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Your ref
Our ref CSH/JMR
Date 11 July 2008

Dear Sirs

Response to ASB/PAAinE discussion paper on *the financial reporting of pensions*

1 I am writing on behalf of Universities Superannuation Scheme Limited in response to the discussion paper on the financial reporting of pensions issued by the ASB in February 2008. Universities Superannuation Scheme Limited is the corporate trustee of Universities Superannuation Scheme (USS), the primary pension scheme for the higher education sector in the UK. USS is a centralised scheme for non-associated employers which is not sectionalised. As such, the principle of mutuality applies to all aspects of the scheme. All employers pay the same contribution rate, members moving between employers retain full accrued rights with no transfer value being paid between employers, and the cost of early retirement (after age 60) is borne by the scheme. The comments in this letter are generally restricted to those which are of particular relevance to USS and its participating employers.

2 We recognise the need to review existing standards for the financial reporting of pensions, particularly as part of an exercise to unify international standards. It is also timely given the recent increase in corporate bond spreads which has highlighted a need to address one of the main features of existing pensions accounting standards.

3 The paper states that it represents a "fundamental reconsideration, starting from first principles, of the accounting that should be required for pensions". While this is evident in some aspects of the paper, in other areas we question whether the review has been as fundamental as is suggested as we believe there remain areas where further, perhaps more radical, thinking is required.

4 In particular, we believe that there are aspects of defined benefit pension schemes, such as their long-term (potentially indefinite) nature and the uncertainties surrounding the valuation of the liabilities, which merit accounting treatment which may differ from normal accounting principles. Chapter 1 of the paper makes it clear that this possibility

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has not been considered and we feel that this has limited the scope of the review and the potential benefit that may have been derived. In many cases the application of "the same solution as that used elsewhere in financial reporting" to pension fund transactions and balances results in solutions that are unhelpful, meaningless or misleading.

5 While proposals based on fair value accounting, discounting at a risk free rate and using actual returns rather than forecast returns all sound eminently sensible, their impact on financial statements if applied to accounting for pension schemes will be to produce numbers that are divorced from reality and introduce excessive and unnecessary volatility into company accounts.

6 While it is desirable to account for pensions liabilities consistently between different employers in different countries, in our view it is not possible to understand the impact on a company's financial position of its pension scheme deficit/surplus without an understanding of the scheme's investment strategy, its level of maturity and cash flow, and the covenant of the employer. Such an understanding cannot be gleaned by the inclusion of a number in the balance sheet calculated on some prescribed basis intended to cover all schemes in all countries. Moreover, there are enormous differences (for example, in scheme structure and governance, forms of benefit design, regulatory regimes etc) between the various countries of the world that have an established culture of second-pillar pensions, which makes it difficult to gain meaningful comparisons from any single international accounting standard.

7 Looking specifically at the position of USS participating employers; because of the cost sharing nature of USS, USS employers cannot identify their share of the underlying assets and liabilities of the scheme on a consistent and reasonable basis, and therefore USS employers account for USS as if it were a DC scheme. This is presumably regarded by accounting purists as a failing of FRS17. To USS employers, however, it is an entirely appropriate way to account for USS. As at 31 March 2005, USS had a deficit of around £6 billion on a risk free basis (a funding level on that basis of 77%). The board of the trustee company, however, acting on actuarial advice, was content to rely on investment performance in the medium term to deal with the deficit rather than seek additional contributions, while ensuring that future service contributions were sufficient to cover future accruals. This was entirely justifiable: the majority of USS employers (certainly those representing virtually the whole of the membership) are likely to continue in existence for the foreseeable future (some have been around for hundreds of years); the scheme has a positive cash flow, and is likely to have for some years, so that it does not need to sell assets (for example, at depressed prices) to meet liabilities; and its investment policy, as a consequence, is heavily biased to equities and other return seeking assets. At the time of the last valuation, the new funding regime did not apply to USS but it is likely that USS would have been able to present a fully funded position on prudent technical provisions. What, therefore, would have been the point of showing each employer's 'share' of the deficit (assuming that was possible) on its balance sheet when there was no expectation on the part of the USS trustee company, the USS actuary or the Pensions Regulator that the deficit was likely to result in additional contributions from the employer? How much better simply to record the actual annual cost of the scheme in the income statement and declare the existence of the scheme deficit in the

notes to the accounts along with sufficient information in those notes for a user of the accounts to determine for themselves what the deficit is likely to mean to the employer.

