PRAG

PENSIONS RESEARCH ACCOUNTANTS GROUP

Please reply to:

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25 July 2008

Accounting Standards Board
Aldwych House
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Attn: Mr A Lennard

Dear Andrew

ASB Discussion Paper – The Financial Reporting of Pensions

This letter is to introduce PRAG's response to your January 2008 Discussion Paper "The Financial Reporting of Pensions", and may I begin by thanking for agreeing to accept our late submission. Your help in allowing us an additional two weeks beyond the formal deadline to finalise our response is much appreciated.

May I, for the record and also to explain how our response is structured, just confirm PRAG's status and interest in this subject? PRAG is the leading UK independent research and discussion group promoting best practice in financial reporting and accounting in the pensions field. Its efforts are concentrated mainly on the communication of financial information by pension schemes to scheme members and other stakeholders, but it has also produced reports on other related operational and technical matters.

The membership of the Group comprises accountants, trustees and managers of pension schemes, together with practitioners in the actuarial, auditing and pensions consultancy professions. It therefore represents a very broad cross-section of pensions expertise, all of whom have a professional interest in the better communication of pension scheme financial information, and which between them represent the interests of a significant number of major pension schemes. The Group operates on an entirely voluntary basis, and is proud of it ability to produce high quality guidance and advice without any permanent secretariat or paid research and consulting resources.

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As you are of course fully aware, the Group is currently recognised by the Accounting Standards Board as the appropriate body to issue Statements of Recommended Practice (SORPs) governing the form and content of the financial reports of pension schemes.

This background means that PRAG views its expertise as:

- Grounded in the UK context of pensions legislation, regulation, history and practice, but aware of the impact of international financial reporting and European law and regulation;
- Centred on the reporting of financial and accounting information on pension schemes, but aware of the range of other information available to scheme trustees, members and advisers;
- Centred on the reporting of pension scheme financial information, but aware of the interaction with the financial reports of sponsoring employers.

We have therefore structured our response into 2 appendices, the first covering Chapters 1 to 10 of the Discussion Paper dealing with sponsoring employers' accounts; and one on Chapter 11 dealing with the financial reports of pension schemes themselves.

In both appendices, you will find comments which specifically reflect our experience and knowledge of pension legislation, regulation, disclosure and accounting in the UK and the occasional disclaimer that any particular comment should not be taken out of its UK context.

We do feel obliged nonetheless to make some introductory comment on the relationship of this consultation project with the development of International Financial Reporting Standards. The paper was issued on 31st January 2008, with the declared objective (1.3 of Ch 1) of contributing to the long-term review of the financial reporting of pensions by the IASB and the FASB. In the previous subsection the IASB was said to be undertaking a project that would address a limited number of topics in its first phase, aiming to issue an interim standard that improves IAS 19 *Employee Benefits* by 2011.

On 27th March the IASB issued a Discussion Paper *Preliminary Views on Amendments to IAS 19 Employee Benefits.* These are said to be short-term improvements, with the above mentioned long-term review described as taking "many years to complete".

Given the ASB's reference to 2011, it is not clear whether the recent IASB document is just the first installment of amendments that will appear over the next year or two or 2011 has suddenly become 2008.

With the two boards seemingly acting independently of each other, some PRAG members fear that there may be many separate consultations before the subject is finally addressed (presumably by the IASB). Piecemeal consideration of such a complex subject is both less effective and wasteful of respondents' time. In particular, some

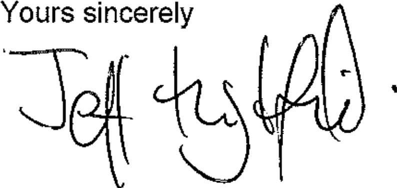
assurance that the IASB will, eventually, take into account the ultimate findings of the ASB's present review would be welcome.

Nevertheless, PRAG fully supports the ASB's implicit view that the financial reporting of pensions needs to be brought to a point of closure to give a period of stability and certainty to pension scheme sponsors, scheme trustees and scheme members. Accounting standards have behavioural consequences (a point covered in more detail in our first appendix) and PRAG's view is that the maintenance and expansion of the provision of good quality occupational pension schemes is behaviour to be encouraged. Uncertainty as to the future impact of the financial reporting of pensions on the reported financial position of sponsoring employers will deter employers from maintaining or expanding occupational pension provision. However, certainty bought at the price of unrealistic and inflexible assumptions about asset and liability values will only serve to accelerate the contraction and closure of occupational pension provision, which is the last thing PRAG would wish for.

Similarly, to take an example from the reporting of pension schemes' own financial positions, the issue of the inclusion of actuarial liabilities needs to be brought to a conclusion so that trustees, scheme accountants, actuaries and auditors can develop accounting systems, valuation practices and audit procedures that will serve them for a significant period. Previous consultations on this subject took place in the not too distant past, and the responses from PRAG and other interested parties (including the Pensions Regulator) were clearly and consistently against inclusion. Repeating a question does not necessarily lead to a different answer being given.

