OPPDRAGSRAPPORT NR. 9 – 2014

JON LUNDESGAARD

# IAS 19 and Employee Benefits:

## Some reflections on the Norwegian experience

Høgskolen i Hedmark

Jon Lundesgaard

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Høgskolen i **Hedmark**

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**Summary:**

The accounting law of employee benefit plans is complex, and it demands a lot both of prepares and users. It is an observation that this in itself is a problem. Benefit plans include such things as defined benefit pensions. On this, Norwegian companies report according to either the international standard, that is International Accounting Standard (IAS) 19 Employee Benefits, or the equivalent national standard. A fundamental question is what this does to financial statements, and whether it is an improvement. This has to do with more than just the problem of whether what is reported is distorted or even incorrect.

A serious and possible result is that the company's situation is not understood in its essence, with all what this may lead to. Of course, this is something that concerns all parties involved. The effects of the accounting law of benefit plans are clarified on a more general basis, and by a case study. After a closer analysis of the problem of financial reporting, the conclusion is that the reporting of effects of benefit plans should be limited to notes, or otherwise.

Høgskolen i **Hedmark**

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**Sammendrag:**

Foretak kan etablere forståelser med de ansatte som inneholder lovnader om ytelser under gitte betingelser. Retningslinjene for den regnskapsmessige behandling av slike ytelsesbaserte ordninger er sammensatte. Dette krever en god del både av regnskapsprodusenter og regnskapsbrukere, og dette er i seg selv et problem. Ytelsesbaserte pensjonsordninger er en viktig del av de ytelsesbaserte ordningene.

Norske foretak rapporterer slike ordninger i henhold til den internasjonale regnskapsstandarden IAS 19 Employee Benefits/Ytelser til ansatte, eller tilsvarende norsk regskapsstandard. Et grunnleggende spørsmål er hva dette gjør med resultat- og balanseoppstillingene, og om dette virkelig er noe som representerer en forbedring. Gitt at dette er mindre åpenbart, står en overfor det problem at det rapporterte bilde er fordreid. Det kan føre til at foretakets situasjon ikke blir riktig forstått, med alt det kan lede til for berørte parter.

I bidraget blir den ytelsesbaserte ordningen beskrevet, og de regnskapsmessige effektene klargjort og analysert. Dette omfatter en faktisk situasjon som et case. Arbeidet avsluttes med en prinsipielt orientert diskusjon der det konkluderes med at rapporteringen av de regnskapsmessige effektene av ytelsesordninger ikke bør innarbeides i oppstillingene, men begrenses til noter eller på annen måte.

# FOREWORD

The report presented is a following up of a more extensive report in Norwegian found in Lundesgaard (2014). The reports both address the same sort of problem. The present report is a considerably shortened version in English.

*J.L.*

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# IAS 19 and Employee Benefits: Some Reflections on the Norwegian Experience

## 1. Introduction

Employee benefit plans lead to future obligations believed to have the character of corporate liabilities. Plan assets held separate from the corporate sponsor raise the question of the funded status of the plan. Since the beginning of the 1980s, the policy of accounting standard setting has been that effects of this has to be included in financial statements, and that details behind what is included are reported in notes. However, this is one of two alternatives in making effects visible. First, elements are included in financial statements/reports as stated by standard setters. Second, information on effects of employee benefit plans is limited to notes. This problem, and the reflections it leads to, motivates what is offered in this paper.

In Norway, the Norwegian Accounting Act of 1998 regulates financial reporting. Norway is not member of the EU, but since 1994 associated through the European Economic Area (EEA) agreement together with Iceland and Liechtenstein. The effect of this is that EU rulings are made effective in Norway, such as EU accounting directives functioning as broader guidelines, in addition to EU regulations with the character of strict statutory law. This starts out with EU Regulation 1606/2002. This regulation establishes a private foundation, International Accounting Standards Board (IASB), as the official supplier of strict financial accounting regulation in the EU. In Norway, when it comes to financial reporting regulation, the situation does not differ that much from that in EU member states. Companies which do not report according to international standards (International Financial Reporting Standard/IFRS), report according to the national accounting act supplemented with national accounting standards (NRSs). That is N GAAP. Even if there is some mixing of regimes, financial reporting regulation in Norway is presently a double track system consisting of two separate and parallel regulatory regimes. The two regimes differ in their foundations. IFRS is balance sheet oriented and open to “fair value accounting.”

N GAAP is income statement oriented in that matching of revenue earned with related expenses is fundamental, and transaction historic cost (THC) based.

In forming N GAAP, the role of the Norwegian Accounting Standards Board (NASB) is important. NASB is a private foundation established in 1989. In spite of not being a public administrative body, NASB brings into life financial reporting guidelines with wide reaching consequences. That is, NRSs and what come with these standards. The legal authorization for this is found in Section 4-6 of the accounting act stating that "[t]he preparation of the annual accounts shall be in accordance with good accounting practice", and the understanding is that "good accounting practice" is administered by NASB. Simply, as long as accepted by competent law making organs, NASB will continue to form legal accounting in Norway.

With the introduction of IFRS in Norway, companies that report according to international standards are required to follow IAS 19 Employee Benefits. This standard is among the "old" standards taken over by the reorganized international standard setter. The acronym IAS stands for International Accounting Standard, and "new" standards are identified by the acronym IFRS. In the first half of the 1980s, IAS 19 and SFAS 87 Employers' Accounting for Pensions administered by the American standard setter Financial Accounting Standards Board (FASB), were in place. Both standards require that effects of employee benefit plans are included in financial statements. In what follows in Norway, the history is summarized by a series of episodes or events.

- Around the mid 1990s, first as a preliminary standard, the Norwegian accounting standard NRS 6 Pensjonskostnader (Pension Costs) is released by NASB. The standard is drafted in looking to IAS 19.

- However, the inclusion of pension effects is not limited to reporting entities that report according to the Norwegian Accounting Act of 1998 and thus NRS 6. Local governments have to do this

too according to an adapted version of NRS 6. This is stated in Section 13 Regnskapsføring av pensjon (Pension Accounting) of regulations from the Ministry of Local Government and Modernisation (2000).

- The state accounting system is double track. First, a cash-based part in parallel to what is found in the state budget system administered by the Ministry of Finance. Second, what more recently is stated in state accounting standards (SRSs). The SRSs represent an accrual-based sorts of system of somewhat preliminary character. A government agency is administering these standards, see Norwegian Government Agency for Financial Management (2011). SRS 25 Personal- og pensjonskostnader (Personal and Pension Costs) is concerned with what is found in NRS 6.

