Whither IAS 19 or wither IAS 19?

On 10 November 2005, a small earthquake occurred in Norwalk, Connecticut: the Financial Accounting Standards Board (FASB) announced a major review of its FAS 87 *Employers' Accounting for Pensions* and FAS 106 *Employers' Accounting for Post-Retirement Benefits other than Pensions* standards. In terms of the proposed speed of implementation of the changes contemplated, this announcement was virtually unprecedented. The FASB announced that by the end of 2006, subject to consultation, reporting companies would be required to bring pension scheme and other post-retirement deficits onto their balance sheets. This is a seismic shift. It could, for example, add more than $50bn in liabilities to General Motors' balance sheet.

It was not generally appreciated at the time, but the Norwalk event was actually an aftershock. On 14 October 2005, in London, the Accounting Standards Board (ASB, part of the UK Financial Reporting Council, which is now also responsible for supervising the UK actuarial profession) had itself announced that it was undertaking research into the financial reporting of pensions that would encompass not just FRS 17 *Retirement Benefits*, but also the statement of recommended practice covering the preparation of accounts for pension plans themselves. Of course, FRS 17 and, to some extent, IAS 19 *Employee Benefits* were already more market-oriented standards than FAS 87.

The initial reaction of corporate America to the proposal to bring deficits onto the balance sheet was more muted than might have been expected, although the publication of the exposure draft at the end of March may give rise to a more vocal response over the coming months. The rating agency Standard & Poor's had already illustrated a lack of faith in the FAS 87 numbers by calculating and publishing its own "core earnings" figures.

ADVENTURES IN PENSIONLAND But the real surprise was the very public reaction of Bradley Belt, Executive Director of the Pension Benefit Guarantee Corporation (PBGC). The PBGC is, roughly, the US equivalent of the UK's much younger Pension Protection Fund (PPF) and itself had a deficit of $23bn at the date of its last accounts (2005). On 13 March 2006, Belt presented a paper to the National Association for Business Economics entitled *Through the Looking Glass: Adventures in Pensionland*. This was unusual for two reasons. First, the senior executives of US corporations seldom quote Lewis Carroll. Second, they hardly ever utter what is effectively public criticism of bodies such as the FASB. So what caused this break with tradition?

In his paper, Belt recited the many criticisms of FAS 87 that have been well known almost since its formulation in 1985, but did so with an uncharacteristic vehemence. This was all the more surprising given that the FASB had already conceded that major changes were overdue. One quotation in particular may give a general flavour of Belt's attack: "When we gaze upon the pension landscape, we are struck with the peculiar sensation that much of what we were taught – about economics, about corporate finance, about accounting – no longer applies."

Some of the points on which he expanded critically were:

- That companies can book to profits the expected return rather than the actual return on pension assets, encouraging them to invest in riskier assets;
- That a dollar's worth of stocks is considered more valuable than a dollar's worth of bonds; and
- That asset values can be disguised by 'smoothing', allowing losses to be presented in small 'slivers' and thereby smoothing earnings.

Although Belt resigned from his position "to pursue other interests" within 10 days of presenting this paper, it is clear that the PBGC is likely to be lobbying the FASB hard on each of these points. It is also worthwhile considering what the FASB itself had to say when it announced the review.

THE DEVELOPMENT OF FAS 87 In common with other accounting standards, FAS 87, first released in 1985, has continued to be developed. Significant enhancements have included:

- Statement No 106 (1990), which applied similar practices as in FAS 87 to post-retirement benefits other than pensions; and
- Statement Nos 132 *Employers' Disclosures about Pension and Other Post-Retirement Benefits* (1998) and 132R (2003), which revised employers' disclosures about pension and other post-retirement benefits to enhance the information disclosed about changes in the benefit obligations, the fair value of plan assets and cashflows.

The objective of the FASB's November 2005 project was to improve the reporting of pensions and other post-retirement benefits in financial statements still further by making information more useful and transparent for investors, creditors, employees, pensioners and other users. The FASB accepted that the accounting and reporting issues were broad and complex, and did not lend themselves to a simple fix, but said it believed that improvements were necessary and

PHIL TURNER AND **JOHN HAWKINS** EXAMINE THE INTERNATIONAL MOVES ON ACCOUNTING FOR PENSIONS.

Executive summary

- Setters of accounting standards across the world are wrestling with reform of accounting for pensions, and doing so at a breakneck pace. But some major questions remain unresolved, and the impact on corporates, especially in the US, could be tremendous.

should be addressed immediately.

