CORPORATION PENSIONS AND IAS 19 – HOW NEW ACCOUNTING STANDARDS WILL CHANGE THE WAY COMPANIES MANAGE THEIR PENSIONS

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Since the introduction of the International Accounting Standards for employee benefits (IAS 19) in 1980, they have influenced the way corporate sponsors manage their pension funds. With every new revision of the standard since, the short-term financial impact of Defined Benefit (DB) pension funds on their sponsors has increased. As a result, DB pensions have become an increasingly unpredictable drag on companies' profits.

The latest version of IAS 19, introduced in June 2011, represents a considerable step towards even greater transparency with respect to pensions. Consequently, companies are likely to take a new look at how they manage pension risk. By reviewing the new elements introduced into IAS 19, we can assess the effects these new standards will have on companies with DB pensions.

Timeline	Amendment
01 January 1983	IAS 19 Accounting for Retirement Benefits in Financial Statements of Employers
01 December 1993	IAS 19 Retirement Benefit Costs (revised as part of the 'Comparability of Financial Statements' project)
01 February 1998	IAS 19 (1998) Employee Benefits
01 May 2002	'Asset Ceiling' amendment to IAS 19 (2000) Employee Benefits
29 April 2004	Exposure Draft of Proposed Amendments to IAS 19 about recognition of actuarial gains and losses
22 May 2008	IAS 19 amended for 'Annual Improvements to IFRSs 2007 with regard to negative past service costs and curtailments
20 August 2009	Exposure Draft of proposed amendment to IAS 19 relating to discount rate
01 October 2009	Exposure Draft of proposed amendment to IAS 19 relating to discount rate will not be finalised
29 April 2010	Exposure Draft Defined Benefit Plans published.
16 June 2011	Amended IAS 19 issued
01 January 2013	Effective date of June 2011 amendments to IAS 19

Figure 1: Timeline – the development of IAS 19[1]

Pension liabilities in Europe

If we look at companies listed in the main stock indices of European countries, companies listed in the UK have the greatest International Financial Reporting Standards (IFRS) pension obligations (€250 bn) followed by Germany (€150 bn) the Netherlands (€135 bn), and Switzerland (€105 bn). However, seen from the perspective of market impact, by viewing the IFRS pension obligations as a percentage of the market capitalisation of companies, IFRS pension obligations have the greatest impact on Dutch companies, followed by Germany and the UK (as shown in Figure 2). For this reason, we will look here at the largest listed Dutch corporations as an example to explain the impact of the latest changes in IAS 19.

[1] Source: Deloitte IAS Plus

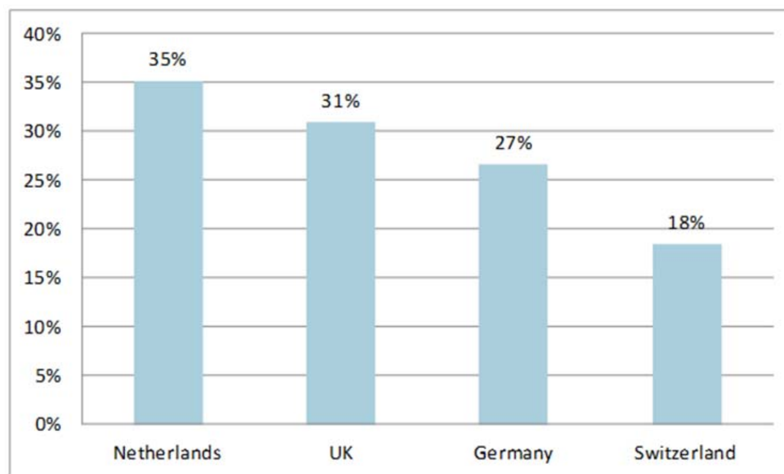

Figure 2: Gross IFRS pension obligations as percentage of share price/market capitalisation (2010)

IAS 19 today

IAS 19 covers all forms of consideration given by an entity in exchange for services rendered by employees, including short-term employee benefits, post-employment benefits, and other long-term employee benefits and termination benefits. It describes how pension benefits are accounted for on the balance sheet and on the profit & loss account of a corporate sponsor.

