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Dear Mr Lennard

PRO-ACTIVE ACCOUNTING ACTIVITIES IN EUROPE
DISCUSSION PAPER: THE FINANCIAL REPORTING OF PENSIONS

The Institute's Accounting Standards Committee and Pensions Working Party have considered the discussion paper 'The Financial Reporting of Pensions' and their views are set out below.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires its committees and working parties to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

In the context of this discussion paper we believe that the public interest is best served by the accounting and reporting of pensions

- in a transparent manner
- where users of accounts understand the nature and limitations of the information supplied.

We should also like to thank you for meeting with our members on 9 May and 19 June, for explaining the thought processes underlying the discussion paper and addressing our queries. We welcome this open and extensive consultation and are grateful for the opportunity to contribute.

We believe that it is important that accounting for pensions is being considered from basic principles rather than simply amending existing practices and we welcome this debate. Discussions within our membership highlighted the existence of very differing viewpoints on some fundamental issues addressed in the discussion paper and we believe that a considerable difficulty for a pensions standard is finding proposals that have the support of all stakeholders.

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We have set out below what we see as the key areas in the discussion paper, and the ones which generated the most debate amongst our membership. Where there are differing opinions, we have set out both viewpoints, and where possible, we have attempted to recommend a way forward. Our responses to the questions set out in the discussion paper are included at Appendix A.

The conceptual framework

The first area of disagreement amongst members was around the extent to which the financial reporting of pensions should be in accordance with the conceptual framework applicable to other entities. Some members support the ASB's view that pension accounting should be based on the IASB's framework for the Preparation and Presentation of Financial Statements, and do not believe that there is a sound basis for arguing that pensions should be an exception to the application of GAAP. Financial statements are intended to provide decision-useful information to investors and other users and to demonstrate management's stewardship – these are relevant objectives in the reporting of pensions by the management of entities providing pension promises to their employees and by pension trustees. The assets and liabilities of a pension scheme which meet the definitions set out in the conceptual framework therefore should be accounted for as such. To permit exceptions specific to pensions could result in financial reporting that lacks consistency and comparability.

Some of the concerns expressed in relation to the proposals in the discussion paper are not unique to pensions and are common to other areas of financial reporting, for example, the use of fair values has been widely criticised. Therefore, many perceived problems with these proposals should be addressed via the conceptual framework rather than by addressing pensions accounting in isolation.

It should be recognised that criticisms of particular accounting treatments can relate in large part to the way in which the resulting financial information is used, rather than simply the quality of that information. Therefore it is important that users and preparers of financial statements are aware of the impact of changes in the information provided, and understand the nature and limitations of the information.

However, another view espoused, particularly by members working in the pension industry, is that due to the long-term nature of pension liabilities and the way in which the related assets may be invested, the application of the framework to pensions would seem to result in short-term information that does not accurately reflect economic reality, particularly in the long-term. There is a concern that economic behaviour is influenced by the resulting accounting treatment. If this is the case then it is argued that some of the proposals in the discussion paper will be detrimental to the interests of many pension schemes and their members.

Arguably, FRS 17 has been partly responsible for the closing of defined benefit schemes by a combination of bringing point-in-time deficits on to company balance sheets, and the short-term measurement and volatility of the deficits. Pension deficits attract considerable adverse comment in the media and, hence, reactions which can undermine the confidence of members of occupational pension schemes as well as impacting on potential investment in a company and on pension investment strategy. The reporting of pensions, therefore, needs to reflect the underlying long-term value and nature of the pension scheme, its assets and its liabilities, and its investment strategies, as well as its short-term metrics.

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Measurement of assets
The continuation of this latter argument is that the proposal that pension investments should be measured at current values is flawed. Due to the long-term nature of most pension schemes' investment strategies, a market value would arguably usually not provide relevant information and could introduce irrelevant volatility into the financial statements. Marking to market reflects current transaction values only and may be said to exaggerate the short-term risks of immediate liquidation of a portfolio which, it is argued, is designed to be held for a much longer term.

This group among our members argues that an alternative to fair value for pension investments could be an approach similar to FRS 11, which takes the higher of net realisable value and value in use as its measurement basis. We note that any measurement base involves an element of subjectivity with assumptions made by management and others and that no one base provides perfect or correct information. Equally, it would be helpful if preparers and users of accounts understood that the financial statements give a snapshot at a balance sheet date, and that perceived short-term volatility does not necessarily mean that there is significant change in the underlying long-term economic substance of a pension scheme.

