An International Analysis of Pension Recognition and Presentation Alternatives: Executive Summary of the Final Report

Funded by the *Informing the IASB Standard Setting Process Research Program*

Sponsored by the
International Association for Accounting Education and Research, KPMG LLP,
and the KPMG Foundation

June 10, 2011

Principal Investigators:

Carol Ann Frost	University of North Texas
Elizabeth A. Gordon	Temple University
Lili Sun	University of North Texas

Acknowledgements

We appreciate helpful comments and suggestions from workshop participants at presentations made in Palm Springs, CA (Jan. 28, 2011) and Singapore (Nov. 7, 2011) in connection with the IAAER-KPMG Research Opportunities Program, and from Mary Barth, Holger Erchinger, Tom Linsmeier, Katherine Schipper, and Donna Street. We gratefully acknowledge funding provided by the *Informing the IASB Standard Setting Process Research Program*, sponsored by the International Association for Accounting Education and Research, KPMG LLP, and the KPMG Foundation; Temple University; and the University of North Texas.

An International Analysis of Pension Recognition and Presentation Alternatives: Executive Summary of Final Report

This study analyzes the financial statement and valuation effects of alternative recognition and presentation approaches for reporting defined benefit (DB) pension-related information. Our research addresses issues raised and amendments proposed to IAS 19 as presented in the IASB's exposure draft *Defined Benefit Plans – Proposed Amendments to IAS 19* (2010b), and in subsequent IASB deliberations. Our research is also relevant for the joint IASB/Financial Accounting Standards Board (FASB) project on financial statement presentation. We have three main objectives:

- *to comprehensively describe cross-country variation in companies' pension plan offerings and practices* as there is only limited evidence on how plans differ across countries at the individual firm level.

- *to examine alternative DB pension recognition and presentation approaches including*
  - two approaches for the recognition of actuarial gains and losses: (1) the deferred recognition "corridor" approach, and (2) the "full recognition" approach.
  - alternative presentations (classifications) of interest cost, expected return on plan assets, and remeasurements.
  - two balance sheet aggregation approaches: (1) the current approach of offsetting (netting) plan assets and pension liabilities; and (2) separately reporting the two amounts.

- *to assess the economic implications of recognition and presentation alternatives* using the strength of the association between annual returns (and market values) and the alternative measures as a proxy for the extent to which the performance measures are being used by investors. We also compare the goodness of fit of different alternatives.

We examine a broad sample of 480 companies for the years 2004 to 2008 using primarily hand-collected data in six countries: Canada, France, Germany, the Netherlands, the United Kingdom, and the United States.

First, we observe wide variation across countries in prevalence of DB and DC plans. For example, in contrast to Germany and the Netherlands, where DC and/or DB plans were reported in all or almost all firm-years, pension plans were absent in 57 U.K., 20 U.S., and 201 Canadian firm-years, as reported in the annual reports (ARs).[1] DB plans were reported more frequently than DC plans in only one country – Germany. More German and Dutch companies are potentially affected by alternative DB pension recognition and presentation approaches, since very few firm-years in each sample do not report DB plans.

We find that DB plans (either alone, or along with DC plans) are reported in about one-half of the sample firm-years (for the four European countries combined). This is a much smaller percentage than observed in prior research that focuses on relatively large companies.[2]

We also observe all three different accounting treatments for recognizing actuarial gains and losses used in each of the four IFRS-reporting countries. The corridor approach is used in about 66% of the firm-years examined. Finally, we observe variation in the presentation of DB pension expense components. Each of the four European countries studied represent a mix between presenting interest cost and expected return on plans assets as operating expense versus financing expense. Taken together, our descriptive analyses indicate wide variation in European companies' choices related to recognition and presentation options.

Second, when we examine alternatives in income statement reporting, we find large differences between pensions costs, net income and comprehensive income when current reporting when remeasurements are taken to net income or other comprehensive income, especially for companies using the corridor approach. We also find that the choice of reporting interest costs and the expected return on plan assets as operating or financing has significant effects on financial results. When we examine alternatives in balance sheet reporting, we observe that reporting the full net pension obligation would materially affect reported leverage, although the differences are not significant conventional levels. Again, the difference is more pronounced for firms using the corridor approach.

---

[1] If an AR provided no disclosure about pension plans, we assumed that the company did not operate a plan during that fiscal year.

[2] See Fasshaeur, J.D., M. Glaum, and D.L. Street. 2008. "Adoption of IAS 19R by Eruope's Premier Listed Companies: Corridor Approach Versus Full Recognition – Summary of an ACCA Research Monograph." *Journal of International Accounting, Auditing and Taxation* 17: 113-122.

Third, when we assess the economic implications of recognition and presentation alternatives we find that net income is significantly related to returns whether remeasurements are reported in net income, or other comprehensive income. When we explore alternatives in classifying interest costs, expected return on plans assets, and remeasurements, we find that those firms classifying interest costs and return on plan assets as financing appear to better match the economic perception of these costs.

Finally, in our analysis of the valuation of balance sheet alternatives, we find the reported net pension obligation is positive and significant, counter to expectations for a liability. Interestingly, the estimated coefficient on the net pension obligation is not significantly different than the estimated coefficient on the book value (adjusted). This result is consistent with the view that the employees are stakeholders of the firms with an equity-like interest. Results of the subsample of firms using the corridor approach are consistent with the full sample.

The evidence in this study should be useful to the IASB as it considers alternative pension recognition and presentation approaches. International Accounting Standard (IAS) 19 offers substantial flexibility in allowable approaches for pension reporting. By examining firms' actual reporting choices, we document the extent to which financial statement numbers and ratios might potentially vary as a result of revised reporting requirements.

Our financial analyses should help the IASB better understand financial statement effects of proposed changes in pension reporting requirements. The IASB should be interested in such evidence, since financial statement effects have implications for firms' contracting costs and pension reporting incentives. Finally, the IASB can use evidence from this study to better understand which recognition and presentation approaches are most closely aligned with actual valuation practices used by market participants.