STATEMENT OF SIR DAVID TWEEDIE
CHAIRMAN, INTERNATIONAL ACCOUNTING STANDARDS BOARD,
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE

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Mr Chairman, Ranking Member Sarbanes, and Members of the Committee:

I greatly appreciate the opportunity to discuss a topic about which I care deeply—the accounting for pensions and more broadly post-retirement benefits. My interest in this topic may subconsciously stem from the fact that I am reaching an age when pensions seem to matter more, but I believe there is more to my interest than that. The area of post-retirement benefits is one topic where the public interest is great. Together, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) could make progress in improving existing accounting practices that are deficient, distort behaviour, have inter-generational consequences, and could lead to great cost to taxpayers.

This hearing is particularly timely, because the International Accounting Standards Board (IASB) is now in the process of adding a project onto its active work programme on post-retirement benefits. The IASB plans to work closely with the FASB on this project, and I am delighted that Robert Herz, the chairman of the FASB, is here with me today on this panel. Bob has been one of the leading advocates of the development of high-quality international accounting standards, known as International Financial Reporting Standards (IFRSs), and has provided essential leadership in the international convergence process between the FASB and the IASB.

The IASB and progress on international convergence

Before turning to the specific topic of this hearing, I would like to put the work on post-retirement benefits into the context of the IASB's current strategy and our joint efforts with the FASB.

As you know, the IASB is a private-sector, independent accounting standard-setter, based in London and comprised of 14 members. The IASB's objective is to develop a single set of international accounting standards that are used worldwide and are consistent, comprehensive, and based on clear principles to enable financial reports to reflect underlying economic reality.

Since my first appearance before this Committee in February 2002 (less than a year after the IASB began its work), we have made progress toward the objective of a single set of accounting standards used worldwide has been steady. Nearly 100 countries now require, permit, or have adopted a formal policy of convergence with standards developed by the IASB. Significantly, beginning in 2005, all publicly traded companies in the European Union are producing their consolidated accounts according to IFRSs. Australia, South Africa, and New Zealand, countries with a strong history of independent standard-setting, have followed the EU's lead in requiring IFRSs.

The other major developed and developing economies are making similar commitments to IFRSs. The IASB is undertaking a convergence project with the Accounting Standards Board of Japan. In February this year, China introduced an entirely new system of accounting that brings Chinese accounting into substantial convergence with IFRSs with the exception of two topics (related party transactions and impairment) —and these are being re-examined. This policy marked a major step forward for the quality of Chinese accounting and its convergence efforts. In addition, the Indian standard-setter is proposing an initiative aimed at converging differences of existing Indian standards with IFRSs.

At the same time, cooperation with the FASB is now an integral part of IASB's work programme. It is clear that no system would be truly international without the participation of the United States, and convergence between US GAAP and IFRSs remains a leading priority. It is the promise of improving access to US and European markets, which convergence work makes possible, that has encouraged many countries to opt for convergence with IFRSs.

The FASB and the IASB have worked together on a formal convergence program to eliminate differences between US GAAP and IFRSs since the autumn of 2002 following the issuance of the Norwalk Agreement. As you know, our goal from the outset has been not just to eliminate differences in existing standards, but to improve the consistency and quality of financial reporting worldwide by developing new solutions to accounting issues when standards failed to provide sufficient transparency to make informed economic judgements. This strategy has yielded results, and both boards have made changes in their standards, bringing them closer in line. The IASB's work on business combinations, financial instrument accounting, and assets held for sale brought IFRSs closer in line with US GAAP. The FASB has made changes in its standards on inventory cost, asset exchanges, and accounting changes and error correction to adopt internationally accepted approaches. The boards' work on share-based payments, or stock option accounting, is an example of how both boards could raise the quality of financial reporting by building on each other's work.

For the IASB, it is important to ensure convergence proceeds to such a point that companies using IFRSs are able to access US capital markets directly without reconciliation to US GAAP. For many companies throughout the world, the objective is to make IFRSs a passport to all of the world's capital markets, and the continuing need to reconcile to US GAAP to access US investors has been a source of frustration for many. My conversations with major business groups in Europe and elsewhere indicate that support for convergence is contingent on the eventual removal of the reconciliation requirement.

