the action, commits to a plan of termination.
- b. The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and the expected completion date.
- c. The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including but not limited to cash payments), in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.
- d. Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

The FASB specifically observed that the basis for recognizing a liability is because the communication of a promise to provide one-time termination benefits if employees are terminated creates a constructive obligation at the date of communication.

8.5.1.1 Management approval of one-time termination benefits

ASC 420 requires both approval of the plan by management having the appropriate level of authority and announcement of the benefits in sufficient detail in order to recognize the liability. If a company's ordinary decision-making process requires approval by the board of directors for a plan of termination, a liability cannot be established until board approval has been obtained. Even if a plan

did not require board approval, but management nonetheless elects to seek such approval, the approval must be obtained before an accrual can be established.

8.5.1.2 *Affected employee groups of one-time termination benefits*

ASC 420 does not require the employer to give individual employees notice of termination prior to the accrual of involuntary postemployment benefits. Rather, it is the overall benefit arrangement that must be communicated to employees. The notification must include the provisions of the involuntary termination benefit formula in sufficient detail that each employee would be able to calculate the severance benefit that he or she would receive if terminated involuntarily. If the employees are not informed in sufficient detail, no accrual can be recorded.

As noted above, ASC 420 requires that management must have an approved plan, which provides detailed information about the employees that are to be terminated, including identification of not only the number of employees to be terminated, but also specific job classifications or functions and locations, prior to the accrual of involuntary termination benefits. Because notification is an essential element obligating the employer to fulfill its commitment, notification of benefits to be received pending involuntary terminations must be made specifically to employees within the classifications or functions at risk of being involuntarily terminated prior to the balance sheet date in order to accrue the liability.

8.5.1.3 *Terms and actions of one-time termination benefits*

The third and fourth conditions described in PEB 8.5.1 are intended to ensure that the plan is sufficiently detailed as to give rise to a liability. In general, we would expect the plan to be comparable in terms of the level of detail and the precision of its estimation with other operating and capital budgets that the company prepares, such as annual business unit budgets.

8.5.2 *One-time termination benefits versus an ongoing plan*

ASC 420 includes a rebuttable presumption that, absent evidence to the contrary, if a reporting entity has a past practice of providing similar termination benefits, the benefit arrangement is presumed to be an ongoing benefit arrangement that should be accounted for under other accounting standards, such as ASC 712 (see PEB 8.4). Additionally, under ASC 420, any termination benefits that are deemed to be enhancements to an ongoing benefit arrangement (i.e., the enhancement would result in a benefit that would be in addition to the benefit provided under the current arrangement) should be accounted for under other accounting standards, such as ASC 712. ASC 420-10-55-1 notes that, in order to be considered an enhancement to an ongoing benefit arrangement, the additional termination benefits must represent a revision to the ongoing arrangement that is not limited to a specified termination event or a specified future period. Otherwise, the additional termination benefits should be considered one-time termination benefits and accounted for under ASC 420.

Judgment will be necessary in determining if the relevant facts and circumstances indicate that the benefits represent one-time termination benefits that should be accounted for under ASC 420 or represent benefits pursuant to an ongoing benefit arrangement that is subject to other accounting standards. Additionally, entities will need to distinguish whether the relevant benefits to be accounted for under an ongoing benefit arrangement under ASC 712 relate to past service and vest/accumulate (ASC 710 model) or result from "an existing condition, situation, or set of circumstances" that results in a probable liability (ASC 450 model).

For many companies, a written postemployment benefit plan exists that evidences an employer's promise to provide termination benefits to involuntarily terminated employees. An employer with such a plan has a mutual understanding with its employees regarding the benefit arrangement and has therefore obligated itself to pay the benefits in the event employees are involuntarily terminated. Accordingly, the requirement to pay benefits for prior service is met and a liability for the cost of the benefits would be recognized under ASC 712 when payment is probable and reasonably estimable. See PEB 8.4.2.2.

For other companies, although no written plan exists, a history of paying severance benefits may exist. In such a case, the history of severance payments should be analyzed. A benefit arrangement that is mutually understood by an employer and its employees because of a consistent past practice of paying benefits would constitute a postemployment benefit plan that would be within the scope of ASC 712. We believe the guidance in ASC 715 on what constitutes a "substantive" plan when a written plan does not exist would generally be applicable to determine whether a benefit plan exists and is within the scope of ASC 712. See PEB 1.11.

ASC 420-10-55-17 through ASC 420-10-55-19 includes an example to illustrate the application of the guidance in the context of a typical involuntary termination benefit plan subject to the provisions of ASC 712.

Question PEB 8-16

PEB Corporation does not have a written severance plan and does not have a history of significant involuntary terminations of employees. On December 15, 20X1, PEB Corporation makes a general announcement that cost-cutting measures are underway and an involuntary work force reduction will occur in the near future. As of December 15, 20X1, PEB Corporation has identified affected employees, but has not notified them and does not plan to do so until January 20X2. Management has approved a plan to provide terminated employees with a benefit equal to 5% of their annual base salary upon termination, which is communicated to potentially affected employees in January 20X2. Upon termination, no future services will be required of the employees.

What model for termination benefits should be used?

PwC response

Because PEB Corporation does not have a mutually understood benefit arrangement with its employees—neither an existing plan nor past practice that would constitute a substantive plan—the involuntary termination benefits in connection with the proposed reduction in force would be considered a one-time benefit under ASC 420.

Question PEB 8-17

What constitutes a past practice of providing termination benefits for purposes of assessing whether a benefit is a one-time termination benefit?

PwC response

The term "past practice" is not defined in either ASC 420 or ASC 712. ASC 715-60-35-51 provides some guidance, indicating that a past practice would be indicated when the nature of the change and duration of the past practice are sufficient to warrant a presumption that it is understood by the plan

participants. Judgment will be necessary in determining if the relevant facts indicate that a reporting entity has a past practice of providing termination benefits.

Question PEB 8-18

An employer does not have a written plan regarding payment of involuntary termination benefits. The employer determines that it will initiate a reduction in force (RIF) during its fiscal fourth quarter and has decided that it will pay termination benefits to employees who are involuntarily terminated as part of the RIF. The employer has had one RIF in its history. Employees affected by that RIF were provided termination benefits.

How should the employer determine if it has a past practice of providing benefits?

PwC response

The employer should evaluate the facts surrounding the payment of benefits for the previous RIF to determine whether the previous action, including the related communication of the decision to pay benefits, was sufficient to establish a mutual understanding between the employer and the remaining employees such that the employees would expect to be entitled to receive termination benefits if they were ever terminated. Each situation should be evaluated based on its facts and circumstances.

Although it is unlikely that benefits paid as a result of a single RIF would constitute a past practice, management's communications at that time or subsequently could have established a mutual understanding.

Question PEB 8-19

What factors should be considered when evaluating whether the current benefit arrangement is "similar" to prior termination benefit arrangements?

