ACTUARIAL SOCIETY OF SOUTH AFRICA

Impact of revised IAS 19 on Top 40 companies in South Africa

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Agenda

1. Introduction
2. Objectives of Revised IAS 19
3. Key changes and impact of these changes on Balance Sheet and P&L
4. Expected impact on SA, UK and European companies

Introduction

- Effective for reporting periods beginning on or after 1 January 2013. Early adoption is permitted.
- The aim of the amendments to IAS 19 is to improve transparency and comparability of companies' accounting for employee benefits.

Revised IAS 19 - Objectives

- Recognition – All changes to pension liability and plan assets have to be recognised immediately;
- Presentation – An entity should disaggregate changes in the pension liability and assets into service cost, finance costs and re-measurement components.
- Disclosures – Aimed at improving the disclosure characteristics and risks of DB plans.

Key changes to revised IAS 19

- Recognition of actuarial gains and losses (re-measurements)
- Recognition of past service cost/curtailment
- Distinction between ‘short-term’ and ‘other long-term’ benefits
- Treatment of expenses and taxes relating to employee benefit plans
- Termination benefits
- Risk or cost-sharing arrangements

Key change – recognition of gain / loss

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Summary of options on recognising actuarial gains and losses
Under current IAS 19, companies have three options on recognising actuarial gains and losses: 1. Immediate recognition in Other Comprehensive Income (OCI) 2. Immediate recognition in P&L; 3. Deferred recognition ('corridor' approach), amortising excess over the corridor in P&L.

- Under revised IAS 19 options 2 & 3 fall away
- The balance sheet will reflect the accounting surplus or deficit (subject to any asset ceiling restrictions)

Implications for Balance Sheet

- On adoption of revised IAS 19, all previously unrecognised gains and losses will be taken directly to equity.
- Balance sheet volatility will increase as actuarial gains and losses will be recognised immediately in the period they occur.
- This may have a significant impact on balance sheet ratios and shareholder equity, particularly for entities with large unrecognised losses.

Implications for P&L

- P&L volatility reduces going forward as all actuarial gains and losses (re-measurements) will be recognised outside P&L
- For entities with an asset ceiling restriction due to irrecoverable surplus, movements in the asset ceiling will no longer go through P&L (other than interest item).

Key change – Net Interest Cost

Summary of change	Implication for P&L
Interest cost and expected return on assets will be combined into a net interest cost or credit	1. Companies no longer able to take credit for anticipated equity outperformance above that of government bonds in the P&L; 2. In most cases, this will increase the pension expense reported in the P&L; 3. For companies with significant pension schemes, this could affect performance indicators such as EPS;

Key change – Net Interest Cost

Summary of change	Implications
The **net interest** cost will be based on the **net defined liability or asset** (after allowing for asset limit) and allowing for net cash flows over the period	Entities with asset limits may experience an increase in reported P&L costs as they must recognise interest on effect of asset ceiling
Companies will continue to have the **choice** to recognise the net interest item in **operating** costs or **financing** costs	Under revised IAS 19, entities will continue to have flexibility, although eliminating EROA may give fewer incentives to include the net financing item in operating costs.

Example calculation

Assumption	
DBO	R35,600
Fair value of plan assets	R42,500
Asset ceiling adjustment	R2,900
Discount rate	5.5%
Expected return on assets	7.75%
Benefit payments	R3,700 (assume occur on average mid-year)
Employer contributions	R2,800 (assume occur on average mid-year)
Investment expense	R600
Administration expense	R400

Solution

- Net interest cost = Net defined benefit liability (asset) multiplied by discount rate, taking account of any changes in the net defined benefit liability (asset) during period as result of contributions and benefit payments
- (-35,600 + 42, 500 – 2,900) *0.055 + (2,800 – 3,700)* 0.055/2 = R195,25

Key change – Past service costs and curtailments

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Area	IAS 19	Revised IAS 19
Past service cost (arise as a result of a plan change)	Recognise vested portion immediately through P&L; non-vested portion over vesting period	Recognise entire past service cost immediately through income statement
Curtailments	1. Reduction in future accruals or significant reduction in future service; 2. Recognised when employer is "demonstrably committed"; 3. Pro-rata recognition of past service cost and actuarial gain/losses	1. Significant reduction in employees covered; 2. Measured as change in obligation.