The US Securities and Exchange Commission has recognised that the FASB and the IASB are eliminating differences between US GAAP and IFRSs, IFRSs have the confidence of a growing number of jurisdictions, and the pool of non-US companies registered with the SEC will grow to nearly 1,000 by the end of the decade. In this context, the SEC staff has laid out a "roadmap" which sets out steps required to eliminate the need for companies using IFRSs to reconcile to US GAAP by no later than 2009. This roadmap was particularly helpful to the FASB and the IASB, because it provided a clear demonstration of support for the two boards' efforts on convergence.

From the standard-setting standpoint the SEC roadmap was significant. The IASB and the FASB would no longer need to concentrate on a possibly endless series of changes to get the reconciliation removed. In consultation with the SEC and the European Commission, the IASB and the FASB agreed that trying to eliminate existing differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources—instead a new common standard should be developed that improves the financial information reported to investors. Topics, including post-retirement benefits identified as part of SEC report on off-balance sheet items and as part of a recent study by Committee of European Securities Regulators, could receive priority.

It was in this context that in February 2006, the FASB and the IASB issued a new Memorandum of Understanding that described their joint work programme for the coming years. (The Memorandum of Understanding is attached as an appendix.) The FASB and the IASB agreed that convergence work should proceed on the following two tracks:

- First, the boards will reach a conclusion about whether major differences in focused areas should be eliminated through one or more short-term standard-setting projects, and, if so, the goal is to complete or substantially complete work in those areas by 2008.

- Second, the FASB and the IASB will seek to make continued progress in other areas identified by both boards where accounting practices under US GAAP and IFRSs are regarded as candidates for improvement, culminating in common standards.

The project on post-retirement benefits falls into the second category.

The public's interest and an example from the UK

Accounting standard-setters often hear that accounting should not change behaviour, but there is a case, I fear, that poor accounting has led to neglect or mismanagement of pension resources. The numbers are staggering, and the emergence of large pension deficits are not confined to the United States. The overall deficit for the European companies in the Dow Jones STOXX 50 was €116 billion at 31 December 2004 and for the UK FTSE 100 was £37 billion at July 2005.[1] The SEC staff estimated in June 2005 that the overall deficit for active US filers might be $201 billion.[2]

For a long time, companies and investors failed to give proper attention to a growing problem of increasingly unhealthy pension programmes, and the accounting shares some of the blame. The international standard, IAS 19 *Employee Benefits*, and US GAAP obscure reality by permitting gains and losses to be smoothed over time with the result that

- income and expense may be under or overstated.

- the asset or liability in the balance sheet may be under or over stated

To give you an example, suppose a pension fund is in equilibrium having liabilities of $40 million matched by assets of a similar amount. If the value of the assets was to fall to $30 million and liabilities remained the same, the fund would have a deficit of $10 million.

[1] Source: Lane, Clark and Peacock 'Accounting for Pensions Survey' 2005
[2] Source: SEC Report under the Sarbanes Oxley Act into off-balance-sheet arrangements June 2005

Under what I expect will be the most commonly used option of IAS 19, the deficit is reduced:

a) by a reduction of 10 percent of whatever is the higher of assets or liabilities—in this case liabilities, leading to a reduction of $4 million

b) by ‘spreading’ the remaining deficit of $6 million ($10 million minus the $4 million) over the expected working lives of the employees—say 10 years for this example.

The result is that deficit shown in the financial statements becomes $600,000. The incomplete nature of such an amount recognised in income and expense and the balance sheet obscures the impact of the cost on the entity. While information about the total deficit is shown in the notes, standard-setters know that disclosure is no substitute for good accounting. Moreover, there is a growing body of academic research indicating that market participants do not incorporate the disclosures in decision making.

Eliminating the smoothing mechanisms can have a profound, positive impact. In one of the last actions before I joined the IASB, the UK Accounting Standards Board (ASB) took an important first step in improving accounting for pensions—a step that foreshadows, in my opinion, the direction that the FASB and IASB are likely to head. The UK standard, known as FRS 17, eliminates the smoothing mechanism by requiring companies to value their assets and liabilities of their pension funds at year end. Surpluses and deficits are shown on the balance sheet, and changes are shown, not in net income, but in a display similar to what in the United States is termed ‘other comprehensive income’.

