WELLS FARGO ASSET MANAGEMENT

Wells Capital Management

Market insights

Liability-Driven Investment Team

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Recent pension reporting changes may alter plan sponsor incentives

Introduction

Earlier this year, the Financial Accounting Standards Board (FASB) quietly issued a modification to the reporting of pension expense that has large implications for the presentation of earnings. Expected return on assets (EROA) has been demoted from operating to non-operating earnings on the income statement. This is especially impactful for companies with large pension plans relative to the size of their corporate earnings, as well as companies that prioritize operating earnings over net income.

What's the background?

Pension expenses (known as the net periodic pension cost or NPPC) currently flow through operating earnings on the income statement for U.S. GAAP (generally accepted accounting principles) filers. This calculation of NPPC recognizes the changes in the pension liability due to benefits earned (service costs), the passage of time (interest rates and investment earnings), and changes in market forces and estimates (such as changes in discount rates or other gain/loss items).

Earnings and its related ratios, such as earnings per share (EPS) and price to earnings (P/E), are important metrics tracked by analysts and investors. Currently, pension plan sponsors report higher earnings for higher expected-return-on-asset (EROA) assumptions. In other words, for pension plan sponsors with higher growth allocations or more-aggressive EROA assumptions, the net pension expense shrinks. Thus, the greater the EROA, the greater the plan sponsor's operating earnings.

What's changing?

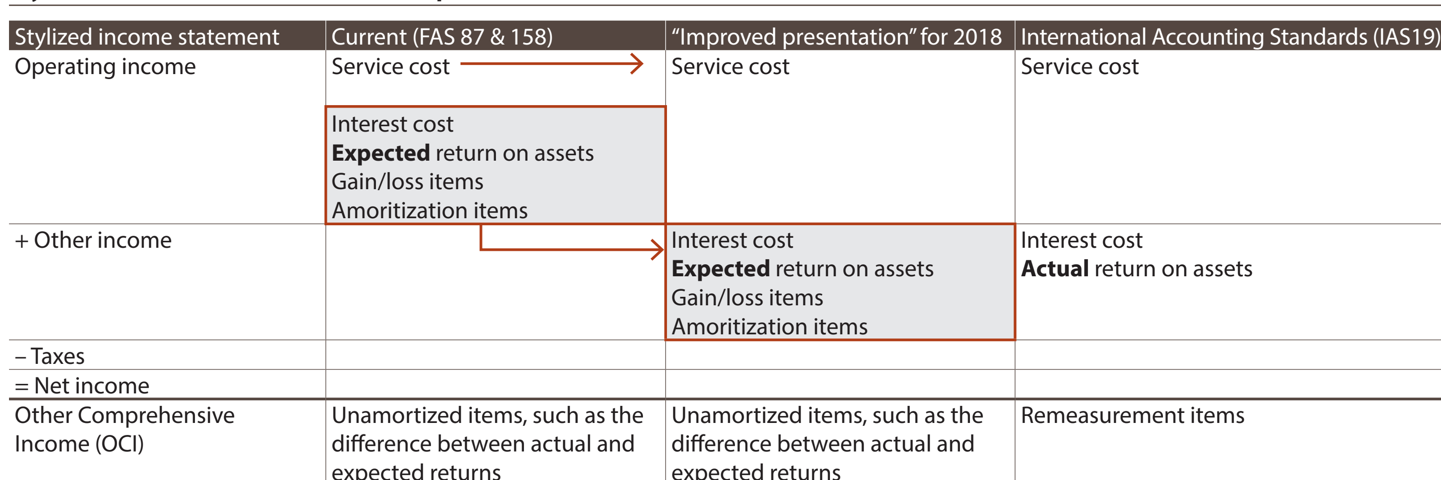
In early March 2017, FASB adopted a revision to the presentation of pension expenses on the income statement. All components of the NPPC except for service costs have been relegated to the non-operating segment of the income statement. Service costs will remain in operating earnings since they are considered employee compensation costs. Even though EROA and other pension expenses have been moved out of operating earnings, they will still be considered "above the line," and therefore included in net earnings and EPS calculations. That said, removing EROA from operating earnings is certainly a demotion.