Key change – Settlements

Area	IAS 19	Revised IAS 19
Settlements	1. Settlement of liability in respect of benefit promise occurs when entity no longer has any legal or constructive obligation to provide the benefit 2. Require accelerated recognition of pro-rata unrecognised actuarial gains/losses and past service cost based on DBO settled	1. No change in definition from current IAS 19 2. Measured as change in obligation and fair value of assets

Key change – Investment expenses

Area	IAS 19	Revised IAS 19
Investment expenses (excluding tax)	Generally companies deduct this from expected return on asset via reduction in EROA% assumption	Investment related expenses will be included under the re-measurement component of OCI

Key change – Fair value of Plan Assets

Area	IAS 19	Revised IAS 19
Fair value of Plan Assets	Measured at Fair Value, generally using Bid prices for securities quoted in an active market	IFRS 13 now provides that a company shall apply the price that is most representative of fair value (i.e. midmarket pricing is allowed)

Key change – Asset ceiling

- Revised IAS 19 paragraph 8 defines the asset ceiling as the present value of any economic benefit available in the form of a refund from the plan or a reduction in future contributions to the plan.
- AC 504 and IFRIC 14 provides details regarding the application of an asset ceiling adjustment.
- Required to test impact of AC 504 / IFRIC 14 when fund is in surplus or deficit position.

Key change - Assumptions

- Revised IAS 19 paragraph 82 states that an entity shall determine its mortality assumptions by reference to its best estimate of mortality of plan members both during and after employment. An entity should take into consideration changes to mortality.
- Compared to many other countries, most valuations for South African companies already take improvements into account.

Key change - Tax

- Revised IAS 19 requires taxes payable on the payment of benefits or contributions should be allowed for in the DBO, as they form part of the ultimate benefit cost.
- Investment related and other taxes should be deducted from the actual return on assets.
- This change has currently **no impact** on South African market due to current tax regime.

Comparative amounts

IAS 8 requires comparative amounts to be disclosed as if revised IAS 19 has always been applied.

What does that mean?

30 June 2012

- Adjust year-end values
- Recognise unrecognised amounts immediately

30 June 2013

- Comparative figures
- As if revised IAS 19 always been in force
- No unrecognised amounts

30 June 2014

- First year-end starting after 1 January 2013
- Revised IAS 19 applicable
- No unrecognised amounts

Expected impact of changes on companies in SA, UK and rest of Europe

- Based on the FY11 consolidated financial statements of SA's Top 40 companies.
- Focussed on the changes in
  - **Balance sheet** (the recognition of actuarial gain/losses);
  - **Earnings** (calculation of net interest item).

Expected impact of changes on SA companies

- **28** of the Top 40 companies have DB liabilities recorded on the Balance Sheet, of which **14** companies recorded pension liabilities.
- **1** Company provided details of Long-service award benefit. Revised IAS 19 has limited impact on Other long-term employee benefits.
- **22** of the Top 40 companies have post-retirement medical liabilities recorded on the Balance Sheet.

Expected impact of changes on the pension expense of SA companies - methodology

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- Calculated the P&L impact by calculating what the pension expense (ignoring one-off events) would be under Revised IAS 19 and comparing that to the reported pension expense.
- The change in pension expense is compared to the EBIT to identify companies likely to be most affected by the change.
- We did not try to estimate the actual Rand value of impact as that will depend on market conditions as at 31 December 2013.
- Based on the information collected internationally, we had an expectation of significant impact.

Change in pension expense / EBIT for companies in UK

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UK Company	Market Cap (£m)	Change in Pension Expense/ EBIT
BABCOCK INTERNATIONAL	3,056.3	-19%
BAE SYSTEMS	9,519.8	-16%
IAG	3,187.5	-14%
ROYAL BANK OF SCOTLAND	26,489.1	-7%
CRODA INTERNATIONAL	3,076.8	-7%
GKN	3,244.7	-7%
LLOYDS BANKING GROUP	20,898.8	-5%

Source:Datastream and J.P. Morgan estimates

- 67 of UK companies with market cap > than £2bn had an impact of 3% or more of EBIT