Other members, however, are content that pension scheme assets should be measured at current value. They believe that market values are the most appropriate measurement basis for most financial instruments, and argue that for financial assets a 'value-in-use' would not differ from a fair value. They note that the use of market values, whilst it may result in reported volatility, is merely a reflection of the underlying economic reality. They also acknowledge that there is widespread criticism of the use of fair values, particularly where there is little or no market activity. This issue is not restricted to the pensions industry and has to be considered in this wider context. Finally they note that it is important to ensure that the measurement of pension assets is consistent with changes made under other IASB projects.

Financial statement presentation
Some of our members believe that the solution to the perceived problems created by the use of fair values, both for pensions and for financial reporting more widely, lies in income statement presentation. Regardless of the recognition and measurement criteria used in the balance sheet, the geography of the income statement is critical in assisting users to understand an entity's financial performance. This means that the income statement should readily show the items that are within management's control, and distinguish those that are influenced by external factors, thus meeting the objectives of financial reporting of decision-usefulness and reporting on stewardship. For example, this would allow re-measurement gains and losses to be separately identified from other income and expenditure and therefore would give a clearer understanding of the elements making up a company's pension costs.

Others question this approach in relation to pension accounting and consider that a range of disclosures would be more useful. At the heart of this debate is whether the attempt to report pension performance in a few accounting entries lends an air of certainty to both assets and liabilities which is misleading. The average pension scheme may have a lifespan in excess of eighty years and it is almost impossible to pinpoint exact amounts of future liabilities or the future value of assets, especially in the short-term.

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Measurement of liabilities
On the liabilities side, there were two main areas of debate for our members – the use of a risk-free discount rate and the recognition and measurement of liabilities in pension plan accounts.

Many of our members are concerned about the proposal that the discount rate for pension liabilities should reflect only the time value of money and therefore would be a 'risk-free' rate. They believe that the use of a risk-free rate will significantly increase the amount at which pension liabilities are reported, which will not reflect economic reality. While other members are more comfortable with the concept of a risk-free rate, there was consensus that the discussion paper does not adequately justify this proposal. We would therefore welcome a fuller justification of the paper's preference for a risk-free discount rate.

There were two distinct viewpoints amongst our membership on the recognition and measurement of a liability to pay future benefits in a pension plan's financial statements. Members working in pensions tended to support the status quo i.e. that the liability should not be recognised in the pension plan's accounts. They argue that this recognition would add costs via the requirement for an audit of the liabilities, and would not be useful or relevant to users of the accounts, who are generally interested in the investment performance and contributions paid into the scheme alone. Solvency reporting to members and other interested parties is covered elsewhere in actuarial reports and individual statements which fall outside the pension scheme audit.

Other members agree with the ASB that the recognition of the liability is necessary in order to assess scheme solvency, provide decision-useful information to members, and to demonstrate trustees' stewardship, and concur that the measurement base should be the same as the measurement of the liability in the employer's accounts.

We hope our comments are useful to you in the development of this discussion paper. Please do not hesitate to contact either of us should you wish to discuss any of them further.

Yours sincerely

Charlotte Barbour

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Appendix A

Specific questions

Question 1 Should a liability to pay benefits that is recognised be based on expectations of employees' pensionable salaries when they leave service, or on current salaries (including non- discretionary increases)?

We believe that a liability to pay benefits should be based on current obligations incurred up to the date of the balance sheet. Any liability arising by virtue of future increases in salary should only be recognised as those increases occur. As at the balance sheet date those future increases, unless vested in some way, are not a present obligation of the entity, and therefore do not meet the definition of a liability.

Question 2 Should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? What consequences do you consider your view has for the recognition and measurement of pension obligations?

The views of our members were split on this issue. Some believe that the liability is owed to the workforce as a whole but do not believe that this would affect the recognition of the liability – the liability to the workforce as a whole is simply the sum of the liabilities owed to individuals. Those who believe that the liability is owed to the individual argue that pensions costs are a sub-set of employment for which the unit of account is the individual, therefore pensions accounting should be consistent with this approach.

In summary, although there are opposing views, we do not believe that the unit of account will affect the recognition of liabilities i.e. we do not agree with the view that if the unit of account is the whole workforce then future salary increases become part of the liability.

Question 3 Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?

Yes, this would mean that pension liabilities are recognised on the same basis as other liabilities under the conceptual framework. We agree that this would provide more useful information than spreading the pension cost across employees' service lives.

Question 4 Do you agree that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate?

Yes, we agree that there is no sound basis for pension plans to be exempt from the normal consolidation principles.

