14 July 2008

Accounting Standards Board
Aldwych House
71-91 Aldwych
London
WC2 B 4HN

Dear Sir/Madam

The financial reporting of pensions-Discussion paper

We are pleased to provide you with our comments on the Discussion paper 'Financial Reporting of Pensions', which was issued on 31 January 2008.

The responses on a question-by-question basis are responses to the practicalities of these proposals. It is possible to construct intellectual arguments both to support or to contest the arguments made by the ASB, so instead we have focussed on practicalities. The users of financial statements would be best served by consistency of reporting over time rather than by a search for a theoretical ideal.

As a general response:

The priority for financial reporting purposes is that the net surplus or deficit is fairly reported in the balance sheet and the primary statements reflect movements in the asset or liability for the year.

Arguably this is already the case under current accounting standards and the current accounting standards limit the extent to which the profit and loss account is subjected to unnecessary short-term volatility relating to medium or long term funding of pension obligations.

For example equities are often held where the proportion of active membership is high. Although the balance sheet, under current accounting standards reflects a snapshot at a given point in time, the income statement reflects expected returns. If the income statement were to reflect actual returns there would be a risk of increased volatility due to short -term improvements/ reductions in equity values and returns on assets that in practise will be held over the medium to long term. Obviously there is currently a risk of distorting the profit and loss account if the expected return on assets is always too high, but if the expected return on assets is reasonable over the medium term, a difference in actual return on assets in one particular year does not currently distort the reported earnings of a company, it goes through the Statement of Recognised Gains and Losses ('STRGL').

A period of stability is required in financial reporting, constant changes to standards and increased volatility in reported earnings confuse and may alarm readers of the accounts, without representing any real volatility in the performance of the company itself.

Arguably the latest proposal is yet another disincentive for organisations to keep their defined benefit pension schemes open so an unintended consequence of the proposed changes to the standard may be to reduce the number of schemes offering valuable benefits to members.

There may be arguments in support of new proposals where there are going concern issues within the relevant reporting entity, however.

Q1 -Should the liability to pay benefits that is recognised be based on expectations of employee's pensionable salaries when they leave service, or on current salaries including non-discretionary increases?

Although there may be an intellectual argument to support the fact that pay rises are discretionary, in practise the reality for most employers is that if no wages inflation is built in to the salary proposals, they would lose their workforce.

There may be particular specific economic conditions e.g. severe depression or recession where this is not the case, but in this case salary growth assumptions could be adjusted to nil, or very low, depending on the relevant economic reality.

It would be useful to obtain clarification from the ASB for the proposed disclosures in the financial statements relating to salary increases not reflected in prior year balance sheet pension surpluses or deficits.

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?

The liability is owed to the workforce as a whole. The consequence of this viewpoint is that pension obligations should reflect realistic salary increase expectations.

It is generally accepted that there is a liability to pay benefits when there is a present obligation to the workforce for benefits that are guaranteed by law or contract.

There is also an argument that, although benefit increases e.g. linked to salary increases may not be guaranteed by law or contract, constructive obligations to past/ or present employees may be inferred from past actions. e.g. where there is an established practise of granting increases every year.

As noted in para 4.9 on page 36 of the Discussion Paper, the present guidance on constructive obligation in IAS 19 is quite permissive.

'' An example of a constructive obligation is where a change in the entity's informal practises would cause unacceptable damage to its relationship with employees'. "

We would argue that this is the realistic interpretation, which should be retained, in all but exceptional circumstances (such as unusual economic environments such as long term recessions).

<u>Q3-Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities</u>

Yes with the caveat that the present obligation includes constructive obligation, as interpreted in response to Question 2 above, to include future salary increases due to the workforce as a whole.

<u>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?</u>

We believe that where there is separate trusteeship, governance and controls, pension schemes should continue to be exempt from consolidation.

<u>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')?</u>

Yes, changes in assets and liabilities should be recognised immediately.

