Response No.91

26 Chapter Street,
London,
SW1P 4NP
Tel: 020 7663 5441
Fax: 020 8849 2468
www.cimaglobal.com

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

E-mail: asbcommentletters@frc-asb.org.uk

23 July 2008

Dear Andrew

The Financial Reporting of Pensions

The Chartered Institute of Management Accountants (CIMA) is pleased to have the opportunity to comment on this consultation. CIMA is a global professional body representing accountants in business. CIMA represents over 164,000 members and students in 161 countries. CIMA is committed to high quality, global, principle-based, neutral financial reporting standards and supports the widespread adoption of International Financial Reporting Standards.

We welcome the ASB discussion paper as a comprehensive review of current thinking on the subject of the financial reporting of pensions. We are sure that the final report will provide a useful input into the long-term IASB project to produce a replacement standard for IAS 19 Employee Benefits. We believe that this replacement project should focus more on ensuring that future pension accounting is practical to prepare and provides useful information to users of financial statements and less on seeking theoretical precision.

Responses to the specific questions raised in the discussion paper are attached. However, we would like to make some specific points first.

We do not think the arguments in the discussion paper in favour of either the restriction to current salary levels or the change to a risk-free discount rate are logical. The valuations of pension fund assets used implicitly contain an estimate of future inflation and so does the discount rate applied to the future liabilities. Therefore the liabilities which are funded by these assets should also.

We also believe it is inconsistent to use a risk-free rate to discount pension liabilities. The same arguments could be used to justify a risk-free discount rate for other long term liabilities. This could lead to the requirement to recognise a day-one loss whenever an entity borrowed funds at normal commercial rates and we do not believe that this accounting treatment would convey useful information to the users of accounts. We see no need to change current practice.

We agree with the proposed removal of the corridor approach and other smoothing techniques as they are a source of complexity and opacity in financial reporting. There will undoubtedly be increased volatility in financial statements if these approaches are removed from pension accounting standards. As regards the income statement then it should be possible to explain this volatility (subject to the final outcome of the IASB's Financial Statement Presentation project) through appropriate presentation and clear narrative disclosure.

However we are more concerned with the effect on the balance sheet. Volatility in the recognised pension deficit can in some circumstances affect a company's ability to pay a dividend in the UK by significantly reducing distributable reserves in the parent company. This impact may have little to do with liquidity and we continue to call for a change in the law relating to dividend payments. We believe a solvency approach should be adopted. Loan covenants will also need to be reconsidered.

It is important that all involved recognise that the amounts included in financial statements in respect of pension obligations are subject to considerable uncertainty. The provision of sufficient narrative information is essential to allow users to assess the risks involved and place them in context.

Finally, we would like to commend the ASB for the brief guide that accompanied the main report. This is a very useful reference document which outlines the main recommendations of the report in a clear and concise manner and, we are sure, makes the subject more accessible to many.

We would be pleased to discuss with you any aspect of this letter that you may wish to raise with us.

Yours sincerely

Nick Topazio *Jim Metcalf*

Nick Topazio
Business & Financial Reporting Specialist,
Financial Reporting Development Group
CIMA
London

Jim Metcalf
Chairman of Financial Reporting Development Group
CIMA
London

Responses to the specific consultation 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 note that the discussion paper's proposal that the liability should be based on current salaries was a majority view of ASB members and we also find merits in both sides of the argument. It would seem consistent with other accounting standards that the liability to pay benefits is based on the benefits that the employer is presently committed to provide i.e. current salary levels.

However, this view seems to be divorced from the reality that every year the majority of companies award salary increases to their workforce and not to include these increases in the calculation of pension liabilities appears to be counter-intuitive.

One view expressed at our pensions seminar, was that measuring the future liability based on current salary levels would build up a wall of cost as employees got older. It would become prohibitively more expensive, if the full impact on the pension obligation was taken into account, to give a pay rise to an older employee relative to a much younger employee due to the number of pensionable service years to which the increase would need to apply. This could lead to inappropriate behaviour by some companies.

We believe that the question of whether or not to include future salary increases cannot be looked at in isolation from other areas of accounting for pensions under review in the discussion paper. For instance if pensions liabilities are to be based on no increases in salaries or other factors such as deferred rights this should be combined with using a 'real' (discount rate which excludes inflation.

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?

The legal form of the relationship is that the liability is owed to an individual employee rather than to the workforce as a whole. There are a number of decisions that are made on an individual employee basis that will impact the future amount of the pension liability such as when to commence membership of a pension scheme, salary levels, whether or not to take early retirement and whether or not to take part of a pension benefit as a lump-sum payment on retirement.

