Given the volatility we have experienced in the financial markets, many would–be acquirers are understandably wary of taking on defined benefit pension plan risk. This is a risk that no one is eager to take on and that some actively seek to avoid even when the target sponsoring the plan is an attractive asset.

In today’s low discount rate environment and following several rounds of pension funding relief, a divide has grown between the valuation principles that govern the size of the deficit on the balance sheet for accounting purposes and the economic cost of the cash needed to fund that shortfall. As a result, buyers are increasingly looking at alternative measures to determine the valuation of the pension deficits aside from the amounts recorded on the balance sheet.

Our comments here focus largely on the U.S. market, as funding rules differ by country. But in general, this arbitrage opportunity exists in many regions.

Overview of Alternative Valuation in Transactions
The current mergers and acquisitions market is very competitive. As enterprise valuations remain high, buyers may seek additional input to determine how to consider the impact of a pension deficit on the purchase price. To advance in an auction process, a buyer is often challenged to find rationale for an increased deal price. We believe that in some circumstances, buyers may ultimately get comfortable with a lower purchase price deduction for pensions if they better understand the present value of required contributions rather than look to the valuation reflected under U.S. GAAP. Similarly, a seller may be able to increase the transaction price by avoiding an overstated price reduction for pension funding shortfalls.

While the detail is laid out below, the primary driver of this difference is the widening gap between the interest rate used to measure the liability for accounting purposes and for funding purposes. Additional drivers are described below.

Differences Between Accounting and Funding Requirements
Broadly speaking, four main factors contribute to the disconnect between balance sheet liability under U.S. GAAP and expected cash contributions: (1) discount rates, (2) timing, (3) funding relief and (4) asset returns.

<table>
<thead>
<tr>
<th>U.S. GAAP – Balance Sheet</th>
<th>Required Contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Discount rates</strong></td>
<td>Discount rates are based on spot rates for high-quality (AA) corporate bonds.</td>
</tr>
<tr>
<td><strong>Timing</strong></td>
<td>Changes in liability must be immediately recognized on the corporate balance sheet at the relevant measurement date (fiscal year-end or transaction closing date).</td>
</tr>
</tbody>
</table>
Recent funding relief included under the Highway and Transportation Funding Act of 2014 (HATFA) permits the use of a smoothed discount rate subject to a minimum of 90 percent of the 25-year average AA corporate bond rate (for 2016). As a result, changes in cash funding requirements due to discount rates lag changes in balance sheet accruals by more than 7 years.

Plan assets held in a pension trust are typically assumed to earn an average of 7–8 percent per year (significantly in excess of AA corporate bond rates, which were roughly 4.3 percent at November 30, 2015). U.S. GAAP makes no explicit allowance on the balance sheet for the expectation that average asset returns will exceed the discount rate going forward.

Historically, in a transaction, the full pension deficit on a U.S. GAAP basis would typically be included as a reduction to purchase price, and pro forma earnings would be adjusted to reflect the “normalized” profit and loss statement charge. This level of burden for an acquired pension plan was generally considered to be reasonable and an accurate reflection of the true economic impact of the pension plan.

However, recently we have seen an increasing number of buyers and sellers choose to value pensions using a discounted cash-flow approach whereby the purchase price reduction for pension underfunding is equal to the net present value of expected cash contributions into the plan rather than focusing on the U.S. GAAP deficit.

The increased popularity of this approach is primarily driven by the current historic low discount rate environment pushing up U.S. GAAP deficits while funding relief simultaneously decreases short-term cash demands. The value of this delay in short-term funding requirements can be significant. As noted above, the delay in funding allows time for asset returns to cover a portion of the plan underfunding (average asset returns of 7–8 percent versus a current GAAP discount rate of 4.3 percent). Even more importantly, the delay in pension funding means that a company can invest in its core business instead of investing in its pension plan.

Taking all of these factors in concert, you have a reasonably strong argument that, at least in certain situations, the current U.S. GAAP deficit overstates the economic value of the plan.

When using the discounted cash-flow approach, several key considerations need to be factored into the discounted cash-flow model, including:

- Volatility of cash flows: For many plans (e.g., U.S. qualified plans or unfunded plans that pay lump sums) cash flows can be volatile. For such plans, cash-flow projections need to be rigorous and cannot simply be based on average historical cash flows.
- Terminal values: To the extent that the plan is not fully funded at the end of the cash-flow projection period, a terminal value of the liability should be included in the model in order to avoid understating the liability.
- Cost of ongoing accruals: For a plan where employees continue to accrue additional benefits, care should be given to how...
Looking Ahead
While we are seeing increased interest in alternative approaches to valuing pensions in corporate transactions, this approach is still far from being common practice — typically limited to competitive bidding situations or pension-savvy sellers who want to avoid being penalized for selling in a low discount rate environment. That said, we would expect alternative methodologies for valuing pensions to continue to become more common, particularly while historically low interest rates exist.

Alvarez & Marsal Taxand Says:
Ultimately, we recommend that both buyers and sellers in a transaction consider whether alternative pension valuation methods may be appropriate in order to ensure that the enterprise valuation fully reflects the true economic impact of the plans.

For More Information

Leslie Nielson
Managing Director, New York
+1 212 763 9805

James Deets
Senior Director, Dallas
+1 214 438 1017

Disclaimer
The information contained herein is of a general nature and based on authorities that are subject to change. Readers are reminded that they should not consider this publication to be a recommendation to undertake any tax position, nor consider the information contained herein to be complete. Before any item or treatment is reported or excluded from reporting on tax returns, financial statements or any other document, for any reason, readers should thoroughly evaluate their specific facts and circumstances, and obtain the advice and assistance of qualified tax advisers. The information reported in this publication may not continue to apply to a reader’s situation as a result of changing laws and associated authoritative literature, and readers are reminded to consult with their tax or other professional advisers before determining if any information contained herein remains applicable to their facts and circumstances.

About Alvarez & Marsal Taxand
Alvarez & Marsal Taxand, an affiliate of Alvarez & Marsal (A&M), a leading global professional services firm, is an independent tax group made up of experienced tax professionals dedicated to providing customized tax advice to clients and investors across a broad range of industries. Its professionals extend A&M’s commitment to offering clients a choice in advisers who are free from audit–based conflicts of interest and bring an unyielding commitment to delivering responsive client service. A&M Taxand has offices in major metropolitan markets throughout the United States and serves the United Kingdom from its base in London.

Alvarez & Marsal Taxand is a founder of Taxand, the world’s largest independent tax organization, which provides high quality, integrated tax advice worldwide. Taxand professionals, including almost 400 partners and more than 2,000 advisers in nearly 50 countries, grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.


Related Issues
Ten Considerations in Tax Due Diligence... You Won't Believe Number Seven! [4]

“Wow, this seems like a great company. I’m going to spend millions of dollars to acquire it without performing any basic due diligence to determine whether I’m inheriting any unrecorded liabilities that will diminish its future value. Shut up and take my money!”

IRS Announces Significant Changes Impacting Qualified Retirement Plans [5]

In a pair of rulings issued recently, the IRS announced some significant changes impacting qualified retirement plans.


Source URL: https://www.alvarezandmarsal.com/insights/defined-benefit-pensions-buy-now-pay-later-and-pay-less

Links