Leeds University Business School

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Accounting for Pensions

Rethinking the Economics of Pensions March 2013

Overview

Background and remit

Timeline and history

Finance director interviews and NAPF Annual Survey Results

Standard setting

The economic consequences of pension accounting

Alternatives and Conclusions

Background and remit

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“Current accounting standards have been very damaging to defined benefit provision, leading many companies to close their schemes …pension funds are long-term institutions but today’s accounting standards fail to reflect this.”

Lindsay Tomlinson, Chairman, NAPF, March 2010

History and timeline

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Evolution of accounting from ED 32 – IAS 19

Death and Taxes

Pension regulation and the hardening of a ‘soft’ obligation

“Pensions have been regulated to death”

The rise of financial economics and a schism within the actuarial profession

Finance director interviews and the NAPF Annual Survey

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To understand what are the key issues?

What are the strengths and weaknesses of current pension accounting?

How has your relationship with investors, trustees and analysts changed as a result of scheme deficits and additional funding?

What are the main drivers for the decline of the defined benefit pension?

What information should the annual report contain about a defined benefit scheme?

Strengths of market value accounting for pensions

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Has forced managers to look closely at the pension scheme and to start dealing with pension risks

Good for deficit recognition as it now sits on the balance sheet

Weaknesses of market value accounting for pensions

Snap shot – 1 point in time problem

Wrong indication of funding

Funding bears no resemblance to the covenant of the scheme or agreements with trustees

Forces short-term decision making

Competition issues – new firms and legacy issues

Too much information is disclosed that many users of financial statements do not understand

Valuing assets using market values is inappropriate for pensions

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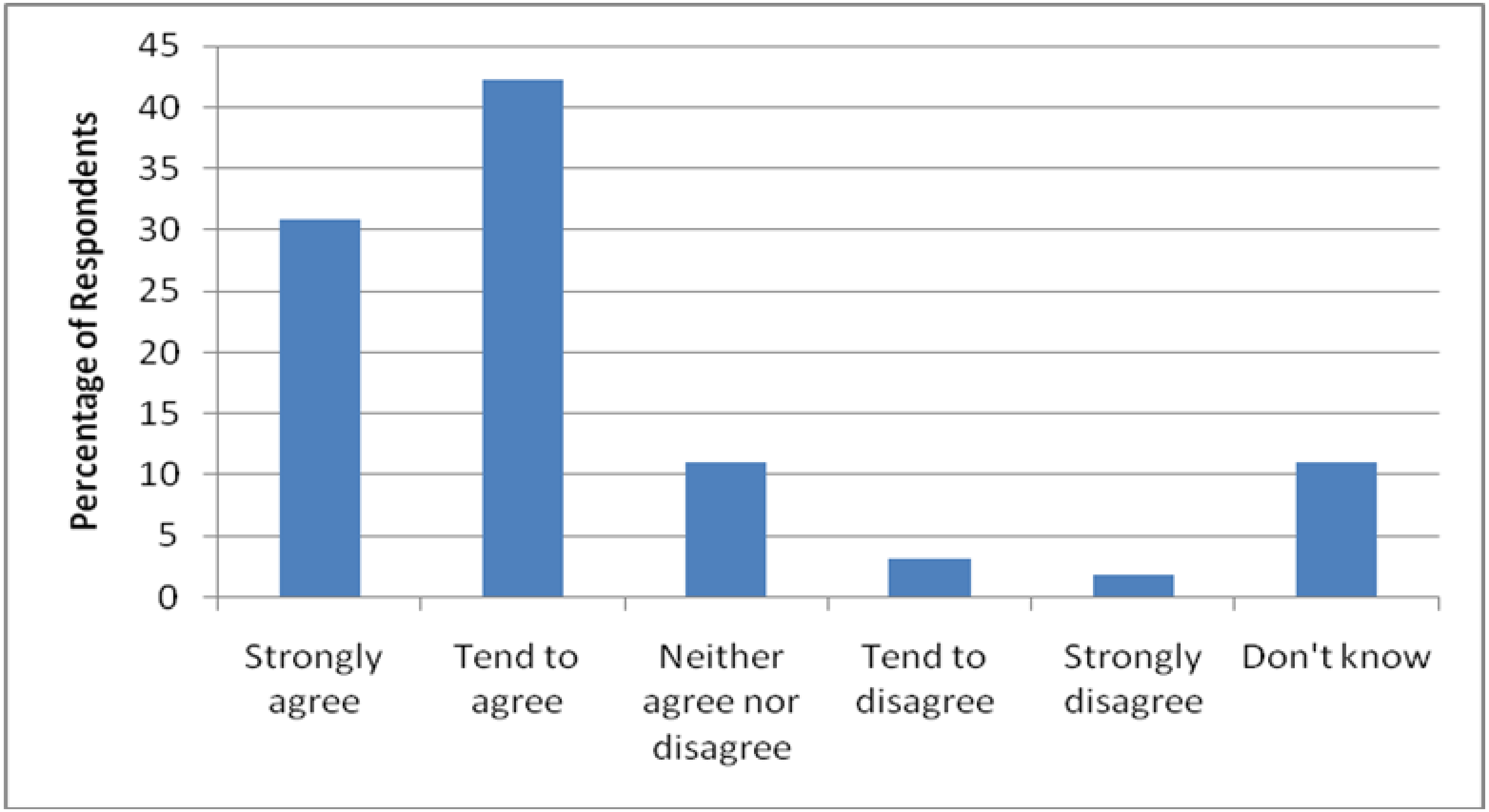

