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INSURANCE AND PRIVATE PENSIONS COMMITTEE
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RECENT DEVELOPMENTS IN PENSION ACCOUNTING

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Executive Summary

1. In March 2008, the International Accounting Standards Board (IASB) published proposed changes to International Accounting Standard No. 19 (IAS 19). 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.

2. The IASB's proposed changes are interim in nature and 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 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.

3. The proposed IASB changes are significant and this paper identifies and discusses some of these changes, as well as, the likely impact they will have on exchange-listed companies reporting in accordance with IAS 19. In particular, the IASB proposes to do away with the current classification of pension promises as either defined benefit or defined contribution. Rather, they have introduced a new classification. In the proposed new version of IAS 19, pension promises will either be considered defined benefit or they will be considered to be in 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.

4. The proposed new version of IAS 19 calls for other changes, as well. 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.

5. Given that these proposed changes by the IASB are an interim step in a long-term process towards an ultimately new method of accounting for companies' pension promises, it is important to consider whether or not the scope and direction of the current changes are appropriate. It is also important to consider how these changes are likely to shape how companies design, finance and think about the pension promises they offer to their employees.

6. The IASB are accepting comments on their proposed changes until 26 September 2008.

I. Introduction

7. In March 2008, the International Accounting Standards Board published a discussion paper outlining their vision of the future international standard for the financial reporting of company pension obligations. The proposed changes are considered an interim step to improving standards for the financial reporting of company pension obligations and are expected to go into effect in 2011. A comprehensive overhaul in addition to the current proposed changes is planned for the long-term.

8. The scope of the current interim review of IAS 19 as described by the IASB covers the following topics:

- Accounting for benefits that are based on contributions and a promised return;
- Accounting for benefit promises with a “higher of” option;
- The deferred recognition of some gains and losses arising from defined benefit plans; and,
- The presentation of defined benefit liabilities.

9. This paper explores the implications of some of these proposed changes, including a discussion of the effects these proposed changes may have on exchange-listed companies reporting under IAS 19. We have not covered all the changes proposed by the IASB but have attempted to focus on some key and controversial issues.

10. The purpose of this paper is to provide background information on the planned reforms of IAS 19. The paper is not intended to give an opinion of how the OECD may or may not wish IAS 19 to evolve.

11. The IASB’s full proposal can be found at www.iasb.org in their March 2008 discussion paper titled “Preliminary Views on Amendments to IAS 19 Employee Benefits”.

II. Discussion of Proposed Changes

12. The scope of the current interim review of IAS 19 covers a number of topics, some of which will mean substantial changes from how companies are currently accounting for their pension promises. In this paper, we have focused on some key proposed changes.

II.1 Accounting for Benefits that are Based on Contributions and a Promised Return

13. The main change that the IASB is proposing is the introduction of a new classification for pension promises. Pension promises will no longer be classified as defined benefit or defined contribution. Rather, pension promises that fit the specifications listed below will be classified as “contribution-based” promises. Any promises that do not fit this category will be classified as defined benefit.

14. The IASB proposes to define contribution-based plans as follows:

A contribution-based promise is a post-employment benefit promise in which, during the accumulation phase, the benefit can be expressed as:

- *The accumulation of actual or notional contributions that, for any reporting period, would be known at the end of that period, except for the effect of any vesting or demographic risk; and*
- *Any promised return on the actual or notional contributions is linked to the return from an asset, group of assets or an index. A contribution-based promise need not include a promised return.*

15. The new contribution-based promise category includes defined contribution plans and cash-balance plans. What appears to be one of the most controversial points of the proposed changes is that career-average pension promises will no longer be classified as defined benefit, but rather will be included in the contribution-based category. The reason the IASB gives for this classification of career-average plans as contribution-based is that there is essentially no difference between a career-average plan and a cash-balance plan that offers a fixed rate of return of 0%.

How will the Measurement of Pension Obligations be Affected?

16. According to the IASB, the proposed changes are not expected to have any significant impact on defined contribution plans. Also, the measurement of the pension obligation (termed “DBO”¹) for traditional final average salary defined benefit plans will not change. Further, post-employment life insurance plans and post-employment medical plans have not been considered within the scope of the IASB’s review and their measurement should not change.

