Institutional Group

Why Are Pension Plan Sponsors Switching to Mark-to-Market Accounting?

Recent news headlines have highlighted a few examples of Fortune 100 companies making changes to their accounting methods for pension plans and other post-retirement benefits. In one instance, the company announced that it is adopting a mark-to-market accounting policy for its pension plan expenses that recognizes portfolio gains and losses more quickly, but not necessarily immediately. Another company announced that it adopted a new market-based benefit accounting methodology that recognizes gains and losses in the year incurred, instead of amortizing them over time. In both of these instances, the companies immediately recognized billions of dollars of adjusted-pension losses.

As financial executives overseeing pension plans read about these examples, questions arise regarding why companies are making these changes and whether or not such a change would make sense for their organizations. This summary provides an overview of and insight into these changes and what, specifically, they mean for plan sponsors.

How do defined benefit plans currently calculate the effect of the plan on corporate financial statements?

Plan sponsors must recognize the fiscal-year expense associated with the pension on the income statement. As part of this process, plan sponsors are allowed to deduct from expenses the expected return on assets for the year. Under the current rules, a sponsor also has the option of using a value for assets that can be “smoothed” over a period of up to five years. When markets are poor, this smoothed value will usually outperform the fair value of assets and vice versa. The goal of this exercise is to decrease the year-to-year volatility of the pension expense.

Another aspect of the pension expense smoothing has to do with the amortization of plan gains or losses. Under the current rules, the sponsor is allowed to defer recognition of plan gains or losses into future years. These gains or losses are offset by losses or gains in future years and then partially amortized into expense (typically, over the future working life of the plan participants).

What is mark-to-market accounting for defined benefit pension plans?

In general, mark-to-market or fair-value accounting refers to accounting for the value of an asset or liability, based on its current market price. Mark-to-market accounting for defined benefit plans means getting rid of some or all of the smoothing methods described above. The plan sponsor may choose to no longer use a smoothed value of assets or an expected return assumption in calculating the return on assets but rather, use the actual return on the fair value of assets (FVA). Further, often the sponsor will no longer defer the gains or losses into the future but may recognize them immediately when they occur, including gains and losses on the liability or Projected Benefit Obligation (PBO), as well as on the FVA. One outcome is that the adjustment to shareholders’ equity will be reversed, and the plan sponsor’s balance sheet will no longer show a drag on shareholders’ equity to the extent that there are large, unrecognized losses.
What does a change to mark-to-market accounting mean for plan sponsors?

The change to mark-to-market accounting requires a modification to the accounting methods used for the plan sponsor’s financial statements, in that gains and losses will be recognized more quickly, and often in the periods in which they are realized. Most plan sponsors’ financial statements currently show large losses and therefore will see a large adjustment in the year of adoption. Additionally, the notes in the financial statements will show the pension expense under the newly adopted methodology and its effect on prior years. Moving forward, all gains or losses could be recognized immediately through the profit-and-loss statement. The net effect of mark-to-market accounting to defined benefit pension plans may be to increase the year-to-year volatility of the pension plan’s expense.

It is important to note that a shift does not necessarily signal a change in the corporate sponsor’s strategic outlook for the pension plan. There are many outside forces that are pressuring sponsors to look at the way that the plan is accounted for and to increase the transparency of that accounting.

Why are plans switching to mark-to-market accounting?

One major reason is that U.S. Generally Accepted Accounting Principles (US GAAP) is on a path to converge with International Accounting Standards (IAS), which uses mark-to-market accounting. Adopting companies assume that this convergence will continue and are simply making the move in anticipation of these changes.

Another reason some plan sponsors are changing is that analysts and other financial statement users understand that the current smoothing methodology delays recognition of certain events. In some instances, analysts that cover the company might already be using mark-to-market accounting in an attempt to get a more accurate view of the assets and liabilities of the organization. The companies might be adopting mark-to-market accounting to avoid confusion by simply recognizing that methods of smoothing are ultimately removed in an analyst’s review.

An additional consideration is whether or not the company’s stock is traded on international exchanges. If that is the case, the company may have to provide financial statements that comply with the international accounting standards and the organization might decide to move its U.S. pension accounting treatment in line with those standards. Ultimately, it could help with the transparency initiatives that these global companies are currently undertaking.

One final reason is that mark-to-market accounting could help plan sponsors control the volatility of pension expense by implementing a more effective asset/liability, or LDI strategy. Smoothing mechanisms can cause additional volatility, as assets and liabilities are not smoothed similarly. As a result, the most effective implementation aligns assets and liabilities directly, which requires mark-to-market accounting.