Pensions have too great an impact on sponsor decision making

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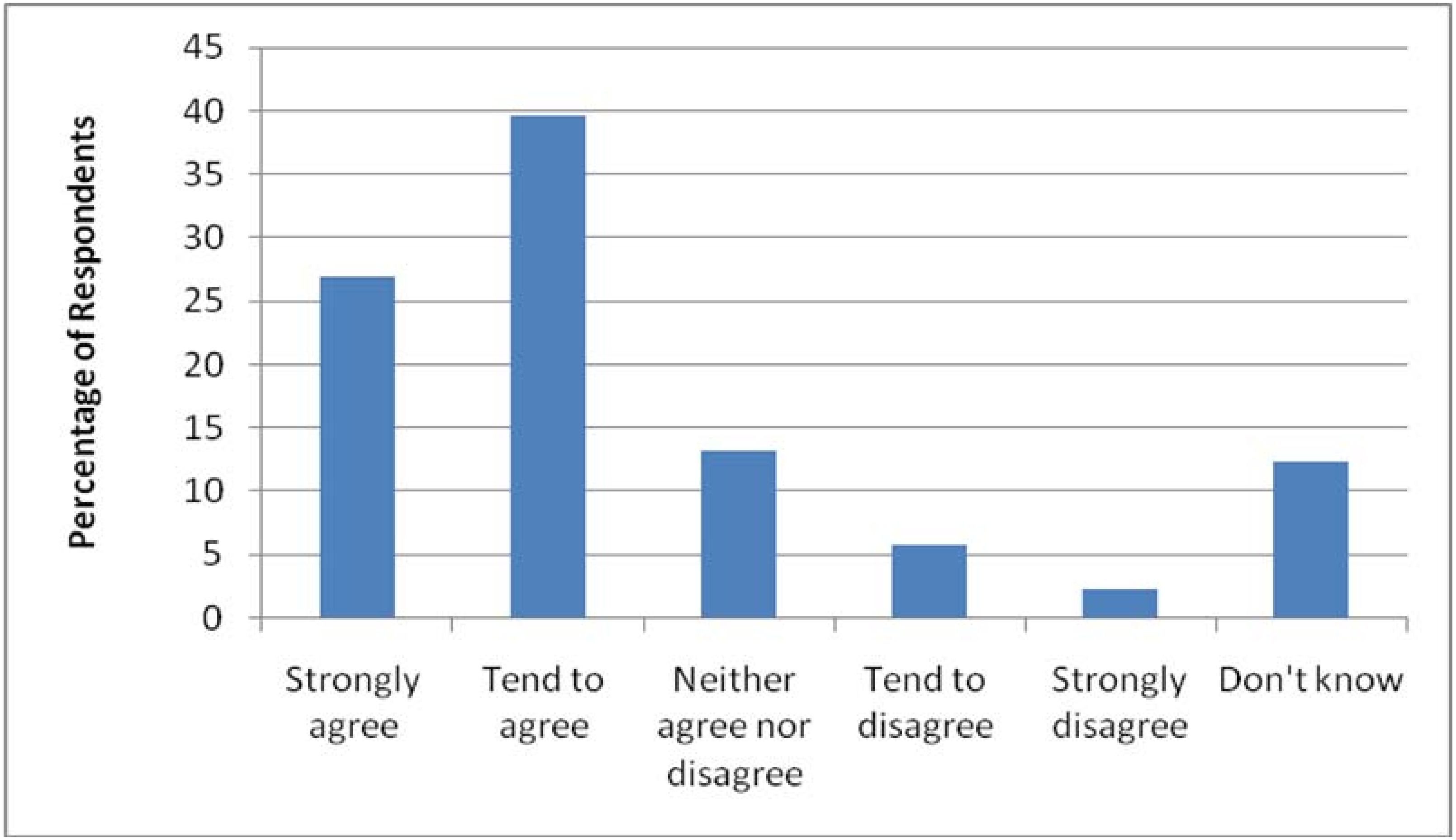

Should some form of smoothing be allowed?

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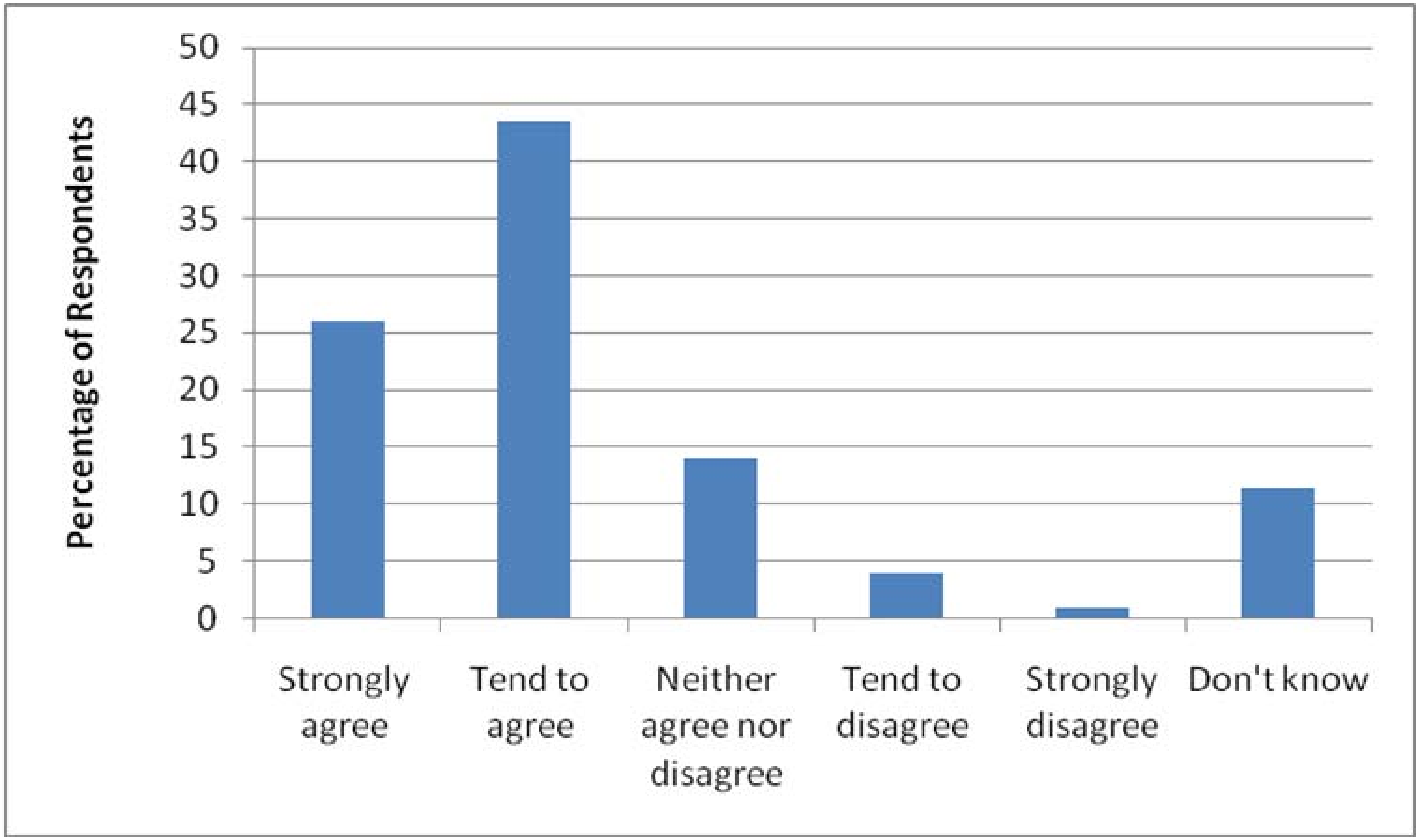