PwC response

Determining whether the current benefit arrangement is similar to prior termination benefit arrangements will depend on the facts and circumstances. Factors to consider include (a) whether the arrangements were based upon the same benefit formula, (b) the employees' understanding of the nature and amount of the benefits to be provided, and (c) the events and decisions giving rise to the payment of the benefits.

Question PEB 8-20

An employer does not have a written plan regarding payment of involuntary termination benefits. However, it has provided such benefits as part of a reduction in force (RIF) in each of the last several years. It intends to initiate a RIF during its fiscal fourth quarter and pay termination benefits to employees who are terminated as part of that RIF. The employer believes it has a mutual understanding with its employees that the employees will receive some level of termination benefits if they are terminated as a result of the RIF (i.e., the past practice threshold has been met).

How should the employer evaluate whether the benefits to be provided in the current RIF are "similar" to those in previous RIFs?

PwC response

The employer should evaluate both the terms and amount of the current benefit arrangement relative to prior arrangements to evaluate whether there is reasonable similarity, including, but not limited to, evaluating the accumulating and vesting provisions of the benefit arrangement and the basis for the amount. Each situation should be evaluated based on its facts and circumstances.

If there is a trivial difference between the current arrangement and prior arrangements (e.g., the current arrangement includes two weeks plus one day of severance pay for every year of service and the prior arrangements included two weeks of severance pay for every year of service), we believe the benefits would be similar. Conversely, if there is a substantive difference between the current arrangement and prior arrangements (e.g., the current arrangement includes six weeks of pay for every year of service per employee and the prior arrangements included two weeks of pay for every year of service), the benefits would generally not be similar.

Question PEB 8-21

An employer has a written involuntary termination benefit plan that provides, upon involuntary termination, one week of severance pay for every year of service (i.e., the benefits accumulate). The employer has not previously determined that involuntary terminations were probable, thus no liability has been recognized. During its fiscal fourth quarter, the company determines that it will initiate a reduction in force (RIF) and determines that payment of benefits is probable and reasonably estimable.

Additionally, the employer decides it will provide a one-time benefit (additional week of severance for each year of service) to the employees who are to be involuntarily terminated as part of this RIF. The additional benefit is not part of the written plan and will not apply to employees affected by any future RIFs. Management communicated the increased one-time benefit to its employees in its fiscal fourth quarter.

Would the additional benefit be considered an enhancement to an ongoing benefit arrangement?

PwC response

No. Since the additional benefit relates only to a specified termination event and is not intended to be available for future employee terminations, it is not an enhancement that would be accounted for under ASC 712, but a one-time termination benefit that would be accounted for under ASC 420. The benefit was communicated to all employees in a manner such that employees understand that the benefit represented a one-time benefit. Accordingly, since the employees will not receive the additional one-time benefit until the termination date (six months after the fiscal year end), the liability for the one-time benefit should be measured initially at the communication date (fiscal fourth quarter) based on the fair value of the liability as of the termination date. The liability would then be recognized ratably during the first and second quarters of the next fiscal year (the future service period). The benefits payable under the written plan would be recognized under ASC 712 when the amounts payable under the plan become probable and estimable, in the manner described in Example PEB 8-1 in PEB 8.4.2.2.

Question PEB 8-22

As part of involuntarily terminating employees in a certain non-US country, companies are required to negotiate with the local works council and agree on the terms of the involuntary termination, including the total amount of severance benefits that will be paid to the terminated employees. Severance benefits include a minimum benefit pursuant to statutory requirements, the amount of which is based upon years of service. They may also include an additional benefit that is agreed upon between the works council and the company, which may be based on the same benefit formula prescribed by statute.

An employer is initiating a reduction in force (RIF) and intends to pay an additional amount of severance benefit (i.e., over and above the statutory requirement) to the involuntarily terminated employees. Past negotiations have not always resulted in the payment of an additional benefit. However, the employer has a history of negotiating with the works council for additional benefits and will likely do so under future RIFs.

Would the statutory benefit be subject to ASC 712? Would the additional negotiated benefit be subject to ASC 712?

PwC response

The statutory arrangement would, in substance, be the equivalent of a severance benefit plan and thus subject to ASC 712 because the employer and its employees have a mutual understanding of the benefits that employees will receive if they are terminated. The determination of whether the additional negotiated benefit would be subject to ASC 712 or considered a one-time termination benefit that would be accounted for under ASC 420, would hinge on whether there is a similar mutual understanding regarding that benefit and whether that additional benefit would be applicable to future RIFs.

If the negotiation with the works council regarding non-statutory benefits is perfunctory, a mutual understanding regarding the additional benefit arrangement could exist based on the employer's past practice or when it is communicated to the affected employees. However, if the negotiation with the works council regarding non-statutory benefits is not perfunctory or the outcome cannot be reasonably predicted, there generally would be no mutual understanding of the additional benefits employees would be entitled to receive until the negotiation is finalized and becomes binding on the employer.

8.5.3 Recognition and measurement of one-time termination benefits

Under ASC 420, a commitment to an exit plan does not, by itself, result in a liability for the costs of a planned exit or disposal activity. The timing of recognition of the liability for one-time termination benefits under ASC 420 is dependent upon whether employees are required to render services until they are terminated in order to receive the termination benefits and, if so, whether the employee will be retained to render service beyond a minimum retention period.

As described in ASC 420-10-25-7, the minimum retention period should not exceed the legal notification period (defined in ASC 420-10-20 as “[t]he notification period that an entity is required to provide to employees in advance of a specified termination event as a result of an existing law, statute, or contract”) or, in the absence of a legal notification requirement, 60 days. For example, certain actions may fall under the Worker Adjustment and Retraining Notification Act of 1988 (WARN Act),

which requires employers with 100 or more employees to notify affected employees 60 days in advance of a plant closing or mass layoff. Also, under the WARN Act, all employees are legally employed and paid by the employer until the end of the 60-day notification period, even if the terminated employees will cease providing services immediately. Collective bargaining or other labor contracts, or statutory requirements in foreign countries, may require different notification periods.

If employees are not required to render service until they are terminated in order to receive the termination benefits (that is, if employees are entitled to receive the termination benefits regardless of when they leave) or if employees will not be retained to render service beyond the minimum retention period, a liability for the termination benefits would be measured at fair value and recognized at the communication date (see PEB 8.5.1).

If future service is required beyond a minimum retention period for employees to receive the one-time termination benefit, entities must initially (at the communication date) measure the liability at its fair value as of the termination date. That liability must then be recognized (accrued) ratably over the future service period, effectively as a stay bonus.

The retention period should be determined from the communication date (as described in PEB 8.5.1) through the date employees must work to receive the termination benefits. The period begins when the plan has been committed to and communicated to the affected employee groups, not when individual employees are notified of their pending termination. Based on the plan of termination, it is possible that certain affected employees may be retained to render service beyond the minimum retention period and others may not. In such a case, the recognition of the liability for the termination benefits should be bifurcated.

