Reaction on Discussion Paper

The Financial Reporting of Pensions

INTRODUCTION:

Overall position and suggestions.

The present ideas about the pension liabilities and investments made to pay for those liabilities seem to me not to reflect the long term impact that pensions have. Due to the current system, changes in interest rates can immediately have a serious effect on both the liabilities as well as the expectation for the investments that cover those liabilities in any current year. In another year the effects could be going in a opposite direction.

The present presentation of the whole pension situation in the notes to the accounts has as a result that in charity accounts (as well as those in the commercial companies) there are about two to three pages that almost all users/readers of these accounts do not understand. They provide information for insiders who understand what all the terminology means. For almost everybody else it is next to impossible to understand which figures are taken into account in the P&L/SOFA and which figures are not part of the P&L/SOFA.

The approach I propose may meet a lot of opposition both from auditors and others as they may feel that the accounts may not reveal all the ins and outs of pension. Yet I feel they should not reveal all these ins and outs on a year to year basis, but over a longer period that reflects better the long impact on pension liabilities.

The pension benefits, liabilities and the assets set aside to pay for these liabilities should be part of a separate statement to the accounts and guided by actuarial evaluations and calculations. Possibly, as an annex to the accounts or a special statement after the cash flow statement, but it should not be incorporated in the P&L or SOFA.

I would strongly suggest that in the SOFA/P&L the pension costs for that year will be taken into account as part of the staff costs. The actuary should annually determine what the contribution for pension should be, based on:
a. the current employees building up pension rights and
b. the possible 'gap' between assets and the actuarial liabilities to be paid off in 10 (or other agreed number of) years.
The total of these figures (possibly separate) are the only pension costs and pension transactions in the P & L.

For smaller companies < 150 (total of active, deferred pensioners and pensioners) and/or less than US$ 5 million liabilities: the actuary should recalculate this figure every three years; for all other companies it should be recalculated every year.

What in these years results from the investment performing better or worse than expected, or from the actuarial losses or profits, or higher or lower inflation rates, should not have an effect in the P & L of that year (alone), but should be reflected in higher or lower pension contributions calculated by the actuary for the following years. And indeed under the staff costs it could be clearly stated that the pension burden for the current staff is 'x', while the company will pay the coming 10 (or other agreed number of) years an additional amount of 'y' to bring the pension liability to a fully funded level.

If due to favourable investment results or actuarial gains the pension contribution could be lessened, then it should also be spread over a period of 10 years (no contribution heaven for 1 or 2 years), as the situation over that period may change again. In that way the year to year changes will not be that dramatic, will be calculated in the very beginning of the year and therefore not have many serious surprises.

The special separate pension statement will result in either a shortage or a surplus in the pension fund. It seems to me proper to incorporate that figure in the balance sheet , being more or less the present value of the ‘z’ years commitment that is still outstanding. It could be a separate line in the reserves (negative, if there is a ‘gap’) as it is a result of paying less than required for pensions in the past and thus too high retained profits in the past on which this is a correction. This could result in a straight transaction in the reserves.

Now the questions as presented by the ASB:

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)?
It should be based on current salaries, including clearly contractual committed increases. But not based on habitual increases and such as they may differ according to different (economic) circumstances.
The increase for future career developments should not be part of the present liabilities, neither should salary increases: these are resulting from decisions to be taken in the future and they should not be incorporated in the present.

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?
It should be based on the liability owed to an individual, yet where it is appropriate general assumptions for the whole workforce may be applied. The risk that the workforce as a whole does not meet average criteria is too high, so the start is from the individual. It may have some implications on the issue raised under Question 1.

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

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?
NO, the pension business is a long term issue in principle and therefore should not be propped in a one year limit. It is also different from other liabilities because of its nature and the way it is funded. (See the introduction part). The actuarial developments and the investment performance of the very year will have an impact of the future years and should therefore not be part of that very year alone.
In a pension paragraph in the notes to the accounts, the pension costs for the current staff as well as the additional costs (or reduction) to bridge the gap between assets and liabilities in a certain period (10 years, but even 20 is not bad, seeing the long time liability). Furthermore it could be explained how the next years costs do relate to the past years costs.

Q6 Do you agree with the paper's views in the measurement of liabilities to pay benefits?
Not entirely, the approach looks to be too cautious.
Inparticular, do you agree that:
- Regulatory measures should not replace measures derived from general accounting principles..
Agreed as long as the specifics of Pensions are taken into account.
- The discount rate should reflect the time value of money only, and therefore should be a

risk free rate?
NO, whether there exists a complete risk free rate may be a theoretical question, but since not all investments will be done against the risk free rate, there is no reason to calculate the liabilities on that 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?
Agreed, but where the actuary is rather certain about his/her assumptions and basic rules it should be incorporated and not left to words alone.
-The liability should not be reduced to reflect its credit risk?
Agreed, a company should always be prepared to honour its commitment to (former) employees. In case of a foreseen bankruptcy then special calculations should apply as always.
Expenses of administering the plan's accrued benefits should be reflected in the liability?
Agreed.

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 ?
If the choice is beyond the employers' control it would be prudent to report the highest amount; if there are however figures from experience about the choices made in the past, they may well be taken into account when assumptions in this respect are made.

Q8 Do you agree that assets held to pay benefits should be reported at current values?
Yes the normal valuation rules for assets should apply.

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?
Looks appropriate.

Q10 Do you agree that different components of changes in liabilities and/or assets should be presented separately?
YES, as long as they will not be part of the annual P&L or SOFA, but on a separate statement (See introduction).

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
NO, not on a year to year basis: over a longer period that starts from the very reporting year, the underperformance of investments against the expected return will lead to additional contributions which will be part of the outstanding commitment (see introduction).

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?
The objectives are fine.

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?
The multi employer plan will definitely have an actuary to advise them. If the premium or contribution is set according to the individual employees the employer should get the information required to put in their accounts. If there is a general contribution then the actuary should be able to give all the information based on the share this particular employer has in the multi employer pension plan.

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?
YES, as that may give the members the right information. Indeed the liabilities should be quantified in the same manner. At the same time in many cases the Pension Plan will only act on behalf of the employer and be given all the information by the employer. The real liabilities are still resting with the employer, I believe. In very few cases the Pension Plan has taken over the liabilities as such. Yet to give the full picture for the participants/members, I feel that they should have insight in the funding gap if that exists.

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?
It should indeed reflect an asset in respect of the amount receivable from the employer, as the employer is likely bound by the Pension Plan's constitution to make sure that enough funds will be made available to fulfil the commitments; it is the employer who has given the employees the pension rights and therefore created the liability and the Pension Plan could well be set up to set aside and safeguard the assets, but if the Plan may fall short of the pensioner's expectations, they may likely sue the employer and not the Pension Plan.
It is therefore not a good idea take into account the credit risk of the employer. He is to pay for the gap anyway, so if the credit risk would lead to a 90% value of the debt, who will pay for the difference? The full amount should be presented, unless there is a foreseeable bankruptcy, when all other kind of calculations and valuations will fall in place.

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.
Not known to me.

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?
See the dissident approach in the Introduction to my comments.

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