Actuaries & Consultants

Accounting Standards Board
Aldwych House
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11 July 2008

Dear Sirs

The Financial Reporting of Pensions

I am writing further to your discussion paper on the Financial Reporting of Pensions.

As requested, I have attached Buck Consultants' comments on the discussion paper. Our comments are set out in the Appendix to this letter.

Yours faithfully

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Appendix – Response to the discussion paper "The Financial Reporting of Pensions" issued by "Pro-Active Accounting Activities in Europe"

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)?

In our opinion, the information that would be of most use to the users of accounts is the costs incurred by the entity over the accounting period and the liabilities of the entity at the end of the accounting period. Future salary increases will be granted to generate future revenues. Absent a requirement to book the value of future revenues, we do not see the point of booking costs associated with future salary increases, for example the value of employee benefits based on future salaries.

The costs incurred over the year will include the increase (or reduction) in pension liabilities over the year resulting from any salary increase granted that year. They do not include the possible future increase in pension liabilities resulting from any salary increase granted in later accounting periods (except to the extent that the entity is legally or constructively committed to granting such future salary increases during the accounting period).

Identical comments apply to the liabilities of the entity at the end of the accounting period.

Hence, in our opinion, the liability to pay benefits that is recognised should be based on current salaries (including non-discretionary increases).

It should be noted that some territories require benefits to increase in line with particular indices when an individual leaves pensionable service. Similarly some arrangements grant benefits either only if or on an enhanced basis if an individual retires from that entity rather than merely leaves service. To reflect this possibility, and to be consistent with our proposal that future discretionary salary increases not be allowed for (except to the extent that such increases are not discretionary at the accounting date), in our opinion, benefits should be valued using the entity's best estimate of the rates at which employees would leave service if no non-discretionary future salary increases were granted.

It should also be noted that, within the UK, when an entity closes its retirement benefit scheme, this currently results in a profit being shown equal to the release of the provision held in the liabilities for future salary increases. It is hard to see why a profit should be reported in these circumstances. Our suggested approach would help to reduce this effect.

Even so, information about future cash flows that reflect likely salary increases may be helpful to investors when presented in the footnotes.

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?

Our view is that, as the financial reporting is for the entity as a whole, liabilities should be looked at on the basis of the obligation to the workforce as a whole but it is unclear to us that the distinction leads to a difference in measurement principles. If the pension scheme provided a lump sum death benefit, it would be reasonable to measure the death benefit obligation by the cost of the insurance needed to provide the death benefit to each individual. On the other hand, the value of nonvested pension benefits (not usually insurable except at a cost approximating full vesting) might be better measured through discounting the probability

of termination before full vesting. And even that solution would have limits. For example, the value of a nonvested benefit in a plan covering only one individual might be measured according to the general accounting rule for contingencies. [In the USA, this would the FAS 5 rule that the obligation is recognized only when it is likely that the benefit will be paid and its value can be determined.]

That said, given our answer to question 1, the answer to this question makes no difference to the way in which we believe salary increases should be allowed for when accounting for pension obligations.

In particular, either an entity has an obligation to increase pensionable salaries or it does not have such an obligation. If it has such an obligation (either to an individual employee or to a larger grouping) the impact of that salary increase should be allowed for in its pension accounting.

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

We do not agree with this principle. See, for example, our discussion of vesting in response to Q2.

We feel that benefits should be recognised in entity accounts when the entity is constructively or legally committed to provide those benefits.

Hence, using the example in paragraph 6.34 of the consultation paper, if no contributions are due in the first two years and 30% of salary is legally due in the third year, conditional on the employee completing 2 years' service, we feel that the employer should account for an appropriate portion of the benefit in each of the first and second year of service, allowing for the entity's best estimate of the employee completing 2 years' service. However, if the employer is not legally committed to making this payment in advance, we feel that the employer should account for this benefit only when it becomes legally committed to making this payment (presumably at the end of the 2 years' service). This principle is particularly important in the USA, where valuable augmented early retirement benefits and medical benefits may not vest until after a long period of service.

An equivalent issue arises when considering the value of employee stock options and some long term incentive schemes, which only vest if an employee completes a future period of service. In our view, these different arrangements should all use identical accounting principles.

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?

As long as the gross position (ie both the pension assets and pension liabilities) is disclosed, as a minimum, we have no views on this.

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?

In our view, there is no reason not to recognise changes in pension plan assets and liabilities immediately.

That said, in our view the users of accounts will want to be able to identify separately an entity's underlying trading results and its overall results allowing for the impact of its non-trading profits or losses (such as changes in property values, changes in pension arrangement asset values and changes in pension arrangement liabilities). Hence we feel that, where an entity believes that particular items of profit or loss do not relate to its trading, entities should be permitted to separate out those items. The current Statement of Recognised Income and Expenditure can be used to achieve this objective.

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?**

  As a general principle, we agree. However, if an entity is legally required to fund a pension arrangement at a higher rate than general accounting principles would suggest and if the entity can not obtain economic value from those extra contributions (eg a subsequent contribution holiday or a refund from the pension arrangement), in our opinion, that higher cost should be reflected in the entity's accounts.

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

  We would not agree with this approach. In our view, the arguments set out in paragraph 7.9(b) of the consultation paper (which addresses the need for consistency with the approach taken when accounting for non-pension debt issued by a company) are persuasive. We would note that the measurement of pension debt on a consistent basis with other non-pension debt would suggest that pension debt is valued on a yield consistent with the entity's creditworthiness. However, for practical reasons (ie difficulties measuring some entities creditworthiness on a systemic and reliable basis and difficulties to users of accounts in understanding an entity's year-on-year progress if the value of pension scheme liabilities were to change year-on-year with changes in the entity's creditworthiness), we feel that pension debt should continue to be measured by reference to the yield available on high rated corporate bonds of an appropriate duration. While the yield will change from year to year, the impact of the change will, subject to duration, be consistent enabling users of accounts to make valid comparisons between different entities.

