

News Alert 2011/03

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Company pensions accounting overhauled – new IAS 19 published

At a glance

On 16 June 2011 the International Accounting Standards Board (“IASB”) published its long-awaited new version of the international pensions reporting standard IAS 19. The new version changes how pensions are reflected in company profits and balance sheets, and requires further disclosures in the notes to accounts.

Key Actions

Companies

Urgently review how profits and balance sheets will be affected by the new rules, for example in profit forecasts for 2012 and beyond, and consider early adoption of the new standard.

Plan how the company’s pension obligations and risks will be presented to investors under the new rules, both at the time of change and in future accounts.

Understand the consequential impact of the new accounting rules on other areas, such as investment strategy and any de-risking measures currently being considered.

Investors

Understand the impact of the new accounting standard on company accounts and on methods used to value companies.

Trustees

While there are no immediate actions for trustees, they will no doubt want to keep abreast of these developments because of their wider significance for the accounts of sponsoring employers.

The Detail

The new version of IAS 19 follows a long process of consultation, with a discussion paper in 2008 and an exposure draft last year. The new standard will be mandatory for accounting years beginning on or after 1 January 2013, with earlier adoption permitted. For a company with a 31 December balance sheet date:

- The new standard will first apply for the 2013 accounts; and
- The 2012 profits and balance sheet shown in the 2013 accounts as prior year comparators will need to be restated according to the new rules (along with any other prior year comparator figures provided).

Comment

Given the timing, companies should consider the impact on 2012 profit forecasts, to assess the overall impact and to decide whether to adopt the revised standard early (which may be advantageous in certain cases).

Summary of key changes

Abolition of the expected return on assets	Under current IAS 19, the return a company expects to achieve on its pension plan assets is credited to profit. Under the new standard, the credit to profit will be calculated using the discount rate. In many cases the discount rate is lower, resulting in lower profits.
Abolition of the “corridor”	The “corridor” method, used by a minority of companies in the UK, allows the impact on the balance sheet of market movements and other experience to be smoothed. Companies currently using the corridor (including many companies in continental Europe) will see a big change to balance sheets and increased volatility, as well as a significantly different calculation for the pension cost.
Revised disclosure requirements	All companies will see substantial changes to the information about pension plans they are required to give in the notes to the accounts, which are intended to give investors more insight into the nature of the plans and the associated risks.
Other changes	There are numerous changes to the detail of the standard, including rules on special events, accounting for the running costs of plans, and changing the accounting for some plans that share risks between the employer and employees.

Comment

While the changes are considerably watered down compared to the IASB's earlier proposals, they still achieve the IASB's key objectives of removing the lack of comparability inherent both in the option to use the corridor method and in the expected return on assets. By removing these they have produced a shorter, more objective standard, but have also added requirements to give more information for investor scrutiny.

No more profits from anticipating asset outperformance

The "expected return on assets", which is credited to profits, reflects a company's view of the expected return in future and is therefore inherently subjective. The new standard removes the expected return on assets, removing this subjectivity from pension costs. In place of the current expected return on assets and interest cost, there will be a single net interest figure, calculated using the discount rate.

Comment

The removal of the expected return will be unwelcome news for many companies, as it will wipe a considerable amount off headline profits for those with investment portfolios with "performance" assets such as equities. Conversely, some companies with more conservative investment strategies will see higher profits.

Past experience suggests that changes in accounting rules can influence company decision-making, and the removal of the credit to profit from holding performance assets may speed up the move away from equities. Companies will wish to consider the timing of any such switches in order to avoid additional cash-calls, ideally using "intelligent switching" to capture any good performance.

While this change may help investors comparing companies using international standards by removing the subjectivity of expected returns, many such companies will find themselves at an apparent disadvantage compared to their US peers who will continue to enjoy higher headline profits due to "expected" returns above the discount rate. It is disappointing that this appears to be a step away from the path of convergence, that would see a single set of accounting numbers adopted for all international companies in the US and elsewhere.

No more corridor

While the removal of the corridor increases standardisation and clarifies balance sheet deficit figures, it also brings potentially significant short-term volatility to the balance sheet for companies currently using the corridor. Many firms in continental Europe will see an immediate negative impact.

Comment

The loss of the “corridor” will be a challenge for some companies and an opportunity for others. For example, if it causes a reduction in distributable reserves, it could reduce competitiveness on dividend policy for some companies using international standards.

More disclosures

Whilst certain disclosure items can be removed, and there is a move not to mandate disclosures, it is likely that overall more disclosures will be required. Disclosures will generally need to include sensitivity analyses on key assumptions as well as a number of additional narrative disclosures.

To give just one example, companies operating multi-employer plans will face new reporting requirements. The prevalence of such plans should not be underestimated; they are common in the US, the Netherlands, Sweden and many other countries. Companies will need time to prepare the information required. If this is to be done for the December 2011 year-end, by way of an exploratory test run, processes will need to be thought about in the second half of 2011.

Comment

The new disclosure rules will mean a real change for companies. Instead of specifying what companies should tell investors about their pension plans with a set of detailed rules, the IASB is setting out principles and objectives alongside a list of requirements to help meet those objectives. We welcome this approach, although it remains to be seen how it will work in practice.

Other changes

There are a number of changes to the details of the rules. These mean that:

- companies whose balance sheets are affected by rules on an “asset limit” (and associated rules in “IFRIC 14”) will see these rules have an impact on their profits for the first time;
- the new rules affect accounting for special events, including enhanced transfer values, closure to accrual, and benefit changes;
- while the IASB have backed away from earlier proposals that would have forced companies to reserve for the running costs of pension plans in advance, the changes will still influence the way that many companies account for the running costs of their plans; and
- there are changes to the distinction between defined benefit and defined contribution plans, which could see some plans, particularly abroad, treated as

defined contribution instead of defined benefit – radically changing the accounting figures.

Comment

The devil is in the detail, and companies should ensure that their plans and profit forecasts take account the numerous changes to the accounting standard that could affect their figures.

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