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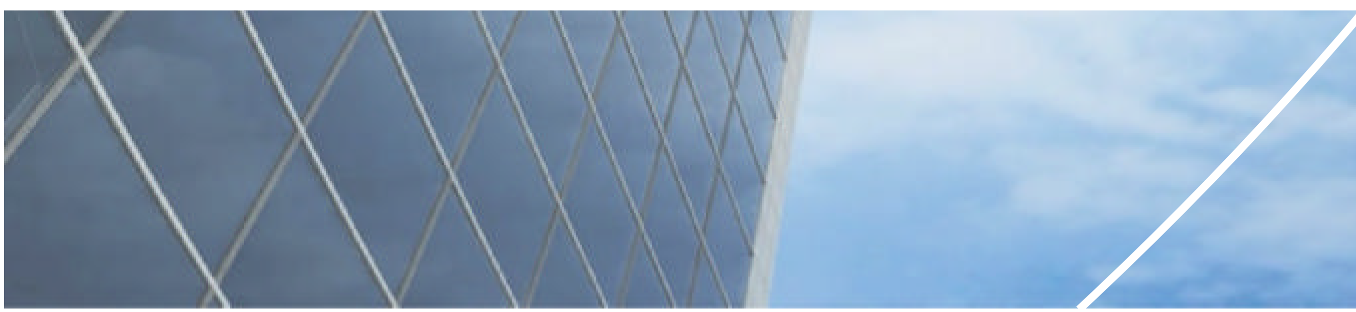
Understanding Pension Plan Accounting & Valuations



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Jim has over 34 years of experience working with plan sponsors to manage their qualified defined benefit, supplemental executive, and retiree medical plans. His experience includes actuarial valuations to determine minimum and maximum funding requirements, fiscal accounting cost, and governmental form reporting.

He has consulted his clients on retirement risk reduction, including lump sum windows, annuity purchase, early retirement windows, and plan termination studies. He has supported his clients during bargained agreement negotiations, merger & acquisition projects, and the design of pension and retiree medical plans.

He also serves as the Manager of the Defined Benefits Administration Team. He and the team manage a call center for participant inquires, process benefit calculations, maintain participant data for qualified defined benefit plans, and assist clients with plan document work. His areas of expertise include determination of benefit payments for plan participants, defined benefit plan administration, interpretation of plan documentation, and application of regulatory guidance.

Jim is a Fellow of the Society of Actuaries and an Enrolled Actuary under the Employee Retirement Income Security Act. He received his Bachelor of Science degree in mathematics from Bradley University.

