Response No.63

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Response of the Accounting Committee of the Institute of Chartered Accountants in Ireland

Discussion Paper: Financial Reporting of Pensions

Dear Sir/Madam,

The Accounting Committee (AC) of the Institute of Chartered Accountants in Ireland welcomes the opportunity to comment on the proposals contained in the above document.

The appendix to this letter provides answers to the detailed questions posed in the document. Some of the key AC conclusions on the proposals are as follows:

- AC completely supports the immediate recognition of all changes in assets and liabilities relating to pension plans and does not support the deferral of any actuarial gains or losses to future periods;
- AC believes that the liability to pay benefits should be based on the terms of the promise made to the employees, not on current salaries;
- AC believes that general accounting principles, and not regulatory measures, should govern the measurement of the liabilities;
- AC believes the discount rate should not only reflect the time value of money but should also reflect the risks associated with the liability that is being measured;
- AC believes that the financial performance of an entity should reflect the actual return on assets;
- AC believes that the decision whether to consolidate a pension plan should be based on whether the scheme is controlled by the entity;
- AC believes that the general purpose financial reports of a pension plan should include its liabilities to pay benefits in the future.

Please refer to the answers to the individual questions for further discussion of the above conclusions.

Should you wish to contact us about any of our comments please feel free to do so.

Yours faithfully,

Mark Kenny

Secretary, Accounting Committee

Appendix

Question 1: 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 Accounting Committee (AC) of the Institute of Chartered Accountants in Ireland believes that the liability to pay benefits should be based on the terms of the promise made to the employees. Where the promise made to the employees is a final salary promise, the liability should be recognised based on the company's best estimate of final salary payable to that employee. Where the promise is a current salary, it would be appropriate to use current salary in determining the amount to be included in the financial statements. AC believes that in a final salary scheme, the employee earns a portion of the pension based on expected final salary in each period worked and not a portion of pension based on current salary. AC considers that basing the cost on current salary does not faithfully represent the promise made to the employee.

AC considers that it is inconsistent to use current salary to estimate an amount payable at a date in the future where there is a clear expectation that the amount of pension payable at that date will be based on a final salary that is different to current salary. There is also an inherent contradiction in saying that my present obligation is only based on current salary but I will then assume that this will not be paid out until many years in the future and therefore I will discount it to a present value. AC considers that the amount shown as a liability at any date should be the present value of the best estimate of the amount of pension that will be payable in the future, and that has been earned by service to date.

To the extent that an employer believes future salary increases are within its discretion, this should be reflected in the assumption made in the measurement of the liability based on final salary, including the effect of estimated future salary increases. If the employer believes that future salary increases will be awarded to the employees over their remaining working lives, then it is appropriate to include this expectation in the measurement of the liability that has been earned to date. Alternatively, if the employer believes that future salary increases will not be given, then future salary increases should be set at zero %.

Question 2: 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?

AC considers that the liability should be based on the promise made to each individual in the work force. However, AC considers that this does lead to ignoring expected future salary increases. AC considers that whether the unit of account is determined to be the individuals or the workforce as a whole should not impact on the calculation of the liabilities to be recognised. AC acknowledges that the measurement of the liability is more realistic when regarded as a measurement of the liability to the existing workforce as a whole.

Question 3: Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?

AC concurs that recognition should be based on the principle of reflecting present obligations as liabilities. However, as explained above, this does not mean that the present obligation in a defined final salary pension plan should ignore the best estimate of the employee's final salary. The present obligation to the employee is the current value of the pension based on expected final salary that has been earned by service to date.

Question 4: 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?

AC agrees that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate. To the extent that there are trustees operating the pension scheme that are independent of the entity, it will be unlikely that the pension scheme will be consolidated. However, if the trustees are controlled by the entity, which may be the case where a subsidiary acts as corporate trustee, then the employee plan should be consolidated.

Question 5: 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)?

AC completely supports the recognition of all changes in assets and liabilities relating to pension plans immediately. AC does not support any deferral of actuarial gains or losses to future periods.

Question 6: 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?**
- **The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?**
- **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?**
- **The liability should not be reduced to reflect its credit risk?**
- **Expenses of administering the plan's accrued benefits should be reflected in the liability?**

(a) Regulatory measures

AC does not believe that regulatory measures should replace general accounting principles in the measurement of the liabilities.

(b) Discount rate

AC does not believe that the discount rate should reflect only the time value of money. AC believes that the discount rate should reflect the risks associated with the liability that is being measured. In connection with this, we see a number of potential items that could be included in this risk adjustment. These include the following:

(i) adjustment for variability in size of ultimate liability (potentially increasing liability);

(ii) adjustment for discretion of employer (potentially reducing liability);

(iii) adjustment for credit risk of employer;

(iv) Adjustment for collateralisation of the liability.

