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Dear Andrew

Discussion Paper "The Financial Reporting of Pensions" January 2008

As you know I was a Consultant to the ASB in developing FRS17 and all of us involved were clear about FRS17's continuing anomalies. The current Discussion Paper is an excellent analysis of these anomalies and gives practical ways of addressing them.

In particular, I strongly welcome:

1. Excluding expected salary growth from pension liabilities and costs, to reflect the underlying economics of above inflation salary increases.
2. Discounting pension liabilities at a "risk free" rate, which should be the swap rate.
3. Including actual not "expected" returns in the P and L. "Expected returns" are "made-up" numbers which have no place in financial reporting.
4. Requiring multi-employer schemes to report costs and liabilities on a DB not DC basis, which will show the real costs and liabilities for many major schemes.
5. Requiring pension plan accounts to report liabilities to pay pensions. At the moment pension plan accounts show the assets which will meet pension liabilities but ignores the underlying pension liabilities.

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The aim of good financial reporting is to allow the efficient allocation of capital through rational decision making by investors and management, not to paper over the cracks. FRS17 has been attacked by supporters of the defined benefit pension industry and held responsible for the demise of UK defined benefit pensions.

Over recent years companies have certainly increasingly realised that making promises to pay pensions over many decades is very expensive and involves significant longevity risk. They have also realised that holding equities to pay these pensions involves significant investment risk.

The transparent accounting of FRS17 has not created this cost and risk, but has allowed investors to see it. It has also allowed companies to measure and manage pension costs and risk better, encouraging rational decisions about remuneration and investment.

The proposals contained in the Paper are a very important further step in increasing transparency to improve rational decision making.

Please feel free to ask any questions.

Yours sincerely,

John Ralfe

The Financial Reporting of Pensions. Answers to questions

Chapter 1: Introduction

Comments

- The Paper suggests that Defined Benefit and Defined Contribution pensions are part of a spectrum and that some "risk sharing hybrid" pensions do not fit comfortably in the current accounting.
- However, rather than consider a hybrid pension as somewhere between DB and DC it is better to think of it as two pensions, with a DB and a DC component and account for each separately. Although there are many different possible hybrids, in practice, each can be broken down into a DB and DC part.
- A cash balance plan, which guarantees an amount of cash at retirement, often with a fixed return, but leaves the individual with the annuitisation risk, is a straightforward DB plan. The current service cost is the NPV at the swap rate of the increase in pension promised. The liability is the NPV of the total pension promised.
- A plan under which inflation increases are discretionary is also straightforward. The DB cost and liability should be based on the guaranteed pension. Any employer contribution over this cost would be recognised as a DC cost, but there would, of course, be no associated liability. If an inflation linked increase is granted this simply increases the DB liability, with an equal transfer from the accumulated assets in the DC fund.

Chapter 2: Liabilities to pay benefits

Q1 The recognised liability to pay benefits should be based on current salaries, including any non-discretionary increases, especially inflation linking. Unlike FRS17 and IAS19, expected salary growth should be excluded.

Q2 Financial reporting should be based on the premise that a liability is owed to an individual, not to the workforce as a whole.

Q3 Recognition should be based on the principle of reflecting only present obligations as liabilities, ie ABO not PBO.

Comments

- Accounting does not recognise costs and liabilities which a company may incur in the future. In particular it would be curious to recognise expected future salary increases as a cost of employing people today.
- Although the likely cost of a final salary pension is certainly higher than a career average pension, this cost should be recognised when it is incurred and not before the above inflation salary increase is given, which matches the underlying economics.
- Table 1 (page 41) illustrates that recognising the cost before the salary increase is misleading. Example B, current accounting, smoothes the cost of above inflation salary increases, recognising the same cost in each of the 5 years of prospective employment.
- This overstates the percentage cost in early years (year 1 is 13% of salary, not 10%) and understates it in later years. In practice the impact will be greater as the assumed period of employment will be longer than 5 years in the example.
- The proportion of UK pension liabilities represented by current employees, including expected salary growth, has fallen in recent years with the closure of most UK private sector pension schemes to new members.

- Many UK companies have also moved from a final salary pension to career average, so expected salary growth will no longer be included in the liabilities.
- The distinction between a liability to individual employees and to the workforce as a whole is a distinction without a difference.

Chapter 3 Assets & liabilities: reporting entity consideration

Q4 The consolidation of pension plans should be subject to the same principles as usually applied to determine if consolidation is appropriate.

