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Dear Sir

The financial reporting of pensions

UK – Pension funds provided by the top 100 UK-listed companies had a combined surplus of £40bn at the end of March, according to figures from Watson Wyatt.

... the consulting firm found the FTSE 100 companies had combined surpluses to the tune of £40bn on an FRS17 basis – the largest sum since it began monitoring pension fund surpluses and deficits in 2002.

While listed equity prices fell in March, surpluses still rose by over a third because the increase in corporate bond yields was strong enough to counter the equity losses....

*"The credit crunch continued to increase companies' borrowing costs during March, **thereby reducing the measured value of pension liabilities**. This is the principal reason why surpluses increased from £29.2bn to £40.4bn, despite this being a month in which pension assets were clearly badly affected by falls in equities. **It underlines the volatility of pensions accounting numbers.**"*

I am responding to the above consultation in a personal capacity and as the former financial secretary of the Church Commissioners. The Church Commissioners, now an investment fund of over £5billion, have clergy pension liabilities which were first subject to formal actuarial assessment in 1993. At that date it was found that the clergy pension liabilities were of a similar size to the entire fund. Following the restructuring of the clergy pension liabilities in cooperation with the Church of England, they amounted to just over half the fund in 1998 and have now declined to under 30%. The Commissioners have used actuarial methods since 1993 to monitor their clergy pension liabilities and determine their spending levels and, in particular, explicitly use actuarial assumptions which are even-handed, with no margin for prudence. They also use a heavy degree of smoothing of the results of actuarial reviews when setting their distributions (analogous in their case to a company's contributions to its pension fund). This has to date been a successful approach. Alongside excellent investment performance, it has provided a reasonable measure of the clergy pension liabilities and has stabilised their distributions. It has protected the Commissioners and the Church from the onerous fluctuations in pension surpluses and deficits, as portrayed under FRS17, which have contributed to the closure of many defined benefit schemes. Because the Commissioners' financial statements do not include the clergy pension liabilities, so that they do not have to measure their liabilities using that standard, they have focused their attention on measures which better enable them to measure and manage their long term pension liabilities and their distributions.

I am now a member of the Board for Actuarial Standards. I have been assisted by the report of the Value Working Group of the Board and by the March 2008 exposure draft of its conceptual framework for actuarial standards. Nevertheless, this response is made in a personal capacity and does not represent the views of the Board or its other members. I am also chairman of a defined benefit pension scheme.

This response is concerned wholly with defined benefit schemes and the traditional method of employers funding them by setting money aside in a pension fund. It accepts that the assets and liabilities of the fund should be included in the employer's financial statements. It is concerned with the

financial, or actuarial, assumptions used in the employer's financial statements to value the assets and liabilities of the fund. ¹

In order to enable the various methods to be assessed, relevant key concepts underlying financial statements may be summarised as follows:

Going concern² - Assets and liabilities are valued on the assumption that the entity will continue in business. No adjustments are made to write down assets, such as plant or work in progress, or to provide for liabilities, such as staff termination payments, which would arise on cessation of business.

Stewardship – The financial statements portray the results of the directors' stewardship of the entity, to enable investors to assess their performance.

Decision usefulness³ – The financial statements provide historical information which assists investors, potential investors and others to assess future cashflows and to make economic decisions.

No prudence – Assets and liabilities are valued in an even-handed manner. There is no deliberate bias towards valuing on a prudent basis. By even-handed is meant that the valuation has the intention that, on liquidation or settlement of the asset or liability, more favourable outcomes, than the amounts shown in the financial statements, are just as likely as less favourable outcomes, in terms of probability and amounts combined. The valuation is the mean, or average, of the possible outcomes.

Consistency - Assets and liabilities are valued consistently with each other.

Substance over form – The legal form of transactions may not represent their economic substance. The latter should be represented in the financial statements. FRS5 is a key standard in this area.

It is the central contention of this response that all these concepts are breached by FRS17 (except for the last concept) and by the proposals in the discussion paper.

FRS17 and the discussion paper both appear to regard pension liabilities as obligations which will be settled by a payment to a third party, such as an insurer, to assume them from the entity. Hence they require the use of a discount rate based on, respectively, corporate or government bonds, as these are regarded as akin to the rates used by insurers in such transactions. This is fundamentally the wrong approach to such liabilities. Although there have been a small number of transactions by entities with insurers, the overwhelming majority of pension liabilities are settled in due course by the pension fund established by the entity for this purpose because this, although risky, is likely to be the cheapest way for the entity to meet its obligations.