The project was divided into two phases. Phase 1, which is expected to be finalised by the end of 2006, seeks to improve financial reporting by requiring that the funded or unfunded status of pension and other post-retirement benefit plans, measured as the difference between the fair value of plan assets and the benefit obligation (in other words, the projected benefit obligation in the case of pensions and the accumulated post-retirement benefit obligation for other benefits), should be recognised on the balance sheet. Much of this data is currently reported in footnotes. The exposure draft has also indicated that inclusion of pension data at the same date as company data (rather than up to three months earlier) will become mandatory.

Phase 2, which is broader and has not yet been assigned a target completion date, will comprehensively address remaining issues, including:

- How best to recognise and display in earnings and other comprehensive income the various elements that affect the cost of providing pension and other post-retirement benefits;
- How best to measure the obligations, in particular obligations under plans with lump-sum settlement options;
- Whether more or different guidance should be provided regarding measurement assumptions; and
- Whether post-retirement benefit trusts should be consolidated by the plan sponsor.

As is usual in such cases, the FASB has said that it will consult widely in seeking the views of interested parties. Furthermore, consistent with its effort towards international convergence of accounting standards, the FASB has said that it expects to work with the IASB and other standards-setters.

IMPORTANT AND CONTROVERSIAL The likelihood of the FASB adopting the pension accounting project had been widely discussed in advance, so it was no surprise in October 2005 when the ASB had announced a similar project, noting that accounting for pensions remained one of the most important and controversial areas of financial reporting. The main point made by the ASB was that the legal and regulatory environment for company pension schemes in the UK had changed dramatically and in an unexpected way since the publication, in 2000, of FRS 17. In particular, it cited the following events as having had a major impact:

- A new statutory obligation on solvent companies to meet their pension obligations;
- The establishment of the Pension Protection Fund to provide a partial safety net for employees; and
- The establishment of the Pensions Regulator, with significant new powers.

The ASB project, which is intended to conclude during 2006 with the issue of a discussion paper, will reconsider the fundamental principles of pensions accounting and address, among other issues, the following questions:

- How should the relationship between an employer and a pension scheme best be reflected in a company's financial statements?

- How should the employer's liability in respect of pensions be quantified (including the choice of discount rate, allowance for future salary increases, actuarial method, and so on)?

- What exactly is the expected "return on assets" and how should this be reflected in the company's financial statements?

- What is the impact of financial reporting of pension plan regulation arrangements, such as the Pension Protection Fund levy?

- Are the disclosures currently required sufficient and appropriate – for example, in relation to liabilities that might arise in the event of a takeover?

- Are the requirements for the financial reports of pension schemes appropriate – for example, in relation to the liability to pay pensions (see *Box 1*)?

To facilitate this project, the ASB has set up a broad-based Pensions Advisory Panel in the UK, the main role of which is to ensure that a number of knowledgeable points of view are fully considered. There is also a European working group that brings continental experience to the project.

The changes under consideration would, if implemented, have an effect on both liabilities and earnings, although perhaps not to the

BOX 1: Accounting for pension schemes

In the UK, the accounts of pension schemes are prepared in accordance with a statement of recommended practice, recommended by the Pensions Research Accounting Group and recognised by the ASB. Although compliance with a statement of recommended practice is usually voluntary, the pension statement is unusual in that its adoption was virtually mandated by the 1995 Pensions Act and continues to be mandated by the 2004 Pensions Act. The pension statement does not require schemes to recognise any liability to pay pensions and other benefits falling due after the end of the current scheme year and, in practice, such liabilities are indeed not recognised by schemes in their accounts. This is in direct contrast to the actuarial valuations that have to be produced by the scheme and the accounts that have to be produced by the scheme's sponsor. In essence, pension scheme accounts produced according to the statement are no more than a statement of net assets, together with a fund account. Although some conceptual difficulties would have to be dealt with – for example, would any shortfall be shown as a receivable from the sponsor? – it must be considered likely that the statement of recommended practice will not survive the scrutiny of the current ASB review unchanged.

The approach of excluding long-term liabilities is not adopted in many other jurisdictions, including the US, where pension plan accounts are prepared in accordance with FAS 35. The FASB has not indicated that this standard will be reviewed along with FAS 87 and 106, although several board members have said that it does not make sense for the plan and the employer to assign different values to the same obligation. It would be logical for FAS 35 to be reviewed in the second phase of the FASB project.

extent of those already caused by the adoption of FRS 17 or IAS 19 (see *Box 2*). As an aside, those companies that have not already done so will need to consider the impact of adopting one of these existing standards on financial covenants contained in loans and other documents (see *Box 3*).