17. The measurement of the DBO for career-average plans and cash-balance plans, which the IASB proposal classifies as contribution-based, will change significantly. The IASB’s preliminary views are that a so-called “fair value” measurement should be applied to determine the benefit obligation associated with these contribution-based pension promises (which for consistency will also be called “DBO” in this paper). It is not completely clear how this fair value measurement will be made. It appears, however, that to value a contribution-based pension promise, all future cash-flows scenarios would need to be estimated and then weighted by their respective probability of occurring. These probability-weighted estimated cash-flows

¹ DBO stands for Defined Benefit Obligation and is a measurement of the pension plan’s obligations in relation to past service pension benefits of the existing plan members.

would then be discounted for the time-value of money at some type of market rate. The DBO for contribution-based promises would further be adjusted for the credit worthiness of the company sponsoring those pension promises.

18. In comparison, pension promises that are classified as defined benefit will continue to be valued based on one scenario of future cash-flows based on the sponsoring company's best-estimate assumptions, and then discounted by the yield available on high-quality corporate bonds. No adjustment for credit worthiness should be made when calculating the DBO for defined benefit pension promises.

19. If the proposed changes are enacted, this will mean that companies will need to apply different assumptions, different calculation methodologies and different complexity levels in determining the pension obligations for their defined benefit and their contribution-based pension promises.

How will the Measurement of Pension Obligations be Affected: Retirees and Deferred Members

20. As discussed above, the DBO for pension promises that are defined benefit and the DBO for pension promises that are contribution-based would be calculated in fundamentally different ways, regardless of whether the plan's members are actively accruing benefits, in retirement or in deferment. This can lead to some inconsistencies.

21. To illustrate an inconsistency that could arise, consider the following scenario where two age-65 individuals retired on the same day, from the same company, with the same pension benefit:

- Individual A receives a pension annuity of €1,000 per year. While he was still actively working, he accumulated his benefit in the company's **career-average** pension plan.
- Individual B receives a pension annuity of €1,000 per year. While he was still actively working, he accumulated his benefit in the company's **final average pay** pension plan.

22. Given that Individual A and Individual B are both retired, are the same age and gender and are receiving the same amount of pension benefits each year, the future payments the company is expected to make to each of them are identical. The only difference between the two individuals is that their pension benefits accrued in different manners while they were still actively working.

23. The current version of IAS 19 would assign the same value to the DBO associated with Individual A as the DBO associated with Individual B. The new version of IAS 19 would most likely require different values for the DBO for Individual A and Individual B. The reason for this is that the proposed new version of IAS 19 would require the DBO for Individual A who was in the career-average plan to be valued as the price in the market for an annuity of €1,000, adjusted to reflect the credit worthiness of the company. However, the DBO for Individual B who was in the final average pay plan would be valued as the present value of the expected future cash flows, with no adjustment made for the creditworthiness of the company and using a discount rate based on high-quality corporate bonds. The IASB admits that the inconsistency of methodology and assumptions in this situation is a problem in their proposal.

24. A further issue is the practical administrative implications for companies with many deferred and retired members. In order to determine which of the two valuation methodologies to use, companies that have offered both defined benefit and contribution-based pension plans to their employees at some point in the past will need to identify which of their deferred and retired members accrued their pension benefits in

which historical plans. For some companies, for instance, those with a long history of acquisitions or divestitures, this could be a cumbersome, if not impossible administrative task.

II.2 Accounting for Benefit Promises with a “Higher-of” Option

25. Some pension plans offer their members a pension benefit that is the higher of a defined benefit promise and a contribution-based promise. For instance, a pension plan could offer a member the higher of the balance in the member’s defined contribution account and a lump sum based on the member’s final salary at retirement.

26. The IASB has decided not to classify these types of benefit promises that include a “higher-of” option as contribution-based. One reason that the IASB gives for this is based on an example. Consider a pension promise that is overwhelmingly defined benefit in nature with a very small “higher-of” option attached. Given the distinctly different valuation methodologies required for defined benefit and contribution-based plans, if this plan was classified as contribution-based, then the accounting for this plan could be significantly different than would be the case for a pension promise that was identical in all respects, but that did not have the very minor “higher-of” option attached.

