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Pension Costs for Multinationals
A Report on International Accounting Standard 19

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Introduction

Significant changes in the accounting requirements for multinational companies can be expected in relation to the treatment of employee benefits. A revised international standard is about to be introduced and there will be implications for multinationals in all countries. The new Standard is planned to apply to financial statements for periods beginning on or after 1 January 1999, with some transitional arrangements.

The IASC

International Accounting Standards are developed by the International Accounting Standards Committee. The IASC was formed in 1973 by the professional accountancy bodies at which time its main role was to develop standards which provided a framework for existing national standards and encouraged harmonisation. Since its early days the IASC's role in world affairs has changed quite radically. The Board now includes representatives of the national accounting standard setting bodies. Furthermore, the International Organisation of Securities Commissions (IOSCO) has been applying pressure on the IASC to develop international standards in a number of core areas, including employee benefit costs. This pressure is emanating from multi-national companies in Germany and elsewhere in Europe which intend to seek quotations on stock exchanges in the US, Canada and Japan amongst others. If the IASC do not develop satisfactory international standards these multinationals will adopt US standards and the IASC would then cease to be a major influence. The IASC has been working hard to complete a number of standards by March 1998 in order to meet IOSCO's targets -and it has largely succeeded.

The Significance of IAS19

The existing International Standard, IAS19 (accounting for retirement benefit costs in financial statements of employers) came into effect on 1 January 1985. At that time it provided a standard which could be adopted in countries where there was no local standard and it was accordingly used in a number of countries outside the UK and the US. In practice, the other standard which has been widely used in other countries has been FAS87. Given the broad provisions of IAS19, which accommodated the approaches under both SSAP24 and FAS87, IAS19 had virtually no impact in the UK or the US.

This position is about to change radically. The new Standard involves significant differences from both SSAP24 and FAS87 - although it is closer to FAS87. Local accounting standard setting bodies have to decide whether they will fall in line with international standards, in which case they can continue to have some influence on developments, or will stand aside and develop local standards which are different. Over time a local approach is unlikely to find favour with multinational companies - with the effect that the local accounting standards bodies probably would end up with rather less influence.

This is particularly relevant in the UK where the Accounting Standards Board (ASB) has to find a compromise between the strongly held views of its constituency - which favour a SSAP24 style of standard - and the need to find as much common ground as possible with the proposals for the new International Standard.

The outcome of this political struggle is likely to be the introduction of a revision to SSAP24 in the UK which will embody many features of the new IAS19 whilst keeping to a minimum the differences so that the additional reporting requirements for UK quoted companies will not be excessive. Even in the US it is likely that FAS87 would need to be amended in order to remain fully in line with the new International Standard, although in most respects calculations in accordance with IAS19 would comply with FAS87. The Securities and Exchange Commission (SEC) and the Federal Accounting Standards Board (FASB) in the US have already had a significant influence on the development of the new IAS19 - and indeed other standards.

How will IAS19 affect Multinational Companies?

The IASC is hoping that IOSCO will recommend to its members that they accept the package of new international standards. If all the stock exchanges accept IOSCO's recommendation, every major stock exchange would be obliged to accept financial statements prepared in accordance with international accounting standards. Local stock exchanges would still be

able to apply their own specific requirements for domestic companies, but would have to accept statements prepared in accordance with IAS19.

This is, of course, conditional upon the acceptance by IOSCO of the new standards and the agreement of the various exchanges. It is uncertain at present whether the SEC in the US will agree to the new standard without requiring a reconciliation to US GAAP to be shown.

It is not yet clear whether multinationals could comply with international standards in accounting areas other than employee benefits, and still meet the requirements of the local exchange by providing pension cost figures only in accordance with local standards. It is more likely that if they wish to apply international standards at all, they will have to do so in **all** areas - in which case it is conceivable they might consider not complying with any international standards in order to avoid having to use IAS19.

In practical terms this implies that companies may have to choose between complying with the local accounting requirements wherever they are quoted or applying IAS19 and the other international standards. Thus a company quoted in both London and New York could continue to prepare two separate sets of financial statements or could prepare a single set of statements complying with the International Accounting Standards. Whilst the preparation of a single set of financial statements may have its attractions, companies will need to investigate the implications for them of using IAS19.

IAS19 Before Revision

The current IAS19 covers only retirement benefits and allows a relatively free choice of actuarial method and assumptions. It was revised with effect from 1 January 1995 to provide for accrued benefit methods as the benchmark approach with projected benefit methods permitted as an alternative. The approach to assets permitted assets to be taken in at an actuarially assessed value (as in SSAP24) or as an average market value (as under one of the approaches under FAS87), as well as at market value. Amortisation of actuarial gains and losses is required to be over the expected working lifetime of employees in normal circumstances but exceptions are permitted. The discount rate for discounting the liabilities is required to be the long term rate at which obligations are expected to be settled - which is broad enough to encompass the provisions of both SSAP24 and FAS87.