Change in pension expense / EBIT for companies in Europe

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EU Company	Market Cap (€m)	Change in Pension Expense/ EBIT
ALCATEL-LUCENT	3,290.4	-96%
PHILIPS ELECTRONICS	14,468.7	-86%
THYSSENKRUPP	9,420.3	-23%
IAG	3,889.4	-14%
SOLVAY	7,523.2	-13%
LINDT & SPRUENGLI	6,239.0	-13%
SVENSKA CELLULOSA	8,463.5	-12%
ELECTROLUX	4,925.9	-11%
FIAT	4,727.9	-11%
HOCHTIEF	3,296.9	-10%

Source: Datastream and J.P Morgan estimates

- 50 of European companies with market cap > €2.5bn had an impact of 3% or more of EBIT

Change in pension expense / EBIT for SA companies

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Company Name	Market Cap (in ZAR million)	Change in pension expense
Sanlam Ltd	60,585	-1.75%
Remgro Ltd	53,691	-0.88%
British American Tobacco	775,266	-0.75%
Nedbank	66,570	-0.46%
Bidvest	46,508	-0.59%
Old Mutual	28,912	-0.33%
Anglo American Plc	394,300	-0.20%
Sasol Ltd	259,247	-0.18%
Tiger Brands Ltd	33,378	-0.14%

Source: Annual Financial Statements, Bloomberg

- Double hit for earnings as result of asset ceiling restrictions, as the net interest item is calculated on lower assumed return (in most cases) as well as on a lower asset base (assets less asset ceiling).

Elimination of smoothing

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- Absence of smoothing will result in greater volatility in OCI and net assets/liabilities recorded on balance sheet.
- Some companies would have experienced a drag on future earnings as a result of the corridor approach requiring unrecognised gains/losses to be ‘drip fed’ into the P&L.
- To determine impact on companies we calculated the ratio of changes in shareholder equity (unrecognised actuarial gain/loss) to market cap.
- **14** SA companies used the ‘Corridor-method’, while **54%** of companies in Europe and **7%** of companies in UK, used the ‘Corridor-method’ respectively.

Expected impact of change on Balance sheet of UK companies

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Company	Market Cap (£m)	Change in CE vs m/cap
IAG	3,187.5	-39%
ROYAL DUTCH SHELL	137,405.7	-7%
BARCLAYS	26,117.7	-7%

Source:Datastream and J.P. Morgan estimates

- 3 UK companies with market cap > than £2bn showed an impact in reported shareholder's equity of 5% or more of market cap.
- Result of UK GAAP requiring immediate recognition of actuarial gains / losses

Expected impact of change on Balance sheet of European companies

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Company	Market Cap (€m)	Change in CE vs m/cap
LUFTHANSA	4,514.8	-61%
FIAT	4,727.9	-51%
IAG	3,889.4	-38%
AEGON	6,947.3	-20%
SWISS LIFE	2,619.3	-17%
THALES	5,246.4	-15%
UBS	36,549.8	-14%
DEUTSCHE POST	17,015.7	-11%
ARCELORMITTAL	20,190.4	-11%
SWISSCOM	14,658.4	-11%

Source:Datastream and J.P. Morgan estimates

- 25 EU companies with market cap > than €2.5bn showed an impact in reported shareholder's equity of 5% or more of market cap.

Expected impact of changes on Balance sheet of SA companies

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Company name	Market cap (in ZAR million)	Change in Equity / Market Cap
Woolworths Holdings Ltd	24,580	-0.03%
Truworths International	31,432	-0.03%
Tiger Brands Ltd	33,378	0.53%
Sasol Ltd	259,247	0.03%
Sanlam Ltd	60,585	-0.02%
Remgro Ltd	53,691	-0.04%
Old Mutual	70,193	0.00%
Nedbank	66,570	0.14%
Firstrand Ltd	111,913	0.32%
Bidvest	46,508	-0.27%
Mondi Group	29,151	-0.09%
Absa Group	101,268	-0.02%
BHP Billiton	28,912	-0.04%
Assore Ltd	29,318	0.04%

Source: Annual Financial Statements, Bloomberg

- Impact muted because of offsetting actuarial gains/losses in individual plans.

Conclusion

- Revised IAS 19 will, in the short term, require additional work which will lead to increased advisor fees, however the expected impact on South African companies will be smaller than the impact expected on UK and European companies.
- However in future it will lead to increased volatility of liability/asset recorded on company balance sheet as well as increased pension cost.

Sources

- IASB – IAS 19 Employee Benefit (June 2011).
- PwC market research.
- J.P. Morgan Cazenove European Equity Research