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DB SOLUTIONS Industry Watch

Pension accounting standard changes will lead to a shift in risk philosophy

Canadian corporations have finalized the details for the transition to International Financial Reporting Standards (IFRS) effective January 1, 2011. One implication is that pension disclosures in financial statements will lead to greater transparency of changes in the funded status of a defined benefit (DB) pension plan. This transparency could lead to a shift in philosophy by Canadian DB plan sponsors whose current asset mix has an equity bias.

However, what's brewing in the next wave of potential reporting changes may be the real catalyst for a shift in philosophy. The International Accounting Standards Board (IASB) is currently deliberating changes to pension accounting. A new standard is expected to be effective in 2013, which could drive sponsors concerned about accounting impacts to consider de-risking DB plans by reducing equity allocations. An Exposure Draft (ED IAS 19) was published in April of 2010 and the new standard is expected to be effective by 2013.

Future accounting changes are in response to a number of criticisms of existing standards:

Distorted reflection of funded status

Due to amortization of gains/losses in the pension expense calculation, there is often a major difference between what's reflected on the balance sheet and the actual funded status of the plan. This has resulted in situations where a plan sponsor has a large prepaid asset on the balance sheet, when the pension plan actually has a deficit. The deficit is only disclosed in the footnotes.

Subjectivity and timing of expected return on assets

The expected return on assets to determine pension expense is a management best estimate based on the plan's asset mix. It also reflects a return premium for investments in equities before it is earned, which encourages an equity-bias asset mix.

Extensive smoothing of assets

Under current reporting standards, a smoothed asset value could be used for the purposes of determining expected return. The greater volatility of a high-equity asset mix compared to a low-equity asset mix is largely hidden due to this smoothing effect. This could change if ED IAS 19 is adopted in 2013.

Together these characteristics support the current equity bias of DB plans, since the return premium reduces current pension expense, while the actual volatility of returns can be smoothed away.

Pension accounting 2013

Under the new standard, ED IAS 19 will put the actual funded status on the balance sheet. If ED IAS 19 is adopted, the changes which take place in a plan during a reporting period would be recognized as follows:

	Presentation	Comment
Service Cost	Profit or loss (employment costs)	Past service cost would be recognized immediately
Net Interest Cost	Profit or loss (finance costs)	Net interest cost would be determined using a high quality corporate rate
Remeasu-rements	Other comprehensive income (OCI)	Actuarial gains and losses

These changes have the potential to increase balance sheet volatility for DB plans, and could lead to a fundamental reassessment of the merits of an equity bias.

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Accounting implications

There are four key implications:

1. **Pension expense will go up**
   Currently the assumption for the long-term expected return on assets is typically higher than the discount rate, due to the ability to reflect an anticipated equity return premium. With a net interest approach, there will not be a higher rate for asset return assumption as a result of investment in equities.

2. **Pension expense will be relatively stable**
   While pension expense will be higher, it will be relatively stable, reflecting the current service cost, plan amendment costs, and net interest on the surplus or deficit.

3. **Higher actual returns from equity will only indirectly impact expense**
   If remeasurements are recognized in the OCI and not in the income statement, higher returns on equities will not directly reduce pension expense, but would only indirectly impact pension expense by increasing the surplus, or reducing the deficit.

4. **Balance sheet volatility will increase if equity bias is maintained**
   Volatility in the balance sheet will reflect the volatility of pension funded status (through OCI). If the current equity bias is maintained, the funded status will be directly influenced by the rise and fall of the equity markets.

Out with the old, in with the new

The accounting changes will make equities less attractive than they currently are in a DB plan asset mix strategy. Companies concerned about balance sheet volatility will reduce allocations to equities and increase allocations to matching bond assets. This move will increase the long-term accounting and funding costs of providing the benefits.

A unique consideration may be to reduce risk through the purchase of traditional annuities. There is nothing new about annuities; they have been used by plan sponsors for decades when winding up a pension plan. What is new, is the use of traditional annuities to transfer pension risks for ongoing DB plans from the plan sponsor to an insurance company.

Annuities provide some merits over simply reducing risk by investing in matching bonds:

Transfer of risk

Annuities provide DB plan sponsors the ability to transfer investment and longevity risks off of a company's balance sheet to the insurer.

Longevity risk of bonds

Bonds can only hedge the investment risk and not the longevity risk.

Bond investing keeps risk in the plan

With bonds, the assets and liabilities are retained by the DB plan, so the company maintains the risk (albeit lower than equities).

Smaller plans can maintain some risk

Transferring the liabilities (and assets) to the insurer reduces the size of the pension plan, which may afford sponsors the ability to maintain an equity bias for the smaller assets that remain.

There will be no single solution or quick fix to addressing the future changes in the pension accounting standards. However, the ability to transfer pension liability risk from the sponsoring company to an insurer is a unique solution that many DB plan sponsors will consider in light of the new standards.

For further information about how IFRS and ED IAS 19 changes could impact your company, contact your accountant or pension consultant.

For further information about how Sun Life can help you manage your DB pension risk, please contact:

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