The key shortcomings perceived by the IASC in IAS19 were that it gave

- little guidance on balance sheet treatment;
- inadequate guidance on specific types of plan;

- too great a diversity of accounting methods;
- restricted comparability of accounts between different enterprises.

Initial Proposals - E54

This led to the development of Exposure Draft E54, issued in Autumn 1996, in which the following fundamental changes appeared

- the balance sheet was required to show the net asset or liability represented by the difference between the value of assets and liabilities;
- the Projected Unit Credit Method was prescribed;
- the Discount Rate was prescribed to be the current yield on corporate bonds of appropriate maturity (or government bonds where there is no market in corporate bonds);
- there was to be a 10% corridor within which actuarial gains and losses would be deferred, but with **immediate** recognition of gains and losses which fall outside this corridor, **in the year in which they occurred.**
- plan assets were to be taken at market value.

Final Changes in the Revised IAS19

After much debate these early proposals were retained except in relation to actuarial gains and losses. The final proposal on this aspect is as follows :

- there is to be a 10% corridor within which actuarial gains and losses are deferred indefinitely; gains and losses which fall outside this corridor are to be recognised over the expected average remaining working lives of the employees participating, **commencing in the following reporting period**; also permitted is any systematic method which results in faster recognition, provided it is applied consistently from period to period; in particular full immediate recognition is permitted.

A Comparison Between IAS19, FAS87 and SSAP24

The schedule attached to this paper provides a comparison of key features of the principal accounting standards which will now exist. Some key points in relation to pension plans are :

- the requirement to include the net asset or liability on the balance sheet
- for US users, the absence of an option to use averaged market values
- for UK users, the requirement to use a current bond yield to discount the liabilities
- a significant volume of disclosures.

In addition, the new Standard covers other employee benefits including post-employment medical benefits and short-term benefits.

The Involvement of the IFAA

The International Forum of Actuarial Associations (IFAA) became involved immediately after its formation in September 1995 and formed a subcommittee (of which I am the Chairman) to develop a response to the IASC. This was too late to influence the initial IASC proposals, although we have been invited to attend as observers and participate in meetings of the IASC Board and Consultative Group, and also in the meetings of the Steering Committee drafted the new standard.

The IFAA is effectively an association of over 40 actuarial associations worldwide, covering over 95% of the world's actuaries. Public Statements (such as submissions to the IASC) issued by the IFAA require the formal approval of the member associations. The IFAA's submission to IASC was the first such public statement to be issued.

Actuarial Concerns

A key concern which has been argued strongly by both the ASB in the UK and also the IFAA is that whilst the move to market value of assets is acceptable it is essential that the discount rate reflects the returns from appropriate investments according to the nature of the liabilities (in particular having some regard to the returns on equities for salary related liabilities, at least in those countries in which the normal practice for such liabilities would be to fund in this fashion) rather than simply be based on bond yields.

The second key point was that the amortisation of actuarial gains and losses should be spread over the expected future working lifetime of the employees. The IFAA argued that the corridor is an unnecessary complication and that amortisation should be applied to all actuarial gains and losses, but coupled with the suggestion that beyond a threshold of 25% of the greater of assets or liabilities, actuarial gains and losses should be recognised immediately. In this area, the IFAA had some success as its proposed approach will be permitted under IAS19 as now revised.

The Discount Rate

The UK Accounting Standards Board similarly argued that equities are the most appropriate match for salary related liabilities. They are concerned that the proposed use of bond yields for discounting will overstate the liabilities and cause unnecessary volatility.

The initial IFAA line of argument was based on the concept that the appropriate discount rate for a given set of liabilities should be the expected long-term return on an appropriately matched portfolio of assets, determined for example by asset liability modelling. This approach was, however, viewed with suspicion, as being too much of a black box and leaving too much to the subjective judgement of actuaries.

This led to the IFAA putting forward the concept that the discount rate should be determined by the nature and term of the liabilities (irrespective of the actual assets held). For this purpose the liabilities need to be separately identified, and the discount rate chosen accordingly :

- for fixed monetary liabilities, the redemption yield on fixed-interest bonds of appropriate duration
- for price-related or index-linked liabilities, the redemption yield on price-related or index-linked bonds of appropriate duration
- for salary-related liabilities, the long-term real return on assets which best match the liabilities, as determined appropriate by the actuarial bodies in each country.

It was argued that equities were appropriate assets in many countries for matching salary-related liabilities and that this should be reflected in the discount rate.

These proposals were considered at some length by the IASC but in the end they were rejected.

