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Mr. Ian Mackintosh
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Dear Ian

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Re: Invitation to Comment – PAAinE Discussion Paper:
The Financial Reporting of Pensions

We welcome the opportunity to comment on the PAAinE Discussion Paper: The Financial Reporting of Pensions, to which I am responding on behalf of BP p.l.c.

Our comments are laid out in response to the specific questions raised in the invitation to Comment.

Yours sincerely

Mike Starkie

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Appendix

The Financial Reporting of Pensions: Responses to the Questions 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)?*

We could support either the inclusion in the pension liability of an allowance for future salary growth (the "PBO" basis") or calculation of the pension liability based on current salary levels (the "ABO" basis). ABO is perhaps a better fit with other accounting policies (especially if there was an intent to move pension accounting to a discontinuance basis), but PBO also shows a fair reflection of the cash flows required to settle the liability if you assume that the pension plan will remain open to existing employees and changes to the pension benefit design are not planned.

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?*

Financial reporting should be based on the premise that a liability is owed to the workforce as a whole (as at present).

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

Yes, subject to continuing to use decrements of the best view of future changes (such as staff turnover, and future salary growth).

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?*

We support the existing IAS19 approach: inclusion of the net surplus or deficit, and inclusion of the cost of providing the benefit in the Group's financials, but only reflecting the cash payments from the company (as opposed to cash payments from the fund).

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?*

We agree that changes in assets and liabilities relating to pension plans should be recognised immediately.

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?

We agree

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

(i) We are strongly opposed to the ASB's proposal to discount at the yield on government bonds,

(ii) Discounting at a risk-free rate is in our view wholly inappropriate, as the pension liability is based on the aggregation of pension cash flows which are not risk free and can be expected to vary significantly from the "best estimate" basis reflected in the accounts if (as is likely) assumptions such as mortality, inflation, salary growth, staff turnover turn out different to expectation. If the pension liability/deficit was traded in the open market, the price of this asset would be expected to settle at a level which would provide sufficient returns to investors to compensate them for this expected variability in their cash flows. The yield on these pension balances would therefore be higher than the yield on government-issued bonds. While there is no perfect market which sets an arm's length price for pension liabilities, these observations are based on the pricing levels seen in the pensions buyout market.

(iii) The current basis (discounting at corporate bond yields) gives roughly the right discount rate for most companies' pension liabilities,

(iv) The current basis is transparent, provides a level playing field allowing cross-company comparison, and the sensitivity disclosures provided in Financial Statements allow the user of the accounts to restate the liabilities and costs at a different discount rates if he wishes to do so.

There are two reasons why we believe the corporate bond yield to be approximately the right rate (and a much better approximation than the yield on government bonds).

First we understand that this is the basis on which pensions buyout firms value the liability: these firms buy and hold corporate bonds to back the pension obligations, and set aside an amount for corporate defaults. The amount needed for corporate defaults for AA corporates is very small so does not have a perceptible impact. While the buyout firms do value the liabilities at a higher amount than the IAS19 value of the liabilities, this is because the underlying cash flows of the pension benefit are uncertain – the buyout firm requires a margin to compensate them for the risk that the cash payments to pensioners will be higher than "best estimate" .

The buyout valuation thus represents the valuation of the liability on a discontinuance basis. Measurement of any liability on a discontinuance basis will usually result in a larger liability than when measured on a going concern basis. Therefore it follows that the valuation of a pension liability in the company accounts (measured on a going concern "prudent best estimate" basis) should be at a smaller liability than when valued on a buyout basis (which is measured on a discontinuance basis).

If the ASB proposal to discount pension liabilities at government bond yields was adopted, then for many pension funds the (discontinuance) buyout valuation would be a smaller liability than the (best estimate) liability shown in the company accounts. This is illogical. It shows that the idea of discounting these cash flows at the yield on government bonds is flawed.

Second, if you regarded the pension liabilities as being an obligation of the companies which operate pension funds, and consider that they should trade at the same yield as debt issued by those companies, then the average yield (on a weighted basis) of debt raised by all companies would probably be at a similar level to that of an investment grade company (BBB). The fact that the pension liabilities are secured with pension assets reduces, but does not eliminate, the risks. This factor therefore drives the yield lower than the yield on BBB bonds, but the yield would remain higher than the yield of a government-issued bond (to reflect the level of risk that remains).

We support the existing basis which is to discount the liability at the yield on AA corporate bonds as this is an objective and accessible measure which is at roughly at the right yield.

A reasonableness check on using the AA corporate bond yield as the discount rate involves considering the relative level of long term return (on a 100% funded pension fund which has a typical investment mix) with the size of unwind of discount. Both these amounts are included in company accounts as part of “other finance expense”. A typical pension fund’s investment portfolio will have a proportion of the fund invested in equities (yielding a higher expected amount than the yield on a corporate bond), a proportion of assets invested in corporate bonds, and a proportion invested in lower yielding assets such as government issued bonds or cash. The aggregate expected return on pension assets will be lower than the return on equities, but higher than the return on government bonds. The aggregate return would be similar to the yield on corporate bonds, and thus (if all other pension assumptions remained stable), over time the funded status of the pension fund would remain close to 100%. Discounting the liabilities at the yield on government issued bonds would be a flawed approach, as over time a 100% funded pension fund would become better and better funded as the returns on the high yield assets would exceed the amount of the unwind of discount.

