MAKINSON COWELL

Accounting Standards Board
Aldwych House
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14 July 2008

Dear Sir/Madam,

THE FINANCIAL REPORTING OF PENSIONS

Makinson Cowell

Makinson Cowell is a capital markets advisory firm specialising in investor relations. As part of our advisory role we advise large quoted companies on how their accounts are interpreted by investors, what questions those investors might ask, and what additional information, in the form of adjustments to the IFRS figures, would be helpful to investors. We work for more than one third of the FTSE 100 and for over 40 of the FTSEurofirst 300.

We would note that despite our views differing in some areas we fully support the ASB's involvement in producing a Discussion Paper on this subject and welcome your attempt to influence the development of financial reporting standards in this important area.

There follow our comments and suggestions on the Discussion Paper.

Q1 ABO vs PBO

We disagree with the idea of using the adjusted ABO approach suggested by the Discussion Paper. We believe that the current PBO approach more fairly represents cost to the employer over the period of employment. Our reasons for opposing this suggested change are as follows:

The approach of valuing pensions by reference to their cost to the employer arises from the difficulty of measuring the services provided. The use of ABO for a single employee could result in a recognised cost for the employer which is clearly out of line with the benefit received by it. We believe that this would be a reflection of a misrepresented cost to the employer. Consider the case of an employee with a number of historic years of service being promoted and receiving a significant pay rise as a result. The ABO approach would result in a very large charge being recognised in that year followed by much lower charges as the employee continued service in subsequent years. This would not faithfully represent the value of service provided by the employee.

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The paper puts forward the argument that the employer is not constructively committed to increase any given employee's salary in the future. While not increasing salaries may be a viable option for any given employee it is not for the workforce as a whole. In this sense using the whole workforce as a unit of account would likely lead to accounting which more helpfully represented the economics of the company as options which would be remote contingencies for a single employee are likely occurrences for the entire workforce. While we consider that a unit of account consisting of the entire workforce would make little difference to our views, we believe it is more conceptually correct and would make the problems with the views with which we disagree more evident.

We support the argument made in Chapter 2, para 4.42. It is argued in 4.50 and by other proponents of ABO over PBO that employers have recently been demonstrating that they have the option to restrict the proportion of salary rises to which pension increases apply or to pay employees with no or average salary pensions differently to employees who are not accruing final salary pensions. If an employer were to adopt this policy we believe that users of accounts would be better served by showing the effect of adoption of the policy at the time that it occurred as it would presumably be shown in the same way if the employer closed the plan to new accruals by existing employees. This would allow users to weigh this up against potentially higher salaries or employee turnover rather than assuming that the decision was in place before it was, in fact, enacted. We do not believe that the ABO approach would, as claimed in Chapter 2, 4.50, enhance comparability. Nor would we agree with the argument in 4.51 that this represents the true economic cost of such a promotion. Indeed we would argue (as above) that the practice of promotion where this resulted in a revision of prior service benefits is strong evidence that a constructive obligation for such liabilities exists. We would, however, support the measured liability recognising the future effect of an expected closure of a plan to future accruals by existing employees.

We also note that the use of a zero discount rate in table 1 on p41 of the paper makes this example misleading. Discount rates and pay inflation offset one another and the effect of the two methods of accounting would be more realistically represented if a discount rate closer to the rate of salary inflation were assumed. In addition the effect of return on assets in a funded scheme is ignored.

In respect of the issues of apportionment covered in Section 6 of Chapter 2 we do not feel it is necessary that this be on a straight line basis over the expected period of employment, we are merely concerned that it needs to reflect liabilities associated with future pensionable salary increases and not result in a representation of, for instance, rises resulting from increased seniority or responsibility as huge charges in the year in which they occur. This again would be easier to consider under a whole workforce unit of account. We would be happy, for instance, for apportionment to be proportional to salary (and expected salary) paid as this could be assumed, in the absence of evidence to the contrary, to reflect service rendered over the period. We note, however, that excepting step increases above inflation occurring from events such as promotions, that discounting over time has an effect in this direction in any case.

Q2 Unit of account

We consider that a unit of account consisting of the workforce (or members of a particular scheme) would be more representative of the economic situation with regard to fixed benefit schemes. See above for our observations in this regard.

Q3 Recognition of present obligations only

As noted above we believe that the obligation to pay benefits based on future salaries is a present constructive obligation of the employer providing a fixed benefit scheme. This is clearly also the case for indexation of future benefits.

Q4 Netting of pension liabilities.

While acknowledging that this results in some inconsistency we would support retention of the net presentation of pension assets and liabilities in cases where these are held by a separate legal entity or have some form of trust-like protection from creditors. We believe that:

Incorporating pension assets and liabilities into the balance sheet line by line would make it difficult to analyse these and separate them from the remainder of the employer's assets and liabilities.

We believe being able to separate these assets and liabilities easily is useful for analysing the employer's statements. The number of material pension schemes in the companies we analyse the net treatment a material benefit to analysis of the entity's financial statements. Our reasons for preferring this from a user's point of view are:

Such assets are not generally directly related to the conduct of the business of the employer and thus give a misleading impression of its assets, liabilities and solvency.
Such assets and liabilities have similar properties across companies making comparison on this basis easier, and finally, from the point of view of creditors, because the assets involved in a pension fund have a degree of legal protection which most other assets do not have in the case of insolvency.

In addition we would note that, in the UK at least, regulation is moving so as to significantly reduce the employer's ability to control or benefit from the assets of pension schemes.