How helpful would it be if standards reflected the long-term nature of pensions?

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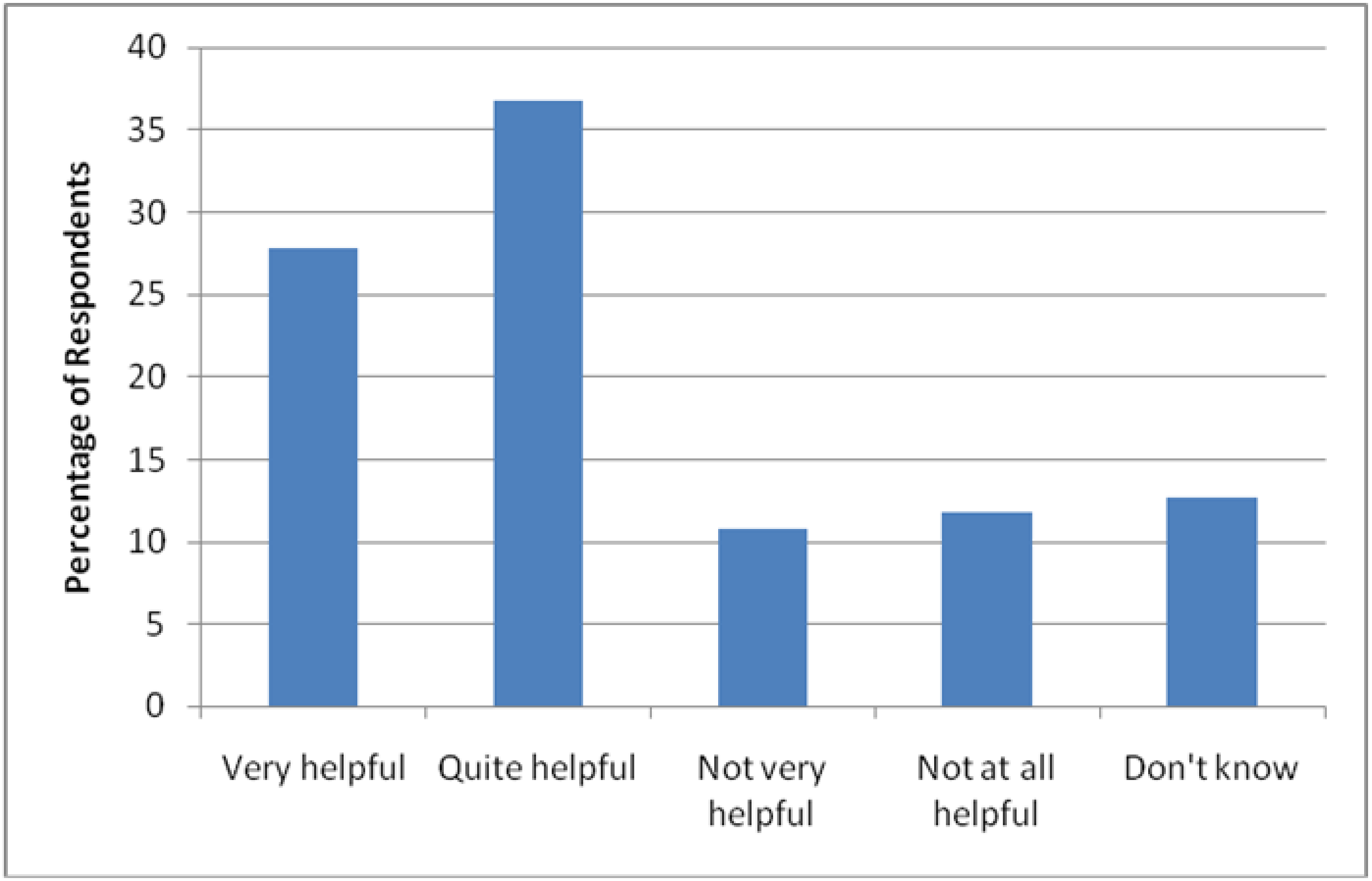
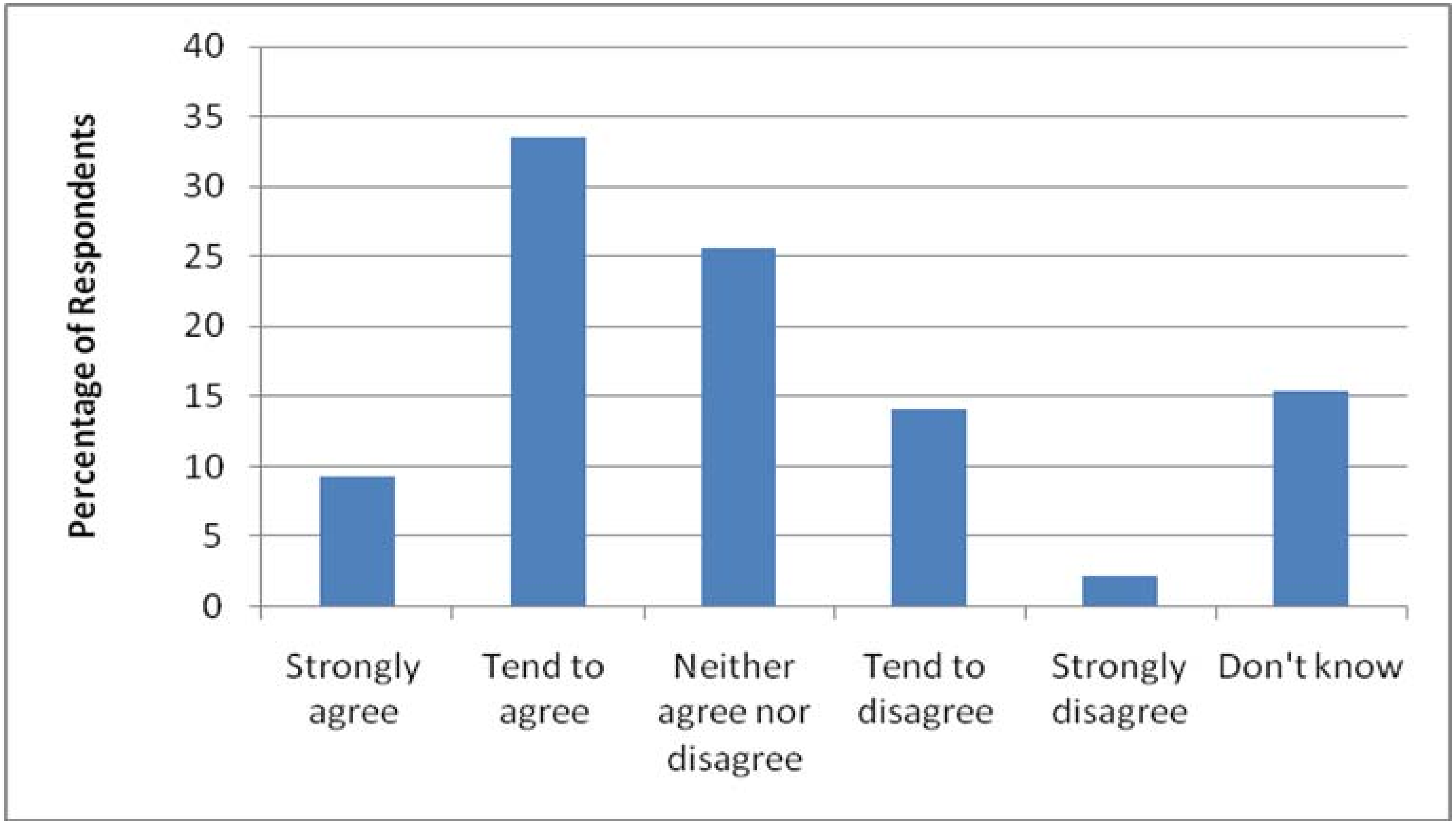


