FOR AGENDA



EBS/99/62

CONFIDENTIAL

April 21, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **International Accounting Standard 19—Accounting for Pension Benefits in the Fund**

The attached paper provides background information for the discussion on the review of the Fund's income position, precautionary balances, burden sharing, and special charges for FY 1999 and FY 2000 (EBS/99/53, 4/6/99), which is now tentatively scheduled for discussion on Friday, April 30, 1999.

Mr. Keuppens (ext. 37813) or Mr. McCoy (ext. 37833) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

# International Accounting Standard 19—Accounting for Pension Benefits in the Fund

Prepared by the Treasurer's Department

(In consultation with the Administration and Legal Departments,
and the Office of Budget and Planning)

Approved by David Williams

April 21, 1999

## Executive Summary

1. The International Accounting Standards Committee (IASC) issued a comprehensive revision of the method of accounting for post-retirement benefits (International Accounting Standard 19 - Revised (IAS 19)—Employee Benefits). This standard requires employers to recognize the difference between actuarially determined pension liabilities and the fair value of plan assets on the balance sheet, and prescribes a specific method for valuing plan assets and liabilities. The accounting change should be implemented by April 30, 2000.

2. This paper provides, for the information of Executive Directors, background for the discussion of the Fund's income position later this month.[1] No decisions are required at this time. The main purpose of this paper is to outline the effects of the accounting change proposed in IAS 19, so that they can be taken into account in the discussion of the Fund's income position. It is the intention to come back to these issues during the year, when a more detailed and up-to-date actuarial valuation will be available.

3. Compliance with the required change in accounting principle will result in a significant one-time gain in the General Resources Account (GRA), which, on a provisional basis, is presently estimated on the order of $500-700 million, inter alia, because the market value of investments exceeds the net present value of the estimated benefits. This asset would need to be recognized on the Fund's balance sheet and the disposition of this one-time gain will need to be decided by Directors by the end of FY 2000. In the meantime, measures have been proposed to exclude the effect of the expected accounting gain on the determination of the rate of charge for FY 2000.

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[1] *Review of the Fund's Income Position, Precautionary Balances, Burden Sharing, and Special Charges for FY 1999 and FY 2000* (EBS/99/53, 4/6/99).

4. Since the Fund follows generally accepted accounting principles, which reflect international accounting standards as they apply to the Fund, this standard will affect the Fund's method of accounting for these benefits. Prior to the revision, the standard permitted the pension liability (or asset) to be excluded from the balance sheet provided the details were disclosed in the notes to the financial statements. Pension liabilities were then reported "off balance sheet."

## I. Introduction

5. The paper discusses the accounting for post-retirement benefits, primarily pensions, as a result of the issuance of a comprehensive revision of an international accounting standard. The paper is organized as follows: Section II describes the requirements of the new standard and Section III briefly discusses the impact for the Fund as it relates to the financial statements, the Fund's income position, and the pension plan itself.

## II. Accounting for Post-Retirement Benefits

6. The new accounting standard requires employers to recognize in the balance sheet a net asset or a net liability equal to the difference between the fair value of pension plan investments and the net present value of the defined benefit obligation, as measured using the criteria of the standard.[2] If pension liabilities, in net present value terms, exceed the fair value of investments, a net liability is reported; if, on the other hand, the value of the investments exceeds the pension obligations, a net asset would need to be included among the other assets. The standard also requires the inclusion in annual income of the difference between the change in plan assets and the change in the defined benefit obligation that results from employees' service during the current year. IAS 19 specifies the methodology for measuring the defined benefit obligation and requires that plan assets be valued on the basis of market values. The standard itself is comprehensive (over 120 pages) and sets out the detailed requirements. The significant aspects of this accounting standard are summarized in Box 1.

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[2]This accounting standard is closely aligned with the standard applicable in the U.S. and, as a consequence, has already been implemented by the World Bank. Failure to comply with a generally accepted accounting standard could result in a qualified audit report.