Consolidating such assets would result in any analysis by investors starting by reversing this decision. This is likely to result in preparers feeling obliged to produce statements adjusted to reverse this policy or at least to make reversing it easier to provide for users' needs. This will further separate statements used by investors from those compliant with the IASB's standards. We can see no benefit to this.

We do not believe that an employer's control over the asset allocation policy of a fund is sufficient for this to be usefully represented as a subsidiary. Even in the case of an employer with no assets supporting its fund we believe it would be helpful for the pension liabilities to be shown separately from other assets in most cases.

Q5 Timing of recognition of changes in assets and liabilities

We would strongly support the board's view here.

Q6 Measurement of liabilities

- We agree that regulatory measures should not replace measures derived from general accounting principles.

- We are not convinced that discounting of liabilities should be at a risk free rate.

  The major point in favour of this proposal would seem to us to be that reported income and discount unwind in the financing section would be on a similar basis producing a positive return from a surplus and a negative return from a deficiency. Further points in favour of this proposal from our point of view would be a reasonable level of objectivity and consistency between companies and consistency with insurance companies reporting under the CFO forum's MCEV methodology. On the latter point insurance companies have a similar range of long term liabilities and under MCEV would discount liabilities at near risk free rates in relevant markets. We point out, however, that the CFO Forum's proposals note that swap rates would generally be a better measurement basis than the sovereign benchmark as the swap curve is generally more liquid further out in the yield curve in areas where supply of government paper may be restricted or non-existent. We note the current level of swap rates in the UK as a counterargument on this but would agree with the CFO forum's proposal here. If a risk free rate is what is desired there are strong reasons for using a swap rate rather than a sovereign curve.

  Arguments against would be that liabilities to shareholders are essentially just another source of capital for companies. It is not clear why this source, and no others, should be discounted at sovereign rates. While pension liabilities often have substantial hypothecated asset backing, and in the UK at least, some legislative protection, it seems likely a liability with similar cash flows and security would be discounted at a much higher rate by the market. Alternatively if the company instead issued a bond with similar cash flows and security its price would be much lower than that achieved from using a "risk free" rate. If other financial liabilities (such as bonds) are not revalued at risk free rates why should the pension liability use this rate.

  Essentially it seems to us that this proposal improves the income statement but damages the reliability of the balance sheet by replacing one largely arbitrary rate ("high quality corporate bond") with another (the "risk free" rate). The advantages of the latter are greater comparability and objectivity between companies, and of the former, a measurement closer to what market value would likely be.

- We agree with the board's view that liabilities should not change in value due to own credit risk and that risk of variability of liabilities is best dealt with through disclosure.

- We agree with the board's view that expenses of administering accrued benefits, but not asset administration expenses or pension fund levies, should be reflected in the liability.

Q7 Options for employee benefits

We believe that liabilities for employee's options to receive benefits in different ways should reflect the probability of take up of those options. This is particularly the case when an unrealistically low discount rate such as that proposed is the case as, amongst other factors, employees views about discounting and credit risk may vary considerably from the valuations the company would be obliged to reflect through accounting regulation.

Q8 Assets

We agree with the board's view that assets should be shown at current market values

Q9 Measurement of assets and liabilities on a net basis

In principle we believe that measurement of assets and liabilities should be based on the difference between the amounts that the assets and liabilities would be measured at if they were measured directly. We would not, however, support this being used to justify applying a misleading measurement basis to pension liabilities because this had been designated as the appropriate measurement basis for purportedly similar non-pension liabilities elsewhere on the balance sheet.

Q10 and 11 Separate presentation of changes in assets and liabilities

We do not agree with the board's view here.

We agree with the board's view that the components of changes in assets and liabilities should be presented under consistent titles between reporting entities and disclosed separately. We also agree that it would be helpful if the financing cost of pensions appeared within the financing category of the income statement. The current option of including this within either operating profit or financing makes it more difficult to compare cost or profitability between entities. We do not agree however with the board's view that reporting actual return on assets or changes in the discount rate within financing would be helpful to users of the financial statements. In our view the current practice of including an expected return on assets in financing costs is consistent with presentation of discount unwind in the same location. Separating this from actual return on assets, actuarial gains and losses, and effects of change in the discount rate is helpful to investors. If reporting standards were to be changed as the board proposes in this matter, we believe the likely response of companies would be to produce adjusted figures excluding actuarial and discount rate changes in order to assist their investors in understanding the financial statements. We also note that this removes one of the points in favour of applying a "risk free" discount rate (see Q6 above). Note we do not propose omitting or concealing "unexpected" movements in assets, merely that these should be included in a separate section of the income statement making it easier for investors or other users to draw conclusions about the performance of the business during the period reported on. We would also add that if the board follows these proposals it would be important for reporting entities to disclose associated effects on taxation and minorities of these movements enabling users to make their own adjustments. The current requirements of IFRS in respect of separating taxation from the items on which it is incurred are not helpful in this respect.

Q12 Disclosure

We agree with the board's proposals on aggregation of data subject to specific disclosures for plans which are material separately.

Q13 Multi-employer plans

We do not have a view on multi-employer plans

Q14, 15 Financial reporting by pension plans

We do not have a view on financial reporting by pension plans

Q16 Non-standard pension schemes

No comment

Q17 Any further issues

We would urge the board not to recommend proposals which would be reversed by investors for their own use. We fear several of the proposals above fall into this category and introducing them would result in extra cost for preparers in producing information which was less rather than more useful to investors and providing and clarifying additional information to allow users to reverse it.

Regards

Andrew Jones

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