The Impact of IAS 19 on Company Financial Statements

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Under European Commission regulation No. 1606/2002, publicly traded companies in the European Union must report in accordance with International Financial Reporting Standards (IFRS) from 2005 on. In this context, publicly traded means that the company's securities are traded on a regulated market or that the company has issued bonds to the public.

German companies already accounting in accordance with other internationally accepted standards that correspond to §292a HGB (German commercial law), e.g., American Financial Accounting Standard (FAS), must use IFRS from 2007 if they fulfill certain additional conditions.

The IFRS for the measurement and accounting of company pension schemes is the International Accounting Standard 19 (IAS 19). IAS 19 differs fundamentally from conventional German measurement and accounting under commercial and tax legislation. In particular, IAS 19 requires the complete recognition of any pension liability within the balance sheet, whereas German commercial legislation allows the company to choose whether or not to recognise the liability when the pension promise was given before 1987. Furthermore, pension liabilities are not required to be recognized when the company makes use of an external funding vehicle, even if the corresponding assets are not sufficient. This often happens in Germany when pensions are externally funded through the use of a support fund.

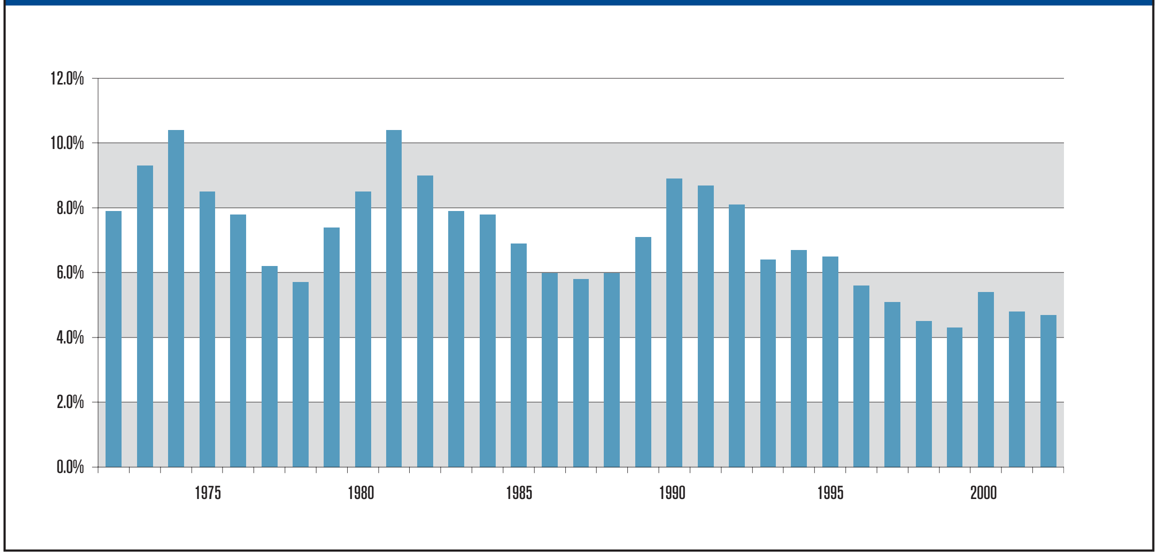
Accounting for pension liabilities under IAS 19 is also quite different than current German practice. IAS 19 requires the consideration of future adjustments of pensions in the course of payment. However, this rarely happens in German commercial balances, since it is not accepted for tax purposes. As a result, the pension liability measured in accordance with IAS 19 often outruns the conventional German value by as much as 40%. This is not always the case, as some pension plans have the opposite effect.

The interest rate used for discounting future pension payments is very important. In Germany, an interest rate of 6%, which is obligatory for tax purposes, is often used for the commercial balance as well. IAS 19 requires companies to use an interest rate corresponding to the effective interest yield of high quality corporate bonds, wherein high quality means at least an AA rating. If there is not a sufficient market for corporate bonds, the use of the yield on government bonds is allowed. In practice, this yield is often increased by a half or even a whole percentage point in consideration of the supposed higher solvency of such government bonds.

It is a matter of fact that the effective interest yields of fixed-interest bonds vary considerably. In Germany, it was about 10.4% in 1974, dropped to 5.7% in 1978, increased back up to 9.4% in 1981, dropped again by 1987 to 5.8%, reached another peak in 1990 at 8.9%, and then dropped steadily to 5.4% in 2000 and probably about 3.9% in 2003 (see Figure 1). These ups and downs of effective interest yields influence the accounting of pension liabilities in accordance with IAS 19. The value of the same pension liability can vary by a factor of two or even three within only a few years. This is especially true if the pension is not salary-related. Otherwise there is a counter-effect from assumed salary increases, due to the fact that in periods of low interest rates, salary increases are low as well, and vice versa.

