18 July 2008

Our ref: ICAEW Rep 83/08

Your ref:

Mr Stig Enevoldsen
Chairman
European Financial Reporting Advisory Group
13-14 Avenue des Arts
B-1210 Brussels

By email: commentletter@efrag.org

Dear Stig

THE FINANCIAL REPORTING OF PENSIONS

The Institute of Chartered Accountants in England and Wales (the Institute) is pleased to respond to your request for comments on Discussion Paper *The Financial Reporting of Pensions*, published by 'Pro-active Accounting Activities in Europe' (PAAinE) in January 2008.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

Desmond Wright

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FINANCIAL REPORTING FACULTY

ICAEW Representation

ICAEW REP 83/08

THE FINANCIAL REPORTING OF PENSIONS

Memorandum of comment submitted in July 2008 by the Financial Reporting Faculty of The Institute of Chartered Accountants in England and Wales, in response to the Discussion Paper *The Financial Reporting of Pensions*, published by 'Pro-active Accounting Activities in Europe' (PAAinE) in January 2008.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Discussion Paper *The Financial Reporting of Pensions*, published by 'Pro-active Accounting Activities in Europe' (PAAinE) in January 2008.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued. [I think there is now a standard bit we add in here about FRC and the people on it – see recent responses]

MAJOR POINTS

Welcome for the Discussion Paper

4. We welcome this Discussion Paper, which provides a timely, cogent and comprehensive analysis of the principles of accounting for pensions. The Institute has supported FRS 17 in the UK and its international counterpart IAS 19. We consider that FRS 17 has played a vital role in the UK in ensuring that the economic issues underlying company pensions schemes have become transparent and widely debated. However, we accept that neither FRS 17 nor IAS 19 is perfect, and we support the moves by the FASB and IASB to improve transparency in the accounting for post-employment benefits. This Discussion Paper makes an important contribution to this process.

ANSWERS TO SPECIFIC QUESTIONS

CHAPTER 2: LIABILITIES TO PAY BENEFITS

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)?

5. In considering what benefits the entity is committed to, the accounting for pensions should conform to the results of the wider debate on liabilities and the proposed revision of IAS 37. Assuming this continues to conclude that only an enforceable obligation (encompassing a constructive obligation) can appear on the balance sheet, then in principle constructive obligations to provide increased benefits should be included in the liability. However, the measurement of such a constructive obligation may be altered as a result of

the IAS 37 project, which might also have implications for accounting for pensions.

6. With regard to future increases in pensionable salaries we can see arguments in favour of both their inclusion and exclusion, because we can see arguments for both a wide and a narrow view of the entity's constructive obligations. For the 'wide' view, we acknowledge that salaries will generally rise and that a final salary promise differs from a current salary promise. Moreover, a final salary pension is clearly more valuable to the individual recipient than an average salary pension. However, on balance we believe that the pension liability should generally be based on current salaries, since the entity does in fact retain the discretion not to award pay increases to each individual within the scheme, or to award them in a non-pensionable way. However, as proposed in the Discussion Paper, to the extent that future pay increases are non-discretionary (eg, if negotiations with a union have committed the entity to increases for a number of years) then they should form part of the liability.

7. It may be difficult to determine when a constructive obligation exists for non-salary enhancements. If a scheme has a history of consistently giving discretionary enhanced benefits (ie, where the discretion has always been exercised), it may result in a constructive obligation. However, where the record is inconsistent - for example, if there have been one or more breaches - the position becomes less clear. It would have been helpful if Example 9 on page 37 had explored this issue by addressing the question of whether there is a constructive obligation to give an unreduced pension in the given circumstances.

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?

8. The existence of a liability should be based on the premise that it is owed to an individual employee, ie, the 'narrow' view outlined above. However, measurement should be on a portfolio basis - ie, based on the expectation across the workforce as a whole.

9. The discussion in the Paper rightly uses language such as 'valid expectation' in determining whether a constructive obligation exists in respect of an individual employee. It is difficult to see that the workforce as a whole could have a valid expectation, because it is only the individuals who make up the workforce who can have such an expectation.

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

10. We agree that recognition should be based on the principle of reflecting only present obligations as liabilities. However, this raises the question of how to determine what constitutes a present obligation. In our view, a liability arises as service is provided, giving rise to an obligation for both vested and unvested benefits. We find the discussion in 2.3.21/22 and 2.3.27 about service bringing into existence a 'stand-ready obligation' persuasive.