Keep MV accounting but provide more information to users



How satisfied are you with the current standard?

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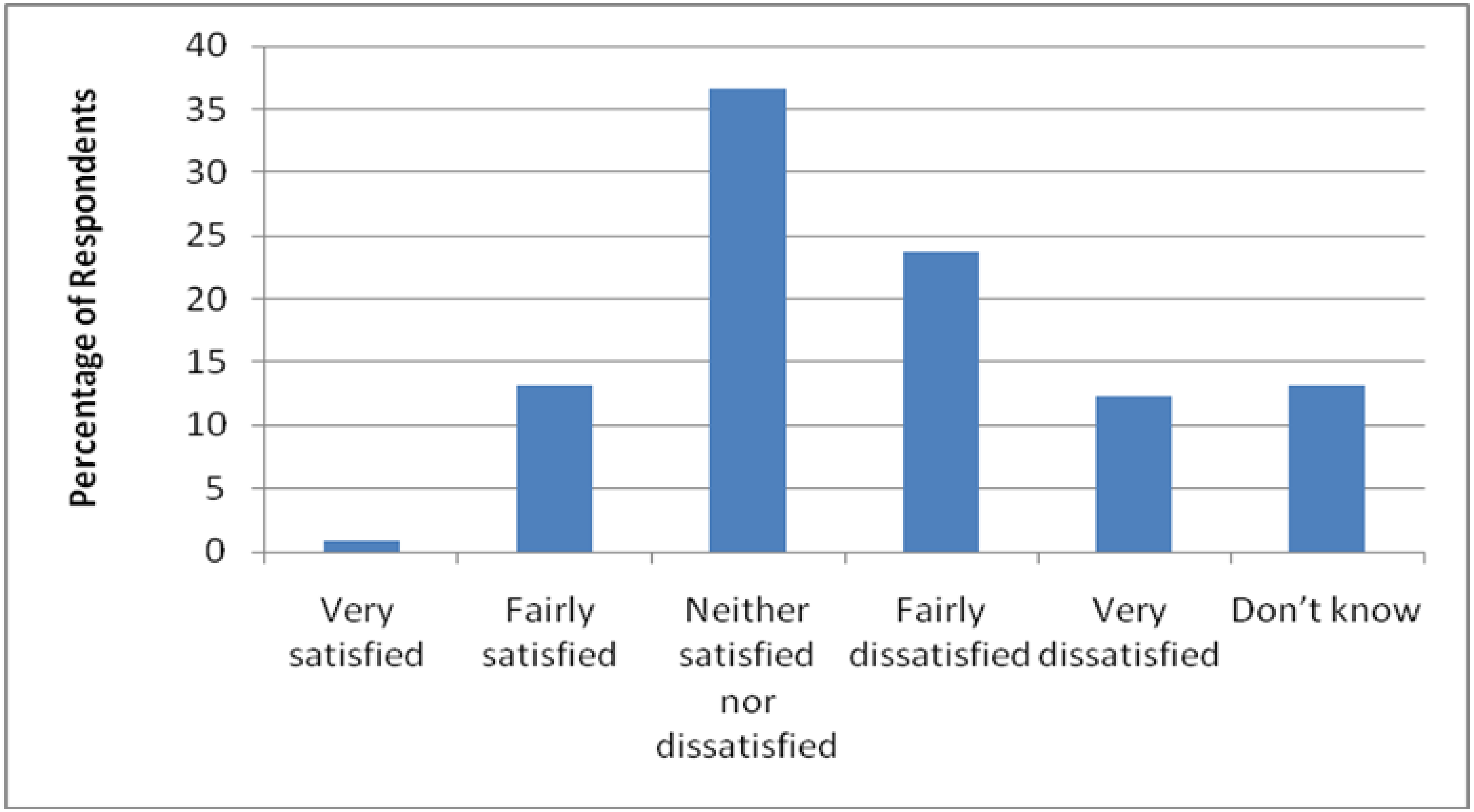