Comments

- The Paper distinguishes between a company's direct obligation to pay pensions (liabilities and assets shown gross) and an indirect obligation to ensure that a separate legal trust has enough assets to pay pensions (liabilities/assets netted).
- But the economic risk for the sponsor is identical, which the accounting should reflect. Moving from a direct obligation to an indirect obligation by setting up a separate legal trust does not change the underlying economics.
- The SEC's concerns about not consolidating pension plans are well made (quoted in 3.12). It is significant that the SEC was examining pensions in the much wider context of off balance sheet vehicles.
- The Paper considers "control" of a separate pension trust in a narrow legal sense, which varies in different countries, for example who appoints trustees. But different legal practices do not change the underlying economics.
- Accounting should reflect who gains and who loses from asset outperformance and underperformance. In a DB pension the sponsoring company takes the risks and rewards of asset performance, even if legal control rests with a trustee board. It is difficult to see why the pension assets and liabilities should not be consolidated in line with this.

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Chapter 4: Recognition of pension assets and liabilities

Q5 Changes in pension plan assets and liabilities should be recognised immediately, not deferred, smoothed or subject to an IAS19-type “corridor”.

Comments

- In practice there are very few major UK companies reporting under IAS19 which have chosen to use the “corridor”.

Chapter 5: Measurement of liabilities to pay benefits

Q6 The measurement of liabilities to pay benefits

- Regulatory measures should not replace measures derived from general accounting principles, but companies should be required to disclose the costs and liabilities on a regulatory basis. In the UK this should mean disclosing the Pension Protection Fund value of liabilities and the buy-out value.
- The discount rate should reflect the time value of money only and should be a risk free rate.
- Information about the “riskiness” of a liability should be disclosed and not be used to adjust the reported liability.
- The liabilities should not be reduced to reflect its credit risk.
- Plan expenses should be reflected in the liability.

Comments

- The liability should be at the lower of the buy-out value or the calculated amount. (5.14)

- The "risk free" discount rate should not be government bond rates, but the swap rate discount rate, which is rightly favoured by the Paper *"as a more liquid alternative with longer maturities available"* (6.37). The Pension Protection Fund uses swap rates to calculate its liabilities and, with *"full collaterisation, the risk and impact of default is small".* (PPF Annual Report p63)
- If the pension promise is from the government, then the discount rate should be the appropriate government bond rate.

Chapter 6: Measurement of assets held to pay benefits

Q8 Assets held to pay benefits <u>should</u> be reported at market or current values, when the asset is not actively traded.

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

Q9 When the assets and liabilities of a pension trust are not consolidated, the "net" asset or liability <u>should</u> be measured based on the difference between the values of the assets and liabilities if they were measured directly.

Chapter 8: Presentation in the financial statements

Q10 The different components of changes in liabilities and/or assets should be presented separately.

Q11 The reported financial performance of a company should reflect the actual return on assets, <u>not</u> the expected return, as in FRS17 and IAS19. Expected returns should be disclosed.

Comments

- Using “expected” asset returns in practice turns net finance expense into income for many companies, artificially improving their interest cover.
- The current accounting disguises the impact of the asset/liability mismatch of holding equities to fund pension liabilities, encouraging companies to continue running this mismatch.
- The volatility of reported performance is not caused by the proposed accounting, but reflects the underlying economics of holding equities to fund pension liabilities.

Chapter 9: Disclosures in the employer’s financial statements

Q12 The Paper correctly analyses the objectives of disclosure in the employer’s financial statements.

Comments

- Companies should be required to explain and quantify pension risk and risk management, consistent with discussion of their on balance sheet treasury risks - usually much smaller than their pension risk.
- This would include how they manage the asset and liability mismatch and sensitivities showing the impact of changes in financial and longevity assumptions, which have become best practice in the UK.

Chapter 10: Accounting for multi-employer plans

Q13 Multi-employer plans should be reflected in an individual employer’s financial statements using the same principles as those for a single employer plan.