When the ASB published its proposals for FRS 17, some criticised the standard as providing a snapshot that was inappropriate considering assets and liabilities in pension funds are long-term. For that reason, FRS 17 requires disclosure of the position of the pension fund at balance sheet date over a five-year period, so investors and pensioners can see the trends and determine whether a deterioration of the pension fund’s position is an anomaly or an indication that attention is needed.

The introduction of FRS 17 in the United Kingdom has led to an important national discussion on the future of pensions and the state of private and public programmes. When first published, the business community was split on whether the standard would improve financial reporting. When the press reported the deficits of the pension funds for the first time, the ASB was accused of destroying pensions. However, the attitude in the United Kingdom has changed. UK finance directors have informed me that pensions are now a topic of discussion in boardrooms for the first time and companies are taking action to address deficits.

Furthermore, FRS 17 has given additional important information to investors, because companies are beginning to explain to investors how they plan to address these deficits. HBOS, a major UK bank, provided a good example of the type of statements that are becoming more commonplace in the UK’s equivalent of the Management’s Discussion and Analysis (MD&A) is:

> As announced in late 2005, we intend to eliminate the IFRS deficit of our defined benefit pension schemes within ten years. At 31 December 2005, the

> IFRS deficit was £1.8bn (2004 £1.8bn) and £1.3bn (2004 £1.2bn) net of tax. As the first steps in meeting this goal, we have signalled our intention to contribute an additional £1bn to the schemes over the next five years, £800m having been earmarked as the up-front payment before the end of 2006. Our Tier 1 capital ratio of 8.1% at 31 December 2005 makes full allowance for these intended payments.[3]

This sentiment in favour of the UK FRS 17 approach was evident when UK publicly traded companies were potentially faced with a requirement to abandon FRS 17 accounting for the smoothing mechanism of IAS 19 in order to comply with European Union's requirement to use IFRSs beginning in 2005. When the IASB asked whether companies should be allowed to continue using the FRS 17 methodology, 15 UK companies and two major business groups responded, without any UK opposition, that they should. The IASB therefore introduced an option into IAS 19 to permit the use of FRS 17 accounting.

Critics of the approach taken under FRS 17 will point out that companies are withdrawing from defined benefit plans and moving to defined contribution plans, shifting the risk from employers to employees. That has been the trend for some time, and it is possibly true that some companies have opted to end their pension plans after the health and cost of the programmes were clear. This does not, however, constitute an argument against improved accounting.

Would it be better if employees planned for a retirement on the basis of benefits that a company is unable to keep? If companies are unable to fulfil their obligations, will that burden be shifted to the taxpayers?

While some accounting issues may seem arcane, here is an issue where the public policy consequences are significant. Improved accounting will enable companies, investors, and public officials to make informed judgements regarding the future of post-retirement plans, the sharing of risk in society, and questions of intergenerational consequence. This should be the beginning of an informed debate on the future of pensions, not the end.

The proposed path for the FASB and the IASB

The introduction of the FRS 17 option to IAS 19, the IASB's post-retirement benefits standard, did mark an improvement in IFRSs, but was not intended as a long-term solution. FRS 17 itself was an incremental change, addressing one deficiency of pension accounting, but leaving other important questions for later. For example, FRS 17, like US GAAP, allows a company to recognise an assumed return on assets, rather than actual returns, in net income.

There is a need now to address the issue of post-retirement benefits in a comprehensive matter. In addition to the SEC report, the IASB has received support for a comprehensive look at post-retirement benefits and will be discussing this topic with its advisory council at the end of this month. (Examples of the support are included as Appendix B.) Assuming continued support, the IASB intends to add the project to its formal agenda at its July 2006 meeting.

[3] Source: HBOS plc Annual Report and Accounts 2005, Financial Review

The IASB recognises that the FASB has already initiated work on a first phase project on its own. It is our intention over the coming months to join efforts together in order to ensure the quality of both sets of standards is improved by drawing on the shared resources and expertise of both boards. The February 2006 Memorandum of Understanding anticipates the publication of one due process document by 2008.