**Box 1. Main Features of IAS 19**

The requirements of IAS 19 in respect of defined benefit plans are summarized below. The standard requires an employer to:

(a) determine the present value of defined benefit obligations and the fair value of any plan assets with sufficient regularity that the amounts recognized in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date;

(b) use the projected unit credit method to measure its obligations and costs;

(c) attribute the benefit to periods of service under the plan's benefit formula, unless an employee's service in later years will lead to a materially higher level of benefit than in earlier years;

(d) use unbiased and mutually compatible actuarial assumptions about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries, changes in medical costs, and certain changes in staff benefits). Financial assumptions should be based on market expectations, at the balance sheet date, for the period over which the obligations are to be settled;

(e) determine the discount rate by reference to market yields at the balance sheet date on high-quality corporate bonds of a currency and term consistent with the currency and term of the post-employment benefit obligations;

(f) deduct the fair value of any plan assets from the carrying amount of the obligation;

(g) limit the carrying amount of an asset so that it does not exceed the net total of:

- (i) any unrecognized past service cost and actuarial losses; plus
- (ii) the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan;

(h) recognize past service cost on a straight-line basis over the average period until the amended benefits become vested;

(i) recognize a specified portion of the net cumulative actuarial gains and losses that exceed the greater of:

- (i) 10 percent of the present value of the defined benefit obligation (before deducting plan assets); and
- (ii) 10 percent of the fair value of any plan assets.

The portion of actuarial gains and losses to be recognized for each defined benefit plan is the excess that fell outside the 10 percent 'corridor' at the previous reporting date, divided by the expected average remaining working lives of the employees participating in that plan.

7. The change in accounting required by IAS 19 applies to all forms of post-retirement benefits including defined benefit plans, defined contribution plans, deferred compensation arrangements, profit sharing, and bonus plans. Its impact on the Fund's accounting and financial reporting applies mainly to the post-employment benefits extended through the pension and medical plans in the Fund. On the basis of summary data, the Fund's outside actuary has made preliminary calculations which indicate, on a provisional basis, a one-time accounting gain on the order of $500-700 million (Attachment I presents summary calculations for the Staff Retirement Plan (SRP), the Supplemental Retirement Benefits Plan (SRBP), and the Retired Staff Benefits Investment Account (RSBIA)). Variations in the assumptions, within the permissible ranges, could significantly affect the amount, and, therefore, the provisional estimate is in the range of $500-700 million.

**Requirements of the Accounting Standard**

8. IAS 19 provides specific rules for estimating the defined benefit obligation and requires the use of certain discounting techniques and specific actuarial assumptions.

- The defined benefit obligation must be measured using the projected unit credit actuarial method. The defined benefit obligation is the present value of the total projected benefits attributable to service rendered to date by existing plan participants. This method is different from the actuarial method presently used for funding purposes[3]—the aggregate method—which includes assumptions about the cost of future service of existing plan participants and future participants. The accounting standard does not allow for the inclusion of estimates about the future population of beneficiaries or future service of present members. The use of the projected unit credit method results in a lower defined benefit obligation in net present value terms in comparison to the use of the aggregate method.

- The actuarial assumptions are narrowly defined: demographic assumptions (life expectancy, medical claims rates, staff turnover, etc.) and financial assumptions (e.g., discount rate, investment return, inflation, and salary and benefit levels, etc.) are to be "unbiased and mutually compatible." In general, the Fund's existing actuarial assumptions are in line with the requirements of the standard, except for the discount rate used to calculate the net present value of post-retirement obligations, which is to be set equal to the market yield of "high-quality fixed-rate corporate bonds." This rate is currently 7.0 percent, in contrast to the rate of 8.5 percent used by the Fund for its annual actuarial valuation to calculate the Fund's contribution to the SRP.[4] The use of a lower discount rate has the effect of increasing the net present value of the pension obligation.

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[3]The differences between the funding requirement and the accounting requirement are spelled out in paragraphs 11 and 12.

[4]The actuarial assumptions are reviewed by SRP committees every five years. The discount rate reflects the expected long-term rate of return on plan assets and is set at a fixed level.

- Investments are to be valued at market value (as is the case in the balance sheet of the SRP) rather than at another value to determine the annual expense under the new accounting standard. The Fund uses a five-year moving average for its annual actuarial valuation to determine its contribution and to cushion against market fluctuations and the possible erratic effect this might have on annual contributions; the notes to the financial statements of the GRA currently reflect the value of the assets of the SRP using the five-year moving average.

- Under the new standard, the valuation of the post-retirement assets and obligations must be determined on an annual basis so that amounts disclosed in the financial statements reflect current circumstances and market values. The annual cost of pension and medical benefits reported in the income statement of the employer is to be determined as the sum of the participants' annual service cost, the interest cost of the defined benefit obligation, (or increase in pension obligations, because, with the *passage of time, the net present value increases), plus any amortized actuarial gains or* losses,[5] less the return on plan assets. Market conditions will have a more pronounced effect on the measurement of the cost and the size of the asset, although the new accounting standard allows the amortization of sudden changes over the estimated remaining working life of employees. The expense as determined under IAS 19 will be different from the amount the Fund decides to pay into the SRP, which is equal to the Fund's calculated contribution ratio, and from the amount that is presently determined as the annual expense.