Defined Contribution and Defined Benefit plans

Under IAS 19, a pension plan can be either defined contribution (DC) or defined benefit (DB); this classification has profound accounting implications.

DC plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and has no legal or constructive obligation to pay a further contribution if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. DC plans do not require valuation, and the accounting requirements are limited to reporting contributions: these can be found on the income statement as contributions due, and on the balance sheet as unpaid/paid contributions.

DB plans are defined as all post-employment benefit plans other than DC plans. For DB plans, the employer's obligation is to provide the agreed amount of benefits to current and former employees (legal and constructive), and all actuarial and investment risks are retained by the employer. DB plans require actuarial valuation (except for multi-employer plans and insured plans), which makes reporting more complex. Also, the valuation still allows for many assumptions to be made by the sponsoring corporation itself, which may obscure the true financial risk of a Defined Benefit Pension fund. As DC plans do not require valuation, this article will focus on the impact of IAS 19 on companies with DB pensions.

Changes to IAS 19 and the impact on company results

The International Accounting Standards Board (IASB) published proposed changes to IAS 19 in April 2010. In June 2011, the final amended IAS 19 standard was issued. The changes described in the new IAS 19 will probably be applicable from 2013, with early adoption permissible, although this will be subject to EU endorsement. In phase II, the IASB will perform a comprehensive review of the accounting for employee benefits. New changes are not expected before 2018.

With the latest change in IAS 19, companies will be most affected by the:

- Removal of the 'corridor' approach
- Elimination of the assumption for the expected return on assets
- Removal of recognition of gains and losses in profit and loss (P&L)
- Immediate recognition of plan amendments in P&L
- Application of mark-to-market and 'ceiling tests' on plan assets; and
- Increased disclosure requirements.

The IASB has developed a new method of reporting changes in the plan's obligations and assets, splitting it into three components:

1. Service Cost Component: This will be reported in P&L and contains the current service cost, past service costs (that is, the full impact of any plan amendments or curtailments) and the effect of any settlements.
2. Net Interest Component: This will be reported in P&L and contains the net interest income or expense on the plan's surplus or deficit.
3. Remeasurements: This component will be reported in Other Comprehensive Income (OCI) and contains the impact of gains and losses, any assumption changes (like longevity changes), actual return on assets (excluding amounts included in the Net Interest Component above), and changes in the effect of the asset ceiling.

After the change – how risk will affect results

With the removal of the corridor approach, the limitation of amortisation possibilities, and the application of interest rates instead of average return on assets, corporate balance sheets and P&Ls will change. In general, pension volatility will have a greater impact on company balance sheets as a result of the immediate recognition of remeasurements. In the graphs below, the impact on the largest listed Dutch companies is shown, by calculating their balance sheet provision and P&L expense before and after the introduction of IAS 19.

Figure 3 shows the balance sheet impact of the change on combined AEX companies.

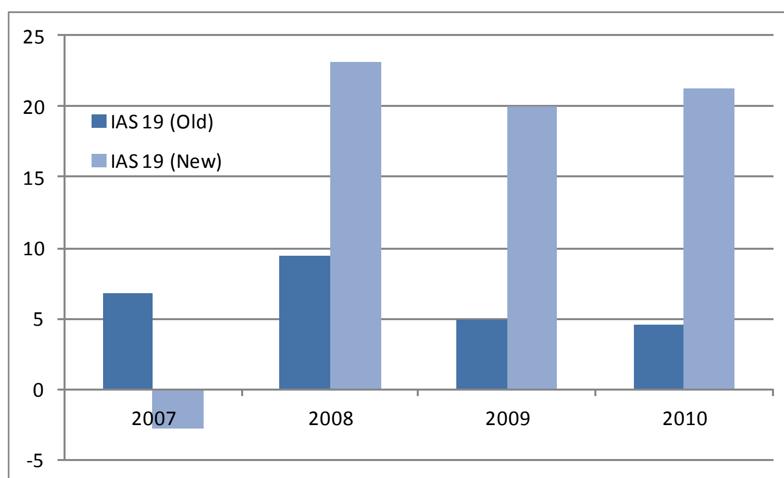

Figure 3: The balance sheet provision of the combined AEX companies (in € bn)[2]

[2] Source: PriceWaterhouseCoopers (PwC).