Discounting at the corporate bond yield thus gives a closer approximation to what the value of the pension obligation would be if it was a freely traded asset in liquid markets.

The only argument we can see for deviating from the current IAS19 discounting approach is that the recent credit crunch has exposed an inconsistency. The allowance needed for default risk is usually small and can therefore be ignored. However when an economic recession is expected, the credit spreads rise on bonds from their typical amounts (0.7%-1% for AA corporate bonds) to a much higher level. Spreads of 2% have been seen recently on AA corporate bonds. The resulting impact is counter-intuitive – as the impact of the worsening credit outlook is to reduce the value of the pension liability (as the discount rate has increased). The reality is that the market is telling the investor that a higher proportion of defaults can be expected (and therefore the pension investor should set a larger amount aside for future bond defaults on its AA bond portfolio). Perhaps it would be better to discount pension liabilities at the yield on government bonds plus the long term corporate bond spread over the whole economic cycle. Alternatively, swaps plus a spread could be used as the basis.

This is simply a refinement of our assertion that corporate bond yields are generally at roughly the right level, and therefore remains a fully acceptable basis for measuring liabilities on a transparent and objective basis. We believe the existing IAS19 basis (discounting at the yield of a high quality corporate bond) to be an acceptable basis and see no grounds for change.

- *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?*

As regards that rate at which to discount pension liabilities, please see our response on discount rate above. As far as the undiscounted underlying pension cash flows are concerned, we agree that these should continue to be on a "best estimate" basis, with disclosure of the financial impact of any material estimates turning out differently to expectation shown as a sensitivity,

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

Please see our response on discount rate above.

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

We agree.

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 be an amount that reflects the probability of different outcomes; (i.e. the expected outcome not the worst case).

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

We agree.

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?*

We support the current approach outlined in IAS19/FRS17. We agree that the 'net' asset or liability should be based on the difference between the values of the assets and liabilities when measured independently. We support the current IAS19 approach which has both asset and liability valuations measured on a broadly comparable basis with assets and liabilities both reflecting an element of risk.

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

We agree and support the current IAS19 disclosure basis

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?*

We do not support the proposed change. We support the existing approach, reflecting the expected return on assets in the financial performance of the entity combined with full disclosure of actual return with the difference charged or credited through the Statement of Recognised Income and Expense. We support this because the P&L reflects within the cost of providing the pension both the amount of funds backing the pension liabilities, and the assets in which those funds are invested. The better funded the plan, the lower the expected pension cost, as more pension assets can be expected to deliver a higher return in the long run. Furthermore a pension fund which invests in higher risk/higher return assets also has the expectation of a lower pension cost in the long term. In both of these cases, IAS19 reflects the expected all-in cost of the pension benefit in a fair manner in the P&L (and discloses clearly the actual returns of the assets in the Statement of Recognised Income and Expense).

Under the current IAS19 disclosure a user of the accounts can assess whether they think the expected asset return assumptions selected by the company are reasonable, and if not, the user is able to assess the P&L impact of using a different asset return. The user has all the information in the pension disclosures to recalculate or eliminate the pension financing costs if he wishes to do this. We see no compelling case for change.

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?*

Where companies follow the current disclosure requirements of IAS19, we believe that disclosure is at an appropriate level of detail. We therefore believe that the focus should be on ensuring that companies follow the current disclosures, not adding to the existing requirements.

- We support proposals to split pension assets into all material asset classes.

- We would support a requirement to report each future year’s expected pension cash flows of the company. This comprises funding from the company into the pension fund and company pension payments to members of unfunded plans.

- Companies should be required to split their pension balances and assumptions between the major countries in which they provide pensions.

- We do not support disclosure of the liability measured on the buyout basis, as this is a calculation which may not be readily available at each year-end (especially outside the UK), and we believe that disclosure of this would add complication, ambiguity and additional cost to the preparation of the pensions disclosures.

- We would not support any requirement to disclose contractual terms agreed between the company and its fund’s trustees.

- Mortality disclosures: the accounting standards should explicitly require companies to report average number of years’ survival in each major country for males and females from retirement age and average number of years’ survival from retirement age assumed for someone who is currently 20 years’ from retirement.

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?*

In principle we support reflecting multi-employer plans in the employer's financial statements, but we do have concerns that at times the employer does not have the information from the pension provider to enable him to do this.

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?*

We agree that the pension plan liabilities should be included, and that they should be quantified on the same principles as in the employer's accounts. However additional disclosure valuing the liabilities on a local funding or valuation basis may also be relevant, so a statement showing reconciliation from the IAS basis to the valuation basis should also be included.

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?*

We do not believe that the plan's statement of financial position should include assets not yet received. Reflection of the employer's credit risk into the pension plan's statement of financial position would be too subjective, and hence we advocate no change to the existing approach.

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.*

- Post retirement medical plans and post retirement life assurance plans should be covered by the accounting standard. The principles underlying the calculation of these liabilities should be the same as those underpinning the calculation of pension costs and liabilities.

- Any impacts of early retirements (which took place in the year) should be reflected in the year-end pension liability and in the year's pension costs.

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?*

No