9. The revised standard calls for the consolidation of all post-retirement benefits into a single liability, rather than individual liabilities for different types of benefits. The net asset resulting from the valuation of the pension plans (SRP and SRBP) will be combined (and offset) with the net liability of the RSBIA (which accrues the cost of medical and life insurance for retirees). Under current accounting rules, the net defined benefit liability for the medical and insurance costs of retirees amounts to $58 million as of May 1, 1998, which is being amortized and recorded as an administrative expense of the GRA at an amount slightly more than $4 million per year. The one-time gain resulting from the accounting change required by IAS 19 would fully absorb the residual of this accounting liability and could thus reduce the burden on future administrative budgets and expense.[6] Likewise, the net accounting liability for pension provisions for contractual staff, which is not funded, could be set off against this one-time accounting gain.

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[5]Actuarial gains or losses arise when the actual outcome differs from the actuarial assumptions. Actuarial gains or losses must be amortized and recognized as income or expense in the income statement if the aggregate amount exceeds 10 percent of plan assets.

[6]Executive Directors may recall that the Fund discontinued "pay-as-you-go"accounting for post-retirement medical benefits in FY 1994 and began investing resources in the RSBIA. At that time, it was agreed to amortize (and fund over time) the past-service cost of existing staff and to immediately expense and finance the cost in relation to existing retirees. The $58 million net liability represents the unfunded and unamortized portion of the past service cost of current staff.

**The Difference Between Funding and Accounting for Pension Obligations**

10. In determining the periodic amounts to be funded for its employee retirement obligations, an entity may be influenced by many factors such as the availability of cash and tax considerations. In contrast, the objective of accounting is to ensure that the cost of retirement benefits are recognized as an expense as services are rendered by the employee and that the net asset (or liability) is properly reflected in the balance sheet. The requirements of IAS 19 apply to the method of measuring a net asset (or net liability) in the balance sheet and cost in the income statement (i.e., the accounting requirement) and not to the actuarial method used to determine the Fund's annual contribution to the SRP and the RSBIA (i.e., the funding requirement).[7] The accounting standard does not specify amounts as regards funding, i.e., whether and how many resources are to be set aside into separate accounts to meet present and future obligations. Because the requirements for funding and for accounting are different, it is not uncommon to rely on different actuarial valuations. One valuation could be used to determine the amount of the annual contribution to be made through a cash transfer to meet future obligations (the funding valuation), with the other used to determine the measurement of the net asset or liability and current period expense (the accounting valuation). The *1998 Survey of Actuarial Assumptions and Funding of Pension Plans with 1000 or More Active Participants*, conducted by Watson Wyatt Worldwide, indicates that 45 percent of the respondents use different actuarial methods for accounting and funding purposes. For other notable results of this survey, see Box 2.

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[7]The difference between funding and expensing was also discussed in *The Fund's Annual Contribution to the Staff Retirement Plan* (RP/CP/97/6, 8/8/97) and an extract of that paper discussing this is reproduced in Attachment II.

**Box 2. Results of a Survey of Pension Plans in the U.S.**[1]

- Approximately 45 percent of the plans use two different valuation methods; the projected unit credit method is used to estimate the accounting expense and other methods are used to determine contributions to the plan.

- Almost three-quarters of the respondents do not value assets at market when valuing the plan for funding purposes.

- Most respondents have funded their plans, at least to meet current liabilities, and the funded status (i.e., total assets as a proportion of accrued liabilities) averages 130 percent.

- Most plans used the highest possible discount rate to determine obligations. The rate ranged from 6.09 to 7.62 percent for the two years 1996 and 1997.

- The average assets are about three times the current value of benefits for current retirees.

- Rates of return averaged 8.2 percent and ranged from 6 to 9.75 percent.

[1]Based on an independent survey of more than 500 companies in a 1998 survey of pension plans with at least 1000 active plan participants.

11. For financial years prior to FY 2000, the accounting standard permitted the actuarial method for determining the funding requirement to be used for measuring the accounting cost. On this basis, the Fund recorded as an expense its annual contribution, except in recent years when, based on the Pension Committee's recommendation, an exceptional prepayment contribution was made to the plan, with the approval of the Executive Board, with a view to avoiding the impact on the administrative budget of large financial fluctuations in SRP *funding. During these years, the Fund has carried an asset on its balance sheet for the* difference between the calculated contribution and the amount actually paid.[8] Finally, it is important to note that the accounting gain does not affect the financial resources held by the SRP, which will remain in that plan and are strictly segregated from the Fund's assets. Pension assets cannot be transferred to the GRA. Nevertheless, the change in accounting will produce a large accounting gain in the GRA, which will be recorded as an "other asset."

