TREASURY, RISK AND FINANCE PROFESSIONALS

The Association of Corporate Treasurers

Comments in response to
Discussion Paper on the Financial Reporting of Pensions
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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org .

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer* magazine, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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As your paper identifies, within this area of pensions accounting there can be many different arguments and justifications for various different treatments. Unless the justifications in one direction or another are overwhelming this can mean ending up with a pragmatic outcome to accept the least bad solution, knowing that it is not perfect and is possibly arbitrary. A good example of this is the debate over discount rates applicable to scheme liabilities, which is discussed below.

Response to specific questions

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 agree that the pension liability should reflect only benefits that an entity is presently committed to pay and therefore the consequences of expected increases in future pensionable salaries would no longer be taken into account up front but year by year only as increases actually occur. This means that a 10% increase in the salary of a long serving employee will have a far greater P&L cost than a 10% salary increase to a new employee at the same salary level. This is a fair representation of the effect of a pay rise and probably one that is not appreciated by all employers, because the accounting treatment thus far has not picked it up, but it is a very real economic consequence dependent on the accrued years of pensionable service.

Having said that expected increases should not be factored in we believe there is an exception to this. The present obligation should include future increases to benefits that are guaranteed by law or contract, so that expectations of such future increases would have to be reflected in the liability that arises during service. Furthermore if there is a constructive obligation to give other increases this should also be included. This means that if there is a genuine and realistic expectation that salaries will move in line with inflation this should be taken into account. We feel that this is justified if one takes as the unit of account the liability to the workforce as a whole. It may be possible to avoid paying some individuals inflation compatible pay increases for some time but taken across the workforce as a whole if a firm's pay structure becomes totally uncompetitive due to failure to keep up broadly with inflation that firm will be unable to attract employees. These points would presumably be taken up in discussions with the auditors.

Salaries relating to performance or promotion should not be taken into account until they happen.

While our proposals above relate to the accounting, we recognise that it may be perfectly sensible and appropriate to take some other approach to the regulatory funding needs of a DB pension scheme or to the sponsor's cash contributions.

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?*

As mentioned in Q1 estimates of the future may be better carried out if one takes as the unit of account a larger population where statistical measures will be more reliable. So, for example unvested benefits would, when taken individually, not be regarded as an obligation until they vest, but taken as a whole across the whole workforce it is possible to make estimates of the proportion of employees that will in time satisfy the vesting conditions, such as a minimum number of years service to gain a pension entitlement.

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

We agree with this approach.

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?*

We accept that taking a rigorous theoretical view if a company has control over the assets and liabilities of the fund there would logically be arguments for consolidating those assets and liabilities gross. However unless the company genuinely has the ability to displace the pensioners rights and can take over those assets or renege on the pensions promise it would present a misleading picture of its financial position for the company to show the gross positions. Rather than trying to open a debate on achieving some sort of consistency over consolidation rules we recommend sticking to the current approach which shows the net position and furthermore we feel that this remains the best presentation even where the assets and liabilities, as in Germany, are not segregated into a trust fund.

This gives a useful consistency with jurisdictions such as the UK where it is appropriate to recognise the separate legal entity nature of the pension scheme trust and the net liability or surplus (subject to conditions) is shown on the sponsor's balance sheet.

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?*

While the deferral method or corridor approach provided companies with a welcome smoothing effect to counteract the volatility in taking point of time market values for assets it cannot really be defended from a purist point of view. If one accepts that a balance sheet shows a snapshot of the financial position it is logical to recognize the gains and losses immediately.

However, this does then lead on to the further debating point as to whether revaluation differences should be shown as a separate category of profits. Users of accounts frequently say that in their analysis of accounts they are seeking to establish the sustainable underlying earnings and that short term volatility from long term pension assets are a distorting factor here. It is therefore essential that the current IAS 19 option to take actuarial gains and loses through the statement of recognized income and expenses (or Other Comprehensive Income) as an alternative to the P&L is retained. See also Q 10 and Q11.

As in Q1 what is appropriate for accounting is in this instance not so appropriate for determining the cash flow funding requirement of a pension scheme. Taking the longer term approach implies spreading revaluation gains and losses should be done in calculating funding needs.

