Our Ref BRS/JG

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Dear Sir

The Financial Reporting of Pensions

We welcome the opportunity to respond to the issues raised by the discussion paper, and the debate that the discussion paper has stimulated. We agree that this is an important area in financial reporting and that it is important to engage interested parties in a timely manner.

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We set out below our views on the questions you have raised.

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)?

On balance we believe the liability should be based on current salaries. We find the argument persuasive that where an entity is not currently legally, or through a constructive obligation, committed to give future pensionable pay increases then such increases should not be included in the valuation of the liability.

Where future increases are guaranteed by law or contract, ie the increases are non-discretionary and are independent of the entity's future actions, they should be included in the calculation of the liability.

We believe that this provides a more faithful representation within the income statement of the impact of granting pensionable pay increases. Calculating the liability by taking into account expected future salary increases might give a more accurate indication of the expected cash flows expected for the scheme. However, accounting in this way would not, in our view, give a faithful representation of an entity's results in the future period in which a pensionable salary increase is granted.

The accounting for pension liabilities will ultimately need to conform with the accounting for other liabilities, for example the debate on what constitutes a liability in the conceptual framework project and the discussions on defining a constructive obligation.

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

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consequences do you consider your view has for the recognition and measurement of pension obligations?

In our opinion it is not possible for an entity to owe an obligation to an unidentified individual. As such we believe that financial reporting should be based on the premise that a liability is owed to an individual employee and not to the workforce as a whole.

We also believe that whilst an individual employee might reasonably have a valid expectation a group of individuals could not, in our opinion, be said to have a valid expectation beyond those of the individuals within that group.

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

We agree that recognition should be based on the principle of reflecting only present obligations as liabilities. We see no conceptual reason for recognising a liability to pay a pension on another basis.

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?

In principle we agree that pension schemes should be consolidated where they are controlled by the entity. However to do so would raise practical issues. For example the parent company might have a policy to account for investment property at cost, or the pension scheme might hold a property which is used by an entity in the group. Consolidating the pension scheme and reverting to cost for accounting for these assets in accordance with the group's accounting policies might not reflect the group's true economic position.

In addition, if the pension scheme holds an investment in the group's equity instruments, in accordance with current UK and International accounting standards, once consolidated, these would need to be deducted from equity.

Also, the impact on the income statement would need further consideration. We believe that investors will not necessarily welcome the potential swamping effect on an entity's results of consolidating that entity's pension scheme.

Therefore we have reservations about consolidation. It might be possible to treat the pension scheme assets as restricted and hence disclose them separately, but this would raise other questions about how to display consolidated information regarding assets and liabilities where not all of the assets are available to pay the liabilities (for example because they are in different group companies).

Also, if it is accepted that consolidation is appropriate where an entity controls its pension scheme, it would also be appropriate for the group to consider equity accounting where it did not control the scheme but where the entity had significant influence.

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?

Yes, we can see no arguments for continuing to use a methodology which arbitrarily defers an amount of an asset or liability. However the presentation issues, for example the volatility that is introduced into the income statement, will need careful consideration.

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

Regulatory measures should not replace measures derived from general accounting principles?

We agree that regulatory measures should not replace measures derived from general accounting principles. However we recognise that regulatory measures may sometimes have an impact on the accounting treatment, for example if the result of a regulatory measure is that the entity has an onerous contract.

However, where there is a material difference between a regulatory measure and the accounting measure, we believe that the regulatory measure should be included in the notes to the accounts along with an explanation of the difference.

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

We agree with the ASB's view that the current approach of using a AA corporate bond rate is conceptually flawed. We also note that using a risk-free rate is conceptually flawed if the cash flows are not risk adjusted. Most estimates in accounting are required to be made using either a risk-adjusted cash flow or a risk-adjusted discount rate, for example in provisions and impairments.

On balance we agree with using a risk-free rate, because we believe that the risk-free rate is closer to the true accounting liability. In reaching this conclusion we note the arguments in paragraph 6.50 that the impact of including risk within the measurement would have the effect of increasing the liability further.

However, before concluding on this point we would encourage the ASB, and other accounting standard setters, to consider arguments that:

- the liability for some defined benefit pension schemes is similar in substance to some life assurance and as a result the accounting treatment should be similar. We note the IASB discussion paper "Preliminary Views on Insurance Contracts" called for the inclusion of a risk margin in measuring insurance liabilities
- a pension scheme deficit is similar to other forms of borrowings and the interest rate applied to the liability should recognise this fact.

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?

In order to convey sufficient information about the nature of the liability, the notes will need to include additional disclosures about the riskiness of the liability, whether or not risk is built into the liability recorded in the balance sheet.

Once a measurement basis is decided upon, the disclosures in the financial statements will need to make clear that there is a far greater degree of uncertainty around the pensions number, and in particular the liability side, than other liabilities. Disclosures which would be useful to assess the riskiness of the liability would include disclosures on the expected timings of outflows from the scheme and the age profile of participants within the scheme.

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

We agree that the liability should not be reduced to reflect the credit risk of the entity. If the going concern concept continues to be a central tenet of accounting then we do not

believe that the entity can avoid settling the obligation in full. This assumes that the buy-out cost is greater than the liability calculated on a settlement basis. Were the buy-out cost to be the lower cost option and be available to the company, ie within the employer's control to achieve, the lower cost option would be the appropriate measure.

