The Financial Reporting of Pensions

A Personal View
by Derek Scott

Thank you, Alan [Thomson]. Good Afternoon.

Points I Intend to Cover

- Regulatory Capture leads to Regulatory Arbitrage
- Double Standards?
- Is it a Nail .... or is it a Dagger?

And as I'm a member of the ASB's Pensions Advisory Panel, maybe I've had my say already?

I'll try to limit my comments/concerns to 3 areas.

Improving Standards is as Easy as 1-2-3?

Andrew talks of 1st Generation accounting standards and therefore implies that we are now looking at a 2nd Generation proposal for FRS 17, IAS 19 and IAS 26.

What comes to mind is my 15 year old daughter and the three iPods she's had over the last three years or so.

The 1st Generation had its critics – about battery life, screen issues. Protective cases were made like socks.

The 2nd Generation went a little way to addressing these issues but really wasn't much better than the first. Protective cases were hard plastic. Still not fit for teenage purpose, I mean.

The 3rd Generation iPod Nano, though, seems so far to be a lot better. The case is remix metal.

I use this analogy merely to suggest to Andrew and others that 2nd Generation may not be what we really <u>need</u>. It's certainly not what many people "in pensions", as members of pension schemes, or as representatives of members of pension schemes, <u>want</u> to see just now.

Regulatory Capture

"**Regulatory capture** is a phenomenon in which a government regulatory agency which is supposed to be acting in the public interest becomes dominated by the vested interests of the existing incumbents in the industry that it oversees." *Wikipedia*

So, what qualifies me to comment about accounting standards using socio-economic terms like regulatory capture?

It certainly wasn't part of my undergraduate education in political economy or later CA studies. But when I was at Arthur Andersen I had the privilege to work with their UK Head of Small Business, Pat Desmond, a very sound accountant and business adviser of the old school, who was apt to warn about dodgy business with the expression "They'll end up in Carey Street" meaning the London bankruptcy courts just off Lincoln's Inn Fields.

Little did I realise then that I would end up in Carey Street myself so many times, "before the beaks", as Brian Souter liked to describe them, at the Monopolies & Mergers Commission, now the Competition Commission, during my years with Brian at Stagecoach. It was this formative experience which prompted me to add to my understanding of competition law and economic theory and practice. *[Update note: ironically a member of my first MMC panel, Ken Whittington, was in the ICAS audience!]*

In case some of you haven't come across the term, Regulatory Capture, I offer a couple of definitions. This one ....

And this one .... from The Economist.

I think many of us will be more familiar with Gamekeeper turns Poacher, when, for example, former auditors become company directors, which I once did back in 1987, although some progress has been made in stopping some of that nonsense from happening these days.

Beware Vested Interests?

- Actuaries (a Big Four?)
  - Valuations that used to take weeks, now take months? Does the actuarial profession have the capacity to move from triennial to annual valuations?
- Auditors (another Big Four)
  - Huge difference in scope [and costs to users] between cross-referring audited accounts to an actuarial statement and having to "audit" a full balance sheet or set of actuarial disclosures.
- Consultants (yet another Big Four!)
  - Bound to gain?
- Insurers of last resort (the Big Two + the PPF + the fifteen or so "New Kids on the Block" funded by Private Equity)
  - With most to gain?

I was tempted to call this slide, "The usual suspects". In economic terms, Big Fours = Oligopolies = High Potential for Collusion.

Call me paranoid, but I'm afraid I see a lot of collusion here, which isn't necessarily in the public interest. Just yesterday I read that one of the Big Four is providing an interim head of investment to the Pensions Protection Fund, continuing the trend we "in pensions" have seen with the staffing at the Pensions Regulator, full of Big Four secondees.

Then my wife tells me she bumped into Emeritus Professor of Accountancy, David Flint, in a Dobbies Garden Centre in Perth this week. I wondered If I this was an omen for my short talk today (the Good Professor, who may have a taught a number of us in this room or at least be remembered certainly as an eminent Past President of this Institute, has retired to live in nearby Auchterarder). Professor Flint in his practising days used to stress to his students the importance of the quality of "neutrality" in accounting standards.

By this I mean, and let's use the US FASB's definition :

"Neutrality means that accounting standards should be designed to provide the best possible information for economic decision making without regard to how that information may affect economic, political, or social behaviour. Putting it another way, accounting standards should not be intentionally biased for the purpose of promoting either private special interests or government policy goals."

I conclude these musings about whether we may already be seeing 2nd Generation Regulatory Capture in accounting for pensions by asking: where is the Impact Assessment in any of the ASB's or IASB's work?

How HM Government Does It These Days

Ministerial Sign-off For SELECT STAGE Impact Assessments:

"I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading option(s)."