The fair value of the termination benefits reflects the cost that the company would need to pay a market participant to transfer the liability for the benefit payments. While ASC 420-10-30-2 notes that quoted market prices are the best representation of fair value, it goes on to state that quoted market prices will typically not be available and other valuation techniques, such as a present value technique, will typically be used to estimate the fair value of the benefit liability. Where discounting is required (and in some cases, the standard notes that the period of time until payment occurs may be so short that the effect of discounting may not be material), ASC 420-10-35-1 provides for the use of the credit-adjusted risk-free rate. Changes to the liability due to the passage of time are recognized as an expense; this expense is not considered “interest cost” for purposes of applying ASC 835-20 on the capitalization of interest.

Changes to the liability due to changes in the amount or timing of estimated cash flows are measured using the credit-adjusted risk-free rate that was used to measure the liability initially, and reflected in the income statement in the period of change.

If a plan of termination changes and employees that originally were not expected to provide services beyond the minimum retention period (and therefore the full amount of the liability for their one-time termination benefits was recognized at the communication date) are now expected to be retained beyond the minimum retention period, it may be acceptable to recognize the liability for any incremental benefits prospectively over the remaining (new) required service period. Alternatively, the liability previously recognized could be adjusted (reduced) to the amount that would have been recognized to date if the liability had been recognized ratably over the remaining future service period from the original communication date to the updated termination date. See ASC 420-10-55-2 through ASC 420-10-55-10 for several examples of the valuation and attribution of one-time termination benefits.

***Chapter 9:
Employee benefit plan
financial reporting—updated
June 2022***

9.1 Overview of benefit plan financial reporting chapter

The guidance in this chapter deals with matters of presentation and disclosure related to financial statements of employee benefit plans, including defined benefit and defined contribution retirement plans and health and welfare plans. ASC 960, *Plan Accounting - Defined Benefit Pension Plans*, ASC 962, *Plan Accounting - Defined Contribution Pension Plans*, and ASC 965, *Plan Accounting - Health and Welfare Benefit Plans*, establish standards of financial accounting and reporting for the financial statements of employee benefit plans of nongovernmental organizations. Further guidance, along with discussions of financial statement requirements for defined contribution plans and other employee benefit plans, can be found in the AICPA Audit and Accounting Guide, *Employee Benefit Plans* (AAG-EBP). This chapter includes incremental or complementary interpretive content related to that guidance. It is not intended to be a complete summary of all employee benefit plan accounting and reporting guidance.

See PEB 1 through PEB 8 for guidance on a plan sponsor's accounting for employer-provided benefits.

9.2 Framework and overall objectives for plan reporting

The primary objective of a plan's financial statements is to provide information to the plan participants that is useful in assessing the plan's present and future ability to pay benefits when due.

9.2.1 Differences between FASB and regulatory guidance

When the financial reporting model for benefit plans was originally created, the FASB's objectives were to provide useful information to stakeholders but in a way that balanced some of the administrative burden of compliance. As such, ASC 960 considers the manner in which actuarial information is generated for plans, information that is generally available to insurance companies, and would not differ from the requirements of the United States Department of Labor (DOL) for plan reporting. Although these goals were largely achieved, many mechanical differences between the DOL rules and regulations and ASC 960 have emerged. The DOL's rules for plan reporting are set out in the Employee Retirement Income Security Act of 1974 (ERISA). Importantly, ASC 960 does not alter the requirements of ERISA.

Figure PEB 9-1 summarizes the principal differences between ERISA reporting requirements (specifically Form 5500, "Annual Return/Report of Employee Benefit Plan") and ASC 960. Similar differences exist between ERISA reporting requirements and ASC 962 and ASC 965.

Figure PEB 9-1
Differences between ASC 960 and ERISA

	ERISA	ASC 960
Accounting basis	ERISA permits the use of accrual, cash, or modified cash basis accounting. Cash basis financial statements that adjust securities investments to fair value are considered to be prepared on a modified cash basis.	Only accrual accounting is acceptable under GAAP.

	ERISA	ASC 960
	Financial statements prepared on the modified cash basis should include all informative disclosures that are appropriate for the basis of accounting used.	
Actuarial information	Schedule SB of Form 5500 includes actuarial information used in determining the plan's funding requirements under ERISA.	ASC 960 designates actuarial information as essential to plan financial statements and sets forth a method of reporting pension obligations that differs from that used in the preparation of Schedule SB. This difference may result in additional discussions with actuaries and plan administrators when GAAP financial statements are prepared.
Investments	Form 5500 and/or the supplemental schedules require disclosure of the cost of investments or the separation of investment gains and losses into realized and unrealized components.	ASC 960 does not require this information.
	Form 5500 does not require separation of readily marketable investments from those with a limited market.	ASC 960-325-45-1 requires this distinction in the statement of net assets.
Comparative statements	ERISA requires a comparative statement of net assets.	In certain circumstances described in ASC 960, comparative statements are not required.
Operating assets	ERISA requires fair value accounting for all plan assets.	ASC 960-360-35-1 states that operating assets of the plan should be reported at depreciated cost.
Liabilities	Liabilities to plan participants for the amount of benefit claims that have been processed and approved for payment as of year-end are required to be reported in Form 5500.	Such liabilities are not liabilities for financial statement purposes and thus should be presented in the reconciliation between the financial statements and the Form 5500.

9.2.2 Benefit plan cash flow statements

Under ASC 230-10-15-4, defined benefit pension plans that follow ASC 960 and other employee benefit plans that present financial information similar to that required by ASC 960 are exempt from the requirement to provide a statement of cash flows with their annual financial statements. However, when a statement of cash flows would provide relevant information about the ability of the plan to meet future obligations, ASC 230-20-15-4 encourages its inclusion in the financial statements.

9.3 *Defined contribution plan financial statements*

ASC 962, *Accounting and Reporting by Defined Contribution Pension Plans*, establishes standards of financial accounting and reporting for the financial statements of defined contribution plans of nongovernmental organizations. Financial statement requirements for a defined contribution plan are found in ASC 962-205-45-1, ASC 962-325-50-1 through ASC 962-325-50-2, and ASC 962-205-50-1. Further guidance can be found in Chapter 5 of the AAG-EBP.

9.3.1 *Self-directed defined contribution plan accounts*

Self-directed investment options in defined contribution plans allow participants to invest their account balances in any investment offered under the plan, subject to certain limitations as specified by the plan document and/or trustee service agreement. AAG-EBP 5.28-5.31 provides guidance and considerations for self-directed accounts.

9.3.2 *Employee stock ownership plans*

An employee stock ownership plan (ESOP) is a unique form of a defined contribution plan. An ESOP has the ability to borrow money and to concentrate plan investments in qualifying employer securities. An ESOP that has an obligation to a financial institution or a related party lender to repay money borrowed is considered a leveraged ESOP. The debt is collateralized by the sponsoring employer's stock that is owned by the ESOP. The sponsoring employer commits to making future contributions to the ESOP in sufficient amounts to enable the ESOP to meet the debt service requirements.

Financial statements of a leveraged ESOP should segregate allocated and unallocated assets (and liabilities) that belong to plan participants from those that are still available as collateral for the ESOP loan. The debt of the plan should be shown as a liability of the plan, even though it is typically guaranteed by the sponsor.