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

i. *Regulatory measures should not replace measures derived from general accounting principles?*

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

iii. *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?*

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

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

(i) Regulatory measures are targeted on ensuring long term viability of pension schemes and can therefore quite properly take in more assumptions and expectations to ensure adequate funding **over time**. This can be different from and should not replace the reporting of actual performance to date in the accounts and the "snap-shot" picture inherent in balance-sheet reporting.

(ii) The proposal to discount liabilities at the risk free rate on the other hand is a concept that we cannot agree with. While there are arguments to suggest that an AA bond portfolio may not be optimal[1], we conclude that the AA bond rate is a suitable middle course to take. There are a variety of arguments supporting various different discount rates but in the end the decision will inevitably be somewhat arbitrary. We need a useful general rule rather than pursue an unattainable perfect measure. There being no overwhelming justification for a risk free rate we believe the accounting guideline should remain as is.

Before responding to the direct question, even though we disagree with using it, we would like to note that mention of the risk free rate itself is not clear. Should it be (for GBP) a Gilt rate or indexed Gilt rate? If liabilities ignore inflation uplifts, then logically the phrase should refer to the real risk free rate; and if inflated liabilities are used, it should refer to the full nominal risk free rate.

1) It is important to recognise that pension liabilities are neither sovereign government liabilities nor backed by sovereign government guarantees and pension funds are not obliged to invest only in sovereign obligations.

Many schemes have recently adopted a significant element of "liability driven investing" such that the asset and liability expected cash flow forecasts broadly match. Valuing shorter-term and liquid investments and liabilities is really not a problem. The issues arise in valuing longer term investments and liabilities.

Projected expected cash flows associated with longer-term investments should either be

a) after taking account of expected defaults and losses-given-default (or equivalent) in the asset portfolio.
Here, a discount rate excluding the default risk premium should be used. This discount rate will still be above the relevant risk free-rate (nominal or real, see discussion above) to acknowledge the point that a long-term investor can capture other constituents of the market return, notably liquidity and maturity risk premiums. OR

b) before taking account the of default effects.
In which case, a discount rate even higher above the relevant risk-free rate should be used to include also a default risk premium.

In valuing liabilities, it is not appropriate to apply the default element in the discount rate. However, to maximise consistency, the liability side should be discounted using the rate above the risk free rate in a) above. Given the availability of superior portfolios[1], we consider the AA bond rate is a reasonable and available approximation.

For such economically neutral strategies, the proposal to use a risk free discount rate on liabilities would result in a distortion of deficits or surpluses, introducing an imaginary effect that would not adequately reflect the economic reality. Accounts on that basis

[1] AA rated bonds have been highly concentrated in the financial and the pharmaceutical sectors. A portfolio of AAA and A rated bonds eliminating the sector concentration but otherwise with the same risk profile shows a significantly higher expected return

would not help the users to understand the economic substance and the overall financial position and results of the company.

2) If the company were to use a risk free rate, the very real consequence would be to throw pension schemes more heavily into deficit and therefore to hasten the closure of schemes and it is not the role of the accounting standard setters to be driving this sort of social change. Furthermore when the pension buyout market sometimes uses a rate nearer the AA bond rate (probably, in the end, on similar grounds to the arguments set out above) then there would be a gain to be had from sponsoring companies selling out as compared to retention of liabilities. Again such an accounting change would be driving actions that in the long run would remove from pensioners the comfort of an unlimited promise from the sponsor. The accounting profession should not ignore the real world impacts it could cause, namely encouraging scheme closures.

(iii) The accounts require a single amount to bring in as the liability so one should build in to that valuation the consequence of the riskiness around the flows to create a best estimate. However users of the accounts might find it helpful to have explained in the notes the extent to which, even so, there is a range of reasonably possible outcomes, by way of a sensitivity range.

(iv) We agree. By comparison in IAS 39 it is thought illogical to discount own liabilities using own credit rating hence one should not discount pension liabilities at the higher rate to reflect the risk of non performance of the pension promise by the company. We acknowledge that from the viewpoint of the pension recipient the credit standing of the Company (plus insurance) is highly relevant and could form a part of the discount rate. Recognition of this risk to the receivable in the pension fund's own accounts may be appropriate but within the sponsor company accounts it is not so much that the issue is illogical than that it produces perverse effects for regulators and users – lower liabilities and apparently a higher funding ratio for the more risky companies. For the most risky – about to become bankrupt with no prospect of recoveries – an infinite discount rate would be used and the value of pension liabilities would be nil.