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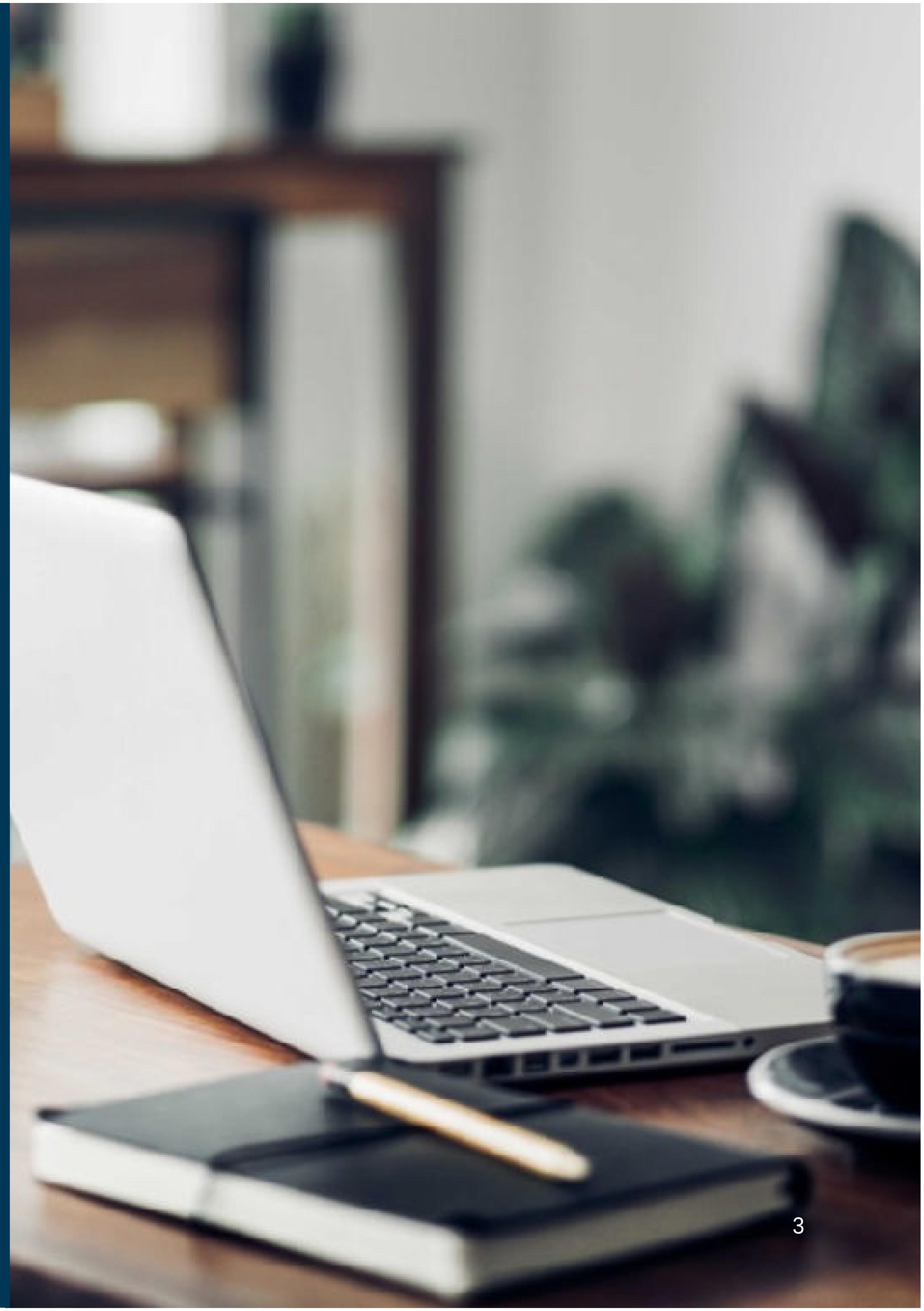

What Types of Benefit Plans Need a Valuation

- Traditional Defined Benefit Pension Plans
- Cash Balance Plans
- Retiree Medical Plans (OPEB - Other Post Employment Benefits)
- Non-Qualified Executive Compensation Plans (SERP – Supplemental Employee Retirement Plan)

What is an Actuarial Valuation

Calculating the present value of future benefit payments to determine if there are adequate assets to pay for those obligations

MEASURING OF LIABILITIES

KEY ASSUMPTIONS

FUNDED RATIO

ANNUAL CONTRIBUTION

Contribution Funding Policy

Funding policies are critical to ensure that these plans remain financially sustainable and can meet their future obligations to participants.

A well-defined funding policy outlines how contributions will be determined and how the plan will achieve its funding goals.

Here are some common funding policies:

- **Required Contribution –** Based on the funding regulations, it is the minimum amount that an employer needs to contribute to the pension or OPEB plan to ensure that it is adequately funded over time.
- **Funding Goals and Targets -** Funding goals specify the desired level of funding for the plan, often expressed as a percentage of the total pension or OPEB liability.
- **Contribution Smoothing -** Stabilizing contribution rates over time to avoid large fluctuations due to changes in market conditions.
- **Contingency Plans -** Outlines actions to be taken in response to adverse financial conditions or unexpected changes.

Plan Reporting (valuation and accounting) is not merely a compliance exercises but integral to the sound management and long-term sustainability of pension and OPEB plans. They provide the necessary information for making informed decisions, ensuring financial stability, and delivering promised benefits to an organization's employees.

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Why Plan Reporting (Valuations) are Important

Effective Plan Management
- Understand Plan’s Funded Status
- Review Annual Cost of the Plan
- Contribution Decisions
- Benefit Sustainability

Governmental Accounting Standards and Regulations
- GAAP Accounting Compliance
- Government Regulations

Prudent Investment Decisions
- Developing Investment Strategy
- Review Asset Performance
- Asset Adequacy

Issues with Inaccurate Plan Reporting

Valuations are a snapshot of future expectations and if not managed can have the following consequences:

- **Inaccurate Financial Reporting**
  - Misrepresentation of plan's financial health
  - Misleading of stakeholders and investors
- **Regulatory Compliance Risks**
  - Noncompliance can lead to increased audits
  - Increase scrutiny from regulators
- **Underfunded Risk**
  - Increased funding volatility
  - Increased contributions

Actuarial Assumptions and Methods

The assumptions and methods used in a valuation are critical for accurately assessing the financial status of pension and OPEB plans.