Signed by the responsible Minister:

The above example is from HM Treasury's latest consultation on the slimmed down Myners Principles for investment decision-making.

I can't say that I wholly endorse this particular approach. In the example I've used, first of all it's signed by a somewhat Junior Minister. Just as the principal authors of significant parts of the ASB Discussion Paper (this is on page 4 of the 231 numbered pages, by the way) are identified as three ASB staff members and an audit partner in KPMG Nederland, which is hardly a Champions League-winning team among accountants. And The Netherlands, by the way, is the country where it was reported yesterday that 89%, yes 89%, of the MPs in their Parliament have signed up to a resolution (which similar to an early day motion in Westminster, but the proportions who sign these at Westminster are tiny by comparsion) asking the Dutch Government and like-minded EU countries such as the UK and Ireland to tell the IASB to retain corridor principles in pensions accounting. Maybe the fight back is starting at last?

So, Andrew, something along these lines in terms of Impact Assessment is surely worth thinking about at ASB, please?

Regulatory Capture leads to Regulatory Arbitrage!

e.g. Occupational Pensions Trusts (an alternative pension buyout firm)

- OPT believes the ASB is likely to make companies far more aware of their pension liabilities by using overly cautious calculations
- There are other solutions out there, like OPT *[of course]*, which allow companies to divest themselves of a pension scheme at a price considerably lower than buyout

I've referred to the overlap in staffing between Big Four accounting and consulting firms at UK Pensions Regulators.

In terms of Market Impacts, I'll use this example from OPT, but they are just one of many of the New Kids on the Block. Goldman Sachs last week reckonned there'd been 25 new start-up pensions buy-out firms to challenge the previous duopoly of L&G and the Pru.

And what form does this Regulatory Arbitrage take exactly?

Limits to Arbitrage?

Trustees keep the active liabilities *(with most mortality uncertainty, by the way)* and sell out the over 50s *(with least mortality "risk")*?

- counterparty risks?
- mis-selling?
- solvency regimes vary
  - L&G and the Pru are AA-OK ....
  - .... but PE-backed New Kids are Alright?

This is my personal and initial reaction to most of the pensions buy-out proposals I see.

I really struggle to understand why trustees of some schemes (not all, I admit, because I don't want you to get the impression I oppose pensions buy-out in all circumstances) should be asked to swap a good part of a diversified portfolio of assets with agreed contributions from sponsoring employers and members for an annuity package, in some cases of doubtful quality and which leaves fat margins for insurers and private equity backers.

We're told (and I quote from LCP's Pensions Buyouts 2008) "Insurers are using more sophisticated investment techniques than many pension schemes to maximise future investment returns whilst achieving close matching of the liabilities." I doubt this proposition very much.

But that's what going on out there. It's not pretty.

Double Standards?

- Accounting for Pensions Investments
  versus
  Accounting for Fixed Asset Investments
- Liability accruals based on expert opinions
  - of management? YES
  - of engineers? YES
  - of legal advisers? YES
  - of actuaries? NO
- Accounting for Distributable Reserves
- Accounting by Banks (for shareholders)?
- Accounting for Share Buybacks, generally accepted ways of enhancing reported EPS, often at shareholders' expense?

Moving on to my second point.

[I won't but I'd love to discuss inter-bank accounting in black writing on this slide, because it seems be a black day these days when banks won't lend to each other, implying they have little faith in each other's mark-to-model accounting! I'd also love to discuss accounting for distributable reserves, where Andrew in an earlier ASB conference in London has made some interesting personal comments about moving to a solvency-based model. On better accounting for sharebuybacks I defer to market practitioners like Andy Brown at Cedar Rock. But I remind myself we're here today to discuss the financial reporting of pensions.]

Accounting standards for pensions assets seem to me and others to be based on an investment model of buying current assets to be held for resale. Is it significant, Andrew, that the Discussion Paper has a chapter (it's number two, first one after the introduction) on Liabilities to pay benefits but there is no equivalent chapter on Assets held to pay benefits? The ASB seem to suggest that the asset side is all about measurement. But it isn't; Andrew; there should be something in there about diversified portfolio investment.

Contrast this narrowly based ASB view of pensions assets with accounting for M&A and other fixed asset investments by corporates, where lighter regulated company executives are allowed to account for things in ways which arguably overegulated pensions trustees are not.

It doesn't stop there. Andrew in another place has described SSAP 24 as an actuarial-based standard, as if that makes it somehow inferior to anything coming later based on fair values, marked to market. But why can't we allow for accounting by experts? Again, we seem to do just that in other places.

