Hewitt Associates Limited
6 More London Place
London SE1 2DA
Tel +44 (0) 20 7939 4000 Fax +44 (0) 20 7939 4411
www.hewitt.com/uk

The Financial Reporting of Pensions
Date: 9 July 2008
Prepared for: Accounting Standards Board
Prepared by: Hewitt Associates

The Financial Reporting of Pensions Response from Hewitt Associates

Introduction

In January 2008, the ASB and others issued a discussion paper considering the principles that might be reflected in future accounting standards on pension benefits that are related to employment.

This paper contains Hewitt Associates' response to the paper, both some wider comments and responses specific to the questions posed.

Proposals exacerbate difference of treatment with comparable assets and liabilities

At first sight, most of the proposals in the paper follow logically from the arguments presented in the paper. However, those arguments are based on premises that are not applied in other areas of accounting. The table below provides examples of this.

	Current IAS19	ASB Proposal	Debt issued by the entity	Lease arrangements (asset and deposits)	Bank fixed rate loans/ deposits	Framework	Conceptual framework
Mark to market	Yes (with option to amortise)	Yes	No	No (not all on balance sheet at all)	No	No preference for one measurement model over others	Not addressed yet
With impact reflected in P&L	An option (which few UK entities adopt)	Yes	No	No	No	No stated preference for P&L vs SoRIE	Not addressed yet
Allowance for credit risk	Yes – independent of entity risk	No – risk free	Yes – as at issue	Yes - implicitly	Yes – implicitly (interest rate reflects risk)	Not addressed	Not addressed yet
Disclosure of "contractual" terms	No	Yes	No	No	No	Not addressed	Not addressed yet
Disclosure of impact if interest rates etc change	If IAS 1 requires because material	Yes – even if not material	No (because impact is nil if not marked to market)	No (because impact is nil if not marked to market)	No (because impact is nil if not marked to market)	Not addressed	Not addressed yet

The above table shows that many similar long term assets and liabilities:

- are not marked to market at all;

- so apply neither immediate nor delayed recognition of gains or losses anywhere in the financial statements, never mind in P&L;
- are measured including allowance for credit risk (normally implicitly); and
- have far more limited disclosure requirements.

In particular, it is very hard to distinguish in nature between the commitment made by a company to its bondholders and the commitment made in the form of pensions for former employees. (The dependence of pensions on life expectancy, whilst in the news a lot recently, has a small impact compared with the effect of movements in interest rates, and is therefore almost irrelevant in this context.)

The different treatment of pension assets and liabilities is important. It makes pension assets and liabilities appear riskier than those comparable liabilities. This misleads management and investors, and consequently guides them to sub-optimal decisions, leading them to spend time managing the wrong risks. These inappropriate behavioural consequences have had an adverse impact on the current and future workforce by causing the closure of pension plans on the basis of misleading information as to relative risk.

The IASB has argued in the past that it is concerned with appropriate representation of the underlying financial position, and that it cannot be swayed by the behavioural consequences. However, the behavioural consequences that have affected pension plans do not result from the "fair" representation of pension plans. Instead, they result from the different treatment of pension assets and liabilities compared with other comparable long-term assets and liabilities. As things stand, pension plans seem risky against a background of a generally non-volatile balance sheet. If the accounting was consistent, pension plans would seem just as volatile as now, but against a background where large chunks of the balance sheet (generally larger than the pension plan) are equally volatile. Pension plans would in context not seem anything like as risky (relative to the rest of the business) and different decisions would be made.

Real people have suffered real losses (in their reliance on the security provided by a defined benefit pension plan) as a result of the biased and misleading accounting for pension plans imposed by the ASB and the IASB.

We would not suggest turning back the clock and ending the marking to market of pension plan assets and liabilities, even though this would be more consistent with the treatment of many other similar assets and liabilities. However, we would suggest that there should be no further changes to the accounting for pension plans that exacerbate the difference in treatment compared with the other assets and liabilities considered above (and have the effect of making them seem, by comparison, yet more volatile or more onerous compared with those other assets and liabilities).