In an effort to define the scope the potential project, the IASB instructed the staff to develop an agenda proposal for a comprehensive long-term project that would involve a fundamental rethink of all aspects of pension accounting. The Board also instructed the staff to identify issues within the project that could be resolved relatively quickly, with a view to issuing an interim standard that significantly improved pension accounting within four years. The items discussed as possibilities for this first phase were:

- Definitions of defined contribution and defined benefit plans;

- Accounting for cash-balance plans, including for cash-balance features incorporated in existing defined benefit plans. Cash-balance plans challenge the IAS 19/FAS 87 accounting model. In many ways, these plans are more similar to financial instruments or insurance contracts with embedded guarantees than to old style defined benefit plans;

- Elimination of the smoothing options;

- Elimination of the assumed rate of return on plan assets;

- Guidance on pension settlements and curtailments, in particular whether additional guidance is necessary after giving effect to the elimination of the smoothing mechanism. It is likely that pension settlements and curtailments will increase, as employers grapple with the financial burden of defined benefit pension obligations. The International Financial Reporting Interpretations Committee (IFRIC), our equivalent to the US Emerging Issues Task Force has already received one request for interpretation, and it may well be the first of many;

- Revisions to disclosures occasioned by changes in recognition and measurement; and,

- Presentation in the statement of recognised income and expense, in particular:
    - Whether some components of annual pension expense should be reported as other recognised income and expense rather than directly in net profit, and;
    - Whether those amounts should be recycled to profit or loss over time.

The FASB is intending to issue a standard removing the smoothing mechanisms from the balance sheet, but not from net income, towards end of the year. I would hope that the IASB will follow suit by dealing with the matters mentioned above. Our work will be of assistance to the FASB in the same way that their forthcoming deliberations on issues, such as the appropriate interest rate to discount pension liabilities will assist the IASB. This will enable both boards to work towards a soundly-based common standard on post-retirement benefits.

In addressing these issues of critical public importance, the FASB and the IASB are aware of the need to consult the wide range of interested parties. This will include the use of experts to provide guidance on a range of issues, full transparency in the FASB's and the IASB's deliberations, an opportunity for interested parties to comment on proposals, and meetings and visits with leading national and international associations.

The soundness of retirement systems of most countries throughout the world depend on the three-legged stool of government-provided pensions, pensions accrued from employment and private savings. If the financial health of public or private-sector pensions is brought into question, the ability to provide a financially secure retirement for the population is brought into doubt. For too long, accounting has concealed the health of employer-provided plans. As the populations of developed economies age and public systems, including social security programmes, are strained, we cannot afford to let private sector pensions fail. Good accounting will not solve the problem, but it will enable businesses, employees, investors, and public officials to address an issue of growing concern. It is in this light, the IASB is committed to working with the FASB to develop a high-quality, principles-based, global standard for the accounting for postretirement benefit obligations that will faithfully report the underlying economic effects of those plans. In doing so, we will listen to all views, but our first responsibility is to good accounting.

Appendix A

A Roadmap for Convergence between IFRSs and US GAAP—2006-2008

Memorandum of Understanding between the FASB and the IASB

27 February 2006

After their joint meeting in September 2002, the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their Norwalk Agreement in which they 'each acknowledged their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, the FASB and the IASB pledged to use their best efforts (a) to make their existing financial reporting standards fully compatible as soon as is practicable and (b) to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained.'

At their meetings in April and October 2005, the FASB and the IASB reaffirmed their commitment to the convergence of US generally accepted accounting principles (US GAAP) and International Financial Reporting Standards (IFRSs). A common set of high quality global standards remains the long-term strategic priority of both the FASB and the IASB.

The FASB and the IASB recognise the relevance of the roadmap for the removal of the need for the reconciliation requirement for non-US companies that use IFRSs and are registered in the United States. It has been noted that the removal of this reconciliation requirement would depend on, among other things, the effective implementation of IFRSs in financial statements across companies and jurisdictions, and measurable progress in addressing priority issues on the IASB-FASB convergence programme. Therefore, the ability to meet the objective set out by the roadmap depends upon the efforts and actions of many parties—including companies, auditors, investors, standard-setters and regulators.