27. Rather, the IASB proposes that when valuing and accounting for a benefit promise with a “higher-of” option, the defined benefit portion of the pension promise and the “higher-of” portion of the pension promise should be separated from each other and treated in distinctly different ways. The defined benefit portion would be valued and accounted for just as any other defined benefit promise. The remaining “higher-of” portion of the promise would be valued and accounted for as a contribution-based promise.

II.3 The Deferred Recognition of Some Gains and Losses Arising from Defined Benefit Plans²

28. Historically, the financial reporting of company pension obligations has allowed companies to “smooth” the effect of market fluctuations on the pension plan assets and obligations that get reported in

² In the following sections, we discuss the concept of:

- A company’s balance sheet; and,
- A company’s statement of profit & loss.

The company’s balance sheet is published in the Annual Report at the end of each fiscal year and shows a snapshot picture as of the last day of the fiscal year as to the company’s total net worth. In other words, the balance sheet shows the total value of the company’s assets and the total value of the company’s liabilities as of that particular day. The company balance sheet would also include the value of the assets and liabilities associated with the company’s pension plan.

A company’s statement of profit and loss is also published in the Annual Report at the end of each fiscal year. It shows the total of the company’s revenues and expenses over the past fiscal year. On a very simplified basis, the statement of profit and loss indicates whether or not the company was profitable that fiscal year: If the amount of money that came in during the fiscal year in the form of revenue exceeded the amount of money that the company paid out in the form of expenses, then the company would have made a profit. Alternatively, if the company paid out more money in the form of expenses than the revenue they brought in, then they would have made a loss. A company’s statement of profit and loss would also include the past year’s cost of running the company’s pension plan.

the company's balance sheet. This means that the financial position of a company's pension plan at a particular point in time could be reported as significantly better funded or worse funded than would be the case if no smoothing was used and the actual assets and liabilities of the pension plan were reported. The IASB proposes to eliminate the ability to use smoothing.

How Does Smoothing Work under the Current Version of IAS 19

29. Under the current version of IAS 19, companies are allowed, but are not required to use smoothing. The companies that do use smoothing must follow a series of relatively complex rules which we describe briefly below.

30. What happens in practice for companies that use smoothing is that the value of a company's DBO and the pension plan assets are determined at the beginning of each fiscal year. The DBO and the plan assets are then projected to the end of the fiscal year using best-estimate assumptions. These best estimate assumptions would include estimates as to the expected salary increase over the course of the year, the number of people leaving the company, the number of people retiring, etc. It would also include an estimate as to the expected return on plan assets over the course of the fiscal year. At the end of the fiscal year, the company's DBO and plan assets are remeasured. The difference between the expected DBO at the end of the fiscal year and the actual DBO, as well as the difference between the expected plan assets and the actual plan assets at the end of the fiscal year are called "actuarial gains or losses":

**DBO Actuarial Loss/(Gain)
for the fiscal-year**

= actual DBO at fiscal year-end
less
expected DBO at fiscal year-end

**Plan Asset Actuarial Loss/(Gain)
for the fiscal-year**

= expected plan assets at fiscal year-end
less
actual plan assets at fiscal year-end

31. The actuarial gains or losses that arise over the course of a fiscal year due to actual experience differing from beginning-of-year expectations do not affect a company's balance sheet position as of the end of the fiscal year, nor do they affect the company's statement of profit and loss over the course of that fiscal year. Rather, any actuarial gains or losses over the course of the fiscal year would be listed as an "accumulated unrecognized actuarial gain or loss" together with any existing unrecognized actuarial gains and losses from prior fiscal years.

