

The Proposed International Accounting Standard for Pension Plans

Changing the Rules for Pension Investments

The International Accounting Standards Board's (IASB's) recent release of an Exposure Draft proposing changes in accounting for defined benefit pension plans marks a fundamental shift from past practice. If adopted as proposed, the new accounting rule would eliminate a significant incentive for defined benefit pension plan sponsors to hold stocks in the plan trust. While the proposed changes would apply only to companies following International Financial Reporting Standards (IFRS), the Financial Accounting Standards Board (FASB) could choose to make similar changes in connection with the convergence of U.S. Generally Accepted Accounting Principles (GAAP) and IFRS.

- **In contrast with the current accounting rule, the proposed rule does not use an expected return on assets assumption to calculate pension expense.** Under the current rule, a plan sponsor with a riskier asset portfolio would typically assume a higher expected return on assets, resulting in lower pension expense — an incentive to hold stocks and other “risky”

assets. By effectively replacing the expected rate of return on assets assumption with the discount rate, pension expense for the year would no longer be related to asset allocation. **And for most plan sponsors, the pension expense hitting P&L would increase.**

- **The proposed rule places both the investment risk and reward in Other Comprehensive Income (OCI).** In contrast, the current rule immediately credits the P&L with (and increases earnings per share [EPS] by) the expected added returns coming from investing in stocks, while the risk of underperforming expectations is recognized in OCI. **For most plan sponsors, this change will reduce year-to-year pension expense volatility.**
- **These changes will impact the nature of the perceived risk/reward trade-off in holding stocks.** Rather than providing a strong incentive for the plan to hold stocks, the proposed rule produces a muted trade-off of risk and reward from holding stocks.

Pension accounting addresses the “when” and “where” of recognizing the cost of operating a pension plan. The “when” component dictates the point at which the cost associated with a change in the plan's financial condition (for example, a plan amendment improving benefits) affects P&L and/or OCI. The “where” component identifies where on the Statement of Comprehensive Income (either on the P&L or OCI) the effects are reported. (EPS is based on P&L.) Pension accounting — or changes to it — does not change the effect of asset allocation on the ultimate cost of the plan. But it does affect where those costs are reported, which may change the perception of the risk and reward in the decision about how pension assets are invested.

Recently, the IASB issued an Exposure Draft that proposed a change to the pension accounting rule

(IAS 19) under IFRS. The proposal would change both the “when” and “where” of pension accounting. From an investment perspective, the change in the “where” of investment earnings (i.e., how they are allocated between P&L and OCI) will be crucial: The proposal marks a philosophical shift from the current rule, which is generally quite similar to the rule under U.S. GAAP, with respect to measuring and reporting the expected return on assets (EROA).

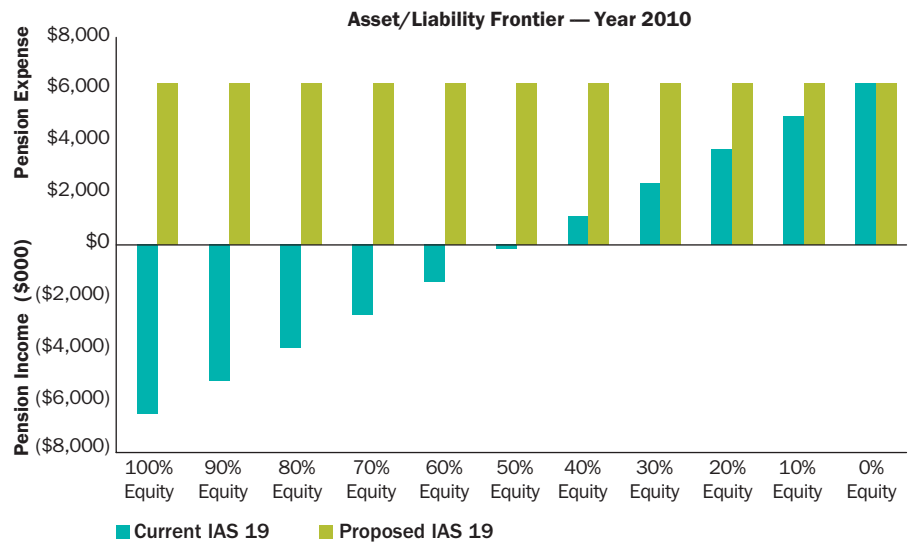
While this paper concentrates on the investment implications of the proposed rule on companies currently reporting under IFRS, the effect of the change in EROA treatment on U.S. companies reporting under U.S. GAAP will likely be similar should the FASB choose to make similar changes in connection with the convergence of U.S. GAAP and IFRS.