In a nonleveraged ESOP, the employer contributes its own stock or cash to the ESOP. If cash is contributed, the ESOP then purchases the company's stock on the open market or directly from the company. A nonleveraged ESOP would not segregate the net assets into allocated and unallocated categories.

AAG-EBP Chapter 5B provides guidance and considerations for ESOPs. Also see SC 11 for guidance on employers' accounting for ESOPs.

9.4 *Defined benefit plan financial statements*

ASC 960, *Accounting and Reporting by Defined Benefit Pension Plans*, establishes standards of financial accounting and reporting for the financial statements of defined benefit plans of nongovernmental organizations. Financial statement requirements for a defined benefit plan are found in ASC 960-205-45-1 through ASC 960-205-45-5, ASC 960-325-50-1 through ASC 960-325-50-3, and ASC 960-205-50-1 through ASC 960-205-50-5. Further guidance can be found in Chapter 6 of the AAG-EBP.

9.4.1 *Defined benefit plan – benefit information date*

ASC 960-205-45-4 permits the presentation of accumulated plan benefits as of the beginning of the plan year or as of the end of the plan year; however, an end of year information date is preferable. ASC 960 indicates that, in the event that an actuarial valuation has not been prepared as of the beginning or the end of the plan year, the plan administrator may nevertheless prepare financial statements using estimated accumulated benefit information. If the benefit information is so estimated, plan administrators should be satisfied that the methods and assumptions used to estimate the accumulated benefit information are reasonable in the circumstances.

9.4.2 *401(h) accounts in defined benefit plans*

In addition to a normal retirement income benefit, defined benefit pension plans can provide funding for a portion of an employer's post-retirement health care and welfare benefit obligation. This can be done pursuant to Section 401(h) of the Internal Revenue Code (IRC), whereby a "401(h) account" is established in the pension plan to fund the payment of current retiree health care and welfare benefits. 401(h) accounts may be funded by employer contributions or "qualified transfers" of excess pension assets under Section 420(f) of the IRC. If the full amount of the funds set aside in the 401(h) account is not used in the current year, it can be accumulated in the account to pay future retiree health care and welfare benefits. Refer to the illustrative examples in ASC 960-205-55-2, ASC 960-205-50-4, and ASC 960-205-50-5, and the AAG-EBP for further discussion and examples of required disclosures.

9.4.3 *Discount rate for accumulated plan benefits*

ASC 960 provides that the discount rate used to determine the actuarial present value of accumulated plan benefits can reflect the expected rates of return during the periods over which payments of benefits will occur. These rates should be consistent with returns realistically achievable on the types of assets held by the plan and the plan's investment policy. In general, use of the expected asset return assumption for corporate reporting of the pension plan under ASC 715-30 would be appropriate for determining the actuarial present value of accumulated plan benefits.

Alternatively, employers are permitted to use a settlement rate approach to set the discount rate. This approach would be consistent with how discount rates are established under ASC 715-30, see PEB 2.4.1. Therefore, use of the discount rate assumption used for corporate reporting of the pension plan would also be acceptable for determining the actuarial present value of accumulated plan benefits.

A switch between the expected rate of return approach and the settlement rate approach would be considered a change in accounting principle. Preferability would need to be assessed in order to change the approach used. See FSP 30.4 for a discussion on accounting changes.

Under the Pension Protection Act of 2006 (PPA) guidance for plan funding valuation purposes, the present value of benefits is generally determined using three 24-month average interest rates ("segment rates"), each of which applies to cash flows during specified periods. As such, use of the PPA funding rates as the discount rate under ASC 960 is not appropriate because the PPA rate is not based on expected asset returns in accordance with paragraph ASC 960-20-35-1 nor is it a settlement rate under ASC 960-20-35-1A.

9.4.4 Mortality assumptions and other actuarial data

Nongovernmental employee benefit plans should consider the specific requirements of US GAAP, which require the use of mortality assumptions that reflect the best estimate of the plan's future experience for purposes of estimating the plan's obligation as of the current measurement date (that is, the date at which the obligation is presented in the financial statements). Therefore, plan management should consider the specific demographics of their plan when evaluating the appropriate mortality or other assumptions to use, as well as relevant available mortality data.

The Society of Actuaries (SOA) publishes mortality tables from time to time, which are generally considered to be reliable sources for developing mortality assumptions. These tables are based on observed experience over a defined study period and considering past trends, and reflect more recent data and the latest actuarial techniques.

The SOA also releases updated mortality improvement scales on an annual basis, which reflect additional mortality data from the Social Security Administration (SSA). Companies should consider any published new mortality data for their plans in relation to their plan-specific mortality experience and future expectations. AICPA Technical Practice Aid 3700.01 – *Pension Obligations* provides guidance on how and when to consider updated mortality tables in financial statements that have not yet been issued at the time the updated tables are published, including the effect when the plan obligations are presented as of the beginning of the plan year. In estimating mortality, GAAP requires that all available information through the date the financial statements are available to be issued should be evaluated to determine if the information provides additional evidence about conditions that existed at the balance sheet date.

The existence of updated mortality conditions is not predicated upon the date that updated mortality tables are published, as tables are based on historical trends that go back many years. Management should understand and evaluate the reasonableness of the assumptions chosen, which may require assistance from an actuary acting as a management specialist, and document its evaluation and the basis for selecting the mortality tables and other assumptions it decides to use for its current financial period.

A plan's assumptions of expected mortality and other relevant assumptions are based on each plan's specific demographics and other relevant factors, and changes in actuarial assumptions made to reflect changes in a plan's expected experience would be viewed as a change in estimate in accordance with ASC 960-20-35-4. That is, the effects of those changes are accounted for in the year of change (or in the year of change and future years, if the change affects both) and would not be accounted for by restating amounts reported in financial statements for prior years or by reporting pro forma amounts for prior years.

For additional information on mortality tables, see PEB 2.3.1.

9.5 *Health and welfare plan financial statements*

ASC 965, *Plan Accounting - Health and Welfare Benefit Plans*, provides the following guidance about disclosures for defined benefit health and welfare plans:

- Information about the benefit obligations can be presented in a separate statement, combined with other information on another financial statement, or presented in the notes to the financial statements.
- Benefit obligations should be presented as of the plan's year end, but ASC 965-30-35-6 permits use of the most recent benefit obligation valuation rolled forward to the plan's year end, provided it is reasonable to expect that the results will not be materially different from the results of a valuation as of the plan's year end.
- Postretirement benefit obligations should be measured using the measurement concepts of ASC 965-30-35-9. Accordingly, the obligation should be measured as the actuarial present value of benefits expected to be provided under the plan, reduced by the actuarial present value of contributions expected to be received from current plan participants. Disclosure is also required of the portion of the plan's estimated cost of providing postretirement benefits funded by retiree contributions.
- Disclosure of the weighted-average assumed discount rate used to measure the plan's obligation for postemployment benefits is required in the notes.
- Disclosure of the effects of a one-percentage-point change in assumed health care cost trends rates on the postretirement benefit obligation is required in the notes.

