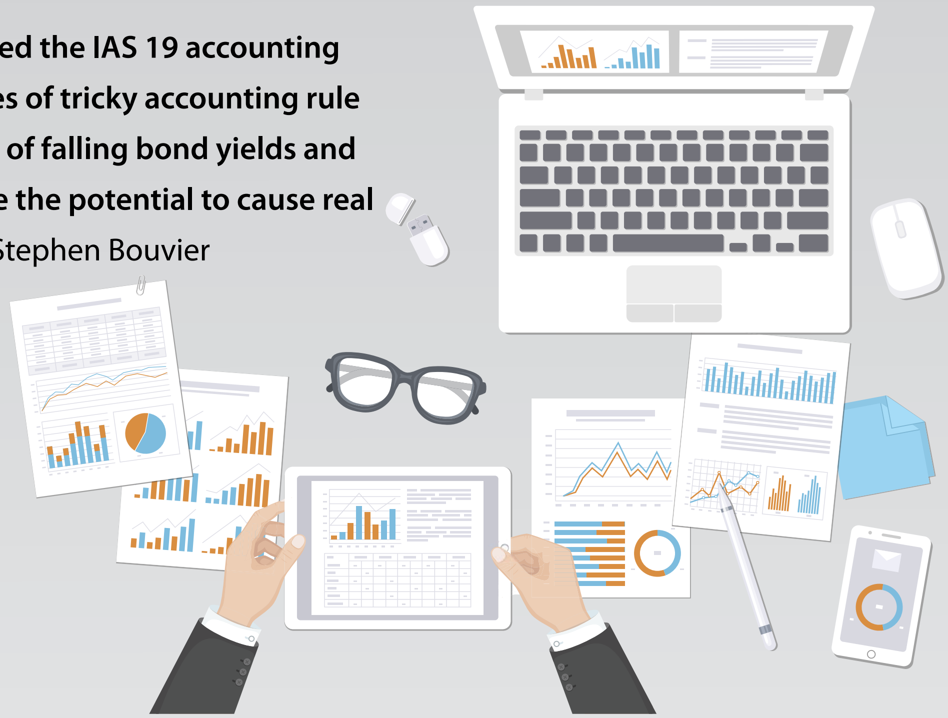
ACCOUNTING

Challenging times for FDs

Observers have often dismissed the IAS 19 accounting measure as a fiction. But a series of tricky accounting rule changes against a background of falling bond yields and lagging investment returns have the potential to cause real mischief, discovers Stephen Bouvier



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As we approach the year-end reporting season, Brexit, depressed bond yields and potentially onerous changes to the accounting rules covering defined-benefit (DB) pension schemes have combined in a near-perfect storm for scheme sponsors. This has the potential to affect not only exclusively UK-based corporates but also European companies with exposure through a UK subsidiary.

Deficits

Even before the Brexit vote, the cost of providing a traditional final-salary pension scheme was rising inexorably, such that consultants Lane Clark & Peacock now estimate that UK scheme sponsors face a hit to their accounting service cost of between 50 and 70 per cent of salary. Meanwhile, on the balance sheet, liabilities have risen by around 40 per cent this year. Although assets have performed well, they have failed to match the increase in deficits.

And DB scheme sponsors can no longer dismiss the IAS 19 numbers as an artificial accounting construct. First, investors pay close attention to balance sheet deficits. Second, deficits translate directly into lower distributable reserves for dividend payments. Other considerations include regulatory capital, credit ratings and banking covenants.

In short, pension deficits of the scale now emerging have the very real potential to impact how DB sponsors manage their schemes in the long term. And recent changes to the accounting framework from the International Accounting Standards Board (IASB) and the International Financial Reporting Standards Interpretations Committee (IFRS IC) have increased the pressure.

In June last year, the IFRS IC issued an amendment to IFRIC 14 to clarify when a third party, such as a DB scheme's trustees, can restrict a scheme sponsor's ability to recognise a plan surplus in its accounts. The proposals drew a decidedly mixed response among commentators.

After a lengthy hiatus, the IFRS IC redeliberated its proposals in September and proposed a number of drafting changes. It is these changes that have prompted many advisers to warn that the final impact of the IFRIC 14 amendments could be far greater than seemed apparent from the 2015 exposure draft.

