The Unquoted Companies' Group

Founded in 1968 to study the contribution made to the economy by the unquoted sector

Date: *Please reply to:*

07 July 2008

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Dear Sirs

ASB discussion paper on "The financial reporting of pensions"

The Unquoted Companies' Group ("UCG") represents some 35 sizeable private companies, which are controlled by founding family shareholders or their descendants. Although the Group may appear to have a restricted membership, it is believed that it speaks for concerns of family companies generally. Further details of its aims and objectives are contained in Appendix 1 to this letter.

The methodology for the financial reporting of pensions is of particular interest to the UCG. There are real concerns that as accounting for pensions becomes more and more conservative, defined benefit schemes will increasingly be forced to close for accruals, as well as to close for new members as has already largely happened. We believe that accounting for pensions should proceed on the basis that a best estimate of future liabilities should be provided for and not a worst case and, as we say below, we believe that in places the latest ASB discussion paper trends in the direction of the latter.

It has to be faced that perfection in the financial reporting of pensions is tantamount to the Holy Grail. A particular area of concern to us is that the result of the number of subjective judgements which have to be made in accounting for pensions will introduce a volatility into financial statements such as to outweigh focus on trading results. This is particularly so in the not uncommon case where the size of a pension fund has grown to such an extent that it dwarfs the size of its contributing employers.

We would have supported the financial reporting of pensions to be dealt with through a separate non-consolidated set of financial statements such that company accounts consisted of conventional financial statements dealing with trading results, assets and liabilities and cash flow on the one hand and pension fund accounts on the other. However the debate has progressed too far to explore such a contentious basis for the financial reporting of pension funds.

A particular concern of UCG members is that their lack of access to capital markets renders the funding of pension schemes a greater challenge than would be the case in listed companies of similar size. Originally, virtually all UCG members maintained defined benefit schemes for all their employees. A string of events in the last few years, such as the abolition of repayable tax credits, low interest rates and volatility in the stock markets has caused almost all the defined benefit schemes of our members to be closed to new employees and in a significant number of cases, closed to accruals also. We fear that escalating costs of maintaining defined benefit schemes will soon result in all or most of our members' schemes becoming closed to new accruals. As we explain below, the ASB discussion paper, if it is adopted in its present form, will substantially increase reported costs. The same is true of the conservative mortality assumptions which the Pensions' Regulator is seeking to introduce and the revised proposals on the PPF levy, which have the effect of drawing additional contributions from well funded schemes, thereby weakening them.

The ASB discussion paper

We propose to address ourselves purely to the 15 questions posed in the section of the discussion paper entitled "Summary and Invitation to comment". Our overall view of the discussion document is that it comprises a well argued and presented dissertation on the most difficult features of pensions fund accounting. We agree with the conclusions drawn on many of the 15 questions referred to above. However, there are some questions where we are in disagreement. We deal with these areas of disagreement in the next section of this letter. Other questions where we are broadly or wholly in agreement are set out in Appendix 2 to this letter, together with our comments thereon.

Areas of disagreement

Question 6 of the discussion document reads as follows:

6. 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 discount rate should reflect the time value of money only and therefore should be a risk-free rate?*

- *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?*
- *the liability should not be reduced to reflect its credit risk?*
- *expenses of administering the plan's accrued benefits should be reflected in the liability?*

The only one of these propositions with which we disagree is the proposition to fix the discount rate as a risk free rate. This presumably means utilising the rate of return on gilt edged securities, rather than the rate of return on AA rated corporate bonds. The effect would be inevitably to reduce the discount rate and therefore substantially enlarge the reported liabilities of the fund. This is both impractical and unreasonable. The market in gilt edged securities is not a perfect market but is affected by the vicissitudes of Government funding and by Government measures to reduce borrowing costs by forcing pension fund investment into gilt edged stocks, thereby reducing their stated interest rates to a level which taken in isolation does not make economic sense. We consider their utilisation of an AA corporate bond rate is both more realistic and will make some small contribution to rendering defined pension schemes more affordable. The ASB should recognise that the welter of imposed regulatory cost, coupled with expected poor investment returns, renders the survival of defined benefit schemes in the private sector at serious risk. Over-conservative accounting rules would exacerbate this.

A similar point arises in relation to Question 11. This question reads as follows:

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?

The key point here is that expected returns are a long term rate, which squares with the fact that pension fund liabilities are themselves long term. The actual return on assets represents short term performance. The use of an actual return will inject considerable volatility into company results, which will needlessly discomfit investors and possibly affect the ability of the company to raise finance in the capital markets. We view the use of the actual return on assets in a company's income statement as likely to lead to excessive conservatism which is the last thing which pensions accounting should be imposing.

We would be pleased to discuss our objections to your proposals with you or to provide any additional information which you may require.

