The Financial Reporting of Pensions

Response to discussion paper by the Accounting Standards Board

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Introduction

This paper sets out our response to the discussion paper “The Financial Reporting of Pensions” by the Accounting Standards Board. We note the difficulty of accounting for pensions and support many of the general principles underlying the proposed changes to the reporting of pensions. However, we do believe that the presentation of pensions in company accounts will have implications for the long-term sustainability of defined benefit pension schemes and this needs to be a key consideration for any review of the accounting practice, especially if it is proposed that pension schemes be treated an a manner inconsistent with other company liabilities.

This paper provides initial commentary on several elements of the proposals. However, given the review being carried out by the IASB we have restricted our comments to certain areas of the ASB proposals.

1 The calculation of liabilities

1.1 The discount rate used to value the liabilities

The choice of the discount rate to be used for determining liabilities is a complex area. We understand the willingness of the ASB to more accurately reflect the principles of corporate value when assessing pension scheme obligations.

However, we feel that an important concern is the need for accounts to present the employers pension deficit consistently. We believe that the adoption of a risk free discount rate would, in practice, lead to inconsistency between the treatment of other obligations in company accounts. In particular, we would draw parallels between pension scheme liabilities and other forms of corporate debt.

The issuance of market debt is recorded at sale value rather than market value. The effect of moving to corporate value based principles for corporate debt would be damaging to the market, because companies would be reluctant to issue debt (from which the market prices default risk) if the subsequent liability on the balance sheet were considerably higher (by not allowing for default risk) and no allowance were made for the possibility of the company defaulting on the debt.

Similarly, companies with pension schemes would be penalised if they were required to record pension schemes at corporate value. The effect would be that pension schemes would appear less attractive than other comparable forms of corporate debt and unfairly add to the difficulties faced by defined benefit pension schemes. Whilst we accept that the role of company accounts is to accurately portray a company's underlying liabilities, requiring pension schemes to be reflected at corporate value, but not other forms of debt would be misleading and give a false relative impression of the company's obligations to the pension scheme.

We believe that the use of too penal a discount rate could contribute to the closure of defined benefit schemes and encourage moves by employers to reduce their exposure to such schemes. We therefore believe that the discount rate should continue to reflect some default risk.

Furthermore, one of the most important criteria for the discount rate is that it should be consistent between different employers and that it should, therefore, be well defined. The use of the corporate bond yield to discount liabilities has proved to be flawed because of the wide range of yields that can reasonably be adopted. This is exacerbated by the corporate bond yield being particularly poorly defined at the long durations, which correspond to the liabilities of many pension schemes.

Using the swap curve as a base for the discount rate would seem reasonable for the following reasons:

- It is well defined and publicly availably
- There is a reasonably deep market, even at long durations
- The swap curve exhibits relatively low volatility, which would provide stability from one period to the next
- It is possible to invest in the swap curve

We would therefore suggest that the discount rate be derived with reference to the swap curve but with an upward adjustment of 1% to reflect default risk.

An additional measure that we would like the ASB to consider is that as well as the disclosures prepared using the discount rate suggested above, the accounts could include an alternative “realistic long term funding” balance sheet position and P&L charge. These figures would be calculated using a discount rate reflecting the expected return on the assets of the pension scheme.

1.2 Allowance made for administrative expenses in the calculation of the liabilities

We agree with the ASB that clarity is needed over the treatment of expenses when accounting for pensions. We agree that, as day to day administrative costs are unavoidable, they do represent a liability to the employer at the accounting date and so agree that they should be incorporated into the calculation of the liabilities. Where unusual administrative costs are incurred (for example relating to reviews of scheme design), we believe they should be recognised via the P&L charge.

With regards to the PPF levy, we agree that the ability to mitigate the risk based levy would suggest that it should be excluded from the calculation of the liabilities and instead presented in the periodic pension expense. We also feel that there would be considerable difficulty associated with estimating the risk based levy in future years given the unpredictability of various factors affecting the size of the levy and so, for practical reasons, we suggest that it would be preferable to report it on an annual basis.

We note the arguments suggesting that the scheme based levy should be allowed for in the calculation of liabilities because it is not possible to mitigate this element of the levy. Whilst we agree with this in theory, in practice the scheme based levy is small and will not have a material impact on the calculation of the liabilities. Therefore, we suggest that it be grouped with the risk-based levy for simplicity.