- The Norwegian Public Service Pension Fund is a state "pay as you go" (PAYG) arrangement. In spite of a state guarantee of what comes of employee benefits under the arrangement, institutions reporting according to the Norwegian Accounting Act will have to follow NRS 6 and include pension effects in their financial statements based on a system with "fictive funds."

- A special sort of arrangement is the Contractual Early Retirement Scheme referred to as AFP (Avtalefestet pensjon). We have an old and a new version of AFP, and the new version raises accounting questions. The views of NASB (2010) and the Financial Supervisory Authority of Norway (2010) have been that pension effects should be included in accordance with NRS 6. Due to opposition against this, the Ministry of Finance (2011) came out with a report on the problem. In the Autumn of 2013, the Ministry announced its intention not to require inclusion of accounting effects of the new AFP.

Internationally, pension accounting is controversial, or at least discussed. Recently, this led to a new IAS 19 being effective from January 1 2013. In this new standard, options are limited and effects come to the balance sheet via the income statement. Whether this will settle unrest around pension accounting is an interesting question. In Norway, as we have seen, lots of effort has been spent in direction of bringing in pension accounting close to everywhere. This based on old versions of IAS 19. Given NASB's policy of "look to IFRS," it is not unlikely that much of this is going to be redone.

The paper is organized in the following manner. The basics on pensions, and employee benefit plans in particular, are outlined in Section 2. The "mechanics" of pension accounting are complex, and we are not going all way in this. Nevertheless, this has to be carried sufficiently far, and both Section 3 and Section 4 are needed for this. Section 5 is important in introducing the "two-process idea." In addition, effects of pension accounting are discussed. Section 6 includes a case study. In Section 7, the paper is concluded in advising the standard setter to limit reporting on employee benefit plans to notes.

## 2. On pension plans

When it comes to the pensions of employees, companies as employers are typically active in two ways. This leads to two different types of plan regimes.

- First, we have defined contribution plans in which employers contribute to funding of the pension arrangements of employees. With the transfer of the agreed on contribution the obligations of the employer are settled.

- Second, we have defined benefit plans in which employees are guaranteed certain pensions such as some percentage of salary earned. Under this sort of plan regime, obligations of the employer are extended to more than just contributing to the plan.

In Norway, recently a law on hybrid pensions is passed which will have accounting implications. However, to a certain extent, the really interesting implications are a result of defined benefit plans. That is what reflections offered are focused on. Defined contributions plans are less interesting from an accounting point of view.

Before turning to defined benefit plans and accounting, a few words are said about differences between regimes. First, the guaranty of benefit plans make these arrangements less controllable for the employer, and eventually more costly depending on how good the arrangements are for employees. With a contribution plan, employers know what pension expenses are. Second, in a contribution plan, risk is shifted so that risk associated with plan assets are borne by the employee/retiree. In Norway, and internationally, the tendency has been in direction of contribution plans. Exhibit 1 contributes with a picture of the situation in the private sector in Norway.

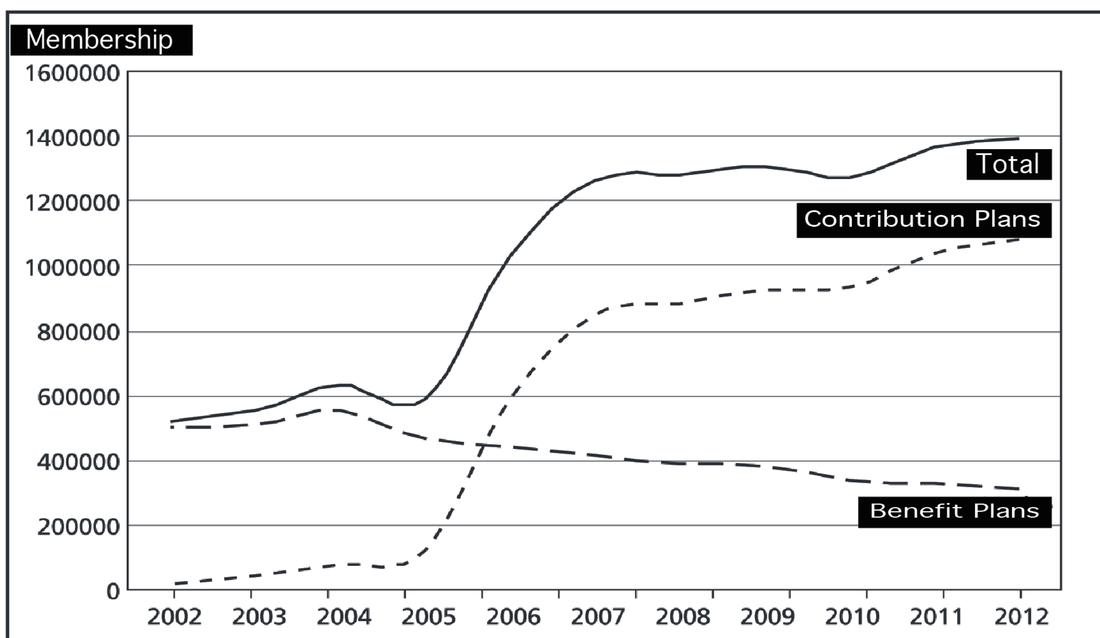


*Exhibit 1: From Veland and Hippe based on FNO (Finans Norge) statistics.*

It is seen that the number of plans is increased and this has to do with mandatory aspects associated with law making in the area of pensions. New plans are typically contribution plans. In addition, the number of benefit plans is reduced and this is to some extent a result of conversion from benefit to contribution plans. In business, defined benefit plans are simply less popular, and this may also have something to do with accounting standards, as we will see. In principle it is possible to make pension plans equivalent from an expected value point of view. However, in going from a benefit plan to a contribution plan employees are exposed to uncertainty. In assuming risk aversion, this is something that should be compensated for.

Defined benefit plans are funded or unfunded. When unfunded, and no other provision is arranged for, the benefits of future retirees are guaranteed by the employer's capacity to meet future obligations. Of course, this adds risk to unfunded plans. In many countries, the lawmaker restricts the establishment of unfunded benefit plans. We may see funding as the normal case, and that is also what we look at in what follows. In Exhibit 2, some fundamentals are outlined.