<u>Q6-Do you agree with the paper's views in the measurement of liabilities to pay benefits. In particular do you agree that:</u>

<u>Regulatory measures should not replace measures derived from general accounting principles?</u>

Yes.

<u>The discount rate should reflect the time value of money only and therefore should be a risk free rate?</u>

No. A risk free rate is not necessarily the true time cost of money for an individual pension scheme. When attempting to arrive at net present value or net present cost in other circumstances, typically companies use the equivalent cost of borrowing or the cost of interest foregone.

Typically schemes now are increasingly liability driven (i.e. the funding represents the nature of membership of the scheme, with more emphasis on equities where the scheme is less mature, for example). Use of a risk free rate would increase the carrying value of the liability in many case to beyond the level which would be paid to an insurer valuing liabilities against AA yield for buyout.

It would seem counter intuitive to value liabilities at more than it would cost to insure against the obligation i.e. more than it costs to effectively buy out the liability. However the discussion paper does allow an entity to reflect the liability at the value it would cost to settle the liability. Page 133 9c) 'If alternative means of settling a liability are currently available to an entity (i.e. it is within the employer's control to achieve them), the liability should be reported at the lowest amount of the available alternatives'.

Presumably this is an incentive for companies to try to value their liabilities on a buyout basis. It would be a big cost to actually obtain a buyout quotation every year but if a transparent agreed methodology of valuing liability on a reasonable buyout basis (probably with a discount rate of slightly less than AA bonds, to reflect default risk) then this may be an option for valuing liabilities as an alternative to the risk free rate proposed in the paper. To do this would increase comparability between companies that have been involved in negotiations relating to buy out processes for some of their pension liabilities and companies that haven't.

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?

We believe a risk adjusted discount rate rather than a risk free rate should be used to discount the liability.

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

We would like further clarification from the ASB on the practicalities of reflecting all the aspects of a liabilities credit risk.

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

Arguably any matter, which affects the likely probable outcome of the settlement of the liability, should be reflected in the value of the liability.

Q7 -Where the 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?

The value of the liability should reflect the likely probable outcome rather than the highest likely amount of liability.

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

We believe that the balance sheet figure for assets should reflect the actual market value at the balance sheet date, but the income statement should continue to reflect the expected return on assets, with the difference between actual and expected return going through the Statement of Recognised Income and Expenditure (STRGL).

Q9- No comments

<u>Q10 -Do you agree that the different components of changes in assets and liabilities should be presented separately?</u>

Yes.

<u>Q11 Do you agree that the financial performance of an entity should reflect the actual return on assets rather than the expected return and the expected return should be required to be disclosed?</u>

There is an intellectual case to reflect actual return on assets in the profit and loss account, but there is also an intellectual and practical and reasonable case to retain expected return on assets, provided that the expected return on assets is reasonable compared to the actual return on assets over the medium term.

Arguably current accounting standards limit the extent to which the profit and loss account is subjected to unnecessary volatility e.g. due to short term improvements/ reductions in equity values and returns on assets that in practise will be held over the medium to long term (because equities for example are normally held where the proportion of actives in the scheme are high so they are held for longer term returns). Obviously there is currently a risk of distorting the profit and loss account if the expected return on assets is always too high, but if the expected return on assets is reasonable over the medium term, a difference in actual return on assets in one particular year may unnecessarily distort the reported earnings of a company.

Q12 <u>Do you agree with the objectives of disclosure that are identified in this Chapter? Are there any specific disclosure requirements that should be added or deleted from those proposed?</u>

We agree with the objectives of disclosure that are identified in the Chapter.
See earlier comments relating to the reporting of disclosure of actual return on assets and other of the key proposals.

<u>Q13-Q17</u>

Q17 note comments re volatility of earnings and disincentive to keep defined benefit schemes open.

No further comments.

Please do not hesitate to contact me if you require clarification on any of our comments.

Ross Paterson
Group Director of Finance and Company Secretary