Instead, we suggest that the treatment of pension plans should remain as it is unless and until the issues addressed in the paper (marking to market, recognition of gains and losses, allowance for credit risk etc) have been addressed at a high level, and are being applied across the board, not just to the accounting for pension plans. Consistency (as far as possible) between the treatment of different (but similar) assets and liabilities is more important than making further changes to the accounting for pension plans that arguably are of limited benefit (because pension plan accounting is already ahead of the game).

Signed on behalf of Hewitt Associates Limited

Simon Robinson FIA
Associate
+44 (0)20 7939 4958
simon.robinson@hewitt.com

Appendix – Summary & Invitation to Comment

Question 1

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)?

In our covering letter, we suggested that the accounting treatment of employment-related pension plans should remain as it is unless and until the issues addressed in the discussion paper (marking to market, recognition of gains and losses, allowance for credit risk etc) have been addressed at a high level, and are being applied across the board, not just to the accounting for pension plans. Consistency (as far as possible) between the treatment of different (but similar) assets and liabilities is more important than making further changes to the accounting for pension plans that arguably are of limited benefit (because pension plan accounting is already ahead of the game).

Given that, we do not agree to this proposal. However, on the basis that the concerns raised in the covering letter are addressed, we agree that the impact of expected future pay increases should be reflected in the value of the liability only if there is a constructive obligation.

However, the discussion paper appears to ask the question:

- is there a constructive obligation to give pay increases?

We believe that the correct question is:

- is there a constructive obligation to increase accrued pension benefits in line with future pay increases? The level of pay increases to be reflected is then a measurement issue (what is the best estimate of future pay increases) rather than a recognition issue.

For a final salary plan, whilst the entity will generally have the right to terminate or amend the plan is such a way that the link to subsequent pay increases is broken from the date of amendment or termination, we believe that until such a termination or amendment, there is a constructive obligation to link the accrued benefit to future pay increases (albeit not a legal obligation because of the option to terminate/amend).

Even with the approach taken in the paper, we believe that the appropriate unit of account is the workforce as a whole, not each individual employee. (This is consistent with other areas of accounting, where no liability would exist under the current IAS 37 for warranty claims etc if the unit of account was taken as the individual item sold.) We also believe that there is then a constructive obligation to grant competitive pay increases arising from the implicit understanding with its workforce and because otherwise the entity will incur costs in relation to recruitment and training of new employees to replace leavers in excess of the cost of granting pay increases. We note that it is less clear that there is a constructive obligation in relation to promotional increases in excess of general inflationary increases.

If the pension liability does not reflect future pay increases, we do not see how it can reflect the increases that would apply during deferment on the assumption that employees leave service on the balance sheet date, because they are not expected to leave service. In any case, this seems to be just a comforting fudge to justify omitting the link to future pay increases by arguing that there is a sensible fallback amount. This argument might be valid in the UK, but not around the world. Outside the UK, it is generally the case that there is no indexation in deferment. If no allowance is made for future pay increases, the only alternative measure is the accrued benefit with no future increases of any sort, giving an unrealistically small and misleading value. This is just one of many examples of where the paper blindly takes a UK-centric approach, ignoring the differences in pension plans around the world.

Excluding the value of future pay increases would place a misleadingly low value on the benefits from a final pay plan compared with the value of benefits payable under a career average plan where each year's benefit is revalued in line with, say, the index of National Average Earnings.

Excluding the value of future pay increases from the value of final salary pension benefits would appear to be inconsistent with the treatment of wage inflation in assessing other long term liabilities, such as:

- the labour cost involved in decommissioning nuclear power stations; and
- the expenses of administering insurance policies and other long term financial products.

We agree, however, that the value of the liability ignoring future pay increases should be disclosed in addition to the value including future pay increases that is reflected in the financial statements.

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?

See Q1.

Question 3

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

In our covering letter, we suggested that the accounting treatment of employment-related pension plans should remain as it is unless and until the issues addressed in the discussion paper (marking to market, recognition of gains and losses, allowance for credit risk etc) have been addressed at a high level, and are being applied across the board, not just to the accounting for pension plans. Consistency (as far as possible) between the treatment of different (but similar) assets and liabilities is more important than making further changes to the accounting for pension plans that arguably are of limited benefit (because pension plan accounting is already ahead of the game).