8 We appreciate that a similar analysis could not be applied to the pension scheme of a company in financial difficulties with a mature scheme and a less equity biased investment strategy, but this simply emphasises the difficulties of trying to standardise accounting treatment of pensions across all employers and schemes.

9 The view of the pensions industry is that FRS17 and IAS19 have contributed to the closure of defined benefit schemes. We believe that this is beyond dispute, although we accept that it is not the only cause. The response of the accountancy profession's standard setters has been that this is not their concern – if these accounting standards have highlighted the risks inherent in DB schemes, and this has contributed to their closure, then that is a positive result rather than a negative one. We believe that this not an acceptable response from the profession. We believe that these accounting standards, rather than highlight the risks, have overestimated them (and overstated the urgency of any funding "correction") with the result that schemes have been closed unnecessarily based on an erroneous impression of the risks and potential cost. And when accounting standards produce accounts that result in erroneous decisions based on misinterpretation of the accounts, this has to be a matter of concern for the accountancy profession.

10 The rate used to discount the liabilities is crucial to the process of accounting for pension schemes and the use of the corporate bond rate for this, as introduced by FRS17, was a significant factor in changing the way that employers and others viewed the risks associated with DB schemes. Many considered it to be too conservative a rate which gave a distorted view of scheme funding levels. Recent market conditions have seen corporate bond spreads rise to unprecedented levels and we agree that this necessitates a rethink of this as the recommended rate for discounting pension liabilities. Using a risk free rate, however, clearly exacerbates the problem of distorting the view of scheme funding levels. While it has the benefit of being objective and potentially consistent across all companies, and should be capable of being fully understood, experience of the impact of FRS17 suggests that this is not what will happen. The inclusion of a single number in the balance sheet to represent a pension scheme deficit gives, what was described in the paper issued earlier this year by the Pensions Institute and the Cass Business School as, an "illusion of certainty", and we have plenty of evidence to suggest that headline numbers of scheme funding can be greatly misunderstood. Knowledgeable users of accounts may place less reliance on the number on the balance sheet and look to information in the notes to the accounts and other sources to gain an understanding of the impact of a company's pension scheme on its financial position. As I understand it, bankers and investment analysts routinely remove the FRS17 figure from the balance sheet before analysing it. Perhaps there is a message there for the accountancy profession.

11 The whole point about funding for retirement provision is precisely that – funding. Building up a fund to meet liabilities in the future. Disclosure of a scheme deficit, based on a conservative discount rate, militates against the whole principle of pension scheme funding – bad enough when the discount rate is a corporate bond rate but considerably

worse if this is to be replaced by a risk free rate. And the damage to pension schemes could become self-perpetuating. If company finance directors have to value scheme liabilities discounted at gilt rates, in seeking to de-risk the company balance sheet they will encourage schemes to invest in gilts. Increased investment in gilts will result in a reduction in gilt yields and scheme deficits measured on this basis will increase.

12 As regards the valuation of the assets, at first sight it is hard to imagine valuing them at anything other than market value. Surely the value placed on the assets by the market at any point in time has to be the appropriate value to use? It certainly, for most assets at least, has the benefit of being objective and simple to obtain. But is it necessarily the best value to use when seeking to account for pensions? The markets certainly give you the correct price of an individual stock at any time, but the true value is something different, since market prices are affected by market sentiments as well as fundamentals. And prices fluctuate far more than true values are likely to do. In the past, actuaries used discounted cash flows to value assets, and while there are accepted difficulties in using this method to value assets they are perhaps no less than when using market values. It was consistent with the way liabilities were measured and it certainly reduced volatility. Perhaps there is an argument for taking the higher of net realisable value and value in use (in line with FRS 11). Marking to market assumes that it is the assets themselves that are held to pay the benefits. But in many cases, benefit payments are met from scheme income – contributions and investment income. Only in mature schemes are the assets used to pay the benefits, at which point, of course, market values become fairly crucial. For all other schemes the assets are more akin to fixed assets held for the purposes of generating income. Marking them to market in such circumstances does not seem entirely appropriate.