ASU 2018-14, *Compensation—Retirement Benefits—Defined Benefit Plans—General* (Subtopic 715-20), eliminated the requirement for public entities to disclose the effects of a one-percentage-point change in assumed health care cost trend rates on the (a) aggregate of the service and interest cost components of net periodic benefit costs and (b) benefit obligation for postretirement health care benefits. The ASU, however, applied only to plan sponsor financial statements and therefore does not eliminate the requirement for benefit plan financial statements under ASC 965.

9.5.1 *Accrued liabilities — health and welfare financial statements*

Claim payments made on behalf of plan participants by third-party service providers that have not been reimbursed by the plan as of year-end should be reflected as an accrued liability in the statement of net assets available for benefits.

9.5.2 *Health care saving, spending, and reimbursement accounts*

Health Savings Accounts (HSA) are tax-favored savings accounts integrated with a high deductible health plan. Both employers and employees can make contributions to an HSA. Funds held in the HSA can be used for qualified medical expenses and certain health care premiums. Unused funds roll over from year to year and accumulate earnings on a tax-free basis.

Health Reimbursement Arrangements (HRA) consist of employer contributions made on behalf of enrolled employees that can be used for reimbursement of eligible medical expenses. Unused funds can be rolled over from year to year, subject to limits established by the employer.

A Health Care Flexible Spending Account (FSA) is an arrangement that allows participants to fund qualified, unreimbursed health care expenses with pre-tax contributions to an individual health care account. FSAs are “use it or lose it” arrangements; any money in the individual account that is not used by the end of the plan year (or grace period) is forfeited and returned to the employer.

When HSAs, HRAs, or FSAs are standalone, they generally do not constitute an employee welfare plan for purposes of the provisions of Title 1 of ERISA. For HSAs, HRAs, and FSAs that are a component of a health and welfare plan, it is necessary to determine whether the associated activity should be included in the plan's financial statements. Factors to consider in making this determination might include the sources of funding (employers, participants, or both), who has legal title to the accounts, how claims are adjudicated, and whether a carry-forward provision exists into the next plan year for unused amounts. Consultation with the plan's legal counsel may be needed to make this determination.

9.5.3 401(h) accounts used to fund health and welfare obligations

As described in ASC 965-205-05-2, “[e]mployers may fund a portion of their postretirement medical-benefit obligations related to their health and welfare benefit plans through a health benefit account (401(h) account) in their defined benefit pension plans, subject to certain restrictions and limitations.” The 401(h) account assets and liabilities used to fund retiree health benefits, and the changes in those assets and liabilities, should be reported in the financial statements of the health and welfare benefit plan either as a single line item on the face of the statements or included in individual line items with separate disclosure in the footnotes about the 401(h) amounts included in those individual line items. The 401(h) obligations should be reported in the health and welfare benefit plan's statement of benefit obligations, and the health and welfare benefit plan's statement of changes in benefit obligations should include claims paid through the 401(h) account.

Because ERISA requires 401(h) accounts to be reported as assets of the pension plan, a reconciliation of the net assets reported in the financial statements to those reported in Form 5500 is required for the health and welfare benefit plan. Refer to the illustrative example in AAG EBP Appendix E for further discussion and examples of required disclosures.

Health and welfare plans are not required to disclose 401(h) investment account information, but are required to include a reference to the defined benefit plan that discloses such information.

9.6 Investment disclosures in plan financial statements

ASC 960-325-35-1 requires defined benefit pension plans to report all investments (excluding insurance contracts and fully benefit-responsive investment contracts) at fair value. ASC 960-325-35-3 requires defined benefit pension plans to report insurance contracts in the manner prescribed by Form 5500 (i.e., contract value).

ASC 962-325-35-5 requires defined contribution plans, including health and welfare and pension plans, to report all investments (excluding insurance contracts and fully benefit-responsive investment contracts) at fair value.

See PEB 9.6.1 for information about insurance contracts and PEB 9.6.2 for information about fully benefit-responsive investment contracts.

ASC 820, *Fair Value Measurements and Disclosures*, defines fair value, establishes a framework for measuring fair value, and requires disclosures about fair value measurements. Refer to PwC's *Fair value measurements* guide for further guidance on fair value measurements.

Employee benefit plans that are not subject to SEC filing requirements (i.e., they do not file a Form 11-K) can indefinitely defer the requirement to provide quantitative disclosures of the significant unobservable inputs used in fair value measurement solely of investments held by the employee benefit plan in its plan sponsor's own nonpublic equity securities, including equity securities of its plan sponsor's nonpublic affiliated entities.

Employee benefit plans are exempt from the requirements of ASC 820-10-50-2B(a) to disaggregate assets by nature, characteristics, and risk. The disclosure of information required by ASC 820-10-50 are provided by general type consistent with ASC 960-325-45-2, ASC 962-325-45-5, and ASC 965-325-45-2.

9.6.1 *Direct investments in fully benefit-responsive contracts*

Insurance contracts, as described in ASC 944-20, are required to be presented in the same manner as specified in the annual report filed by the plan with certain governmental agencies as required by ERISA; that is, either at fair value or at an amount determined by the insurance entity (contract value).

9.6.2 *Fully benefit-responsive investment contracts held by benefit plans*

Fully benefit-responsive investment contracts are measured at contract value. An investment contract is considered fully benefit-responsive if all of the criteria in ASC 962-325-20 are met for that contract, analyzed on an individual basis. The criteria are:

- The investment contract is effected directly between the plan and the issuer, and prohibits the plan from assigning or selling the contract or its proceeds to another party without the consent of the issuer.
- Either (1) the repayment of principal and interest credited to participants in the plan is a financial obligation of the issuer of the investment contract or (2) prospective interest crediting rate adjustments are provided to participants in the plan on a designated pool of investments held by the plan or the contract issuer whereby a financially responsible third party, through a contract generally referred to as a wrapper, must provide assurance that the adjustments to the interest crediting rate will not result in a future interest crediting rate that is less than zero. If an event has occurred such that realization of full contract value for a particular investment contract is no longer probable (for example, a significant decline in creditworthiness of the contract issuer or wrapper provider), the investment contract would no longer be considered fully benefit-responsive.
- The terms of the investment contract require all permitted participant-initiated transactions with the plan to occur at contract value with no conditions, limits, or restrictions. Permitted participant-initiated transactions are those transactions allowed by the underlying defined contribution plan, such as withdrawals for benefits, loans, or transfers to other investment options within the plan.
- An event that limits the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan

termination, bankruptcy, mergers, and early retirement incentives) and that also limits the ability of the plan to transact at contract value with the participants in the plan must be probable of not occurring.

- The plan itself must allow participants reasonable access to their funds.

ASC 962-205-45-6 requires the statement of changes in net assets available for benefits to be prepared on a basis that reflects income credited to participants in the plan and net appreciation or depreciation in the fair value of only those investment contracts that are not deemed to be fully benefit responsive.

