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Balance sheet bombshell?

“Explosive” and “bombshell” are words used in the financial press to describe the changes mooted by the Accounting Standards Board (“ASB”) as it issued its discussion paper concerning the reform of defined benefit accounting disclosures. Some have estimated that this could increase defined benefit scheme liabilities on FTSE 100 balance sheets by up to £90 billion, as assumptions used to account for pension scheme liabilities move more into line with those used by bulk-annuity providers.

The conclusions from the ASB’s discussion paper “The Financial Reporting of Pensions” provide an indication of the issues that may be considered by the International Accounting Standards Board (“IASB”) as it gears up to produce a full review of the pensions accounting standard, IAS 19. The most significant proposals include:

- **Discount rate:** the rate of discount used to value future cashflow liabilities would be changed from the yield available on long-dated AA rated corporate bonds to a “risk-free” rate; typically an appropriate gilt yield. Given yields as at 31st January 2008 this would suggest a fall of around 150 basis points in the discount rate, substantially driving up the net present value of pension scheme liabilities.
- **Expenses:** currently there is no requirement to include a reserve for scheme expenses in the company accounts. The ASB propose that this be changed. This would increase the size of the pension scheme liability disclosed on the balance sheet and would be particularly significant for smaller schemes where expenses can be a significant proportion of total liabilities.
- **Salary increases:** future salary increases would not be included in the liability calculation as these are granted at the discretion of the company. This would reduce the net present value of the liabilities for schemes with active members.

- **Actual return on assets:** current practice under IAS 19 is to report the expected return on assets in the income statement, with the actual return passing through the Statement of Recognised Income and Expense (the “SORIE”). The ASB propose the actual return on assets should be included in the income statement. This is likely to make the income statement more volatile.
- **Spreading corridor:** the ASB suggests that companies should no longer have the capacity to spread their actuarial gains and losses over time. Rather, changes in assets and liabilities should be stated when they occur.

Overall the ASB’s proposals would increase the value of pension liabilities on company balance sheets, as well as making disclosed surpluses or deficits more volatile.

An examination of the British Airways’ pension scheme provides an analysis of just how damaging these changes could be to a company’s balance sheet and to their profits. Using the information available from the Annual Accounts as at 31st March 2007, we would suggest that the proposed changes would reduce the current profits after tax from £304 million, to a substantial loss of £695 million. The impact to the balance sheet would be similarly harmful, moving from a net asset position of £2,411 million to £640 million, wiping nearly 75% from the company balance sheet.

Conclusion

Although this is a discussion paper it does give light to some of the underlying accounting issues which could see amendments made in the near future. Companies should be mindful of the potential future changes in accounting practice and the impact this would have on their balance sheets. Managing the balance sheet may well become harder in the future and therefore more time should be devoted to this area in the future.

If you would like further information on this topic or have a specific query please contact or [Richard Jones](#) (020) 7533 6967 or [Lesley-Anne Cameron](#) (020) 7533 6966.

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