ACCA

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Dear Andrew

The financial reporting of pensions

The Association of Chartered Certified Accountants (ACCA) is pleased to have this opportunity to comment on the issues raised in the above Discussion Paper (DP). The issues were considered at a recent meeting of ACCA's Financial Reporting Committee and I am writing to give you their views.

General observations

We support the general objectives of the DP to contribute to the debate on the future shape of pensions accounting. Though the most pressing problems are being addressed in the current IASB discussion paper we agree that a fundamental reconsideration of the issues is timely.

In our experience, the fundamental question of the recognition of pension liabilities in the balance sheet of employer companies remains one on which there is significant difference of views. Some see the estimation of pension obligations as sufficiently uncertain as to constitute unreliable information which may indeed mislead the user of the accounts. However, we agree that despite the uncertainties the liabilities to pay pensions should be recognised in financial statements.

Pension accounting is a particularly sensitive area for financial reporting. It raises questions of public policy because a wider group of stakeholders than usual are involved in the consequences of decisions made on the basis of that financial information – in particular employees and governments looking at financial provision for an ageing population. Any change should therefore be both compelling in the context of the conceptual framework and justified in terms of the cost/benefits consequences. We are not yet convinced that the proposals in the DP on the measurement of these obligations can yet pass those two tests.

Pension provision tends to be heavily regulated and different legal jurisdictions can thus have significantly different issues to address. The DP is firmly focused in the UK context and will need to be further 'internationalised' if it is to be influential at the IASB level.

We have significant reservations about the consideration of the discount rate and do not support the imposition of a risk-free rate. We believe further work is needed on the basis for the selection of an appropriate rate, both in terms of the coherence of accounting standards generally and the practical realities (for example in the management of funded schemes). Our strong preference is for companies to be given more scope for judgement about the appropriate rate to use in their circumstances and to rationalise their choice through disclosure.

ACCA's responses to specific questions raised in the DP

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 note that basing the liability on current salaries does make the accounting for final salary schemes essentially the same as average salary schemes. However such a basis does

- Represent the current extent of the legal commitment
- Produce a more satisfactory annual cost because the full implications of pay rises are reflected in the period in which they are entered into – the current salary effect and the pension cost derived from past service

Nevertheless we note that reflecting expectations of future salaries might

- be more consistent with other accounting standards such as IAS39 and IAS37 (for long term liabilities such as restoration provisions)
- reflect better the employee's perception of the different values of a final salary scheme and an average salary scheme for example

On balance we would prefer the current salary approach which reflects the contractual commitment to the employee at the time.

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?*

Financial reporting should be based on the reality that the pension commitment is to an individual employee and not to the workforce as a whole. Workforce averages are clearly useful in estimating the extent of the liabilities.

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

Yes.

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?*

Yes, we agree with the general principle of consistency in application of the consolidation boundary. We expect however that there will be difficulties in applying the concept of control to pension funds or trusts as the legal position tends to be variable and complex in a number of jurisdictions. There may also be a number of significant accounting implications from consolidation in terms of valuation of some assets.

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?*

Yes. The deferral of actuarial gains and losses and also their non-recognition, currently allowed under IAS19, are unsatisfactory in principle.

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?*
- *The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?*
- *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?*
- *The liability should not be reduced to reflect its credit risk?*
- *Expenses of administering the plan's accrued benefits should be reflected in the liability?*

We agree that regulatory measures should not in principle be the basis for the accounting measurement in the financial statements. We also agree that the costs of administering the plan should be taken into account when measuring the obligation. We agree that the measurement of the obligation should not reflect changes in an entity's own credit risk.

In all other respects we do not consider that the measurement questions (especially those concerning discount rates) have been adequately dealt with in the DP and more work is needed on fitting pensions into a coherent way of measuring the current values of liabilities. We noted that

- There seem to be a number of possible rates and the merits of each of these should be considered in developing any new pension accounting standard. The public roundtable discussion of the DP revealed a range of rates suggested as appropriate. The ASB's own paper on discounting from 1999 reached a different conclusion where there might be matching assets.
- It seems an inherently unsatisfactory conclusion in a paper attempting a fundamental reconsideration of pension accounting to say that risks should be included in principle but a risk-free rate is proposed because of uncertainty about what risks should be included and of practical implementation considerations.
- It is not clear in any case how a risk free rate is to be identified for such long run liabilities.
- There is an insurance project which is considering comparable liabilities

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under life insurance contracts.

