Watson Wyatt
Worldwide

14 July 2008

Accounting Standards Board
Aldwych House
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Dear Sirs

Watson Wyatt's response to ASB's discussion paper 'The Financial Reporting of Pensions'

Watson Wyatt is the trusted business partner to the world's leading organisations on people and financial issues. The firm's global services include: managing the cost and effectiveness of employee benefit programs; developing attraction, retention and reward strategies; advising pension plan sponsors and other institutions on optimal investment strategies; providing strategic and financial advice to insurance and financial services companies; and delivering related technology, outsourcing and data services. Watson Wyatt has over 7,000 associates in 32 countries and we provide actuarial consulting services to sponsors of over 2,000 defined benefit pension plans or other post retirement benefit plans.

We are happy to comment within the limited confines of this consultation. However, we note that the ASB's consultation is happening in parallel with numerous initiatives by the IASB and FASB to provide greater clarity in some of the more complex areas of accounting. Since the whole framework of accounting is in a state of flux, we would have expected that some of the fundamental issues at the heart of the purpose of accounts (such as credit risk and fair value measurement) would have been considered at a higher level in the wider context of company accounting and not in the narrower context of pensions.

The main thrust of our comments is in respect of the proposals related to the definition of liabilities and their measurement, and how volatile items are recognised in the income statement.

We have set out below our arguments why liabilities should reflect only the present obligations, without any allowance for discretionary increases or future salary increases but with an underpin equal to any revaluation to the benefit that would be provided if the member left service voluntarily as of the measurement date. We believe that measurement of these liabilities should reflect an allowance for credit risk since this would be consistent with how liabilities are measured elsewhere within the accounting standards. Moreover, this would better represent the reality of the situation regarding non-governmental plan sponsors.

On the matter of recognition, whilst we acknowledge the merits of immediate recognition we also perceive undesirable difficulties with the treatment of non-operating items in the income statement. We accept the principle of recognising changes in assets and liabilities immediately in the balance sheet, provided that volatile items of experience which are not related to drivers of business performance are kept separate in a statement similar to the STRGL, SORIE or OCI. We suggest, however, that this should be considered again when the outcome of other IASB projects on wider issues (such as the ‘Presentations’ project) are available.

The argument is often made that accounting standards should not be influenced by the consequences of an accounting treatment - if the accounting treatment is right then so will be the decisions that flow from it. But where the proposal is to replace an (admittedly imperfect) approach with another approach that has its own flaws and treats pensions more harshly than other types of obligations, we think that consequences must be considered. We are concerned that these proposed changes will lead to an artificial speeding up of the closure of defined benefit plans, due to the relatively overstated valuation put on liabilities and/or artificial cost volatility, which will affect the views of decision makers as to the economic cost of providing the benefits.

If you wish us to expand further on any of the matters we have raised or have any questions concerning our comments, please contact one of the under-mentioned at Watson Wyatt.

Thank you for considering our comments.

Yours faithfully

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1 Measurement, credit risk and discount rate

Whilst we agree with the general proposition that the time value of money should be assessed on a risk free basis, we also think that where there is a credit risk associated with the payments being valued, then an adjustment should be made to the resulting obligation to allow for that risk. This is particularly true of pensions and so we believe that credit risk should be taken into account in valuing pension obligations. Our primary argument is that there is no reason to ignore credit risk for pensions, when it is generally taken into account in measurement of other obligations, and when it is the IASB's view that it should generally be allowed for. We find the arguments for inclusion of credit risk, as set out in Chapter 5, paragraph 7.9 of the ASB Consultation Paper, convincing.

Also, we do not agree with the statement against allowance for credit risk in Chapter 5, paragraph 7.10(b) of the paper, in effect, that "an entity that holds a pension liability has no opportunity to settle or transfer it in a way that reflects credit risk". Our experience with enhanced transfer values in the UK, uptake of commutation options at retirement and pricing of pensions and retiree medical plans in corporate transactions all suggest liability valuations of less than a "risk free" amount may from time to time be accepted in settlement of obligations. Indeed recent examples of the possibilities available to companies to settle their obligations at less than the risk free cost are deals reached by three US-based automakers with their unions on post-retirement healthcare benefits (involving savings of many billion dollars). We also disagree with the statement in Chapter 5, paragraph 7.4 of the paper that "credit risk is not reflected in the requirements of existing pension standards". We believe that they, in effect, make some allowance, by using a corporate bond based discount rate. We also note that US legislators take a similar view since, under the Pension Protection Act, annuities under defined benefit schemes are converted to lump sums by reference to corporate bond rates.

