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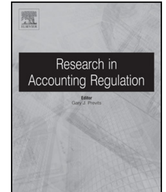

Regular Paper

Harmonizing pension accounting: Income statement effects of applying IAS19R to U.S. firms

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ABSTRACT

With IAS19R, *Employee Benefits*, the IASB simplified the accounting for defined-benefit pension plans by eliminating the use of an expected pension asset return assumption and by eliminating several of the income smoothing techniques included in the previous standard. To provide prospective evidence useful to the FASB's ongoing attempts to simplify and improve accounting standards, this study applies the revised pension accounting rules under IAS19R to a sample of U.S. firms with defined-benefit pension plans. Overall, there is no significant change in total pension expense from applying IAS19R versus current U.S. GAAP for a sample of S&P 500 firms over 2010–2012. This is due to the effects of eliminating the expected pension asset return and the "corridor" approach to smoothing unrealized gains or losses essentially offsetting each other. However, it is shown that IAS19R would significantly increase pension expense for subsamples of firms with high expected pension asset return assumptions, firms with low levels of amortized net pension losses or gains, and firms with better-funded pension plans.

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Introduction

Accounting for defined-benefit pension plans under U.S. GAAP has long been criticized for its reliance on managerial assumptions (e.g., expected pension asset return) and arbitrary smoothing techniques (e.g., the corridor amortization approach). In June 2011, the IASB issued IAS19R, *Employee Benefits*, and mandated its use for annual periods beginning on or after January 1, 2013. IAS19R significantly changes defined-benefit pension plan accounting by eliminating the use of an expected pension asset return assumption and corridor amortization. Thus, IAS19R simplifies the accounting for defined-benefit pension plans under IFRS relative to their accounting under U.S. GAAP. This study analyzes the effects of applying the IAS19R pension accounting rules to a sample of U.S. firms with defined-benefit pension plans in order to provide prospective evidence regarding the potential income statement effects of further harmonization of pension accounting rules.

The issue of defined-benefit plan accounting is economically significant, as pensions and post-retirement benefits represent one of the largest and most frequent sources of income differences between IFRS and U.S. GAAP (Henry, Lin, & Yang, 2009; Plumlee & Plumlee, 2008). The issue is also timely, given the recent change in IFRS and continuing efforts by the FASB to simplify and increase the comparability of accounting standards.[1] Further, several large U.S. firms, including United Parcel Service, AT&T, Johnson Controls and Honeywell International, have recently changed aspects of

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[1] See the FASB's website for further details on the Simplification Initiative and efforts to increase the comparability of international accounting standards. Though the FASB and IASB are not actively pursuing accounting standards convergence, in conference remarks SEC Chief Accountant James Schnurr expressed his view that "it is critical that the two boards continue to work together toward the objective of a single set of high-quality, globally accepted accounting standards" (Schnurr, 2015).

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their pension accounting to more closely resemble some of the revised IAS19R rules (Fernandez, 2012; Monga, 2012), perhaps suggesting a nascent voluntary movement by firms that might further stimulate the FASB.

Accounting for defined-benefit pension plans is complex. Under U.S. GAAP, companies estimate an expected long-term rate of return on their pension assets, and use that estimated return to lower their periodic pension cost (expense). Differences between actual pension asset returns and expected pension asset returns are aggregated, along with the effects of actuarial adjustments, and subjected to a "corridor" amortization test for potential recognition in net income. Critics of U.S. GAAP argue that the expected pension asset return assumption can be used to manage earnings, and Bergstresser, Desai, and Rauh (2006) show that changes in the expected pension asset return are related to meeting important earnings benchmarks. Picconi (2006) finds that even financial analysts have difficulty unraveling the effects of changes in expected pension asset returns. Critics further argue that the corridor amortization test is arbitrary, has no conceptual foundation, and obscures the economic impact of actual pension plan results in the financial statements (e.g., Spiceland, Sepe, & Nelson, 2013; White, Sondhi, & Fried, 2003). Further, when the expected pension asset return exceeds the amount of all other components of pension expense, an income-increasing pension credit results. Some argue that such pension credits reduce the quality of reported earnings as they lack both persistence and an associated direct cash inflow (e.g., Comiskey & Mulford, 2000; Ciesielski, 2005).