[8]*Fund's Contribution to the Staff Retirement Plan for FY 1999* (EBAP/97/26, 3/21/97).

## III. Consequences of a Change in Accounting Method

12. As noted above, the net asset resulting from the measurement of post-retirement benefits under IAS 19 is estimated to be in the order of $500-700 million. The change in accounting method will affect the presentation of the Fund's balance sheet and, in the absence of a decision to exclude the windfall income from the determination of the rate of charge, could affect the rate of charge. The change in accounting may also have some secondary budgetary effects in future years, but it does not affect the benefit provisions of the benefit plans. A preliminary discussion of these issues is provided in the following paragraphs, but an analysis of the full financial effects will need to take place before April 2000.

**Effect on the Fund's Financial Statements**

13. Accounting standards present two alternative methods to implement a change in accounting method: the retrospective method and the prospective method. Under the retrospective method the financial statements of the last two years (i.e., the two years presented in an annual report) are restated for the information of shareholders as if the new accounting method had been in effect from the beginning of the periods being reported. The staff does not recommend this alternative because it would be inconsistent with the decisions already taken on the calculation and disposition of annual income and the allocation to the Fund's reserve.

14. Under the prospective method, the accounting gain is included in the net income of the period during which the change is made, as a separate line item (referred to as the "cumulative effect of a change in accounting method"). The size and nature of the accounting change would then be clearly identified, and set apart from regular income from operations. Nevertheless, this income would be a part of the Fund's overall net income, and thus available for disposition. The Executive Board then would need to decide, under Article XII, Section 6, what part of the net income is to be placed to the General Reserve or Special Reserve (or what part, if any, is to be distributed). Since net income would include this accounting gain, the Executive Board would need to decide on its disposition by the end of FY 2000. This presentation has been followed in the past when the Fund changed accounting methods (FY 1983 and FY 1994), and it is proposed to follow this method again to implement the accounting change proposed in IAS 19. Attachment III provides a pro forma income statement to illustrate the effect of the accounting change.

**Effect on the Rate of Charge and Reserves**

15. Paragraph 27 of EBS/99/53 discusses the introduction of this accounting standard as it affects the determination of the rate of charge for FY 2000. The rate of charge for FY 2000 is calculated so as to achieve a given income target, and inclusion of this accounting gain in the income projections would result in an artificially low rate of charge. Not excluding this accounting gain from the calculation would effectively shift the full benefit of the accounting

gain to members paying charges and result in a real transfer of resources from the Fund to a group of members. Since the accounting gain does not result from the regular operations of the Fund and does not provide additional financial resources, it is proposed in EBS/99/53 that the effects of the accounting change be excluded from the determination of the rate of charge for FY 2000, and it is also proposed to exclude the gain from net income for the purpose of determining any excess income that would need to be refunded to debtor members after the end of FY 2000, should the Board decide on such a refund mechanism. (In EBS/99/53 it is proposed to postpone the decision on the use of income until the end of FY 2000, in which case the determination of excess income is not an issue.)

16. The disposition of this accounting gain will, nevertheless, need to be decided by the end of FY 2000. In principle, this accounting gain would be available for any purpose for which regular net income could be used. In view of the nature of this gain, however, it would not be prudent to use it for any purpose that would reduce the financial strength of the Fund.

**Pension Plan Revisions**

17. As noted above, the proposed change resulting from the adoption of IAS 19 is one of accounting only, and it does not affect the provisions of post-retirement benefit plans, nor does it increase the assets that are available for the payment of plan liabilities, nor does it affect the resources that will ultimately be required to meet obligations under those plans. The actuarial assumptions used for determining the annual funding of the SRP are scheduled for review in FY 2001. It may be noted that if any amendments to the SRP are made at the time the new accounting standard is introduced, the cost of such amendments may be offset against the one-time accounting gain resulting from the adoption of IAS 19.