If the IFAA proposals had been accepted I would have envisaged that in the UK context, the discount rates for salary-related liabilities could have embraced an element of equity returns, reflecting some portion of the equity risk-premium, at least for longer term liabilities.

An approach the IFAA offered to pursue was to see if a framework could be agreed by the 40 or more member associations setting out some general principles with which any Guidance to Actuaries provided by national actuarial bodies would comply. It would be up to each body to decide whether to develop such guidance, but it would be expected that at least the UK, US, Canada, South Africa and probably Australia would wish to. In the UK, for example, we already have Guidance Notes GN13 on FAS87 and GN17 on SSAP24 and it would be a natural development for us to develop a Guidance Note covering the new International Standard. In the absence of any encouragement from the IASC this has not been pursued by the IFAA at this stage.

Future Developments

In practice, the door is not at all closed on further debate on these points of principle. The FASB is understood to favour spreading of gains and losses without a corridor, whilst the IASC Board itself was divided on the issue of the discount rate and is likely to set up a project to examine the whole subject of discounting in accounting statements (as have the FASB and ASB already).

Further work in the actuarial profession on the size of equity risk-premium which it might be appropriate to include when discounting salary-related liabilities and on the most appropriate methodology for recognising actuarial gains and losses is now required.

Members of IACA with an interest in this subject should visit the IFAA Website on http://www.actuaries.org. and make contact with their country's representative on the IFAA Committee.

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Acknowledgement : The attached schedule is reproduced with kind permission of Peter Clark, Senior Research Manager, International Accounting Standards Committee. He can be contacted on 0171 353 0565 and his e-mail address is <pclark@iasc.org.uk>. The IASC Website is at http://www.iasc.org.uk, and copies of IAS19 can be obtained from the publications department.

Table - Retirement and similar benefits: comparison of the new IAS 19 with the old IAS 19, USA and UK

	Old IAS 19	New IAS 19	USA	UK
Actuarial valuation methods	Accrued benefit or projected benefit	Projected Unit Credit only	Projected Unit Credit only	Not specified
Measurement date	At least every 3 years	Balance sheet date	Up to 3 month before B/S date	At least every 3.5 years
Attribution of benefit to periods:				
• attribution starts	Not specified	When employee becomes entitled to benefits (conditional or unconditional)	When plan grants credit	Not specified
• attribution ends	Not specified	When entitlement is no longer conditional on future service	Pension costs: end of service OPEBs: full eligibility	Not specified
• attribution method	Not specified	Note 1	Note 2	Not specified
Discount rate	Long-term rates at which obligations are expected to be settled	Rate on high quality corporate bonds at B/S date	Effective settlement rate / return on high-quality fixed-income investments	Long-term return on plan assets
Measurement assumes future benefit increases?	If regular or automatic	If part of formal or constructive terms of the plan	If regular or automatic	Optional
Actuarial gains and losses	Spread over working life	Optional 10% corridor (note 3)	Optional 10% corridor (note 3)	Spread over working life
Spread past service cost for current and former employees?	Current only	Note 4	Yes	Yes
Past service cost - amortisation basis	Not specified	Straight-line	Employee/year	Not specified
Additional minimum liability in certain cases?	Not specified	No	Pensions - yes OPEBs - no	No
Measurement of plan assets	Fair value (note 5)	Fair value (note 5)	Market Related or Market Value	Discounted cash flow
Limit on recognition of an overall asset	No	Yes (note 6)	No	No

Curtailment/settlement loss: timing of recognition	When probable	When occurs	When probable	When occurs
Include unrecognised actuarial gains/losses (A) and past service cost (P) in: • curtailment gains/losses?	A+P	A+P	P	Not clear
• settlement gains/losses?	A+P	A+P	A	Not clear
Multi-employer plans with defined benefit characteristics	No guidance	Use defined benefit accounting	Use defined contribution accounting	No guidance
Analyse balance sheet/income statement?	No	Yes	Yes	No
Delayed transition allowed?	Yes (note 7)	Yes (note7)	Yes (note7)	Yes (note 7)

Notes:

1. Plan benefit formula (but use straight-line if formula is back-loaded)
2. Pension costs: plan benefit formula, unless back-loaded. OPEBs: straight-line unless front-loaded
3. Inside 10% corridor: may ignore. Outside 10% corridor: must amortise, but may recognise faster.
4. Spread over average period until the amended benefits become vested
5. New IAS 19 - do not use discounted cash flows if a market value (not clear under old IAS 19)
6. Asset limited to unrecognised actuarial losses and past service cost, plus present value of available refunds and reductions in future contributions.
7. New IAS 19 - may spread transitional increase (not decrease) in liability over up to 5 years. Old IAS 19, USA and UK - may spread transitional increase or decrease over remaining working life (USA - longer in some cases).

OPEBs - Other Post-employment Benefits