In contrast to U.S. GAAP, IAS19R eliminates the expected pension asset return assumption and eliminates the corridor amortization test. Under IAS19R, *net interest cost* – defined as the pension plan's funded status multiplied by the discount rate – increases (for underfunded plans) or decreases (for overfunded plans) pension expense.[2] By eliminating the corridor amortization test, IAS19R also eliminates the smoothing effects of unexpected pension asset returns and actuarial adjustments. Under IAS19R the effects of pension plan amendments are recognized immediately in earnings, while the difference between actual pension asset returns and an implied return based on the firm's discount rate is reported in other comprehensive income (OCI).[3] In sum, pension expense measurement (and thus net income) under IAS19R differs markedly from current U.S. GAAP on several dimensions. The purpose of this study is to examine the "as-if" effects of applying the IAS19R provisions to a sample of U.S. firms with defined-benefit pension plans.

For this study, defined-benefit pension plan footnote data are hand-collected for a sample of 316 S&P 500 firms over 2010–2012. The provisions of IAS19R are used to adjust the reported pension expense from U.S. GAAP to an as-if IFRS basis, and the pension expense under the alternative regimes is compared. Several subsamples are examined to determine the types of firms that would be most impacted by a move towards IAS19R.

The analyses reveal several important new findings. First, for the sample examined, IAS19R would not have a significant impact on overall pension expense; that is, total pension expense under as-if IFRS is not significantly different from that currently reported under U.S. GAAP. This somewhat surprising result is due to the further finding that while the net interest cost under IAS19R unambiguously increases pension expense, this increase is largely offset by the exclusion of amortized pension losses via elimination of the corridor amortization rules. This finding is attributed to the sample period following a period of declines in pension asset fair values.

Second, it is shown that overall pension expense would increase under IAS19R for certain subsamples, including firms that use relatively high expected pension asset return assumptions, firms that have a relatively low amount of amortized net pension losses or gains, and firms with the most well-funded pension plans. Together, the overall and subsample results suggest that the potential impact of revised pension accounting rules is contingent on when a change towards IAS19R might occur as well as firm-specific pension plan characteristics.

Third, elimination of the amortization of prior service cost and transition obligation has no significant overall impact on total pension expense, while immediate recognition of plan amendments, settlements and curtailments increases pension expense, albeit by small amounts. Overall, analyses of the various components of pension expense suggest that eliminating the expected return on pension plan assets and eliminating corridor amortization of unrecognized actuarial gains or losses would have much larger effects than would revised rules for these other pension expense items.

The key contribution of the study is to provide timely prospective information on the impact of applying pension accounting rules under IFRS to a sample of U.S. firms. Such information can be useful to standard setters in further enhancing the comparability of international accounting standards and perhaps developing a single set of international accounting standards. The study thus complements related research that examines the potential effects of adopting cash flow (Francis, Glandon, & Olsen, 2013), equity-based compensation (McAnally, McQuire, & Weaver, 2010), and inventory (Comiskey, Mulford, & Thomason, 2008) reporting provisions under IFRS.

The remainder of this paper proceeds as follows. The next section describes the institutional background, including an overview of the key aspects of the pension rules under U.S. GAAP and IFRS. The following sections discuss the sample, and descriptive statistics, and present empirical results.

Institutional background

Comparison of U.S. GAAP and IFRS pension rules

This section compares key provisions of pension accounting under IFRS (IAS19R) and U.S. GAAP (ASC 715) and presents an example of the approach utilized to apply IAS19R

[2] As a result, under IFRS net interest cost will always increase (decrease) pension expense if the plan is underfunded (overfunded). In contrast, under U.S. GAAP it is possible for an underfunded plan to report a net decrease to pension expense if the firm uses a relatively high expected pension asset return assumption.

[3] Like U.S. GAAP, pension expense under IAS19R immediately includes the effects of pension plan settlements and curtailments (though some timing differences exist across the methods).

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