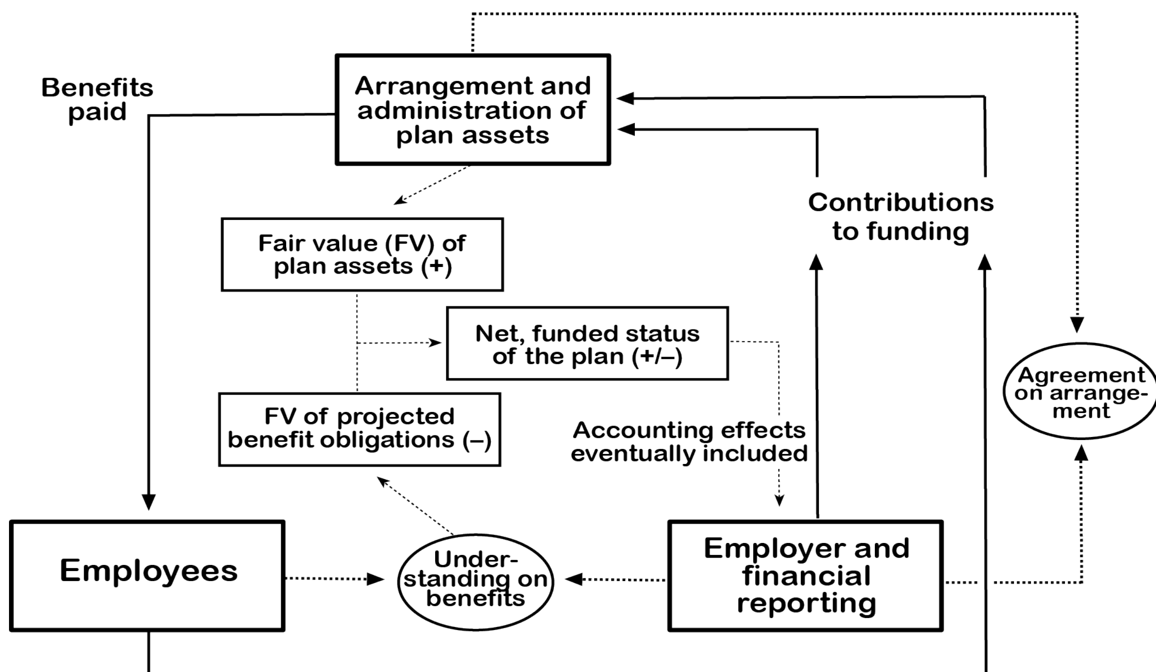


*Exhibit 2: Some fundamentals of employee benefit plans.*

There are three parties involved, and in the illustration, cash flows are drawn with solid lines. Understandings/agreements are marked with dotted lines. The institution responsible for the arrangement is separate from the sponsor and normally in charge of administering plan assets. At any time, plan assets have a fair value understood as the equivalent to market value. SFAS 157 and IFRS 13 by the main standard setters regulate the understandings of what fair value is, and this is more than just observed marked value. The purpose of plan assets is that of building a bridge between contributions and future obligations. Future obligations are abstract, calculated constructs having a present value. In understanding this present value as a fair value, plan assets and obligations can be matched. In matching, the net is a result that represents the funded status of a benefit plan. Both under-coverage and over-coverage is a possibility. The inclusion of this in the balance sheet, and what follows with this, is what pension accounting is about. Traditionally, in accounting, adding to accounts financial information about transactions is essential. Obviously, in adding a net representing the funded status of a benefit plan as presented, we are doing something that is very different.

## 3. The "simple mechanics" of benefit plan accounting

The accounting act of 1998 defines what are small companies (Section 1-6). With the purpose of easing the burden of reporting, small companies report according to a particular set of guidelines. That is, national accounting standard NRS 8 God regnskapsskikk for små foretak (Good accounting practice for small companies) in which guidelines for pension accounting are stated (pp. 50-54). Under conditions specified, small companies may ignore pension accounting effects of defined benefit plans. That is, the employer's contribution to the benefit plan is the sole effect included (as an expense). That is, technically as for defined contribution plans.

What are not small companies are other companies, and they report according to NRS 6. Exhibit 2 may point in direction of that only the net funded status of a defined benefit plan is included in financial statements. However, not only the funded status is included, but also a specific pension expense effect, and other items. What is included can be seen as summarized items being a result of primary, underlying elements. However, first a few words about the dynamics of the net funded status.

We are interested in what happens over the reporting period. Stock and flow magnitudes are involved, and the funded status of the plan is a net stock magnitude with a beginning (opening) and an ending balance. The opening balance of the net funded status is either a liability (under-coverage) or an asset (over-coverage). Consequently, the net of increments in plan assets and projected benefit obligations may be an incremental liability (incremental under-coverage), or an incremental asset (incremental over-coverage). The combinations of this are outlined in Exhibit 3.

| Opening balance - net funded status: | Over the period type of effect: | |
|---|---|---|
| | **Under-coverage** | **Over-coverage** |
| **Under-coverage** | Case 1 | Case 2 |
| **Over-coverage** | Case 3 | Case 4 |

*Exhibit 3: Combinations of opening balances and net increment effects.*

Case 1 and Case 4 end up with more of what is started out with. What the ending balance will be for Case 2 and Case 3 is less clear. In Case 2, the opening under-coverage is reduced, or eventually is eliminated/more than eliminated (ending up with over-coverage). In Case 3, opening over-coverage is reduced, or eliminated/more than eliminated. Obviously, plan assets that "lag behind" are neces-

sarily not what always is the case. How this all works together is related to more demanding questions about the built up and administration of plan assets, this on one hand. On the other hand we have everything of elements that contributes to the determination of projected benefit obligations. Seemingly, what should be aimed at is keeping plan assets and projected benefit obligations reasonably at par.

Even if what is aimed at is keeping assets and obligations more strictly at par, it is less likely that they will end up at par from period to period. This is due to uncertainty associated with the problem, and uncertainty is present in both benefit plan assets and projected benefit obligations. A point of view forwarded is that the uncertainty pointed to is a minor problem due to that it will even out over time. This sounds fine, but it is nonetheless so that it is not unimportant whether magnitudes are smaller or bigger. In addition, we have the question of how long it takes to even out. Moreover, the situation could be that of magnitudes that swing back and forth, without coming to rest in evening out.

In what is essential in the guidelines, the status of a benefit plan as under-coverage, or over-coverage, is brought to the balance sheet. Under-coverage leads to a liability that reduces the owner's equity. Over-coverage brings in an added asset so that the owner's equity is increased. For first-time adopters of NRS 6 this is what is the effect, and these are the "simple mechanics." The "not that simple mechanics" include increments, and so primary, underlying elements play a more explicit role.