Finally, we would welcome confirmation from the ASB that where administrative expenses in a year are different to the expected level, then this would be viewed as an experience item. Similarly, we would assume that if the assumed level of future expenses were revised, this would be seen as an assumption change comparable to changes in economic or demographic assumptions.

1.3 Allowance for future salary growth in the calculation of liabilities

We note that the proposed change to the definition of the liabilities, to exclude future salary growth for existing employees, is in line with IAS37. We also note the wish of the ASB that the same principles be applied whether accounting for defined benefit or defined contribution schemes.

We agree with the proposal that the liabilities for active members must at least reflect the requirement to grant statutory revaluation in deferment.

However, we feel that it is unlikely that employers will be able to restrict pensionable salary growth to the workforce as a whole. We are therefore concerned that adoption of the proposed approach will lead to an increasing pension cost in future years (mitigated partially in the UK by the allowance for inflationary increases in the liability calculation). We believe that an increasing pension cost would make the accounts harder to interpret and so reduce transparency.

Further, we agree with the argument presented in FRS17 that that there is a fundamental difference between the liability arising in a defined contribution scheme (or indeed a career average scheme) and a defined benefit scheme, and that this difference should be reflected in their accounting treatment.

1.4 Allowance for only present obligations as liabilities and allowance for discretionary powers

We agree that only benefits that have been accrued at the valuation date should be included in the calculation of the liabilities. We also agree that no allowance should be made in the calculation of the liabilities for the cost of benefits that are granted at the discretion of the employer. Discretionary benefits should be recognised through the pension cost in the year that they arise.

1.5 Allowance for pension scheme members to take options that change the cost of providing the benefit

In our view, pension scheme liabilities shown in company accounts should realistically reflect the expected cost to the employer of providing the promised benefits. Our view is therefore that financial and demographic assumptions should therefore be chosen to be “best estimate” and options should, therefore, be allowed for in line with a realistic probability of that option being taken. We believe that to force all employers to recognise all options at their maximum cost would be excessively penal.

2 Changes to the profit & loss charge

We agree that the use of the expected return on assets in the profit and loss charge gives rise to some subjectivity and inconsistency. In this context, we accept the merits of allowing for the actual return on the assets in the P&L charge.

However, we also note the wish for most employers to estimate their P&L charges at the start of the year. Clearly, there is some unpredictability in the pension cost introduced by using the actual return on assets but it can be argued that variation between actual and expected return on assets is a function of the investment strategy chosen and this will, so some extent, be under the control of the sponsor. Our main concern therefore relates to the allowance in the P&L charge for changes in the discount rate. Such an approach could lead to significant volatility in the pension cost, particularly for large schemes with few active members. Further, we would question whether the discount rate should be separated from changes in other assumptions to which it is linked, for example assumptions for inflation and pension increases. We would therefore propose that actuarial gains and losses on assumption changes be reported as income or expenses but not be recognised as part of operating activities or financing.

We believe that distinction should be made between gains or losses arising due to changes in the assumptions and gains or losses arising due to the experience of the pension scheme.

An alternative approach would be to allow companies to disclose their P&L charge both including and excluding the pensions items if there is a material difference between the two. This would allow analysts to understand the impact of the pension scheme on the Company and would encourage clarity over what is being reported.

3 Financial reporting by pension plans

In our view, pension scheme accounts are prepared to ensure good scheme governance and are used predominantly by pension scheme members and by Trustees. We believe, that in this context, disclosing the liabilities calculated on the basis used in the company accounts would be confusing for the user and would suggest that this approach should not be adopted.

We agree that an indication should be given as to the ability of the scheme to meet its future liabilities. However, we feel that the inclusion of the summary funding statement in the accounts (as required under the new SORP) fulfills this requirement. Therefore, we do not feel that any further additional disclosure is needed with respect to the pension scheme accounts.

4 Consideration of the regulatory environment

We believe that the regulatory requirements on pension schemes remain relevant because they have an impact on actual cashflow requirements for the employer. We therefore agree that they should be disclosed in the notes to the accounts. However, we agree that to use the funding basis to calculate the liabilities that appear in the company accounts would lead to inconsistency and poor transparency. It could also result in unfavourable effects on scheme funding bases where the employer has input into the funding basis.

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