BRIDGING THE GAAP

The move to International Financial Reporting Standards means better transparency but also more concerns for pension plan sponsors

By ***Scot Blythe***

In the pension fund world, accounting rules sometimes attract more attention than actuarial valuations. That's because, at least among DB pension plans in the private sector, funding results are applied to the bottom line—but only in an approximate fashion.

Let's say the plan's valuation assumes an 8% return on assets. Markets go down? No matter: amortize that loss over a reasonable number of years. A company looks healthy and can even include pension gains on its income statement—even if the pension fund has performed dismally when it comes to meeting its long-term actuarial liabilities.

We saw this scenario play out in the auto sector during the Great Recession, when some companies—weighed down, in part, by future pension and benefits obligations—went through a forced-march bankruptcy as optimistic assumptions on asset returns disguised how dreadful the balance sheet really was. The balance sheet (a company's assets and liabilities) is often less visible than its income statement [a company's annual profit and loss (P&L) summary]. And that annual P&L summary can gloss over long-term liabilities, since only a portion is recognized (or amortized) each year.

But that's about to change, as Canada transitions to International Financial Reporting Standards (IFRS) and abandons the Canadian version of generally accepted accounting principles (GAAP). Amortization, meet mark to market. No more smoothing; assess the assets for what they are worth on market valuation day. For some companies, that could mean showing a significant loss.

"There's a global movement to come to a common set of accounting standards," says Lorraine Gignac, a principal with Mercer Human Resource Consulting. "Many countries—including the U.S., Canada and all of the European countries—have been in discussions for years, trying to come to consensus on one global accounting standard. The purpose is that we're very much a global world now. Does it really make sense to have different accounting standards in different countries for financial results? One would say probably not."

The change in accounting rules, which came into effect for Canada on Jan. 1, 2011 (with further changes contemplated for 2013), won't affect how pension plans are funded, as the current pension funding regulations remain in effect. "At the end of the day, the objective of funding is benefit security," notes Hvroje Lakota, principal, retirement, risk and finance, with Mercer Canada. "Accounting has nothing to do with that. Pension accounting is figuring out how an organization should recognize the cost of its benefits plan in its financial statements." But it may have an impact on how pension funds invest, since what was always there in the footnotes to earnings statements will become more transparent.

Impact of Mark to Market

The accounting changes require companies to immediately recognize annual gains or losses, rather than amortizing them over a period of years. That includes pension fund losses and gains, as well as benefits improvements. Says Gignac, "Two years from now, it will be completely mark-to-market accounting. Right now, it's a lot closer to mark-to-market accounting in that, for example, under Canadian and U.S. accounting standards (GAAP), you can use the smoothed or market-related value of pension expense. Under IFRS, you have to use the market value of assets."

The move to mark to market means two things under IFRS. First, it eliminates the "smoothing" of investment gains and losses—essentially, waiting for markets to pick up and trend toward their expected value after a market dip—in the pension expense category. Second, it transfers gains and losses from the income statement to the balance sheet, where they are recognized as an impact on retained earnings and, ultimately, on shareholder equity.

"The move to IFRS (in 2013) gives companies the obligation to recognize current-year gains or losses immediately as a charge to retained earnings—as opposed to what they've been doing in the past, which is recognizing gains and losses gradually over time," Gignac explains. "Now they can deal with them immediately and have them bypass the P&L statements and go directly into equity. And although the U.S. hasn't done that, we're seeing some U.S. companies trying to deal with recognition of gains and losses immediately to get the impact behind them."

Adds Dan Morrison, chair of the Alberta chapter of the Association of Canadian Pension Management and a practice leader with Towers Watson in Calgary, "The biggest thing is that there will be more volatility in the balance sheet, so that the net position of pension plan assets and liabilities will now be recognized fully on the balance sheet." It has a dual effect, he notes. "Some of the volatility is coming out of the income statement so that unexpected gains or losses, such that if the measurement of the liabilities changes significantly because interest rates have changed, will instead go immediately straight to the balance sheet."

But that's only half of the equation: the other side is how the assets used to deliver the pension promise fare. "So I would say that the biggest shift is less volatility in the income statement in the pension expense that is reported as part of the company's revenue and expenses… but much more volatility on the balance sheet, as we are recognizing the market value of pension assets and a calculated mark to market of pension-related liabilities," Morrison adds.

Of course, P&Ls are material factors for investment managers. An earnings hit might be motivation enough to dump a stock; an earnings surprise might encourage the opposite reaction. The key is taking a hit all at once, rather than spreading it out over time.

Companies may recognize losses now "to get the bad news behind them and then not have the bad news continue to drag down their earnings for the next 10 to 15 years," notes Gignac. "So when analysts look at their results and look at their competitor's results, those companies could look better because they're not having to amortize the financial crisis losses."

Recognizing Risk

Mark to market may also have an impact on how publicly traded companies manage their pension investment projections, since it takes assumed rates of return out of the pension expense calculation. Explains Lakota, "One of the components of pension expense was based on the expected return on defined assets. So, to some extent, by investing in assets that provide a higher expected rate of return than bonds do, companies were able to reduce the pension expense that they reported."