11. Turning to Examples 5 and 6 on page 33 (benefits commence respectively either at age 25 or after five years' service), we note the contrasting views that service prior to commencement of benefits gives rise to a stand-ready obligation, or that future benefits relate entirely to future service unless the employees receive a 'backlog' of benefits at that time.

12. We agree that no benefit arises in Example 5, because there is no prior eligibility for benefits and an employee could join one day prior to turning 25 and the next day become immediately eligible to join the scheme. However in our view a requirement for five years of qualifying service should be distinguished since during that time an employee is accruing a benefit (by each year having to serve one further year less before becoming eligible).

CHAPTER 3: ASSETS AND LIABILITIES - REPORTING ENTITY CONSIDERATIONS

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?

13. We agree that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate, although we note that while all plan assets would be at fair value if the scheme was not consolidated, some would potentially be at historical cost on consolidation. We can see also that this may give rise to a lack of clarity about the impact of the pension plan on the reporting entity's performance and state of affairs and believe that further thought should be given to how best to present this where the impact is material (for example by using segmented presentation either on the face of the primary statements or in the notes).

CHAPTER 4: RECOGNITION OF PENSION ASSETS AND LIABILITIES

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?

14. We agree that these changes should not be spread, since we can see no conceptual grounds for deferring the recognition of part of an asset or liability. However, this leads to a necessary focus on presentation issues since immediate recognition means greater volatility in the financial statements which might in turn lead to the adoption of sub-optimal strategies. We return to this matter in our response to Question 10.

CHAPTER 5: MEASUREMENT OF LIABILITIES TO PAY BENEFITS

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?***

15. We agree that regulatory measures should not replace accounting measures. However, if there is a material difference between the two measures, this should be quantified and explained in the financial statements. We note that where the effect of a regulatory measure is that an onerous contract is imposed on the entity, this means that the regulatory measure *is* the appropriate accounting measure. (This is the impact now formalised in current accounting by the introduction of IFRIC Interpretation 14*: IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*.) There might be other situations where this is also the case – eg, some settlements.

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

16. Moving the discount rate from AA to risk-free would increase the size of the liability, with deleterious consequences for company balance sheets. It is difficult to justify all the economic side effects such a change would bring - such as a further decline in defined benefit schemes and reduced capacity for investment by companies - without a clear and conceptually sound principle to support it. We are concerned that there is little apparent *conceptual* basis for adopting a risk-free rate (indeed, the discussion paper acknowledges that 'in theory the liability should also reflect a margin for risk'). This is difficult to resolve in the context of the anomalous treatment of pension assets (measured at fair value) and liabilities (discounted cash flow). We suggest that a principled solution can only be found by addressing the basis for measuring the liability in full, and not by looking at the discount rate in isolation (see also our comments in paragraph 17 below), for example whether the development of a buyout market for pension liabilities means that fair value might replace discounted cash flows as the measurement basis.

17. We are also concerned particularly that the model proposed in the Discussion Paper reflects no margin for risk at all, since it proposes (6.27) using 'best estimate' rather than risk-adjusted gross cash flows. This is inconsistent with the IASB's insurance project, which proposes (6.26) that probability-weighted estimates should be used, and inconsistent also with the general principle that either the cash flows or the related discount rate (but not both) should be adjusted for risk.

18. We do acknowledge that adopting a risk-free rate is a simple approach that would provide 'cleaner' information to the markets and that it may have anti-abuse benefits. We also share the doubts expressed in the paper that a higher-than-risk-free rate can be seen as the rate that appropriately reflects the risk of the liabilities. At the moment, the rate required by IAS 19 reflects the flexibility of management to reduce pension benefits. This flexibility does not need to be recognised under the model proposed in the Discussion Paper because the accounting will be based only on present obligations. However, management judgement will still need to be applied to apply the correct risk-free rate to the pension liabilities depending on maturity profile.

19. We understand that the result of using a risk-free rate might sometimes be a net present value higher than the buyout value. In these circumstances, we believe the appropriate amount to recognise is the lower cost of settlement, provided that that alternative is currently available (following the general principle of recognising the least cost alternative).

20. Overall, we believe the attraction of the 'simplicity' of the risk-free rate is not enough if a more sophisticated approach would produce a more economically faithful result. Thus, although a move to a risk-free rate may be appropriate, we believe a more persuasive conceptual underpinning is required, at least to deal with matching the cash flows and discount rate for risk, and more work needs to be done on this and the whole area of pension liability measurement.

- ***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?***

21. We agree. Although a risk-adjusted 'certainty equivalent' amount is theoretically superior, we agree that there are unknowable and unquantifiable risks, particularly because of the lack of an arm's length transaction on initial recognition of the pension liability. A 'risky' number augmented by disclosures is likely to provide the most useful information for users.