Whilst we agree that there are some situations in which an entity might be able to crystallise a liability position such that it can take advantage of its increased credit risk, for example where an entity's debt is traded, a pension liability cannot be extinguished in this manner. Therefore we do not believe it is appropriate to take account of credit risk in the calculation of the liability.

Expenses of administering the plan's accrued benefits should be reflected in the liability?
We agree that the expenses of administering the plan's accrued benefits should be reflected in the liability; the expenses of administering future benefits that may accrue to current members should not be included.

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?
We believe that the liability should be reported at an amount that reflects the probability of different outcomes. The obligation to the employee is to honour their choice of settlement alternative. As a result we believe it is appropriate to measure that obligation by reflecting the probability of employees selecting different options. In turn this provides a better reflection of the expected future cash flows and avoids adjusting the liability only when the lower cost option is selected.

Q8 - Do you agree that assets held to pay benefits should be reported at current values?
We agree that assets should be stated at their current values, but we refer you to our comments above on the potential problems associated with consolidating pension schemes.

Q9 - Do you agree that a 'net' asset or liability should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly?
We 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.

Q10 - Do you agree that different components of changes in liabilities and/or assets should be presented separately?
Ultimately we believe it is vital that the income statement shows movements in assets or liabilities in a way that is most helpful to the potential users of those financial statements. We have not canvassed views as to what users might find most appropriate.

We believe that the different elements of the cost of pension schemes provide different predictive value for users of financial statements and therefore whatever the approach taken to presenting the cost in the income statement, the different elements should be disclosed in the notes to the financial statements.

Q11 - Do you agree that the financial performance of an entity should reflect the actual return on assets, rather than the expected return, and that the expected return should be required to be disclosed?
We agree that the financial performance of an entity should reflect the actual return on assets. Reporting the expected return is open to abuse and can result in a positive expected return whilst in fact the actual return on investments has been negative.

We understand that some hold the view that the expected return on assets can provide useful information to understand the expected long-term cash flows associated with the pension scheme. However, we believe similar information can be obtained from disclosing historical actual return information, for example a five year summary of actual returns.

Ultimately to answer questions 10 and 11 appropriately we need to have sight of what the performance reporting project recommends.

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 of disclosure in this Chapter.

Where a liability for a multi-employer scheme has been included on the basis of an allocation key, any final standard should require disclosure of the allocation key used and the basis for using that allocation key.

Q13 - Do you agree that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan? How, in your view, should an accounting standard require that this be implemented in practice?
In principle where sufficient information exists to account for an entity's participation in a multi-employer plan every effort should be made to include an allocation of the surplus or deficit in the plan. Not to do so would result in financial statements that do not represent faithfully the transactions that the entity has entered into. We do however accept that in the most complex schemes it may not be possible to account reliably for an appropriate share of any deficit or liability.

We also note that the accounting in the separate financial statements of entities participating in a group plan is not discussed. We believe that, in most cases, the cost of allocating a pension surplus or deficit amongst the members of that group would outweigh the benefits of allocation.

Q14 - Do you agree that a pension plan's general purpose financial report should include its liabilities to pay benefits in the future? Do you agree that the plan's liabilities for future benefits should be quantified using the same principles as an employer's liability?
We acknowledge that where a pension plan produces general purpose financial statements the liability should be included in the balance sheet.

However, we do not believe that those who might use a pension scheme's financial statements would require general purpose financial statements. In particular those who generally use such financial information, such as trustees, an entity participating in the scheme or a government body would all be able to obtain any information about future benefits that

they might require. Therefore the only potential user of those financial statements who would not otherwise be able to obtain that information would be a member or potential member of the scheme.

In our opinion, a sensible information set for scheme members would constitute:

- a trustees' report setting out how the trustees have fulfilled their obligations to the members of the scheme, including details of the expected disposition of, and return on, scheme assets
- a breakdown of the assets backing the scheme, for example a net asset statement
- a summary funding statement showing the liability calculated on a scheme specific basis and a full cost buy-out basis
- an actuarial assessment of the liability on a settlement basis
- an explanation and reconciliation of the various measures of the liability.

We do not believe that general purpose financial statements would be understandable to members and potential members. Therefore we believe that the discussion paper's starting point, a pension plan produces general purpose financial reports, to be a less helpful approach than asking the wider question: what might a user like to receive?

From our experience of UK schemes we understand that most participants in defined benefit pension schemes rarely request the scheme's financial statements. Indeed, even the administrators of large multi-billion pound schemes receive requests for the full report and accounts from only a handful of those who are entitled to request a copy. In our opinion this gives further weight to the argument that the starting point for this debate should not be to assume that a scheme produces general purpose financial statements.

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?
Were the liability to pay pensions to be included, see our comments above, then we do not believe an asset should be included in the financial statements of pension plans.

Whilst we recognise the conceptual argument for including a matching asset in the pension scheme's balance sheet, we believe that there is useful information content in the gap that would otherwise be presented. We believe that information about the employer's covenant would be better conveyed by narrative, which would:

- explain that any shortfall stands to be made up by a mixture of employer contributions, asset returns and reductions in estimated liabilities, and
- explain how the 'trustees' plan to do this, and the risks involved with their plan, (which would necessarily include the possibility that the employer would be unable to meet the required future contributions).

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.
None at this stage.

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?
None beyond those made above.

If you have any questions on this response, please contact Jake Green (phone: 020 7728 2793; email *jake.green@gtuk.com*).

Yours faithfully

Grant Thornton UK LLP