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2 September 2008

PensionReforms comments on proposed changes to IAS19

Background

PensionReforms is a website run by the University of Auckland's Retirement Policy and Research Centre with the help of an international board of contributing editors – see here for the list of editors. Started in October 2006, PensionReforms is building an online, searchable, sortable library of reviewed papers on all aspects of pensions (public and private) and retirement issues from around the world. Currently, there are 227 mostly academic research reports and these are being added to at the rate of 2-3 a week.

PensionReforms aims to encourage high quality debate on pension issues by making research easily accessible to anyone with an interest in the area. Not only does PensionReforms summarise the reports covered (and give direct, on-line access to the original paper) but it also says what it thinks of each report's conclusions.

Recent abstract on IASB proposed changes

PensionReforms has just published an abstract that reviews an OECD paper on changes proposed to IAS19. What follows is the front page "thumb nail" - the link goes straight to the abstract.

> Shareholders (and others) need to know the expected cost of Defined Benefit pensions that managers promise former employees. Past rules had unintended consequences. Is the proposed IAS19 any better? Probably not. more

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PensionReforms' summary and comments

The OECD has looked at the proposed changes announced in March 2008 by the International Accounting Standards Board (IASB) to International Accounting Standard No. 19 (IAS 19). As the OECD notes, this report is not a complete review; just comments on what might be some of the more "key and controversial issues".

"The ultimate goal of the current changes and future changes is to have an accounting standard in place that provides information in company financial statements about pension and other post-employment benefits that is transparent and of high quality."

Looking across markets, both national and international, the rules that govern how companies' accounts are presented and how contingent obligations, like pension promises are valued should be similar so there is an undoubted need for reporting standards. Shareholders, lenders, regulators and employees all need good, comparable data here.

"IAS 19 is the current standard for the financial reporting of company pension obligations. It is required for exchange-listed companies in many parts of the world. If enacted, the changes to IAS 19 proposed by the IASB are expected to have a significant impact on company financials on a global basis."

The OECD report is a contribution to the comments on the proposed changes that the IASB is seeking – these proposals are said to be interim in nature but are expected to go into effect in 2011.

"For the longer-term, a comprehensive overhaul of the standards for pension accounting is planned. Furthermore, the IASB and its counterpart organisation in the United States have agreed on a convergence project and it is expected that the international and the American pension accounting standards will at some point in the future converge."

The OECD does not directly criticise the IASB's proposals to reform reporting but indicates they will cause greater volatility. PensionReforms suggests that the proposed changes may end up confusing things further. We will no longer have Defined Benefit and Defined Contribution schemes. The first category will remain but the second goes and will be replaced by a new category of pension promises termed "contribution-based".

"In this new classification system, the defined benefit category will include such plans as traditional final average pay plans. The new contribution-based category will include defined contribution plans, cash-balance plans and other hybrid-type plans, as well as career-average plans."

To PensionReforms, this seems an odd distinction and one that seems to misunderstand, from an accounting perspective, the reasons for the difference between the two types of scheme. On the one hand, a benefit is defined and (relatively) certain but the cost is completely unknown and is therefore underwritten by the employer. In the other case, the cost is certain but the benefit is completely unknown and the risk is borne entirely by the members. In the first case, someone (usually an actuary) has to make some informed guesses about the sponsor employer's expected future liability to support the benefit promises. In the second case (Defined Contribution) there is no such uncertainty for the employer.

The issues here seem simple enough to PensionReforms – IAS19 should treat schemes with any element of uncertainty about future employer costs (including promised or minimum returns) as Defined Benefit. There is no need for Defined Contribution reporting standards other than, perhaps some statement that the schemes are Defined Contribution.

"Most significantly, the proposed measurement of pension obligations for the new category of contribution-based promises will change considerably, including a requirement to adjust the pension obligations to take into account the credit worthiness of the sponsoring company. In addition, the IASB proposes to do away with all existing mechanisms for smoothing the effect of short-term market fluctuations on pension plan obligations and plan assets."

PensionReforms suggests the credit worthiness of a sponsoring employer may well affect whether it can actually deliver on the future promises of any kind but that fact affects whether or not it will be in business at all. PensionReforms wonders why that requirement applies only to so-called "contribution-based promises" but not Defined Benefit promises. The OECD also wonders why and the fact that the IASB itself acknowledges inconsistency seems a good enough reason for the IASB to have another go at this.

Getting rid of smoothing also seems to PensionReforms to be a backward step. The value of a pension scheme's assets today is directly relevant if the employer proposes winding the scheme up and has to answer for balance of the cost of the scheme's past promises. Any other view of assets and liabilities should be on some basis that equates to what used to be called a 'going concern'. Shareholders, creditors, employees, trustees and members will almost certainly not be helped by measures that have assets swinging markedly from one year to another when there is no immediate reason for that to be relevant.

"It is important to remember that the current IASB proposal is an interim step to a long-term goal. Is the proposal going in the right direction, and with this long-term goal in mind, what would we like the future of pension plans and pension plan financial reporting to be?"

PensionReforms thinks not. In PensionReforms' experience, most CFOs and many auditors cannot explain the numbers required by the present IAS19 and that should indicate a fundamental problem with the rules-based regulation preferred by the IASB. PensionReforms prefers a principles-based approach that everyone can understand. The likely outcome of a revised IAS19 will be that more employers will get rid of any arrangement that requires the attention of IAS19. That will make life for accountants simpler and that's perhaps the main purpose of the proposed changes. However, that would, in PensionReforms' view, be a backward step.

The IASB wants comments on their proposed changes before 26 September 2008.