14 July 2008

Strictly private & confidential

Accounting Standards Board
Aldwych House
71-91 Aldwych
London WC2B 4HN

By email: asbcommentletters@frc-asb.org.uk

Dear Sirs

Response to consultation: Discussion Paper on The Financial Reporting of Pensions

Thank you for giving us the opportunity to comment on your recent discussion paper.

Our Scheme (the Tesco PLC Pension Scheme) is one of the largest private sector defined benefit schemes that still remains open to new employees in the UK – with around 155,000 employed members and over 240,000 members in total. The Scheme is valued by members for its simplicity and certainty.

Summary

We support the need for high quality accounting standards that provide users of accounts with transparent information on companies' pension obligations so welcome the discussion of what this may look like. However it is critical that pension accounting numbers are useful and do not create any unintended consequences.

There are a number of key areas in this document that give us significant cause for concern:

- This paper does not sufficiently address the fundamental question of whether fair value accounting is appropriate for pensions accounting, ie taking into account the particularly long-term and unpredictable nature of the liabilities.

- The arguments for using a risk free measure for the liability discount rate are no more convincing than for the current rate used of AA corporate bond yields which has to raise the question of "why change from one flawed system to another".

- In addition, the consequences of moving to a risk free rate would be so severe that they cannot be pushed to one side as it could affect the pensions of millions of people.

- The use of actual return on assets would cause significant volatility and should be avoided unless a new approach is taken to the income statement

We cover each of these points in more detail below.

We believe that unless a more fundamental review of the accounting methodology is undertaken the best way to support the current accounting treatment would be increased disclosure of cashflow projections and sensitivity of liabilities to assumptions. The benefit to cost ratio resulting from improved disclosure will be much higher than under the ASB proposals (where the cost to companies will be far more significant and the benefit to analysts will be limited).

Fundamental accounting principles

We have significant concerns over the validity of using fair value accounting for looking at pension liabilities. Whilst pension schemes are very long term liabilities and their cashflows vary only slowly over time in normal circumstances the use of fair value accounting leads to high levels of short-term balance sheet volatility.

Overall this means that a company's reported profits and losses are distorted by changes in interest rates and by point-in-time market movements. In addition the reported income and expenditure is not representative of the true economic cost of running the scheme.

Whilst this discussion paper describes itself as a "…fundamental reconsideration…" of the accounting standard it does not question this part of the methodology. In particular it does not question whether the wide disparity between actual and accounting costs of running a scheme put into doubt the validity of the accounting model.

Risk free return

We believe that the ASB's proposal that credit risk should not be allowed for in the value of pension obligations is inappropriate. There is no reason to ignore credit risk for pensions – it is generally taken into account in measurement of other obligations and it is the IASB's view that it should generally be allowed for. The question of inclusion or not of credit risk is one which relates to the purpose of accounts generally – and we find it odd that the ASB should try to make proposals on this in a pensions context rather than at a higher level.

The fact that scheme sponsors have options to reduce future benefits, to not provide discretionary benefits and to be able to invest in equities to make use of the higher expected returns all were accepted as the rationale for allowing for credit risk when FRS17 was being devised. These options all still apply as much today as they did back then and hence so does the rationale for keeping an allowance for credit risk.

We therefore consider the ASB's proposal to use a "risk free" discount rate to be no less arbitrary than the existing corporate bond based approach and to result in an artificial over-statement of liabilities.

Consequences

The argument is often made that accounting standards should not be influenced by their potential consequences because if the treatment is right then users will be able to make the right decisions. However, in this case the proposals will treat pensions more harshly than other types of obligation within accounts and will lead to fundamental changes in pension scheme accounting, so we think that consequences must be considered. We are extremely concerned that this approach will lead to:

- a speeding up of the closure of defined benefit plans, due to either an overstated valuation of scheme liabilities and/or profit and loss volatility affecting the perception of cost among decision makers. Whilst no accounting standard affects the fundamental cost of a scheme, the perceptions of cost driven by accounting standards do matter - it is no co-incidence that, since the introduction of FRS17 in the UK, the number of open defined benefit pension schemes has reduced from 80% to less than 20%. The proposed changes would artificially accelerate this trend which will have a significant impact on retirement security for millions of people.

- pension schemes are one of the largest investors in equities and the proposed changes will clearly have a major impact on the structure of capital markets as pension plans are much more likely to sell equities instead of bonds.

As such:

- it is critical that sufficient time is taken to make sure that stakeholders are given chance to respond on and debate any proposed changes. Also any decisions taken should have the support of the vast majority of stakeholders.

- the ASB needs to consider whether the proposals are 'fit for purpose' and do not lead to any unintended consequences.

Actual return on assets in the P&L

The use of actual rather than expected returns would cause significant fluctuations in the P&L from year-to-year. Therefore we could only find this acceptable if it were taken through the “financing” rather than the “operating” charge.

The users of the accounts will want to understand how well a business’ operations have performed and it will not be helpful to them to have to remove pension investment returns from the accounts figures to work out what is happening in the underlying business.

We would be pleased to discuss our views on any of these matters further if that would be helpful.

Yours sincerely

Ruston Smith
Group Pensions and Insurable Risk Director