But that door will soon be shut. "That is going away in 2013, so that instead of expected return on assets, everything is going to be based on the accounting discount rate [the rate used to measure pension liabilities]," says Lakota. "So all of

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a sudden, the reported P&L is not going to be as dependent on how your assets are invested—which potentially takes away one of the incentives that exist under the current accounting standards to invest in those higher-growth assets, which don't match the liability very well."

Underlying this change is the fact that pension liability is calculated as the rate of return on high-rated corporate bonds. As a result, explains Lakota, "you're not going to get a credit in your pension expense for investing in anything other than high-quality corporate bonds. Should you, from a pure accounting perspective, take on the additional risk? Should the pension fund take on the additional risk associated with investing in anything other than what matches the nature of the obligation, which is more like a bond?….For those organizations in which their primary measure of risk is P&L impact, in 2013, the rule is going to remove one of the incentives for taking on investment risk."

On the other hand, for companies that want to de-risk the liabilities in their pension plans (by purchasing annuities for retirees, so that the funding risk is transferred to insurance providers), IFRS may provide an opportunity to announce bad news that may affect investor sentiment and get it over with.

"The insurance company pays the benefit, and it removes the obligation for the pension from the plan sponsor," says Gignac. "When you purchase annuities in that way, accounting under both the old Canadian accounting standard and IFRS would say that you've got a settlement—you've gone out and settled your obligation. But when you've got a settlement, you're required to bring in a portion of all of the unrecognized gains and losses that you chose to defer for later recognition. And when you bring in a portion, the way you reflect that is that you have an additional P&L expense in the year that you purchase the annuity, to reflect gains and losses that you were going to defer for later recognition."

Bringing in those losses could be cumbersome, she adds. IFRS offers an easier way. "One of the objections that plan sponsors have had to de-risking through the purchase of annuities is, 'We're going to have a huge P&L expense because we're going to have to bring in a substantial portion of losses.' And they really don't want that expense. For those companies that have transitioned to IFRS and did so using what's called a 'fresh-start' transition approach, those companies brought in all of their unrecognized balances as charged to retained earnings on transition. At this point in time, they've got no or very [few] gains or losses deferred for later recognition in the purchase of annuities. Now they don't have a settlement impact."

Good News, Bad News

Getting the bad news out of the way quickly is good for some companies. "For some Canadian organizations—in particular, subsidiaries of a parent company outside of Canada—this is great news, because typically, a subsidiary is measured on P&L expense," reports Lakota. Yet immediate loss recognition might have a negative impact on others, he adds. "There are companies, like bank and insurance companies, where that could be a very big deal, in that the balance sheet and equity is a very important measure for their capital ratios [the ratio of core equity to risk-weighted assets]. So those companies currently immediately recognize gains and losses through what's called 'other comprehensive income,' which is a component of shareholder equity, which is available under IAS 19. What's happening is that in 2013, it will be the only choice. So companies that have transitioned for 2011 have a decision to make: do we continue to defer and amortize gains and losses as we did under Canadian GAAP, or do we move to the new immediate-recognition approach, with the recognition going to shareholder equity as opposed to P&L? The banks haven't had to make final decisions, yet they are seriously looking at continuing to defer and amortize for as long as they can."

Benefit Improvements

There are also less visible but potentially major effects of accounting changes. One concerns pension benefit improvements. Says Gignac, "When a company amends its plan either to decrease or increase benefits with respect to past service, under Canadian GAAP, the change in the pension liabilities would have been amortized over a long period of time—over expected average service lifetime." But under IFRS, the amortization period is no longer available. That raises the stakes in collective bargaining, in which cost-of-living increases are not embedded in the plan design but are granted in conjunction with investment gains.

"The accounting treatment may cause plan sponsors to reconsider introducing changes for granting things like ad hoc cost-of-living adjustments," Gignac explains. For a benefit improvement for those already retired, "the full increase in the liability is expensed that year—whereas in the past, it was amortized over 10 or 15 years—so it is something that should be considered for union negotiations. Often, union plans are flat-dollar plans: there are so many dollars [to be paid] per month for each year of service, and every round of negotiations, the union pushes to have that flat-dollar increase apply to both past and future service." That change could alter the shape of collective bargaining over plan improvements, because the costs are recognized now, not deferred. "Negotiators are going to have to understand the impact on pension expenses, because it's going to be a much bigger number now." The impact of IFRS, says Morrison, may mean "trying to make sure your accounting policy, your funding policy and your investment policy all support one another so they're consistent with the direction the company wants to go in."

In the end, IFRS means that companies will see reduced income statement volatility, which will come as a gain or a loss to shareholder equity. More important, amortization ceases to be an accounting tool, which means immediate recognition of gains and losses as well as benefit improvements. Companies will have to devise a communications strategy for employees—and be ready for tough negotiations. Less volatility ultimately results from prudent planning.

Wondering what to do next? See our IFRS checklist on benefitscanada.com.

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