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An empirical examination of mark-to-market accounting for corporate pension plans ☆

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ABSTRACT

Since 2010, a small but growing number of firms have voluntarily switched from the prevailing corridor approach (i.e., continuous smoothing) to a mark-to-market (MTM) alternative (i.e., immediate recognition) when accounting for pension gains and losses for their pension plans. This paper investigates the determinants of, and market reactions to, this voluntary adoption as well as its financial reporting and operational consequences. We find that larger firms and firms with greater deferred pension losses are more likely to adopt the MTM approach. On the other hand, we do not find an association between a firm's level of financial transparency or earnings volatility and MTM adoption. Further, our market tests reveal that investors reacted positively to the standalone announcements of MTM adoption and to the magnitude of the one-time pension loss adjustment upon adoption. Finally, in examining the consequences of MTM adoption, we find a reduction in earnings informativeness and an increase in plan assets allocated to debt relative to matched non-adopters. Overall, our study provides early evidence on the implications of MTM pension accounting.
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1. Introduction

Since 2010, a small but growing number of companies (including AT&T, Verizon, Kellogg, and ConAgra Foods) have elected to voluntarily adopt an accounting treatment for gains and losses associated with defined benefit pension and other postretirement benefit plans (pension plans, hereafter). This treatment, commonly referred to as the "mark-to-market" (MTM) approach, allows firms to immediately recognize pension gains and losses on the income statement in the year they occur. By expediting the recognition of gains and losses, the MTM approach deviates from the longstanding "corridor approach" used by most companies, under which gains and losses are initially recorded in other comprehensive income (OCI) in the period in which they arise, and then subsequently recycled from accumulated other comprehensive income (AOCI) into earnings through an elaborate smoothing mechanism. While the corridor approach, introduced in SFAS 87 (Financial Accounting Standards Board [FASB], 1985), is endorsed for generating stable pension expenses and reducing earnings volatility, it is also criticized for obscuring the true economic positions of pension plans (e.g., Nyberg, 2005; Securities and Exchange Commission [SEC], 2005). Interestingly, firms are allowed the flexibility to use the MTM method as an alternative to the corridor approach in the original SFAS 87, as well as the subsequent SFAS 158 (FASB, 2006) and current Accounting Standard Codification (ASC) 715, but this alternative was never adopted by firms until recent years.

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In light of the long existence of this alternative, the relatively recent inception of firms' voluntary adoptions of MTM pension accounting raises several important questions this paper attempts to address. We first examine the determinants of the voluntary adoption of MTM pension accounting. Specifically, we investigate the relationship between the likelihood of MTM adoption and a firm's (1) magnitude of deferred pension losses, (2) financial transparency, (3) earnings volatility, and (4) firm size. A unique differentiator of voluntary MTM adoption versus other voluntary accounting changes, as mentioned above, is the *timing* of MTM adoptions.[1] Coincidentally, the years immediately preceding the inception of MTM adoption, i.e., 2010, witnessed the financial crisis of 2007–2009, which resulted in substantial deferred pension losses for many firms (Whitehouse, 2009). Given that the adoption of MTM method features a one-time adjustment transferring all deferred pension losses from AOCI to retained earnings, the timing of MTM adoption lends the possibility that firms could opportunistically adopt the MTM approach to eliminate future pension loss amortization. Thus, we examine the relationship between deferred pension losses and MTM adoption. In addition, we test whether a firm's level of financial transparency influences the adoption decision, since firms commonly referred to the improvement of financial transparency as the rationale for MTM adoption. However, while immediate recognition of gains and losses under the MTM approach makes pension plan performance clearer, it likely introduces an increase in earnings volatility as well. As such, we further examine earnings volatility as a determinant of the accounting change. Lastly, we explore whether firm size affects the voluntary adoption of MTM because of some operational implications of the accounting switch.