FIGURE 1

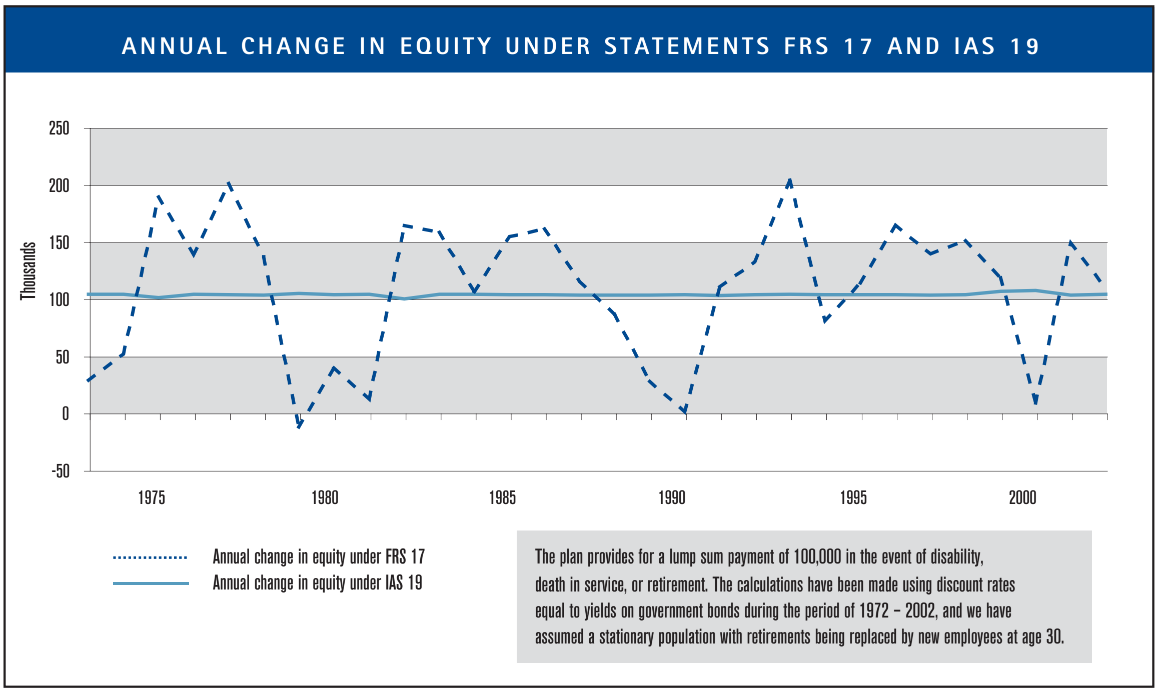
YIELDS OF GOVERNMENT BONDS IN GERMANY



Additionally, the greatly varying interest level leads to a correspondingly large variation in the value of pension liabilities. To reduce this variation, IAS 19 in its present form allows the spreading of pension costs over the average remaining service of scheme members, if the Defined Benefit Obligation (DBO) outruns the net liability by more than 10%. As a result, pension costs do not vary arbitrarily and are not bound to the casual interest rate at the measurement date. A long-term liability, like a company pension scheme, which has to be fulfilled over decades, cannot reasonably be measured with such a casual interest rate. Given term-adequate investment in fixed-interest bonds, variation of the interest rate is balanced out anyway. The investment portfolio covering the pension liabilities will normally contain high-interest bonds as well as those with lower interest yield. It would be inadequate to abandon the described spreading of pension costs, which indirectly causes a smoothing of the differing interest rates within the company’s profit and loss account.

In Great Britain, however, this mechanism of smoothing was attacked. The accounting standard FRS 17, which was developed for Great Britain, no longer allows the spreading of pension costs. If it were in force already, it would cause a no longer understandable chaos within the balance sheets, which would greatly influence the profit and loss account as well as the company’s equity (see Figure 2). In times of high interest rates, the pension liabilities would be unrealistically low, pension costs would be kept down and equity would be inflated. In times of low interest rates the opposite would happen: costs would grow and equity would shrink dramatically. These effects would even be magnified, if the assets covering pension liabilities developed as in the last years, meaning interest level and stock prices decrease at the same time. American and British pension funds especially suffer from this problem. But this effect can occur in Germany as well, if a company has placed the assets for the coverage of pension liabilities in the hands of a trustee, realising so-called contractual trust arrangement models with the corresponding investment policy.

FIGURE 2



For the sake of a sensitive accounting for pension liabilities, the existing standard IAS 19 should not be changed in the sense of the postponed British FRS 17. The consequences would be incalculable, as balancing of accounts would become arbitrary, and a solid rating of companies would no longer be possible. It would be more sensitive to change the existing IAS 19 in a way such that the interest rate used for discounting future pension payments would be the average yield of fixed-interest bonds. Average yield over a long period of time, e.g., 10 up to 30 years, would be most appropriate. This would take into account the long-term character of pension schemes. This basic idea is already used in the German context. It is manifested in §65, Article 1 of the law regulating the supervision of insurance companies and the additional regulations. In contrast to these regulations, it would not be necessary to use only 60% of the average yield, which was mandatory for insurance companies due to the principle of precaution.

In addition, it has to be taken into account that the American standard for the accounting of pension liabilities still uses adequate mechanisms for spreading of pension costs. It would be irresponsible if, by conveying FRS 17 into IAS 19, two completely different accounting approaches came into existence. Convergence of pension accounting standards is necessary for the sake of comparability of the annual balance sheets.