The discussion needs to reflect the practical approach of those responsible for the discharge of pension obligations (for instance trustees of UK schemes) to their valuation in different contexts and to their management of risk.

In the absence of a more coherent principled approach, greater flexibility needs to be offered to companies to set an appropriate discount rate for their circumstances. The cases where the bulk of the pension obligations have been funded might for example be rather different from an unfunded scheme. The AA corporate bond rate currently used in IAS19 is noted as having no rational basis, but it may represent a compromise between a number of different rates – for example a risk-free rate, a rate linked to the expected return on matching assets or the marginal borrowing rate of an enterprise for it to fund the obligation – some of which have been used in the past or are currently used for discounting other sorts of liabilities. It would be important for management to justify and explain their choice of discount rate in such circumstances.

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?*

When there are options open to employees, the liability should be measured using the most probable outcome. This seems to be consistent with economic reality and with other accounting standards such as IAS39 and IAS37. Where the effect of such choices is material it should be disclosed.

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

We agree that current value should be the expectation for scheme assets as that would seem to provide the most relevant information to users. If the scheme liabilities and assets are consolidated into the employer company's accounts then this might involve special rules to be applied to scheme assets – closing off certain cost based options in IFRS (for example property plant and equipment, some financial instruments and investment property). Any new pension standard may need therefore to choose

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between the consolidation principle and some special valuation rules.

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, but see our answer to Q8 above.

Q10 *Do you agree that different components of changes in liabilities and/or assets should be presented separately?*

The DP has explicitly made an assumption about the future model of reporting financial performance and we agree broadly with the presentation of the different components on that assumption. Accounting standards are not yet at that point and so a different analysis might be needed until such a model is in place.

We note that where a net position in the balance sheet is shown there is some inconsistency between that and the performance statement. For example for a net pension asset, the separate presentation of an interest cost could only be understood in relation to the underlying liability shown in a note to the financial statements explaining the breakdown of that net asset. On the other hand we consider the component parts of the movement is important information for an understanding of the pension cost, whether the figure is net or gross on the balance sheet, and so deserves this prominence.

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?*

Yes. We agree that in principle the actual return should be recognised in the finance statements as this would reflect the events of the period. The disclosure of the expected return is important information to help with the assessment of the future cash flows and of the management's view of the trends in the pension cost.

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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?*

Yes we agree with the objectives.

We have noted in our answers to other questions above that various disclosures might be needed, for example if there were to be greater flexibility in the choice of discount rate. The basis of any allocation of a deficit or surplus in a multi-employer scheme would also be needed.

For some entities the possible disclosures scheme-by-scheme could be very extensive. Some guidance on aggregation and segregation of different schemes could be helpful in avoiding overwhelming details and high compliance costs, including the case of subsidiaries and group pension schemes.

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 we agree in principle with the objective. In practice this may be indeed be difficult and allocations may need to be made, in which case disclosure of the basis used would be important as noted in Q13 above.

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 agree that pension plans should include in their reports the value of the liability to pay benefits where the primary responsibility to do so falls on them. Where this is so it should be consistent with the principles used by employer entities, even if specific assumptions might vary.

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?*

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No. Separately valuing the extent of the employer's covenant as a balancing figure between scheme assets and liabilities does not seem very helpful. This would in effect be a minimum value for this covenant which might be worth much more, and might need to be if assumptions in calculating liabilities were to be different in reality. A discussion of the scheme's assessment of the covenant, including the credit risk, would be more helpful.

If pension schemes included the liability to pay pensions on their balance sheet but excluded the value of the covenant, the resulting figure would need a carefully worded description.

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.*

A significant advantage of the proposals in the DP is that the distinction between different sorts of pension promises is not fundamental to the way in which they are accounted for. The DP might helpfully have worked through a number of examples to demonstrate this – typical defined benefit and defined contribution schemes from existing standards, as well as some of the 'hybrids' that are dealt with in the IASB discussion paper for instance.

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?*

Changes in pension accounting are claimed to have had a significant influence on the continuance of defined benefit schemes and also on the investment policies of schemes. These risks should be a factor in any costs/benefit assessment of any new proposals.

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If there are any matters arising from the above please be in touch with me.

Yours sincerely

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