rpmi

Our vision is to be the provider of choice for pension services.

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Dear Mr Lennard

Comments on the ASB / PAAinE discussion paper *The Financial Reporting of Pensions.*

We welcome the opportunity to comment on the ASB / PAAinE discussion paper *The Financial Reporting of Pensions* and would like to set out our views in order to contribute to the debate.

Rpmi is the administrative subsidiary of the Railways Pension Trustee Company Limited ("RPTCL"), responsible for the administration of all the main railway industry pension schemes, which together have over £20 billion in assets, 90,000 active members and more than 260,000 pensioners and preserved pensioners. Rpmi's Executive Chairman, Chris Hitchen, is the current Chairman of the National Association of Pension Funds ("NAPF"). Rpmi also administers the pensions of many organisations outside the railway industry, including the Parliamentary Contributory Pension Fund.

We believe it is important for the future of pension scheme provision in the UK that the ASB take note of the views of those working in the pension industry. Our unique position and daily contact with employers, trustees and members puts us in an ideal position to gauge the opinion of the various interested parties and to see the effects of changes in accounting rules first hand. We hope, therefore, that you will be able to take our observations into account.

Summary

The discussion paper describes itself as a "…fundamental reconsideration, starting from first principles, of the accounting that should be required for pensions." However, rpmi's view is that the proposals are nowhere near fundamental enough. We see three main areas of weakness:

1. The first problem is the current obsession of accounting standards in general and this discussion paper in particular with fair value accounting. The assets of a pension scheme are not held for immediate resale (except in the case of a winding-up), and therefore a more appropriate valuation measure would be the intrinsic value of the assets in use.

2. The over emphasis on fair value in the balance sheet leads naturally to the second problem. The profit and loss charge disclosed in financial statements has already become dangerously divergent from the actual real world cost of running a pension scheme, and the proposals in the ASB paper will amplify this gap, thereby further reducing the utility of the profit and loss account and increasing the gulf between

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reported results and the actual affordability of schemes. The profit and loss charge should pay more regard to the true economic cost of running a pension scheme, which should be calculated with reference to actuarial considerations, long term contribution rates and regulatory measures, rather than being linked to changes in assets and liabilities at fair value.

3. Finally, accounting standards should be neutral, meaning they should attempt to report reality without bias. Recent standards such as FRS17 have undoubtedly been a factor in scheme closures but we are not suggesting that standards should simply be drafted in whatever way will keep schemes open, since that would not be neutral either. However, we do believe the *apparent* cost of running a scheme in financial statements should bear a closer resemblance to the *actual cost* of running a scheme in practice. Employers will then be less likely to erroneously close schemes in future.

Set out below is a more detailed examination of these concerns. The proposals in the discussion paper that are most directly relevant are:

a) Assets should be measured at fair value, marked-to-market where possible.

b) Profit and loss should be based on actual investment returns rather than expected investment returns.

c) All gains and losses should be recognised immediately rather than allowing any sort of deferral or corridor mechanisms (we note that in the UK, this is already the case, but it will still be relevant to some UK companies reporting under IFRS).

Also relevant is the following proposal:

d) The value of liabilities should be calculated using a risk free discount rate as opposed to the current AA corporate bond rate (offset to a small extent by the exclusion of future discretionary pay increases).

Asset valuation

Together these changes would result in an immediate and large increase in value of pension fund liabilities, resulting from proposal (d), coupled with increased volatility of the profit and loss charge in all subsequent accounting periods, resulting from proposals (a) to (c).

In our view, reported results have already become worryingly divorced from the economic reality of running a pension scheme, and the proposals would widen the gap even further. For example, consider the valuation of assets, point (a). In the discussion paper this gets very little attention, perhaps because it is already required by the UK standard. It is assumed almost without comment that fair value (meaning current, marked-to-market value wherever possible) is the correct measurement basis for the assets of pension schemes.

However we would argue that if one wishes to measure reality, especially the affordability of schemes, it is a mistake to account for pension scheme investments as if they are held for immediate sale (unless the scheme is being wound up). The investments of a pension scheme are more akin to fixed assets. They are held for long-term growth and especially for income generation.

For example, consider the fact that all the funded schemes administered by rpmi are able to meet a very high proportion of their benefit expense out of investment income. This is true even of extremely mature schemes containing only pensioners and no members. One scheme we are responsible for is about as mature as it is possible for a pension scheme to be and yet it still meets almost a third of its benefits out of investment income, and has to sell only a small proportion of its total assets in any one year.

Meanwhile, almost all the schemes we administer that are open to new members do not *need* to realise assets at all. When they do trade assets, it is usually to make minor adjustments to their target asset allocations or to implement more significant changes in investment strategy.