"We have some concerns about the recent review of the wording in IFRIC 14," says LCP head of corporate consulting Alex Waite. "It is possible that the proposed changes to the guidance will be more far reaching than anticipated. In fact, the proposed draft now includes words that could turn out to be a major headache for most UK pension schemes and their sponsors.

The focus of the concern is an amendment to the June 2015 wording that tells preparers to look beyond whether trustees have the power to wind up a scheme and instead examine whether they have the power to buy out a scheme's liabilities.

Typically, a DB scheme might go

through a buy-in as a prelude to a buyout before a scheme is finally found up. Because a power to wind up a plan is a much less common power than the ability to purchase a buyout, many advisers are now worried that a far greater number of DB schemes will find themselves forced to recognise an additional liability under IFRIC 14.

European significance

The significance of this amendment has not gone unnoticed in Europe. Mercer's chief actuary in Germany, Thomas Hagemann, says: "The application of the asset ceiling in conjunction with special events is clear in that you first calculate the special event and then correct the asset ceiling. Nonetheless, there are concerns among some actuaries about the amendment.

"This is because you may have a situation where you have a surplus but no asset on the balance sheet until there is a settlement. It comes as a surprise to go from having no obligation in the balance sheet to having a pension cost as a result of a settlement occurring without paying more than the existing plan assets."

Alongside the IFRIC 14 amendment, the IASB has also proposed a change to the accounting treatment of settlements and curtailments. The change forces preparers to remeasure the plan liability using an updated discount rate. Although experts believe the change will have little consequence where a plan amendment happens at the end of an accounting year, there are concerns that it will be onerous to apply and result in a lack of comparability.

"That can produce the situation where the obligation has fallen but the service cost rises because the discount rate is lower than at the beginning of the year," explains Hagemann. "I think this creates issues with comparability. A company with no special events has a different cost than one that does have them. I have to admit that in most cases the effects are not material, but where there are material special events, these effects could have a negative impact. To my mind these amendments are unhelpful."

Impact on dividends

Meanwhile, the question of distributable reserves – the amount of capital available to pay out as a dividend – has also come into sharp focus. "We face a simple problem in the UK in that DB deficits are enormous," says Waite. "In fact, they are so large that they now represent a substantial obstacle to the ability of company directors to make dividend payment."

There are, he warns, three ways in which the problem can rear its head. "The most obvious manifestation of this problem comes down to affordability. A company's directors might decide that they simply cannot afford to pay a dividend.

"On another level, directors might find that both the law and the accounting rules operate in such a way that they wipe out any distributable reserves from which a dividend payment can be made.

"A more subtle way in which the problem can manifest itself is where a dividend payment is made through a complicated group structure with the company paying dividends up the group to the parent company." This can mean, he explains, that a company's ability to pay a dividend hinges on where the pension commitment is lodged within the group – even where there are sufficient reserves at a group level."

Discounting

But one area of practice under IAS 19 where there have been more positive developments is discounting. When European companies adopted IAS 19 in 2005, the most common approach to discounting was to look to the yield on the iBOXX cash bond indices. As practice evolved, some practitioners noted that IAS 19 requires preparers to match duration the discount rate to the pension liability.

Further developments have looked at matching the pension liability's future cash flows and the yield curve and also using a different discount rate for both any buy-in policy and the service cost element. Then in late 2013, consultants Mercer unsuccessfully floated the idea of using a one-year forward rate to calculate the charge in profit or loss.

But, says Hagemann, fresh thinking has not ended there, with practice now moving toward a split discount rate for different components of the pension liability, as well using a spot-rate for discounting. Whereas a 10-year forward rate is simply the rate applicable between years nine and 10, a 10-year spot rate is an average annual rate over the 10 years. Interest in the spot-rate approach has grown since US telecoms giant AT&T moved to it in 2015; with a nod of approval from the US Securities & Exchange Commission.

"We have found that auditors are more willing to accept this approach where you use different discount rates for DBO and service cost," says Hagemann. "Another approach is the spot-rate approach, where the DBO and service cost come out almost the same, but the whole yield curve is also used to calculate the interest cost. I expect some companies will use the spot-rate approach, although at the moment, we don't have a clear view from the auditors." Nonetheless, he expects auditors to be sceptical of an approach that produces lower costs but larger actuarial losses. ■