In the meantime, the ASB has renewed its commitment to international convergence (to which it sees this project contributing) by issuing an exposure draft of proposed amendments to FRS 17 that will align the FRS 17 disclosure requirements with those for IAS 19. At the same time, unable to resist the temptation to move forward the IAS 19 disclosure requirements, the ASB issued a draft "reporting statement" in an effort to establish additional disclosures as best practice. The proposals include disclosure of the mortality assumption and the current buy-out cost.

The ASB's reporting statement proposals should provide further information for analysts which will be valuable where companies have relatively large pension liabilities. It is significant that the additional guidance talks about the level of additional disclosure depending on the extent of pension exposures and consequent risks – in other words, there should be more disclosure where the issues are important, rather than for all companies regardless. It will be interesting to see whether the companies facing the largest exposures choose to respond.

IAS 19 IS FLAWED The IASB has already accepted informally that IAS 19 is flawed and there is evidence that it considers FRS 17 a more robust standard and therefore the model for any changes that will be made to IAS 19. At least one important regulatory body, the Financial Services Authority (FSA) has never been convinced by IAS 19, or FRS 17 (see *Box 4*).

Notwithstanding this, it would appear that the IASB has not yet responded formally to the FASB or ASB announcements about the reviews of FAS 87 and FRS 17. However, it is equally committed to international convergence and it is therefore probable that it will seek to work actively with the FASB and ASB to ensure that revisions to FAS 87, FRS 17 and IAS 19 are as compatible as possible.

Presumably this will depend to some extent on IASB resource availability and an indication from the FASB, as far as the US standard is concerned, that it is prepared to consider the degree of radical change that would be required to bring FAS 87 towards the present FRS 17. This might have seemed unlikely even a few months ago, but it is even possible that the reverse might now be the case, with the

BOX 2: FTSE 350 impact of possible UK changes

The changes under consideration by the various standard boards could have a significant impact on reported numbers in the UK. This box describes the possible effect on FTSE 350 aggregate pension data at today's values of some possible changes to IAS 19.

ABO instead of PBO The logic for recording projected rather than accumulated benefit obligations has always been marginal. A switch would save around 5% of the gross liability, amounting to some £21bn net of tax, or 1% of market capitalisation. In the US the effect would be more dramatic.

Risk Free Discount Rate instead of AA Corporate Bond Rate Thirty years ago the eminent economist, Jack Treynor, set out the theoretical arguments why a risk-free discount rate should be used and these have never been satisfactorily refuted. There is also the practical issue that, certainly in the UK, and to a lesser extent in the US, there is a real shortage of AA bonds of sufficiently long maturity. Assuming a spread of 60 basis points between AA bonds and government securities, this would increase the gross liability by around 12%, equivalent to £42bn net, or 2% of market capitalisation. Historically, spreads in the US have been closer to 100 basis points.

A pension promise is not without risk. There are plenty of pensioners in the UK receiving less than their promised benefits who bear testimony to the risk (now reduced by the Pension Protection Fund). The issue is whether it is appropriate for a company to allow for the fact that it may default on a promise when it values that promise.

Substitution of Expected Returns by Actual Returns The inclusion of expected returns on investments, historically justified on the grounds of the 'long term' nature of plans and the avoidance of unnecessary volatility, may not survive the assault of the 'mark to market' generation. Theoretically, this should be neutral in the medium/long term as long as realistic returns are being assumed. However, volatility in the profit and loss account would obviously increase. A compromise that is sometimes discussed is to retain the expected return, but only at the risk-free interest rate. This would reduce reported profits by around £8bn, equivalent to approximately 5% of aggregate pretax profits.

BOX 3: Accounting standards and financial covenants in loans

Both borrowers and lenders are currently struggling to cope with the introduction of international financial reporting standards with regard to financial covenants in loans, especially IAS 39.

Practice varies, but the commonest way of dealing with IAS 19 (and FRS 17) has been to exclude the pension deficit from the definition of debt; banks have not so far pushed for its inclusion. However, once IAS 19 becomes embedded and retrospective adjustments would not be required, the logic for this disappears (despite a more volatile total debt number), especially given that it is inconsistent with the broad approach adopted by the credit rating agencies.