We therefore see future growth and especially the income investments can generate as being of paramount importance, and certainly a better and more relevant measure than spot prices. Whilst it ought to be true that in efficient markets future income is already priced into the value of securities, the available empirical evidence strongly points to quoted values in practice being more a measure of the psychology of traders and the sentiment of markets rather than of the value of assets in use.

A better standard in this respect is FRS11, which takes the *higher of* net realisable value and value in use as its measurement basis. Such a basis is more relevant to the assets of pension schemes, which are in nature closer to fixed assets than current assets.

Whilst value in use can be criticised for being a subjective measure reliant on actuarial assumptions and calculations, or even as being open to manipulation by unscrupulous finance directors, we do not believe that this criticism succeeds. The net position is already dependent on an actuarial calculation – that of liabilities – and even a flawed valuation for assets in use will be more relevant than a point-in-time valuation which is effectively a random number. As for abuses, these should be addressed directly by regulators and auditors, and we are of the view that it is possible to rely on expert actuaries to make reasonable and prudent estimates.

Profit and loss effect

Market movements of 1% or even 2% in a single day and 20% in a year are not uncommon. Booking such changes through profit and loss would make it appear as though that were the cost of running the scheme during the year, which it is not.

Trying to compensate by simply disclosing the expected return, or perhaps the regulatory position, by way of a note would be a poor substitute for booking a number on the face of the profit and loss that is directly related to the affordability of the scheme, meaning the actual cost to the employer. Anything can be disclosed by way of a note, but it is the figures in the primary statements that draw the attention of finance directors and influence behaviour, therefore it is extremely important that they reflect reality rather than some theoretical, but misguided, accounting principle.

If profit and loss is to be coupled directly to the balance sheet by removing the corridor and reporting returns as the difference between two balance sheet positions, it becomes even more important that the measurement principle being employed in the balance sheet pays regard to the indirect effect it will have on profit and loss as well as its direct effect on assets and liabilities. Placing so much emphasis on fair value and regarding the effect on profit and loss as an unfortunate side-effect is an abdication of the responsibility of standard setters to consider financial statements as a whole. Accounts consist of more than just balance sheets; reported profits and losses need to bear some relation to the real-world expenditure required to fund pensions.

In our experience with RPS employers during both the ordinary running of the scheme and during takeovers and other corporate transactions, it is the cashflows and regulatory position that are of paramount importance. Sensible analysts will always look to these figures first, and so they should. The existence of more than one regulatory measure complicates the problem somewhat, but any regulatory measure we can think of would reflect reality more closely than gains and losses at fair value. The existence of more than one sensible measure is a poor reason for selecting a measure that is neither sensible nor useful.

Reporting gains and losses at fair value in profit and loss would simply be a distraction which would need to be removed from accounts to reinstate a true and fair view. Unfortunately the history of FRS17 has shown us that ignoring misleading pension figures in accounts is easier said than done, and poor decision making is the inevitable consequence.

We therefore conclude that a fairer way to report the profit and loss charge would either be on a regulatory basis, or better still, on an actuarial calculation based on the long-term funding requirement of the scheme. This cost, being the most concrete measure of the actual affordability of the scheme, should be the figure reported on the face of the profit and loss.

Actuaries are best placed to determine the long-term cost, and accountants should find a way of accounting for this cost. Further, we see no reason why the assumptions made by the company in computing this cost should necessarily differ from the assumptions made by the scheme actuary and trustees in preparing the main scheme valuation. Finance directors may protest that this puts key accounting figures outside their control, but that is also true under fair value, except that the actuarial cost is a better measure of the affordability of the scheme.

In addition to providing the fairest measure of economic impact in the long run, an actuarial measure would be automatically consistent with the very long term nature of pension schemes, and the length of the timescales involved is very relevant to the debate. It is easy to imagine, under fair value accounting rules, two pension schemes identical in every respect except with year ends a month apart producing extremely different balance sheet positions in their sponsoring employer's accounts and similarly, one may result in the disclosure of a large profit and the other a large loss. At bottom, however, both schemes will actually be costing the same to operate. This will be reflected in their long run actuarial costs, which will be similar even after taking into account valuation results performed at their respective year end dates.

We think that reporting an actuarial cost would be the best reflection of reality, provide the best information for decision making and allow profit and loss accounts to show the true cost of running a scheme, which is surely what profit and loss accounts should be designed to do.

Neutrality of standards

According to the IASB framework, one of the objectives of financial statements is that they should be relevant, and that "Information has the quality of relevance when it influences the economic decisions of users..." We agree with this sentiment, and believe it follows that accounting standards should be designed, as far as possible, to report the economic truth of transactions without bias. Since accounting standards influence the decisions of users, we need to consider that changes in accounting standards may result in very different reported results and hence very different actions on the part of users. In fact the results may be so different that users take completely opposite decisions based simply on step – changes in accounting rules.