It may be helpful to have in mind some illustrative figures for pension obligations incurred by an entity, both those incurred during a year and the totality of those incurred up to the reporting date. These might be as follows:

£'m	Incurred in year	Incurred to date
Even-handed assumptions	10	100
Prudent funding assumptions	12	120
FRS17	15	150
Buyout	16	160
Consultation document	17	170

¹ Discussion paper chapters 5 and 6

² As mentioned in discussion document chapter 5 para. 7.10

³ As recited in discussion document chapter 5 para. 1.6

Looking at a single year, the money needing to be set aside to meet the pension obligations is assessed at £10m. Inevitably, since we are dealing with pensions, very considerable uncertainty surrounds the question whether this amount will be too much, or too little, to meet the liabilities as they fall due over the following 50 years or more. £10m is the central estimate, using even-handed assumptions, which makes a requirement for further money as likely as a refund.

On the advice of actuaries, supported by regulatory guidance, the pension fund trustees and the employer will normally agree that more money should be paid into the fund than even-handed assumptions suggest, i.e. £12m in the illustration. The calculation of this amount uses prudent assumptions for investment returns and, perhaps, mortality, salary increases and other actuarial factors. Prudence indicates assumptions which are less favourable for the fund than even-handed estimates, with the deliberate intention of reducing the probability that further money will be required. This prudent funding means that the pension fund receives, in respect of that year's obligations, £2m more than even-handed assumptions indicate will be needed.

Against this background, FRS17 dictates that the financial statements show, not a surplus of £2m on the year's contributions, but a deficit of £3m. The accumulated deficit would be £30m, again a sharp contrast to the surplus of £20m that the entity and the fund trustees thought they had created by using prudent funding assumptions compared with an even-handed estimate of the cumulative liability⁴.

This response contends that the correct basis for evaluating pension liabilities which are to be met from a fund of assets⁵ is to use even-handed assumptions which relate to that fund. For the discount rate, the assumption would equate to the even-handed assumption about the return on the assets of the fund, taking into account its stated investment strategy and any distinctions in that strategy between the assets funding various types of liability, e.g. those before and after retirement. For mortality, the assumption would be based on best estimates of the longevity of the current members of the fund. For salary increases, the best estimate would be the entity's best forecast of the salary increases that the members of the fund would receive in future.

These assumptions are not theoretical nor are they based on a model or proforma portfolio. They portray fairly the decisions of the entity and the consequences of those decisions so far as they can reasonably be estimated. Accounting should reflect what has happened and not a model of what might have happened.

The main objection to using a bond discount rate is that it is needlessly, and misleadingly and damagingly, prudent. But it is also inconsistent with the discount rate used to value the assets. Typically the assets of a pension fund include a large measure of equities, and perhaps some property. Equities, if valued at market value, are by definition valued by using a discount rate equal to the expected return on equities. Although equities are often valued by taking a risk free rate of interest on Government securities and adding an equity risk premium, say 3%, the rates of return on the two assets are not always so mechanically linked. In recent years it is recognised that the risk free rate has been reduced by high demand from pension funds intending to invest in assets matching their liabilities, as they perceive them with the aid of FRS17, and that the gap between the risk free rate and equity returns has widened. This gap has widened further still since the onset of the credit crunch.

If, exceptionally, it was cheaper to buy out the liabilities, that lower figure could be used⁶.

⁴ Chapter 6 para. 2.4 expresses this concern.

⁵ This distinguishes them from liabilities covered by SFAS 157 'Fair Value Measurements' as recited in chapter 5 appendix D.

⁶ In line with the conclusion in chapter to para. 5.14.

The arguments can be summarised in the following table, which assesses whether the three methods in point are in line with the concepts underlying financial statements.

	FRS17	Discussion paper	Even-handed assumptions
Going concern	No – the liability is valued on a basis closer to that relating to a buyout and does not recognise that the liability will be met from a fund with investment returns about which reasonable assumptions can be made. It arbitrarily rejects the assumption about future returns to the extent they exceed a risk free rate	No – as FRS17. And the restriction of salary increases to the legal minimum required increases to the pensionable salary is a further departure from reality	Yes – the liability is valued as though it will be met from the assets in the pension fund as this is the most likely outcome as well as being the cheapest
Stewardship	No – even though the liability is prudently funded, a deficit often appears under FRS17	No – as FRS17	Yes – if the liability is funded prudently, the financial statements show a surplus in the first instance. If a deficit occurs later, it will be due to adverse experience and/or adverse changes in actuarial assumptions
Decision usefulness	No - investors, entities and pension funds are misled by the appearance of deficits	No – as FRS17	Yes – the investor can appreciate the consequences of the entity’s pension funding decisions (as well as the effects of subsequent events)
No prudence	No – FRS17 deliberately takes a prudent approach	No – as FRS17	Yes – an even-handed view of the future is taken, with equal chances of favourable and adverse developments
Consistency	No – assets and liabilities are valued on different bases	No – as FRS17	Yes – the same basis is used for valuing assets and liabilities
Substance over form	Yes – by including the assets etc. of the pension fund in the entity’s balance sheet even though it does not own them	Yes – as FRS17. But no – by not including likely salary increases and confining such increases to those legally enforceable.	Yes – by including the pension fund in the entity’s balance sheet and portraying the best estimate of its likely economic impact.

