Response No.69

Balfour Beatty

14 July 2008

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Dear Sirs

Response to ASB's discussion paper 'The Financial Reporting of Pensions'

Following the discussion paper issued by the ASB, I am providing our responses to the questions raised, in the Appendix to this letter.

Balfour Beatty has significant pension liabilities and runs three defined benefit and defined contribution pension schemes with total pension assets under management of around £2billion.

Whilst recognising that this is a complex area, and clearly a lot of thought has gone into the discussion paper conclusions, we feel that the proposals are flawed in two key areas:

- The proposals will continue the trend of increasing the inconsistency of valuation methodologies in the balance sheet. Whilst stating that reporting for pensions should apply the same solution that is used elsewhere in financial reporting, the use of a risk free rate for measuring the liability is at odds with other standards issued by the ASB (e.g. FRS 12, FRS 11, FRS 20, SSAP 21).
- These proposals will introduce additional volatility into the income statement. Including actual return on pension assets will not help an investor to understand the true performance of the business. Despite the increasing complexity of accounts, and ever greater disclosure, price earnings ratios remain one of the fundamental valuation tools used by investors and these recommendations would in a number of cases make these ratios meaningless as a tool for valuation and comparison.

Our view on the valuation of the liabilities within a Defined Benefits Scheme is as follows:

- If a scheme was "fully funded" and perfectly matched i.e. it had assets whose maturity and cashflows matched the liability cashflows, we believe the discount rate for the liabilities should match those of the inherent return within the assets. When assets and liabilities are fully matched, the credit risk of the employer at that point, is secondary as it will only come into play if there is an asset default.

- A completely unfunded scheme has no greater security than any other unsecured creditor of the Employer (this is recognised in the UK through the PPF levy), and consequently the liabilities of such a scheme should be valued using a discount rate that reflects the credit risk of the employer.

- Where you have a scheme with a deficit you in essence have a hybrid of the above two scenarios. An asset return should be used for the funded part of the scheme, and a discount rate reflecting the credit risk of the employer for the unmatched portion of the liabilities.

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We accept that this theoretical approach may have some practical problems. Assessing the credit risk of an individual company can be difficult, although the PPF has to do it, and where the liabilities are potentially material in the context of the Employer's balance sheet, this can lead to a variety of views on the most appropriate rate. We believe that the current IAS 19 and FRS 17 approach of using a corporate bond rate that reflects an element of credit risk, and aids comparisons between companies, is a sensible and practical solution to the problem. We do not agree that a risk free rate is a sensible rate to be used in any circumstances other than where the pension fund liabilities are fully secured by risk free assets. In addition, many pension schemes are moving away from largely equity based asset portfolios to investment in bonds which is another argument to the retention of the AA Corporate bond discount rate.

Whilst the subject is complex and a perfect solution may be difficult to find we believe that the adoption of the ASB proposals will lead to the consequences of producing accounts with a increased variety of valuation methodologies, increased volatility of earnings and harm scheme members by speeding up the closure of defined benefit plans, and shareholders, by pressurising employers to sell off pension schemes to third parties at values that do not reflect the true economic cost to the company.

We hope the ASB will give serious consideration to modifying these proposals.

Yours faithfully

Duncan Magrath
Finance Director

Appendix to letter dated 14 July 2008

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)?

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. However, where obligations in the scheme rules are extended further by statute, for example compulsory indexation for early leavers, as in the UK, then we believe these should also be recognised as part of the legal 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 consequences do you consider your view has for the recognition and measurement of pension obligations?

We have no strong view either way.

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.

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?

Generally yes, but we believe there will be few cases where a company genuinely controls the pension plan, particularly where a trust arrangement exists.

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 but believe that the recognition of volatile items is more appropriate outside the income statement and see no reason to move its recognition from STRGL, as at present.

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?

We do not necessarily agree.

- **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 an easy way of doing so is to use an AA discount rate as a proxy.

- **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?**

  We 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. Currently the company's credit risk is taken into account in measurement under FRS 12 (Provisions, Contingent Liabilities and Contingent Assets), FRS 11 (Impairment of Fixed Assets and Goodwill), FRS 20 (share-based payments) and SSAP 21 (Accounting for leases and hire purchase contracts).

  Also, we do not agree with the statement against allowance for credit risk in paragraph 7.10(b) of the paper, i.e. that "an entity that holds a pension liability has no opportunity to settle or transfer it in a way that reflects credit risk". The experience of "enhanced transfer values" in the UK, uptake of commutation options and pricing of pensions 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. We also disagree with the statement in 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, which is a sensible practical solution, that allows for some element of credit risk but ensures a level of consistency between accounts, and removes an area of estimation where companies do not have a formal credit rating.

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

  For an ongoing plan we do not think it is practical to identify with precision the administrative expenses that relate to accrued benefits and separate them from those that relate to ongoing accruals. The same may be true even in a closed plan where administration is often shared with a successor DC plan and sometimes offered though the same legal vehicle. Therefore we do not think that it should be a general requirement to provide for expenses associated with accrued benefits, as there is often no reliable basis on which to measure what these are.

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 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.

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?

Yes.

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.

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?

Whilst we understand the ASB's reasons for moving away from recognising the expected return in the income statement, we feel that the proposed alternative of recognising actual income would re-introduce market volatility in the income statement; in many cases, due to the size of the pension scheme relative to the company, this could swamp the income statement.

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 and have no suggestions for further disclosures.

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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 separation of assets and liabilities is possible and good quality information is available.

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?

We do not agree with this; it would involve unnecessary additional costs and we foresee considerable practical problems if pension scheme and company financial years are different. What is disclosed in company financial statements should be easily available, so we see no need to duplicate effort in this way.

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?

No, for practical reasons because of the 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.

Further guidance about the accounting treatment for shared cost (as opposed to balance of cost) arrangements would be welcomed.

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 hope that the ASB will work towards achieving convergence between the ASB approach to financial reporting of pensions and the IASB approach. It is extremely costly for companies to have to produce figures under both regimes (for example where statutory UK accounts are required to comply with UK GAAP in addition to consolidated Group accounts which might need to comply with International Accounting Standards).