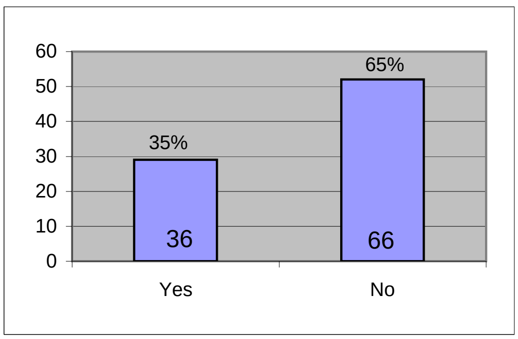
PENSION SURVEY- OUTCOME

Email invites: 1,500
Completes: 102 (7%)
Visits: 148

Launched: 27/06/2008
Closed: 07/07/2008
Comments: 19

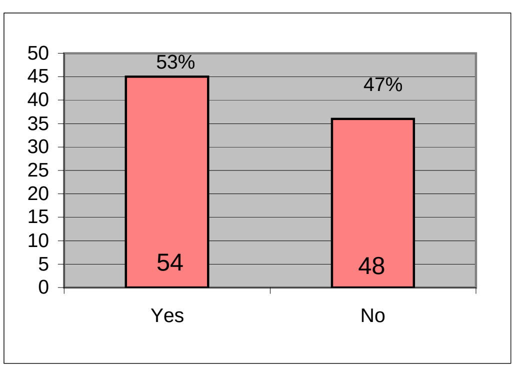
Question #1:

At present, the definition of pension liabilities recorded in the financial statements should include the effect of expected salary increases. A majority of the ASB, however believe that this should be changed so that liabilities would include all benefits for which there is a present commitment ie liabilities would reflect current salary levels (excluding those parts of the compensation package that are genuinely discretionary such as bonuses). **Should recognition be based on the principle of reflecting only present obligations as liabilities?**



Question #2:

The ASB is also proposing to change the rate at which the liability is measured to ensure that there is a reliable assessment of the appropriate level of funding. Currently future cash flows are typically discounted at a high-quality corporate bond rate. The ASB is recommending that this measure should be changed to a risk free rate believing that the riskiness of the liability should be shown in the disclosures to the financial statements rather than by adjusting the liability. **Should the discount rate for measuring pension liabilities reflect the time value of money only and, therefore, be a risk-free rate?**



<u>Question #3</u>: Do you have any comments on the ASB's proposals for the accounting of pension liabilities?

They are consistent with the way that commercial costs and liabilities in general are accounted for, and with the basis on which Life companies will report under Solvency 2 and Market Consistent Embedded Value. I consider them to be better economic common sense that the present accounting presentation.

There should be greater consistency in the assumptions used by companies. This will help to reduce the opportunities available for firms to pick the assumptions that minimise funding deficits. This is particularly important regarding expected return assumptions for the broad equity market. If an equity risk premium that is higher than standard, i.e. 3.5%, is used, there should be an explicit justification. For example, the investments are in very risky assets, hence the probability of a material shortfall is greater than if a lower return asssumption was used as a result of the portfolio being invested entirely in plain vanilla bonds and cash.

Corporate bonds reflect a company's borrowing costs, the risk free rate does not - this is a spurious debate and the ASB should stop wasting time on it.
The standard needs to be significantly simplified. There is too much scope for manipulating numbers and smoothing techniques. The actual deficit or surplus should be very clear. How the company is funding these liabiities should be clearly disclosed (asset allocation detail for example). If there is a deficit, there should be clear information about any cash contributions to be paid by the sponsor.

First and foremost, I think it is important that liabilities reflect conservative mortality assumption and then they are discounted conservatively, i.e. at risk free.

1) include all liabilities that can be (reasonably) expected
2) for discounting, use a rate that reflects the time value of mney and risk as well (for example, swaps, which are liquid and transparent for all maturities, including long-dated)

I strongly believe that liabilities should be discounted at the risk-free rate, any higher rate inplies an intention to default.

