BTPS Trustee response DRAFT 2

**To:** asbcommentletters@frc-asb.org.uk

**Accounting Standards Board**
**Aldwych House**
**71-91 Aldwych**
**London WC2B 4HN**

## The Financial Reporting of Pensions: Comments by the Trustee of the BT Pension Scheme

Comments are being submitted separately by the sponsor, BT Group plc, of the BT Pension Scheme (BTPS). In the comments below on behalf of the Trustee of the BTPS, we have tried to add to what has already been said by BT Group plc, rather than duplicate it.

By way of background, the BTPS has assets of approximately £40 million, and 345,000 members of which approximately 70,000 are still contributing and accruing benefits. The Scheme was closed to new entrants from 1 April 2001, but remains the largest company pension scheme in the UK.

The response of the BTPS Trustee to the questions in the discussion paper is as follows:

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)?

A1 It should be based on current salaries, as there is no obligation on an employer to continue a final salary pension scheme. Liabilities arising from future salary increases are not liabilities at the balance sheet date.

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?

A2 The pension liability of the employer is to fund the company pension scheme so that all benefits and expenses can be paid when they become due. The liability of the employer is therefore to the pension scheme members as a whole – i.e. to employees and to scheme members with deferred benefits or pensions in payment. The reference in the question to employee/workforce seems inappropriate. The present value of pension obligations should be measured by the discounted value (on prescribed best estimate assumptions) of the future year by year employer contributions to the pension scheme considered

necessary (on prescribed best estimate assumptions) to meet future benefits and expenses.

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

A3 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?

A4 Yes. In the UK, legislation requires that occupational pension schemes are totally independent of the employer. Since the employer in no way "controls" the UK pension scheme it should not be consolidated in the employer's financial statements.

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?

A5 Yes.

Q6 Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, do you agree that:

Q6.1 Regulatory measures should not replace measures derived from general accounting principles?

A6.1 No. While regulatory measures may distort comparisons between companies in different countries, the regulatory measures nevertheless govern the cash flow the company is required to pay to the company pension scheme. What is required is realistic global comparisons according to the pension fund contribution the company is actually required to make.

Q6.2 The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?

A6.2 To the extent that the assets of the scheme are not needed for the payment of benefits in the short term, a premium for illiquidity can be accessed to deliver a higher rate of return than the risk-free rate. In addition, each yearly benefit payment should be valued using a different discount rate reflecting the illiquidity premium over the associated investment horizon.

The above points argue for discounting using an interest rate curve, rather than a single rate, which captures the time varying illiquidity premium over the risk-free curve. They also argue against the use of a corporate bond rate because it has too short a duration for most defined benefit schemes and introduces credit spread. The appropriate curve needs to isolate the illiquidity premium without introducing additional risk factors – i.e. credit risk and default risk.

Exactly which interest rate curve best satisfies the above criteria is a matter for debate.

Q6.3 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?

A6.3 If the reported liability is on a best estimate basis, then additional information about the riskiness of a liability and the sensitivities of the assumptions used will aid understanding and transparency.

Q6.4 The liability should not be reduced to reflect its credit risk?

A6.4 Agreed.

Q6.5 Expenses of administering the plan's accrued benefits should be reflected in the liability?

A6.5 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?

A7 The intention should be to report what is considered to be the most likely eventual liability. This should therefore reflect the probability of how options will be exercised by scheme members.

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

A8 Yes. It should then not be too difficult for analysts to make adjustments to compare company balance sheets at different financial year ends.

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?

A9 Assets should be based on current value. Liabilities would be the discounted value of

the expected payments by the employer to the pension scheme.

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

A10 No. The overall change should be presented. The company may then choose to add further information if this seems helpful.

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?

A11 No. Putting actual returns through the income statement is likely to swamp the operating profit and give a misleading view of the underlying earnings trend. The resulting volatility in income (and particularly in the profit and loss account) is likely to encourage Boards to close their pension schemes if they are still open, or seek ways to reduce costs still further if schemes are already closed. A better option is to continue to show estimated returns, but to require more disclosure on actual returns and require disclosure on the assumptions about expected returns for each material asset class. This could be accompanied by historical returns over, say, a five-year period.

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?

A12 We agree the objectives of disclosure set out on pages 204 -206 of the discussion document. There should be disclosure of key assumptions and risks, with the ability to provide additional information without this being a requirement.

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?

A13 Use of the same principles would seem appropriate. The financial statement of each employer should reflect only the liabilities applicable to that employer.

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?

A14 No to the second question. A pension plan's liabilities to pay benefits in the future is covered in its triennial actuarial valuation, the main purpose of which is to allow future contributions to be paid at a rate that will meet future benefits and expenses. The

purpose of pension scheme accounts is to show actual values for assets, income and expenditure over the financial year. With regard to liabilities, this is best covered by a narrative that draws attention to the actuarial valuation process and latest results. What seems to be being proposed by the ASB is a duplication of the sponsor's accounts. It is unnecessary, and undesirable, to have three separate routes (at least) through which scheme members can obtain details of the funding position of their scheme – i.e. the actuarial valuation, pension scheme accounts, company accounts.

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?

A15 Yes.

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.

A16 No comment.

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?

A17 The ASB should bear in mind how its proposals on accounting for pensions might influence the actions of finance directors and company boards and hasten the closure of those final salary pension schemes that still remain available to employees. The proposals in the discussion document would result in a very considerable increase in the estimate of pension scheme liabilities, ranging from perhaps a doubling for an immature scheme to perhaps a 25% increase for a mature scheme. Current accounting practices are already widely held to have contributed to the decline in final salary pension schemes, and this should not be exacerbated by new proposals. Measures of assets and liabilities for pension schemes are very long-term -- up to 80 years or more. Scheme investments will often be held for extremely long periods, and care needs to be taken when looking at short-term market movements.

We hope the above is helpful.

Yours sincerely

Colin Hartridge-Price

Secretary, BT Pension Scheme Trustees Limited