IAS 620 (UK&ROI)
Using the Work of an Auditor's Expert

- "The auditor's education and experience enable the auditor to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation, **<u>such as an actuary</u>** or engineer." *IAS 620 (UK & ROI) para 4*

- "The relevance of the auditor's expert's capabilities and competence to the matter for which that expert's work will be used, including any areas of specialty within that expert's field. For example, **<u>a particular actuary may</u>** specialize in property and casualty insurance, but **<u>have limited expertise regarding pension calculations</u>**."
ISA 620 (revised & redrafted) A13 & A30d

Most CAs in business really glaze over when you move from IFRS to IAS and ISAs. Do you blame us, by the way?

But at least auditing standards seem to acknowledge (albeit in a rather back-handed way) that <u>particular actuaries have significant expertise regarding pension calculations</u>.

But I digress.

Double Standards (contd)?

- FRS 11 (IAS 36) Impairment of assets
  - Measured comparing higher of "fair value" and "value in use"
  - The discount rate used should be an estimate of the rate that the market would expect on an equally risk investment
- FRS 12 (IAS 37) Discount rate
  - The discount rate (or rates) should be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability
- FRS 17 (IAS 19) Expected investment return
  - The average rate of return on the actual assets held by the scheme, including both income and changes in fair value but after deducting scheme expenses, expected over the remaining life of the related obligation.

Returning to the investment of assets held to pay pensions benefits. Andrew admits that the discussion paper proposal to use for measuring pensions benefits a "risk free" discount rate, whatever that means, is at odds with other accounting standards. Here are some examples from IAS 36 & 37.

No one of course is suggesting that we should use Index Link Gilt Yields (currently around 1% real, implying a nominal discount rate close to 4 at a time when corporates are using close to 6 for IAS 19) for discounting fixed asset investment cash flows. If we did, we'd get higher asset NPVs, but I know that's not intended, just as I know that the ASB has spent very little of its Pensions Advisory Panel time on the investment issues.

But before I despair totally of accounting standards in relation to pensions assets, I have to commend the definition of expected investment return set out in FRS 17. Unfortunately not many trustees seem to be aware of this and so, instead of focusing on buy, hold and sell disciplines, portfolio yield and individual realised and reinvested positions, they seem to be led astray by consultants. Many trustees rely instead on index relative measures and flawed attribution analysis as their principal basis for investment decision-making and performance measurement and monitoring. To that extent, I might agree with LCP that there are more sophisticated investment techniques, based on fundamental analysis of yield, potential growth and relative value, to maximise future investment returns whilst achieving close matching of the cash flow profile of the liabilities.

How might Impairment Accounting work with Pensions Assets?

- External impairment indicators
  - (1) Decline in market values (NB: may indicate net selling price is less than its carrying amount, but relevant only if early sale is planned?)
  - (2) Changes in economic or legal environment
  - (3) Changes in interest rates
- Internal indicators
  - (A) cost > “budget”*
  - (B) cash flows < budget
  - (C) physical loss or fraud

*budget=investment portfolio fundamentals in terms of yield, growth and expected “fair value”; or present value of future cash flows

I tried to get the ASB’s Pensions Advisory Panel to reconsider <u>values in use</u> (on which accounting for fixed asset investments is based) for pensions portfolios, but failed miserably.

There are other ways – but again this is not for today’s discussion – at Stagecoach, for example, we have been, with varying degrees of success, using absolute returns relative to actuarial liability costs and cash flows since 1987. This seems to me a much more informed way of measuring investment assets held for benefits and informing decision-making by fiducuary trustees and sponsoring employers.

Asset/Liability Accounting

	Going concern schedules of and recovery Disclose?	with agreed contributions plans Book?	Not a going concern (eg closed to accrual or in wind up)? Book?
Risk-free discount rates for Liabilities	Yes	No	Yes
Assets marked to market	Yes	No	Yes?
Asset values Impaired	Yes	Yes	Yes

I'll now try on the next couple of slides to show where my own thinking is after spending what's felt to me like two years in the wilderness with the ASB's Pensions Advisory Panel.

I distinguish between pension schemes which are going concerns and those which aren't.

You'll see I have no objections IN PRINCIPLE about DISCLOSURE, although the costs versus benefits to relevant stakeholders of estimating the numbers required for such annual disclosures is an issue.

It's when the ASB says that even schemes which are going concerns have to book these numbers that I take issue.

Deficit/Surplus Accounting

	Going concern Disclose?	Going concern Book?	Not a going concern (eg closed or in wind up)? Book?
Market-valued based deficit	Yes	No	Yes
Buy-out based deficit	Yes	No	Yes?
Employer's share of deficit recovery	Yes	Yes (and also as a scheme asset)	Yes
Employer's share of surplus	Yes	No, in most cases	Yes, if realisable

Again, I have no fundamental problems with DISCLOSING mark to market numbers and buy-out quotations or estimates.