## 4. The "not that simple mechanics"

"Not that simple mechanics" of pension accounting is what is a practical reality for preparers and users of accounting information. It is said that pension accounting is complex and difficult to understand. It is not our intention to lay out in full breath the intricacies of pension accounting being a consequence of conceptual and legal complexities (NRS 6, and what comes with it, is approaching

hundred pages). In this, we have the technical complexities associated with some primary, underlying elements. Hence, it is our intension to simplify in still being relevant. In this section, the text presented comes in two rounds. First, what is included in the income statement is discussed. Second, a fuller picture of primary, underlying elements is introduced.

Pension expenses end up in the income statement. However, to begin with let us be somewhat vague about what is included in pension expenses. In addition, we have an incremental item so far referred to as "Eventual other elements." With this, in seeing the opening balance of the funded status as a liability at its absolute value (in Exhibit 4 it is seen that the sign of this liability is negative), we have the following:

*OPENING BALANCE FUNDED STATUS*
– *EMPLOYER'S CONTRIBUTION*
\+ *PENSION EXPENSE*
+/– "*EVENTUAL OTHER ELEMENTS*"
-------------------------------------------------
= *ENDING BALANCE FUNDED STATUS*
==============================

The three incremental items above summarize to what in Exhibit 3 is referred to as "[o]ver the period type of effect." It is registered that this is more than the difference between pension expenses and the employer's contribution, which as a net increment can be plus or minus. Added to this is what so far is called "Eventual other elements." If this has to do with uncertainty, and revised best accounting estimates, Section 4-2 of the accounting act applies. This section states the following:

> In the event of uncertainty, the best estimate shall be applied, based on the information available when the annual accounts are prepared.
>
> When accounting estimates are revised, the effect shall be recognised in the income statement in the period in which the estimate is revised, unless good accounting practice allows for the effect to be deferred.

This leads us to three observations.

- First, we have what is stated above to begin with in part two of Section 4-2. The effect of revised accounting estimates "shall" end up in the income statement. However, the second part after the comma opens for "can" of something else, and that is what is in NRS 6.

- Second, NRS 6 opens for that the effects of revised estimates of defined benefit plans can bypass the income statement and end up directly in the balance sheet.

- Third, for certain conditions fulfilled, NRS 6 opens for that the alternative above can be combined with deferred recognition.

The inclusions of accounting estimates in financial statements brings along uncertainty associated with such estimates. In itself this is not of good, but it is traded off with the informative value of estimates. Employee benefit pension accounting means including "a package" which includes accounting estimates that under circumstances have major effects when revised. This leads to that the question of smoothing is raised. In facing this, the second and third points above can be seen as smoothing devices.

Now, we turn to the primary, underlying elements and how they are summarized. In including all necessary practical details, this is messy problem, and for our purpose this is less meaningful. Thus, a simplified version is presented. First, we are going exclude the effects of payroll tax. Second, any sort of effect that has to do with administrative costs is left un-discussed. Third, we see ending plan assets as fully known, and not as an estimate revised when fully known. That is, net earnings on investment are seen as fully known. Forth, details as to plan amendments are not dealt with. In Exhibit 4, a bird's view is offered.

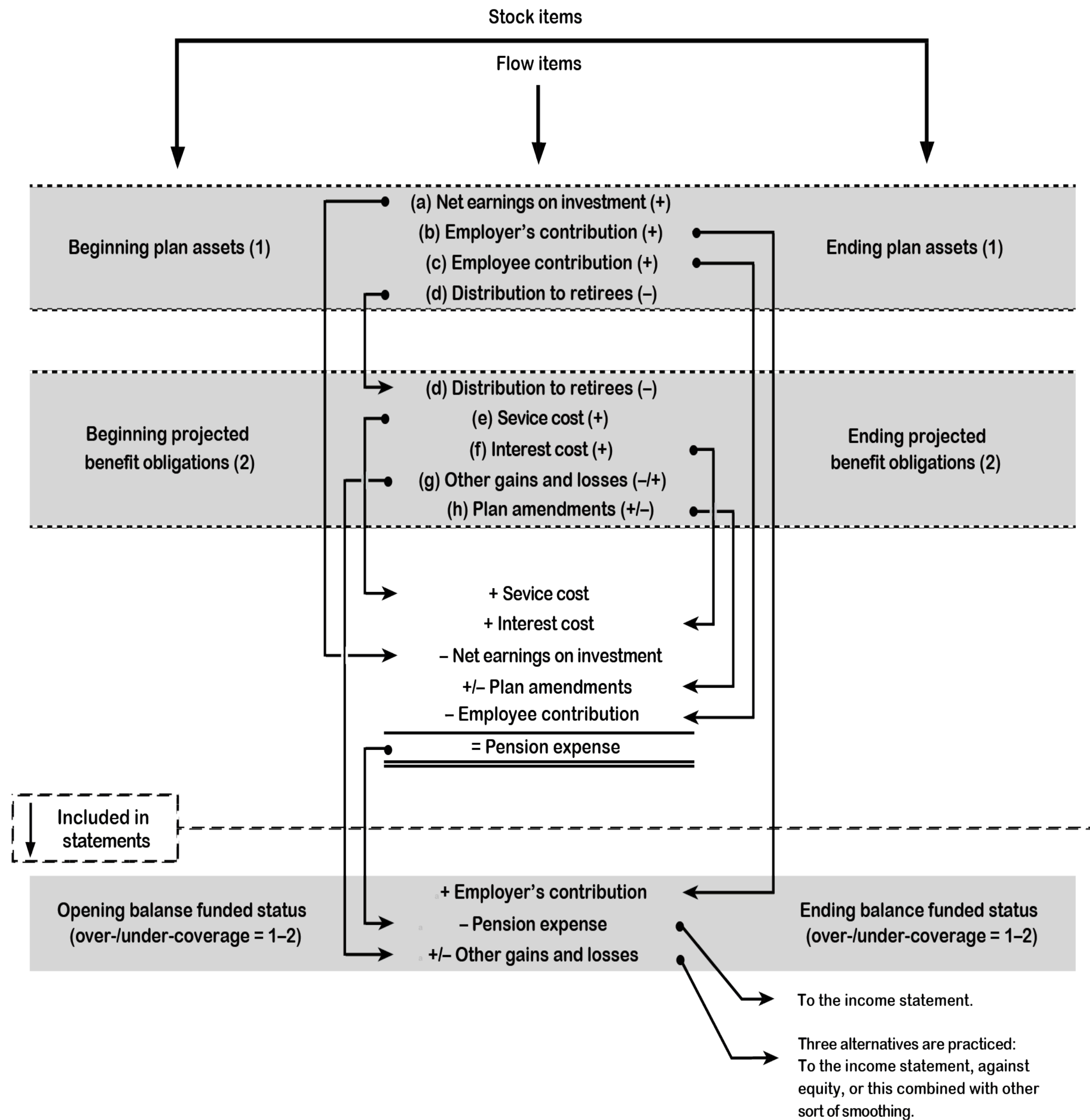


*Exhibit 4: Included items and primary, underlying elements.*

In the illustration, we have four summarized items. That is, plan assets, projected benefit obligations, pension expense, and funded status (over-/under-coverage). In what follows, the text is so organized that the items mentioned function as headings.