However, we are not convinced that this view should have any impact on the recognition of pension benefit obligations as we believe that the measurement of pension liabilities is best addressed from "a workforce as a whole" approach.

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

We agree in principle that the liability should only reflect present obligations existing at the balance sheet date. However, we would not want this principle to result in an entity not recognising a commitment to grant benefits relating to past service on the basis that those benefits have not yet vested.

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 agree in principle that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate.

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?

We agree with the proposed removal of the corridor approach and other smoothing techniques as they are a source of complexity and opacity in financial reporting. There will undoubtedly be increased volatility in financial statements if these approaches are removed from pension accounting standards. As regards the income statement then it should be possible to explain this volatility (subject to the final outcome of the IASB's Financial Statement Presentation project) through appropriate presentation and clear narrative disclosure.

However we are more concerned with the effect on the balance sheet. Volatility in the recognised pension deficit can in some circumstances affect a company's ability to pay a dividend in the UK by significantly reducing distributable reserves in the parent company. This impact may have little to do with liquidity and we continue to call for a change in the law relating to dividend payments. We believe a solvency approach should be adopted. Loan covenants will also need to be reconsidered.

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?**

  Yes. If an entity has agreed a specific cash funding plan with regulators then some believe that it would be difficult to justify recognising pension obligations on another basis. However, we currently do not agree. Regulatory measures will tend to adopt a prudent approach to the future and to concentrate on a pension fund's current ability to settle current pension obligations. We currently agree with the ASB that regulatory measures of liabilities should not replace measures derived from general accounting principles, because the principal purpose of regulatory measures is to control the solvency of pension plans rather than to provide financial statement users with decision-useful information about the underlying obligation to pay benefits.

It may be the case, in some jurisdictions, that a regulatory framework is used to prescribe the future payments that a company needs to make to a pension fund. If the calculation of pension deficits was to be based on these agreed future cash flows then this could significantly simplify pension accounting. There may be issues regarding the prudential nature of these agreements to fund pension schemes and we are also concerned with how pension schemes in surplus would be accounted for. However, as a mechanism to reduce complexity in accounting, we believe that more research could be undertaken in this area.

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

  We do not agree. We believe it is inconsistent to use a risk-free rate to discount pension liabilities. The same arguments could be used to justify a risk-free discount rate for other long term liabilities. This could lead to the requirement to recognise a day-one loss whenever an entity borrowed funds at normal commercial rates and we do not believe that this accounting treatment would convey useful information to the users of accounts. We see no need to change current practice.

  An alternative possibility would be to combine the use of a real interest rate with a restriction to use current salary levels as this would present a more consistent approach to inflation.

- **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?**

  We agree that risk information is best conveyed by disclosure rather than by adjusting the amount of the reported liability.

- **The liability should be reduced to reflect its credit risk?**

  If an appropriate discount rate is used then we agree that the liability should not be further reduced to reflect credit risk.

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

  We agree that expenses of administering the plan's accrued benefits should be reflected in the liability.

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?

We prefer an approach based on the probability of different outcomes.

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

We believe that the valuation method for assets held to pay pension benefits should be consistent with that of other similar assets held for other reasons. To the extent that categories of assets are generally reported at current value then we believe assets in those held to pay pension benefits should also be reported at current value.

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?

We agree.

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

We agree that the different components should be disclosed separately as this should provide more decision-useful information than a net presentation approach. Further, we agree with the presentation proposals of the discussion paper outlined in paragraph S32 on page 13.

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?

The expected return on assets is subjective and very likely for any individual year to be a poor indication of actual returns. We do not consider the use of expected returns in financial statements to be reliable and would prefer the use of the actual return on assets. Nevertheless over the mid to long term the expected return on assets may provide information useful for decision-making by users of the financial statements and we would support a requirement to disclose this information by way of a note.

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?

We agree with the general objectives of disclosure identified in paragraph 2.13 of Chapter 9. This paragraph states that disclosure should have "regard to the materiality of the amounts involved" which we wholeheartedly agree with. A debate as to whether a disclosure should be added or deleted should always include the question – does the benefit to the user of the financial statements of this disclosure outweigh the cost to the preparer to provide the information.

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?

We believe 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 and that the accounting standard should require preparer's "best efforts" to secure the required information to allow this.

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 a pension plan's general purpose financial report should include its liabilities to pay benefits in the future and that those liabilities should be quantified using the same principles as the employer's liability.

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?

We do not believe that financial statements should reflect an asset in respect of amounts that are only "potentially receivable". We believe that this type of information is best dealt with by disclosure.

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.

We are not aware of any types of pension arrangements that require further consideration.

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?

We do not have any further specific issues to raise.