FD Comments

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"It is difficult to explain to some investors what is actually going on. You can have paid large amounts of cash into the scheme to fund it, but when it comes to the corporate accounts this is not reflected as bond yields have shifted or the stock market has fallen. Investors then query where the money has gone and why the scheme appears to be no better off from one year to the next."

"Fair value accounting was only the messenger, not the cause."

How the IASB sets accounting standards

The IASB uses a conceptual framework to make standards consistent

Definitions of assets and liabilities – *fundamental dichotomy*

The balance sheet approach – focuses on assets and liabilities

The profit and loss approach – focuses on revenue and expenses

The conceptual framework and economic consequences

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Economic consequences are ignored in the conceptual framework

The IASB and other standard setters (such as FASB) argue that accounting should be ‘neutral’

Economic consequences *are* implicitly considered through issuing exposure drafts and receiving comment letters from ‘vested’ interests

The case of the IAS 39 carve out

The revenue and expense approach for pension accounting

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A revenue and expense approach focuses on the difference between the value of assets and liabilities

It is the gap that matters!

For pensions this can be seen in SSAP 24

There is matching between cash inflows and cash outflows

The assets and liabilities approach for pension accounting

An assets and liabilities approach is concerned about the measurement of the value of assets and liabilities

Focus is on the valuation of two large numbers

The gap does not matter!

The gap can be volatile as two uncorrelated measurement techniques are applied – *IAS 19*

The macro economic consequences of fair value pension accounting

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There has been a shift in pension fund investment out of equities into bonds as this provides better asset /liability matching (Amir *et al,* 2010)

Accounting solvency was hardwired into legislation with the 2004 Pensions Act

This forced firms to move out of real asset investment into financial investments (Greenwood and Vanyos, 2010)

Net purchases of equities and bonds by UK pension funds (2001-10)

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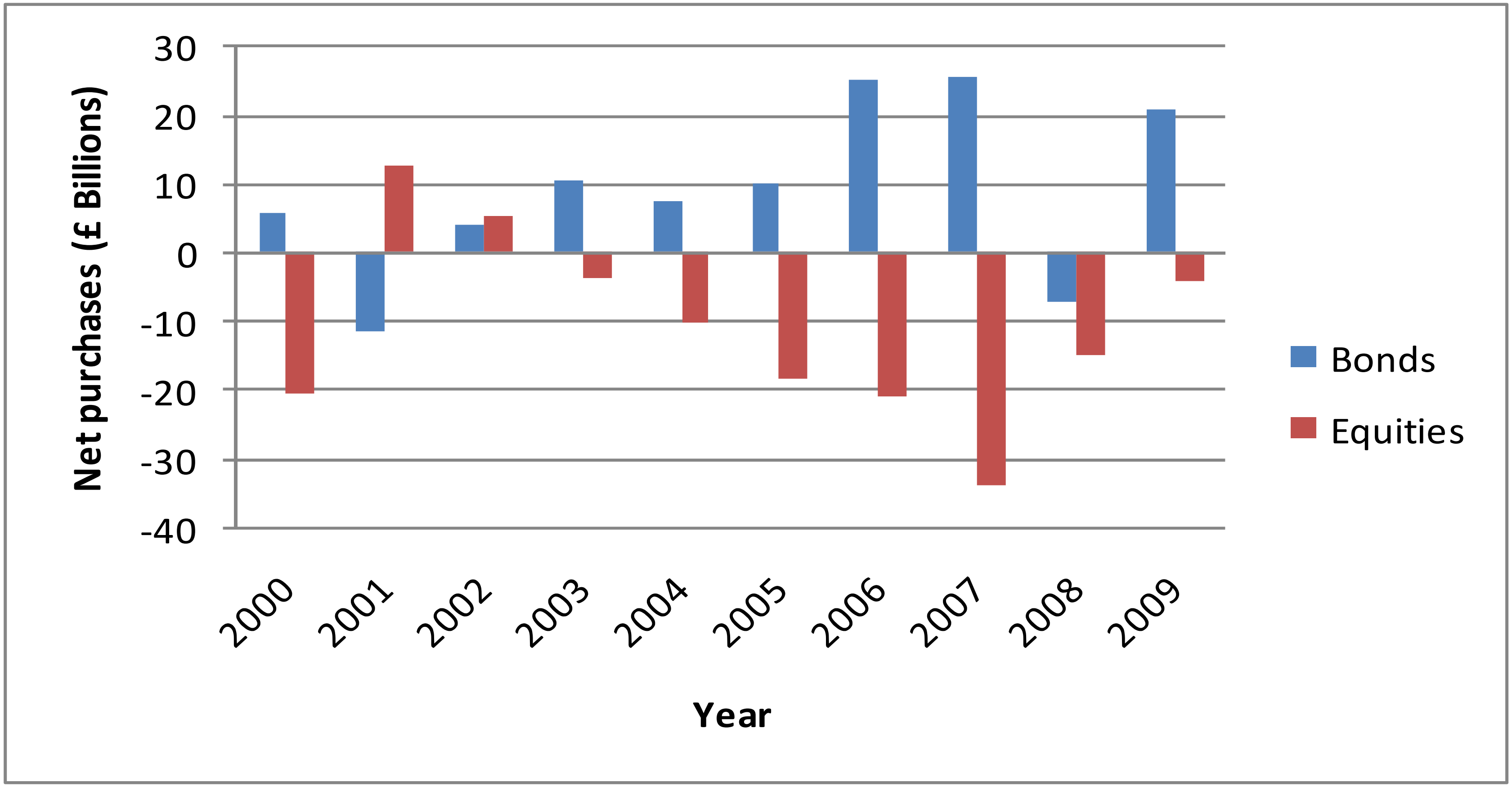