- ***The liability should not be reduced to reflect [the entity's] credit risk?***

22. We agree that the liability should not be reduced to reflect the entity's own credit risk, for the reasons set out in 5.7.10. In particular, for so long as its financial statements are appropriately prepared on a going concern basis, the entity has an obligation to settle its pension liability in full. Moreover, as the Discussion Paper points out, the entity's credit risk is irrelevant in the event of a buyout of the liability by a third party, since that third party is taking on a liability that is unreduced by the reporting entity's financial position. We acknowledge that, if an individual member were to prepare financial statements including the future pension as an asset, that asset might be considered impaired if the reporting entity's financial position weakens, but believe that this asymmetry would be appropriate. However, given the fundamental concept that pension accounting should in general use the same principles as those applied in other areas of accounting, any final conclusion that own credit risk should not be taken into account would have to be justified clearly.

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

23. We agree that where the costs of administering accrued benefits can be isolated they should be reflected in the liability. However, with regard to future levies, while we understand the argument for including them we believe that the appropriate treatment is simply to expense them as incurred, since in our view they are seen more appropriately as a periodic cost of having a scheme in existence.

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?

24. We can see arguments for both approaches, particularly with the emphasis that the ASB is putting on identifying and accounting for the entity's obligations. However on balance we support reporting an amount that

reflects the probability of the different outcomes. Reporting the highest cost would lead to a gain as and when the liability crystallised at a lower amount for a portion of the membership, as expected by the reporting entity, which would suggest that the liability overstated the entity's best estimate of the cash flows required to settle its obligation and therefore did not represent economic reality. This is also consistent with our view that the liability should be measured on a portfolio basis (see paragraph 8 above).

CHAPTER 6: MEASUREMENT OF ASSETS HELD TO PAY BENEFITS

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

25. We agree. This is in line with existing requirements and gives the most accurate measure of the funds available from which the plan will in due course settle its obligations.

CHAPTER 7: MEASUREMENT OF EMPLOYER INTERESTS IN ASSETS AND LIABILITIES OF TRUSTS AND SIMILAR ENTITIES

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?

26. We agree.

CHAPTER 8: PRESENTATION IN THE FINANCIAL STATEMENTS

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

27. We agree. The various components have differing predictive values and separate presentation will make it easier for users to identify them and to review them appropriately. We note that this is consistent with FRS 17 in the UK, but is not necessarily generally accepted practice in other jurisdictions. The final conclusion on how the various elements should be presented should be consistent with the principles determined by the IASB's wider project on financial statement presentation, including in particular the criteria it sets for gains/losses to be presented outside profit or loss or – within that figure – in an 'other' category. It is important to achieve a consistent basis throughout IFRS for the presentation of different aspects of an entity's reporting and we are pleased to note that the IASB, in its Discussion Paper of *Preliminary Views on Amendments to IAS 19 Employee Benefits* states that 'when developing an exposure draft the Board will decide on proposals for presentation in the light of progress in the project on financial statement presentation …'. We urge the ASB and EFRAG to encourage the IASB to make meaningful progress on this project as a great number of current financial reporting issues, as well as pensions accounting, would benefit.

28. Subject to the foregoing, in our view:

    (a) service cost should be presented within operating activities (together with settlement and curtailment gains and losses);

(b) the unwinding of the discount on the liabilities, and the effect of changes in the discount rate, should be presented within financing if a financing section is presented;

(c) the actual return on assets should be presented within financing, ensuring that the asset and liability sides of the financing element are presented consistently, if a financing section is presented;

(d) other actuarial gains and losses arising on the liabilities should be presented within operating activities, since they represent the revision of the originally estimated cost of providing pensions, unless the financial statement presentation project produces some alternative method of presenting such changes in estimates.

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?

29. We agree – see above.

CHAPTER 9: DISCLOSURES IN THE EMPLOYER'S FINANCIAL STATEMENTS

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?

30. We agree with the objectives. Although we have identified a number of desirable disclosures, we have general reservations about hard-wiring too many specific disclosure requirements into a standard. This should be looked at in the broader context of ensuring appropriate and relevant disclosures are given in financial statements on a principled basis, without falling back on a tick-box approach that can lead to irrelevant information swamping what is relevant.

CHAPTER 10: ACCOUNTING FOR MULTI-EMPLOYER PLANS

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?