Because of this, we believe that the proposal to assess obligations using risk free discount rates without adjustment for credit risk is inappropriate. It will result in an overvaluation of liabilities. Just because some retirement benefit plans are funded and so credit risk is reduced by collateral, it does not mean that credit risk should be ignored for all plans. And, even in a funded plan there is some credit risk.

Equally, possibilities exist for the sponsoring employer to change benefits in some benefit plans, thereby reducing the value of such plans to members who should, all else being equal, demand separate compensation for that risk. The cost of that compensation should be accounted for separately, so to ignore the possibility of plan changes results in double counting.

However, we would not suggest seeking a theoretically 'perfect' measurement attribute that accurately prices the specific credit risk of the plan and employer options. We believe theoretical perfection is impractical because:

- There is no single "magic number" that adequately captures the uncertainty in pension plans. The case for this is made in the Cass Business school paper of January 2008 "An unreal number".
- Widely different viewpoints can be justified on credit risk adjustments (but importantly, the adjustment is not zero). This is because of the lack of any developed benchmark to assess credit risk for pensions.

- Also, post-retirement benefit obligations vary widely in their nature globally. It is very difficult to put a value on the employer's option to make plan changes that affect accrued benefits, and where such options exist, widely different values could result.
- There is no universally agreed theoretical basis on which to base such a measurement – this is shown by the debate over what a "risk-free" discount rate might mean.

In view of these points, extensive guidance would be needed on how to apply a sophisticated measurement attribute, to avoid inconsistent application between companies. We think the limited time and resources available to standard setters would better be spent elsewhere than in devising such guidance.

Therefore, on practical grounds, we argue for a simple benchmark that, whilst admittedly imperfect for any plan, is easily understood, is comparable between companies, and makes some allowance for credit risk and employer options. As any such approach involves arbitrary choices, we see no compelling case to change from the existing AA corporate bond – based approach.

Whilst it is said that good disclosure may not compensate for bad accounting, sensitivity disclosures and publication of expected cash flows should allow users of accounts to better understand the uncertainties involved and substitute their own measurement should they have a different view.

Existing FRS17 and IAS19 standards are widely credited with improving the quality of pension disclosure, with increasing consistency of treatment between companies, and with raising pensions to a deserved level of attention. The proposed measurement change would bring no further advantages in these respects. Rather, we think attention should be focussed on further improvements to disclosure and sensitivity analysis, which will have a much higher benefit to cost ratio than a change in measurement attribute.

2 Definition of liability – salary increases

We believe that liabilities based on current salaries are more consistent with the principle that a liability should only reflect the present commitment resulting from a legal or constructive obligation. (The concept a projected salary obligation arises from the principle of uniform or smooth cost recognition. If the intention is to eliminate smoothing from pension accounting methodology, then it follows that it should also be eliminated from the measurement methodology).

However, where the law or the plan's rules provide that leaving service benefits are subject to increases before they are paid, for example, compulsory indexation for early leavers, as in the case in some countries, then we believe these should also be recognised as part of the legal obligation (in this case, future pension increases have been earned but future pay increases have not). In other words, under an accrued liability principle the focus should be on the benefits already earned at the measurement date.

Our arguments against considering future salary increases as part of the liability are:

- The existence of a final salary plan does not create an obligation to increase pay in the future
- Future salary increases, even when they happen, are not guaranteed to extend to pension

accruals. There is ample evidence of employers having re-defined the pension promise to exclude future salary increases.

- There is no precedent elsewhere in financial reporting (eg remuneration costs generally) for future salary increases to be capitalised as liability. Doing so for pensions only, does not provide shareholders with the most relevant information about the current value of their obligations.
- In accounting terms, the existence of a reserve for future salary increases creates a moral hazard for employees through an incentive for employers to freeze the plan and take a curtailment gain, or to move across to other plan structures which might transpire to be inferior. Amongst other things, this misrepresents the value of the pension contract to an employee if it has been factored in pay negotiations.

3 Recognition of expense

We support the proposal to recognise changes in assets and liabilities immediately in the balance sheet, provided the SORIE (or similar) approach is also maintained. We believe it would be inappropriate for all experience items to be recognised through the income statement and believe that it is vital for market volatility to be distinguished from operational matters and recognised in a statement similar to the STRGL, SORIE or OCI.

