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Investor Perspectives

Patricia McConnell: Do you agree that investors will benefit from the IASB's proposals to improve pension accounting?

Today we issued proposals to improve accounting for pensions and other defined benefit plans. You can find more information about this via the pensions section of the IASB website. We are not proposing to change the measurement of defined benefit obligations or plan assets. The proposals primarily cover matters of presentation and disclosure. This article discusses two of the proposals that we think will be of particular interest to investors:

- Immediate balance sheet recognition of all changes in pension liabilities and plan assets and;
- Changes in the presentation of the components of pension cost.

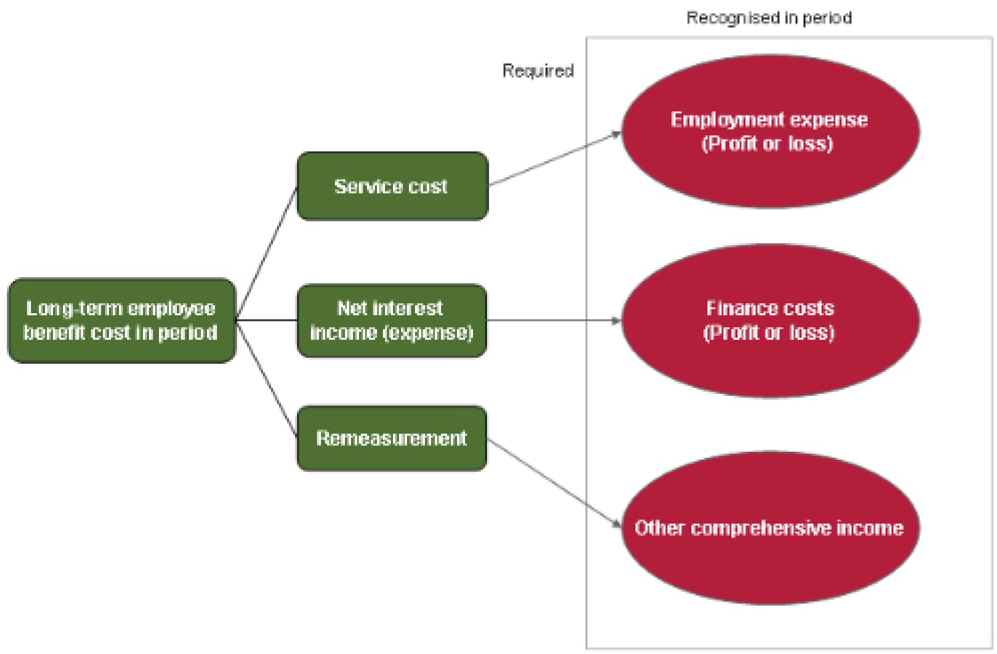
We believe that these changes will provide investors with more easily understandable and useful information. We would like to know if you agree.

Immediate recognition of all pension liabilities and plan assets

We believe that under our proposed changes, the net pension liability or asset recognised in the balance sheet will actually be a relevant measure. It will be the difference between a current measure of what the company owes its employees for services provided (pension liability) and the fair value of the assets set aside to satisfy that liability (plan assets). Under the existing standard, the amount recorded in the balance sheet can be misleading. For example, the balance sheet may include a net pension asset, implying that the plan is over-funded when in fact it has a deficit. That is because current accounting permits delayed recognition of many of the changes in plan assets and liabilities. As a result, profit or loss may include gains and losses from events that happened in past periods. That will not happen under our proposal. There will be no corridor, no deferred recognition, and no expected return on plan assets.

Changes in plan assets and plan liabilities will be disaggregated

Some may be concerned that without these familiar smoothing techniques the volatility of changes in the pension assets and liabilities will obscure the profitability of the company's core business. We were concerned about that as well. In addition, we believe that it is more useful to present separately items that have different predictive implications. So, to enable investors to isolate the different causes of the changes in the plan's assets and liabilities, we propose that the changes should be disaggregated into three components: service cost, net interest expense (income) and remeasurements.



Service cost represents the cost of employment. It will be presented in profit or loss in the same location as other employment costs. For example, in a manufacturing entity, service cost may be allocated between COGS, SG&A, research, etc.

Net interest expense (income) on the net pension liability (asset) represents the financing cost of deferring payment for employee services. We propose that it should be calculated by applying the discount rate used to measure the pension liability to the net pension liability (asset). In other words, it will be the difference between the interest expense on the pension liability calculated using the discount rate and interest income imputed on the plan assets using the same discount rate. Since we consider the net interest expense (income) a financing cost it will be included with the company's other financing costs in profit or loss.

Remeasurements are the remaining changes in the plan assets and liabilities and will be included in other comprehensive income (OCI). They represent period-to-period fluctuations in the long-term value of the net pension liability (asset). Remeasurements include actuarial gains and losses and the net return on plan assets. We propose that the net return on plan assets should be calculated as the actual return on plan assets, less the amount of imputed interest income on the plan assets included in net interest expense (income). Unlike some components of OCI, we are proposing that remeasurements should never be recycled to profit or loss.

Why include net interest expense (income) in profit or loss?

We believe that a net pension liability is equivalent to an amount owed by the company to the plan or to its employees. The economic cost of that borrowing is interest cost. Conversely, we believe that a net pension asset is an amount owed by the plan to the company. The company expects to receive that amount from the plan in the form of reductions in future contributions or as refunds, and like other long-term receivables, it accrues interest. So, including a return on plan assets ensures that profit or loss reflects the difference between plans that are funded and plans that are not.

Why calculate net interest expense (income) using the discount rate?

It is obvious why interest expense on the pension liability is calculated using the discount rate used to calculate it. It is less obvious why this same rate is used to impute a return on plan assets. However, we believe that using the discount rate rather than an expected return on plan assets avoids the problems that have been associated with the use of an expected return in the past. For example, it will improve comparability. It will also remove the temptation (or appearance) for management to use overly optimistic assumptions. In addition, it does not seem sensible to record an expected return on risky investments in profit or loss and at the same time reflect the outcome of having taken that risk in OCI or in a corridor.

Why are remeasurements in OCI?

We are proposing that the remeasurements should be presented in OCI because they represent period-to-period fluctuations in the long-term value of the net pension liability (asset). As mentioned earlier, we believe that it is more useful if items that have different predictive implications are reported separately. Furthermore, many constituents have told us that including remeasurements in profit or loss would obfuscate the performance of the underlying business. In addition, we are carrying forward the current prohibition of recycling remeasurements to profit or loss. To do otherwise would result in events of prior periods being included in curreent period profit or loss.

What do you think?

We believe that elimination of the much criticised corridor approach and deferred recognition combined with the disaggregated presentation of the changes in the net defined benefit liability (asset) and improved disclosures will greatly benefit investors. We would very much to like to hear your views about the proposals described above. In particular we are interested to know:

- whether you agree with the immediate recognition of changes in the pension liability and plan assets;
- what you think about our proposals to disaggregate pension cost; and
- whether you believe that our proposed methodology for calculating the net interest expense (income) on the net pension (asset) will provide useful information.

Patricia McConnell is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.