**Plan assets** These are means of the arrangement set aside separate from the sponsor (employer), and their administration is regulated by law. Element (a) Net earnings on investment, contributes to an increase, and so do (b) and (c) being the contributions of the employer and of employees. The purpose of the

arrangement, (d) Distribution to retirees, contributes to a reduction. It is registered that (d) at the same time leads to that projected benefit obligations are reduced.

**Projected benefit obligations** As pointed to, (d) evens out between the first two summary items. (e) Service cost is the present value of retirement benefits earned by employees over the period. The calculation of this cost is based on a series of factors of actuarial and economic character. Projected benefit obligations are over the period, such as a year, coming one period nearer in time. This leads to (f) Interest cost. That this has to be so is easily seen from the value of an € 100 interest free liability coming to an end at future time $t$. With interest $i$, the cost of coming one period nearer in time is $100/(1+i)^{t-1} - 100/(1+i)^t$ which leads to the interest cost of $100i/(1+i)^t$. Beginning projected benefit obligations is an estimate based on earlier set versions of the sort of factors that contribute to the determination of elements (e) and (f). These factors are of non-permanent character, and so, the beginning projected benefit obligations will have to be recalculated. This leads to actuarial gains and losses. Due to that we here omit effects of not fully known plan assets, else included on the way, the element is simply termed (g) Other gains and losses. A simple version of plan amendment is such as increasing the promise from 66 percent to 70 percent of salary earned. Plan amendments can also be made with effect backwards. The effects of all this are found in (h) Plan amendments.

**Pension expense** Instead of assembling the primary, underlying elements in explaining the period's flow effect of the funded status, an in-between calculation of pension expense is made. In addition, this summary item is needed in the income statement. Flow items from updating projected benefit obligations, (e), (f) and (h), are included in pension expense. In addition to this come elements from the updating of plan assets, that is, (a) Net earnings on investment and (c) Employee contribution.

**Funded status (over-/under-coverage)** Now, the updating of the funded status is fairly simple. The income effects of Pension expense and Other gains and losses are netted with the Employer's contribution. Pension expense ends up in the income statement. For Other gains and losses, we have in addition to ending up in the income statement, the smoothing alternatives as discussed. In Exhibit 4, this is suggested down to the right.

Summary items are included in financial statements, and the details on primary, underlying elements are shown in notes. In notes, this is not done in a bird's eye manner as in Exhibit 4, but in several separate charts. So far, it is not difficult to see that the effects of including employee benefit plans in financial statements can be massively non-neutral. An answer to this is that the meaning of pension accounting is just to show effects, massive or not. On the other hand, we have the question of what all this does to the reported picture of a business. In the next section, this question is addressed.

## 5. Effects of pension accounting

Organizing a business means bundling inputs with a perspective that is typically non-spontaneous. The purpose is value creation, and in this it is believed to exist some sort of sufficient willingness to pay for output. Of course, in organizing, the effort of people is important. A business is much more than an output-producing machine. Infrastructures are input factors that adopt a more permanent character, and in this respect physical infrastructures resemble those of output-producing machines. However, in addition to this we have organizational infrastructures. In the upper part of Exhibit 5, a bird's view of this is offered.

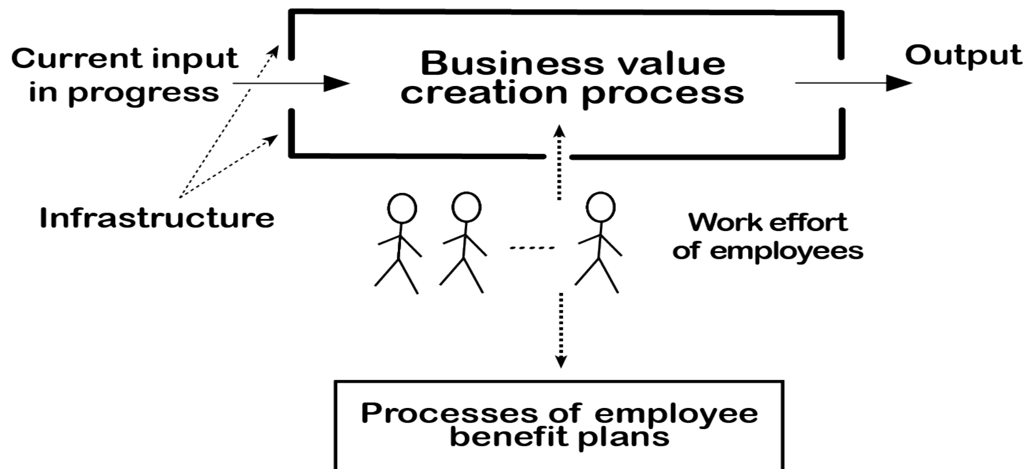


*Exhibit 5: Two processes, the business and employee benefit plan processes.*

In the lower part of the illustration, processes of employee benefit plans are included. Of course, such plans are part of what has to do with organizing an enterprise. As any activity of importance, we may see processes associated with benefit plans as separate activities with effects of interest. However, it is apparent that benefit plans are different from business processes in not having an output with which an explicit willingness to pay is associated. What is associated with a benefit plan are stock and flow items included in financial statements that reflect the plan status. The purpose is simply to show what is the added effect of this, non-neutral or not.

Financial accounting is a long-established device in summarizing what goes on in a business. That is, to keep track of value creation processes and what the business idea gives. Traditionally, consolidation/aggregation is part of this so that the entirety of the business is revealed. The idea behind pension accounting is to contribute to this in making the picture reported presumably more correct. However, the question is whether this is the case. In practicing pension accounting, the picture of what are core activities of a business is most likely distorted. In the following we take a look on this.

