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**Date: 10 July 2008**

**Subject: The Financial Reporting of Pensions:**

Dear Sir

I would like to comment on the discussion paper on the Financial Reporting of Pensions and whilst I have included an appendix which answers each of your specific questions I felt that this resulted in a lot of repetition and consequently I have also summarised my main points below in a more condensed response.

I agree with a number of recommendations but have major concerns over some others.

I agree that the obligations should be calculated based on the current level of salary and should not take into account future discretionary pay increases. All of the other employment costs within the accounts for a particular year are based on current obligations and in most cases an employer has discretion over pay increases and it therefore seems appropriate to apply the same principles to retirement benefits. In addition it seems logical that the effect of pay increases should impact on the year in which they actually occur rather than smoothing their impact over a number of years retrospectively. I therefore feel that only present obligations should be recognised as liabilities at the balance sheet date.

I strongly disagree with certain other recommendations the most significant ones being that all movements in assets and liabilities are included in the Profit and Loss Account and that the discount rate to be applied to liabilities is a risk free (gilt) rate.

Retirement benefit arrangements are long term issues and fund values can be very large relative to the size of the sponsoring company. Volatility in the funding position caused by short term market related factors could therefore significantly distort the results of the sponsoring company if all movements were entered in the P&L account and as such give a misleading picture to the reader of the accounts. In addition companies are unlikely to accept such volatility in their results and will take all available steps to mitigate such a situation. Those steps are likely to include closing all Defined Benefit plans and also transferring the fund's assets into less volatile but lower yielding assets such as corporate bonds or gilts. This situation will cause distortions in the financial markets and will effectively remove any flexibility on investment strategy from companies. This will have the effect of increasing the cost of pension provision as companies will not feel able to operate with assets offering an element of risk premium (as would normally be the case with long term investments) consequently this will have a detrimental effect on pension provision generally within the UK.

It would be more appropriate to continue to reflect in the P&L account only those items which relate to the current year cost of providing retirement benefits. These would effectively continue to consist of the current service costs, past service costs, expected return on assets and interest on the liabilities. All other movements in the assets and liabilities of the plan, including the difference between the actual and expected return on assets, should continue to be taken directly to equity via the Statement of Recognised Gains and Losses or equivalent statement. To take these items through the P&L Account would be to ignore the long term nature of pension planning and would I believe make it extremely difficult for readers of the accounts to identify the underlying performance of a business. In addition it may result in some companies who are performing perfectly adequately finding themselves in financial difficulties due to short term movements in financial markets which have adversely impacted their P&L Account and perhaps resulted in funding problems including covenant compliance issues.

As I mentioned above I do not believe that the risk free (gilt) rate should be used as the discount rate for liabilities. This approach does not seem to recognise the reality of the long standing and generally accepted practice of investment by pension funds in a portfolio of assets including equities, bonds and property.  Given this accepted practice it does not seem unreasonable to suggest that the discount rate to be applied to the liabilities should reflect the likely rate of return on the assets which will be eventually satisfying those liabilities.

I recognise that this would introduce an element of subjectivity into the calculation as it is not as easy to predict returns on some of these other asset classes but perhaps some standardisation may be prescribed such as the equity return being based on average actual returns over the last 25 years.

I appreciate that the above approach is not as simple as the approach recommended by the discussion paper but it would better reflect the reality of how the pension liabilities will be met and it would appear to be more compatible with the going concern concept.

If the recommendations of the discussion paper were to be incorporated into a standard as they stood this would I believe have a seriously detrimental effect on pension provision within the UK. It would effectively lead to the closure of most if not all remaining Defined Benefit schemes and would lead to a shift within fund assets from equities and other longer term investments into gilts and bonds with the consequence of higher effective costs for those historic pension accruals with only the dubious benefit of less volatility in returns which given the long term nature of the investments is a missed opportunity.