Yours faithfully,

Michael Worley

Michael Worley
Chairman – Unquoted Companies' Group

Appendix 1

THE UNQUOTED COMPANIES' GROUP

1.1 The UCG is an informal association of some 35 UK based large family companies, represented by their Chairpersons, Chief Executives or Owner-Managers. Most are long established and some go back as far as the sixth generation of family. These 35 companies represent businesses with UK sales in excess of £5 billion, UK net assets in excess of £6 billion and UK employees in excess of 73,000. In addition these businesses have sizeable overseas investments. The UCG is a founder member of Groupement Europeen des Enterprises Familiales, which represents the interests of family companies in the major economies of Europe.

1.2 The constituent companies of the UCG have a key objective of a long Term sustainable growth strategy sometimes spanning generations. They do not intend to list on the Stock Exchange and all have a priority for long term growth, whilst accommodating all necessary economic change. They are therefore interested in strategies for the long term and are not plagued by the short term earnings and related share price and valuation considerations which afflict listed companies and companies controlled by private equity groups.

1.3The UCG confines its membership to very large family controlled companies as distinct from unquoted companies substantially owned by private equity groups. However, it believes that the issues that it addresses are also those of a much larger constituency of family companies.

1.4 The stability and resilience characteristic of long term family businesses accord with the Government's stated objective to maintain macro economic stability.

It is clear to us that unquoted family businesses can make a more balanced assessment between cost cutting activity or accepting a temporary fall in profits for the sake of longer term growth and company viability. The interest of the unquoted family business corresponds more closely to that of the greater economy and we believe that the economic importance of the sector is enhanced accordingly.

1.5 The commitment and long term policy continuity of owner/managers of long term family businesses are widely appreciated by banks and other financial institutions and ensure that finance although more limited than listed companies is in general available. Such companies therefore do not, in the absence of severe cash demands, have a need to seek capital by public offerings of shares or securities.

1.6 Members of the UCG strongly believe that unquoted businesses should not be put at a disadvantage relative to listed companies, either through the workings of the tax system or through other forms of Government induced regulation or directive. The UCG reviews proposals for new legislation or regulation in its areas of interest and produces comments and counterproposals for Ministers or HMRC as appropriate.

Appendix 2

The ASB Paper on "The financial reporting of pensions"
Responses to questions other than Questions 6 and 11

This Appendix sets out the views of the UCG on questions posed in the ASB's discussion document, including those where an option is proffered as to accounting treatment.

Question 1

Should a liability to pay benefits be based on expectations of employee's pensionable salaries when they leave service, or on current salaries including non-discretionary increases?

We believe that the recognised liability should be based on current salaries including non-discretionary increases.

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?

We believe that financial reporting should be based on the premise that a liability is owed to an individual employee. This reflects reality in that a workforce may often consist of a number of groups of individuals with different pension rights. Scheme membership will usually be reducing as employees leave and new employees are not offered participation in a defined benefit scheme. The only circumstances in which a liability is owed to the workforce as a whole is if the employer proposes to close schemes to accruing benefits.

Question 3

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

We agree with this proposition.

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?
We agree with this proposition.

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 left unrecognised, provided they are within certain limits (a "corridor") approach?

We agree that changes in assets and liabilities relating to pension plans should be recognised immediately. Other recognition policies make no sense.

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?

We believe that the liability should be reported at an amount that reflects the probability of different outcomes.

Question 8

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

We agree with this proposition. We note however that where assets are not quoted in an active market, valuation is particularly challenging. This is particularly illustrated by difficulties currently being experienced in the valuation of asset categories for which the market has virtually ceased to exist as a result of the so called "credit crunch".

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?

We agree with this proposition.

Question 10

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

We agree with the proposed categorisation. However, as noted elsewhere, we believe that it is the estimated long term return on assets which should be included within financing and not the actual return.

Question 12

Do you agree with the objectives and disclosure which are identified in this chapter? Are there specific disclosure requirements that should be added to or deleted from those proposed?

Generally, we agree with the stated objective and disclosure. Reporting in aggregate should usually be satisfactory and analysis of the features of individual plans within the aggregation should only be necessary exceptionally – for example, where there is a scheme conferring radically different benefits operated by a foreign subsidiary.

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?

We believe that the most satisfactory accounting treatment is for the use of a proportionate share of respective pension assets or liabilities. The same principles as those which apply to a single employer plan should be used.

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

We agree with this proposition.

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?

We think that the reality of the circumstances described is that the trustees of the scheme would seek additional support for the scheme from the employer, either through guarantees or charges on assets. If the employer has an adverse credit risk, it would be motivated to look sympathetically on trustee requests of this nature since the effect of implementing them both mitigate the amount payable to the PPF in respect of levy as well as minimising adverse publicity on creditworthiness. We think therefore that employer's credit risk will be an uncommon feature. We believe that it should only lead to provision in extreme circumstances.