Response No.97

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Jennifer Guest
Accounting Standards Board
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Dear Jennifer

Discussion Paper – The Financial Reporting of Pensions

Thank you for agreeing to accept our late response.

The responses to each of your questions are set out in the attachment to this letter.

Should you have any questions about any of our responses, please come back to me.

Yours sincerely

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The Financial Reporting of Pensions
Responses to the questions

Q1 *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 agree that for accounting purposes if the point in time principle is to be applied then it is not appropriate to take into account future costs which are uncertain and may be subject to change. In addition, the liability should be limited to the amount which is enforceable and should not include amounts which are not enforceable. In the current market conditions many employers can and are changing the pension provision that is available to their employees in a number of ways such as by closing their defined benefit schemes to future accrual, by changing the benefit structures, or simply by removing the future benefit by making employees redundant.

For funding purposes the liability to pay pensions should be based on expectations of pensionable salaries when members leave service. This projected cost will be funded from the investments held within the scheme. The remainder, where there is a deficit, will be funded by the employer. It is with this information that the trustees are able to agree their Recovery Plan with the employer to fund the deficit.

Q2 *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?*

Future salary increases could cease for the workforce as a whole by the scheme being closed to future accrual and it is common for schemes to implement such a change. Future pension accrual is by no means certain across the whole membership in today's environment as is suggested by the paper and it is unrealistic to presume that future accrual will be appropriate for any particular members or category of member. On this basis future pension obligations for future accrual should not be recognised across the membership or individually unless there is an enforceable obligation.

Q3 *Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?*

Yes, as stated above in the answers to Q2 and Q3.

Q4 *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?*

A trust is an arrangement whereby investments are managed by the trustees for the benefit of the members. A trust is created by the employer who entrusts their investments to the trustees, whose role it is to manage the investments. The trustees hold legal title to the investments, but they are obliged to hold the investments for the members. The trustees owe a fiduciary duty to the members, who are the beneficial owners of the trust investment. The trust is governed by the terms of the trust deed.

The Financial Reporting of Pensions
Responses to the questions

If the trustees have insufficient funds to pay the liabilities promised, negotiations will take place with the employer to improve the funding of the scheme as this is (the employer) where the deficit resides and not with the trust. If there is no employer and the liabilities cannot be met the scheme may enter the Pension Protection fund which will ensure that 90% of the liability is covered and the remaining 10% will be unpaid. It is therefore clear that the deficit beyond the value of the assets does not reside with the trust and rests with the employer or Pension Protection Fund. It is the employer that has voluntarily made the promise of delivering these liabilities to their employees when agreeing the terms of their employment. On this basis it makes sense for the deficit to be included in the corporate balance sheet and not to be duplicated in the scheme accounts.

It would be misleading to consolidate the assets and liabilities of both defined benefit and defined contribution schemes on a gross basis into the employer accounts as this would give the impression that the assets of the trust were available to the employer and potentially the employer creditors by overstating the assets of the scheme. Clearly these assets are held for the benefit of the members. Even if the assets and liabilities were consolidated, separate accounts would be required by the pension trust.

Q5 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?

Changes in assets and liabilities that have accrued to the year end date should be recognised and where changes are not currently enforceable they should not be recognised.

However the long term nature of the pension trust should be recognised in the accounting treatment. Pension schemes are not short term investment vehicles and there is a danger that a short term accounting approach may encourage short termisim rather than the long term view required to manage a pension scheme successfully and which if not carefully thought through may not create the desired result

Q6 Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, do you agree that:

Regulatory measures should not replace measures derived from general accounting principles?

The Accounting Standards Board should take account rather than ignore the regulatory regime that is already in existence to ensure that there is 'joined up thinking' to these issues rather than an unsatisfactory fragmented approach.

Schemes are already required to calculate their scheme liability which is already reported to members in the Summary Funding Statement. For years commencing on or after 6 April 2007 the revised SORP encourages schemes to include the Summary Funding Statement in the Annual Report and there is a requirement to include a cross reference at the foot of the Net Assets Statement to the Summary Funding Statement and to disclose the fact that the Net Asset Statement does not include the actuarial liabilities. Many schemes have early adopted the SORP and are already including the Summary Funding Statement in their Annual Report. The full actuarial valuation is also available to members. Schemes are required to put a Recovery Plan in place where the scheme is not fully funded and to set out the contributions that are payable in their Schedule of Contributions. The proposal to include yet another liability in the scheme accounts (which in many cases would be different to the employer liability as it is the trustees responsibility and not the employers to agree the assumptions used) would only add to the confusion of the members who already have access to employer liabilities (FRS17), ongoing liabilities and buy out liabilities (in the Summary Funding Statement).

