



# Pension in The News

## Recent Company Pension Accounting Announcements

A presentation to the Atlanta Actuarial Club  
by David Fournier

April 1, 2011

# Recent Headlines...



at&t

**AT&T takes \$2.7 billion charge in Q4 from pension accounting change**

– Fierce Telecom 01/14/11

**AT&T cuts \$17 billion from earnings on pension accounting changes**

– PI Online 01/13/11

# Recent Headlines...



**Verizon to take \$600M  
charge on pension  
accounting change**  
– Business Insurance 01/21/11

**Recent Headlines...**

# Honeywell

**Honeywell Announces Change In  
Pension Accounting And Plans For 2011  
Pension Funding**

**– Honeywell Press Release 11/16/2010**

# Recent Headlines...

## Rewriting Pension History

***Some Big Firms Move to Recognize Gains and Losses in the Years They Occur***  
- WSJ 03/09/2011



### Sweeping Away Pension Losses

Some companies with deferred pension-plan losses have simplified their accounting to recognize gains and losses more quickly...

	Unrecognized losses as of 2009	Losses as % of pension assets
AT&T	<b>\$23.04 billion</b>	49%
Verizon	\$12.20	43
Honeywell	\$7.57	55

...while others haven't changed but appear to have enough deferred losses to merit it.

	Unrecognized losses as of 2010	
DuPont	\$9.03	49%
Goodyear	\$3.15	54

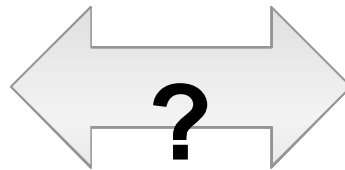
Sources: The Analyst's Accounting Observer; companies' 10-K annual reports

# Recent Headlines...

## Honeywell

**Honeywell Changes Pension Accounting Adding Transparency**

- Morningstar 11/16/2010



**Honeywell's Pension Announcement Is A Smokescreen**

- Seeking Alpha 11/7/2010



**at&t**

towerswatson.com

**Verizon, AT&T Pension Switch May Amplify Profit Swings**

- Bloomberg 02/04/2011



# Components of Pension Accounting Expense

**Service Cost**

**Cost of benefits** accruing during the year

**Interest Cost**

**Growth** in liability due to passage of time

**Return on Assets**

**Expected earnings** on market-related value of plan assets

**Amortization**

**Prior Service Cost** (plan improvements)

**Losses/Gains** on liability and assets

# MTM Pension Accounting

- Annually Recognize Mark-To-Market Gains or Losses Outside Corridor in Income Statement (MTM Accounting)
  - Corridor Calculated as 10% of the Greater of Fair Value Plan Assets or PBO\*
- Pension Expense Will Be Presented as Two Elements:

<u>Elements</u>	<u>Components</u>	<u>Period of Recognition</u>
1) Ongoing Expense	Service Cost Interest Cost Assumed Asset Return	Quarterly
2) MTM Adjustment - Gain/Loss Outside of Corridor	Discount Rate Changes Actual Returns vs. Assumed Returns	Potential Q4 Each Year

- IFRS Today and IASB Proposal Treat Gains / Losses as Non-Operating (OCI)\*

\* PBO – Pension Benefit Obligation; OCI – Other Comprehensive Income

**Isolate Possible Pension Variability From Ongoing Results**

# Key Accounting Differences

<u>Current Accounting</u>		<u>MTM Accounting</u>	
(\$B)		(\$B)	
	<u>2010E</u>		<u>2010E</u>
Pension Expense Components		Pension Expense Components	
Ongoing { Asset return *	1.2	Ongoing { Asset return *	1.1
Interest cost	(1.0)	Interest cost	(1.0)
Service cost	(0.3)	Service cost	(0.3)
G/(L) Amortization	<u>(0.7)</u>	4Q MTM Adjustment **	<u>~ (1.4)</u>
Pension Income/ (Expense)	<u>(0.8)</u>	Pension Income/ (Expense)	<u>~ (1.6)</u>
*Based on Smoothed Value of Assets; 9% Assumed Rate of Return (RoA)		*Based on Fair Value of Assets; Utilizes 9% Assumed Rate of Return (RoA)	
		**MTM Adj. Assumes 4.75% Discount Rate and 10% RoA	
<ul style="list-style-type: none"> <li>• Smoothed Value of Assets – 3 Years</li> <li>• Deferred Gains / Losses Outside the Corridor Amortized Over 6 Years</li> <li>• Recognized Gains/Losses More Rapidly in Earnings vs. Peers</li> <li>• \$7.5B Losses Yet to be Amortized</li> </ul>	<ul style="list-style-type: none"> <li>• Fair Value of Assets – No Smoothing</li> <li>• Gains/Losses Outside Corridor Recognized <u>Annually</u> in Q4</li> <li>• Ongoing Pension Expense <u>Plus</u> Transparent 4Q MTM Adjustment</li> <li>• Recognize ~\$5.5B Losses in Prior Periods</li> </ul>		