**Accumulated unrecognized
actuarial loss/(gain)**

= actuarial loss/(gain) that arose in current
fiscal year

plus

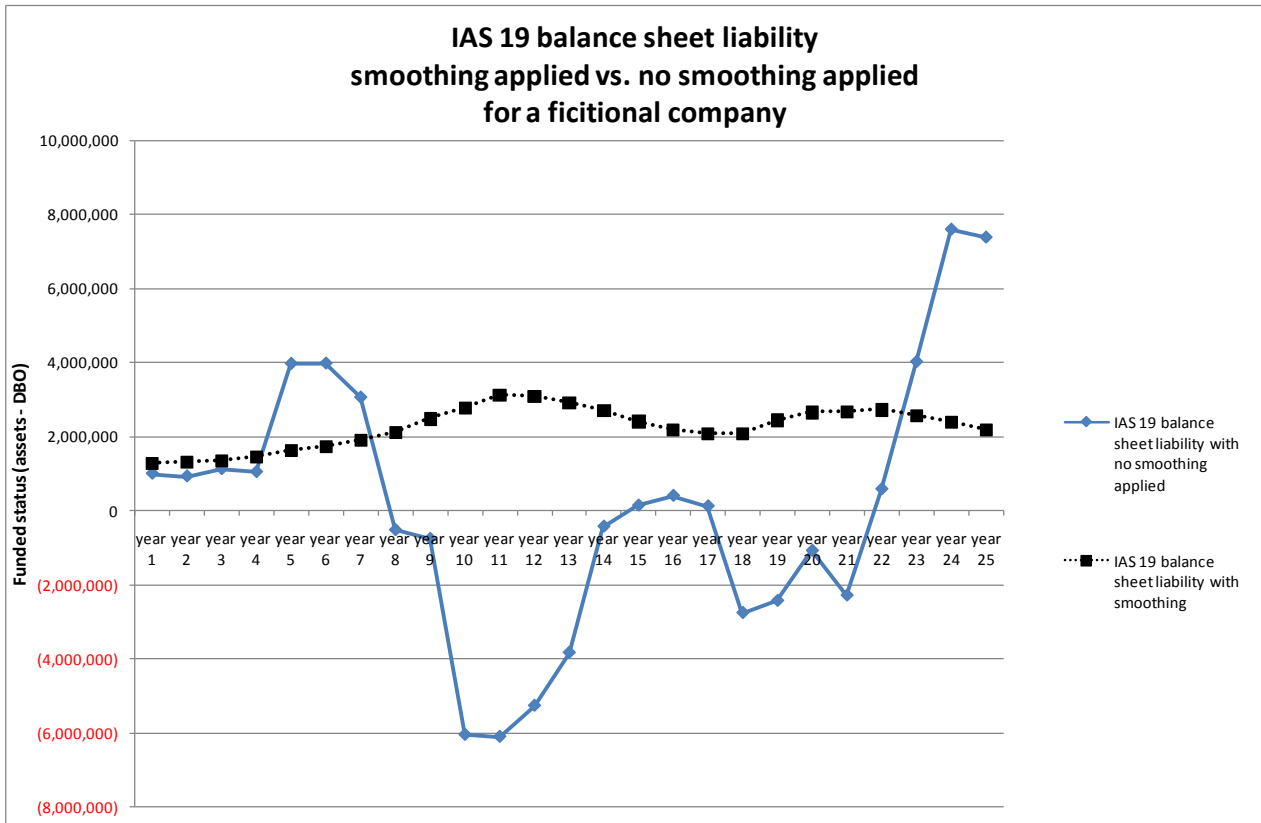
any remaining unrecognized actuarial gains and
losses accumulated from prior fiscal years

32. Once these accumulated unrecognized actuarial gains and losses exceed a pre-defined "corridor" amount³, the excess would need to be incrementally recognized in the company's statements of profit and loss over future years. The incremental recognition is done by taking the excess amount and dividing it by the average number of years the company's active employees are expected to remain in service with the company (and accruing benefits within the pension plan). For each of those future years, that amortised excess amount will need to be added to the company's profit and loss statement.

