

It could pay to keep up on pension changes

Expect a heated debate on accounting for pensions. The IASB has kicked off with proposals for significant change, and if you want to influence the discussion you need to get involved now, argue **Richard Keys** and **Richard Davis**

There are some problems in accounting that refuse to go away. There have been arguments about what to do with deferred tax, goodwill and the impact of changing prices for decades, and accounting for pensions is another subject one might include in that illustrious list. Post-retirement benefits, including pensions, are on the IASB agenda and in March the board issued a discussion paper representing its first proposals for significant change in this area.

At this stage, the IASB's aim is to eliminate some of the deferred recognition and smoothing mechanisms permitted or required by the current standard, IAS 19, and to address perceived problems in respect of plans that have features of both defined benefit and defined contribution.

Deferred recognition to go?

Some would argue that getting rid of the deferred recognition options allowed under IAS 19, in particular the 'corridor approach' to recognising actuarial gains and losses, is an overdue and much-needed fix to ensure a meaningful balance sheet. The approach of recognising actuarial gains and losses immediately was adopted in the UK some time ago. At the time, many plans were falling into deficit after a prolonged period of surplus, which made the new standard unpopular with the corporate community. Immediate recognition was introduced into IAS 19 in 2005, but only as an option, with the result that most European companies and a minority of UK companies include some other number in their balance sheet that bears little discernable resemblance to the current surplus or deficit in the pension plan.

Smoothing considered inappropriate

Equally, many would say that recognising an assumed rate of return on plan assets in the income statement, irrespective of the actual return, does not reflect reality. When equity markets fell in the aftermath of the dotcom boom, there were many examples of companies recognising an expected return on plan assets that was greater than their disclosed profit (or loss) for the year. Furthermore, if estimates prove to be on the high side, the bad news gets reflected in equity and does not impact on the income statement.

Where should the expense go?

The next question addressed in the discussion paper is where the resulting pension expense should be recognised – an expense that is potentially large and highly volatile. Various models are being considered, ranging from recognising everything in the income statement to recognising only certain items. A common feature of all of the proposals, however, is that more of the components of pension expense would be reflected in the income statement. Whether this would increase or reduce profit or loss would depend on

market movements and how good actuaries' predictions have been.

Is it fair to fair value?

Finally, the IASB proposes a radical new approach to pension plans that have features of both defined contribution and defined benefit plans. So called 'contribution-based plans' entitle a member to benefits that are expressed in relation to a contribution, for example a percentage of current salary plus some form of indexation or return, such as the return on a pool of assets or a stock market index.

The discussion paper proposes that obligations in respect of such plans should be measured at fair value. This could have significant practical implications. If fair value means exit price – and there have been indications from other IASB projects that that is a likely direction of travel – then this might be equivalent to the cost of buying an annuity from an insurance company. In many countries, the mortality assumptions used by insurance companies are more conservative, or perhaps less optimistic, than those used by pension funds, and the yields underlying annuity contracts are seldom as high as the high-quality corporate bond yields. So the value placed on a pension liability from a contribution-based plan could be considerably higher than the value placed on the same pension payable from a defined benefit plan.

What next?

These proposals represent the first phase in the IASB's project. An important topic not yet addressed is the measurement of defined-benefit obligations. A discussion paper issued in January by the European Financial Reporting Advisory Group (EFRAG) and certain European standards setters – under the auspices of the Pro-active Accounting Activities in Europe (PAAinE) – has suggested that pension obligations should be measured using a risk-free rate rather than the corporate bond rates currently used.

Some actuaries estimate that this change could add as much as 25% to pension plan liabilities and significantly increase reported deficits. But if the fair value model proposed for contribution-based plans was to be applied to all defined benefit plans, the impact could be even greater.

Although the IASB's discussion paper represents only the first step on what could be a very long road towards a new accounting standard, those who want to influence the debate will need to get involved now.

Richard Keys is the global chief accountant at PricewaterhouseCoopers. Richard Davis is a pension specialist in the Global Accounting Consulting Services group at PwC.