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TRADE UNION SUBMISSION TO THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

REVIEW OF IAS 19 ACCOUNTING STANDARD FOR DEFINED BENEFIT PENSION PLANS

COMMENTS ON THE PROPOSED AMENDMENTS TO THE EXPOSURE DRAFT ED/2010/3

6 SEPTEMBER 2010

1 In April 2010, the International Accounting Standards Board (IASB) issued an exposure draft of proposed amendments to IAS 19 for public consultation. IAS 19 is the accounting standard for measuring pension liabilities under defined benefit (DB) schemes on the companies' balance sheet. As is the case for other standards under the International Financial Reporting Standards (IFRS) system, IAS 19 applies to most OECD economies and should converge with the US Generally Accepted Accounting Principles (GAAP) standards as part of the G20 & Financial Stability Board (FSB) Action Plan on financial reform. The International Trade Union Confederation (ITUC) and the Trade Union Advisory Committee (TUAC)* to the OECD welcome the opportunity to provide comments on the exposure draft.

About ITUC and TUAC

* The International Trade Union Confederation (ITUC, www.ituc-csi.org) is the main international trade union organisation, representing the interests of working people worldwide. It has 312 affiliated member organisations in 156 countries and territories, with a total membership of 176 million workers. The Trade Union Advisory Committee (TUAC, www.tuac.org) to the OECD is an interface for trade unions with the OECD. TUAC's affiliates consist of over 58 national trade union centres in the 34 OECD industrialised countries which together represent some 66 million workers. ITUC & TUAC are members of the Council of Global Unions (www.global-unions.org).

The exposure draft

2 The exposure draft builds on, and to a large extent repeats, an IASB discussion paper published in March 2008. In particular, the exposure draft proposes to enforce immediate recognition at fair value of all changes in pension obligations when they occur. As such, the IASB proposes to remove the option that is currently available to companies to defer and hence smooth those changes over several years within a 'corridor'. It would thereby depart from the equivalent US GAAP standard, which allows companies to smooth the changes in their pension liabilities in their income statement. The exposure draft would also force companies to

measure annual pension asset returns based on the discount rate, regardless of how the pension scheme assets are actually invested and the asset mix of the portfolio composition.[1] Unlike the 2008 IASB paper, however, the exposure draft requires the calculation of pension liabilities to reflect risk-sharing mechanisms with workers (or other stakeholders) and conditional indexation of plans that do not fall strictly within the 'pure' DB category. Subject to a parallel review of IAS 1[2], the gains and losses should be recognised in the "other comprehensive income" statement, which companies should publish separately from the profit or loss section. Other proposed changes include enhancing disclosure requirements concerning the pension plan's characteristics, particularly with regard to the company's exposure to longevity risks and disclosure of participation in multi-employer plans and un-funded nation-wide pension schemes.

3 The exposure draft lists several questions for public consultation. Among these, question n°1 reads:

"The exposure draft proposes that entities should recognise all changes in the present value of the defined benefit obligation and in the fair value of plan assets when they occur. (Paragraphs 54, 61 and BC9–BC12) Do you agree? Why or why not?"

4 In the Basic Conclusions (BC n°11) the IASB states that "failure to recognise all gains and losses during the period" of reporting would not be "a faithful representation of the entity's obligation". It is argued that "financial reporting will be significantly improved if entities recognise all changes in the fair value of plan assets and in the long-term employee benefit obligation in the period in which those changes occur." The Board makes it clear that "any future review will retain the fundamental conclusion that an entity must account for its obligation to provide benefits as a result of services already rendered by employees". In the conclusions, the Board also responds to some of the concerns expressed in past public consultations:

- With regard to the risk of increased volatility on the company's account (as a result of the removal of the 'corridor') the Board says that "a measure should be volatile if it faithfully represents transactions and other events that are themselves volatile, and financial statements should not omit such information". In other words, if pension liabilities are volatile, that should be reflected in the accounts.
- Addressing the social consequences of such an accounting change, the Board stresses that "it is not the responsibility of accounting standard-setters to encourage or discourage particular behaviour". Rather, it is the "provision of relevant information that faithfully represents an entity's financial position [...] so that users of that information can make well-informed decisions".

5 With regard to the calculation of asset returns, question 5 reads:

"The exposure draft proposes that the finance cost component should comprise net interest on the net defined benefit liability (asset) determined

1 Any return in excess of the discount rate would be recognised outside of the company's profit and loss statement, through "other comprehensive income".

2 Presentation of Items of Other Comprehensive Income - Proposed amendments to IAS 1, Exposure Draft ED/2010/5, May 2010.

by applying the discount rate specified in paragraph 78 to the net defined benefit liability (asset). As a consequence, it eliminates from IAS 19 the requirement to present an expected return on plan assets in profit or loss. Should net interest on the net defined benefit liability (asset) be determined by applying the discount rate specified in paragraph 78 to the net defined benefit liability (asset)? Why or why not? If not, how would you define the finance cost component and why? (Paragraphs 7, 119B, 119C and BC23–BC32)

6 In the Basic Conclusions (BC n°23-32) the IASB argues against the current method of "expected returns" because it finds it "difficult to find a practical method" for measuring the performance of "assets that do not bear explicit interest" (which basically include the full spectrum of financial assets except fixed-income products such as bonds, loans and collateralised debt obligations (CDOs). Although it acknowledges the "arbitrary" nature and "the limitation of a net interest approach" which "would not be a faithful representation of the return that investors require or expect from each type of asset", the alternative of "expected returns" is considered worse because it is based on "subjective judgement". For the IASB, using the liabilities' discount rate to measure asset performance is "a practical expedient".