33. What these complicated rules mean in practice is that swings in the financial markets or adverse demographic experience within the plan do not immediately affect the company's financial statements or its profit and loss. In fact, if an experience loss in one year is offset by an experience gain in a subsequent year, then these gains and losses may never need to be recognized. Ideally, over the life of a pension plan, years with bad financial experience would balance against years with good financial experience to offer smoother financial results. However, this method of smoothing unexpected gains and losses also means that good or bad experience within the pension plan could have an effect on the company's financial statements many, many years into the future.

34. To illustrate, the following example shows the evolution over 25 years of a fictional company's pension plan balance sheet liability if no smoothing of actuarial gains and losses is applied. This is compared to the balance liability value that could be booked under the current version of IAS 19 if smoothing was used.

³ The total accumulated unrecognized actuarial gain or loss is amortized over the future average working lifetime of the active employees in the plan to the extent that they exceed 10% of the greater of the pension plans assets or DBO.



35. As can be seen by the dotted line representing the fictional company’s balance sheet liability for its pension plan with smoothing applied, it is significantly less volatile than the balance sheet liability with no smoothing applied.

36. Proponents of the smoothing techniques allowed by IAS 19 state that smoothing protects the pension plan which is a very long-term promise by the company to its employees from short-term swings in financial markets. For instance a drop in bond yields of 1% could in some cases increase a pension plan’s DBO on the order of 20%-30%. Proponents of smoothing argue that these types of short-term fluctuations have little meaning on the long-term sustainability of the pension plan or the company’s ability to pay future promises. Rather, bringing such extremely volatile short-term effects into a company’s financial statements on as much as a quarterly basis has the undesired effect of making the decision of offering employees a defined benefit pension plan a decision based on arbitrary and often changing accounting rules, rather than a decision based on the long-term financial sustainability of the pension plan and the company’s remuneration policy towards its employees.

37. Critics of smoothing argue that such techniques hide the true financial status of the pension plan. Pension obligations are like any other company obligation and should be treated as such. Furthermore, smoothing produces a distorted picture of reality with complicated and hidden off-balance sheet liabilities. For instance, why should a company be allowed to show a financial gain in the pension plan in a year when assets could have performed poorly and liabilities could have increased more than expected? Alternatively, why should a company have to show a financial loss in a year that assets and liabilities developed better than expected?

38. The IASB falls into the second of these two camps. Their preliminary view is that “entities should recognise all changes in the value of plan assets and in the... (DBO)... in the financial statements in the period in which they occur”. In other words, the proposed changes to IAS 19 will do away with smoothing.

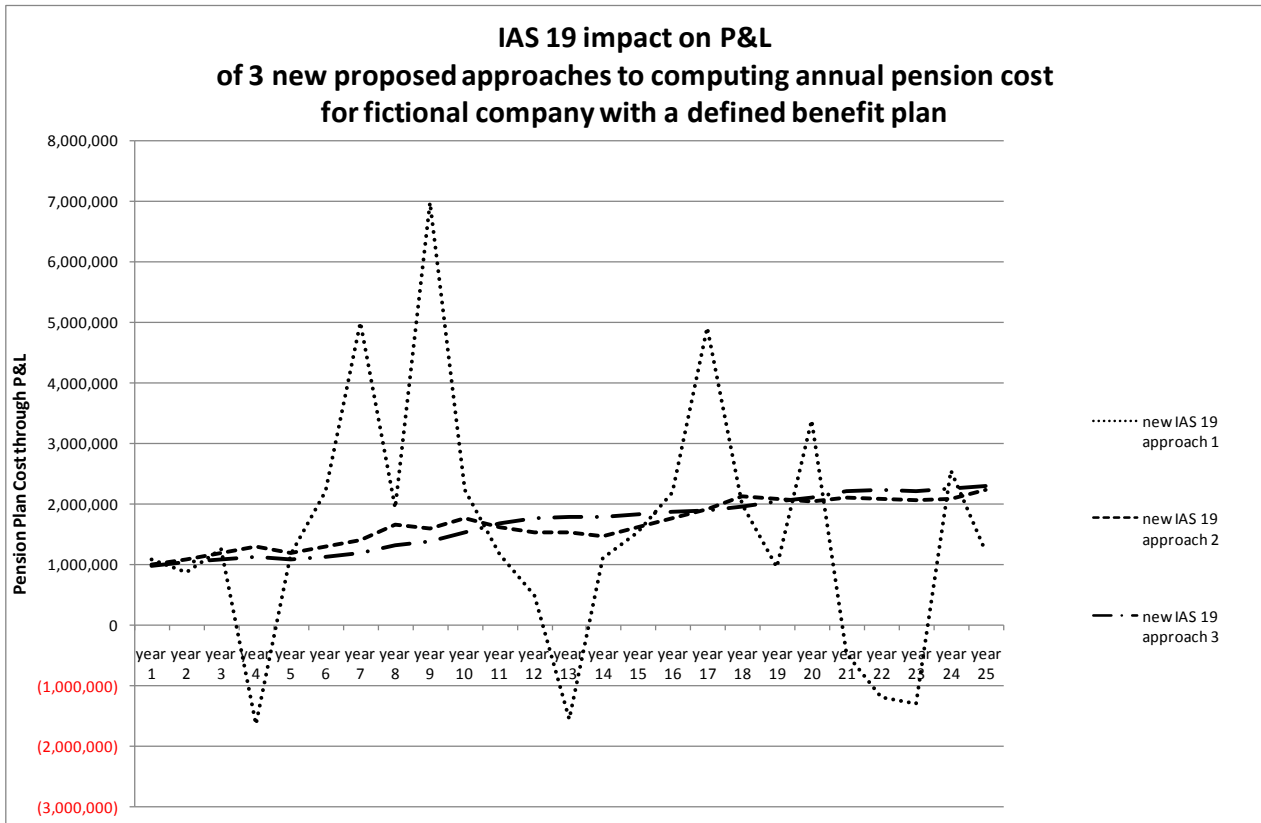
II.4 The Presentation of Defined Benefit Liabilities