13 Turning to the proposals in the paper concerning multi-employer schemes, we agree that, in principle, those that have the characteristics of defined benefit plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan.

14 However, we have considerable reservations about the proposals put forward in chapter 10 of the paper, particularly as they relate to non-sectionalised schemes such as USS. Our comments below refer to such schemes.

15 With regard to each of the proposals in the table in section 9.3 of chapter 10:

15.1 Settlement amount

The paper states that to obtain information on settlement amounts from the multi-employer plan "may be challenging". We agree with this statement! It would certainly not be possible for USS to obtain a buy-out quote for each individual employer. To calculate the settlement amount for each employer, even assuming the information is available and reliable, potentially at different dates in the year for different employers, would be more than challenging, and USS has a high standard of data. For many schemes it will be impossible.

Even if the information is available, it is highly unlikely that it will be reliable given that it is not information that has ever been required by the scheme. There are also a number of different ways of determining a settlement amount, depending on how the liabilities for different periods of service at different employers are allocated. The employer debt regulations do indeed specify a default method for calculation of the debt in multi-employer schemes (known as the "liability share basis"), however there are provisions to enable a scheme trustee to apply a different method of calculation through a "scheme apportionment arrangement", and USS – in common with many other multi-employer schemes – is expected to utilise such arrangements to modify the method of calculation of the buy-out debt. It is worth saying that there is no "correct" way to do this for each type of participating employer in USS, and each method contains flaws and anomalies. If such methods were to be used to determine liabilities to be included in an employer's financial statements, it would add a new consideration when employers were recruiting new members of staff and would favour recruitment of individuals who have no past service history in the scheme – a highly undesirable consequence arising as it would do from an accounting standard rather than being driven by an economic need.

15.2 Proportionate share of the surplus/deficit of the scheme

FRS17 currently requires employers in multi-employer schemes to account for the scheme as a defined benefit scheme unless "the employer is unable to identify its share of the underlying assets and liabilities in the scheme on a consistent and reasonable basis". This seems to be an acceptable stance to take. Our concern with the proposal that the scheme surplus/deficit is allocated between the employers in proportion to the pensionable salaries of individual employers, is that it results in an allocation which will not be a reasonable allocation of each employer's share of the total assets and liabilities of the scheme. Clearly it refers only to active members and ignores length of service. It would be particularly inequitable, for example, for employers who have a large number of active members, but relatively fewer deferreds and pensioners, compared with employers with a large number of deferreds and pensioners but relatively few actives. It would also be inequitable for new employers joining a multi-employer scheme compared with employers with a long history in the scheme. USS is a scheme, like many others, where there is a wide spread of employers that are long standing or have only recently been admitted to participation, or have a high proportion of actives or a lower proportion compared to deferreds and pensioners.

15.3 Recording of pension assets/liability only to reflect the effects of recovery plans or asset refund plans

For this approach, the additional contributions to be paid each year (in respect of a recovery plan) would be relatively easy to calculate and in the event that a recovery plan or asset refund plan exists we would agree with the proposed treatment in line with IAS19 and IAS37.

16 Our view on the inclusion of liabilities in the financial statements of pension schemes follows the same principles as set out above in our general comments about the discussion paper's proposals for the employers' accounts. We believe that the accounts of pension schemes merit accounting treatment that differs from normal accounting principles; and that the inclusion of a number in the scheme's balance sheet calculated on some prescribed basis is not helpful to a user of the accounts. It may be considered desirable for financial reporting to converge on a single set of standards for all types of entities, but if the result of trying to shoehorn pension scheme accounting into complying with these standards is financial statements that are meaningless or misleading, it would be regrettable indeed.