For public filers, these changes are effective in 2018.

Why does it matter?

In short, this is a simple reorganization of the income statement. Such a minor change, however, could have meaningful implications. First, splitting the pension expense adds transparency to financial statements. This could put greater focus on pensions. Operating expense should go up, and therefore operating earnings should go down. Non-operating expense should go down, and non-operating earnings should go up. To the extent that equity investors assign higher multiples to operating earnings than to non-operating earnings, this could push equity valuations down in sectors where pension obligations tend to be material liabilities.

Stylized income statement treatment of pension costs



Stylized income statement	Current (FAS 87 & 158)	"Improved presentation" for 2018	International Accounting Standards (IAS19)
Operating income	Service cost Interest cost **Expected** return on assets Gain/loss items Amortization items	Service cost	Service cost
+ Other income		Interest cost **Expected** return on assets Gain/loss items Amortization items	Interest cost **Actual** return on assets
– Taxes			
= Net income			
Other Comprehensive Income (OCI)	Unamortized items, such as the difference between actual and expected returns	Unamortized items, such as the difference between actual and expected returns	Remeasurement items

*Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.
Implementation for public business entities filing for years beginning after December 15, 2017; implementation for non-public entities filing for years beginning after December 15, 2018.
Income statement is highly simplified to focus on how pension expenses are categorized.

Second, the appeal of higher risk/return asset allocations may decline with lower operating earnings. This may result in greater adoption of liability matching through the acquisition of long bonds. The long corporate bond market already experiences strong demand from insurance companies and pension funds, so further demand could influence pricing on corporate bonds. This may lead to downward pressure on corporate bond spreads, especially long-dated spreads.

Conclusion

For some plan sponsors, the EROA can create an incentive to allocate to higher-expected-return asset classes, such as equities and alternatives, instead of bonds. These riskier allocations come with higher funded status volatility and less focus on mitigating liability risk.

While we do not believe the accounting changes will immediately lead to wholesale changes to asset allocations, some corporations that focus on operating earnings may choose to revisit their asset allocations. Further, this change could foreshadow further FASB actions, such as the long-anticipated income statement pension expense overhaul. If other topics of convergence with International Accounting Standards give any indication, we may see the income statement completely rid of EROA in years to come.

In the appendix, we provide an example of how the treatment of pension-related items on the income statement will change under the new FASB modification.

Appendix – ABC Company pension-related items on the income statement

ABC Company reported $110.5 million in operating income in the current period and is subject to a marginal tax rate of 35%. We assume an 85% funded status. Other pension related assumptions follow:

ABC Company Defined Benefit Pension Plan

- Pension Liability: $1,000 million
- Pension Assets: $850
- Service costs: 3% of liability
- Interest cost: 4% of liability
- EROA: 7%

Current		
Net Revenue		110.5
Pension Cost		-10.5
Service Costs	*-30.0*	
Interest Cost	*-40.0*	
EROA	*59.5*	
Operating Income		100.0
Other Income		0.0
Income Before Tax		100.0
Taxes (35% marginal)		-35.0
Net Income		65.0

New		
Net Revenue		110.5
Pension Cost		-30.0
Service Costs	*-30.0*	
Operating Income		80.5
Other Income		19.5
Interest Cost	*-40.0*	
EROA	*59.5*	
Income Before Tax		100.0
Taxes (35% marginal)		-35.0
Net Income		65.0

Pension-related interest costs and EROA are now reported within *Other Income* with an offsetting impact to *Operating Income*. There is no nominal change in reported earnings. However, if the market places a premium on operating earnings, this may have a negative impact on valuation multiples, other things equal.

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