As outlined in ASC 962-325-50-3, defined-contribution plans, including both health and welfare, and pension plans are required to disclose the following in connection with fully benefit-responsive investment contracts, in the aggregate:

- A description of the nature of those investment contracts (including how they operate) by type.
- A description of the events that limit the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives), including a statement that the occurrence of each of those events that would limit the plan's ability to transact at contract value with participants in the plan is not probable of occurring.
- A description of the events and circumstances that would allow issuers to terminate fully benefit-responsive investment contracts with the plan and settle at an amount different from contract value.
- The total contract value of each type of investment contract (for example, synthetic investment contracts or traditional investment contracts).

9.6.2.1 Indirect investments in fully benefit-responsive contracts

Some plans indirectly invest in fully benefit-responsive investment contracts through holdings in a collective trust (CCT) (or similar vehicle). CCTs are reported in the plan's financial statements at fair value, often using the net asset value (NAV) (or its equivalent) practical expedient, in a manner consistent with the measurement principles of ASC 946. NAV represents the plan's fair value since this is the value at which the plan transacts with the CCT.

9.6.3 Separate account investments held by benefit plans

A separate account is an account established by an insurance entity solely for the purpose of investing assets of one or more employee benefit plans. The assets of a separate account are assets of the insurance company but are not commingled with the insurance company's general assets.

A separate account in which several plans participate is generally referred to as a pooled separate account, with each plan's share of a pooled separate account determined on a participation-unit or variable-unit basis.

A separate account in which only one plan participates is generally referred to as an individual separate account or as a separate-separate account. These assets are not commingled with assets of the insurer or other plan sponsors.

Separate accounts that calculate a net asset value (NAV) per participation unit are valued under ASC 820-10-15-4 through ASC 820-10-15-5. For separate accounts that do not calculate NAV per share, for purposes of determining valuation, it is appropriate to look through to the underlying investments in the account. For some separate accounts, typically those providing a guaranteed rate of return, contract value may be the best evidence of fair value.

Plans may invest in an investment contract issued by an insurance company that will generate returns based on the performance of underlying or reference assets (e.g., pooled accounts). In these situations, plan management may determine that the appropriate unit of account is the investment contract rather than the underlying investments. Alternatively, some investment contracts require that the underlying assets be maintained in a "separate account" of the insurance company, and sometimes plan management has some involvement in investment decisions relating to the separate account. These assets are generally not commingled with assets of the insurer or other plan sponsors, and while the insurer legally owns the assets, they may not be available to its general creditors in bankruptcy. Accordingly, it may be appropriate to look through the separate account to use the underlying investments as the unit of account.

9.6.4 *Benefit plan master trust investments*

A master trust holds assets of more than one plan sponsored by one employer or by a group of employers under common control. A master trust is a vehicle that receives cash, invests it, liquidates investments, and has neither rights to contributions nor obligations to pay benefits, as these rights and obligations belong to the plans that participate in the master trust. Therefore, receivables (and payables) that relate specifically to the master trust (such as an interest receivable for bonds in the master trust) should be reported at the master trust level and not the plan level. Similarly, receivables (and payables) that relate specifically to the underlying plans in the master trust (such as a contribution receivable) should be reported at the plan level, and not at the master trust level. Accrued expenses should receive similar treatment, with a facts and circumstances analysis to determine whether an item relates to the master trust or the underlying plans, thereby determining its presentation in the financial statements. Generally, investment-related expenses (e.g., trustee fees, custodial fees) are recorded at the master trust level and specific plan-related expenses (e.g., actuary fees, legal fees) are recorded at the plan level.

Plans participating in a master trust are required to disclose the percentage of the plan's interest in each type of investment, other assets, and liabilities of the master trust.

9.6.5 *Securities lending by a benefit plan*

Securities lending is the temporary loan of a security from one financial institution to another to earn additional income. Plans that engage in securities lending should present the assets received in return for the securities (collateral), as well as the exchanged securities, on the statement of net assets available for benefits. The exchanged securities, as well as the assets received for them (if an investment), should be reported on the supplemental schedule of assets (held at end of year) required by ERISA with the appropriate disclosures. A liability should be recorded on the statement of net assets available for benefits for the return of the collateral. See PEB 9.10.1 for discussion of supplemental schedules required by ERISA.

For securities lending arrangements within a master trust, note disclosure of the master trust investments should include the collateral received, as well as an offsetting liability for the return of the collateral. Since plan investments in a master trust are recorded as a single line item on the plan's

statements of net assets, securities lending in the master trust would not be reflected on the face of the plan's financial statements.

See AAG-EBP Chapter 8 and ASC 860 for additional information regarding securities lending.

9.7 *Employer contributions receivable*

ASC 960-310-25-1 and ASC 960-310-25-2 states that contributions receivable are amounts due as of the date of the financial statements, including legal or contractual obligations and, for a single employer plan, obligations resulting from a formal commitment. Evidence of a formal commitment may include (a) a formal resolution by the sponsor, (b) amounts relating to an established policy, (c) a deduction on the federal tax return, or (d) the employer's recognition, as of the reporting date, of a contribution payable to the plan. With regard to criteria (d), AAG-EBP 5.52, AAG-EBP 6.58, and AAG-EBP 7.61 note that the existence of accrued costs in the employer's financial statements does not, by itself, provide sufficient support for recognition of a contribution receivable by the plan.

9.7.1 *Contributions receivable in a defined benefit plan*

Employer contributions to a defined benefit plan are actuarially determined to ensure compliance with the funding requirements of ERISA. To meet contractual and legal obligations, defined benefit plans must record a contribution equal to the minimum funding targets as outlined in the Pension Protection Act.

In situations when minimum contributions cannot be made, a funding waiver for a business hardship can be sought. If granted, waivers generally permit a plan sponsor to pay the minimum contributions over a five-year period. In these instances, the plan should record a receivable for the full required minimum contribution, plus interest, as of the plan's year end. The collectability of the receivable should be evaluated and a reserve recorded, when necessary.

Plan sponsors may make contributions to the plan that exceed the minimum for a variety of reasons, including management of Pension Benefit Guaranty Corporation (PBGC) premiums (which are based in part on the plan's funding status), excess cash flow available, and tax planning strategies to reduce the plan sponsor's tax liability by increasing the contribution to the benefit plan. Because plan sponsors have until their tax return filing deadline to make contributions, these additional contributions are frequently made after the plan year end.

To determine if an employer contribution receivable should be recorded for contributions made subsequent to year end, the factors described as evidence of a formal commitment in PEB 9.7 should be considered. Contributions, as indicated on Schedule SB (or MB) of the plan's Form 5500, are often the clearest indication of a "formal commitment" in the absence of a formal resolution or written policy on contributions. Plan sponsors are encouraged to establish a formal policy regarding recognition of contributions.