The Financial Reporting of Pensions
Responses to the questions

The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?

Research shows that the liabilities of pension schemes will increase dramatically if the discount rate is changed from highly rated corporate rates to the risk-free rate. Even in periods where corporate bond spreads are less wide compared to the gilt market and there is by no means any certainty that there will be a return to such an environment in the near future. The result of this change in rate will be the closure of more schemes and the increased incentive of employers to seek to buy out the liabilities. The Accounting Standards Board should think carefully about the impact of any changes that are introduced and question who would benefit from this change at all.

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?

There is a great deal of uncertainty about future pension liabilities, not least because of the uncertainty surrounding longevity. It is therefore essential that information about how liabilities are compiled and the uncertainty surrounding them is disclosed in a way that readers of accounts can understand. It may also be potentially misleading to provide just one number for the reader to understand the full position.

The liability should not be reduced to reflect its credit risk?

It would not be appropriate for the liability to reflect the employer's credit risk.

Expenses of administering the plan's accrued benefits should be reflected in the liability?

The costs of administering the plan should be accounted for in the same way as other costs that are accrued for the period to which they relate.

Q7 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?

The latter, reflecting the probabilities of outcomes. However the highest amount could also be disclosed particularly where the difference is significant to the scheme, together with the appropriate discourses.

Q8 Do you agree that assets held to pay benefits should be reported at current values?

Yes.

Q9 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.

Q10 ***Do you agree that different components of changes in liabilities and/or assets should be presented separately?***

Yes.

Q11 ***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?***

Yes.

Q12 ***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?***

Yes, however the disclosures should be relevant and specific and not too lengthy and meaningless to many readers of the accounts.

Q13 ***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 we agree that the proportionate share of the assets/liabilities should be disclosed.

Q14 ***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 the plan's liabilities for future benefits should be quantified using the same principles as an employer's liability?***

The starting question should have been whether general purpose financial statements are appropriate for pension schemes at all. At present pension scheme accounts are stewardship accounts, which show in the Net Assets Statement how the trustees have administered the assets of the trust with which they have been charged by the employer. The accounts include a statement which explains that the actuarial liabilities are not included within the Net Assets Statement at the foot of the statement and this cross refers to the Summary Funding Statement which quantifies the liabilities and it also cross refers to the actuarial certificates. There is no requirement to file pension scheme financial statements and although theses financial statements are available to members, in most cases no members or only a handful actually request them at all. Other information is sent to members in the form of the Summary Funding Statement, benefit statements, scheme booklets, summary accounts etc. Members make limited decisions such as whether to join the employer scheme or not, on leaving whether to transfer their funds, on retirement whether to take a lump sum and whether to make further pension provision. Members do not use these accounts to make their decisions and are provided with other information by the scheme and employer. There are no investors in pension schemes and investors in companies will look at the corporate accounts and not the pension scheme accounts for information about pension liabilities. There are no calls from any parties that we are aware of for the existing accounting arrangements for pension schemes to change because it does not work, therefore it seems that the proposals to change the existing structure would provide no benefit.

The Financial Reporting of Pensions
Responses to the questions

If liabilities are to be quantified they should follow the same principles as the employer, however the assumptions made by company directors and trustee boards may be different and this would result in different liabilities.

Q15 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?

The liability for pension obligations over and above the asset value rests with the employer and schemes put in place Recovery Plans and Schedules of Contributions with their employers setting out how the employer will pay the deficits. If the liabilities were included in the a scheme balance sheet with no corresponding asset the statement would show many trustees and trustee directors to be carrying in their business while the scheme was insolvent. Clearly therefore an asset must be recognised, if the liability is recognised, to reflect the fact that the liability rests with the employer and not with the scheme.

The inclusion of an asset would require trustees to reflect their assessment of the employer's covenant, which may result in difficulties where trustees have access to confidential and price sensitive information, which may require them to reduce the value of the asset. The asset would clearly not in all cases be equal to the liabilities that cannot be paid from the scheme assets, to bring the net position to nil, due to these considerations.

Q16 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.

No.

Q17 Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?

Additional costs would be incurred as a result of these changes in the form of audit, actuarial and pension manager and trustee time. The additional work involved would purely be undertaken to comply with accounting requirements but would not provide any benefit to anyone.