REGULATION

The complexity of simplification

Just how complex is the regulatory framework for pensions accounting in the European Union? Stephen Bouvier **explores the issue**

WRITTEN BY STEPHEN BOUVIER, A FREELANCE JOURNALIST

One way of looking at the regulatory framework that covers the European Union's approach to pensions accounting is to see it as comprising three more or less complementary layers. First, there is the legal framework that mandates the use of International Financial Reporting Standards (IFRS) for traded debt and equity securities within the bloc.

Next come national law and local accounting requirements or generally accepted accounting practice (GAAP). On top of that sits a third layer comprising accounting enforcement and securities regulation. Although the advent of IFRS might have been expected to diminish the role of local standard setters, this has not in fact turned out to be the case.

IFRS accounting framework

The EU's accounting rules for listed companies – including the pensions accounting rule book, International Accounting Standard 19, Employee Benefits (IAS 19) – are set by the London-based International Accounting Standards Board (IASB). EU companies with publicly-traded equities or debt applied the IASB's standards since 2005.

In order for an accounting standard to become binding in EU law, the EU must first endorse it in accordance with a procedure set out in the so-called IAS Regulation (No 1606/2002). At the moment, the EU endorses accounting standards in their entirety with no carve-outs. This decision meant that in 2007 the US Securities & Exchange Commission scrapped its requirement for companies reporting under IFRS as issued by the IASB to reconcile certain areas of their accounting – among them pensions – to US GAAP.

Once the IASB has either released a new IFRS, or made an amendment to an existing one, the European Financial Reporting Advisory Group (EFRAG) steps in to assess the new requirements against the EU's endorsement criteria. In fact, EFRAG also plays a potentially important role in the IASB's due process in that it conducts outreach with EU businesses and interest groups and communicates those findings to the standard setter.

Matters of national law

But EU endorsement of a new accounting standard is only part of the picture. Complex and often competing interests – pension payments and dividends – can produce a bewildering local landscape.

In Germany, for example, companies must produce three balance sheets. First, there is the IFRS balance sheet, next is the local commercial or HGB balance sheet, which is used to determine both going concern and dividend payments, and finally there is the tax balance sheet.

"Where there is a difference is at the level of local accounting standards," says Mercer principal Tim Reay, "not least because local statutory accounting can affect a company's ability to pay dividends. For that reason, we can't overlook local GAAP.

"The commercial balance or HGB sheet, in respect of pensions, is broadly similar to IAS 19 with the notable exception of the discount rate. The tax balance sheet is also relevant to pensions because it is used to determine the tax deduction that is available on the pension liability. And in respect of dividends, a German company can only pay dividends out of the balance sheet profits that are prepared in accordance with German law."

Pensions, dividends concerns

So, what we have in Germany is a regulatory and accounting landscape that reflects a strict local approach to dividends, on the one hand, and companies with large pension liabilities because they are unfunded or matched by a comparatively small asset pool.

Alongside its impact on dividend payments, German GAAP also impacts pensions accounting. Until 2009, German GAAP was relatively brief on the subject of pensions. The Bilanzrichtlinien-Gesetz of 1985 (BiRiLiG) required companies had to report their pension obligation in the balance sheet, although this did not include obligations that existed

before 1987.

These were simply reported in the notes. Indeed, it this still the case today with some pre-1986 legacy obligations where they are held through external pension vehicles. Moreover, with the introduction of the Bilanzrechtsmodernisierungs-Gesetz (BilMoG) in 2009, Germany took a policy decision to retain their own local GAAP – in marked contrast to the UK where FRS 102 has tended to follow IAS 19.

Mercer's chief actuary in Germany, Thomas Hagemann, says: "We are very close to IAS 19. We use the PUC method to calculate the DBO, although some companies still use an alternative method. They have to also show salary increases and indexation, as in IAS 19. For most companies the only difference in the valuation is the discount rate, which is now based on an average rate over 10 years. This nonetheless produces a higher rate than we see under IFRS."

Challenges for Swiss, Belgian plans

Meanwhile in Switzerland, practitioners have struggled to apply IAS 19 to local plans, which typically sit somewhere between DB and DC. Under IAS 19, anything that cannot be expensed as a DC plan is automatically accounted for as a DB plan. This means that sponsors have to project the benefit promise forward and discount back using a AA-corporate bond rate – the projected unit credit (PUC) method.

"The main difference in practice, as a result, is that the IAS 19 calculation pension 'funds' – Pensionskassen, Stiftungen – are valued from the view of the fund, using local reserving requirements," says Mercer partner Norman Dreger.

"IAS 19 looks at the company obligations arising from the pension promise and sets against this amount the pension plan assets for reserving in the company accounts. This is a very different approach to IAS 19 where you add in a reserve for components such as longevity. When the sponsor prepares its accounts under Swiss GAAP, they might thus just report the contributions as an expense."

This complexity contrasts with the position in Belgium where the requirements are much less restrictive. This is because the Belgian accounting model recognises the reality that pension funds are either insured or in a structure that is not dissimilar to an insurer from an economic erspective. For this reason, they simply book the cash expense.

IORP boost

Another EU country that has struggled to apply IAS 19 to its local plan design is Belgium, where pension plans often have a higher-of investment return component as part of the benefit formula. In fact, this type of hybrid plan was one of the drivers behind the IASB's decision to seek public comments on a new fair-value accounting methodology in a 2008 discussion paper. The proposals were widely panned and quietly dropped by the board.

But since then, the Directive dealing with Institutions for Occupational Retirement Provision (IORP) has seen Belgium emerge as a perhaps surprisingly popular domicile for the new pensions vehicle.

Aon Hewitt partner Thierry Verkest says: "In the EU today, each country has its own pension system in terms of design, taxation and social security law. What the IORP Directive does is to allow these schemes to be brought together as a single vehicle. That massively increases efficiency because you have a single trustee board where you can concentrate expertise and you can pool all your assets and liabilities.

"Typically, the decision to go with an IORP vehicle does not involve changes to the existing benefit design. So, within the vehicle you would have a section for each country where the employer has a pension scheme, meaning that the net effect for members is that only the funding vehicle changes."

[IFRSs] HAVE HAD SURPRISINGLY LITTLE EFFECT ON THOSE MATTERS THAT REMAIN FIRMLY WITHIN THE COMPETENCY OF EU MEMBER STATES SUCH AS PENSION BENEFIT DESIGN AND DIVIDEND PAYMENTS

But what you do see in the IAS 19 numbers, he adds, is a reduction in plan administration costs, which in turn feeds through to profit or loss. In addition, the pooling effect has a beneficial impact on the plan's asset position.

So at first glance, you might have expected that the adoption of IFRSs across the EU would have simplified at least some aspects of the regulatory framework around pensions. In fact, they have had surprisingly little effect on those matters that remain firmly within the competency of EU member states such as pension benefit design and dividend payments. And for as long as policy areas such as distributions to shareholders remain within the competency of each of the EU's 27 remaining member states, that complexity is here to stay. ■