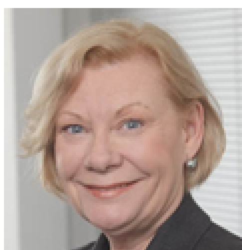
August 2011

Investor Perspectives

Patricia McConnell: Benefits of the IASB's recent revisions to pension accounting



In June we issued a revised IAS 19 *Employee Benefits* to improve the accounting for pensions and other defined benefit plans. Those revisions, which take effect from 1 January 2013, changed the presentation and disclosure of net pension liabilities or assets and net pension cost, but did not change their measurement.

This article discusses two of the changes that we think will be of particular benefit 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 hope you agree.

Immediate recognition of all changes in pension liabilities and plan assets

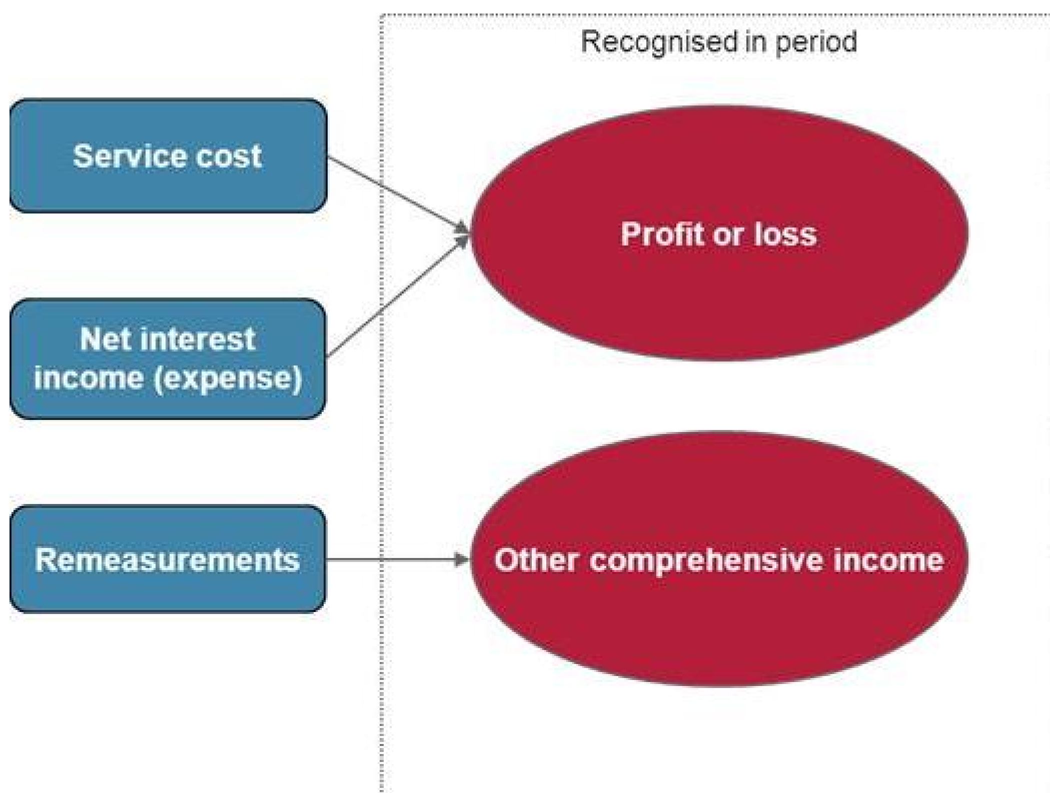
We believe that as a result of the changes that we made to IAS 19, the net pension liability or asset recognised in the balance sheet will actually be a relevant measure. It will be the difference between a current measure of what the company owes its employees for services provided (pension liability) and the fair value of the assets set aside to satisfy that liability (plan assets). Under the previous version of IAS 19, the amount recorded in the balance sheet could be misleading. For example, the balance sheet may have included a net pension asset, implying that the plan is over funded when in fact it was in deficit, because IAS 19 previously permitted delayed recognition of many of the changes in plan assets and liabilities.

IFRS

As a result, profit or loss may have included gains and losses from events that happened in past periods. That will not happen under our revised standard. Now there is 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. To address that concern, and because we believe that it is more useful to present separately items that have different predictive implications, the revised standard requires that the changes must be disaggregated into three components: service cost, net interest income and expense and remeasurements. Service cost and net interest income and expense will be presented in profit or loss, and remeasurements will be presented separately in other comprehensive income (OCI). We believe this will enable investors to isolate the different causes of the changes in the plan's assets and liabilities.



Service cost represents the cost of employment. It is composed of current service cost, past service cost and gains or losses on non-routine settlements. There is no change to how these items are measured. Service cost will be presented in profit or loss.

Net interest expense or income on the net pension liability or asset represents the financing cost or income of deferring payment or pre paying employee services. It is calculated by multiplying the net pension liability or the net pension asset by the discount rate used to measure the pension liability (that is, the yield at the end of the period on high quality corporate bonds.). In other words, the net interest income or expense will be the difference between the interest expense on the pension liability, calculated using its discount rate, and interest income imputed on the plan assets using the same rate. If the interest on the pension liability exceeds the imputed interest on the plan assets, it will be net interest expense. If the imputed interest on the plan assets exceeds the interest on the pension liability, it will be net interest income. Net interest income or expense will be presented in profit or loss.

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

Presentation in P&L

Like the previous version, the revised IAS 19 does not specify where the individual components of net pension cost should be displayed, beyond specifying that service cost and net interest income or expense should go to profit or loss, while remeasurements go to OCI *unless* another IFRS permits or requires their inclusion in the cost of an asset. For example, service cost, or some portion of it, may qualify for capitalisation as a cost of inventory under IAS 2 *Inventories*. Consequently, a portion may remain in inventory at period end, while a portion may be in cost of sales. The portion, if any, that did not qualify for capitalisation will be included in profit or loss as well. It will be included in the same line item in which the

company's related compensation expenses are presented (eg within selling expenses, administrative expenses, research and development expenses etc.).

Answers to some common questions

Why include net interest income or expense 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 equivalent to 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. Consequently, including net interest income or expense ensures that profit or loss reflects the difference between plans that are funded and plans that are not funded.

Why calculate net interest income or expense using the discount rate?

It is obvious why the rate used to discount the pension liability is also used to calculate interest expense on the pension liability. 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 over optimistic assumptions for the expected return. 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.

Why are remeasurements in OCI?

We are requiring the remeasurements to be presented in OCI because they represent period-to-period fluctuations in the long-term value of the net pension asset or liability. 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 mask the performance of the underlying business. In addition, we are carrying forward the current

prohibition on recycling remeasurements to profit or loss. To recycle would result in events of prior periods being included in current period profit or loss.

Do you agree?

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 asset or liability, together with improved disclosures, will greatly benefit investors. We would very much to like to know whether you agree.

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.