Given that, we do not agree to this proposal. However, in broad terms we agree with this principle, but see the answer to Q1 and see below as to what should be regarded as present obligations.

We agree that straight line attribution should not change the allocation of accrual to service merely because of the impact of salary increases.

We agree that the attribution approach should be consistent between DB and DC plans (and that the requirements of IAS 19 do not achieve this at present). This is more complex than it appears at first sight. For example, assuming (for this example) straight line attribution where the plan benefit formula is back loaded:

- a final salary plan providing a benefit of 1% of pay for each year of service does not have a back loaded benefit – but has a back loaded cost
- a DC plan that has increasing contributions designed to replicate the final salary plan appears back loaded – but is expected to provide a straight-line benefit (if returns are as expected): does this count as back loaded?

However, despite expending an inordinate amount of space on whether to attribute on a straight-line basis benefits that are linked to pay, the paper ignores far bigger issues relating to the treatment of plan benefit formulas that are inherently back loaded. This is one of many areas where the paper is UK-centric, ignoring issues that are insignificant in the UK because of UK specific legislation, but which are important elsewhere. We agree the suggested approach for the example included in section 6.34 of Chapter 2, but the suggested approach appears from nowhere. The paper neither identifies “the approach advocated in this paper” referred to in that paragraph nor explains how that approach leads to the suggested conclusion (which appears at odds with everything that goes before it).

We suggest that where the benefit that will be payable to someone (who at the balance sheet date has been in service for a period) if he/she stays to the retirement date (or other relevant date) exceeds the benefit that would be payable to a new employee who is otherwise identical (same salary and age etc), then the present obligation should not be less than the present value of the difference in benefits (allowing for the expected probability of staying till the benefit becomes vested), even if this exceeds the value of the vested benefit.

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?

This is a technical accounting issue on which we do not have a view.

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 or left unrecognised provided they are within certain limits (a ‘corridor’) approach?

We believe that immediate recognition provides a clearer picture than amortisation of gains and losses.

However, we note in the initial comments of our response that many similar long term assets and liabilities are not marked to market at all (with neither immediate nor delayed recognition). This misleads both management and investors by making pension liabilities appear riskier than those similar liabilities, and consequently guides them to sub-optimal decisions leading them to spend time managing the wrong risks. These inappropriate behavioural consequences have had an adverse impact on the current and future workforce by causing the closure of pension plans on the basis of misleading information as to relative risk.

We would therefore encourage putting the measurement and recognition of all assets and liabilities on a comparable basis as soon as possible to avoid the continued misleading of management and investors by inconsistent accounting standards.

Certainly, there should be no changes that make pensions seem more risky than under current accounting standards until accounting standards treat all assets and liabilities consistently.

Question 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 be 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?**

We agree that the measurement of pension liabilities should reflect general accounting principles, rather than regulatory measures. However, where regulatory measures create or will create surpluses on the accounting measure that will not be available to generate value for the employer, this onerous obligation should be reflected along the lines of IFRIC 14.

Whether the discount rate should reflect or ignore credit risk (and the equivalent question as to whether the liability should be reduced to reflect its credit risk) is an issue that should be addressed at the level of general accounting principles. It is not an issue that should be considered in relation to pensions in isolation. Only once the general question has been addressed one way or another, and is being applied to all liabilities, should the question be considered in relation to pensions. As most long term liabilities currently reflect credit risk (at least implicitly – see first page of our response), pension liabilities should continue to do so for the time being.

Whether information about the riskiness of a liability should be conveyed by disclosure or by an adjustment to the liability is also an issue that should be addressed at the level of general accounting principles. It is not an issue that should be considered in relation to pensions in isolation. However, our initial reaction is that (across all accounting) riskiness should be conveyed by disclosure rather than by an adjustment to the liability. Also, the level of disclosure required should be consistent between different types of liability. The level of disclosure required in relation to pension liabilities is already disproportionately high compared with other long-term liabilities, even without the increase in disclosures proposed by the discussion paper.