PRAG hopes that this current discussion process will be the start of reaching a long-term consensus on this major issue.

Yours sincerely



Jeff Highfield
Chairman

APPENDIX 1
PRAG –Response to Chapters 1 to 10 of ASB Discussion Paper "The Financial Reporting of Pensions"

1. Introduction

PRAG's constitution as a voluntary organisation with no permanent secretariat or research resources makes it difficult for us to respond in a systematic way to all of the points raised in the Discussion Paper relating to areas outside of PRAG's core expertise of financial reporting by pension plans. The comments below represent views raised by PRAG members on reporting of pensions by sponsoring employers, without purporting to be a comprehensive reply to the specific questions the ASB raise (i.e. up to Q13 of the Invitation to Comment).

2. Behavioural Consequences

Given the purported fundamental nature of the project, PRAG members are surprised that the ASB has not directly addressed the question whether particular proposals should be evaluated for the likely consequences in terms of interested parties' changes of behaviour.

A good illustration is provided at 2.4 of Ch 6, where, according to the ASB, "some commentators" have criticised the present accounting model in that it results in "structural deficits" being shown on the employers' balance sheets that do not represent the reality of the actual situation. Given that the plan's assets are expected to earn higher rates of return than the rate at which liabilities are discounted, the critics say that the liabilities should be viewed as adequately funded on a cash flow basis. Hence the application of the current requirements of FRS17 is potentially misleading. Significantly, the section goes on to cite claims that the [accounting] model drives entities to take decisions about funding and investment strategy (and perhaps benefits) that they would not otherwise have taken (and, it is suggested, they ought not to have taken).

A similar point considered by the IASB, presumably some years ago, and cited in Appendix E of Chapter 5, is where they are discussing the effect of discounting liabilities at a prescribed discount rate rather than the discount rate that is implicit in the fair value of the plan's assets (assumed to be biased towards equities). They quote critics as pointing out that the result will be a systemic overstatement of the [net] liability and misleading volatility. The conclusion is "these factors will deter entities from operating defined benefit plans and lead to switches from equities to fixed interest investments. Where defined benefit plans are largely funded by equities, this could have a serious impact on share prices. The switch will also increase the cost of pensions. There will be pressure on companies to remove the apparent (but non-existent) shortfall."

In the UK the introduction of FRS 17 resulted, in some PRAG members' opinion, in exactly what is quoted above, with a distortion of investment, funding and employment policy decisions. Arguably this has had the most serious consequences for very many employees and in due course for the State. The question is, what is the mechanism for considering the likely impact of accounting policies and evaluating whether the likely behavioural consequences are in the public interest.

3. Fair Value

Again, given the purported fundamental nature of the ASB's project, PRAG members would have expected some mention of criticisms that have been made about requiring the use of market values for measuring assets in financial statements.

Echoing concerns expressed in the previous section, one group of critics has focussed on the resulting behavioural patterns in banking, where a market price weakness for a particular type of instruments may precipitate a rash of selling for fear of having to carry the asset on a published balance sheet at a reduced value, with the concomitant unrealised loss being displayed. In effect, any fair estimate of the value to maturity that results in a higher present worth to the bank is ignored. Such perverse short-termist behaviour may be reinforced by the incentive system operating for those making the decisions. In the market the off-loading may well be self-feeding.

More pertinently, it has also been pointed out that valuing the pension fund assets at market value is a fundamentally different process from calculating the present value of the liabilities' cash flows at a chosen discount rate. This is for two reasons. First, the market value of any assets that did not match the bond or bonds that underlie the discount rate will be affected by a risk premium that is volatile. So a general shift in interest rate prospects will not be reflected in similar movements as between assets and liabilities. Since the net of the two present value figures – one for the assets and one for the liabilities – is, under both present and proposed practice, the key figure for the employer's balance sheet, this will lead to spurious volatility. (Hence the headlines about UK pension schemes' aggregate deficits lurching from one incredible figure to another, something that cannot be based on reality.)

The second, more fundamental reason is that it is not safe to say that the market value of a share reflects any useful view on the cash flows that the shareholder will experience (and on which, in practice, pension fund trustees have to rely). Everyday experience, as well as learned papers on the subject, tells us that from this point of view stock markets are not efficient. The Efficient Market Hypothesis is accurately described as just a hypothesis. Many PRAG members are of the opinion that accounting practice has come to rely far too much on market values and the supposed information they convey, simply because market values are relatively easy to obtain.