UBS Pension Fund Indicators

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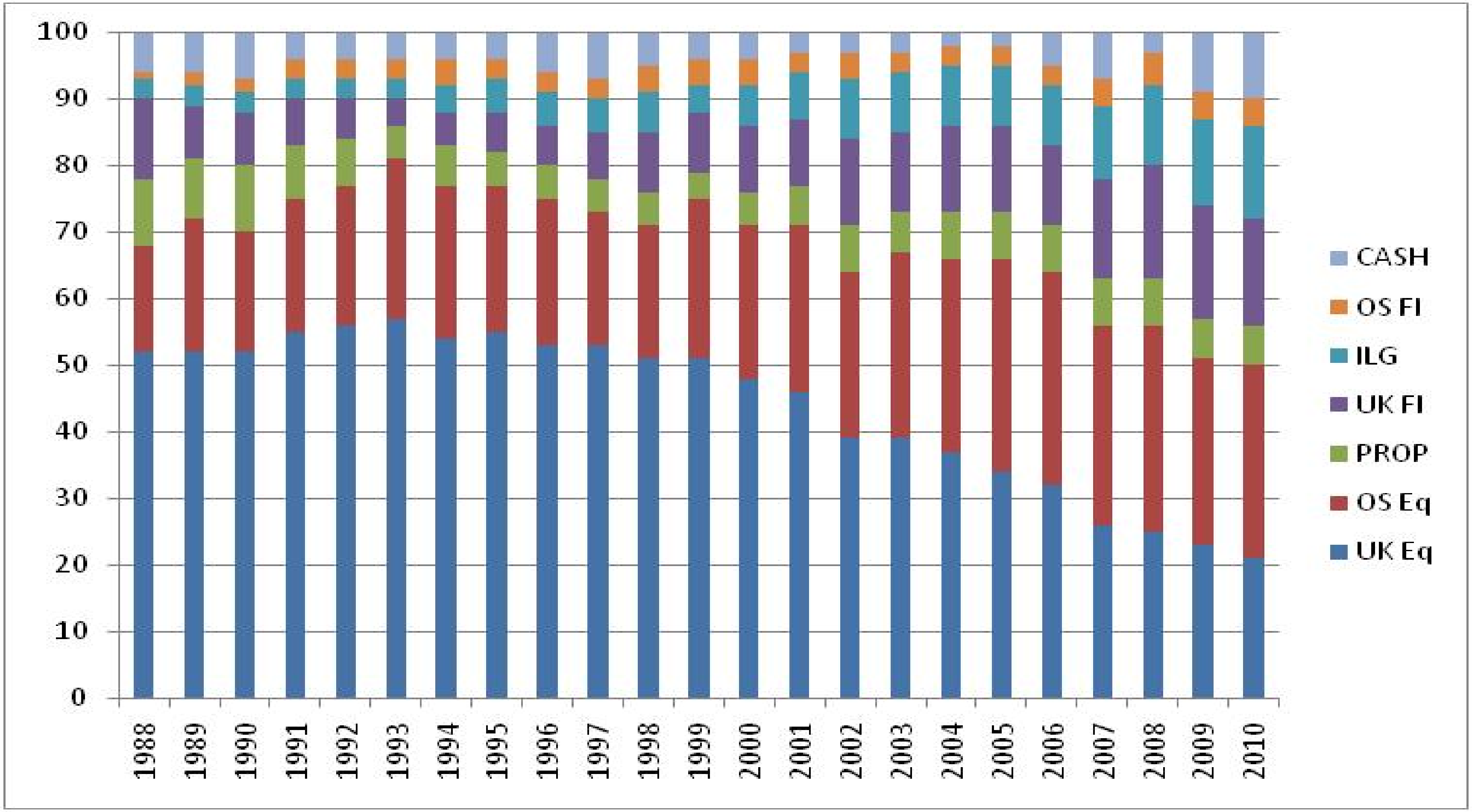