“EROA assumption” eliminated under the proposed changes

Currently under IAS 19, the pension expense recognized in P&L incorporates an offset attributable to the EROA. This offset is calculated by multiplying the market value of assets by an EROA assumption, which the plan sponsor sets depending on the asset allocation of the pension plan. Over the long term, stocks are expected to have higher returns than bonds, and consequently a portfolio holding more in stocks will typically have a higher EROA assumption than one holding less in stocks. This aspect of the accounting rule allows the current year’s pension expense to be reduced based on the expectation of earning this assumed investment return in the current and future years. (U.S. GAAP rules work in a similar way, but allow the use of a smoothed value of assets instead of market value.) Under the current rule, the difference between the EROA and the actual return on assets in the year (the asset gain or loss) flows into OCI or unrecognized net gain/loss, depending on the company’s accounting policy,* making larger equity allocations more attractive because investment gains and losses are either never recognized in P&L or are amortized over time.

Under the proposed accounting rule, plan assets are effectively assumed to have returns equal to the discount rate used to measure liabilities (determined by market-based yields on high-quality corporate bonds) regardless of the actual asset allocation. Any differences between the discount rate and the actual rate of return on assets in the year would flow into OCI and would never be amortized back into future years’ pension expense. Consequently, the asset allocation decision would have no immediate impact on pension expense (Figure 1), and — as discussed in more detail below — over longer time horizons, the higher returns anticipated for a portfolio holding more in stocks will decrease only marginally, on average, the cumulative pension expense flowing into P&L. As a result, the proposed rule would increase pension expense recognized in P&L for most plan sponsors and move the consequences of both investment risk and reward into OCI.

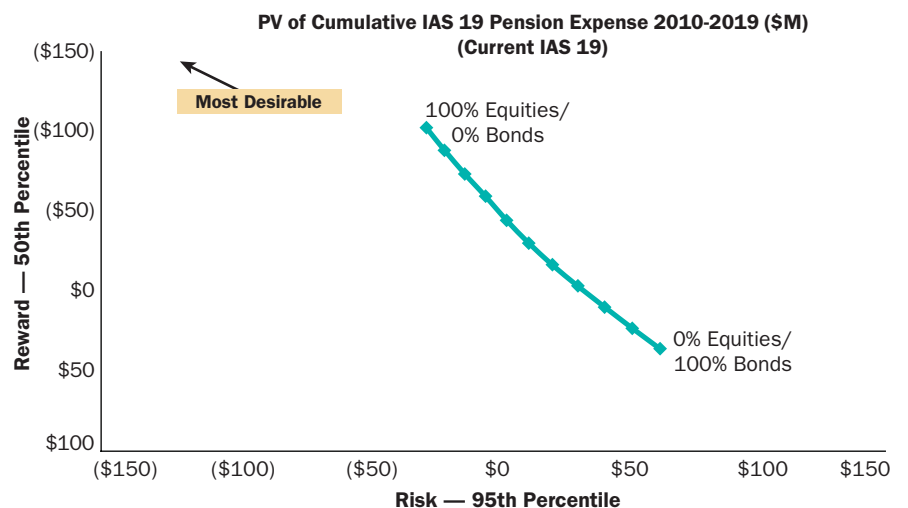
Figure 1. Under the proposed changes to IAS 19, pension expense in any single-year period is independent of asset allocation



The risk/reward trade-off between stocks and bonds over longer time horizons

The current accounting rule generates a bias toward holding stocks. Stochastic forecasting of pension plans under the current rule typically results in the portfolios with the highest allocation to stocks having the lowest expected and worst-case level of accumulated expense over a 10-year period (Figure 2). This is consistent with how the rule apportions risk and reward: Reward for holding stocks reduces pension

Figure 2. The current accounting rule encourages holding stocks — the 100% stock portfolio has both the lowest expected and lowest worst-case cumulative pension expense (P&L) over a projected 10-year period



*Under the current IAS 19 accounting rule, companies may choose to amortize gains and losses (including investment gains and losses) outside a corridor into future years’ pension expense. Alternatively, a plan sponsor may elect to recognize all gains and losses immediately in OCI, with no effect on future years’ pension expense. The analysis presumes the latter approach, which is more prevalent, is being used.

expense (regardless of whether stocks actually perform as expected), but the risk of underperformance flows primarily through OCI.