The FASB and the IASB recognise that their contribution to achieving the objective regarding reconciliation requirements is continued and measurable progress on the FASB-IASB convergence programme. Both boards have affirmed their commitment to making such progress. Recent discussions by the FASB and the IASB regarding their approach to the convergence programme indicated agreement on the following guidelines:

- Convergence of accounting standards can best be achieved through the development of high quality, common standards over time.
- Trying to eliminate differences between two standards that are in need of significant improvement is not the best use of the FASB's and the IASB's resources—instead, a new common standard should be developed that improves the financial information reported to investors.
- Serving the needs of investors means that the boards should seek to converge by replacing weaker standards with stronger standards.

Consistently with those guidelines, and after discussions with representatives of the European Commission and the SEC staff, the FASB and the IASB have agreed to work towards the following goals for the IASB-FASB convergence programme by 2008:

Short-term convergence

The goal by 2008 is to reach a conclusion about whether major differences in the following few focused areas should be eliminated through one or more short-term standard-setting projects and, if so, complete or substantially complete work in those areas.

Topics for **short-term convergence** include:

To be examined by the FASB	To be examined by the IASB
Fair value option*	Borrowing costs
Impairment (jointly with the IASB)	Impairment (jointly with the FASB)
Income tax (jointly with the IASB)	Income tax (jointly with the FASB)
Investment properties**	Government grants
Research and development	Joint ventures
Subsequent events	Segment reporting
FASB Note: *On the active agenda at 1 July 2005 ** To be considered by the FASB as part of the fair value option project	*IASB Note:* Topics are part of or to be added to the IASB's short-term convergence project, which is already on the agenda.

Limiting the number of short-term convergence projects enables the boards to focus on major areas for which the current accounting practices of US GAAP and IFRSs are regarded as candidates for improvement.

Other joint projects

The goal by 2008 is to have made significant progress on joint projects in areas identified by both boards where current accounting practices of US GAAP and IFRSs are regarded as candidates for improvement.

The FASB and the IASB also note that it is impractical, when factoring in the need for research, deliberation, consultation and due process, to complete many of the other **joint projects** by 2008. The two boards understand that during this time frame measurable progress on such projects, rather than their completion, would fulfil their contribution to meeting the objective set forth in the roadmap.

Furthermore, it is noted that the strategy regarding other joint projects and the goals described below should be consistent with one of the IASB's objectives of providing stability of its standards for users and preparers in the near term.

After consultations with representatives of the European Commission and the SEC staff and consistently with existing priorities and resources, the FASB and the IASB have expressed the progress they expect to achieve on their convergence project in the form of a list of 11 areas of focus. It is noted that these projects will occur in the context of the ongoing joint work of the FASB and the IASB on their respective Conceptual Frameworks. As part of their Conceptual Framework project, the FASB and the IASB will be addressing issues relating to the range of measurement attributes (including cost and fair value) to enable a public discussion on these topics to begin in 2006.

After considering the complexity of those topics and consultation requirements, the boards set the following goals for 2008 for convergence topics already on either their active agendas or the research programmes:

Topics already on an Active Agenda			
Convergence topic	Current status on the FASB Agenda	Current status on the IASB Agenda	Progress expected to be achieved by 2008
1. Business combinations	On agenda – deliberations in process	On agenda – deliberations in process	To have issued converged standards (projected for 2007), the contents and effective dates of which to be determined after taking full account of comments received in response to the Exposure Drafts.
2. Consolidations	On agenda – currently inactive	On agenda – no publication yet	To implement work aimed at the completed development of converged standards as a matter of high priority.
3. Fair value measurement guidance	Completed standard expected in the first half of 2006	On agenda – deliberations in process	To have issued converged guidance aimed at providing consistency in the application of existing fair value requirements.[4]
4. Liabilities and equity distinctions	On agenda – no publication yet	On agenda (will follow FASB's lead)	To have issued one or more due process documents relating to a proposed standard.
5. Performance reporting	On agenda – no publication yet	Exposure draft on a first phase	To have issued one or more due process documents on the full range of topics in this project.
6. Post-retirement benefits (including pensions)	On agenda – deliberations underway on the first phase of multi-phase project	Not yet on the agenda	To have issued one or more due process documents relating to a proposed standard.
7. Revenue recognition	On agenda – no publication yet	On agenda – no publication yet	To have issued one or more due process documents relating to a proposed comprehensive standard.