Where I take issue is with the current asset accounting which means that to avoid accounting deficits you have to pre-fund all liabilities. The asset accounting is wrong, and so is the treatment of distributable reserves, in putting pensions deficits ahead of shareholders' reasonable expectations of getting dividends from solvent companies with agreed, actuarially-based pensions funding commitments.

If I'd known that pre-funding was so desirable when I started out as a trustee at Stagecoach in 1987, then I wouldn't have taken the job. I would have left it to the insurers and, by the way, it now looks as if many successful pension schemes of the 20th century should never have been started.

Where I stand on ASB Discussion Paper's Big Questions

Q1, 3 - PBO or ABO?	ABO (or VBO)
Q4 – Consolidate plans?	Yes, but control test not met under UK trust model; unsure about UK contract model and buy-out vehicles
Q5 - Immediate recognition?	Yes for ABO liabilities; No, for assets (but subject to impairment test)
Q6 - "Risk free" discount rate?	Yes for ABO; No for PBO
Q8 - Assets at "current values"?	No, if going concern; Yes, if not
Q14, 15, 17 - SORP "double entry"?	No to future liabilities; Yes to accruing employer covenants as assets

I don't like the modern style of consultation documents which set the number of questions to be answered. The option to ask other questions and/or to respond in terms of errors and omissions is much restricted as a consequence. It's human nature, but it's also political.

But for what they're worth, here are my views on some of the ASB's current questions.

ABO (or Vested Benefit Obligations) rather than PBO because evidence since FRED 20 is that pension schemes are shutting down. That shutting down to me confirms that employers can serve notice on and/or re-negotiate many of their obligations, so it's wrong to assume that historic benefits should then be projected forwards without adjustment. Just as it's often wrong to project historical numbers as a likely indication of future outcomes. This even applies to inflation indexation, where I've seen us move in many schemes from uncapped RPI to LPI capped at first 5% and now 2.5%. Lawyers also query whether the constructive liabilities which the ASB alleges are really a mixture of contractual and contingent liabilities.

As for putting scheme liabilities on scheme fund accounts, the answer to tPR's consultation from the industry last year was a resounding no. If the ASB does only one Impact Assessment in this area, this is it, please. The incremental costs of moving from triennial actuarial valuations to annual ones and the additional costs of moving auditors from cross-referring to actuarial statements to actually doing some auditing of the liabilities are huge. The benefits are frankly hard to see anywhere. tPR even came off the fence and told the ASB's Pensions Advisory Panel this last year.

Where Others Stand

- Pensions Institute
  - An Unreal Number (How company pension accounting fosters an illusion of certainty)
- NAPF
  - Fearful of a £30bn increase in reported liabilities
- CIMA
  - The Pension Liability – managing the corporate risk
  - Apocalyptic demography? Putting longevity risk in perspective
- ICAS?

The same day as ASB published their 230-odd-page book, the Pensions Institute came out with their paper, “An Unreal Number”, which is about a third of the length, if anyone here’s interested in reading it. The PI calmly debunk the tendency of accounting standard setters to reduce the complexity of pensions to a single deficit or surplus number for accounting purposes or to put through the P/L an odd mix of relatively stable long-term costs along with, at times, highly unstable market-related movements.

Having spent 8 frustrated years on NAPF’s investment council and accounting standards working parties, I suppose I should mention one of their concerns. But their £30bn number is bound to be wrong, either way.

In terms of our profession’s institutes, CIMA for some time has led the way. But there’s at least one CA, a Second Generation Flint, whom I was at University with, on their Pensions Advisory Group, which may explain it.

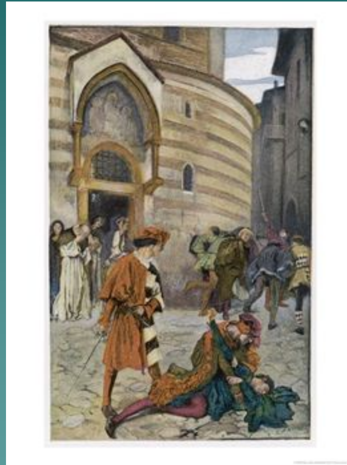
So, ICAS members, where do we stand on this? I’m looking forward to hearing the views of those present.

Is it A Nail ....?

I leave you with a couple of pictures.

But the latest ASB proposals being “The final nail in the coffin” is an overused cliche and frankly wrong, as the patient, in this case, UK pension schemes, is still breathing, if only just.

Or is it A Dagger?!



So I prefer instead a-dagger-to-the-heart analogy used by Aon, one of the leading consultant firms, on hearing of the ASB’s latest discussion paper.

In terms of a picture, I’m using the death of Mercutio from Shakespeare’s Romeo & Juliet.

And Mercutio’s dying words (or Shakespeare’s words, anyway) seem appropriate last words to give to accounting standard setters and regulators:

“.... A plague o’ both your houses!”

Thank you.