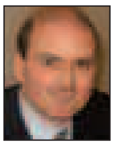
Fairies and crocodiles



PRETENDING THAT VOLATILITY DOESN'T EXIST IN A PENSION SCHEME'S ACCOUNTS CAN MAKE FOR A VERY SHORT WALK ON THE PLANK. **PETER ELWIN** CHAMPIONS A REALISTIC TREATMENT OF FAIR VALUE PENSION ACCOUNTING.

The International Accounting Standards Board (IASB) published its latest proposals for pensions accounting in April. No doubt this will refresh the broader debate surrounding pensions accounting but one aspect of particular interest to treasurers is volatility and "fair value".

The credit crunch has thrown asset price volatility into sharp relief, and raised questions about the merits of market prices as the basis for accounting fair values and the risk that such a methodology is inherently pro-cyclical, in terms of both market and regulatory behaviour. The demise of various financial names over the past two years shows that this debate is far from esoteric. If value accounting is to blame, then the cost of this experiment has been enormous.

Various alternatives to fair values have been suggested. Some are based on arguments such as "we hold instruments to redemption, so market values are less relevant" and others are based on the idea that market prices can be "wrong" as they are distorted by dysfunctional markets and irrational behaviour among market participants.

The problem that critics of current values all encounter is what to use instead. Various solutions have been proposed, ranging from using an average of the past x months (but with no agreed rationale for determining x) to allowing the government or a regulator to set an appropriate premium over fire-sale prices and use that across the board for accounting purposes when there's a fast market. This latter suggestion sounds appealing until the situation is reversed and it becomes clear that a regulator would have to impose discounted values on companies for accounting purposes if market prices were somehow judged to be over-exuberant.

PENSIONS, CORRIDORS AND YOUR SHOE SIZE Pensions present particular problems for accountants given the inherently uncertain, long-term nature of the liability. The IAS 19 requirement to mark assets and liabilities to (different) markets, combined with the leverage inherent in a funded defined benefit structure, results in volatile IAS 19 pension deficits for most companies.

To alleviate this volatility, IAS 19 currently permits a form of smoothing through what is referred to as the corridor method, which allows actuarial gains and losses (from marking to market) to be ignored unless they are material (outside the "corridor"). It is not an approach that meets with much enthusiasm among investors. Their scepticism is shared by Sir David Tweedie, chair of the IASB, who has memorably referred to this method on a number of occasions as equivalent to taking the loss and "dividing it by the cube root of the number of miles to the moon and multiplying it by your shoe size. It does not mean a thing."

Given this, it is not surprising to see that the latest IASB proposals include removing the corridor method as an option. Instead, companies applying international financial reporting standards (IFRS) will be required to do what many UK companies already do and recognise the volatility on their balance sheets.

Some people had feared that the IASB would require companies to

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book the full mark-to-market loss (or gain) in the profit and loss account, swamping operating earnings in many cases. This fear has proved groundless: operating earnings will remain untainted by volatility.

If the IASB is not going to permit the corridor method, then several questions will arise:

- How will investors feel about the balance sheet volatility that will be revealed across Europe?
- Can the IASB be persuaded to adopt alternative smoothing mechanisms by those who argue that a long-term structure such as a pension scheme should not be subject to short-term mark-to-market accounting?
- Aside from the accounting, what are the broader implications in terms of asset allocation within pension funds? Is economic volatility something to be avoided or embraced?

INVESTORS PLAY SPOT THE BALL Investors understand that defined benefit pensions are inherently complex and expose the sponsoring company to a variety of risks over a very long timeframe.

Many investors are also implicit unbelievers when it comes to the efficient market hypothesis. They wouldn't be active investors, trying to beat the market, if they genuinely believed that market prices were always right. However, many investors are uncomfortable when someone suggests that they have a method for determining the "right" price – a better value for pension assets than the current market price. Investors are happy to make their own decisions about value (and, unlike accountants, will back their views with real cash) but they tend to prefer the market's collective flaws when it comes to pricing rather than the "wisdom" of a board of directors, trustees or, dare one say, actuaries. Too many snake-oil pyramids have been sold on the back of such systems to encourage investor confidence.

By and large, investors understand the arbitrary nature of a spot value such as an IAS 19 pension deficit and its deficiencies when it comes to conveying information about the underlying structure. It is a little like judging an entire football season from one spot-the-ball photograph. What they really want to understand are the cashflow implications, a point I shall return to later.

LONG-TERM PRICES FOR LONG-TERM ASSETS The current IAS 19 corridor method provides a good test of whether smoothing mechanisms serve the needs of investors. Deficits are certainly less volatile for companies using this approach but the complexities of the method, and the fact that it is not universally used, mean that reported data collated by information services such as Bloomberg and Reuters is not comparable. Stock screens based on balance sheet data or simplistic sum-of-the-parts valuations will be wrong, and any investors relying on such tools will be in for a rude awakening when the IAS 19 changes take effect in 2013.

And here lies one of the fundamental problems with the "let's have long-term prices for long-terms assets" argument. Shares in the sponsoring company are not necessarily held by long-term investors, and their needs are poorly served by measures that ignore changes in present values.

CAPTAIN HOOK SURVIVED FOR MUCH LONGER BY ACKNOWLEDGING THE CROCODILE'S EXISTENCE – DENIAL WOULD HAVE BEEN A FATALLY FLAWED STRATEGY.

The riposte might be that we should be designing our reporting systems to satisfy the needs of the long-term providers of equity capital. We should certainly be very wary of doing anything that harms the willingness of pension funds to invest in companies since this equity investment provides a vital source of funds for economic growth. But even pension funds need to sell stocks at some point (as the fund matures, or for more tactical reasons), and at that point they will have to accept the market price set by the marginal buyers and sellers in the market.

Some people argue for less frequent measurement as an alternative way to combat accounting volatility, and to address the concern that providing volatile spot valuations to the market is affecting investor and company behaviour in a negative way. At the extreme this approach is akin to the well-established cartoon physics principle of "don't look down!", a strategy that has saved many a character after they have hurtled horizontally off a cliff. Not looking down allows you to continue as if on solid ground until you get to the other side. Not measuring financial assets at current value is equivalent to this. It's what therapists call "living in denial". And while denial is a comforting place to be in the short term, it is an unsustainable situation, particularly in a global market where in the absence of actual data it is relatively easy to make an intelligent guess and participants are incentivised to do so.

DOES VOLATILITY MATTER TO PENSION FUNDS? More important is the question of whether pension funds should be concerned about economic volatility and whether pension funds and their sponsoring companies could do more to help investors understand their economic exposures.

There isn't space here to discuss the different approaches that pension schemes might take to funding their defined benefit promises, but there is no doubt that investors (including potential acquirers) would find more information about the long-term cashflows very helpful. There is a significant risk that accounting volatility leads people to panic and do the wrong thing at the wrong time, and cashflow information would serve to remind investors that the deficit is simply a spot valuation, and would help them to understand better the four-dimensional nature of pension liabilities and the asset cashflows that back them.

If there are sound economic reasons for taking investment risks in the pension fund relative to the liabilities, then it would be far better to disclose the information and try to explain to the reader how they should interpret it, rather than try to persuade them that the volatility does not exist (one might call that the inverse Tinkerbell approach: "I don't believe in volatility, I don't, I don't!"). Captain Hook survived for much longer by acknowledging the crocodile's existence – denial would have been a fatally flawed strategy.

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