The objective of the goals set out above is to provide a time frame for convergence efforts in the context of both the objective of removing the need for IFRS reconciliation requirements by 2009 and the existing agendas of the FASB and the IASB. The FASB and the IASB will follow their normal due process when adding items to the agenda. Items designated as convergence topics among the existing research programmes of the boards include:

Topics already being researched, but not yet on an Active Agenda			
Convergence topic	Current status on the FASB Agenda	Current status on the IASB Agenda	Progress expected to be achieved by 2008
1. Derecognition	Currently in the pre-agenda research phase	On research agenda	To have issued a due process document relating to the results of staff research efforts.
2. Financial instruments (replacement of existing standards)	On research agenda and working group established	On research agenda and working group established	To have issued one or more due process documents relating to the accounting for financial instruments.

[4] The fair value guidance measurement project will not extend requirements for the use of fair value measurements, and any proposals regarding increasing the use of fair value accounting will be addressed in the context of the Conceptual Framework and other projects on the FASB's and IASB's respective agendas.

3. Intangible assets	Not yet on agenda	On research agenda (led by a national standard-setter)	To have considered the results of the IASB's research project and made a decision about the scope and timing of a potential agenda project.
4. Leases	Pre-agenda research underway	On research agenda (led by a national standard-setter)	To have considered and made a decision about the scope and timing of a potential agenda project.

In setting out the projects for both the short-term convergence topics and the major joint topics, the FASB and the IASB recognise that with respect to its foreign registrants the SEC staff will undertake an analysis of their 2005 IFRS financial statements across companies and jurisdictions. This analysis may reveal the need for additional standard-setting actions by one of the boards or both. Furthermore, the FASB and the IASB note that their work programmes are not limited to the items listed above, but remain committed to fulfilling their contribution to meeting the objectives set out by the roadmap.

The FASB and the IASB also recognise the need to undertake this work in a manner that is consistent with their established due process, including consultation with interested parties on their ongoing joint efforts before reaching conclusions.

Appendix B—Examples of Support for a Comprehensive Project

John Plender, The Financial Times, 19 December 2003

Pensions accounting is encouraging companies to delude themselves about their profitability and financial health. If this ends in tears, as well it may, the standard-setters have much to answer for.

CBI response to 2004 amendments to IAS 19

We agree a fundamental review needs to take place in order to determine the appropriate accounting treatment covering the range of circumstances and situations that need to be addressed in connection with final salary schemes.

Standard and Poor's response to 2004 amendments to IAS 19

We strongly encourage the IASB to add a project to its near-term agenda that would comprehensively look at the accounting for costs and obligations arising from defined benefit plans. We recommend that the aim of the project be to require a single model of accounting that would mandate the full recognition of assets, liabilities and costs and reduce the potential for abuse. In our view it is desirable that the project be conducted in parallel with other accounting standard setters such as the FASB to further improve international conformity of financial reporting.

Institute of Chartered Accountants of England and Wales response to 2004 amendments to IAS 19

There is an urgent need for the Board to undertake the comprehensive review of IAS 19 at the earliest opportunity.

Astra Zeneca response to 2004 amendments to IAS 19

However, we do believe that the area of pension accounting is in need of review and would urge the IASB to complete such a review as soon as practicable.

KPMG response to 2004 amendments to IAS 19

We would prefer that all of the proposed changes, other than the change in respect of participation on group plans, be considered as part of a comprehensive project on post-employment benefits covering all areas, preferably as a joint project with other standard setters, including the US FASB and the UK ASB.

PricewaterhouseCoopers response to 2004 amendments to IAS 19

We encourage the Board to progress to a more wide ranging update of IAS 19, in conjunction with the development of the single performance statement, as soon as possible.