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Analyzing employee benefit costs in mergers and acquisitions

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(Ed. note: This is the second of two articles on the actuary's role in mergers and acquisitions. The first was published in the October Actuary.*)*

Cost analysis

Presumably an actuary engaged in a M&A project already knows how to evaluate employee benefit costs and liabilities. Therefore, this article is focused instead on what to watch out for.

1. Employee data

• Actual employee data (e.g., age, sex, service and pay) are rarely available. Age and service distribution tables, sometimes found in pension valuation reports, may be out of date or may include noncompany employees, who may differ demographically from the seller's employees.

• Allow for data changes up to the anticipated acquisition date (e.g., a rush of retirements may result if employees are offered incentives to retire before the acquisition).

• Identify the different groups of employees or their survivors who may or may not be picked up by the buyer (e.g., active at work, laid off, disabled, terminated vested or retired).

• Be careful when using averages (e.g., average salary when dealing with a Social Security offset or step-rate pension plan).

2. Actuarial assumptions

• Review whether the seller's assumptions are reasonable (e.g., a 5% inflation rate for medical insurance premium or a 10% valuation interest rate for a pension plan with lump sum options based on PBGC rates).

• Take into account the buyer's business plan for the company (e.g., reduction in work force or salary freeze). Cost projections should be based on these revised assumptions, whereas the seller's assumptions may be useful only for negotiation purposes.

• The discount rate or interest rate used in valuing a non-tax-exempt plan (e.g., supplemental pension plan for executives or postretirement health care) should be an after-tax rate.

• Identify the exposure for early retirement. Watch out for assumed retirement age after, say, 62 if there is a supplemental pension or other form of "early retirement subsidy" for retirements before age 62 (because the age-62 retirement assumption would imply that the supplement and the subsidy are "no cost" benefits).

• Plan expenses (e.g., legal or actuarial fees, PBGC premium especially after OBRA, and perhaps even internal administration costs) should be recognized, regardless of whether they are paid by the plan or by the employer. Allow for any increase in expenses resulting from disassociation of the company from the seller (e.g., if the company's pension plan participates in a Master Trust run by the seller, or if a substantial portion of the benefits administration is handled by seller's personnel). Consider the transition costs of establishing new plans for the company, taking out new insurance policies, and setting up the necessary administrative support system.

• The assumptions for the executive plans should be appropriate for this group.

• Medical insurance rates should be appropriate for the employee group being considered (e.g., active versus retired employees, with or without Medicare, composition of single and family coverages, etc.). They should represent the actual cost of insurance rather than, for example, the monthly deposit under a minimum premium or retroactive rating arrangement.

• Beware of distortions in insurance costs caused by unusually large dividend credits or changes in the reserve or underwriting arrangement.

• Although the cost of a bonus or incentive plan is merely a function of where the threshold for payoff is set, it may be difficult to raise the threshold significantly. Consequently, the thresholds and payments in recent years need to be reviewed.

• Is any deferred compensation or other executive benefits program treated by the seller as a "no cost" benefit because the cost is expected to be recovered through corporate-owned life insurance policies?

3. Level of benefit

• Consider how benefits may be changed after acquisition and whether there is any restriction against such changes (e.g., union agreement or a provision in the purchase and sale agreement prohibiting substantial benefit reduction within five years after acquisition). Isolate the cost of postretirement insurance for employees currently eligible for retirement, and find out if the company or the seller has reserved the right to change the plan.

• Is there a history of increasing pensions to keep up with inflation (e.g., periodic updates under a career-average plan or cost-of-living adjustments after retirement)?

• For pension plans of the dollar-times-service type (e.g., $10 per month for each year of service), prepare cost estimates allowing for reasonable future increases in the pension unit.

• Mandated benefit changes (e.g., 5-year vesting of pension starting 1989) should be incorporated in the cost analysis even though they may not be effective yet. The same goes for anticipated future increases in the IRC Section 415 limits and for collectively bargained benefit increases scheduled for the future.

• Watch out for any back-loaded pension formula (e.g., $15 per month for each of the first 10 years of service and $20 per month for each additional year) because it shifts the benefit accruals toward the later years of an employee's service.

• If the seller retains liability for accrued pension benefits, determine the cost effect of recognizing or not recognizing future service with the

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Analyzing costs cont'd

buyer for vesting, early retirement reduction and other eligibility purposes.

- Find out if any severance payment or management bonus may be triggered by the acquisition.
- Pay special attention to any golden parachute or change-of-control provision that may substantially alter the benefit costs. Do not overlook any penalty tax on gold parachute that is picked up by the employer, which would require substantial grossing up of the parachute payment.

