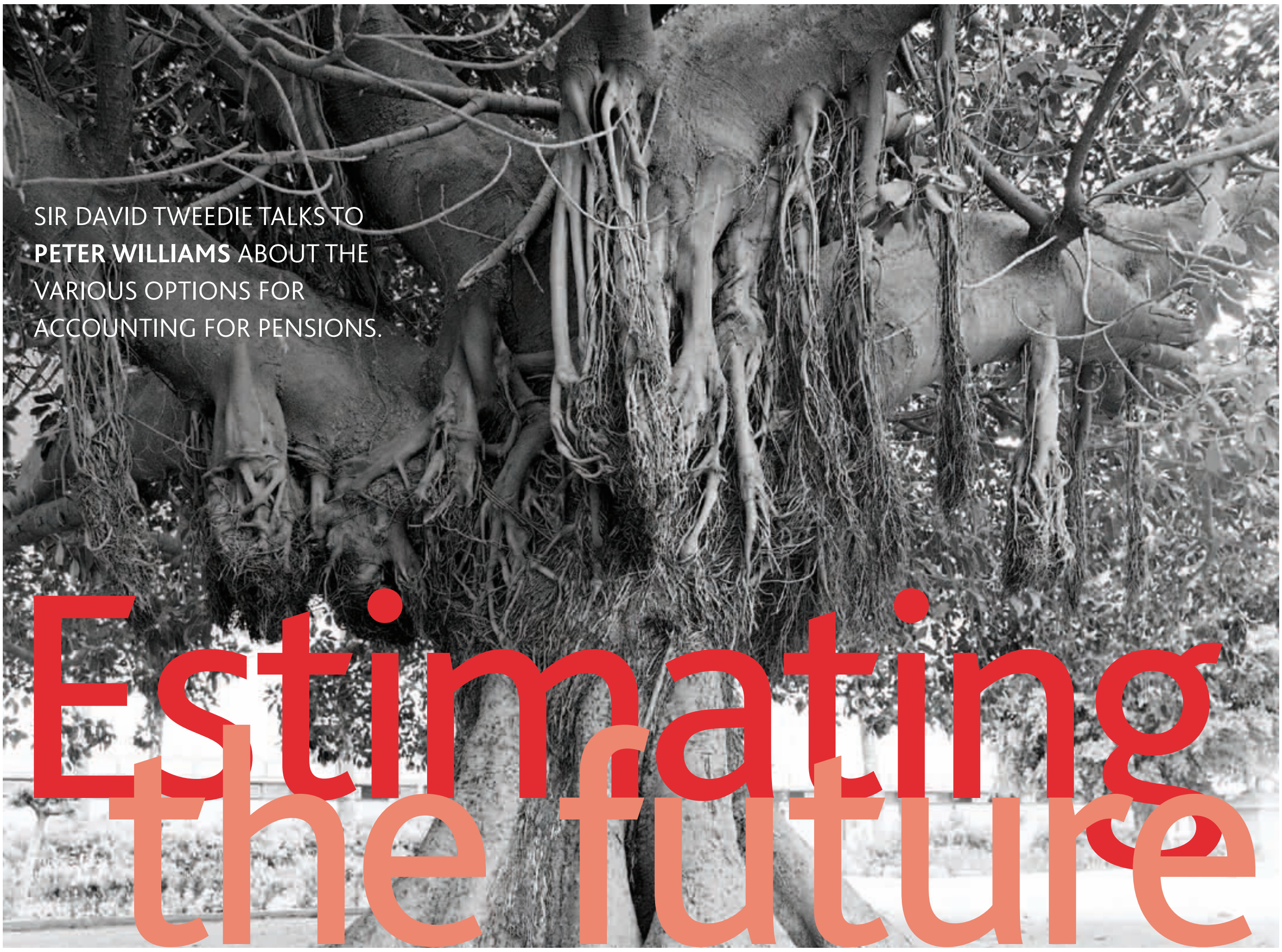

Estimating the future

SIR DAVID TWEEDIE TALKS TO **PETER WILLIAMS** ABOUT THE VARIOUS OPTIONS FOR ACCOUNTING FOR PENSIONS.

Executive summary

- The costs of pension schemes have to be recorded in financial statements. But while there may be consensus on that issue, significant questions remain for standard setters on the measurement bases to be adopted.

Accounting for pensions is such a seemingly impenetrable problem that there is no wonder that much of the debate is characterised by exasperation. Sir David Tweedie, the chairman of the International Accounting Standards Board (IASB) is used to dealing with the flak over the vagaries of accounting for pensions. But Tweedie typically gives a robust defence of the actions of the standard setters while freely admitting that accounting for pensions is far from perfect.

While difficult questions remain, Tweedie is convinced that progress has been made on the issue. For instance, he points to the amendments that the IASB has made to IAS 19 *Employee Benefits* to allow FRS 17 type accounting. He says: "We wanted to allow people who wanted to do FRS 17 to continue and we had a lot of support for that. The British respondents were all in favour."

Prior to the amendments, IAS 19 has been similar to the US standard No 87 *Employers' Accounting for Pensions*. But the FRS 17 type accounting solutions have put pressure on the US standard setters and in Autumn 2005 the Financial Accounting Standards Board (FASB) announced a comprehensive project to reconsider accounting for pension and other post-retirement benefits.