Financial Assets Vs Real Assets

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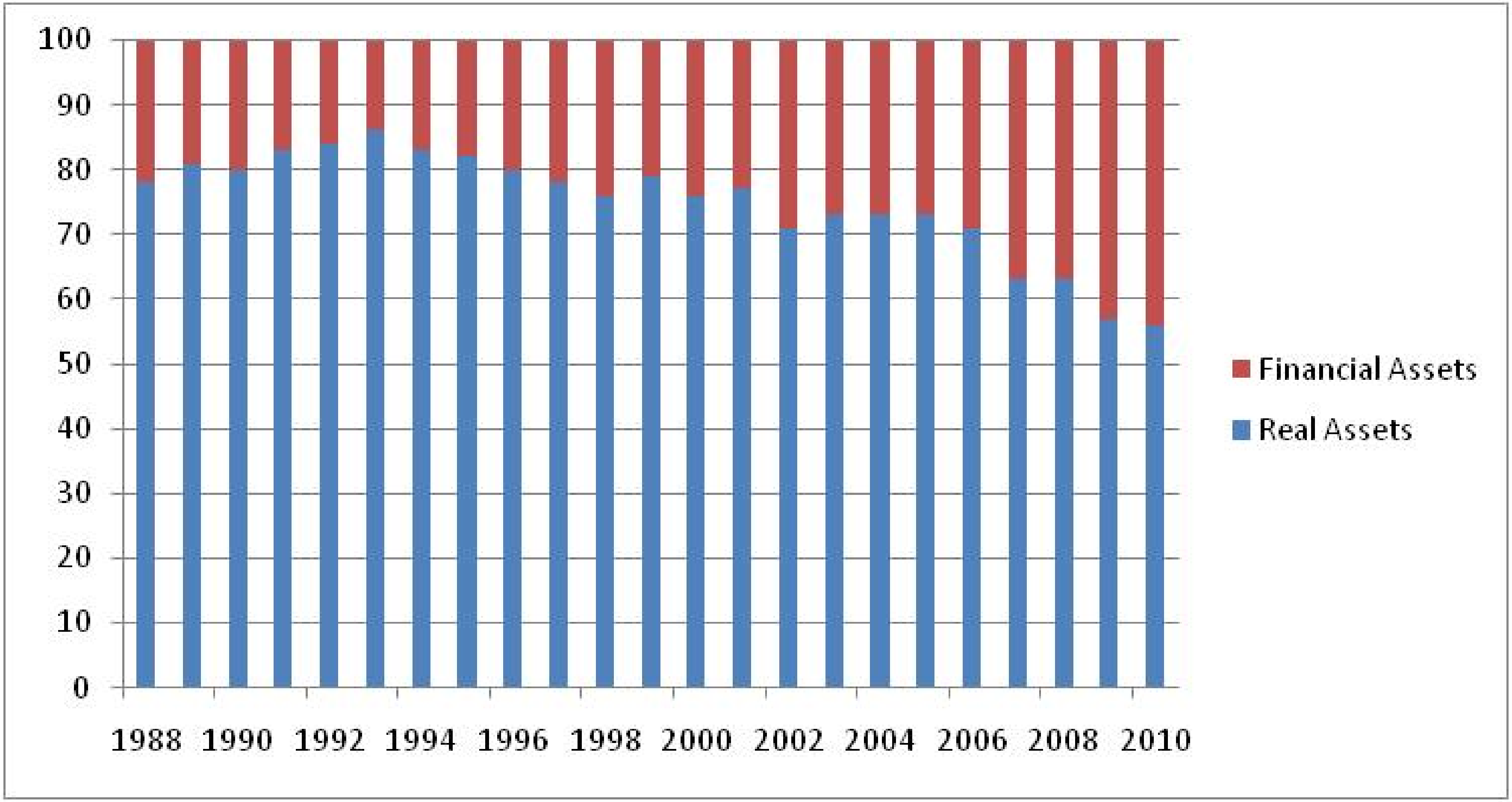

The micro economic consequences of fair value pension accounting

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Fair value pension accounting has contributed to the closure of defined benefit pension schemes (Kiosse and Peasnell, 2009)

Fair value pension accounting has resulted in increased volatility in Comprehensive Income (Amir *et al*, 2010)

The move into financial assets will increase the cost or pension provision for corporate sponsors

AonHewitt200 Index (2005-2011)

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AonHewitt 200 Volatility Index