- Plan Sponsors should carefully review and select the assumptions that reflect the plan’s true experience.
- This helps make informed decisions about contributions and benefits.
- Accurate assumptions are essential for compliance with accounting standards.
- Provide transparency and accountability in financial reporting.

Actuarial Assumptions

Economic Assumptions:

- **Discount Rate -** The interest rate used to discount future benefit payments back to determine the present value. It reflects the current market conditions, which will vary from year-to-year.
- **Salary Growth:** Assumptions regarding future salary increases for employees, which affect the amount of benefits earned and the overall liability.
- **Investment Return Rate:** The expected long-term rate of return on the plan's investments, set with assistance of the investment manager.

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Actuarial Assumptions

Demographic Assumptions:

- **Mortality Rates:** Assumption about the life expectancy of plan participants, impacts the total amount of benefit that retirees and beneficiaries will receive from the plan.
- **Retirement Age:** Assumptions regarding the age at which employees are expected to retire, which can affect the timing of benefit payments.
- **Employee Turnover:** Estimates of how many employees are expected to leave the workforce before retirement, which impacts the number of future retirees.

Healthcare Cost Trends (for OPEB):

- For OPEB plans, assumptions about future healthcare cost trends are essential, as they influence the expected costs of providing healthcare benefits to retirees.

Actuarial Methods

Actuarial Cost Method:

- The method used to allocate the total pension or OPEB liability to different periods. Common methods include:
  - **Entry Age Normal (EAN)**: Allocates the cost of benefits evenly over the employee's working career
  - **Projected Unit Credit (PUC)**: Allocates projected benefits considering future salary increases.
  - **Aggregate Cost Method**: Allocates cost based on the total liability instead of looking at a specific year of service.

Asset Valuation Method:

- The method used to value the plan's assets, which can include:
  - **Market Value**: The current market value of the plan's investments.
  - **Smoothed Value**: A method that smooths fluctuations in market value over time to reduce volatility in reported assets.

Issues with Not Managing Assumptions

Assumptions impact the future expectations of the plan and incorrect assumption can have the following issues:

- **Plan Management -** The real cost of providing benefits to participants is not accurately being reflected, it could be under or overstated.
- **Accounting Compliance –** Financial reporting may not be compliant with the regulations and auditors may challenge assumptions that appear to be unreasonable.
- **Financial Stability-** Assumptions that do not accurately reflect expectations can produce volatile results and can be difficult for plan sponsors to manage and budget for.
- **Investment Decisions-** Asset managers rely on cash flow projections of the plans liabilities to help them make investment decisions.
- **Benefit Delivery –** Plan Sponsors rely on these results to help them manage the benefit programs and deliver competitive benefits to attached and retain talent.

Common Mistakes/Challenges

Here are some common mistakes Plan Sponsors make regarding the assumptions used for their benefit programs:

- **Lack of Monitoring -** Plan Sponsors may not review these assumptions on an annual basis to understand their impact. Also, it is a best practice to conduct an experience study every three to five years to review/change assumptions.
- **Global Assumptions –** Single assumption being used for different demographic populations, for example hourly and salary employees usually have difference historical experiences.
- **Overall Results –** Focusing only on the overall change in liability versus understanding the impacts of individual assumption. Some assumptions have offsetting impacts that can disguise an underlying issue.
- **Data Requirements –** The necessary participant data needs to be collected on an annual basis so assumptions can be reviewed and if necessary updated.

Questions to Identify Value Add Propositions

Here are a few questions we suggest to help discover if there are issues so we can provide value added solutions and consulting to your clients and prospects:

- **Benefit Cost –** Does the client understand the cost of the benefits they are providing?Have they reviewed cost projections or “what if” scenarios to understand the future cost of the plan?
- **Cost Volatility -** Have they experienced volatility or surprises in annal cost? Do they understand what is the root cause of the volatility?
- **Assumption Review -** Are assumptions being reviewed each year? When was the last time an experience study was done?
- **Benefit Management –** Does the client understand the amount of the benefit they provide to participants, sometimes measured as a percent of pay. Has this amount changed over time? Is it competitive in the market?