31. We agree that the same principles should be applied to multi-employer schemes as to single employer schemes.

32. Where sufficient information is available about a multi-employer defined benefit plan, the employer should account for its proportionate share of the defined benefit obligation, plan assets and post-employment benefit cost associated with the plan, in line with the requirements of IAS 19. However, in the absence of the requisite information, it is still important that the employer should make every effort to calculate the appropriate share. We believe that any rational non-IAS 19 basis should be acceptable, on the grounds that accounting for even a simplistic best estimate (accompanied by disclosure) provides better information to users than no accounting, as it is easy otherwise to overlook the existence of the entity's obligation in this respect.

33. We note that the treatment in an entity's separate financial statements of its participation in a group plan is not addressed by the Discussion Paper. Within a group, we question whether there is a cost-benefit case for requiring those financial statements to account in this way, whatever the conceptual merits. We suggest that the current requirements of IAS 19.34A are satisfactory.

CHAPTER 11: FINANCIAL REPORTING BY PENSION PLANS

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?

34. We note that in the UK the law requires specific information including actuarial information to be presented to members and that general purpose financial statements are therefore not the only information available to them. The net asset statements of pension plans prepared for statutory purposes include the plan's assets, but exclude the liability; this information is given elsewhere. We responded in August 2006 to a consultation by the UK Pensions Regulator, confirming that we did not believe that this position needed to change.

35. However, while we agree that exclusion of the liability is a satisfactory solution for users of UK pension schemes' regulatory accounts, we do not believe that it provides an argument for excluding the liability from general purpose financial statements. In an international context, where general purpose financial statements may be the only information available to users, including the liability is necessary in order to meet users' needs. Furthermore, we can see no conceptual basis for excluding the liability from any general purpose financial statements of pension plans, since general purpose financial statements are designed to present comprehensive information of the entity's financial position and performance.

36. Having said that, we do not regard it as axiomatic that general purpose financial statements - designed to be 'useful to a wide range of users in making economic decisions' - will necessarily meet the needs of primary users of financial information about pension plans (ie, their members, whether active, deferred or retired). Regulators would be under no compulsion to require pension plans in their jurisdiction to prepare such general purpose financial statements, and therefore to follow IFRS. They could continue to require pension plan accounts to be prepared on whatever basis they chose to specify. No doubt in drawing up that requirement they would have regard to the level of information about the pension plan available to the primary users through other channels. The Discussion Paper might usefully have looked at the role of general purpose financial statements of pension plans in meeting the needs of primary users, including consideration of cost-benefit issues (which would be relevant also to the inclusion of any asset in respect of the employer's covenant – see below).

37. We agree that the *principles* for quantifying the liability should be the same as those applicable to the employer. As noted in the Discussion Paper, the assumptions made by the plan's management may well differ from those

made by the employer, so the amounts may differ. Again, there may be some cost-benefit issues arising from such variations.

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?

38. We are not sure that such a potential receivable constitutes an asset under the conceptual framework. Nor do we think that recognising an asset in the plan's statement of financial position in respect of the employer's covenant is the most helpful approach for users, although we acknowledge the tightly regulated framework in which UK plans, for example, operate and that the analysis of whether the definition of an asset is met may vary between jurisdictions. We do, however, agree that the specifically agreed contributions of the type described in 11.7.2 should be recognised as assets. Rather than recognise any further asset in relation to the employer's covenant, we believe that it would be more helpful to a user to show any shortfall and provide note disclosure about how the trustees intend to address it, including discussion about the regulatory environment in which the scheme and the employer must operate, and their assessment of the employer's ability to provide any necessary support, should asset returns be insufficient. We believe that this narrative approach better reflects the position that the employer might not in fact be called upon for the entire shortfall reported at the year end, as the plan evolves over its life.

39. There are also practical issues that in our view make recognition inappropriate, in particular that any assessment made by the trustees of the strength of the covenant – and, therefore, the measurement of any asset recognised – would almost certainly reflect confidential information that would not be available to third parties.

40. If, however, the ASB concludes that the employer's 'covenant' asset should be recognised, we agree that the amount should reflect the impact of the employer's credit risk.

GENERAL QUESTIONS

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.

41. As noted above, we believe that further consideration should be given to the recognition of group plans.

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?

OTHER ISSUES

42. Without commenting on the implications, we note that the higher liability that would most probably result from using a lower discount rate than at present – even combined with a tighter focus on committed benefits – would depress

the level of companies' distributable profits. There would also be distributable profit implications for companies participating in some multi-employer plans if the allocation key approach were adopted. Although not directly relevant to the proper financial reporting of pensions, this would be an important issue to consider in the context of practical application issues and cost-benefit considerations.

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