The moving target

A project to amend the notoriously tricky IFRIC 14 guidance, surging interest from regulators in pensions accounting, not to mention falling yields and rising inflation, mean pensions accounting is now more than ever a minefield for the unwary. Stephen Bouvier explores the issues

Summary
- IFRIC 14 restricts the amount of pension surplus a DB sponsor can place on its balance sheet in the shape of either a refund of any surplus or a reduction in future contributions.
- IFRIC 14's draft changes explore the trustees' potential power to implement a buyout without the sponsor's consent. They do not affect investment decisions.
- The changes may force more DB schemes than first feared to book an additional liability.
- Sponsors have largely adopted a 'wait-and-see' approach to the FRC's preferred IFRIC 14 approach.

Rarely has a minor wording change to an obscure piece of accounting guidance provoked the reaction that the International Financial Reporting Standards Interpretations Committee's amendments to its IFRIC 14 asset-ceiling guidance has received.

IFRIC 14

In June 2015, the IFRS IC issued an amendment to IFRIC 14. The changes aimed to clarify when actions by a third party, such as a DB scheme's trustees, could restrict a scheme sponsor's ability to recognise a plan surplus on its balance sheet. The feedback on the proposals was sharply polarised.

After a long hiatus, the IFRS IC reignited the controversy around the changes by proposing a number of drafting changes – potentially forcing more defined-benefit schemes than first feared to book an additional liability. Under the new wording, schemes could have to look beyond whether their trustees have the power to wind up a scheme – a relatively rare power – and instead consider the much more common power to buy out a scheme's liabilities.

But for the uninitiated, what does IFRIC 14 actually do? Put simply, it interprets the requirements of the IASB's pensions standard, IAS 19, and effectively restricts the amount of pension surplus a defined-benefit sponsor can place on its balance sheet to the 'present value of economic benefits' in the shape of either a refund of any surplus or a reduction in future contributions. The refund route is unaffected by the IFRS IC's latest proposals.

And, crucially, those economic benefits are only available if a sponsor has an unconditional right to them. Furthermore, a sponsor would be unable to claim it has an unconditional right where a third party could step in and block it. A trio of pensions-accounting experts has told *Pensions Age* that sponsors and trustees face hard bargaining in the months ahead over the issue.

"Buy-ins are still safe," says Willis Towers Watson senior consultant Andrew Mandley. "I think that is very clear in the wording, because the committee is still very much of the view that it is an investment decision. So schemes can carry on de-risking – whether through better matching or by buying annuities in the trustees' name – without causing issues in relation to IFRIC 14."

Fundamentally, he explains, the IFRIC 14 changes are not about the actions that schemes take to de-risk, rather they are to do with the powers that exist in the scheme rules. In other words, the changes are about the trustees' potential power to take chunks out of a plan and send them off to an insurer through a buyout without the sponsor's consent. They do not, however, affect investment decisions.

"A joint power trustee and company doesn't create any IFRIC 14 problems," adds Mandley. "When it does happen, it is a settlement and it needs to be considered. We are talking about pre-empting future actions. And the ones we need to pre-empt are the ones that the trustees can carry out without the company's consent.

Further complications

Further complicating that high-stakes conversation between sponsors and trustees is both the delay in finalising the proposals and the intervention of the Financial Reporting Council.

In October 2015, the FRC announced that it would expect sponsors to disclose any "significant accounting judgments made when assessing trustees' rights" against the context of the IFRIC 14 exposure draft.

The fallout from the intervention was dramatic. Last January, in a shock move, Royal Bank of Scotland recognised an additional £4.2 billion liability for past service cost in expectation of the changes. And the potential for the IFRS IC to make further drafting changes has complicated matters.

LCP partner Alex Waite says: "Preparers currently have three different versions of IFRIC 14 to think about: what the interpretation currently says, the FRC's requirement to apply the proposals in the IFRS IC's 2015 exposure draft, and, finally, a set of wording changes that the IASB tentatively agreed at its December meeting.

"So, which of those should you be most worried about? All of them, in my view. The rules are the rules, the proposed changes are what the FRC is asking companies to consider, but your real issue is the change to the wording. If those wording changes go through, they will have a pretty substantial impact."

Response

As for how DB sponsors should respond, Waite has advised most of the companies he works with to mull a change to their scheme rules. Mandley agrees, but cautions that trustees are aware that they might live to regret surrendering powers.

In common with other practitioners, the Willis Towers Watson expert says certainty will only come with the final wording. "The staff paper discussed whether the trustees can settle benefits in full," he notes. "Does that mean settling the entire scheme – IASB staff indicated this is equivalent to what was intended in the exposure draft by winding-up the scheme – or does it mean settling in full just some of a scheme's benefits?"

"If so," continues Mandley, "one school of thought says this is not a big difference because in pretty much any scheme, currently, the trustees have insufficient assets to settle all of the benefits. The proposed changes to IFRIC 14 say you don't need to consider uncertain future events when considering the availability of a surplus.

"So, if you are not fully funded on a solvency basis now, it is uncertain whether you will be in the future. On the other hand, if you project assets and obligations forward as a going concern, with a scheme closed to future accrual, there must be a point at which the scheme is fully funded on a solvency basis."

Overall, warns Marklew, the expectation is for substantial diversity of practice and a lack of comparability: "This is potentially quite an unfair situation where two very similar companies with similar pension schemes fall on one or other side of this line for reasons that don't make much sense."

And what is more, the FRC has again signalled its interest in pensions accounting and disclosures. A case study in the FRC's *2016 Annual Review of Corporate Reporting* underlines the point with an analysis of it challenging a sponsor's pensions accounting, not on the basis of its literal treatment of an annuity contract at fair value but rather over the quality of its disclosures about the transaction.

And although the anecdotal evidence among practitioners is that sponsors have adopted a wait-and-see approach to the FRC's preferred IFRIC 14 approach, those who resist the regulator's nudge might well find their pensions accounting under the microscope.

IAS 19

As if this were not enough to cause preparers sleepless nights, the International Accounting Standards Board is also finalising an IAS 19 amendment, dealing with the treatment of settlements and curtailments. In brief, this proposal will force sponsors to remeasure plan liabilities with an updated discount rate. Opinion is split on the merits of the move.

Although Mandley believes they are relatively uncontroversial, Marklew thinks otherwise: "In my view, this is unnecessary tinkering with IAS 19. I take the view that the IASB is changing the rules with no obvious benefit and making the rules harder for everyone."

One final piece of the puzzle in the IAS 19 accounting picture is rising inflation and the increased funding pressure that it puts on sponsors. As at 31 December 2015, a typical IAS 19 discount rate in the UK stood at roughly 3.8 percent, with long-term annual 'break-even' inflation of around 3.1 per cent – a net annual rate of 0.7 per cent – which is the important figure for discounting.

But, notes Waite, following the Brexit vote, discount rates plunged below 2 per cent in August, causing, as he puts it, "huge increases" in pension liabilities of 30 per cent or more. Since then, although there has been something of a recovery, inflation has also picked up so that, by the end of 2016, breakeven inflation stood at 3.5 per cent – much higher than discount rates of around 2.6 per cent.

For the next year or so, the IAS 19 numbers and disclosures look set to make for unexpectedly riveting reading.

Written by Stephen Bouvier, a freelance journalist