It is difficult to provide precise comments on how exactly this should be done without being clear about the structure of the income statement going forward. We note that the present SORIE approach has worked well, although we appreciate that this will be reviewed in the light of other accounting reforms with a much wider scope, in particular the outcome of the IASB's project on *Presentation of Financial Statements.* We do however support the idea that all items entering the income statement should be separated with regard to their drivers or predictive values.

On a practical note, a switch from the present regime involving deferrals to one which does not would be regarded by most as a significant change and we would expect that it would therefore be accompanied by suitable transitional arrangements.

4 Expected return on assets

We understand the ASB's reasons for moving away from recognising the expected return on assets in the income statement. We would, however, be very concerned if the proposed alternative of recognising the actual return was done hastily without consideration of the alternatives, including their presentation. We think it is imperative for this to be considered in conjunction with changes in the structure of the financial statements. Any change towards recognising the actual return should, we believe, be accompanied by not just a separation of the financing items from the operating activities, but also by a presentation of the financing items outside the profit and loss account. Otherwise, there is the potential for the pension items to distort the sponsoring company's core financial results, and in many cases, due to the size of the pension scheme relative to the company, swamp them.

We are not clear as to whether a separate presentation of financing items outside the profit and loss statement (as set out in the alternative presentation outlined in Appendix A to Chapter 8) is within the scope of Phase B of the IASB's '*Presentation*' project. If not, then we would prefer further consideration of other alternatives whereby an element of the expected return is recognised in the income statement, and the balance of the return shown in OCI.

We agree with the ASB (paragraph 2.9 of Chapter 8) that whilst the IASB and FASB are still considering the distinction between business and financing activities, the task of discussing how to present amounts related to pensions within OCI is difficult. We believe it would be a mistake to try to take this discussion to any conclusion without a clear understanding of the structure of the new income statement that might be envisaged and how it would work in conjunction with OCI. At this stage we would simply remark that it is imperative to segregate the various components of pension expense, such that financing aspects do not impact operating income and are shown ‘below the line’. This is important to avoid financing items distorting headline profit figures, and also to provide the level of transparency required for users with varied needs to understand the cost of pension programs and to adjust the income figures, if appropriate, to suit their purpose.

5 Responses to the specific questions raised in the Discussion Paper

Chapter 2: Liabilities to pay benefits

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)?

Current salaries, subject to an allowance for the rate of any revaluations (statutory or in the plan rules) to leaving service benefit (see paragraph 2 above). We consider future salary increases to be discretionary, until they are granted.

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?

We do not consider it necessary to make this distinction to arrive at the conclusion in Question 1.

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

Yes, for consistency with the principle of a present commitment. See paragraph 2 above.

Chapter 3: Assets and liabilities: reporting entity considerations

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?

There is merit to this but we have no strong views; we suspect that the criteria for pension plan control would rule out such consolidation for most pension schemes in the UK. Even in the US, Canada and many other countries, qualified defined benefit pension assets are actually held in a trust that is separate from the company and generally, the money held in that trust can only be used to pay pension benefits or expenses incurred by the plan (as long as it is ongoing). As a result, the claim that *the trust represents a company asset and belongs on the company's balance sheet seems difficult to justify and putting the plan's funded status on the balance sheet is a fairer representation of the effect of the plan on the company's balance sheet.*

Chapter 4: Recognition of pension assets and liabilities

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 accept the principle of immediate recognition in the balance sheet provided that items which are not related to the drivers of company performance are reported separately through the SORIE or OCI, and not allowed to distort the income statement. See paragraph 3 above.

Chapter 5: Measurement of liabilities to pay benefits

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?

  Regulatory measures would generally follow different objectives. We therefore agree with the reasons advanced in the consultation paper (paragraph 6.16 of Chapter 5) that such measures should not replace those derived from general accounting principles.

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

  It is our general position that allowance should be made for credit risk and other non-performance risk in the measurement of pension obligations for non-governmental entities, and a pragmatic way of doing so is to use a corporate bond discount rate as a proxy. Given that no single method is going to be technically perfect, we see no compelling reason to change from the use of a AA credit assessment. See paragraph 2 above.

- 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?

  Agree, disclosure of sensitivity information would be more appropriate.

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

  Disagree, see paragraph 2 above.

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

We do not think that there is a simple answer to this and the conceptual argument needs to be considered further. Whilst a benefit promise creates an obligation to pay benefits and should be recognised as a liability, it is not obvious that the associated administrative expenses for meeting the benefit payments can necessarily be categorised as a liability. Arguments for doing so would be that the sponsoring entity has taken on a commitment which it cannot escape. Arguments against would be that general running costs of a business are not capitalised so why treat pensions differently?

