Ask the experts:

If it ain't broke...

The IAS 19 accounting standard does not provide a realistic indication of the price for which a pension scheme's liabilities can be settled, but conventional estimates of buy-out liabilities are now probably too high, particularly given deals like Citibank's acquisition of the Thomson Regional Newspapers pension scheme and the Pensions Corporation acquisition of the Thorn and the Thresher schemes. So what liability measurement basis should the principal interested parties be demanding the company accounts use? Three ACT members give their views.

David Poynton, Principal, Lane Clark & Peacock

The IAS 19 measure of liabilities is imperfect and arbitrary. It does not take proper account of the specific risks associated with a particular scheme or company. However, ditching it in favour of a buy-out measure would neither serve the needs of investors, nor improve understanding of the pension disclosures. With all its flaws, the present IAS 19 is a workable and well-understood benchmark.

Under IAS 19, the company makes the best estimate of pension payments from the scheme and discounts them to the present day using the yield on high-quality corporate bonds (typically, AA-rated bonds). This approach is hard to defend on theoretical grounds. Why should a pension payment be valued as if it were an AA-rated bond issued by a company? Why not a BBB-rated or a AAA-rated bond? The choice is arbitrary, and not based on any analysis of the risks faced in any particular case.

But using the buy-out cost would also be fraught with difficulties. Although there is a well-developed buy-out market in the UK, there may not be in other territories. Estimating a buy-out cost where there is no significant buy-out market is likely to be a subjective exercise. Even in a developed market, pricing bases for pension buy-outs are likely to be regarded as confidential by market participants; any calculations for accounting purposes are likely to be based on estimates and rules of thumb, and so would not necessarily be easily comparable between companies. Perhaps more importantly, the buy-out figure is only really relevant where a pension scheme is wound up, rather than the more common situation where it continues to operate, paying benefits from its resources as they fall due.

No one number will summarise a pension liability. Any particular measure may meet the needs of some users of accounts, but be totally unsuitable for others. The best that can be hoped for is a well-understood benchmark – which IAS 19 already provides – coupled with clear disclosures that enable the figures to be understood, compared between companies and adjusted for investors' individual needs. The focus should be on ensuring disclosures enable this, rather than a new, untested measurement approach.

The current IAS 19 measurement achieves what is required of it. As someone once said: "If it ain't broke, don't fix it."

John Hawkins, Principal, Mercer

Clearly, something more closely reflecting an economic estimate of the liability would be a good start, probably based on a risk-free discount rate, realistic mortality assumptions, no smoothing (for example, via the "corridor") and accrued benefit obligation rather than projected benefit obligation.

We can only hope that IAS 19 ends up closer to this after the current review is concluded.

Since this will generally increase the liabilities appearing on a sponsor's balance sheet, it might not appear to represent an improvement at first sight, but there is an argument that this would indeed be the outcome.

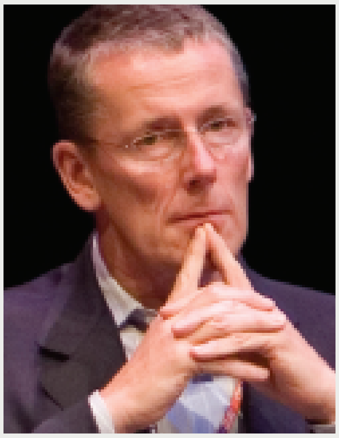
The higher the liability, the greater the likelihood that CFOs and treasurers will be able to afford to take derisking steps. In effect, they would be given more flexibility to act without giving rise to an adverse accounting consequence.

The existing solvency or buy-out basis does have some attractions, although sponsors may need to invest more time in ensuring that the figures stated reflect the very competitive quotations currently available – for an average scheme, a premium of 10 to 15% is now the norm. Sponsors that believe they can do even better than this should be free to say why and at what level.

The Citibank scheme adoption approach does not provide pensioners with exactly the same level of security as an insurance company buy-out, but the liability is settled in the conventional sense and this seems a reasonable basis for accounting.

There is at least one potential advantage of using a pension liability in accounts that is closer to buy-out. Companies would be more likely to be rewarded by stakeholders (once they got over the shock of seeing the true market value of the liabilities), particularly equity investors, if they then shed pension risk entirely by buying out or doing a Citibank-type transaction and concentrated on actually running their commercial operations.

Many scheme sponsors would readily acknowledge that they are not taking advantage of the current buoyant buy-out conditions because of anticipated adverse shareholder reaction rather than because they think further improvements will occur.



Paul Wilkinson, Group Treasurer, Tomkins

To answer the question, you should really go back to the question of the purpose of accounts and the financial information that users need to make decisions. However, in the absence of a clearly defined conceptual framework and definition of decision usefulness, it's hard to make an argument for accounting for pension liabilities fundamentally, differently from how we do now under IAS 19.

The question really comes down to whether the liability should be measured on the basis of the amount expected to be settled in the future (that is, under IAS 19) or the amount for which the company could transfer any further exposure to the liability (for example, under a buy-out valuation).

In simple terms, under IAS 19 you estimate the amount of the cashflows that will need to be settled at some time in the future and then present-value those cashflows using an appropriate discount rate. You should estimate expected future cashflows by using current best estimates of the variables that could change the amount paid (mortality, and so on), and then present-value those cashflows using a discount rate applicable to a current safe investment that could pay the anticipated future cashflows.

Some people debate whether a discount rate should be used that matches each of the individual cashflows or whether a single period discount rate should be used. It is also debated whether the discount rate should be based on gilts or AA-rated bonds or some other instrument and which mortality basis should be adopted, but these are just refinements of the basic accounting principle that currently supports IAS 19 and the requirement to recognise the pensions liability on a settlement basis.

On the whole IAS 19 does a pretty good job at recognising the liability. It also adopts the same basis as other non-financial liabilities recognised in the accounts under IAS 37. There seems to me no obvious conceptual basis for unilaterally varying this principle for pensions liabilities.

A couple of years ago the IASB issued an exposure draft on measurement of non-financial liabilities which effectively proposed a move away from settlement to a transfer basis (which could have resulted in liabilities being recognised at buy-out value).

But why should any liabilities be recognised at their transfer values? Simply because transfer values are generally available for most traded financial instruments does not mean accounting should be driven down the path of adopting transfer values for all liabilities. It is also highly questionable whether meaningful transfer values could be obtained; even if they could, the cost of obtaining pension liability transfer values could be substantial.

Not surprisingly, the IASB exposure draft was put on ice and I think the same problems would apply if we went down the path of measuring pensions liabilities on a buy-out basis.

The measurement of pension liabilities goes to the heart of a broader debate about the purpose and value of accounts generally that is dividing preparers and users alike. But it is not IAS 19's job to lead that debate.

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