  In addition, if sensitivity figures are disclosed and users of accounts wish to calculate the value of plan liabilities on a risk-free discount rate or a discount rate appropriate to the entity's creditworthiness (or any other discount rate) they will be able to adjust the value of the plan liabilities appropriately.

- **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?**

  There are fundamental difficulties in quantifying the amount by which pension benefits will differ from today's expectations. As a result, adding any particular risk margin to the liabilities would be arbitrary and would provide little useful information to users of accounts. In the circumstances, in our opinion, it would be best to convey the possible financial impact of risks on pension benefits by disclosure of the impact on the liabilities of changes in the relevant risk measures (eg if pensioners lived one extra year or if the discount rate were 50 basis points lower).

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

  As set out above, we do not agree with this proposal because it is inconsistent with the way other corporate obligations are accounted for.

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

  In theory, we agree with this proposal. However, given that the entity has control of most expenses with the exception of government levies and given the arbitrary and unpredictable nature of government levies, it is not clear whether this proposal would be helpful to users of accounts. In the circumstances, and given that future expenses are likely to be small in comparison to the gross liability (which itself is only an estimate) we would propose that entities have the flexibility to account for these expenses either as a cost when the expense is incurred or by creating a reserve for them, provided disclosure was made of the method adopted.

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?

In our view, the obligation should be reported at an amount that reflects the probability of different outcomes where the probabilities are justifiable based on past experience or reasonable expectations of future experience.

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

We agree that assets should be reported at current values.

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 it would be useful, perhaps imperative, to users of accounts if the different components of changes in liabilities and/or assets were presented separately.

We note that the consultation paper proposes that the effect of changes in the discount rate and the actual return on assets be included within financing. We would also propose that the effect of all market related changes in liability measurement assumptions be included within financing. In particular, the impact of changes relating to inflation should also be included within financing. To use a simple example, if a pension scheme promised to pay a pensioner the proceeds of an index-linked bond and invested in that bond, the current proposals would lead to changes in the asset, and changes in the discount rate being included within financing, but changes in the liability arising from changes to inflation expectations (being an actuarial gain and loss) being included in the profit and loss account within other financial performance. It would seem more appropriate for all three impacts to be included within financing.

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?

We feel that the issue for users of accounts is that they can tell the entity's underlying trading performance as well as the entity's overall performance.

Hence, in order for users of accounts to see the entity's overall performance, we agree that the financial performance of an entity should reflect the actual return on assets, rather than the expected return.

However, in order for users of accounts to be able to identify and assess the underlying trading results, we feel that it is important that the actual return on pension scheme assets is separately disclosed.

We have no view as to whether the expected return should be disclosed. We feel that the split of assets into major classes should be disclosed and that users of accounts should be able to form their own views as to the likely future returns on those asset classes.

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?

In general, we agree with the objectives of disclosure and the specific disclosure requirements identified.

However, in our view, the proposed disclosure list will lead to a pensions note of undue length. The excessive length of this note will both increase the cost of preparing the disclosure and act to hide the most critical information from users of accounts. We would therefore suggest not requiring disclosures about the number of members of the scheme (item 8) and the future projected cashflows (item 9) as these two items in particular appear to be of only marginal relevance to users of accounts and similar information relating to the timescales of cashflows can be obtained from the sensitivity disclosure being proposed.

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?

From a theoretical position, it is clear 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 (with appropriate adjustments for any unusual details of the arrangement and the extra risks arising from the potential actions of other participants in the arrangement). However, at a practical level, it is highly unlikely that the necessary information would be available in a timely fashion. We therefore agree with the summary set out in 9.3 of this Chapter.

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 liabilities?

We strongly disagree with the proposal to include liabilities for future benefits in a pension plan's general purpose financial reports.

There are material differences between a pension plan's general purpose financial reports and company financial reports. In particular, the users and purposes of the reports differ.

As set out elsewhere in the consultation paper, the users of company financial reports are principally investors deciding where to direct their investments. However, pension plans do not have equivalent investors (for example, members of plans commonly do not have any realistic alternatives other than remaining in the plan. Hence a pension plan's general purpose financial reports principally serve to show safe custody of the plan's assets.

Additionally, the value of the liabilities on the basis set out in the rest of the consultation paper will often not be available at the pension plan accounting date, as it is common for a pension plan not to have the same accounting date as its sponsoring company. Preparing an additional valuation of the liabilities at the pension plan accounting date will have cost implications which, in our view, will outweigh the benefits of increased disclosure. Our view is based on UK experience, where members have been given a statutory right to obtain a liability valuation (via the pension plan's actuarial valuation report) and have, almost without exception, not requested that information.

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 strongly disagree with this proposal.

As discussed above, the purpose of a pension plan's general purpose financial report is to show safe custody of the actual plan assets. The value of the employer's future contributions to the plan would materially detract from this purpose. It is also not practical to have to assess the employer's credit risk on a regular basis for this purpose.

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 requirement development to secure appropriate financial reporting for them.

It is clear that further consideration is required around multi-employer schemes for non-associated employers.

In addition, further consideration is required around accounting in subsidiary accounts for group multi-employer pension plans (ie for multi-employer schemes for associated employers).

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?

Our comments on these points are set out in the answers above,