The US move has to be seen in the context of the February 2006 Memorandum of Understanding (MoU) between the FASB and the IASB where they both pledged to use "their best efforts (a) to make their existing financial reporting standards fully compatible as soon as is practicable and (b) to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained." Pensions is one of the items that Tweedie is hoping will be added to the MoU's agenda. Topics are added after due process such as gaining the agreement of the trustees and advisory councils.

According to Tweedie the question the stakeholders in the accounting standard setting process have to decide is whether they want a complete revamp of accounting for pensions or whether they want to tackle the more immediate and apparent problems. Tweedie says he is in favour of a more immediate solution rather than some long-drawn out process. "My view is that we should just target certain parts of the standard." Which ones Tweedie would target are not too hard for treasurers to guess.

MEASURING LIABILITIES One of the questions which keeps returning is how do you measure liabilities? Tweedie says: "Ideally you would go to a pensions provider and say this 'This guy is on a final salary scheme, how much to buy an annuity?' But the pension

provider would refuse to sell you an annuity on the basis that it is a final salary scheme where the salary could increase and the pension provider would be out of pocket. Such annuities are not available because of the moral hazard."

As Tweedie sees the situation, it may be possible to procure a valuation for the present value of a final salary pension but it is impossible to look to the market to provide a future value. He says: "It is difficult to obtain a market value for liabilities so we are left with estimations." The present pension standards are based on estimating the final salary but Tweedie asks the question why is that, why use estimated final salary and not the present salary?

RATING THE RATES The second seemingly intractable problem is rates – interest rates and the return on assets and, perhaps even harder to tease out, the discount rate that should be used for working out the liability value of pension plans. Tweedie is frank when he says: "We have problems in FRS 17 with the interest rate. The first time we [the UK's Accounting Standards Board] looked at it the advice was to base it on the return on the assets. But we decided that couldn't be right. If I invest in nothing but junk bonds I just don't slash my liability, I've still got to fund it."

The next proposal looked at by the ASB was to use the yield on equities. Tweedie says: "We thought that made sense because if companies do well, the yield on equities and salaries will go up. We found that the correlation between salaries and yield on equities was zero. So that was out."

Eventually of course the standard setters in the UK came down to the AA corporate bond because, as Tweedie says: "Everyone else around the world used it. We had given up by that stage, we had spent two years trying to find a discount rate."

And we all know what has happened as a consequence of the fixation on corporate bonds. Tweedie says: "In the present market people are trying to avoid volatility and that itself has created volatility by diving in on a very short supply of bonds. The yield has just disappeared so the liability has gone up. That's daft. But there is not a lot we can do about that. Whatever instrument we choose, if there is a shortage [of the instrument] that is going to happen."

So pick your instrument. Treasury bonds? Going forward Tweedie says that the standard setters have to involve themselves again with the actuaries as, in the UK, they did over FRS 17. Tweedie says: "The actuaries should give us their view along with the evidence of what they see as the better answer."

ON THE ASSET SIDE Liabilities aren't the sole cause of pension headaches. We have seen a distinct shift towards lower return on assets assumptions in the UK and the euro zone over the past few years, although this trend seems to be slowing in some regions.

However Tweedie points to what can only be called creative accounting (though he does not use those words) in terms of those assumed rate of return by some. Instead he suggests that "some of those estimates have been heroic".

In the period 2000-2004, research seen by the IASB suggested that the estimated revenue of the US S&P Top 500 was nearly 35% lower than the outturn. Because of the smoothing mechanisms permitted under the FASB accounting rules, the difference between expected and actual returns are accumulated off-balance sheet. In other words accounting rules have masked an increasing amount of corporate debt. As Tweedie asks: "Can we allow that to go on, how should we present it, FRS 17 style with gains and losses going straight into the statement of recognised gains and losses?"

The IASB also recognises that there are other disclosures and assumptions which really need to be tackled – longevity is the most obvious one. But if accounting standards are meant to reflect the real world then standard setters have the problem of trying to keep up with changes in the nature of the market and new products for pensions, just as in other financial areas.

Despite all the controversy over accounting for pensions, Tweedie remains optimistic that the standard setters are gaining broad support. He says that when FRS 17 was introduced in the UK he reckons the 100 Group of Finance Directors were pretty evenly split. He says: "After a couple of years people had stopped saying it was only a snapshot because trends had started to become apparent. FRS 17 happened at a time when pension funds were all going into deficit so it was difficult to argue it was irrelevant." The accounting standard FRS 17 performed a remarkable feat: it forced the subject of pensions onto the agenda in the boardroom, whereas under SSAP 24 *Accounting for Pension Costs* it remained largely hidden. Such lack of clarity encouraged companies to make promises they could not keep. Tweedie says: "If you needed funding of say £10m and you put in a payment of £11m, you showed a prepayment, an asset of £1m even though you may have a thumping great deficit. It just didn't show because SSAP 24 was a bad standard."

In contrast Tweedie praises the "very mature" way that British businesses are now facing up to the deficits in their pension schemes. He says: "Companies are looking at the deficit, the assets and the yield and working out how many years before they are back in equilibrium. People now know where they are coming from."

There will be many more problems in the years to come before the corporate pension problem could be described as solved, but maybe there is an increasing sense that people now know where they are coming from.

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