Response No.67

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Accounting Standards Board
Aldwych House
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Dear Board Members:

I appreciate the opportunity to comment on the ASB's Discussion Paper entitled, "*The Financial Reporting of Pensions*" (hereafter 'the Discussion Paper'). I support the Board's objectives and efforts to develop sound accounting principles for this challenging area of financial reporting. I have conducted my own PhD research on employers' pension costing, and have research in progress that relates to some of the issues identified in the Discussion Paper.

I believe that the central issue to be resolved is that of the appropriate 'unit of account' and that this could help to resolve many of the specific questions raised in the Discussion Paper.

Unit of Account and PBO vs ABO
I strongly agree that the measurement of the pension liability is central to the financial reporting of pensions. The Board promotes the concept of using the measure of accumulated benefit obligation (ABO) instead of projected benefit obligation (PBO) for the balance sheet obligation. I urge the Board to consider resolving the unit of account question *jointly* with the PBO versus ABO debate rather than looking at these two issues separately. Resolving the unit of account question at a conceptual level may lead to the eventual solution to the measurement issue.

In my view, the debate over ABO vs. PBO is conventionally tied to two competing economic models of the labour market, the 'implicit life-time contract' and the 'spot contract' model. In a 'spot contract' model, neither the firm nor the worker looks beyond the current period when the workers' total compensation is being determined. Then the appropriate measure of the firm's pension obligation is arguably ABO, which has no forward-looking component. If, however, pensions really represent deferred compensation, an 'implicit life-time contract' in which the firm is a long-term 'going-concern' and employees' total compensation is not necessarily equal to the value of their labour services that is remunerated on a periodic basis, then a forward-looking measure (PBO) characterizes more accurately the firm's pension commitment. The fact that most benefits accrue at the end of workers' tenure is consistent with the view that the defined benefit pension contract is an 'implicit lifetime contract' between workers and the firm during their service life.

However, the above conventional analysis of ABO vs. PBO implicitly assumes that workers negotiate their total compensation with the firm *individually*. For example, under the spot contract view, the salary inflation for an older worker should be smaller than that for a younger worker, *ceteris paribus*, since any percentage pay increases for an older worker lead to a magnified increase in his/her pension accruals. Yet the validity of the 'spot contract' model remains an empirical question. It is therefore possible that ABO may not capture a firm's true economic pension liabilities, which undermines the usefulness of this measure.

However, if we start by examining the tradeoff between wages and pension accruals at the level of the *employee group as a whole* (so that this is the *unit of account*), the ABO measure can still be argued to be valid. This is because the older members of the workforce receive wage increases (producing large benefit accruals) which may be offset by current wage concessions made by the younger members of the group. Similarly, if an unusually large number of employees qualify for an early retirement benefit, this may be offset by unusually large current wage concessions from other members within the employee group as a whole.

I commend the Board's efforts to revisit the most debatable issues in pension accounting, and attempts to apply the principles of accounting used elsewhere to pension accounting. I hope the Board will give careful consideration to my comments, and would be pleased to discuss the comments further, if so desired.

Sincerely yours,

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