Comments by the ITUC & TUAC

7 The purpose of any accounting standard is to produce a faithful representation of the performance of the company and the distribution and nature of the risks to which it and/or its stakeholders are exposed. Such representation is needed for the stakeholders of the company, including workers and their trade unions, to make informed choices when they negotiate with others parties, including management. The ITUC and TUAC support the proposals to enhance the disclosure requirements of the pension plan's characteristics and the amounts in the financial statements resulting from those plans. We also support the proposal to ensure that risk-sharing mechanisms, which may exist for certain hybrid DB and Defined Contribution (DC) schemes, are taken into account in measuring pension obligations.

8 We are concerned, however, about the proposal to enforce immediate recognition and the arguments put forward by the Board. If enacted, it is widely accepted that the change would prompt a structural shift from DB to DC schemes.[3] This already happened in the UK when the introduction of new accounting rules in the 1990s led to the first wave of termination of DB plans. And yet DB schemes are far superior to DC schemes. They protect workers against market and longevity risks – risks that do not place any additional burden on employers or on taxpayers if they are properly managed. Further-

3 As OECD experts (2010a) argue "accounting standards are a major driving factor in the decision of many corporations to discontinue their DB pension plans". "The effect of DB systems on volatile corporate profits as actualised by marked-to-market accounting rules" the OECD states "may increasingly dominate over other arguably more fundamental issues such as long-term corporate profitability, corporate culture, the regulatory environment and long-term financing strategies as the biggest driver behind how and in what manner corporations remunerate their employees". In a paper on the impact of the preliminary IASB proposal, the research centre of EDHEC concludes that "immediate recognition would mean the end of defined-benefit plans" (EDHEC 2009). In a survey covering the DB pension liabilities of the largest 50 US companies and 10 non-US companies, PWC (2010) has found that in almost have of the cases, the change to the new IAS 19 would impact the companies' net income by - 18.7% and that the negative impact would be greatest by far in the manufacturing sector (- 60.2% on net income).

more, DB funds contribute to the better allocation of capital and are better equipped for to managing riskier assets than DC schemes.[4]

9 The ITUC and TUAC also question the IASB's confidence in the fair valuation of pension obligations. Unlike other financial liabilities that are included in the profits or losses of companies, pension liabilities are not traded. There is no market as such to measure the longevity risks to which companies may be exposed under DB schemes, the measurement of which is largely dependent on a broad range of assumptions, decisions and the choice of discount rate (typically the benchmark rate set by the central banks or long term corporate bonds). The recent volatility of long-term interest rates and hence the discount rates used by DB schemes have, by any standard, little to do with the economics of pension funds.

10 The IASB proposal would not only increase volatility on the companies balance sheet, but it is also likely to inflate artificially the overall net defined benefit liabilities. The proposal to force companies to measure asset performance by a uniform rate that would be identical to the discount rate runs against the very *raison d'être* of DB funds' investment policy, for which the portfolio mix is highly diversified with a large proportion of non-fixed income assets in comparison to DC schemes[5]. Accounting for pensions should be based on the reality of pension plans as they actually work and the performance of assets, not on some hypothetical view which may overestimate pension plan net liabilities.

What the IASB should do

11 The ITUC and TUAC consider that the objective of the IASB is indeed to ensure a transparent and fair valuation of pension risks so as to secure equally transparent and fair discussions and negotiations between the key constituencies: workers, employers and government. We also agree that it is not the job of accountants to fix the pension system at large, nor it is the responsibility of the IASB "to encourage or discourage particular behaviour". Yet, the current exposure draft would do precisely that. Some of its disclosure requirements regarding plan characteristics and risk-sharing are welcome. Yet if enacted, the proposals laid down in the exposure draft will encourage employers to shift from DB to DC based on an inaccurate, volatile and inflated measurement of net defined benefit liability. Rather than contributing to a transparent and fair discussion on pension design, it would produce the opposite result: fuelling un-founded fears and risk aversion against DB schemes and pushing management into short-termist behaviour.

12 More work remains to be done to ensure the proper measurement of pension liabilities that is consistent with market-to-market valuation techniques, as shown in the controversies over the discount rates. To our

4 DB funds will follow more aggressive and hence risky investment strategies than DC schemes because of their pension liability structure. For European regulators for which "in countries where the pension promise is linked to a guaranteed return on the contributions rather than a final or average salary, we see a greater investment in debt securities and guaranteed return investments with limited equity exposure" (CEIOPS 2010).

5 As stated by the OECD "what this means is that regardless of how the pension scheme assets are actually invested, whether in bond's or equities, risk-free assets or in the very riskiest assets, the effect on the company's annual profits would always be determined by the yield on long-term high-quality corporate or government bonds, and not by the actual rate of return of the assets in the pension scheme's portfolio." (OECD 2010a)

knowledge, no large-scale and comprehensive impact assessment exercise has been conducted in relation to the exposure draft. As a member of the FSB, the IASB should also ensure that its work is effectively coordinated with other bodies, including the International Organisation of Pension Supervisors (IOPS). The review of IAS19 should not bias the pension debate.

13 Accordingly, in relation to question 1 of the exposure draft, the ITUC and the TUAC call on the IASB to:

- maintain the 'corridor' approach which allows companies to amortise and smooth pension liabilities gains and losses;
- condition any further consideration of this topic on the implementation of large-scale impact studies.

14 In relation to question 5 of the exposure draft, the ITUC and the TUAC call on the IASB to:

- maintain the right for companies to use an expected return approach that is based on the actual portfolio composition of the fund, rather than using the discount rate which is arbitrary in nature.

References

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