Attachments

## Estimate of Impact on General Department of Revised IAS 19
**May 1, 1998**
**(in thousands)**

| | SRP | | SRBP | | Medical & Life Ins | | Total |
|---|---|---|---|---|---|---|---|
| **Balance Sheet Analysis** | | | | | | | |
| Present value of obligation | $2,349,000 | | $28,200 | | $233,700 | | $2,610,900 |
| Fair value of plan assets | ($3,070,000) | | ($200) | | ($175,000) | | ($3,245,200) |
| Unfunded | ($721,000) | | $28,000 | | $58,700 | | ($634,300) |
| Unrecognized actuarial gains (losses) | $0 | | $0 | | $0 | | $0 |
| Unrecognized past service cost for non-vested benefits | $0 | | $0 | | ($700) | | ($700) |
| Unrecognized past service cost for vested benefits | $0 | | $0 | | $0 | | $0 |
| **Balance Sheet Impact (Asset)/Liability** | **($721,000)** | | **$28,000** | | **$58,000** | | **($635,000)** |
| | | | | | | | $0 |
| **Income Statement Analysis** | | | | | | | $0 |
| Service cost | $99,800 | | $0 | | $10,200 | | $110,000 |
| Interest cost | $162,500 | | $1,937 | | $16,100 | | $180,537 |
| Expected return on plan assets | ($260,100) | (1) | ($17) | (2) | ($14,800) | | ($274,917) |
| Net actuarial (gain) loss recognized in year | $0 | | $0 | | $0 | | $0 |
| *Amortization of past service cost - non-vested benefits* | $0 | | $0 | | $50 | | $50 |
| Amortization of past service cost - vested benefits | $0 | | $0 | | $0 | | $0 |
| ***Current year expense*** | **$2,200** | | **$1,920** | | **$11,550** | | **$15,670** |
| | | | | | | | $0 |
| **Cumulative adjustment from implementation** | **($721,000)** | | **$28,000** | | **$58,000** | | **($635,000)** |

(1) Assumes no contributions between 5/1/98 and 4/30/99

(2) Expected benefit payments of $1.8M are assumed to be paid outside of the plan assets

Source: PricewaterhouseCoopers



ATTACHMENT I

## FUNDING AND EXPENSING[1]

1. The Fund may record as an expense only an amount that results from an actuarial calculation that uses an actuarial method acceptable under international accounting standards. The annual contribution amount calculated under the open group method or under any of the smoothing approaches discussed in this paper **could not be recorded as an expense** and charged against the Fund's income. The Fund could, however, actually pay that calculated amount into the Plan (**"funding"**) and show that amount in its budget. The amount that could be recorded as an expense would be limited to the contribution calculated under a method acceptable under international accounting standards.

2. If another funding method were adopted and yielded a larger contribution amount than the closed group method, the amount **funded** would exceed the amount **expensed**, and in respect of the excess the Fund would record an asset in its balance sheet that would be designated "prepaid pension expense." During periods in which the amounts that must be expensed were **more** that the amounts that the Fund would fund, "prepaid pension expenses" would be reduced. The World Bank has in recent years been using the open group method and following this approach in its accounts.

3. In contrast to the amount expensed (which is governed by the accounting standards), the amounts **funded** can be chosen by the Fund in a manner that meets its needs—for example, to maintain some agreed level of assets in relation to accrued benefits or by a method that stabilizes annual contributions. Thus, in any of the options discussed here that would diverge from the closed group method currently in use, the method of determining the amount **funded** would be decided by the Fund, while the amount **expensed** would be the amount yielded by the current method or any other method permissible under generally accepted accounting principles.

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[1]Extract from *Fund's Annual Contribution to the Staff Retirement Plan* (RP/CP/97/6, 8/8/97).

**Pro Forma Income Statement of the General Resources Account for the Years Ended April 30, 2000 and 1999**

| | 2000 | 1999 |
|---|---|---|
| Operational Income | | |
| Periodic Charges | xxx | xxx |
| Interest on SDR Holdings | xxx | xxx |
| Other Charges and Income | xxx | xxx |
| Burden Sharing Contributions Net of Refunds | | |
| Additional charges | xxx | xxx |
| Reduction of remuneration | xxx | xxx |
| Deferred Income, Net of Settlements | - xxx | - xxx |
| | xxx | xxx |
| Operational Expense | | |
| Remuneration | xxx | xxx |
| Allocation to the Special Contingent Accounts | xxx | xxx |
| | xxx | xxx |
| Net Operational Income | xxx | xxx |
| Administrative Expenses | xxx | xxx |
| Net Income of General Resources Account before Net Effect of Change in Accounting Method | xxx | xxx |
| Cumulative Effect of Change in Accounting Method for Post-retirement Benefits[1] | xxx | -- |
| Net Income of General Resources Account | xxx | xxx |

[1]The notes accompanying the Fund's financial statements will provide additional disclosure on the accounting change.