Comments

- FRS17/ IAS19 allows multi-employer schemes to be shown as a defined contribution scheme, where the “joint-and-several” nature of the pension obligation makes it impossible to identify individual assets and liabilities.
- University Superannuation Scheme, with £30bn assets at March 2007, is the largest UK multi-employer scheme (and second largest UK funded scheme). Individual universities currently show only their cash contributions to USS, not their share of its assets, liabilities and costs.
- This means universities concentrate on their individual schemes for clerical & manual staff, but ignore the much bigger cost and risk of USS.
- The FRS17/IAS19 service cost for a multi-employer scheme can be calculated easily and individual employers should be required to recognise this cost, rather than the cash contribution, which is likely to be much lower.
- Individual employers should show in their balance sheet their (primary) share of liabilities, assets and deficit pro-rated to their share of payroll or FRS17 service cost. This reflects the economics that any deficit contributions would be pro-rated to their share of payroll.
- The existence of the “joint & several” liability should further be disclosed.
- Employers in UK unfunded public sector schemes have an obligation to make annual cash contributions to the schemes, but the obligation to pay pensions and make good any shortfall, rests with the Government. Public sector employers report their schemes as DC, because *“the employer’s contributions are set in relation to the current service period only (ie are not affected by any surplus or deficit in the scheme relating to past service of its own employees or any other members of the scheme)”. (FRS17 9a)*
- Public sector employers should be required to report annual costs on a DB basis, not a DC basis, based on a government bond discount rate.

Chapter 11: Financial reporting by pension plans

Q14 It is crucial that a pension plan's financial reports <u>should</u> include its liabilities to pay future benefits. This liability should, in principle, be the same value as the employer's liability shown in its accounts.

<u>Comments</u>

- Pension scheme accounts currently include financial assets held to pay future pension benefits, but do not include the underlying liabilities. Although the latest value of actuarial liabilities is disclosed this is likely to be out-of-date and to have been calculated on an arbitrary and inconsistent basis.
- The ability to ignore pension liabilities and have a "one-sided" balance sheet is a bizarre hangover from the days before FRS17 and IAS19 requiring corporate sponsors to show net pension liabilities in their own accounts.
- The value of pension liabilities in the pension plan accounts should be identical to the FRS17/IAS19 value in sponsor accounts, absent different reporting dates. In practice, it is possible, but unlikely, that the pension plan and sponsor would use different longevity, leading to different cash flows or use different discount rates.
- The P and L of a pension plan operates on a cash not an accruals basis, netting pension benefits paid against cash contributions received to show *"Net additions from dealings with members"*. The P and L then shows income from investments, change in market values and expenses to show a *"Net return on investments".*
- This cash "pay-as-you-go" approach encourages trustees, and employers, to believe the plan is "cash positive", because cash contributions are more than benefits paid, likely to be the case for most UK plans, which are still open to new accruals and are relatively immature.

- But cash contributions are not "income", rather they are to meet the cost of new pension promises made during the year, which increase pension liabilities. Using contributions to pay pensions is a form of pyramid selling.
- The plan P and L should mirror that of the sponsor, with the service cost shown as an operating cost, increasing pension liabilities. Cash contributions would not show in the P and L.
- Actual returns, plus the interest charge represented by the unwinding of the discount would be shown as financial income/expenditure.
- Simply transposing figures from the sponsor's accounts to the pension plan requires virtually no effort and cost.

Q15 A pension plan's financial reports <u>should</u> only show as an asset any amounts the employer is contractually obliged to pay. As always with long-term receivables, the cash value would be discounted for the time value of money and the employer's credit risk. (7.2) A pension plan's financial reports should NOT show as an asset any amounts the employer has simply undertaken to pay, but which is not legally binding.

<u>Comments</u>

- If a pension plan's liability exceeds its assets, then the deficiency is real not "apparent". Financial accounting should not seek to disguise this economic reality by showing an item to reflect the employer's covenant on the plan balance sheet.
- The plan accounts should report the employer's general legal obligation to ensure it has enough assets to pay the promised benefits, or any more specific agreement to do so. This is similar to disclosing agreed parent support for a subsidiary with negative net assets.
- Showing a "balancing item" *"an asset, based on the difference between the amount of its liability and the value of its assets available to pay those benefits" (7.5)* on the plan's balance sheet would give a misleading picture for trustees and members and creates a dangerous precedent for other financial reporting.

- Plan accounts should include the latest Pension Protection Fund and buy-out value of liabilities, which gives an idea of how much of their benefits they might lose in the event of the employer entering administration.
- The buy-out value is already included in the annual statement to members, but this is not updated. The marginal cost of updating this and including the PPF position is small.

General questions

Q16 I do not believe there are any UK pension arrangements which are not covered by the Paper.

Q17 I do not believe there are further specific issues relating to the cost and benefit of the proposals to be taken into account.

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