17 The ASB paper implies that pension scheme accounts fall into the category of general purpose financial statements providing information that is useful for external decision makers. We believe that this is not an appropriate view of pension scheme accounts which, in our view, are simply a statement of assets and transactions for stewardship purposes. The paper also states that members and their advisers should be seen as the primary users of pension scheme accounts because, unlike other main users of the accounts (eg trustees, employers), they will not "normally be able to secure whatever information they wish concerning the financial affairs of the plan". Apart from the fact that members can request information from various sources (trustees, administrators, employers), in the UK at least, all members receive each year a summary funding statement which gives them precisely the sort of information they need to make a judgement on the financial affairs of the scheme. And, of course, they are also entitled to receive the triennial valuation report from the actuary. And it is these documents which members should be using, together with the scheme accounts, to assess the financial position of the scheme.

18 As with company accounts, the inclusion of a single number in the balance sheet for the liabilities to pay benefits gives that number an 'illusion of certainty' which can be misleading to users of the accounts. We believe that the current format of UK pension scheme accounts, consisting of a statement of net assets and a fund account, is sufficient for stewardship purposes and that there is little merit, other than one relating to technical accounting arguments, in including liabilities to pay benefits in the balance sheet. We would add that the paper's dismissal of the arguments against their inclusion (paragraph 6.9 "The arguments ..... do not seem to be convincing") is somewhat light on sound argument.

19 We note below our responses to the questions posed in the paper, restricting our responses to those of direct or potential relevance to USS and its participating employers.

19.1 Questions

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)?

Given that employers are able to cease future accruals, we believe that any liability to pay benefits should be based on current salaries.

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?

This question appears to be considering the same point as question 1. The paper appears to suggest that employers can cease future accrual for individuals but not for the workforce as a whole. However, we do not believe that is the case, and indeed ceasing future accrual is not unusual.

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

Yes

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?

See comments in 5 above. We are concerned that immediate recognition of changes in assets and liabilities gives rise to excessive volatility which is inappropriate in the context of accounting for pension schemes. An important factor is the extent to which the changes are taken through the income statement.

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?

  While we agree in principle, particularly if international comparability is key, we can see an argument in the UK, with its strong regulatory régime and sound regulatory principles, for recognising a scheme's technical provisions for calculating the employer's surplus/deficit for accounting purposes.

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

  See comments in 10 and 11 above. We believe that it would be preferable to use a rate which is comparable to current corporate

bond rates but linked to gilt rates (eg gilts + 1.5%) to avoid the current problems associated with volatility of corporate bond spreads.

- Information about the riskiness of a liability (ie 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?

  We agree that greater disclosure is essential to enable greater understanding of pension liabilities.

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

  See comments in 6 above.

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

  We do not agree. Expenses should be recognised as they arise.

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 based on an amount that reflects the probability of different outcomes based on past experience.

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

See comments in 12 above. We have reservations about the use of fair value for valuing the assets of a pension scheme.

Q9 Do you agree that a 'net' asset or liability [where assets are held in a separate trust to pay benefits] should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly?

We can see no reason for different treatment between assets held in a trust or held directly.

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?

See comments in 6 above. We believe that the expected return should continue to be shown in the income statement with greater detail on actual returns in the notes. Auditors should be tasked with ensuring that expected returns used are realistic.

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?

We agree that greater disclosure in the accounts will assist users in achieving a greater understanding of the risks and rewards of the scheme. In particular, it would be helpful to require disclosure of scheme surpluses/deficits using alternative measures of the liabilities such as regulatory measures.

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?

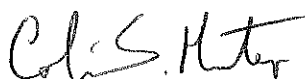
See comments in 13-15 above. While we agree in principle that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan, we do not believe that this is appropriate, or can be achieved, for non-sectionalised schemes such as USS.

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?

See comments in 16-18 above. We see no benefit in this proposal and good reasons to leave pension scheme accounts as they are.

We hope you find our comments on the discussion paper helpful.

Yours faithfully



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