We agree that the expenses of administering the plan's accrued benefits should be reflected in the liability.

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 it is consistent with other areas of accounting to reflect expected outcomes. (For example, insurance accounting reflects expected rather than worst case persistency.)

Question 8

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

Yes. But see response to Q5 and our initial comments in this response.

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?

Yes. But see response to Q5 and our initial comments in this response.

Question 10

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

This is a technical accounting question on which we do not have a strong view, but we are inclined to agree.

We do not agree that gains and losses should be included in P&L unless and until accounting generally moves to marking- to-market all assets and liabilities with all consequential gains and losses recognised through P&L. As demonstrated in the cover letter to this response, there are many assets and liabilities that are comparable to pension assets and liabilities but which are not marked to market at all. It would therefore be misleading to include pension gains and losses in P&L unless and until accounting generally moves to marking-to-market all long term assets and liabilities. As discussed in our initial comments, the treatment of pensions is already misleading both management and investors with inappropriate behavioural consequences. Recognising pension gains and losses through P&L (without corresponding changes to general accounting) would exacerbate this impact.

Question 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?

We agree that it is difficult to justify inclusion in P&L of the expected return as currently derived.

However, as demonstrated in the cover letter to this response, there are many assets and liabilities that are comparable to pension assets and liabilities but which are not marked to market at all. It would therefore be misleading to include the actual return on pension assets in P&L unless and until accounting generally moves to marking to market all long term assets and liabilities. As discussed in the covering letter, the treatment of pensions is already misleading management and investors with inappropriate behavioural consequences. Recognising the actual return on pension assets through P&L (without corresponding changes to general accounting) would exacerbate this impact.

Instead, we would suggest including in P&L a notional expected investment return calculated as the asset value multiplied by the discount rate used to value the liabilities. This is a more objective amount. It treats assets and liabilities consistently. It is also avoids increasing the discrepancy between the treatment of pension assets and that of the many types of long term assets and liabilities measured at amortised cost using the effective interest method.

We do not see any benefit in requiring disclosure of an expected return on assets derived as currently required if this is not to be reflected in P&L. Any user of the accounts can derive the expected return using his own assumptions as to the expected return on equities etc from the information as to the split of the assets included in the accounts. This measure does not become any less subjective or become more comparable between entities just because it is no longer reflected in P&L.

Question 12

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?

We agree with the high level disclosure objectives set out in the paper.

However, the principles should be applied consistently across all significant long term assets and liabilities. The demand from some investors for more disclosure relating to pensions has arguably been generated by the inconsistent treatment of pensions compared with other long term assets and liabilities which makes pension liabilities seem more risky (relative to those other assets and liabilities) than in reality they are. If those other assets and liabilities were treated consistently, and similarly marked-to-market, there would be a more balanced assessment of the need for disclosure relating to different assets and liabilities.

There are many assets and liabilities where different measures would give different values. It would therefore be inconsistent to require disclosure of more than one measure of pension liabilities.

Contractual arrangements between the entity and its suppliers, customers and banks are not disclosed in the accounts, and confidential provisions within such agreements are often of far more significance than the provisions governing pension plans. Requiring disclosure of the “contract” between the entity and the trustees/managers would therefore be inappropriate. (Just the fact of disclosing powers that plan trustees have can - inappropriately and with adverse behavioural consequences - make a pension plan seem relatively risky compared with other long-term assets and liabilities where there is no disclosure of similar provisions.) Such disclosures would in case be impractical (within any reasonable length of financial statements) for a group with multiple plans across different countries, where there can be no objective measure of what plan provisions would be “usual” (across country borders) and since little aggregation of the disclosures across plans would be possible.

There is no requirement to disclose expected cashflows for other long term assets and liabilities, so it is unduly onerous to require disclosure of expected cashflows for pension plan liabilities. In any case, it is surely the expected cashflows from the entity to the plan that matter to users of the accounts, rather than the plan’s cashflows, and these cashflows are generally easier for the entity to adjust in the light of the entity’s financial state than is the case for other long term liabilities.

