Pensions accounting: the future

ACA Sessional Meeting
19 October 2006

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Why does accounting matter?

- **Visibility of liabilities (sometimes large)**
- **Volatility—but is it real?**
- **Design/existence of pension plans**
- **Asset allocation**

How should accounting regulators factor these in?

Background

- UK standard (FRS17) fully effective 2005
- Much comment, some conflicting:
  - size of liabilities (too big or too small?)
  - disclosures
- New pension regulation in the UK
- International and US thinking

Who is doing what

- FASB
  - initial phase standard out (Sept 2006)
  - comprehensive reconsideration to come
- IASB
  - interim standard under development
  - will develop a converged standard with FASB
- ASB
  - revised disclosure proposals
  - comprehensive project under way
    - *includes pension scheme accounts*

ASB's disclosure proposals

- Conform FRS17 with IAS19
- Non-mandatory additional disclosures
  - funding obligations
  - sensitivities of scheme liabilities
  - more on assumptions (mortality)
  - relationship between employer and trustees
  - buy out basis

Comprehensive project Objective

- Discussion Paper to inform the development of a new accounting standard that can be applied globally
- Principles-based approach
  - examine fundamentals
  - integrate with current/emerging thinking

Other relevant IASB work

- Conceptual framework
- Non-financial liabilities (IAS 37)
- Consolidation
- Measurement
- Reporting financial performance
- Insurance

Conceptual framework: IASB preliminary views

- Objective is decision usefulness
  - focus on value of future cash flows
- stewardship downgraded
  - less emphasis on transactions and their consequences?

What does the balance sheet try to represent?

- Value of future cash flows?
- Residues of past transactions?

Comprehensive project
Working method

- Pensions Advisory Panel (meets monthly)
- EFRAG working group established (meets quarterly)
- Significant ASB staff resource
- Papers copied to IASB and FASB staff
- ASB, EFRAG TEG, NSS updated
- Updates on ASB website

Discussions to date

- Scope – mainly (but not exclusively) pensions
- Defining the liability
  – nature of pension promise
- what future events are included?
- Who has the liability?
- How should separate funds be reflected?
  – individual and consolidated financial statements
- Surpluses
- Defined benefit /defined contribution/cash based schemes

An infallible accounting method

- Wait!

A fallible accounting method

- **Attempt to produce a snapshot at a point in time**
  - **requires separating past from present**
  - **or (perhaps equivalently) separating new *information* from new *events***

Defining the liability

- Only present obligations give rise to liabilities
  - legal obligations or
  - constructive obligations
- Present obligations should be recognised as liabilities if they can be measured reliably
- Distinguish obligations relating to
  - past events
  - effects of future events on current liability

What is the present obligation?

- Vested benefits are in
- Guaranteed increases in vested benefits are in
- Unvested benefits are in (?)
- Possible future changes to benefits are out (?)
- Right to join a plan after a period of service is in—but may be of small value

Discretion

- Does discretion matter?
  - some believe all expected payments should be in (discretion affects measurement)
  - others believe only present obligations should be in (discretion affects definition)
- Future salary increases – in or out?
  - view that final salary pension promise is more valuable (PBO)
  - view that it is a reward for *future* service (ABO)
  - view that some inflation should be reflected

Who has the liability?

- Assets held to settle a liability
  - part of employing entity, or
  - held by separate entity (e.g. trust-based fund)

- Individual financial statements
  - does the employer retain the obligation to pay benefits?

    OR

  - does the fund assume the obligation to pay benefits

- What if the employer guarantees?

Should a fund be consolidated?

- Current standards exempt funds from consolidation
- IASB consolidations project – control test
- Trust-based funds (and similar entities)
  - powers and duties of trustees may preclude control by employer
- Consider special purpose entities

Implications of a principles based approach!

Measurement—assets

- Why depart from market value?
- Decision to retain might imply that owner believes an asset is worth more than market

BUT

- Owner can realise market value
- Equivalent assets can be acquired at market value

Why should a pension fund hold significant assets that do not have a ready market?

Measurement—liabilities

- We need a measurement objective, or premise of value
- Discounting future cash flows is a calculation technique—not a measurement objective

Measurement—liabilities

- Entry value— value of services received
  - reflects value of exchange with employee
  - but is it measurable?
  - how to update?
- So some kind of exit value?

Measurement—liabilities exit values

- Cost of settlement in ordinary course (by paying pensions)
- Buy out amount?
- What if there is no buy out market? Is buy out then relevant?
- Lower of buy out or settlement?
  - Why would they differ
- and what about credit risk?

Presenting gains and losses

- **Assume operating, financing and 'other' model**

- **<u>Operating</u>**
  - **service cost**
- **<u>Financing</u>**
  - **interest on liabilities**
  - **return on assets**
- **<u>Other</u>**
  - **changes in estimates (some or all)?**

‘Actuarial’ gains and losses

- Liabilities
  - differences between estimated and actual mortality, pension increases, etc
  - changes in estimates of future mortality, pension increases, etc
  - changes in discount rate
- Assets
  - differences between expected and actual return

Presenting gains and losses some views

- Changes in assets and liabilities should be recognised immediately, in the year they arise. (No non-recognition or amortisation)
- actual (total) return on assets should be used; expected return has no place
- the concept of actuarial gains and losses is probably not useful

Solomons on pensions accounting (October 1998)

- service cost is increase in liability attributable to current service (not contributions)
- obligations should be discounted at an annuity rate
- include future salary increases
- assets should be valued at market value
- net asset or liability asset should be recognised
- no smoothing of income
- disclose sensitivity analysis
- pension funds should sometimes be consolidated

In conclusion

- Challenges are many
  - Not all are discussed here
- Existing standards have insufficient conceptual backing
- ASB/EFRAG Discussion Paper 2007

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