AC considers that the employer is in the best situation to assess the impact of these risks on the pension liability. AC considers that the employer should be required to include an assessment of these risks in the discount rate applied to determine the present value of the pension liability. However, AC considers it is vital that users of the financial statements should understand the adjustments that have been made to the risk free rate and the financial impact of the adjustment. Consequently, AC considers that it is appropriate to disclose the liability calculated at the risk free rate at the balance sheet date in the notes to the financial statements and for the employer to disclose the reasons for applying a rate different to the risk free rate in measuring the liability for accounting purposes.

(c) Information about riskiness of a liability

AC believes that it is important to disclose further information regarding the riskiness of the liability and AC concurs that this is best conveyed by disclosure of the sensitivities to changes in the assumptions used in measuring the liability. This information should include reference to the discount rate, as discussed at (b) above.

(d) Credit risk

AC believes that credit risk should be included in the measurement of the liability as it is in the measurement of any other liability.

(e) Expenses of administering the plan's accrued benefits

AC believes that it is appropriate to include the expenses of administering the plan's accrued benefits in the measurement of the liability. AC believes it is also important that users of financial statements know how this adjustment has been included in the liability and that disclosure should be given of the amount included in the measurement.

Question 7: 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?

AC believes that the amount reported should reflect the company's best estimate of the amount that will ultimately be required to be settled. Consequently, AC believes that the probability of different outcomes should be factored in to measuring this best estimate.

Question 8: Do you agree that assets held to pay benefits should be reported at current values?

AC believes that assets held to pay benefits should always be reported at current values at the balance sheet date.

Question 9: 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?

AC agrees that the net asset or liability should be based on the difference between the amounts at which the asset and liabilities would be measured if they were measured directly.

Question 10: Do you agree that different components of changes in liabilities and/or assets should be presented separately?

AC believes that it is necessary to show the different components of the change in the liabilities and assets in order to enable the user of the financial statements to appreciate the impact of the various items on the measurement of the asset and liability.

Question 11: 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?

AC concurs that the financial performance of an entity should reflect the actual return on assets. AC has some doubt as to the importance of the disclosure of the expected return. Where the expected return is not included in the financial statements, it seems inappropriate to require it to be disclosed in the notes.

Question 12: 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?

AC considers that the objectives of disclosure as identified in the chapter are appropriate.

AC believes that it is too early to discuss specific disclosure requirements which should be added to or deleted from those proposed in the appendix to Chapter 9, except for those disclosures referred to in the responses to earlier questions. The level of specific disclosure is dependent on the decisions made regarding a number of major areas highlighted above.

Question 13: 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?

AC agrees that multi-employer plans should be reflected in an employer's financial statements in as far as possible using the same principles as those that apply to a single employer plan. AC concurs with the proposal in the paper that it would be necessary to adopt some allocation key in order to achieve this result. AC agrees that in the absence of any alternative that pensionable salary is a reasonable proxy for the amount to be allocated. However, AC is conscious that there may be cases where this does not represent a best estimate of the employer's obligations for a deficit in the fund. For example, it may arise where the employer has only deferred and/or pensioner members of the fund. In this case AC considers that it will be necessary to provide disclosures that make it clear the obligation of the company in regard to any outstanding deficit.

Question 14: 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?

AC concurs that the pension plan's general purpose financial report should include an estimate of the liabilities of the plan to pay benefits to members in the future. AC concurs that the plan's liabilities should be best represented by using a measurement objective the same as the employer's liability, however, if this is not possible, we believe that it would be acceptable to disclose the liability on the basis of the funding assumptions made by the actuary for the scheme updated to the current balance sheet date.

Question 15: 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?

In relation to the employer's covenant, AC has some concerns as to whether it is consistent with the Statement of Principles to recognise this as an asset of the pension scheme. In addition, the measurement of any such asset by those responsible for the financial statements of a pension plan will require the attribution of a value to the covenant and this would be highly subjective (and indeed sensitive and perhaps prejudicial). As most members of a plan are employees or ex-employees of the employer, they are perhaps in the best place to form their own opinion as to the worth of the employer's covenant. In summary, AC does not believe that it is appropriate to require the recognition of the employer's covenant as an asset.

AC understands, however, that trustees may not be comfortable approving financial statements that appear to have significant deficits. In order to alleviate this concern, AC would be comfortable with 'balancing' the financial statements to an amount that represented 'Amounts recoverable from the employer'. The financial statements would comprise something along the lines of:

Net assets of the pension plan	1,000
Defined benefit obligation	(1,200)
	(200)
Additional amounts due from employer	200

Question 16: 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.

The number and types of pension arrangements being operated by employers in the workplace are changing rapidly. In many cases hybrid schemes are being introduced which have elements of both a defined contribution and defined benefit nature. We believe that it would be useful for further investigations to be undertaken in how these types of hybrid schemes should be accounted for. The recent IASB ED on IAS 19 provides useful material on this issue.

Question 17: Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?

AC is not aware of any further issues that need to be considered.