In the past, the corridor of 10% was able to dampen funding increases or deficits. Increases in longevity, for instance, could be amortized, and would therefore not always show up in the provision. The current remeasurements component will have to be reported immediately and therefore show up in the balance sheet and the OCI. Due to the removal of the corridor approach, and the immediate recognition of remeasurements, the balance sheet will become more volatile, and, in the case of these Dutch sponsors, showing a larger provision, and hence an increase in corporate debt.

In addition to this, any funding deficit or surplus will now have to be discounted at the high quality corporate bond rate (the net interest component), which will decrease funding ratios for those companies that are used to assuming a high average return on assets. The example in Figure 3 shows this increase in volatility and deficit for Dutch companies. US and UK-based pension funds in particular have historically had a higher equity component in their pension assets and therefore any existing deficits that they have may increase more than is the case with their Dutch counterparts.

Figure shows the expected P&L impact on the largest Dutch corporate sponsors. The combination of amortization, financial expenses and service costs has now been replaced with operational and financial expenses. Operational expenses are a direct translation of service costs, which are equal to the new liabilities discounted at a high quality bond rate. However, financial expenses now signify the increase or decrease in expected assets, using the same high quality bond rate as for liabilities (net interest component) as an average return, instead of the expected rate of return of those assets. Any real returns or losses will flow through the OCI. The result is a less volatile P&L but with increased pension expenses for most corporate sponsors. If in the past these sponsors were used to a high average rate of return, the pension expenses will increase under the new IAS 19.

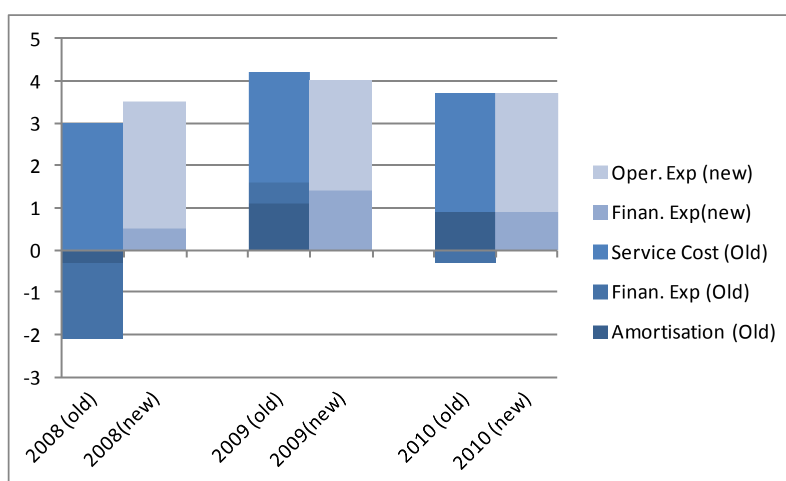

Figure 4: The pension expense of the combined AEX companies (in € bn)[3]

In addition to the direct impact on the balance sheet and profit and loss, pension risk will also be more visible due to the additional asset ceiling test[4] and increased disclosure requirements[5]. This

[3] Source: PwC.

[4] IAS19 also contains complicated 'asset ceiling' tests which may limit the amount of assets that can be recognized on the balance sheet for plans with surplus assets. The intent is to recognise surplus assets only to the extent that they are available to the plan sponsor. Imposition of the 'asset ceiling' tests potentially drives down the utility of plan surplus and further exacerbates the asymmetry of plan deficits and surpluses. This may cause plan sponsors to further consider risk management or transfers methods that 'take risk off the table' as the plan becomes better funded.

[5] The IASB is requiring increased disclosures designed to provide more insight into the characteristics of the plan and the amounts in the company's financial statements resulting from the plan, as well as the risks

will confront corporate sponsors and investors with their pension risks in a very clear and transparent manner.