Some more detailed comments on chapter 5 of the discussion paper follow:

Para. 1.5 – A further, and perhaps the most important, difference between pension liabilities and other liabilities is that pension liabilities may be met out of the assets of a fund set aside for this purpose.

Para. 2.3 – This sets out four different measurement bases for liabilities. While ‘present value’ comes close to it, the list does not include the basis of measurement underlying this response, which could be articulated as ‘Funding requirement – amount of money estimated, if set aside and invested, to be sufficient to meet the liability when due.’ This is an important omission from the Framework which is relevant to liabilities that are settled out of funding set aside for this purpose.

Para. 6.5 – I question the assertion that ‘in this situation [where markets were efficient and at equilibrium] market value and “run-off” value might be expected to be equal.’ As explained more fully in para. 6.22, the counterparty accepting pension liabilities will usually be an insurance company which follows more cautious investment policies than most defined benefit pension funds. It also has to allow for its own profit and for its administration expenses (although, as the paper argues elsewhere, the latter ought perhaps to be treated as a liability of the pension fund in its own balance sheet). For these reasons the market value on a transfer of liability can be expected to be more than the liability seen from the perspective of the pension fund and the sponsoring entity.

Para. 6.19 - I agree entirely. The table earlier in this letter refers to liabilities calculated on prudent funding assumptions and these are not put forward as suitable accounting measures.

Para. 6.37 – The central argument of this letter, that the discount rate should be the same as the expected return on the assets held, is dismissed without comment. The insurance discussion paper may well not be a good precedent since, unlike funded pensions, it is not dealing with liabilities that will be met out of a fund of assets held for that specific purpose.

Some accept that the return on the assets held is the correct rate, but are uneasy that this rate can be varied by the fund changing its asset allocation⁷. A riskier asset allocation leads to a higher expected return and this has the, to them, perverse result of reducing the liability. But it cannot be denied that the amount of assets needing, on even-handed assumptions, to be held has indeed reduced although it must also be accepted that the range of possible outcomes around that central estimate has increased in line with the increase in the riskiness of the assets.

A compromise way of addressing this concern would be for standards to prescribe proforma asset allocations (such as equities for liabilities not yet in payment and government bonds for pensioners) which could not be varied by the entity and so would provide an objective and independent way of arriving at the appropriate discount rate. The writer does not favour this as it is one step away from the reality of the funding situation. The financial statements should show the true measure of the funding requirement together with an explanation of the level of risk surrounding that figure.

Appendix E (IAS 19 discount rate) – Para. 27 recites what I consider the correct approach, to use the expected return on the actual assets held, but then rejects it as leading to variability in the amount of the liability. As explained above under para. 6.37, this is the reality of the situation – a fund that that invests in higher yielding but riskier assets will, on even-handed assumptions, need less money than a fund with safer assets such as index-linked bonds. Why else would pension funds invest in risky assets such as equities, if not to reduce, on a better than even chance, the long term cost of paying the pensions and consequently the amount of that liability as currently measured?

⁷ This unease is described in chapter 5, appendix E para. 27. Contrary to that paragraph, I believe that the amount of the pension liability, which is to be met out a specific fund, does vary according to how the fund is invested, as described in the text above.

Most of the remainder of appendix E is concerned with the quest for a portfolio that matches the pension obligations in terms of economic risk. This is a fruitless quest but, more importantly, it is irrelevant. The accounts should portray what the entity actually does and not a theoretical model of what it might do.

Para. 3 of this appendix rejects using a return on a portfolio of assets as being insufficiently objective and then reverts to using a corporate bond rate. In other words, IAS19 would rather be precisely wrong than roughly right.

Appendix F (FRS17 discount rate) – The appendix starts unpromisingly by stating that actuaries traditionally use a prudent estimate of the return on assets to discount liabilities. As is recognised by the Board for Actuarial Standards, different discount rates are appropriate for different purposes. The rate referred to is appropriate for determining funding requirements but not necessarily for other purposes.