39. The final IASB’s proposed change that we discuss is how the changes in plan assets and DBO over the course of a fiscal year should be recognised in a company’s financial statements. In other words, what portion of the changes to the DBO and plan assets should affect the company’s bottom line by being recognised in its statement of profit and loss, and what should be accounted for elsewhere in the financial statements.

40. The IASB presents three possible approaches to how changes in the DBO and assets that arise in a particular year should be recognised.

41. The first approach would mean that all changes in the DBO and plan assets would be taken through a company’s statement of profit and loss. The second and third of the approaches make a distinction between the treatment to be made for defined benefit pension promises and the treatment to be made for contribution-based promises. For contribution-based promises all changes in the DBO and plan assets would be taken through a company’s statement of profit and loss just as in the first approach. For defined benefit pension promises, a portion of the change in DBO and assets over the course of the fiscal year would be taken through the statement of profit and loss and the remainder through an accounting item that is separate from the statement of profit and loss called “other comprehensive income”. The IASB states that they regard the first of their suggested approaches “as the least complex to implement and understand”, but they do not clearly state which of the three approaches they prefer.

42. To illustrate the various approaches under consideration, the following chart shows the impact the various approaches would have on the statement of profit & loss for a fictional company’s defined benefit pension promise:



43. For contribution based promises, the second and third approaches are identical to the first approach.

44. The first of these approaches suggested by the IASB is perhaps the most simple of the three, but it also would introduce the most volatility into the statement of profit and loss. The second and third suggested approaches would produce a more stable pension cost through the statement of profit and loss, but are more complex to compute.⁴

45. In the fictional example shown above, approaches 2 and 3 produce fairly similar results and do not represent a significantly different impact on the statement of profit and loss than would be had under the current version of IAS 19.

⁴ In approaches two and three, the remaining portion of the change to the DBO and plan assets over the course of the fiscal year would be taken through “other comprehensive income” which is an accounting item outside of the statement of profit and loss.

III. Conclusion

46. The IASB's proposed changes to IAS 19 will significantly affect how company's design, finance and think about their defined benefit and hybrid-type pension plans. The new changes will make pension plan financial results more accurately reflect current market reality, yet they will also make those results much more volatile. Also, the new category of contribution-based promises will likely become more and more important as company's move further towards plans that involve risk-sharing with their employees.

47. 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?