This proposal may be of limited relevance in the UK because, in theory, the control test is not met under the UK trust model, although some of our members have commented regarding corporate trustees where the control test may be met for some schemes.

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Question 5 Do you agree that changes in assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods or left unrecognised provided they are within certain limits (a 'corridor') approach?

There does not appear to be a valid rationale for treating changes in pension assets and liabilities differently from other similar assets and liabilities. However, the consequences of this may be increased volatility and some of our members question whether this provides decision useful information in relation to a pension scheme, particularly if assets are held for their long term value and return. As noted in our covering letter, a solution to this problem could be improved income statement presentation, with re-measurement gains and losses presented separately from other items of income and expenditure.

Question 6 Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, do you agree that:

1. *Regulatory measures should not replace measures derived from general accounting principles?*
   Financial statements are not prepared primarily for regulators and therefore regulatory measures should not be used. The Pensions Regulator already has access to the specific information it requires via the schemes' annual returns and by requesting additional information. We do not think it is appropriate to try and meet other potential users' information requirements by using regulatory measures. We may however support the use of 'one report fits all' with hypertext linking and menu options.

2. *The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?*
   As noted in our covering letter, a number of our members have concerns about the use of a risk-free discount rate and note that this will significantly increase the amount at which pension liabilities are reported. While other members are happy with the idea of a risk-free rate, in general we note that it is not adequately justified in the discussion paper. A risk-free rate seems to be preferred because it is proposed in the IASB's discussion paper on insurance contracts; however this diverges from the approach to discounting of provisions under IAS 37, therefore we would prefer to see a fuller discussion of the two approaches in this paper.

3. *Information about the riskiness of a liability (i.e. the risk that the amount of pension benefits will differ from today's expectations) is best conveyed by disclosure rather than by adjusting the amount of the reported liability?*
   In general, our members agree that it is preferable to convey information about the riskiness of a liability by disclosure rather than by adjusting the amount of the liability, agreeing that some of the risks associated with pensions liabilities cannot be meaningfully quantified. However as noted previously in this response, some members question whether a single figure should be recognised as a liability at all, arguing that this lends an air of certainty which is misleading. Others note that recognition is preferred to disclosure by users of accounts.

4. *The liability should not be reduced to reflect its credit risk?*
   The liability should not be reduced to reflect its credit risk. This applies not just to pension liabilities, as the inclusion of own credit risk in the measurement of liabilities results in counter-intuitive information which merely confuses users of the accounts.

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5. *Expenses of administering the plan's accrued benefit should be reflected in the liability?*
   Yes. The expenses of administering the accrued benefits should be reflected in the liability – they are part of the economic cost of providing the pension promise and the liability cannot be settled without incurring these expenses.

Question 7 Where employees have options to receive benefits in different ways, should the liability be reported at the highest amount or at an amount that reflects the probability of different outcomes?

Some members believe that where employees have options to receive benefits in different ways this should be an amount that reflects the probability of different outcomes, which is in accordance with the measurement of provisions under IAS 37.

However, other members question this approach because in their view it results in a single quantification of a liability which is unlikely to be the exact figure that will occur. They believe that disclosure of the options would provide more useful information than recognition.

Question 8 Do you agree that assets held to pay benefits should be reported at current values?

As noted in our covering letter, the measurement of assets held to pay benefits is an area of disagreement amongst our members. One viewpoint is that current values are not relevant to the assets of a pension plan since they are held for their long-term benefit. Its proponents argue that the use of market values will increase volatility in the income statement which will not reflect the economic reality of the underlying pension scheme, and may thus contribute to poor decision-making by users of the accounts. These members would prefer current values for pension assets to be disclosed, but not recognised.

Other members contend that assets held by a pension scheme should be measured on a consistent basis with other similar assets, which is generally a fair value under IFRS. A current value is also consistent with the measurement of pension liabilities. They recognise that no one measurement basis provides perfect information, but note that some of the problems associated with the use of fair values may be remedied through improved income statement presentation.

Question 9 Do you agree that a 'net' asset or liability should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly?

Yes.

Question 10 Do you agree that different components of changes in liabilities and/or assets should be presented separately?

The idea of aggregating the different components of the changes in pension assets and liabilities and presenting a single figure for pension costs on the face of the income statement is undoubtedly attractive, allowing users to readily assess the pension cost impact on the employer's financial statements. However, since changes in assets and liabilities have different drivers and therefore different predictive values, more useful information will be provided by separate presentation of these different elements.

