Punter Southall
CONSULTING ACTUARIES

126 Jermyn Street
London SW1Y 4UJ
Tel: 020 7839 8600
Fax: 020 7533 6961
www.puntersouthall.com

Private & Confidential
asbcommentletters@frc-asb.org.uk
The Accounting Standards Board
Aldwych House
71 – 91 Aldwych
London
WC2B 4HN

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Dear Sirs

Discussion Paper: The Financial Reporting of Pensions

Thank you for the opportunity to comment on the above paper.

This letter sets out Punter Southall's comments on the above discussion paper. Punter Southall provides a full range of actuarial advice, pensions consultancy and pensions administration services. Our clients are primarily large and medium sized occupational pension schemes and their employers.

Comments on Discussion Paper

Introductory Comments

The most significant recommendation of the discussion paper for UK pension schemes if adopted is the proposal to discount liabilities using a risk-free rate.

We believe that the principle of accounting for pensions on a risk-free basis is counter to the best estimate approach adopted for valuing going concerns. We further note that use of a risk-free basis will produce very high values with serious consequences for UK companies.

We were recently commissioned to carry out some calculations for the National Association of Pension Funds on the potential effects of the paper's proposals for typical UK final salary pension schemes. Using market conditions as at 31 December 2007, we estimate that a change from the current AA bond rate to a risk-free rate would increase liabilities by around 25% for a mature scheme and up to double for an immature scheme. Taking the estimated liabilities of FTSE 350 schemes at that date and assuming average maturity would give an increase in liabilities of approximately £250bn.

We accept that there is no intellectual justification for using AA bond yields as the measure of pension fund liabilities. We note that the credit crunch has also shown this measure to be very volatile. Our alternative proposal is to adopt the same basis as set out in the scheme's Statement of Funding Principles. This is a basis agreed by the scheme sponsor and trustee as a prudent estimate of liabilities, taking into account the particular circumstances of that scheme.

This would have the advantage of reflecting the basis used to determine companies' cash costs directly. Furthermore, disclosures would be easy to produce as regular updates are required for other purposes. The paper concludes that a risk-free discount rate should be used with suitable sensitivities disclosed for the benefit of users of accounts such as analysts. Users of accounts would surely find disclosure of the basis used to determine cash contributions important, so why not make this the starting basis and publish sensitivities enabling users to estimate a risk-free basis should they so desire?

We do not accept the arguments in the Discussion Paper that Scheme Specific Funding gives a flawed measure because it recognises higher liabilities for companies with a weaker covenant. It is true that on a going concern basis the probability of insolvency does not arise and hence the scheme should account for the full level of benefits regardless of the company covenant. However, where the covenant is weaker, the trustees of the pension fund are likely to seek to tie up more of the company's resources to provide security for the members and hence this capital will not be available for company use unless or until it emerges as surplus. It is valid that the accounting basis should reflect this.

Where such a regulatory regime does not exist, we would propose using the risk-free rate plus a fixed margin (for example 1%). While the size of this margin is arbitrary, it does make an allowance for a best estimate type approach, but is not subject to the volatility arising from changes in AA credit spreads.

Specific Comments

Question One: *Should the 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)?*

This is not a significant issue for a large proportion of UK schemes, where active members represent a diminishing proportion of the liabilities.

If our suggestion to use the Scheme Specific Funding measure were to be adopted, the question would become irrelevant. An allowance for future salary increases is generally included in technical provisions.

If the risk-free approach outlined in the paper were adopted, we believe allowing for current salary would be appropriate (though with allowance for statutory increases in deferment) as the proposals are generally consistent with a termination approach in measuring liabilities.

Question Two: *Should the 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?*

We consider that it should be the workforce as a whole for consistency with other elements of the liability calculation. For example allowing for the probabilities of events such as mortality makes no statistical sense for an individual.

We do not consider that the answer to this question makes a difference to the outcome. We consider that the employer always has control over future pensionable salary increases. In the UK, salary can be divorced from pensionable salary via scheme benefit design and so the arguments over control become irrelevant from a pensions point of view.

Question Three: *Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?*

Yes, though this should be subject to any relevant overriding statutory requirements.

Question Four: *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?*

We have no comment on this issue.

Question Five: *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)?*

We support the removal of deferral mechanisms for gains and losses as this is more transparent to users of accounts. UK companies had become used to this approach under FRS17 and the majority use the SORIE option under IAS19.

Question Six: *Do you agree with the paper's views on the measurement of liabilities to pay benefits. In particular, do you agree that:*

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

We do not agree, see introduction. We do not believe that the fact that a regulatory regime does not exist in all jurisdictions makes it inappropriate to ignore the regime that does exist in the UK.

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

We do not agree, see introduction.