I also feel that the level of disclosure suggested in the paper is excessive and would effectively mean that virtually everything in the Pension Plan’s own accounts is duplicated with the company’s accounts. This would make it more difficult for most users of the accounts to extract the key pieces of information and I would prefer a more limited level of disclosure perhaps incorporating some limited sensitivity analysis on the key assumptions such as mortality but would not include for instance the full investment strategy of the fund, detailed risk analysis or details of how the liabilities tie in with the investment policy. I feel that there is a danger that the length of the pensions note would be such that it would distract the reader from the underlying performance of the company.

I trust you will take these views into consideration when deciding on how to proceed in these proposals.

Yours faithfully

Janet Rose FCCA
Assistant Group Financial Controller

## Appendix

**Answers to specific questions raised in the discussion paper**

*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?*

The answers to these 3 questions are grouped together as I feel there is significant overlap.

Having carefully considered this issue I agree with the recommendations of the discussion paper that obligations should be calculated based on the current level of salary and should not take into account future discretionary pay increases. My view is that other figures within the accounts for a particular year are based on current obligations and in most cases an employer has discretion over pay increases. In addition it seems logical that the effect of those pay increases should impact on the year in which they actually occur rather than smoothing their impact over a number of years retrospectively. I therefore agree that only present obligations should be recognised as liabilities at the balance sheet date.

There is a strong argument that in a larger scheme the liability is owed to the workforce as a whole. However an employer still has discretion over the level of pay increases. In addition applying the effect of pay increases to the year in which they occur better matches the cost with the benefit (i.e. the productivity of the workforce). This will have the effect of an ever increasing current service cost as a percentage of pensionable salary but offset against this is the return on the assets which are being built up in the fund to cover those obligations which themselves should be increasing and taking all of the figures as a whole should result in a more equitable allocation of pension cost to each accounting period.

*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?*

Yes and given the strict regulatory regime in the UK this is likely to result in very few pension funds meeting the conditions for full consolidation as the funds will be under the control of the Trustee rather than the sponsoring company.

*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?*

Yes I agree that any kind of corridor approach is very subjective and artificial and therefore accept that changes in assets and liabilities should be reflected immediately. However I do not agree that all movements in those assets and liabilities should be reflected in the P&L account. This will make P&L Accounts extremely volatile to short term movements in financial markets and will have the effect of forcing companies to close Defined Benefit schemes as they will not be able to accept this volatility in their primary performance statement. In addition it will make it extremely difficult for users of the accounts to deduce how a particular company has performed in a period as the impact of movements in pension fund figures will mask the underlying performance of the company's operating activities. Funding retirement benefits is a long term issue and as such it is not appropriate to reflect all of the short term movements within each year's P&L account.

I therefore strongly disagree with the concept of putting all of the movements through the P&L Account and feel that the P&L account should purely contain the net cost of operating the pension fund for the year in question which would seem logically to consist of:

The Current and if applicable Past Service Cost
Less the Return on Assets held to fund the scheme
Plus the Interest on liabilities of the scheme

In addition I disagree with the recommendation that the "actual" return on assets be included in the P&L account rather than the "anticipated" return. This is on the basis again that it will result in extremely volatile figures appearing in the P&L Account over which the company management have little control in the short term. It will therefore again detract from the underlying performance of the company's operations and consequently could result in misleading interpretations of the results by many readers of the accounts. Again it must be recognised that Pension Fund investments are long term investments and short term fluctuations are not indicative of their long term performance and should not be incorporated into the main performance statement.

Poorly performing assets will impact on the overall funding position of the Pension Plan and consequently on the balance sheet surplus or deficit but to include highly volatile movements within the P&L will have severe consequences for some companies including perhaps causing them to fail funding covenants while the underlying operating activities are performing adequately.

I believe that to expose companies' P&L Accounts to such volatility will inevitably result in the closure of the last few remaining Defined Benefit Schemes in the UK and will also distort investment decisions which may have a serious impact on investment markets.

*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?*

Yes general accounting principles should override any regulatory arrangements.