There should be easier to understand disclosure from the pension fund to the employee.

For question 1, as a minimum, the liability should include the effect of revaluation in deferment up to the expected payment date.

Many, I've written a response letter. I also disagree with the proposal to bring actual returns on assets into the income statement. I agree however with the proposals to remove deferral methods, include the effect of liability administration expenses.

The whole understand of pension liability is confused and becoming more confused. It should not be part of any companies balance sheet but should be held in trust for the benefit of the pensioners. The only liability the company should have is the percentage of its salary bill it is liable to contribute. Surpluses should accrue to the benefit of the fund and treated as a reserve against future shortfalls ultimately becoming taxable orphaned assets.

I think the ASB should support conservative valuations and continue to promote prudence.

Re question 2, I would use a Libor rate or something that is more liquid and flexible, although there is still a bit of risk. Maybe Libid for example.

The ASB should refrain from changing measurement standards too often as it causes unnecessary distortions, cost and short term behaviour. The measurement of liabilities should be fixed as the corporate bond rate or rate at which the corporate borrows and leave it. ASB should make it clear that this is a measurement of liabilities only.

Pension liabilities should be discounted back at the expected return on assets that finance this liability, i.e. normally a mix of equity bond and property returns. changing the calculation in this way would make pension obligations on the balance sheet much more easily understandable and would do away with the complicated reporting of income on assets and cost of liabilities at the discount rate, as they would unify both.
Happy to discuss further (ulrich_kaltenbronn@yahoo.co.uk)

Pension funds/liabilities should be shown in the BS based on the funding valuation and altered with the triennial actuarial review. As I understand it the FAS17 valuation is merely used as the accounting valuation in the case of attributing assets in an M&A situation. However, because it is there and is revised each quarter/half we have this crazy situation where analysts use it in their SotP valuations. As demonstrated by some of the recent pension buy-outs there is a country-mile between FAS17 and the funding valuation. Just glancing at the situation at C&W's FY08 results, showed that with a £20m injection into the PF, it was funded on an actuarial basis, whilst the FAS17 valuation was over £200m. So C&W elected not to recognise the £200m+ on the BS because in reality it didn't exist! This is just a ludicrous situation. Surely there is no need to value PFs (which probably have a duration of 30y+) on a quarterly basis.

There is a clear flaw with the current treatment of pension credits in the P&L. When a company books pension credits these are accounted for as if they are profits, but they are not profits in any real sense, since they relate to items that are subject to fluctuations in long-term assumptions and will only impact the cash-flow of a company over the very long term. For this reason I would like to see all movements in pension liabilities and assets kept off the P&L. All the analysts I know value the fundamental business of a company and then adjust the value of the business for the pension fund, rather than treating the pension fund as an integral part of the operating business. This seems to me to be a sensible way of treating the assets and liabilities of a pension fund, not artificially accounting for them via the P&L.

We can think of pension liabilities as corporate debt. If we adopted the same approach to the bonds issued by a company, equivalent treatment would be - issue bond of nominal 100 at par (say coupon of 6%) and then revalue the bond at the risk free rate (say 4%) and put it on the balance sheet at 125!
Furthermore bonds issued by companies are not marked to market where pension liabilities are!

The discount rate should reflect the asset allocation of the fund. In other words, we should return to the previous regime, which was based on common sense.

I agree that a liability should reflect only a present obligation (it's in the definition of a liability) but I also believe that a company making final salary pension promises has a present obligation to pay pensions based on the expected final salaries (thus the measurement should differ from that of a career average salary pension promise). So I cannot answer the question posed, as my agreement that liabilities are present obligations would be misinterpreted as agreeing that final salary pension obligations should be measured at current salary levels, ignoring future salary increases.

Regarding future salaries...there are strong arguments for only putting in existing salaries...A crucial determinant should be the Board's view on the wider debate on liabilities and achieving consistency with that.