The Actuarial Profession
making financial sense of the future

Accounting network evening
Gary Hibbard

Discounting pension cashflows for accounting valuations

Accounting themes

30 March 2010

Overview

- The planned fundamental review of IAS19
- Some fundamental (pension) accounting questions
- Some themes from IASB discussions to date
- Thoughts on different measurement approaches

IASB’s fundamental review of IAS19

- In April 2009, Sir David Tweedie asked the IAA to assist the IASB in setting discount rates used in the measurement of defined benefit obligations
  - Views on the current objective of a high quality corporate bond?
  - Would a fair value objective provide more relevant information? What discount rates would this point to?
  - What other objectives could be used?
  - How much guidance should the IASB provide on implementing the proposed objectives for the discount rate?

- This would inform the IASB’s fundamental review of IAS19 planned for 2011
  - Definition of a liability
  - Measurement
  - Consolidation

Conceptual framework

- The objective and purpose of accounts
  - financial reporting should provide information that is useful in making business and resource allocation decisions
  - information must be timely and complete for it to be relevant and reliable
- Disclosures convey additional information on quality of decisions and risk considerations
- Ongoing debate between the accounting standards setters
  - Number of inconsistencies built up over time in accounting treatment of different liabilities
    - Pensions in the forefront on fair value measurement (& re-measurement)?
  - New financial instruments merit review of basics
  - What does accounting on an ‘ongoing basis’ mean?

Ultimate cost of any pension plan

Benefits Paid from the Plan

Plus

Administrative Expenses,
Taxes & Levies

Less

Investment Gains
(Net of Losses)

Simplified summary of Pension expense for defined benefit plans

	Funding contributions	Accounting expense (IAS today)	Accounting expense (IAS ED)
"Normal" components	Regular contribution	Service cost + (interest cost – expected return on assets)	Service cost + net interest cost
"Special" components	Additional contribution to fund a deficit (or contribution reduction if in surplus?)	Smoothing elements (amortisation components)	Re-measurement in OCI

What defines a liability

IASB - "A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."

…..a legal or constructive obligation

…..a past event must have occurred to give rise to a present obligation

- Do you only take into account contingent events when they have happened, or do you measure them now by assigning a probability to them? E.g.
  - ill health benefits ; early retirement terms
  - 'stand ready' obligations like vesting schedules ; right to join a top up plan on reaching a given age or on promotion
  - future pay or pension increases ; use of surplus in a plan to pay benefit improvements ; other benefit improvements etc
  - guarantees and options
  - do you linearly accrue for a benefit that has a non-linear form
  - what about expenses of running a plan

What defines an asset?

1. The entity controls a resource……ability to use to generate future benefits
2. That control is the result of past events (contributions paid)
3. Future economic benefits are available to the enterprise in the form of a reduction in future contributions or a cash refund, either directly to the entity or indirectly to another plan in deficit

- Does it matter if the asset is on the sponsor’s balance sheet, in a trust or held by a third party?
- Should there be a limit on the asset that can be recognised?
- How far do you go in arguing you can get an economic benefit from a plan surplus?
  - Is surplus a real asset or a contingent asset
  - If contingent, what probability to ascribe to its receipt
  - What if Trust Deed or law sets restrictions on access to surplus
- How to factor in that accounting basis surplus may not be same as the basis used in law to determine refunds?

Some themes from IASB discussions to date

- Not possible, or misleading to users of accounts, to measure all risks?
  - Obligations and risks can be measured, disclosed, both or neither
  - Do cashflows provide more valuable information than measurements?
- Which obligations do the IASB want to measure / disclose?
  - ABO or PBO
  - Contractual benefits
  - Constructive benefits
  - [Obligations brought forward from use of uniform accrual]
  - Discretionary benefits?
- Are constructive benefits really constructive?
  - Non performance risk
- Is a pension scheme a “contract”?

Some discount rate specific themes

- Are we discounting to target a measure of fair value, settlement value, fulfilment value or other?
- Credit risk?
- “Nil risk” rate
  - Liquidity premium?

- Estimation in deep and non-deep markets
  - Which market characteristics provide the desired term structure for discount rates. Which are most important?
    - Risk free
    - Easily observable
    - Tradable
    - Robust ?
  - IAS19 currently specifies government bonds where high quality corporate bond markets are not deep

IAA work programme

- The IAA pensions committee currently meet with the IASB twice a year
- Started work on
  - Similarities and differences between insurance and pensions
  - Implications of different approaches to measurement
    - Economic
    - Solvency
    - Legal / delivery vehicle specific
    - Enterprise risk management
- Your views now and going forward on these or other approaches most welcome
  - Should we promote focused cashflow related information?

Economic approach?

- Analyse cashflows according to those that are

	Collateralised / priority creditor status	Non-collateralised / low priority
Vested		
Unvested		

- Apply different discount rates reflecting nature of cashflows
  - Vested/collateralised : "nil risk" rate
  - Other : Higher rate allowing for non-performance or credit risk ?
- Accounting liability cannot be less than local funding law liability?

Solvency approach?

- Start with insurance pricing (‘buy-out’)
- Strip out factors not consistent with the nature of pension cashflows
  - profit, solvency margins, other margins/re-spread front end loadings for commercial risks etc
- Add in any solvency/funding margins from local pensions law

- Alternatively
  - Start with insurance reserve before adding solvency, expense etc margins
  - Adjust for any solvency/funding margins from local pensions law

Legal & ERM ?

- Legal
  - Accounting measurement looks through the vehicle used to deliver the benefits as if there is a direct obligation from the employer
    - *NB consolidation rules may look at the vehicle*
  - But the vehicle used can change the nature of the obligation and hence the cashflows the employer is obligated to provide
  - Credit & non-performance risks are key considerations
- ERM
  - Look at the pension scheme as part of the employer
  - Model cashflows for the plan and company given local funding rules etc