**No Longer Amortizing Deferred Losses Going Forward**

# Accounting Change Considerations

- **MTM Accounting Preferable**
  - Concurrence of Independent Auditors
- **Aligns to International Accounting Trends**
  - Both IFRS Today and IASB Proposal Utilize MTM (Adjustment Through OCI)
- **Adds Transparency to Operating Performance**
  - Recognize any Pension Gains/Losses Annually in 4Q (MTM)
- **Interest Rates at Historic Lows... Unique Opportunity**
  - Mitigates Pension Expense Downside Volatility – Rates Stable, Likely to Rise
- **Change Retrospectively Applied to Prior Periods – Financials Recast**
  - Recognize ~\$5.5B of Deferred Losses in 2010 and Prior Periods

***Shift To MTM Accounting In 2010***

# Is MTM Accounting Preferable?

- A change in accounting method must be to a preferable method
- Generally, the Securities and Exchange Commission and audit firms have considered changes in benefits accounting methods that result in less cost deferral as preferable
- It is unlikely that a sponsor can change methods in a way that results in slower recognition



# US Convergence with or to IFRS



- Convergence puts an “expiration date” on risks associated with accounting policy change
- Use of fair value of assets is and will continue to be prescribed under IAS
- Gains and losses will not be required to be recycled through the income statement (adjustment through OCI)

# Is MTM More Transparent?

- Honeywell also notes the accounting changes add transparency to operating performance
- It is difficult to understand this assertion
- Pension-related gain/loss recognition is required to be reported as part of net periodic cost



# Are Low Interest Rates Likely To Rise?

- Honeywell observes the historically low interest rate environment creates a unique opportunity
- The point here seems to hinge on the presumed relative low risk of adverse effects in the next several years until the expected US convergence with or to IFRS
- Longer term, a decision to move to liability driven investments would help mitigate large gains or losses



# What About Expense Volatility?

- Q4 MTM will result in higher year-over-year volatility
- Even though IAS proposal utilize MTM, the gains and losses do not necessarily flow through the income statement (adjustment through OCI)
- One of the reasons why the current accounting rules allow smoothing is to take some of the volatility out



# Retrospective Application

- A change in accounting method must be applied retrospectively, resulting in adjustment of prior period financial statements as though the new accounting method had always been followed
- The cumulative effect of the change on years prior to the earliest year presented for comparative purposes is reported as an adjustment to beginning retained earnings of the earliest year presented



# Was 2010 The Best Time for Honeywell's Accounting Change?

- For Honeywell, announcing the change in 2011 would have resulted in better results
  - Higher earnings would have been reported in 2010
- Effect of 2010 losses (due to very low discount rates on 12/31/2010) would have been reported instead in the adjustment to prior year results



# Pension Strategy

- **Today: Estimated Funded Status ~77% at 2010 Year End**
  - Flat to 2009 Due to Precipitous Drop in Discount Rate (~100 bps)
  - Includes \$1B Planned Contributions in 2010 and 10%+ Asset Returns
- **Strategy 1: Plans to Achieve Fully Funded by 2015**
  - \$1B Cash Contribution Planned in 2011
  - 2012-2015 Funding Amounts TBD (Discount Rate and RoA Dependent)
  - Sensitivity: 1 Point Discount Rate Increase ~ \$2B Funded Status
- **Strategy 2: As Approach Fully Funded, Evaluate Asset Mix**
  - Investment / Liability Matching Reduces Pension Expense Variability
  - Lower Rate of Return Assumption As Asset Mix Shifts

**• Future Pension Funding Manageable**  
**• Pension Variability Reduced By Funding/Other Actions**

# Relationship with Investment and Funding Policies

- The following factors should be considered when implementing an accounting policy change
  - Benefit policy (type of plan, open, closed, frozen)
  - Funding policy (commitment to fund, time horizon)
  - Investment beliefs and policy (LDI, equity exposure)
  - Size of unrecognized losses
  - Willingness or aversion to restate prior financial statements?
  - Aversion to volatility or willingness to disclose Q4 MTM adjustments?



# Analysts' Reaction to Honeywell's Changes

- The analyst reaction seen was favorable
- Analysts cited
  - Enhanced transparency (somewhat puzzling)
  - Expectation of lower pension cost
- But the more welcome news appeared to be Honeywell's intent to
  - Move to a more conservative investment strategy
  - Increase funding



# Questions?



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