Responding to the new IAS 19 – Transparency drives derisking

With the introduction of the new IAS 19, companies need to review their investment strategies and asset allocation in order to assess the possible accounting benefits of derisking their DB plans by moving out of equities into bonds. Companies will no longer be able to defer the recognition of gains and losses in their pension plans (using the corridor method) and must instead report the full deficit or surplus (subject to any asset limitation) immediately. This introduces greater balance sheet volatility, particularly for those plans with heavy equity investment, and may present another reason for considering a move from growth to matching assets.

Under the old IAS 19 requirements, pension losses could be amortised. However, if a pension fund is transferred to an insurance company, this loss has to be taken at once. Under the new IAS 19 requirements, this loss is immediately put on the balance sheet when it occurs. Therefore a pension transfer might seem less costly to a corporate under these new requirements.

Another important change in risk perception is the fact that under the old IAS 19 requirements, a decrease in equity would decrease average projected returns, which, would, in its turn, increase pension costs. Since, under the new requirements, the projected returns assumption is now always the Net Interest Component, it is no longer beneficial for the company to increase its equity component in the pension fund in order to decrease pension costs. This means that risk management techniques like liability driven investing will become more interesting since they will no longer increase pension expenses, but will decrease balance sheet and P&L volatility.

Since assumptions like longevity risk must now be reported in increased longevity requirements and actual changes in these assumptions cannot be amortised, these kinds of 'actuarial' risks will now need to become a more important part of the risk management process.

Governance

Because of the increasing impact of local pension funds on corporate balance sheets and P&L, companies will want to increase their governance of the decision-making processes in their pension funds. Although local legislation might bar sponsors from directly influencing pension fund investment decisions, increasing funding requirements will increase the influence of sponsors on these decisions. Multinational companies with multiple pension funds will particularly need to increase their efforts to manage the risk of their pension funds. Any differences in local approaches to risk management will need to be addressed. Increased disclosure requirements will require local pension departments to increase the time and resources they need to spend on reporting pension details to the global head office. This increased need for governance might influence some companies to transfer pension funds to a pension insurance provider.

The natural tendency of UK and US pension funds to have greater equity components, with higher rates of returns than their mainland European counterparties will have to be managed more closely, since under IAS 19 this will generate more volatility but not necessarily increase reported returns. As a result, this change may prompt plan sponsors to revisit the risk/reward trade-offs of investing in

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associated with the plan. The required disclosures include sensitivity analysis for each significant assumption, including longevity risk.

equities or other risky investments that are expected to generate higher returns. Some plan sponsors may decide to modify their investment strategy to reduce risk, since they will lose the corresponding reward of the lower pension expense generated by the higher expected rate of return.

At the writing of this article, it was not yet clear how different DC and DB systems like collective DC and conditional indexation in the Netherlands will be accounted for under the new IAS 19. The impact of IAS 19 on these different systems will need to be reviewed closely.

How corporate sponsors can take control

Given the profound impact that the new IAS 19 regulations may have, it is important that corporate sponsors are well prepared for these changes. Companies will need to:

- Make an overview of the most important local pension funds and stakeholders
- Calculate the impact of the changed IAS 19 for your pensions
- Talk to your advisors and providers for possible IAS 19 proof solutions
- Decide on the corporate pension budget and redesign pension benefits within that budget
- Agree on pension ambitions and acceptable levels of risk
- Set a timeframe for derisking (if desired), with clear decision points
- Implement communications programme to support the employer and employees.

Over time, the company can proceed to:

- Derisk according to pre-established ambition levels
- Manage retained risks
- Manage pensions budget in order to reduce expenses and maximise funding.

Conclusion: from black-box to financial reality

Due to the changes in IAS 19, the pensions 'black box' has become more transparent. These changes will decrease the smoothing possibilities for corporate sponsors, while they increase the visibility of risks and step up the reporting requirements in order to reveal these risks. Corporate sponsors are not rewarded any more with lower pension expenses by taking more risks. Combined with the current volatile market place, this will increase the speed with which derisking solutions are considered by corporate sponsors.

AEGON and derisking

AEGON Global Pensions offers **a broad range derisking capabilities**, knowledge and experience in the UK, continental Europe and the USA. If you are a multinational company with pension funds in one or more countries, AEGON Global Pensions can help you decide on the most efficient derisking route, taking into account the cultural, legislative and accounting aspects of your local pension schemes.