4. An alternative methodology

If, as the above criticism would have it, market value is not, in relation to pension fund assets, "fair value", the question is what alternative would be better. One solution could be for estimated future cash flows to be established not only for benefit payments but also for future normal contributions and the cash flows arising in the pension plan's portfolio of assets. For each future period a net cash surplus or deficiency is then established and the resulting net cashflow pattern is then discounted back to a present figure that represents the actuarial deficiency or surplus. In either case, a note would then be required explaining how this will be dealt with – by way of extra employer contributions or an abatement of such contributions.

It is hard to see why there can be any objection to estimating cashflows on the assets side when the existing process relies entirely on such estimate to calculate the liabilities. No doubt appropriate disclosures of key assumptions, as well as some comparison of outturn against previous estimates can be required, so as to add confidence. If accounting theologians need such a prop, the amount implicitly assigned to the plan assets can be said to the *value in use*.

5. The discount rate

The above suggestion still requires a choice as to the discount rate to be employed. As we understand it, economists who are used to doing these things would discount at the pension plan's cost of capital, but this would presumably be considered too high by standard setters, along the line of argument that led to the adoption of the AA bond rate and, in the Paper, a risk-free rate.

In arriving at a decision on this, PRAG members think that due weight should be given to the recent phenomenon of buying out (final salary) liabilities, where, in negotiations as to the premium (price), the insurer may reveal that internally they regard a rate of return at least equal to the AA bond rates as safely attainable, so that their estimate of the liability they are taking on is correspondingly less than it would be if their model used a risk-free rate.

In passing, we would point out that, to a degree that may be regarded as significant, a sort of market value for pension liabilities is discernable in the buy out process. Going back to the point about behavioural consequences, if, as the Paper suggests, liabilities are valued at the risk-free rate, a company may make an apparent profit by persuading the plan trustees to buy out some or all of the liabilities for a lesser sum, when the reality is that the plan could have continued to service the liabilities more cheaply, even making due allowance for the greater certainty of outcome down the insurance route. After all, the insurer's premium will include both the cost of extra capital reserves they are required to hold and, of course, a profit margin.

Another point to consider regarding the discount rate is that, under the above proposed netting off of cash flows, the use of a lower discount rate will increase a surplus as much as it would increase a liability, i.e. above the respective levels that the trustees, on the advice of the actuary, may be funding for.

When talking about applying a discount rate, we understand that nearer term cash flows will have a different rate applied than those with a longer term, based on the current yield curve considered typical of the instrument that defines the state of the market. Hence an employer with an immature plan will experience less volatility in the balance sheet position than one that has predominantly pensioners' liabilities to service. This seems entirely reasonable.

6. Caveat

PRAG members who have raised these points are at pains to point out that their knowledge of the sort of economic modelling that is being put forward above is entirely second hand. They are merely commending the thoughts of others, which, they would argue, should have been at least considered by the ASB, if the present exercise was to be regarded as fundamental.

Some PRAG members go even further and question whether accountants should risk their reputations on the sorts of calculations, which appear to lie more in the field of economists and actuaries. There is of course a respectable tradition of accountants and auditors relying on the work of other experts, for example in asset valuations. In the opinion of these PRAG members, what is discussed in the ASB's paper is of a completely different order of magnitude. It has been commented that actuaries and accountants may measure assets and liabilities in what they both call pounds sterling but it doesn't follow that the resulting values can be consolidated so that the net result delivers any useful information.

7. Regulatory measures of liabilities

At first glance, PRAG members were inclined to concur with the conclusions of 6.19 of Chapter 5, i.e. that regulatory measures of liabilities to pay pensions should not replace measures derived from general accounting principles. This was because the discussion opened with a description of the *technical provisions* required to be covered by EU legislation. This seemed both remote from accounting and, moreover, an international concept that did not match UK requirements.

However, what became clear is that the consequences of setting technical provision, i.e. adequate funding targets, is, as 6.14 explains, very often for the employer to be committed to a particular cash flow pattern. If his covenant is deemed to be weaker, then the more up front will be the required schedule of contributions. The UK is now becoming familiar with this type of regime, with funding contracts established between the employer and the fund trustees that override the scheme's trust deed.

In the light of this new way of establishing the most likely pattern of employer contributions, particularly in relation to the near term (say, five to ten years) where the present value calculations give most weight, some PRAG members suggest that this may be a concrete way of calculating the employer's net liability. We urge the ASB to consider this further.

8. The ASB's questions

As will be appreciated from the foregoing, the PRAG members who have contributed do not find the ASB's questions very useful because the present general methodology is taken for granted. An exception is Question 1, where it seems logical, if the figure for liabilities is (still) to be calculated separately, for future salary increases to be ignored. However, if the net liability is to be based on expected cash flows, the reality is that the recommended pattern of normal contributions will allow for future salary increases and it would be perverse to construct an alternative model.