In contrast, the proposed accounting rule would create a risk/reward trade-off associated with holding stocks. However, for the reasons outlined above, the magnitude of trade-off under the proposed accounting rule is small (Figure 3).* As a result, if the proposed accounting changes are adopted, the asset allocation decision is likely to be driven primarily by funding rules (Figure 4) or other risk/reward-based considerations.

Another notable impact of the proposed accounting changes is the resulting decrease in year-to-year expense volatility (Figure 5).** This decrease is due to the inverse relationship between the discount rate and the market value of the fixed-income assets in the portfolio.

Figure 3. Under the proposed changes to IAS 19, the magnitude of the risk/reward trade-off is small

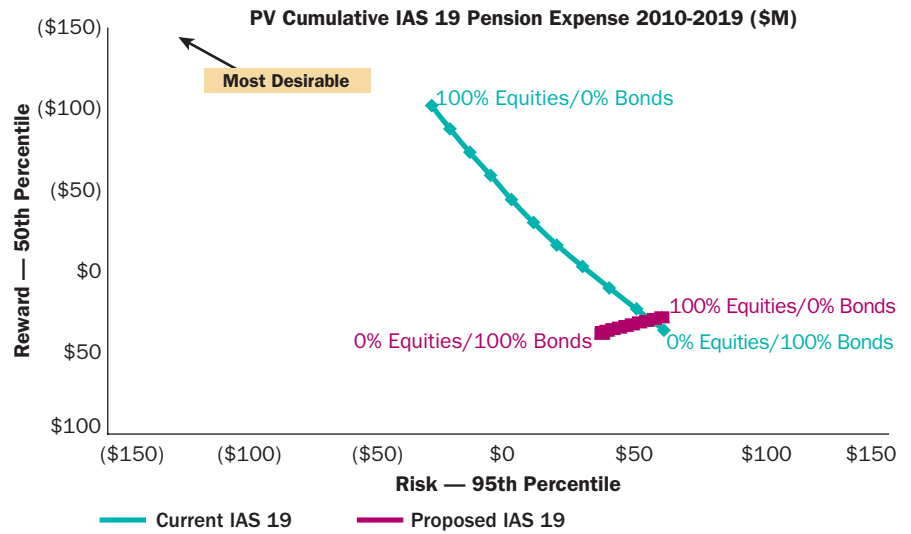
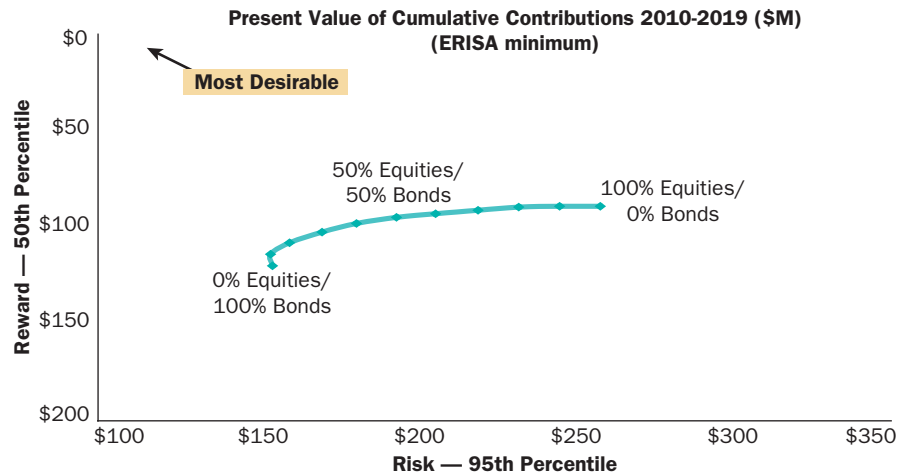