4. Additional considerations

- Find out if the buyer is contemplating a layoff, window retirement or any event that has a SFAS 88 implication (including any event that may have a substantial impact on benefit costs but does not qualify as a "curtailment" because it will not significantly reduce the employees' future services). If so, the cost impact should probably be included in the purchase accounting adjustment described in paragraph 74 of SFAS 87. This applies even to events expected to take place after the customary "one-year window period" for settling up on acquisition accounting.
- Allowance should be made for anticipated changes in pension funding requirements (e.g., minimum funding under OBRA), accounting rules (e.g., accruing the cost of post-retirement insurance over an employee's active service) or, perhaps, even Medicare coverage.
- Distinguish between intercompany charges and stand-alone costs. For example, if the company participates in the seller's pension plan, the seller may have been charging the company pension cost equal to some percentage of the company's payroll, which may be significantly different from the company's stand-alone pension cost.
- The same benefit can mean very different costs to the seller and to the buyer. This can be caused by a difference in tax rates or tax treatments. For example, medical insurance premiums for former employees of the company are current tax deductions to the seller, but they are capitalized costs to the buyer if it is purchasing only the company's assets. Costs also may differ because the buyer and the seller may have different relationships with the employees. For example, if the seller retains liability for accrued pension benefits, it may end up paying subsidized early retirement pensions to employees who later go to work for the buyer; this would not happen if that liability is transferred to the buyer. These differences need to be ironed out at the negotiation table.
- The value of any "surplus" plan assets must be discounted for any legal restriction against taking out that surplus, the time and expense involved in doing so, the 10% excise tax on reversion of pension assets and any increase in benefits precipitated by the reversion. In other words, there should not be a dollar-for-dollar increase in the purchase price on account of the buyer taking over an "overfunded" plan.
- Many items cannot be easily quantified, and the buyer's best course of action is to negotiate provisions in the purchase and sale agreement that will eliminate or limit its exposure. One example is premium or reserve adjustments due insurance companies. A second example is future workers compensation claims based on loss of hearing, which is quite common among employees who have worked in steel mills. Still another example is outstanding litigations or claims relating to employee benefits. From the buyer's perspective the key is to avoid any uncertain exposure.

5. Important reminder

A point that often needs to be reemphasized is that nearly all cost figures relating to employee benefits are before-tax (even for a nonqualified plan) and need to be adjusted for tax effects. Sometimes strange provisions are negotiated when this point is not understood, as illustrated in the following example:

In one case, the seller agreed to "give" the buyer $X in exchange for the buyer's assumption of the liability for accrued pension benefits of the company, which had participated in the seller's pension plan. The seller had estimated that liability to be $X. Assets would be transferred from the seller's plan to the buyer's plan equal to the present value of actual accrued benefits ($Y), to be calculated when the employee data became available. The purchase price would be adjusted by the difference between $X and $Y. Actuarial assumptions to be used in calculating $Y were not specified, except that they should meet the legal requirements. Overlooked was the fact that both $X and $Y were pre-tax numbers but the adjustment would be done in cash, which meant after-tax dollars to the buyer and potentially tax-free gain to the seller. That resulted in a most unusual situation with the buyer's actuary arguing to minimize the amount of pension assets to be transferred and the seller's actuary wanting to maximize it, exactly the opposite of what one normally expects to see.

Putting it together

Once cost analysis has been completed, the key issues should be summarized and communicated to the people doing the pricing and the negotiation. Secondary issues are thrown in sometimes merely as bargaining chips.

Results must be presented as simply as possible, since most people are not conversant in the fine points of employee benefits. In the heat of a negotiation, things can easily get confused and misinterpreted.

Keep close contact with other people working on the project as events can develop very quickly in a M&A deal. Remember that employee benefits is only one of many issues that figure in an acquisition. Be a team player and work alongside the other professionals involved in the project.

Conclusion

An actuary called in to perform an acquisition review for the buyer must learn to work with limited data and very little time. The related cost analysis should encompass both the liabilities as of the acquisition date and the costs in future years. Effects of alternative provisions that can be negotiated with the seller need to be examined, as well as the buyer's business plan for the company after the acquisition. Key issues should be identified and explained in simple terms to the people doing the pricing and the negotiation. Watch out for hidden costs and help the buyer to avoid any uncertain exposure.

Remember that cost analysis is just the first stage of a M&A project. The negotiation and the closing follow. If all goes well, the actuary may even gain a client after the acquisition.

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