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APPENDIX 2
PRAG –Response to Chapter 11 of ASB Discussion Paper "The Financial Reporting of Pensions"

1. Introduction

Chapter 11 raises two major questions: whether future pension liabilities should be included in pension scheme accounts and if so whether the employer's covenant should be reflected as an asset. It also proposes that pension scheme accounts should include further disclosures.

2. Liability for future pensions

The Paper starts from the premise that pension scheme accounts are general purpose financial statements and that as such they are the most appropriate way of delivering information to readers of scheme accounts, and to scheme members in particular. Most PRAG members would contend that it is not appropriate to view pension scheme accounts as general purpose financial statements since legislators and regulators have long considered their primary function to be a stewardship document concerned with assets, liabilities (other than future pension liabilities) and financial transactions.

The vast majority of PRAG members would also dispute on practical grounds that the financial statements represent the most appropriate way of delivering actuarial and benefit information to scheme members. In the UK members are given information about their scheme through a variety of other means with the accounts playing a minor role in this respect. The information regarding future pension liabilities is given in actuarial statements, individual benefit statements and more recently in the Summary Funding Statement (SFS). The present SORP recommends the inclusion of the SFS or relevant extracts in the annual report. Members are therefore already provided with relevant information and have rights under various disclosure regulations to call for more detailed information.

PRAG members are very firmly of the opinion that including a value for future pension liabilities calculated for trustees' accounting purposes and therefore differing from values calculated for employers' accounting purposes can only serve to confuse scheme members and deter them from using the schemes' financial statements at all. There is no evidence that readers of scheme accounts are crying out for schemes to transform their net assets statements into balance sheets, or that there are material gaps in meeting their information needs from a variety of sources. PRAG concludes that present accounting requirements already produce financial statements that are generally sufficiently useful, when taken together with the SFS and other disclosures, to assist scheme members with the limited decisions they have to make in relation to their scheme.

3. Increased costs

Many PRAG members (including those who work in pension scheme audit, for whom there would be a major impact) would dispute the Discussion Paper's contention that there would not be significant increases in costs involved in additional actuarial, accounting and audit work, and of course management time, to incorporate future pension liabilities in scheme accounts. The Paper provides no evidence or conclusions of any research that cost increases would be trivial, and does not

attempt to justify any additional costs in terms of the value of the additional information delivered to readers. The overwhelming view of PRAG members is that the value of extending the scope of scheme financial statements in this way is tiny, and may even be negative, and so cannot justify any additional cost burden.

4. Employer's covenant

The Paper also asks whether the employer's covenant should be recognised as an asset. Clearly logic dictates that if a liability for future pensions were to be recognised, then the corresponding asset represented by the employer's covenant to fund any deficit should also be recognised and that this asset should reflect the employer's credit risk. PRAG members foresee enormous practical difficulties, however, and potentially significant additional costs in implementing such an accounting policy. Valuing the employer's covenant is a technically difficult and specialist task, which additionally may produce significant potential conflicts of interest for trustees. These problems may often only be resolved by the use of expensive independent consultants. In either case, commercially confidential information would be required to generate such assessments, and in the case of public companies such information may well be price sensitive. The accounting and audit work following an assessment would incur still further costs.

Some PRAG members have also raised issues concerning other potential claims or covenants upon which trustees could draw, including, for eligible final salary schemes, the underlying guarantee provided by the Pension Protection Fund to meet 100% of pensions in payment and 90% of pensions in deferment. Is it the ASB's intention that any write down of the employer's covenant to reflect credit risk should be countered by an asset representing the value of any claim on the PPF should the employer's credit risk be crystallised in an insolvency event? What does the ASB think this might add to the readability of the scheme's financial statements?

These considerations are a good example of the difficulties of applying the "decision-usefulness" criterion to pension scheme accounts. What decisions is a scheme member expected to make if the trustees take a view on the credit risk of the employer? New employees can decide whether to join the scheme; members in employment can decide whether to cease active membership; members in deferment can decide whether to take a transfer value; for pensioner members it is too late to make any decisions at all. Skating over the question as to whether the provision of such detailed information verges on giving financial advice, PRAG members would contend that all categories of scheme members are made aware of these possibilities by other means of communication. In many cases, these communications are more promptly available and more reader friendly than a complex set of financial statements produced up to seven months after the end of a financial period. Furthermore members would need a detailed analysis of the relative priority of different classes of benefit, the impact of PPF protection and so on in order to take the decisions.

5. Further disclosures

Finally, PRAG members would wish to comment that all the (admittedly anecdotal) evidence available to them indicates a demand from scheme members to simplify and consolidate, rather than extend and complicate, scheme disclosures. Some have commented that it is disappointing that a purportedly fundamental review of

scheme accounts seems to be leading to a recommendation to make them ever more complex and impenetrable to the ordinary reader, and to risk incurring real additional costs to satisfy theoretical accounting demands.