**Volatility** In most kind of cases, uncertainty is present. In financial reporting, this means that what has been reported does not necessarily repeat. The future contributes with surprises in form of "good news" or "bad news" ("neutral news" is in addition an eventuality). If the future is seen as a likely path, what later is manifest will typically deviate from this reference path. Uncertainty is a likely explanation, and time-series characterized by this are said to be volatile. Volatility leads to that predictions are less than exactly precise, and this can be more or less so. With pension accounting, added uncertainty is brought into reported numbers. That this is so is easily seen from the primary, underlying elements introduced in connection with Exhibit 4. In a contribution by Dichev (2008), it is documented that accounting numbers over time are more volatile. This may well be a result of else well-meant standard setting such as pension accounting. In itself this is not of good. Obviously, for increased uncertainty to be traded off, increased relevance due to pension accounting is needed.

**Financial Analysis** Information financially reported should be reliable and relevant. Relevance is two-sided in that we have both the accounting for stewardship point of view, and the question of usefulness as to the resource allocation problem of users. Analyses of financial statements play a role in this, and traditionally, solidity and profitability is something that is focused on. Pension accounting makes this less straightforward.

**Solidity** In financing an enterprise, the distinction between equity and debt is central. Equity is what owners have paid in of capital, in addition to what is retained of earnings. Debts are liabilities, and ordinarily nominally fixed amounts (money items) with a given maturity and an agreed on payment of interest. Traditionally, as percent of what the balance sheet sums up to, equity is seen to signal solidity. The equity ratio says something about exposure to the burden of debt. With including effects of employee benefit plans, this is upset. Given under-coverage, an interest free pension liability, not nominally fixed, is introduced to the balance sheet. Maturity is less specific or even outright unclear. Equity is correspondingly reduced so that solidity is reduced. This leads to a question of whether the burden of debt is increased to the same extent, and so

the question of relevance. In any case, there are no immediate cash flow effects of this. Given over-coverage, the situation turned around.

**Profitability** This is measured absolutely, in addition to relatively, typically by return on equity (ROE). Of course, as associated with the business value creation process, this is something that is of critical interest. Pension expense and other pension accounting flow items, have a less direct relationship with the business value creation process. When included in the income statement, the question of relevance is raised. In addition, with less relevant equity measurement, ROE is made less interesting.

## 6. A case study

Case studies are important in illuminating effects. When effects repeat, the "case of one" problem is less important. Our case study is based on a prominent social science institute with distinctive pension accounting effects in annual reports. The institution focused, Institute for Social Research (ISR), was established as an independent non-commercial foundation in 1950 and has played an important role in social science research in Norway. More about ISR is found in http://www.socialresearch.no/About-us. The ISR case was first drafted as part of Lundesgaard (2014) where it is one out of seven case studies.

The employees of ISR have the state Norwegian Public Service Pension Fund as organizer of their pension arrangements. The arrangements are favorable defined benefit plans. As sponsor, and from 2003 on, ISR includes pension effects in financial reporting according to NRS 6. Over the years focused, the activity level of ISR has been fairly stable and this makes it more easy to see effects pension accounting. The activity of ISR is advanced and specialized social science research. A well-qualified core of research faculty is, and has to be in place. In organizing this, some farsightedness is needed, and this all leads to fixed costs. If the access to means is not correspondingly long-term, one is faced with a constant need to succeed with projects. That is the kind of situation ISR finds itself

in, and it means that the "bottom line" is very much a result of income uncertainty. In facing uncertainty, independence is secured in owning important parts of the physical infrastructure such as buildings, in having "money in the bank," and in being close to debt free. In the first annual report for 2002 studied, just that is what characterizes the picture presented of ISR. In Exhibit 6, summaries of the income statement and the balance sheet for 2002 are included. For this year, the equity ratio is impressing 73.98 percent.

| **Income statement** | 2002 |
|---|---|
| Revenue | 34 968 889 |
| Operating expenses * | -33 357 084 |
| **Pension expense** ** | **-1 527 996** |
| Operating result | 83 809 |
| Other profit/loss items | 790 069 |
| Net profit or loss for the year | 873 878 |
| **Balance sheet** | |
| Fixed assets | 5 615 000 |
| Current assets | 16 637 486 |
| **Sum assets** | 22 252 486 |
| Equity | 16 462 304 |
| **Pension liabilities** | - - - - |
| Other liabilities | 5 790 182 |
| **Sum equity and liabilities** | 22 252 486 |

* Exclusive pension expense.
** Equal to the employer's contribution.

*Exhibit 6: The last financial statements of ISR not based on pension accounting (numbers are in kroner).*

After 10 years of pension accounting the equity ratio is down to 29.94 percent, and seemingly, ISR is in a very different situation. In reporting, ISR is not specific on the background for starting with pension accounting from 2003 on. However, in Note 6 of the 2002 annual report, the following is found (translation by the author).

> The Norwegian Public Service Pension Fund has advanced a claim of kr. 7,600,000.–; insufficient employer contribution from 1997 on to 2001 included, in addition to 14.1% payroll tax, in total kr.

> 8,671,600.–. Is to be refunded over a period of 5 years from January 1 2003. Institute for Social Research is opposing the claim.

In starting with pension accounting from 2003 on, it is obvious that ISR was less successful in opposing the claim forwarded. This is a likely explanation for ISR's conversion to pension accounting, rather than NASB's constant effort in expanding what NRS 6 applies to (such as including institutions like ISR). Based on income statements, balance sheets, and notes reported, reworked statements of ISR are presented in Exhibit 7. In reworking, statements are made more consolidated/aggregated, in addition to that pension expense and pension liabilities are shown.

