FitchRatings

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Accounting Standards Board
Aldwych House
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Discussion Paper: The Financial Reporting of Pensions

Dear Sirs,

We appreciate the opportunity to comment on the Accounting Standards Board's ("ASB" or "Board") Discussion Paper on The Financial Reporting of Pensions (the "Discussion Paper").

Fitch and the role of pensions in its analysis

Fitch Ratings (Fitch) is a leading global rating agency committed to providing the world's credit markets with independent, timely and prospective credit opinions. Fitch's corporate finance ratings make use of both qualitative and quantitative analyses to assess the business and financial risks of fixed-income issuers. Therefore, Fitch directly relies on the financial statements and that reliance places us in an informed position to comment on information we believe is useful and crucial in the credit evaluation process, which is a critical component of efficient capital markets.

Fitch's key use for pensions accounting and disclosures is in assisting us to determine how an entity's pension commitments affects its ability to service its debts as they fall due.

Across its corporate work Fitch recognises that pensions have some elements which are similar in nature to a debt obligation, but some significant differences. Fitch therefore includes reported pension deficits in certain of its key analytical metrics.

In rating corporates, our analysis also includes forming a view on the drain on operational cashflow which an entity's pension promises represent. Rating analysis of financial institutions includes an assessment of whether the pension liabilities figure needs to be adjusted in our calculation of loss-absorbing capital for unexpected risks. Information on actual and expected near-term cash outflow relating to pensions is an important consideration in credit analysis. Therefore, disclosure of regulatory requirements is particularly helpful.

To a lesser extent the agency uses the data to determine the potential impact of a pension scheme on other classes of creditor in the event of a winding up or financial restructuring. As the liability any scheme represents on a winding up is typically based on regulatory, rather than accounting, measures, the disclosures of regulatory measures of a scheme's deficit are again helpful to analysis.

Overall requirements

Fitch recognises the ASB's attempts to provide a clear and decisive intellectual lead in its proposals, and to spark debate. While Fitch sees some merit in debating some of the basic methodologies surrounding pensions accounting, such as the discount rate and approach to benefit accruals, the agency sees limited benefit for its purposes in changing these basic building blocks, and potentially significant risks in making sweeping changes to accounting treatments which are in themselves comparatively recent in their introduction.

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Fitch would focus, instead, on the significant improvements which can be easily implemented to make pension accounting and its disclosure more straightforward, comparable, and useful. There are a number of key requirements of pension accounting and disclosure if it is to be of use to us in our work. Current disclosure requirements address all of these issues to an extent. Fitch would encourage at least maintaining, if not improving on, current practice in respect of the following points:

1. Transparency, including the clear separation of pension-related items from other items. The operational characteristics and risk profiles of the core business of most of the entities Fitch rates vary considerably from those associated with a pension scheme. It is therefore important to be able to understand what pension accounting entries have been applied, so that we can adjust for them if necessary.

2. Consistency of accounting treatment - this includes a limitation of the number of options available to entities when accounting for pensions, which should aid comparability between entities. Key improvements on current standards include:

    a. an elimination of the option to use the corridor approach; and

    b. a requirement to show pension-related items in a consistent category (or categories) in the statement of financial performance.

3. Consistency of computation - as little choice between companies of actuarial and other assumptions as is practical, and where a choice must be available, comprehensive disclosure of the choices made allowing comparability between companies. Fitch recognises that it is appropriate and desirable for an entity to be able to select certain assumptions, such as mortality, to reflect the characteristics of its workforce and pension obligations. On the other hand, one of the key strengths of IAS 19 is its relatively prescriptive requirements in respect of interest rates. Were this to be replaced, Fitch would welcome a similarly restrictive approach.

4. Disclosure of current, comparative and agreed future cash contributions to pension schemes, and an indication of the regulatory environments governing cash contributions in each of an entity's key jurisdictions. This should include, where possible, disclosures of regulatory measures of the pension deficit, and the key assumptions included in this calculation.

Fitch would be concerned with changes to the current accounting framework which result in pension deficits being grossly different to regulatory bases. Pension obligations, no matter how measured, remain highly uncertain. A regulatory measure gives an indication of the cash commitment needed by the entity in the medium-term (say five years), a period over which there is some certainty. This more reliable measure is useful in credit analysis.

Specific Questions

Fitch's responses to the questions posed below are based on these fundamental requirements.

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)?

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?

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

Q1-3. Fitch is most interested in actual cash flows expected over the medium term. Therefore, reported accounting deficits are most helpful when they are aligned with deficits identified by regulators, with the reasons clearly explained where this is not the case. Otherwise the agency is relatively indifferent to the points raised in questions 1-3 as long as they are implemented consistently across entities.