If administrative expenses are treated as a liability then a further question is how to create the provision. Disentangling costs between active and non active members will be difficult, as will apportioning costs across active member careers (since costs do not depend on service and some costs will be independent of headcount).

This problem is not just confined to pensions. It must arise in other areas as well, for example, in de-commissioning provisions. Therefore, if this principle is likely to prevail, then we believe it needs to be considered in a wider context than just pensions.

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?

Pension scheme options are not exercised with the same financial rigour as options by, say, a bond investor; the drivers are often non-financial and these options are in practice more like alternative benefits. The popularity of cash lump sums at retirement in preference to annuities, when these are offered as alternatives, is an example. We think it is appropriate to allow for options by reflecting the probability of different outcomes – this would be consistent with the best estimate and going concern concepts.

Chapter 6: Measurement of assets to pay benefits

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

Yes, this is consistent with the thrust of modern accounting standards. However, there should be some consideration for the resulting volatility and the need to separate the cost of benefit accruals from the cost related to market conditions. (See paragraph 3 above).

We would also suggest that consideration be given to the practical difficulties of obtaining the necessary information on a timely basis (especially for interim reporting and for certain types of assets).

Chapter 7: Measurement of employer interests in the assets and liabilities of trusts and similar entities

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?

In principle, yes, although it is quite likely that when the 'net' treatment is being followed there may be contractual arrangements affecting reimbursement rights and these would also need to be recognised.

Chapter 8: Presentation in the financial statements

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

Yes, see paragraph 3 above.

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 our comment in paragraph 4 above. We believe the outcome of the Presentation of Financial Statements project needs to be better understood in order to answer this question.

Chapter 9: Disclosures in the employer's financial statements

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 with the objectives.

We think there would be some advantages from having additional sensitivity disclosures (see paragraph 1 above).

We would also suggest additional narrative disclosures to indicate the existence of contingent assets or risk mitigation instruments (such as swaps), which may not be obvious from the traditional disclosures.

Chapter 10: Accounting for multi-employer plans

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?

Yes, where a reasonable estimate of the ongoing commitment of the company is possible. This is not often possible and in such circumstances, we believe a better reflection of the situation would be to recognise a liability equal to a best estimate of any payment due on cessation of participation (subject to relevant provisions in the terms of participation), and to recognise in expense. the contribution due, plus any change in liability.

Chapter 11: Financial reporting by pension 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?

This depends on the purpose of the pension plan accounts. If the purpose is to show a statement of cash flows and assets under management then we see little merit in showing a liability assessed on principles, assumptions and methodologies which may be very different from those employed in arriving at the plan's funding strategy (and may therefore serve to confuse members).

We note however, that in many countries the structure of pension plan accounts is set out in national legislation or has been developed to support local regulatory approaches and in these cases the question would need to be considered against locally set objectives and/or requirements.

We do not believe it is an appropriate question for a "global" standard to address.

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?

Depending on the purpose of the pension plan accounts (see Q14) this might, in principle, be appropriate in some cases, but in practice we perceive considerable difficulty with quantifying this asset.

General questions

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.

Yes, it would be necessary to ensure that the requirements cope equally well and consistently with all types of retirement plans (e.g.cash balance plans, various forms of risk shared plans and pension equity plans).

We would flag certain complex plan designs involving contingent benefits as requiring further consideration. An example would be a pension plan where pension increases are on a sliding scale linked to the level of funding. Suppose that, at the measurement date, the plan was in deficit and this corresponded to no pension increase on the sliding scale. The consultation paper proposes (in chapter 2, paragraph 4.30) that liabilities should not reflect the effect of future changes in the plan's financial condition. In other words, in this example, the liabilities should make no provision for future pension increases. We would regard this accounting treatment as erroneous since it places the same value on the plan in the example as in an otherwise identical plan but one which did not grant any pension increases. We think the correct treatment would be rather more complicated involving option *pricing techniques.*

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?

We would expect that comprehensive cost-benefit analyses would be carried out before any final conclusions were reached.

In addition, we would emphasise that since many of the issues considered in this consultation have a direct relevance to various ongoing initiatives of the IASB and the FASB, the ASB should not be hasty in its conclusions. This applies particularly to fundamental issues such as fair value measurement, the presentation of financial statements and the allowance for credit risk which we believe should be settled first in the wider context of company accounts, and then applied consistently to pensions.

Finally, we understand that transitional issues are to be considered separately and we would emphasise the importance of these to help sponsors and others make a smooth transition to a significantly different accounting regime.

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