- *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.*

As with previous answers, we believe some allowance for the inherent risk of the liabilities should be included in the reported figures. We support additional disclosures to allow users to quantify risk as long as they are reasonable and relatively inexpensive to produce.

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

We support the principle of accounting on a best estimate basis but believe that it is the cost of providing the full level of benefits that should be allowed for, though discounted at a rate that reflects all the risks of the liability. This is the approach adopted in statutory funding valuations in the UK.

We note that credit risk is allowed for in other areas of the accounts but assume that this is done to achieve a best estimate type of assessment. For pension funds the likelihood of benefits not being paid due to the credit risk of the company is a fraction of the overall uncertainty in financing those benefits, whereas for shorter term payments with fewer options it may be more significant.

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

We agree that the current accounting standards are unhelpfully lacking in clarity on the issue of allowing for expenses. However we do not believe that expenses should be required to be reflected in liability.

Under our proposal to use the Scheme Specific Funding measure, this may be the case for certain mature schemes, but in most cases, expenses are paid for as they occur. We believe that this is consistent with the going concern principle. Furthermore, there is no requirement to capitalise such expenses elsewhere in accounts.

However, more clarity is needed on the treatment of expenses in accounting disclosures. For example they should be allowed for separately in the reconciliation of assets where appropriate.

Question Seven: *Where employees have options to receive benefits in different ways, should the liability be reported at the highest amount or at an amount which reflects the probability of different outcomes?*

It should reflect the probability of different outcomes. It is unnecessarily cautious to reflect the highest value, especially when there is good evidence that particular options are regularly exercised.

Question Eight: *Do you agree that assets held to pay benefits should be reported at current value?*

Yes, clearly the current value is most appropriate to compare with the current value of liabilities. We do support more disclosure on asset strategy which gives users of accounts a clearer idea of the existing risks. For example a number of schemes have strategies in place to hedge interest rate and inflation risk that are not necessarily reflected at present.

Question Nine: *Do you agree that a "net" asset or liability should be based on the difference between the amount at which the assets and liabilities would be measured if they were measured directly?*

Yes, so our suggestion would be to reflect the basis set out in the regulatory regime, but updated for market conditions at the balance sheet date.

Question Ten: *Do you agree that different components of changes in liabilities and/or assets should be presented separately?*

Yes, more information should be available allowing greater compatibility between entities.

Question Eleven: *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?*

The actual return on assets is an extremely volatile figure. If this is to be included, it must be linked to the effects of market conditions on the liabilities. This must include expectation of inflation as well as the discount rate.

We agree that the expected return on assets is to some extent arbitrary and subject to manipulation. An alternative to this without the risk of extreme volatility in the profit and loss account would be to allow for the return on the assets at the discount rate. This would effectively lead to the interest accruing on the surplus or deficit being disclosed as the net interest cost item.

We do not support reflecting gains and losses directly through profit and loss rather than the STRGL/SORIE as at present. We broadly agree with the conclusions of paragraphs 37 and 38 of Appendix IV of FRS17.

Question Twelve: *Do you agree with the objectives of disclosure which are identified in Chapter 9? Are there specific disclosure requirements which should be added to or deleted from those proposed?*

We broadly agree with the principles outlined. We would remind the Board that very lengthy disclosures are costly to provide and may be of limited benefit in some cases.

Question Thirteen: *Do you agree that multi-employer plans should be reflected in an employer's financial statements, using the same principles as those which apply to a single employer plan? How, in your view, should an accounting standard require this to be implemented in practice?*

We do believe that multi-employer plans should be properly accounted for using the same principles as a single employer. Under current UK legislation, there is particular emphasis on the covenant of various employers and their liabilities should be properly reflected.

We acknowledge that there can be difficulties in splitting the schemes accurately, but an appropriate approximation should be made. The historic composition of schemes can differ dramatically from current active membership (and indeed there may be no further benefits accruing). Any split should therefore be based on all liabilities, not just active members.

Question Fourteen: *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?*

No, we do not believe any benefit would be gained from this information which is available in the company accounts in any case. Under UK legislation, the members are kept well informed of the scheme's funding position and this would add additional complexity for no benefit.

Question Fifteen: *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 believe this would be very complex information to provide for little benefit. The onus would be on the trustees of the scheme to estimate the creditworthiness of the company which would be very costly to produce and put the trustees of the scheme in a difficult position for no discernable value.

Question Sixteen: *Are there types of pension arrangements which require further consideration?*

No

Question Seventeen: *Are there further specific issues relating to the cost and benefit of the proposals, which should be taken account of in their further development?*

Covered in the answers above.

Conclusion

We have set out practical answers to the questions posed. We hope that a common sense approach is adopted to the presentation of pension schemes in accounts, with full consideration of potential costs versus benefits.

Yours faithfully

Joanne Livingstone

Joanne Livingstone FIA
Principal