| **Income statements** | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| Revenue | 39 470 388 | 36 314 284 | 38 916 549 | 38 284 428 | 41 836 539 |
| Operating expenses * | -36 738 021 | -33 125 774 | -36 502 750 | -36 639 260 | -38 281 801 |
| **Pension expense** | **226 211** | **-3 017 421** | **-2 217 781** | **-1 668 238** | **-4 535 276** |
| Operating result | 2 958 578 | 171 089 | 196 018 | -23 070 | -980 538 |
| Other profit/loss items | 669 970 | 256 810 | 319 310 | 523 445 | 716 883 |
| Net profit or loss for the year | 3 628 548 | 427 899 | 515 328 | 500 375 | -263 655 |
| **Balance sheets** | | | | | |
| Fixed assets | 5 226 500 | 4 948 000 | 4 786 500 | 4 571 000 | 4 429 170 |
| Current assets | 18 830 177 | 17 749 563 | 22 277 672 | 22 055 163 | 22 035 116 |
| **Sum assets** | 24 056 677 | 22 697 563 | 27 064 172 | 26 626 163 | 26 464 286 |
| Equity | 9 740 053 | 10 167 952 | 13 423 585 | 13 923 960 | 13 660 306 |
| **Pension liabilities** | **7 427 910** | **1 547 776** | **1 547 776** | **1 547 776** | **4 467 681** |
| Other liabilities | 6 888 714 | 10 981 835 | 12 092 811 | 11 154 427 | 8 336 299 |
| **Sum equity and liabilities** | 24 056 677 | 22 697 563 | 27 064 172 | 26 626 163 | 26 464 286 |

| **Income statements** | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| Revenue | 43 680 590 | 59 289 080 | 56 546 766 | 56 651 736 | 66 689 649 |
| Operating expenses * | -40 637 007 | -54 913 720 | -53 923 091 | -58 320 800 | -62 227 878 |
| **Pension expense** | **-5 013 827** | **0** | **-418 404** | **-1 238 371** | **-4 324 097** |
| Operating result | -1 970 244 | 4 375 360 | 2 205 271 | -2 907 435 | 137 674 |
| Other profit/loss items | 1 173 962 | -1 133 146 | -696 056 | 426 174 | 1 387 703 |
| Net profit or loss for the year | -796 282 | 3 242 214 | 1 509 215 | -2 481 261 | 1 525 377 |
| **Balance sheets** | | | | | |
| Fixed assets | 4 240 000 | 21 437 000 | 20 992 000 | 21 600 400 | 21 301 033 |
| Current assets | 30 830 540 | 23 692 132 | 21 115 041 | 27 218 585 | 34 341 743 |
| **Sum assets** | 35 070 540 | 45 129 132 | 42 107 041 | 48 818 985 | 55 642 776 |
| Equity | 12 864 024 | 16 106 237 | 17 615 452 | 15 134 191 | 16 659 568 |
| **Pension liabilities** | **9 751 316** | **10 240 771** | **12 946 144** | **13 041 035** | **15 465 936** |
| Other liabilities | 12 455 200 | 18 782 123 | 11 545 445 | 20 643 759 | 23 517 271 |
| **Sum equity and liabilities** | 35 070 540 | 45 129 131 | 42 107 041 | 48 818 985 | 55 642 775 |

* Exclusive pension expense.

*Exhibit 7: ISR's financial reporting 2003-2012 (numbers are in kroner) in practicing pension accounting.*

Over the period, pension expense is a rather erratic figure. The zero pension expense in 2009 is special, and it is difficult to see how this comes about from what is reported. Volatility in pension expense leads to volatility in the operating result and in the "bottom line" (net profit or loss for the year). In calculating these items as percentages of revenue, we have a relative measure of variation in figures over time. This leads to the following time-series (percentage operating result/percentage "bottom line").

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|
| 7.50/9.19 | 0.47/1.18 | 0.50/1.32 | -0.06/1.31 | -2.34/-0.63 | -4.51/-1.82 | 7.38/5.47 | 3.90/2.67 | -5.13/-4.38 | 0.21/2.29 |

Taking this at face value, profitability is something that jumps up and down all the way. Of course, it is of interest to see whether this in fact is so for the core activity of ISR. Revenues minus operating expenses, leads to a simple measure of absolute operational contribution. Calculating this as percentage of revenue, leads a time-series that is less erratic.

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|
| 6.92 | 8.78 | 6.20 | 4.30 | 8.50 | 6.97 | 7.38 | 4.64 | -2.95 | 6.69 |

The conclusion is that pension accounting makes the "bottom lines" of the income statement less interesting from a practical point of view, or even worthless as an indicator of achievement.

For 2004, 2005 and 2006, pension liabilities are included with the same moderate amounts, and this is left uncommented in annual reports. However, ISR is practicing the "corridor approach," so what is pointed to may have something to do with this. Apart from these years, we find that pension liabilities are included with figures that really count. In any case, seen over the period, the balance sheet effects of pension accounting are important. In starting out in 2003, the effect is massive for this year. For the period studied, the equity ratio is the following.

| 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|---|---|---|
| 40.49 | 44.80 | 49.60 | 52.29 | 51.62 | 36.68 | 35.69 | 41.83 | 31.00 | 29.94 |

To begin with in 2002, the economic situation of ISR is good. Over the period with pension accounting, this has in reality also been very much the so. Nevertheless, seen traditionally, the picture reported looks rather desolate. In the balance sheets presented, ISR looks considerably less solid than what really is the case. The good economic situation, and the practicing of the "corridor approach," is what made it possible to escape ending up with negative equity. In Note 4 of the 2012 annual report, it is said that the total of pension liabilities, payroll tax included, is kr. 26,471,883. Due to the "corridor approach," what is in the balance sheet is kr. 15,465,936. The permitted "backlog" set aside, an equity ratio around 10 percent is what this leads to.

## 7. What is more meaningful, reporting limited to notes?

In studies of financial accounting, orientations are typically framed as either positive or normative. This, even though, the distinction is not necessarily hundred percent dichotomous. Anyway, in academia as to what is prestigious, the tendency over years has been strong in direction of the positive accounting orientation. An observation on this by Jiang and Penman (2013:234) is that "[r]esearchers are sometimes advised to avoid normative statements on accounting policy, but to deny this mission would be akin to medical school that has no interest in healing patients." As pointed to, the problem of what financial reporting regulation should look like is ever present, and a normative problem. To the extent that academia shies away, this is something that lawmakers, standard setters, and concerned practitioners and others are left alone with. Or, we may say, it is left more or less up to the politics of financial reporting regulation.

Financial reporting has to do with information, and what is regulated is the structure of this in financial reports. In general, what is reported on is complex. So, in forming regulation, one is faced with a multitude of difficult trade-offs. However, what makes this still more difficult is the lack of consensus even on fundamentals. How points of view are distributed is not a simple question to answer, even if Glover (2014), Macve (2014) and Zeff (2014) are of help in this. Thus, let us concentrate on what the opposing fundamentals are.

- **The classical, income statement approach** In this approach, absolute profitability measurement is essential, and the core principles guiding this are framed as income statement matching. Measurement is to a certain extent transaction historical cost (THC/original cost) based, so that the balance sheet is accumulating "expenses in the waiting line."

