BT

Accounting Standards Board
Aldwych House
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11 July 2008

Dear Sir or Madam

Invitation to Comment – Discussion Paper 'The Financial Reporting of Pensions'

BT Group welcomes the opportunity to comment on the above ASB discussion paper.

The discussion paper rightly states that pension obligations are significant and that this is an important aspect of financial reporting. The discussion paper further considers it appropriate to carry out a root and branch review of pensions accounting. However, in our opinion, the paper does not constitute a root and branch review: rather it has the effect of building on the current approach to pension accounting – an approach which has received negative comments from many users of financial statements.

The discussion paper contains the potentially significant proposal that existing rules should be amended with the effect that future pension cash flows are valued by reference to a "risk free" rate. This proposal would add significant cash costs for companies. In addition we believe the proposal is theoretically unsound and could give rise to significant other consequences. We also believe that, whilst recognising the significance of pensions in financial reporting, the agreement of an overall conceptual framework for financial reporting should be a priority and then pensions accounting could be considered in the light of the revised framework.

A risk free rate is less relevant to the circumstances of a pension scheme than the rate of interest at which its sponsor can finance its activities. Treasury theory confirms that the rate of interest on a gilt edged stock (the risk free rate) is lower than that on a corporate bond because of two factors – immediate liquidity and the elimination of credit risk. For a pension scheme, which needs to meet its liabilities over an extended period (the period to its members' retirement), liquidity is irrelevant. The pension scheme is an unsecured creditor of its sponsor company. We believe the appropriate rate to discount pension cash flows is an interest rate close to the sponsor's marginal cost of capital. In the interests of consistency between companies, we believe that the existing requirement, to use a high quality (AA) bond rate, is a reasonable proxy.

We also believe the ASB needs to consider possible indirect consequences of proposals which, potentially, reduce sustainability of defined benefit pension arrangements.

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In particular:

a) A significant increase in pension liabilities could have the immediate effect of causing companies to report negative equity. In turn, this could lead to a breach of borrowing covenants and cause distortions to equity markets (certain investors are prohibited from investing in companies with negative shareholders' equity);
b) The proposals could significantly diminish companies' willingness to sponsor defined benefit pension schemes. At a time when social commentators are concerned at the level of post retirement benefit provision, this ought to be viewed as a real and significant concern.

The discussion paper is a missed opportunity in that it fails to:

a) require a clear link between a balance sheet asset or liability with expected future cash flows in relation to pension obligations;
b) consider the, often criticised, impact of the non-cash financing charge/credit which arises from the methodology of IAS19 and FRS17.

The discussion paper would have benefited from a more detailed review of the relationship between a company and its pension scheme. In ownership and constitution, a UK pension scheme is usually distinct from its sponsor company. This separate ownership is clear in law and drives the obligations of trustees and the relationship with pension scheme members. The balance sheet position of the company should reflect the obligations arising from the separate ownership. In particular, we believe that the balance sheet liability of a company should reflect the expected cash flows between the company and the scheme in respect of employee service before the balance sheet date.

Pension scheme trustees consider the liability of a sponsor company to a pension scheme to be the (present) value of payments due in respect of benefits previously earned. In many cases this is an agreed amount, and is represented by a schedule of future payments. The discussion paper dismisses this reality as a "regulatory measure", in favour of a measure ("derived from general accounting principals") which is largely unrecognisable to the creditors of the scheme (the trustees). As the former measure represents the amount that will actually be paid over we believe, moreover, that such an amount is more closely aligned to the IASB and ASB's definition of a liability.

We further believe that the discussion paper's analysis of the appropriate measure of financing costs is inadequate. The current approach to recognising income and expenditure by reference to returns on scheme assets and the interest cost on scheme liabilities creates undue impacts on the profit and loss account, which do not have a direct relation to the future cash effects of the scheme on the company. A more relevant financing cost would be the interest cost calculated by reference to the net past service deficit (which represents the amount "borrowed from the scheme").

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We believe that the discussion paper fails to consider either the distinct legal and ownership position of a pension scheme or the implications of extensive disclosures on scheme members.

We comment below on the specific 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)?*

A1 The IASB definition of a liability is "a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits". On the basis of this definition the liability should be based on current salary levels rather than including expected salary 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?*

A2 In the context of UK defined benefit pension schemes the entity generally has a liability to the pension scheme as opposed to the individual members of the pension scheme. It is the pension scheme that has a liability to the individual members of the scheme.

A consequence of this is that the liability that the entity should recognise should be based on the cash flows the entity is obliged to make to the pension scheme in order to make good any past service benefit shortfall.