The appendix goes on, as did appendix E, to search for a theoretical portfolio of assets which would be correlated with the pension liabilities. This search is disappointed but it does not matter. What matters is what the entity actually does, not what it might have done, and it is the task of the accountant to measure what is actually done.

Para. 16 of the appendix rejects using a discount rate higher than the risk free rate, while permitting the expected benefits of equity investment to be recognised as and when they accrue. But the risk free rate of return is not the minimum that will be achieved in all circumstances. It is quite possible, in the short or medium term at least, that returns on equities will be actually less than the risk free rate. But it remains reasonable to assume that over the long term they will exceed the risk free rate while enjoying a good deal of variability around that central estimate.

It is perverse to observe that entities plan their affairs and fund their pension schemes on the assumption that equities will make higher returns, with full regulatory approval, but then refuse to recognise that reasonable assumption when drawing up the financial statements of the entity.

The closing paragraphs of the appendix argue for the allowance of a higher discount rate than the risk free rate to reflect the entity's option to reduce the promised pension benefits. I consider it wrong to understate the amount of future cashflows which are likely to be incurred. And I see no argument which attempts to equate the value of the option with the effect of using a premium over the risk free rate: the two items have no relationship to each other. In recent months that premium has increased to up to three times its previous levels, with the bizarre consequences highlighted in the box at the top of this letter.

Finally, I set out below my responses to those questions on which I express a view.

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)?

The liability should be based on the cash expected to be paid i.e. the pension benefits expected to be paid which in turn will depend, subject to the scheme rules, on the employees' pensionable salaries at some future date, the estimate of which will need to include all estimated increases before the pension payments become due.

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 reporting should be based on the cash that is expected to be paid and not on a legal construct which produces a different result.

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

The obligations are quantified at the amounts expected to be payable when they are due.

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?

No view expressed.

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?

Changes in assets and liabilities would be a great deal less sensitive if they were both valued using consistent discount rates. A drop in asset values due to market movements would result in a corresponding drop in the liabilities if the discount rate, reflecting the future return on the assets, was increased to compensate for the market movement. Actuarial methods of deriving assumptions about future investment returns do not always achieve this result. If, in this way, assets and liabilities moved in harmony with each other there would be a good case for instant recognition of the change in the difference between them (the surplus or deficit). As long as different methods are used to value assets and liabilities, and as long as they do not move in harmony with each other, there is a good case for spreading the surpluses and deficits over extended periods.

Q6 Do you agree with the paper's views on the measurement of liabilities to pay benefits?

No, I disagree as set out in the body of this letter.

In particular, do you agree that:

- Regulatory measures should not replace measures derived from general accounting principles?

Yes. My proposal is based on accounting concepts. Regulatory measures are for purposes such as monitoring funding levels and determining Pensions Protection Fund levies.

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

No. As the liability is to be met from a fund (in the case of a defined benefit scheme which is funded), the discount rate should reflect the expected return on the assets, thus valuing the assets and liabilities consistently with each other and reflecting the economic substance of the liability.

- 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?

Yes. Increasing the liability to reflect riskiness results in the liability being overstated. It can also give false comfort that the liability will not be exceeded in any likely circumstances, even though the range of variability around the central estimate is often wider than such an adjustment would indicate.

Riskiness should be disclosed but should not justify overstating liabilities in the primary statements.

- The liability should not be reduced to reflect its credit risk?

Yes. A going concern entity should project the cashflows it expects to incur if it meets its obligations in full.

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

Yes.

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?

The latter. Any liability should be quantified at the best estimate that can be made of its eventual settlement amount.

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

Yes, providing that changes in current values trigger corresponding adjustments in the expected returns on the assets and in the discount rate for the liabilities funded by the assets. Without these adjustments there is a good case for measuring values over a period around the reporting date, in order to spread the effects of short term market fluctuations.

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 only if both are measured on the same bases, using the same discount rates. If, as is the case when bond or discount rates are used to value the liability but the assets include other types of investment, the bases are inconsistent.

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

Yes. The distinction between the three components made by FRS17 is sound, although the allocation of the different elements between those three is questionable.

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 (to the former question), while noting that my proposals will produce a corresponding and offsetting gain or loss on the liability.

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?

No view expressed.

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?

No view expressed.

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, but only if the liabilities are quantified consistently with the assets. It would be disastrous if the use of a bond related discount rate for the liabilities of pension plans led to pension plans normally showing a deficiency of assets against liabilities, even if they were being adequately funded, due to their different bases of measurement.

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?

This would seem logical. Naturally the provision against credit risk would be eliminated on incorporation into the employer's financial statements.

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.

No view expressed.

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?

No view expressed.

Yours faithfully

Christopher Daws

C W Daws, MA(Cantab), FCA, CTA, MCT