9.7.2 *Contributions receivable in a defined contribution plans*

Employer contributions to a defined contribution plan are typically made as matching contributions based on a stipulated percentage of the employee contributions to the plan. Defined contribution plans that provide for employer contributions determined by an outside event (typically a profit-sharing plan when the contribution is tied to the sponsor's earnings) should report contributions on the

accrual basis. For example, although the profit-sharing contribution will not be made until after the plan's year end, if the contribution is determined based on a factor (e.g., percentage of profits, percentage of salary) relating to the employer's year end which falls on or before the plan's year end, a contribution receivable should be recorded in the plan's financial statements.

Unallocated forfeitures, to the extent realized as an offset against contributions receivable, should be netted against the accrual, and disclosed in the notes.

Example PEB 9-1 discusses the timing of recognizing a contribution receivable for amounts approved after the plan's fiscal year end.

EXAMPLE PEB 9-1

Timing of recognizing a contribution receivable for amounts approved after the plan's fiscal year-end

In April 20X1, the Board of Directors of PEB Corporation established the PEB Corporation Profit Sharing Plan (the "Plan"), a defined contribution plan subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

Under the provisions of the Plan, PEB Corporation's Board of Directors may authorize PEB Corporation to make a profit-sharing contribution to the Plan for any plan year. In February 20X2, the Compensation Committee of PEB Corporation's Board of Directors authorized PEB Corporation to make a contribution to the Plan for the 20X1 plan year in an amount representing three percent (3%) of the aggregate compensation of the covered employees (as defined in the Plan) for the 20X1 plan year.

PEB Corporation plans to recognize a federal income tax deduction for the contribution for the tax year ended December 31, 20X1. An accrual is reflected in PEB Corporation's consolidated financial statements as of December 31, 20X1 for its estimated profit sharing contribution to the Plan.

Plan participants terminated in 20X2 prior to the Board approval of the contribution would still be entitled to the 20X1 profit sharing contribution.

Should the Plan recognize a contribution receivable as of December 31, 20X1 for the contribution approved by the Board of Directors in February 20X2?

Analysis

Generally, yes, although a number a factors need to be considered to make such a determination.

The plan contribution approved in February 20X2 would be analyzed in connection with the factors noted in ASC 962-310-25-1. A contribution receivable should be recorded if there is a formal commitment as of the end of the 20X1 plan year. PEB would consider the following:

- (a) Resolution by the employer's governing body approving a specified contribution - The Board of Directors approved a profit sharing contribution allocable to the 20X1 plan year in February 20X2. The timing of the approval was after the plan year end, but prior to the issuance of the financial statements of both the plan sponsor and the Plan.
- (b) Consistent pattern of making payments after the plan's year end pursuant to an established contribution policy that attributes such subsequent payments to the preceding plan year - As

20X1 was the Plan's first year, it did not yet have a consistent pattern of making payments after the Plan's year-end. A policy had not yet been established. However, the metric for calculating the plan contribution was based upon a percentage of the plan participants' 20X1 salary. Additionally, as stipulated in the facts, had a plan participant terminated in 20X2 prior to the Board approval, the participant would still be entitled to the 20X1 profit sharing contribution.

- (c) Deduction of a contribution for federal tax purposes for periods ending on or before the financial statement date - PEB Corporation plans to recognize a federal income tax deduction for the contribution for the tax year ended December 31, 20X1.
- (d) Employer's recognition as of the financial statement date of a contribution payable to the plan - PEB Corporation has recorded an accrual as of December 31, 20X1 for its estimated profit sharing contribution to the Plan.

While there is no consistent pattern yet established, consideration of the rest of the criteria indicate that there is a formal commitment and a contribution receivable should be reported in the Plan's December 31, 20X1 financial statements.

The Form 5500 filed for 20X1 Plan Year should be consistent with the Plan's financial statements for the 20X1 Plan Year.

9.7.3 Contributions receivable in a health and welfare plan

Health and welfare plans usually pay claims as they are reported (pay-as-you-go basis). In such instances, employer contributions (net of participant contributions) are made to fund claims as they become due. Contributions are typically recorded in the period in which they are made for pay-as-you-go plans.

There may be other funding arrangements whereby periodic contributions are based on a specified dollar amount or an actuarial calculation. The employer's funding policy will be an important consideration in determining the proper period in which to record contributions.

Plans should not record contributions receivable solely for the purpose of offsetting an incurred but not reported obligation or the actuarially determined postretirement benefit obligation described in PEB 9.5.

9.8 Benefit plan mergers and terminations

Certain transactions, such as company mergers and acquisitions, or combining one plan with other qualified employee benefit plans for the same sponsor, may give rise to plan mergers. Other transactions may result in plan liquidations or terminations.

9.8.1 Plan mergers

A plan merger occurs when the net assets and accumulated benefits of one plan (the "merged plan") are merged with and into the net assets and accumulated benefits of another plan (the "successor/surviving plan"). Plan mergers may give rise to an abbreviated reporting period (a "stub period") for the merged plans. The final financial statements of the merged plan should have net assets

of zero, reflecting the transfer of assets to the successor plan. The presentation of a plan merger in a defined benefit plan's financial statements is dependent on the date the actuarial valuations are performed, with merged plans using beginning of the year valuation dates requiring additional footnote disclosure of the actuarial amounts at the merger date. See AAG-EBP Chapters 5, 6, and 7 for guidance in determining the effective date of a plan merger for defined contribution, defined benefit, and health and welfare plans, respectively.

9.8.2 Benefit plan liquidations and terminations

ASC 205-30-25 requires an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. Liquidation is imminent when the likelihood is remote that the entity will return from liquidation and either (a) a plan for liquidation is approved by the person or persons with the authority to make such a plan effective, and the likelihood is remote that the execution of the plan will be blocked by other parties, or (b) a plan for liquidation is being imposed by other forces (for example, involuntary plan termination). For a single-employer defined benefit or defined contribution plan, this would mean that the likelihood would need to be remote that other parties, such as the Pension Benefit Guaranty Corporation or the IRS, would block the liquidation. Such evaluation often depends on whether the termination is a standard termination, or a distressed or involuntary termination. Further, approval for the termination of a defined benefit plan is often more complex than that of a defined contribution plan.

For all types of plans, consultation with legal counsel, plan actuaries (if applicable), and service organizations (for example, trustees or record keepers) may be necessary in order to make a judgment about whether the likelihood is remote that other parties would block the termination of a plan. This evaluation may change over time, depending on the stage of the termination process. Refer to Chapter 6 in PwC's *Bankruptcies and liquidations* guide and the AICPA Employee Benefit Plans Expert Panel Q&A, section 6931.18 (AICPA, Technical Question and Answers) for additional information on determining when liquidation may be considered imminent.

A plan is required to measure assets at the estimated amount it expects to collect in settling or disposing of those assets. A plan should also accrue estimated costs to dispose of assets and costs it expects to incur (for example, audit and actuarial fees) during the liquidation period. However, a plan should not apply discounting provisions in measuring such accruals. Since the majority of plan assets are recorded at fair value, the liquidation basis may have little to no effect on the plan's statement of net assets or changes in net assets (except in instances when the plan has insurance or investment contracts recorded at contract value). However, if the fair value or the liquidation value does not include future expected earnings, the plan should accrue income that it expects to earn through the end of liquidation if and when it has a reasonable basis for estimation. For example, the interest to be earned on a money market account or interest-bearing security generally would not be included in the fair value, so those amounts would be estimated and reported on the financial statements if and when the plan has a reasonable basis for estimation.