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

A3 As noted in our response to Q1, in order to meet the IASB's definition of a liability, it should reflect only present obligations.

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?*

A4 In the UK, a pension scheme is generally an independent entity distinct from its sponsor company(ies). In this respect consolidation is not appropriate. The legal status of a pension scheme may be different in other jurisdictions.

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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?*

A5 Yes.

Q6 *Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, do you agree that:*

Q6.1 *Regulatory measures should not replace measures derived from general accounting principles?*

A6.1 No. The fairest reflection of the liability in the financial statements of the entity is the cash flows the entity is obliged to make to the pension scheme in order to make good any past service benefit shortfall discounted at the entity's marginal cost of capital. The marginal cost of capital of the sponsor reflects the relationship of the sponsor to the pension scheme (as an unsecured creditor) being close to the rate at which the sponsor could borrow.

In the context of UK defined benefit pension schemes, the relevant cash flows would be those agreed in any funding recovery plan prepared to meet the statutory funding objective defined by the Pensions Act and prepared in line with guidance from the Pensions Regulator. Although legislation in different countries may lead to inconsistent measures of the liability, this will reflect the actual obligations of the entity in the territory in which it operates. It will also fully reflect the cash expectations of trustees of the relevant pension scheme.

Q6.2 *The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?*

A6.2 No. We do not believe that the liability should be discounted using a risk free rate. The difference between the interest rate on a bond and that on a risk free security arises from two elements – a compensation for lost liquidity and a credit risk adjustment. For a pension scheme, which has to meet liabilities over an extended period, liquidity is not relevant. Consequently, it expects to be rewarded for a lack of liquidity. Also the pension scheme assumes risks in its investments. We believe that the interest rate used should be based on the company's marginal cost of borrowing, thus reflecting the fact that a pension scheme is a creditor of the company.

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Q6.3 *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?*

A6.3 It is desirable to augment the reported liability with additional disclosure describing the nature of the risks and the sensitivities of the assumptions used in computing the liability.

Q6.4 *The liability should not be reduced to reflect its credit risk?*

A6.4 We believe the fairest reflection of the liability would be to recognise the cash flows that the entity is obliged to make to the pension scheme discounted at the entity's marginal cost of capital.

Q6.5 *Expenses of administering the plan's accrued benefits should be reflected in the liability?*

A6.5 A pension scheme has an obligation to administer plan benefits that have accrued to date. The cost of administering these benefits should be reflected in the liability.

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?*

A7 The liability should be reported at the best estimate of the amount reflecting the probability of different outcomes. The highest amount or sensitivity to key assumptions can be provided to users of the accounts by way of additional disclosure.

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

A8 Where relevant, yes. Although the question as to whether they are relevant to the entity's balance sheet position needs to be considered in the context of whether they meet the definition of an asset being "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity". We believe, as stated above, that a net presentation of asset/liabilities is appropriate. A net asset would only be recognised if it were recoverable by the sponsor company.

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*

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measured directly?

A9 In the context of UK defined benefit pension schemes the entity generally has a liability to the pension scheme as opposed to the individual members of the pension scheme. It is the pension scheme that has a liability to the individual members of the scheme.

Consequently the liability the entity should recognise should be based on the cash flows that the entity is obliged to make to the pension scheme in order to make good any past service shortfall. Generally the entity has no rights or control over the scheme assets.

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

A10 No. Separate disclosure of the different components of changes in assets and liabilities is not meaningful (see Q11 below)

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?*

A11 We believe that a net finance cost should be shown in financial statements based on a net pension obligation (calculated at the present value of future cash flows in respect of past service). In this respect the actual return on assets is not a relevant concept. However, in the context of the current UK pension rules, we believe that moving to an actual return on scheme assets would potentially produce extreme income statement volatility which would further distract from the clarity of pension information.

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?*

A12 We share the concerns expressed in the discussion paper regarding the volume of disclosures in relation to pension obligations and the need to ensure that information is proportional. Companies should concentrate disclosures on aspects of key risks and uncertainties.

Q13 *Do you agree that multi-employer plans should be reflected in an employer's financial*

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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?

A13 Conceptually all plans should be treated in the same manner.

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?

A14 No. The obligations of the pension scheme to meet liabilities can be more effectively explained by means of narrative disclosure.

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?

A15 Yes. It should reflect the amounts agreed as due from the employer for past service.

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.

A16 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?

A17 No further comment.

We trust that these comments are helpful and contribute to your deliberations. If you have any questions or would like to discuss these comments further, please do not hesitate to contact me.

Yours faithfully

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