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Developments in Pension Accounting Standards

- The Path to Convergence

Martin Lowes
Pensions Convention 2004
7 June 2004

Agenda


- European switch to IFRS
- New single performance statement
- Implications for pensions accounting
- Changes to IAS19
- Issues to consider



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European Switch to IFRS

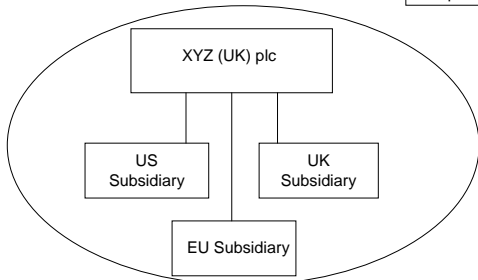
- Applies to group accounts for listed EU companies
- From 1 January 2005
- But 1 January 2007 if already use US GAAP
- Other EU companies as country legislation



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Group Accounts Only

XYZ
Group



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Transition Example (IFRS1)

- Company financial year end **31 March**
- Transition Date **31 March 04**
- 2004/5 accounts **UK GAAP**
- 2005/6 accounts **IFRS**
- (including restatement 2004/5)
 (and 2003/4 if e.g. NASDAQ)

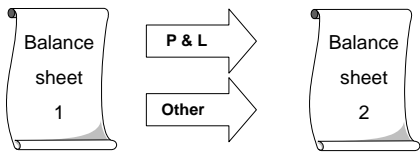
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Accounting Trends

- | | | |
|-----------------------|---|-----------------------------|
| ▪ Issue by issue | ⇒ | ▪ Overall set of principles |
| ▪ Profit & Loss | ⇒ | ▪ Balance sheet |
| ▪ Historic cost | ⇒ | ▪ Current or 'fair' value |
| ▪ Realised profits | ⇒ | ▪ Include unrealised |
| ▪ Detailed rules (US) | ⇔ | ▪ General principles (IAS) |

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Company Accounts - Now



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What goes where?

- Profit and Loss (P&L)
 - Items managed by company (example – wage costs)
 - Guide to the future
- Outside P&L
 - Result of external factors (example – currency movements)
 - Random

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P&L Now

- Sales X X
- Cost of sales X X
- Operating income X X (EBIT, EBITDA)
- Financing costs X X
- Profit before tax X X (EPS)

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Total Change in Balance Sheet

- Profit from P&L X X
- Other gains/losses X X
- (e.g. revaluation of factory)
- Total change in balance sheet X X
- UK – Statement of total recognised gains & losses
- US – Other comprehensive income statement
- IAS – Statement of recognised income and expense

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Company Accounts - Future



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Comprehensive Income Statement

| | Total | Before re-measurement | Re-measurements |
|-------------------------|-------|-----------------------|-----------------|
| Revenue | | | |
| Cost of sales | | | |
| Operating profit | A | | |
| Other business profits | B | Generally nil | e.g. disposal |
| Financial income | C | | |
| Business profit | A+B+C | | |
| Interest etc | | | |
| Financing expense | D | | |
| Tax | E | | |
| Discontinued operations | F | | |
| Comprehensive income | Σ | | |

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Current – FRS17

- Service cost
 - + Past service cost
 - + Other one offs
- } P&L - Operating
-
- + Interest cost
 - - Expected return on assets
- } P&L - Financing
-
- + Loss/(gain)
- STRGL

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Current – IAS19/FAS87

- Service cost
 - + Past service cost
 - + Interest cost
 - - Expected return
 - + Amortisation of gains/losses
- } All in P&L
Operating

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Short Term

- Reporting performance project – delayed
- So major IAS19 changes – delayed
- IAS19 short term fix – comments due 31/7/04
- Option to recognise all gains/losses immediately outside P&L
- Exemption for individual company in group scheme
- Allows UK companies to continue as FRS17
- Additional disclosures

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Immediate Recognition Gains and Losses

- Optional
- Through statement of recognised income and expenses
- Not recycled

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Group Schemes

- Can account as DC if company in a corporate group and
- Group scheme does not segregate company assets/liabilities
- Company or parent produces public IAS consolidated accounts
- No debt/equity listing (current or applied for)

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Additional Disclosures Required (I)

- Reconciliations over year of plan assets, liabilities
- Split of liabilities between funded/unfunded
- Amount recognised outside P&L split between gains/losses and effect of asset limit

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Additional Disclosures Required (II)

- Asset split showing % in each major category
- Expected return on each asset class
- Explanation of derivation of expected return

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Additional Disclosures Required (III)

- 5 year history of asset value, liabilities, surplus/deficit and experience gains/losses
- Expected contributions next year
- Plan descriptions to reflect constructive obligations
- Sensitivity information about medical cost trend rates²⁷

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Payment of Dividends

- UK – Retained (realised) profits
- EU – Generally as UK
- US – Solvent (can afford to pay)
- Legal working party considering EU switch to US approach

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Longer Term

- Joint IASB/FASB convergence project
- By 2007? (When EU exemption for US GAAP expires)

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IAS19/[&FAS87?] - Future

| | Total | Before re-measurement | Re-measurements |
|-------------------------|----------|-----------------------|-----------------------------|
| Pension | | Service cost | Δ projected benefits |
| Operating profit | | | |
| Other business profits | | | |
| Pension assets | | Nil | Actual gain/loss |
| Financial income | | | |
| Business profit | Σ | | |
| Pension financing | | Interest cost | Δ discount rate |
| Financing expense | | | |
| Tax | | | |
| Discontinued operations | | | |
| Comprehensive income | | | |

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Changes to IAS19 (FAS87?)

- Reporting format
- No expected return on assets
- Immediate recognition gains/losses
- Break down gains/losses
- Asset ceiling
 - Service cost indefinitely, refund
 - Ability to pay for higher benefits
 - Protection against losses (option priced)
- Tightening definitions

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Issues – Immediate Recognition

- Tells it like it is
- Alternative view
 - artificial accountants' travesty
 - volatility artificial
 - and will close pension schemes

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Issues – Expected Asset Return

Difficult to justify advance recognition of expected equity returns

BUT

Interest cost in "P&L"

Nil return in "P&L"

} misleading

} exaggerates cost

PERHAPS

Interest (not expected return) on assets?

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Issues – Allowance for Salary Increases

▪Expected cost should reflect expected pay increase

OR

▪Current liability only relates to current pay

Scheme A
Final salary

✓ Scheme B
Career average salary

Which has higher expected cost?

▪Implications if leaver benefits flat/inflation linked?

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