For defined benefit plans, accumulated plan benefits presented on the statement of benefit obligations must also be determined on the liquidation basis. This typically means significant variations in the accumulated plan benefits for a plan on the liquidation basis from a plan considered to be a going concern. These variations are caused by changes in assumptions, as well as the reporting of all benefits as vested. See AAG-EBP 5.203-5.205 for liquidation accounting considerations.

9.9 Other matters related to benefit plan financial reporting

Employee benefit plans may be impacted by other matters such as class actions settlements and subsequent events.

- **Class action settlements**

An obligation arising from the settlement of a class action suit brought against a defined benefit plan related to the underpayment of benefits paid to participants should be reflected in the financial statements on the statement of accumulated plan benefits as an increase in the actuarial present value of accumulated plan benefits.

The settlement benefits should be recorded as benefits paid on the statement of changes in net assets available for benefits and on the statement of changes in accumulated plan benefits for the year in which they are paid to the participant.

The guidance in ASC 450 should be followed when evaluating the impact of a class action suit prior to settlement.

- **Subsequent events**

ASC 855 provides guidance related to the evaluation of subsequent events for potential recognition or disclosure in the financial statements. Plans filing on Form 11-K are considered SEC filers under this standard. As such, subsequent events should be evaluated through the date that the financial statements are issued. The subsequent reissuance of the financial statements for filing with the DOL would not require updating of subsequent events procedures beyond the original issuance date unless a revision to the financial statements was required.

Plans that do not file on Form 11-K do not meet the definition of an SEC filer. For those plans, subsequent events should be evaluated through the date the financial statements are available for issuance. The financial statements should include disclosure of the date through which subsequent events have been evaluated and whether that date represents the date the financial statements were issued or available to be issued.

For defined benefit plans that present beginning of year benefit information, this evaluation should consider events or transactions, including significant plan amendments, occurring after the latest benefit information date but before the financial statements are issued or are available to be issued. See discussion of subsequent changes to mortality assumptions in PEB 9.4.4.

9.10 ERISA reporting requirements

The annual report of employee welfare and pension plans may be filed with the Department of Labor (DOL) in compliance with Section 103 of ERISA or, in conformity with the regulations, may use the limited exemption or alternative method of compliance. The alternative method is described in DOL Regulation Section 2520.103-1 and is used for most plans. Under the alternative method, the filing must include:

- Form 5500 and any schedules required by the instructions to the form. Schedules that may be required include Schedule A (insurance information), Schedule MB or SB (actuarial information), Schedule C (service provider information), and Schedule R (retirement plan information).
- Separate financial statements including:
 - A comparative statement of assets and liabilities at current value at the beginning and end of the year
 - A statement of changes in net assets for the most recent year
- Notes to financial statements
- A report of an independent qualified public accountant. ERISA requires reporting on the pension plan rather than the pension trust fund because it is believed that reporting on the plan will provide the most useful information for plan participants.

9.10.1 Supplemental schedules required by ERISA and the DOL

In addition to the financial statements and related disclosures, ERISA and DOL regulations require the disclosure of additional information that is required to be covered by the auditor's report. The additional information, which is described in detail in the instructions to Form 5500, is presented in supplemental schedules as follows:

- Schedule H, line 4a - Schedule of Delinquent Participant Contributions
- Schedule H, line 4i - Schedule of Assets (Held at End of Year)
- Schedule H, line 4i - Schedule of Assets (Acquired and Disposed of Within Year)
- Schedule H, line 4j - Schedule of Reportable Transactions - these are transactions that exceed 3% (if the plans file their annual reports under the statutory method) or 5% (if the plans file their annual reports pursuant to the alternative compliance method prescribed by the DOL) of the fair value of plan assets at the beginning of the year
- Schedule G, Part I - Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible
- Schedule G, Part II - Schedule of Leases in Default or Classified as Uncollectible
- Schedule G, Part III - Nonexempt Transactions

The instructions to the Form 5500 and information in AAG-EBP Appendix A, Exhibit A-1, provide detailed guidance regarding the information required to be disclosed in each of these schedules.

9.10.2 Reporting gains and losses on benefit plan investments

The reporting of investment gains and losses under GAAP differs from the reporting under ERISA. ERISA requires the use of the current value method (also sometimes referred to as the revalued cost method) for reporting realized and unrealized gains and losses on Form 5500. Under this method,

realized gains and losses are calculated as sales proceeds less current value at the beginning of the year, or acquisition cost if acquired during the year. Unrealized gains and losses are calculated as the current value of the investment held at the end of the year less its current value at the beginning of the year, or acquisition cost if acquired during the year. Essentially, the measure of reporting gains and losses focuses only on the change in value during the current year.

For GAAP purposes, the minimum disclosure required by ASC 960, ASC 962, and ASC 965 is the net appreciation or depreciation in the fair value of investments, which includes realized gains and losses on investments bought and sold during the year measured in relation to their original acquisition cost. Thus, the use of beginning-of-the-year data under ERISA to compute realized gains and losses is not in accordance with GAAP. As such, a plan should not separately disclose realized gains or losses in the financial statements computed under the current value (ERISA) method. Accordingly, to alleviate the audit and financial reporting implications of presenting captions and amounts in the financial statements that are not in conformity with GAAP, plans may display, in their statement of changes in net assets available for benefits, only the net appreciation (depreciation) in the fair value of investments, which would include realized gains and losses on investments bought and sold during the year.

A plan could present its "realized gains or losses" computed on the current value basis, if the plan:

- Titles the amount "excess (deficiency) of net proceeds over market value at beginning of year," rather than the caption "realized gains or losses," and
- Indicates, in the summary of significant accounting policies footnote, the basis of the calculation of this amount.

9.10.3 *Reconciliation between the financial statements and Form 5500*

Under DOL regulations, any difference between Form 5500 and the financial statements must be disclosed and reconciled (e.g., the net assets in the financial statements will be higher than the net assets reported under ERISA if there are any liabilities for amounts due the participant, see Figure PEB 9-1).

In lieu of a reconciliation of the difference in how gains and losses are reported (as described in PEB 9.10.2), however, the DOL will generally allow the plan to present in the statement of changes in net assets the net appreciation (depreciation) in the fair value of investments, consisting of the realized gains (or losses) and the unrealized appreciation (depreciation) on those investments, as long as that form of presentation is disclosed in a note to the financial statements.

9.11 *Form 11-K reporting requirements*

In accordance with the Securities Exchange Act of 1934, a Form 11-K is generally required to be filed annually for certain employee benefit plans if:

- Participants have the option to direct investments in their employer stock (publicly held), or
- A Form S-8 registration statement has been filed with the SEC to register plan securities.

See AAG-EBP 5.209-5.214 for a discussion of filing requirements.