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Question 11 Do you agree that the financial performance of an entity should reflect the actual return on assets, rather than the expected return, and that the expected return should be required to be disclosed?

It is important that the actual returns should be reflected in the financial performance in order to assist those with a responsibility for stewardship. Nevertheless, it would also be useful if expected returns were disclosed, or that the most critical assumptions used were disclosed, in order to assist in evaluating the investment strategy and the management of the assets.

We note, however, that this would make budgeting and reporting financial performance more unpredictable when the income statement is exposed to volatility in asset return relative to budgets.

Question 12 Do you agree with the objectives of disclosure that are identified in this Chapter? Are there specific disclosure requirements that should be added to or deleted from those proposed?

In general we agree with the objectives of disclosure identified, although the disclosure requirements are fairly extensive and add to an existing set of fairly lengthy disclosures, and consequently we would not recommend any additional disclosures. It is important that disclosure requirements are set so that they result in succinct, focussed disclosures which draw the reader's attention to the key information. A principles-based approach should be taken to avoid entities producing lengthy boiler-plate disclosures which do not aid comparability and can obscure the most important information.

Question 13 Do you agree that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan? How, in your view, should an accounting standard require that this be implemented in practice?

Yes, multi-employer schemes should be reflected using the same principles as those that apply to a single employer scheme. If based on master trusts, then sectional accounting should be possible. If there is no sectional accounting, then proportionate bases should be possible, so long as the basis used is disclosed.

Question 14 Do you agree that a pension plan's general purpose financial report should include its liabilities to pay benefits in the future? Do you agree that that plan's liabilities for future benefits should be quantified using the same principles as an employer's plan?

For some of our members there are strong arguments in favour of consistency between the pension scheme accounts and the company accounts. Arguably, in a global market one set of accounting standards should lead to comparability and consistency and, therefore, the pension liability should be included in both the sponsoring company accounts and the pension scheme. Lack of consistency is compounded if the liabilities in the pension accounts are different from those in the company accounts. For these members this means using the same principles when quantifying the liabilities in both the employer's and scheme's accounts. Recognition of the liabilities in the pension plan's financial report is also important in demonstrating the trustees' stewardship.

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Other members question whether a liability should be quantified in the pension plan's general purpose financial report at all. They argue that the accounts of a pension plan are not 'general purpose' and therefore should not be within the scope of GAAP. The members of a pension scheme are generally interested in the solvency of the scheme alone and already receive an annual summary funding statement, therefore full accounts are not required, nor is the additional cost justified. This proposal would also add audit and annual actuarial costs. Liabilities, these members argue, are better addressed in the plan's business plan and funding plan.

Question 15 Do you agree that a pension plan's statement of financial position should reflect an asset in respect of amounts potentially receivable under an employer's covenant, and that this should reflect the employer's credit risk?

At present, in the accounts of pension schemes, there is a tendency to give bald information about point-in-time deficits without an indication of future commitments to remedy the funding position. We consider that it could be helpful for information about the employer's covenant to be disclosed. We have reservations, however, about reflecting the amounts potentially receivable under the employer's covenant as an asset in the pension plan's accounts. In the discussion paper it is said that if the employer recognises a liability in respect of amounts due to the pension scheme then it follows that the scheme should recognise a corresponding asset. This would be acceptable if the criteria for recognition of assets and liabilities were identical, however in general, the threshold for an asset is higher than that for a liability. There is therefore a possibility that an asset is recognised under this proposal that would not otherwise meet the definition of an asset in the conceptual framework.

Question 16 Are there types of pension arrangements that require further consideration? Please identify the specific features of these arrangements and suggest how the principles of this paper would require development to secure appropriate financial reporting for them.

We are not aware of other types of arrangement but if the standard is principles based it should be applicable to any other types of pension arrangements. Given the recent increase in pensions buy-out activity in the UK, this may be an area requiring further examination.

Question 17 Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?

In our discussions of this paper and other recent reporting and regulatory measures for both pension schemes and their sponsoring employers we are increasingly conscious of costs being imposed. These appear to be rising and some members question whether the benefits outweigh the costs.

Of considerable concern to some members is the possibility of including a liability in the pension scheme's annual report and accounts. They strongly believe that the costs of complying with such a requirement would be unacceptably high to provide pension members with information they do not want. In their experience, exceptionally few members of pension schemes ask to be provided with details of the actuarial liabilities. Scheme accounts should have a triennial focus on liabilities, but also recognising that interim valuations may be appropriate to inform proposed corporate transactions or in times of prolonged market stress.

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