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

I strongly disagree with this recommendation on the basis that it is wide spread practice to fund pension fund liabilities by investing in a portfolio of asset classes and the weighted average of the expected long term returns on those assets better reflects the appropriate discount rate to apply to liabilities.

I accept that this results in a much more subjective rate but it better reflects the reality of the situation with respect to a particular pension plan. The long term nature of pension plans must not be overlooked in favour of simplicity as organisations and individuals alike will inevitably be prepared to invest in higher yielding but more volatile assets when the investment is for a long period of time. It therefore seems appropriate and more consistent with the going concern concept to permit companies to use a discount rate which represents a weighted average of the anticipated long term returns on their actual pension plan asset portfolio.

*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?*

Projecting Pension liabilities is inevitably extremely difficult and I agree that the amount reported in the liability should be based on the best estimates available. In addition some limited sensitivity analysis setting out the impact of changes in certain key assumptions (such as longevity) may be appropriate within the disclosures. However I would advise that care should be taken to avoid making the disclosures excessive.

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

I agree with this recommendation.

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

I agree with this recommendation.

*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 liability should reflect the expected outcome based where possible on past experience. It seems to be over prudent to assume the highest possible liability if this is unlikely to actually occur and this is simply another of the many assumptions which have to be made to assess the liability.

*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?*

I believe that the analysis of the movement on assets and liabilities should be shown within the disclosures. However, as I mentioned in my answer to question 5, I strongly disagree that all of the changes should be included in the P&L account. I feel that the items currently included in the P&L Account under FRS 17 should remain but no further ones should be added and the remaining movements should continue to be reflected in the Statement of Recognised Gains and Losses or equivalent statement with an analysis in the notes to the accounts but not on the face of the P&L Account.

*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?*

No I disagree with this recommendation on the basis that it will cause misleading and harmful fluctuations in the sponsoring company's accounts. The assets are held on a long term basis and incorporating short term movements within the primary operating statement is inappropriate and could have serious commercial implications for companies.

*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?*

I feel that the level of disclosure outlined is excessive and will make the accounts less and not more helpful to readers as they will find it difficult to pick out the important issues. In addition I feel the excessive disclosure will result in higher actuarial fees. In particular I feel that the following disclosures should be deleted:

All item numbers relate to Appendix A within the discussion document:

| | |
|---|---|
| Item 9 | the information relating to projected cash flows |
| Item 10 | very limited information on the asset portfolio should be given not a full analysis of investment strategy. |
| Item 12 | A full risk analysis is excessive – some limited sensitivity analysis should be sufficient. |
| Items 13 and 14 | the narrative description of investment strategies and how they match liabilities is excessive for what is the company not the pension fund accounts. |

I anticipate the level of disclosure recommended by the discussion paper will result in:

Actuarial costs rising from what is already a very significant figure for many companies and it is debatable whether the benefit to the reader will justify these extra costs.

The accounts becoming unwieldy with large sections of disclosures masking the real issues. I do not feel that most users will wish to work through such extensive disclosures or indeed understand them. Bombarding users with an array of different figures does not in itself provide better information it merely makes it more difficult to extract the figures that really matter.

*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?*

I do not have any practical experience of these plans.

*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?*

Yes.

*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?*

Yes I agree that the accounts should reflect an asset based on the income anticipated under the employer's covenant. However I am less enthusiastic regarding the issue of assessing the employer's credit risk and feel that this is a very subjective issue which if addressed at all is best dealt with by disclosure rather than actually trying to build it into the asset value.

*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 comment

*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?*

I believe I have covered my main concerns in previous answers and I would just reiterate that care should be taken not to lose sight of the long term nature of pension plans. In addition I would ask the board to be aware of the impact that these changes would have on company accounts and in particular the commercial implications of those changes which would be highly significant.

In addition these changes would increase actuarial costs but this would be a minor issue compared with the huge commercial and financial problems which these changes would create.