Dealing with the impact of IAS 19 adoption on net worth is a little more complicated, since in many cases it will have been reduced and there is little argument for adding back the reduction. Presumably, any companies that would have required waivers and/or amendments have already obtained them, or are in the process of doing so.

For cashflow and income statement-related covenants, the main impact of future changes might well be greater volatility through the inclusion of actual rather than expected returns on pension assets.

BOX 4: Regulatory capital and pensions accounting

In 2005, the Financial Services Authority recognised that the actuarial gains and losses that would be recorded under FRS 17 and IAS 19 could be large and volatile. It therefore provided an optional easement for the companies it regulated that had to submit quarterly capital returns. In these returns, a company may use a "deficit reduction amount" rather than the pension liability shown in its report to shareholders. This amount is defined as the undiscounted sum of the additional funding, net of tax, which will be required to be paid into that scheme by the firm over the following five-year period for the purpose of reducing the firm's defined benefit liability.

IASB finding it difficult to swallow changes such as the inclusion of actual as opposed to expected returns in income statements.

Tweaking IAS 19 was always likely, but its successor may now be almost unrecognisable. However, Charlie McCreevy, the EU's internal market commissioner, has been quoted as saying that while convergence in accounting standards is desirable, the introduction of radical new concepts is not. In March 2006 the EU announced a new working relationship with the European Financial Reporting Advisory Group (EFRAG) in a move designed to strengthen European influence over the IASB.

One interesting feature of the proposed changes to FAS 87 is that the actuarial gains and losses recognised (immediately) outside the profit and loss account will subsequently be "recycled" through the profit and loss account on a gradual basis using the existing mechanism of deferral, 10% corridor and spreading outside the corridor. This is a way of resolving the tension between recording accurate liabilities in the balance sheet and a fair representation of long-term costs in the profit and loss account. A similar approach was considered for FRS 17 but rejected.

Given the fast-track nature of the FASB and ASB projects, the possibility of increased mandatory disclosures in the short term must now be considered even more likely, the most probable area being mortality assumptions and their justification. The lack of these is frequently commented on in the press and company equity analyses, although the accounts of several FTSE 100 companies published this year have included voluntary disclosures, albeit on an inconsistent basis. It may also be noticed in passing that the PPF liability must generally be calculated using the 1992 Pensions Act's mortality tables with the medium cohort adjustment, apparently still a stronger assumption than that used by some, if not most, major companies.

Another area where increased disclosure is likely to be required is information on valuation bases other than FRS 17/IAS 19 – for example, the estimated PPF and buy-out liabilities/deficits. There are clearly strong arguments for at least the latter. Risk is completely removed only when the liabilities are settled. The Pensions Regulator perhaps had this in mind in the Marconi/Ericsson transaction.

The proposed consultation by the PPF on the introduction of an asset liability matching element to the risk based levy may also have an effect on accounting disclosure in due course. While the proportion of plans invested in various asset categories is already required, asset matching under any PPF regime may well involve consideration of the relative duration of assets and liabilities, so that increased disclosure in this area is also possible. This may in itself lead to increased disclosure of derivatives used for duration adjustment and related collateral arrangements.

In attempting to produce a satisfactory international standard there is one other important issue that should be considered: the degree to which a pension deficit is a real liability of the sponsor. Although the relative position between the US and the UK has swung to and fro over the years, it is now clearly the case that the liability is more onerous in the UK following the passage of the 2004 Pensions Act. Picking this up in any accounting standard would be difficult, if not impossible.

FOCUS ON BALANCE SHEET VALUES A look into the crystal ball reveals that the focus on balance sheet values should continue for the foreseeable future and that pension deficits or surpluses should be reflected on company balance sheets by way of immediate recognition of actuarial gains and losses under a converged international accounting standard. However, it would be a surprise if any attempt were made to adjust the assets or liabilities to reflect the substantial differences in the true value to the company of surpluses or deficits in different countries. The picture is less clear when measurement issues are considered, such as the choice of discount rate and the allowance for future salary growth.

The next few years should be interesting. What will corporate America do to shed the huge pension and post-retirement medical benefit liabilities identified by the revised FAS 87 standard? How can companies with a multi-year pension benefit legacy compete with newer rivals offering little or no post-retirement provision (in the US or overseas)? And how will the US experience be translated into the more heavily regulated European market?

These questions will have more than a passing interest for the post-war baby-boom generation approaching retirement.

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