Second, we investigate whether and how equity investors react to firms' MTM adoptions. From an efficient market perspective, we posit that there would not be any market reaction to this accounting change since it does not alter firms' underlying cash flows or expand the financial information available to users, as pension gains and losses are already disclosed in footnotes. However, prior literature has documented that the stock market reacts to changes in accounting policies with no direct cash flow effects (e.g., Aboody et al., 2004; Lev, 1979; Robinson and Burton, 2004) and that financial statement users treat recognized and disclosed information differently (e.g., Davis-Friday et al., 2004; Hirshleifer and Teoh, 2003). Therefore, whether the market reacts to this voluntary accounting switch, which changes how pension gains and losses are recognized in income statements, remains an empirical question to be examined.

Finally, we study the financial reporting and operational consequences of MTM adoption. This investigation helps shed light on how the accounting change impacts adopting firms' subsequent financial reporting and/or leads to related operational changes, which should be of interest to public policy makers as well as firms that have not yet adopted MTM pension accounting. For the financial reporting consequences, we examine the change, if any, in adopting firms' earnings informativeness, which is related to the net effect of MTM adoption on investors' assessment of reported earnings. On one hand, MTM pension accounting could increase the informativeness of earnings by making operating performance easier to understand and more transparent. On the other hand, the MTM treatment could decrease earnings informativeness by reducing the predictability and comparability of earnings. For the operational consequences, we examine whether managers who adopted MTM pension accounting subsequently adjusted their pension plan asset allocations. Since the MTM treatment likely introduces an increase in earnings volatility, firms may choose to change their pension asset allocation strategy accordingly in order to alleviate the variability in pension gains and losses.

To empirically examine these questions, we search for all publicly traded firms that elected to switch to the MTM approach between January 1, 2010, and December 31, 2014, using the Lexis-Nexis, MorningStar, and Factset databases. We are able to identify 38 adopting firms with data available in the SEC EDGAR database and Compustat, and we use these 38 adopting firms as our initial MTM sample and apply various procedures, depending on the analysis, to construct the final sample for each of the empirical tests.[2,3]

We use logistic regressions to investigate why firms elect to adopt the MTM approach. Using two different control groups of non-adopting firms, we find that the magnitude of deferred pension loss in AOCI is positively associated with the likelihood of firms adopting MTM pension accounting. By contrast, we do not find empirical support for adopting firms' most commonly provided argument for the switch—improving financial transparency. These findings, in light of firms' substantial deferred pension losses due to the financial crisis, suggest that firms opportunistically switched to MTM pension accounting to avoid future pension loss amortization, rather than to improve financial transparency. Our findings also do not support the notion that pre-adoption earnings volatility deterred firms from adopting MTM pension accounting, possibly because firms could mitigate the increase in earnings volatility by allocating more pension plan assets to debt upon adoption.[4] Furthermore, we find that larger firms are more likely to adopt the MTM approach, possibly because they have more resources to adjust pension asset portfolios subsequent to the accounting change and are followed by more analysts who could have already implemented the MTM approach in assessing firms' performance.

[1] As described above, no firms elected this accounting alternative when it first became available in SFAS 87 in 1985 or in 2005, when the FASB undertook a pension accounting project that increased in the visibility of this alternative. In 2005, the FASB undertook a project to comprehensively reconsider accounting for pension plans. Phase I of the pension accounting project was completed with the issuance of SFAS 158 in 2006, which requires the fair value of net pension assets and liabilities to be recognized on the balance sheet. In Phase II of the project, the FASB initially planned to consider a more comprehensive revision, including whether to eliminate the corridor amortization and to fully recognize gains and losses in net income, but the FASB eventually decided to focus on improving disclosure, not recognition, of pension plans (FASB, 2007; PricewaterhouseCoopers, 2006).

[2] Our search initially yielded 43 firms that adopted MTM pension accounting. Five firms are not included in our analyses because of data availability in the SEC EDGAR database or Compustat database. We further discuss our sample identification process in Section 3.

[3] Interestingly, all 38 adopting firms have deferred pension losses in AOCI before adoption. Furthermore, upon the MTM adoption, firms on average transferred AOCI pension losses to retained earnings with a magnitude of 8 percent of their total assets.

[4] Our subsequent test on firms' adjustment of pension asset allocation after MTM adoption provides direct evidence in support of this notion.

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