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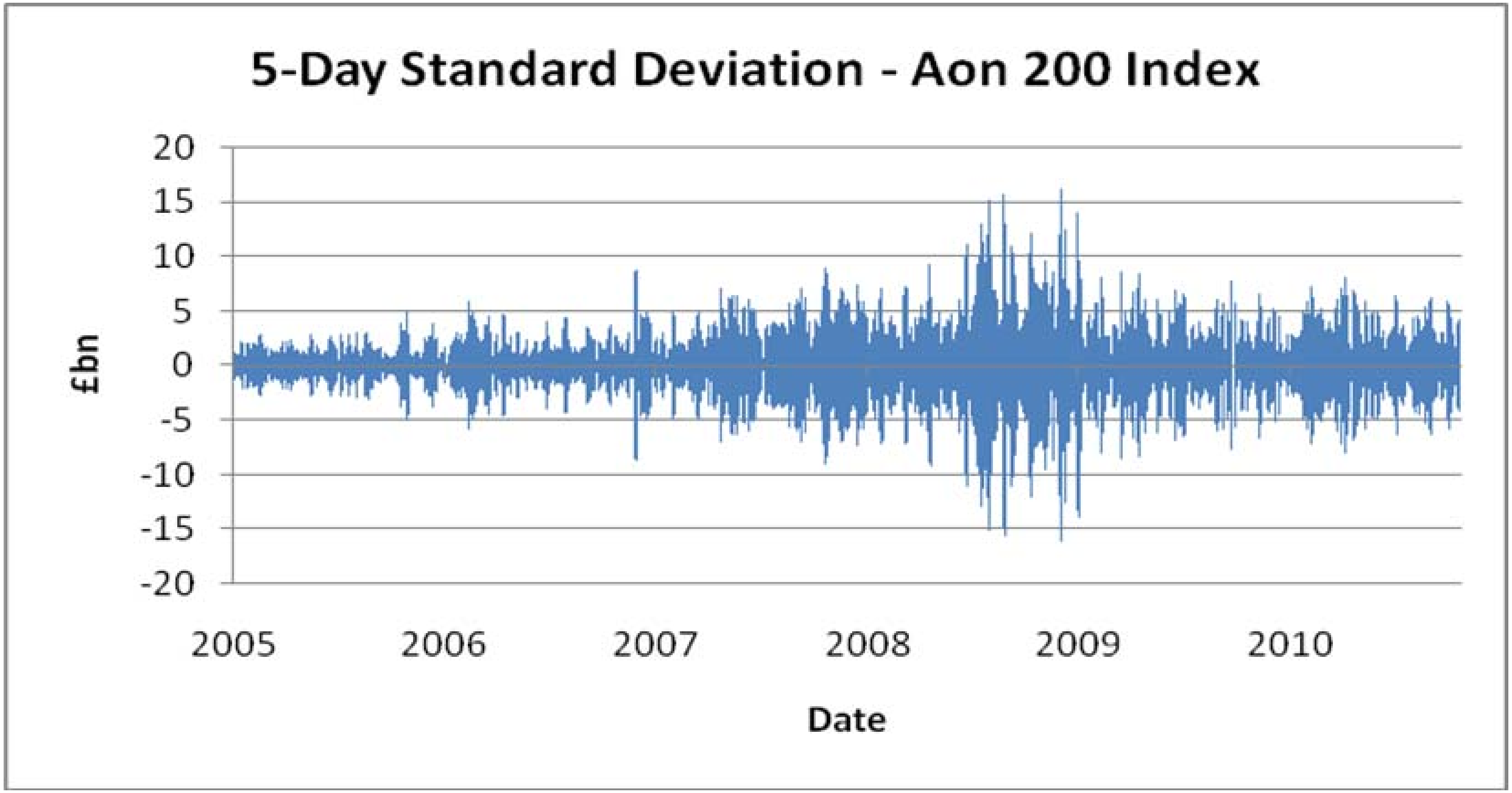
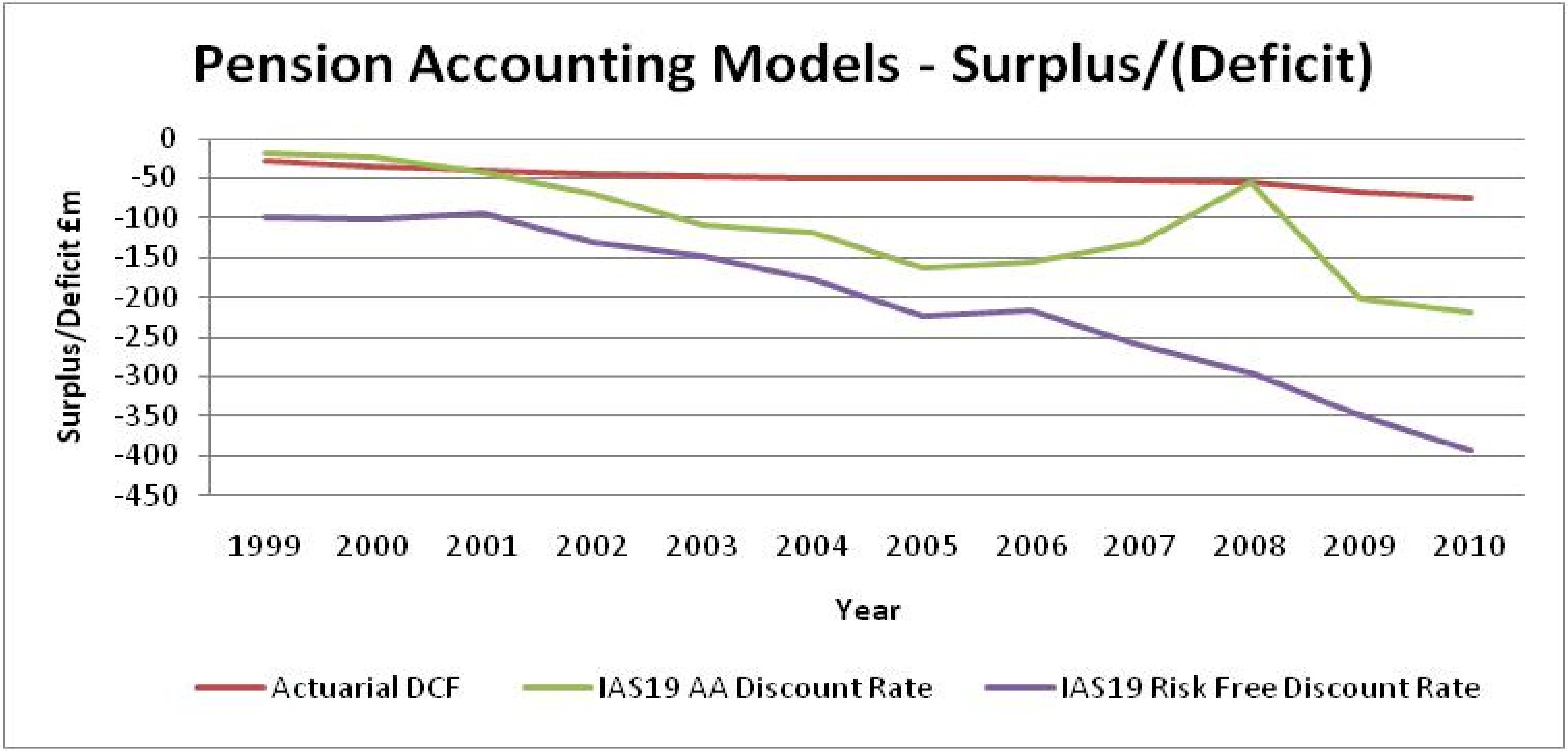


Modeling different methods of accounting for pensions



Conclusions

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Fair value pension accounting has contributed to the decline of defined benefit pension schemes

The current approach is not concerned with the gap between two large numbers

Relevance has been sacrificed for increased verifiability

Pension accounting needs to apply consistent model for valuation and accounting recognition

Conclusions

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The gap matters – net pension liabilities should be valued as the discounted value of future net/asset liability cash flows

Pension accounting disclosure should include:

The fair value position of the scheme

Actual cash contributions that the firm is committed to in the near future – trustee negotiation and the Regulator