With this in mind, it is important that standards connect with the economic substance of running an enterprise. For example no one would thank accountants for writing standards that gave the appearance of insolvency when applied to a perfectly healthy company, especially those whose jobs would be lost during the subsequent winding–up.

Since the introduction of FRS17, data from annual surveys conducted by the NAPF show that the number of UK private sector DB schemes still open to new members has fallen from over 70% to just 31% in 2007. The Association of Consulting Actuaries puts the current figure even lower, at 20%. Whilst accounting standards might not be entirely to blame, most press articles on the topic name accounting changes as the main factor.

The "don't change the standards or schemes will close" argument is hardly new, but the easy criticism of it, which says it is illogical to let the consequences of standards drive their content, misses the point. From the fact that standards should be neutral, and hence that consequences should not drive standards, it does not automatically follow that all unfavourable consequences should simply be endured in the interests of "better" accounting theory. It may actually be the case that the consequences are direct evidence of bias that has already crept into the standards in error and that "better" should actually read "worse."

Almost 40% of DB schemes have closed to new members since the introduction of FRS17. Most of these schemes had previously operated in a state of good financial health (both actual and reported) for many decades. The pace of scheme closures has now slowed, but if accounting rules swing even further away from neutrality, the reporting environment will become such that if it had applied 100 years earlier, many of the most successful pension schemes of the 20th century might never have been started. The consequence for the remaining open schemes is likely to be the ignition of another round of closures.

If accounting standards correctly reflect the true cost and volatility of running a pension scheme and place it in company accounts, and if finance directors find the cost too high or the volatility too great, then the correct decision may well be to close the scheme and probably offload it to a buyout firm as well.

However, what has in fact gone wrong with pension scheme reporting is that accounting standards are already mis-stating the true volatility and cost, because fair value accounting has little to do with the actual economic impact on an employer of running a pension scheme. The proposals in the discussion paper will drive us further away from the truth. This bias in accounting standards needs to be addressed, but it is not necessary to load standards in favour of keeping schemes open; we need only remove the bias in favour of closing them down. Unfortunately the proposals, if implemented, will amplify rather than reduce the problem.

It is worth considering that existing pension buyout firms, and the advisers and private equity backers of potential new ones, are likely to be in favour of the proposals in the paper. If press reports are to be believed, they have already concluded that their market will expand rapidly if the proposals are ever turned into a standard. Finance directors will find it difficult to resist an easy solution to the apparent problems of soaring liabilities and volatility of reported earnings, and yet the actual affordability of pension schemes will not have changed at all. The underlying economic substance will be the same, but the reported figures will be misrepresenting the truth to an even greater extent.

When insurers' analysts perform their calculations unfettered by the need to comply with inappropriate fair value rules and the resulting buyouts still leave room for significant profits, that will in itself prove that the accountants got it wrong, though by that time of course, it will be too late to turn back the clock. Bias in accounting standards will by then be responsible for a large proportion of adults in the UK enduring a less comfortable retirement than need have been the case if only standard setters had been able to keep the reported cost of running a scheme in line with the actual cost of operating one.

Concluding remarks

We hope you find our comments on the discussion paper helpful. A fundamental review of accounting for pensions is most welcome, but the discussion paper is timid in not addressing the main source of weakness in pension reporting, being the inappropriate application of fair value in the balance sheet and especially the subsequent effect on profit and loss.

Like many other commentators, we are of the view that FRS17 has helped to close a large number of UK final salary schemes, and we do not subscribe to the theory that this is simply an unfortunate consequence of "better" reporting in financial statements. On the contrary: we think it is the result of profit and loss accounts drifting away from a fair presentation of the cost of operating a pension scheme, and that the proposals in the discussion paper, if implemented, would erode the true and fair view still further. The consequence would inevitably be the ignition of a round of scheme closures and buy-outs.

Having taken one wrong turn the ASB appears to be poised to introduce changes that will take us even further away from a neutral standard. Instead we should take the opportunity afforded by the fundamental review to devise a method of reporting costs that reflects the actual affordability of schemes. Accounting standards should not be designed to keep schemes open at all costs, but the existing bias should be eliminated so that companies can take sensible decisions.

The next standard on accounting for pensions should result in reported profits and losses that are correlated with prudent estimates of the actual cost of providing pensions, which should be based on an actuarial calculation. We think it is unwise and positively misleading to pretend that employer's financial statements are somehow completely independent of the scheme funding position. Finance directors and other observers find it difficult if not impossible to resist reading undue significance into figures in accounts that actually bear little relation to the true affordability of schemes. This whole approach, derived from "fair value," seems to us to be contrary to the virtues of substance over form and of accounts presenting a true and fair view of costs as well as of assets and liabilities.

A generation of individuals who will be excluded from final salary pension provision will be the ones to pay the price for standard setters following fair value accounting all the way to its unreal conclusion.

Yours sincerely

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