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?

Q4. Fitch has no objection to the consolidation of pension plans per se. However, to the extent that this will introduce inconsistencies and choices in how to account for pension plans, Fitch would favour the current approach.

Fitch recognises that there are potential benefits from better reflecting the legal obligations of the entity. However the simple decision to consolidate or not is unlikely to be enough to fully encapsulate this information and it would need to be augmented by disclosure of rights and responsibilities for key territories. It would be simpler and more transparent to simply include this disclosure.

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?

Q5. Fitch agrees that the corridor option should be withdrawn as this would eliminate choice and therefore aid comparability. In whatever performance reporting format is ultimately used the size, placement, and components of such changes should be easily identifiable to allow them to be stripped out of 'core' operating metrics if necessary.

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?

Q6. Agreed, though in determining potential cash outflows associated with the servicing of pension promises it is useful to understand the regulatory position, so disclosure of the deficit, and how this can affect future cash contributions, is vital.

Fitch would also question the value of adopting a measure which led to an accounting deficit that was grossly different to a regulatory deficit, and would encourage the Board to empirically investigate further the potential implications of the changes proposed in the Discussion Paper's recommendations.

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

No comment, other than general comments above.

- 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?

Fitch welcomes disclosure about the sensitivity of all aspects of pension accounting to key assumptions. Sensitivity-type disclosures are very useful.

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

Fitch does not support inclusion of credit risk components in the valuation of any liabilities. These are a hindrance to credit analysis, which involves establishing what a company's liabilities are and how likely it is that these will be repaid. A heightened credit risk of the company does not reduce the amount it has to repay and a reduction in credit risk does not increase its repayment obligations.

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

These costs need to be met before the obligation can be settled, so it seems reasonable to include them in the calculation. They would also be factored into the price of any transfer to a third party.

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 ?

Q7. Assuming the worst case scenario, if this differs from actual experience, is overly prudent. Realistic assumptions, based around actual experience, and adjusted where necessary for changes in such experience, would be the most appropriate approach in our view. We would prefer to see an amount representing a single, most likely expected outcome with some disclosure concerning the limitations of this amount rather than a probability-weighted calculation from a range of potential outcomes.

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

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?

Q8 and 9. Subject to the more general comments above in respect of the final accounting measure agreed, in all its respects, not differing grossly from regulatory measures, Fitch agrees with this analysis.

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

Q10. Fitch believes that the current disclosures of movements in assets and liabilities greatly aid the understanding of what is driving pension deficit movements. Separate presentation, at least in the notes to the accounts, is vital.

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?

Q11. Fitch firmly supports the recognition of actual returns on assets in full in the period in which they occur. Whether this is an income statement item or one which is recognised directly in equity is to some extent academic for our purposes – though we would favour one or the other rather than a blend which allows companies to choose how much to recognise in which statement. Our main concerns are comparability between the financial statements of different entities, and the ability to isolate such movements from 'trading' profits. Clear disclosure is therefore also key.

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?

Q12. Fitch broadly supports the proposals in this regard, particularly as they relate to additional disclosure surrounding mortality assumptions and sensitivity analysis. With respect to the latter, Fitch would favour simplicity rather than complexity in the way these sensitivities are expressed. While Fitch recognises there is significant complexity involved in performing these sensitivities, they are principally useful for their ability to allow an understanding of the broad magnitude of any risks, rather than as exact measures. Perhaps a way to avoid excessive methodological disclosures would be to include, where there is a wide range of outcomes, that range, and only where this range is large to discuss the key reasons for the differences.

While it is implied by the specific disclosure requirements, it would be helpful to include explicitly requirements to disclose:

- regulatory measures of obligations/deficits;
- a brief discussion of the regulatory framework in each country, with the focus on the interaction between a deficit and the requirement to contribute cash; and
- current and agreed future cash contributions.

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?

Q13. Fitch firmly believes that multi-employer plans should be reflected in an employer's financial statements in a way which reflects the legal and funding requirements of such a plan, even if such a method is only a crude approximation of an ideal situation. In principal there should be no reason why accounting for such plans is done on a different basis to other plans. Where informational constraints prevent the accurate computation of an entity's share of plan assets and liabilities, the entity's best estimate should be included, and these uncertainties, and the estimates used to address them, 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?

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?

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.

We have no comments on questions 14 - 16.

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?

Q17. Fitch reiterates here its general comments on assessing the overall impact of the proposals in generating results which do not grossly differ from regulatory measures.

We would be happy to answer any questions on our comments.

Yours faithfully,

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