- **The balance sheet approach** In this approach, a balance sheet being the consequence of the classical approach is a problem. Instead of classical matching, balance sheet matching of assets and liabilities is seen as more fundamental. That is, a sort of matching that leads to equity, and next to the period's increment in equity. What is particularly important, however, is that THC is abandoned and replaced with fair value accounting as far as possible.

The Norwegian Accounting Act of 1998 is based on the income statement approach, and is THC based. The foundations of IFRS administered by IASB, and so also FASB's approach to regulation, are based on the balance sheet approach. In addition, it is right to say that the two main standard setters have been widely open to including fair value accounting in their standards. Impairment is an example of why fair value, understood as a hypothetical market value, should play a role in accounting. This is an example of sorts of mixing of approaches that has long-standing meaning. However, this has less

to do with adopting approaches as outlined, in a consequential manner. It is an observation that standard setters have not been consequential. Regulation based on mixing types of approach is a problem. FASB and IASB have been working hard in direction of the balance sheet orientation since the 1970s. Most eminently this is seen in conceptual frameworks, see the SFACs from FASB (some are referred to) and IASB (1989/2013). So far, this has led to very voluminous standards, and to standards that are clearly unstable. Of course, this is not of good.

A seemingly obvious foundation for NASB's work with national standards is to base this on the principles stated in the national accounting act. That is, on classical approaches to financial accounting. However, less energy has been allocated to this due to the momentum of IFRS. NRS 6 on pension accounting is one example of how, at an early stage, elements of IFRS are brought into national regulation on financial reporting. With pension expenses, elements that have to do with processes of employee benefit plans are brought into the income statement. These are elements that have a more distant relationship to the value creation process of a business. The effects of this can be massive, as we have seen in the case study included in Section 6. Bottom lines are made less relevant and less reliable. Simply, earnings quality is reduced, and this may well be so to a considerable degree. With pension accounting, the balance sheet is upset and disturbed as we have seen in the case study. The balance is no longer a "Norwegian balance" based on classical foundations. With NRS 6, and for the reporting entities the standard applies to, the balance sheet includes a mix of THC/fair value types of items. The meaning of this is unclear, and this is sometimes referred to as the problem of mismatch. This all is a result of a misguided desire to see the two processes in Exhibit 5 as one, in spite of that mismatch is not of good.

The lack of consensus on fundamentals is already referred to, and positions taken can sometimes lead to heated exchange of points of view. Most likely, the explanation for this has to do with the complexity of the reporting problem. An answer to this could be to go to the users of financial reports. That is,

such as to analysts having a professional interest in how financial reports are worked out. However, as Jiang and Penman (2013:235) point to this is not that simple.

> Indeed, the accounting Boards [such as FASB og IASB] have been very keen to get the opinions of analysts. It appears, however, that this approach does not elicit clear recommendations. For example, the leadership of the CFA Institute [stands for Chartered Financial Analyst Institute being a worldwide organization of analysts with its seat in Charlottesville, Virginia (USA)] has come out strongly in favor of fair value accounting, while rank-and-file working analysts seem to have a different opinion. The Boards' recent insurance proposals have been controversial among analysts, some endorsement (largely in Europe) and some strong opposition (largely in the US). We suspect the reason is that analysts use accounting data in very different ways; there is no common platform for carrying out analysis.

This is rather depressing, and is why financial statement analysis is seen more as an art, rather than a science based discipline. However, as again pointed to by Jiang and Penman (2013), as an alternative to all this, residual income valuation (RIV) is an approach to analysis. The foundations of RIV are firmly anchored in fundamentals of financial accounting and economics of business. Stephen Penman has been important in doing work on this summarized in Penman (2011/2013). In Lundesgaard (2012), this is taken advantage of. In RIV, it is easy to see how both the income statement and the balance sheet play a role. So, it leads astray to accentuate one before the other. Important is that RIV lends meaning to THC, and thus, to income statement matching. The balance sheet that is a result of this is important for RIV. Fair value accounting destroys all this.

To start with in Section 7, two opposed positions on the foundations of regulation were introduced. Above, RIV is pointed to as something else. In this, it

is interesting that pension accounting has been argued for in taking advantage of each of the opposed positions. In commenting on this, Kvaal and Sellæg (2003:46) are starting out as included in what follows (freely translated by the author).

> Pension accounting is justified in referring to the matching principle (such as in NRS 6 [....]), or in referring to the definition of liabilities in conceptual frameworks (such as in IAS 19). In taking advantage of a simple example, the ideas behind this are presented. Funding and discounting are assumed away. We look at a project employing one person over five years. The employee starts out with the salary of 100 per year. In addition, the understanding includes employee benefits equal to last year's salary to be paid out when the employment period is ended. Obviously, from a matching point of view a relevant part of the benefit obligation should be included in payroll expenses of the first year. The relevant part referred to is part of the employee's compensation for work rendered. Correspondingly, this leads to the necessity of including a relevant part of future benefit obligations as a pension liability so that liabilities accumulated are shown. From both points of view, it seems reasonable to approach the problem of distributing the benefit obligation over the period in doing this in an even manner. Now, in assuming a benefit obligation equal to first year's salary, this leads to the pension expense of 100/5 = 20. This is both the first year's pension expense and what is included in the balance sheet as pension liability.

Remarkably, the point of departure does not matter. In any case, the effects of employee benefit plans should be included in financial statements. This may explain why, in Norway, pension accounting after all has been introduced without that much fuzz. The volatility problem is simply swept under the carpet with the even out argument.

It is of good that foundations are discussed. In financial accounting, however, it is difficult to free oneself from the impression of some sort of impasse, or dead end. Pension accounting is something we see in practice. So, asking the question of what this all looks like in practice may bring us ahead. That is what is done in Section 6 with the ISR case. Of course, this may well prompt accusations in direction of being anecdotal. On the other hand, when faulty outcome is observed, it is not necessarily so that particularly advanced investigations are needed to identify what is the problem. To begin with in Section 1, it was stated that it is not necessarily so that the effects of employee benefit plans are to be made visible in including effects in financial statements. The problem with including effects is that the reported picture of the business process is garbled. Nevertheless, all what has to do with effects of employee benefit plans is still of interest. However, information on this may as well be limited to notes, or otherwise reported. This is what is believed to be a solution to what is identified as a problem. Based on financial statements the business process can be analyzed un-garbled. In a second round, the effects of employee benefit plans can be taken into account in analyzing the company in its entirety. It is not given that today's reporting in notes is sufficiently good for this. In any case, this is something that users, as well as producers, are struggling with. In facing what is identified as a fundamental problem of pension accounting, or not, the standard setter is advised to address the question of what is in the notes.

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