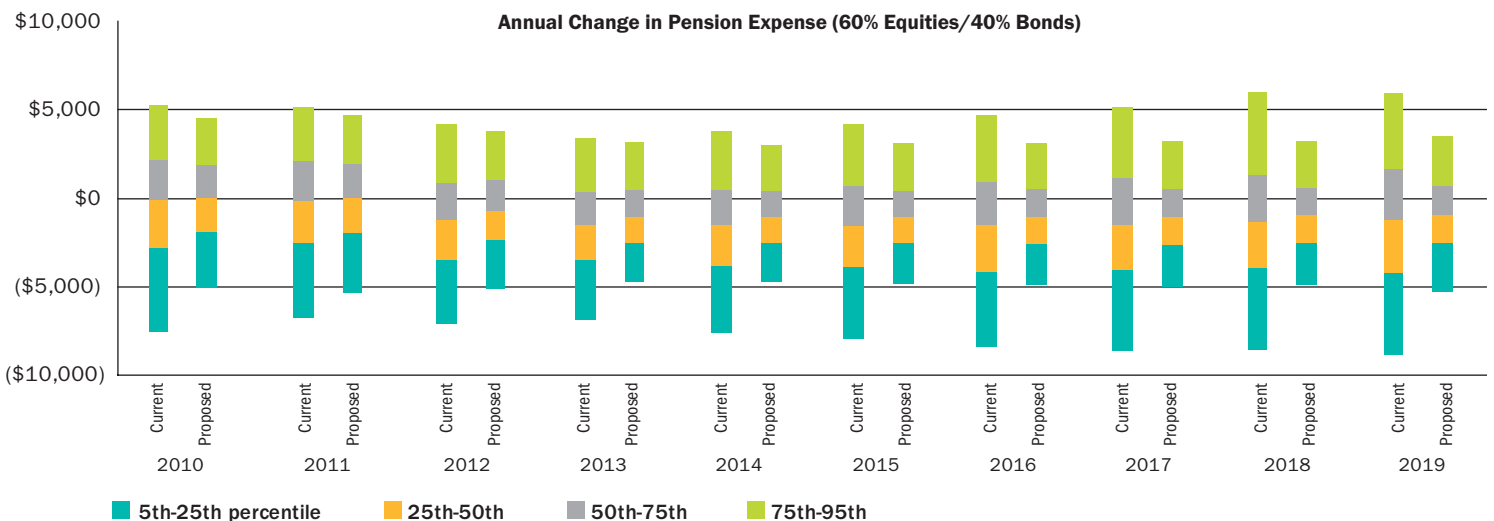
Figure 4. Under the U.S. contribution requirements, there is a substantial risk/reward trade-off for holding equities



* Figures 2 and 3 show the impact of asset allocation only on pension expense, which is currently a primary driver of asset allocation decisions for many plan sponsors. Our modeling allowed forecast contribution levels to vary depending on the stock/bond composition of the different portfolios. However, pension expense is affected by contribution levels: In scenarios where stocks perform badly, larger contributions will be made to portfolios with higher stock allocations, reducing the size of increase in future years' pension expense. To understand the full financial impact of asset allocation, additional plan financial metrics should be considered.

** The change in year-to-year expense volatility for a plan going from U.S. GAAP to proposed IAS 19 would depend on a number of plan-specific facts and circumstances, including the plan's asset allocation, use of asset smoothing and smoothing method.

Figure 5. Year-to-year expense volatility decreases under the proposed changes to IAS 19



Why does the Exposure Draft matter for companies reporting under U.S. GAAP?

While the proposed changes to IAS 19 would not be effective in the near future for companies reporting under U.S. GAAP, this development is still important to U.S. companies for at least two reasons. First, the FASB and IASB have agreed to converge their accounting in several key areas, including the accounting for employee benefits. An SEC decision on whether to require publicly held companies in the U.S. to adopt IFRS is expected in 2011. If adoption is mandated, publicly held companies could be required to adopt IFRS as soon as 2015 or 2016 (with a 2013/2014 transition date). But even if IFRS is not mandated, the FASB will likely adopt benefits accounting rules that

are substantially the same as the IASB's rule. Second, even if only plan sponsors reporting under IFRS are affected, any changes they make to their asset allocations could impact global capital market conditions, with associated implications for pension funding levels worldwide.

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