(v) We agree with your conclusion that measurement of the liability should reflect expenses of administering the plan's accrued benefits.

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?*

Inevitably many aspect of pension accounting are based on assumptions, expectations and probability so is seems correct to align the accounting in this case with the economic position based on a probability weighted approach rather than a legalistic view. This is consistent with the statistical approach of using a unit of account taking in the whole workforce.

Q8 *Do you agree that assets held to pay benefits should be reported at current values?*

Companies may well prefer to report assets at some smoothed valuation and indeed this would avoid distortion to the financial position at time of severe market dislocation, however we have to accept that the nature of accounting means that a market point of time valuation does remain a verifiable and transparent method of valuation. A snapshot market value in the context of a plan that may run for 60 more years does have the potential to present a distorted picture, but then any smoothing methods would inevitably be arbitrary. However assuming we continue to use a point in time market value it is absolutely crucial, as mentioned in the answer to Q 5, that the full variation in values must not be recorded through P&L as this would distort the results from operations and the assessment of sustainable underlying earnings.

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?*

In this section you discuss the measurement of employer interests in the assets and liabilities of trusts and similar entities. You consider the ideas of consolidating the gross assets and liabilities, recording a right to reimbursement where the employer pays benefits directly or showing a net asset or liability or measuring the employer's liability to pay cash contributions into the future.

We agree with your conclusion 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?*

See below.

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?*

A10 and A11
Within this section you start from the assumption that in the future statements of financial performance will provide separate disclosure of operating activities, financing and other financial performance, and that the concept of a separate statement of Other Comprehensive Income is eliminated.

In summary you conclude that part of the change in a pension liability in an accounting period is due to service received and changes made to benefits: this should be reported in the income statement within operating activities. The return on assets and the finance cost relating to the liability (the unwinding of the discount) should be reported in financing, as should the effect of a change in the discount rate. Other changes relate primarily to changes in assumptions and should be reported as income or expenses, but not as part of operating activities or financing.

We agree that breaking down and quantifying the factors that have contributed to the change in the net asset or liability provides essential information to users to help explain the pension position, but we repeat our previous aim that the sustainable underlying earnings is a number that should be apparent from the breakdown and classifications.

This means that your idea of using the actual return (including revaluations differences) on assets to feed into the financing line would not be acceptable and would bring an arbitrary element of market volatility into the income statement. The current rule that the expected return from the assets is brought in and the balancing difference from the actual return is taken up in non operating and financing, by what ever name, presents a more meaningful picture. We accept that taking an expected return is not a perfect approach but it more closely reflects that the plan will be holding a very long term asset position and taking a view on overall returns rather than wanting to be driven by short term market effects.

We fear that if your proposals were adopted we would see more and more companies and analysts making pro forma adjustments to get to the underlying picture and causing damage to the reputation of accounting standards.

This goes to the core of the fundamental debate over what the P&L is supposed to show. We support the concept that the P&L shows a record of the transactions undertaken by management and that it is not simply the difference between the opening and closing balance sheet valuations.

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?*

In summary you are proposing that the disclosures should contain information explaining the risks and rewards from the provision of pensions such that:
(a) financial statements contain adequate disclosure of the cost of providing pension benefits and any related gains, losses, assets and liabilities;
(b) users of financial statements are able to obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those benefits; and
(c) the funding obligations of the entity, in relation to liabilities to pay pension benefits, are clearly identified.

We generally agree with the overall objectives you set out. In understanding the risks it is helpful to give an estimate of the sensitivity to changes in the many assumptions that are inevitably used. But even here we sound a note of caution. Sensitivities have the appearance of attempting to express a range of predictions but even these will be based on the asset and liability situation at year end, and that can itself be an assumption that may be changed e.g. the fund may decide to move from equities into a 100% allocation to bonds.

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?*

No comment

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?*

No comment.

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 comment.

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.*

No comment.

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?*

No comment.

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ACT

The Association of Corporate Treasurers

The ACT is the international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf .

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