The disclosures about risk exposures and management should be required – where material – by general accounting standards (such as IAS 1) rather than setting out extra requirements for pensions.

Requiring disclosure of aggregate contributions to the group's pension plans over the next year or two is sensible. Beyond this period, actual employer contributions are so uncertain that disclosure would be misleading. Disclosure of funding agreements would be simply impractical (within any reasonable length of financial statements) for a group with multiple plans across different countries, since little aggregation of the disclosures across plans would be possible.

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?

In principle, yes.

In practice, any attempt to allocate assets and liabilities between employers within a group, where the principal employer can change the allocation of contributions between the group employers, and where there can be significant changes in the relative size of the membership from each employer, is simply misleading. It is better to disclose the position for the plan as a whole, together with any known information about how surpluses and deficits are expected to impact the entity's future contributions, allowing for any explicit or implicit (eg proportional to payroll) attribution of surpluses and deficits.

The position for non-associated multi-employers plans is complex, with varying approaches as to how well defined is the attribution of assets and liabilities or surpluses and deficits to individual employers.

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 believe that the purpose of the plan's general purpose financial statements is to demonstrate stewardship, and is one of a number of items providing decision-making information to plan members. We do not believe that the plan's general purpose financial statements are expected by themselves to facilitate decision making by any of the stakeholders (trustees/managers, sponsors, beneficiaries). It is therefore far from clear that the plan's general purpose financial statements are required to provide a "true and fair view" of the financial position of the plan (or the equivalent under IFRS).

We therefore do not believe that it is necessary for the plan's liabilities to be included in the balance sheet shown in the financial statements.

The argument that financial reporting for entities *who are required to comply with accounting standards* is converging on IFRS is meaningless. The caveat in italics is important but omitted by the paper. Many entities are not required to comply with accounting standards at all and don't. Pension schemes aren't required to comply with (general) accounting standards, and don't. The stakeholders of entities which are required to comply with accounting standards all have similar informational needs, which is why it was appropriate to require them to apply general accounting standards. The information needs for stakeholders of pension plans are different, and general accounting standards may not be appropriate. Any argument that the same objectives and therefore the same accounting principles should apply for pension schemes as for other entities needs to be constructed from scratch, not taken for granted. The paper is essentially putting forward a circular argument that entities that comply with IFRS should comply with IFRS. Pension plans don't, and the argument breaks down.

There are a number of reasons why the objectives of IFRS are not applicable to pension plans:

- The inappropriate emphasis of decision usefulness over stewardship;
- Decision making by each of the stakeholders will generally require use of several measures of the liabilities, and emphasising one of the measures by putting that measure in the balance sheet is inappropriate;
- The plan's obligations are generally legally limited to what can be provided by the money in the plan (again, the paper's UK-centricity is inappropriate; most regimes do not have a requirement for the sponsor to make good any deficit on termination) and including an asset for future payments from the sponsor to balance the liabilities would be positively misleading;
- Including liability information in the plan balance sheet will significantly increase costs without any benefit to users

---

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?

See response to Q 14.

Also, we do not believe it is possible for trustees to make any adjustment in respect of credit risk to the implied asset for amounts receivable from the employer. In order properly to perform their function, many trustee bodies are provided with insider information on a confidential basis, and would not be legally able to disclose any view they may have without breaching confidentiality commitments. Without such information, trustees would be just guessing, and there is a danger that they could be at risk of legal claims from members if their guesses turned out to be incorrect.

Question 16

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.

Yes.

The paper hasn't started to scratch the surface on the treatment of different types of plan. It is difficult to know where to start. For example, plans which provide a "higher of" benefit or which are largely DC in nature but potentially include some investment guarantees. Use of a deterministic, projected-unit approach ignores the additional value and cost of such guarantees which are “out of the money”.

Question 17

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

The paper is UK-centric and makes many assumptions about what pension plans look like that are not applicable outside the UK. Suggestions that are workable if restricted to UK plans would not work around the world.