

Issues arising from the IASB Discussion Paper “Preliminary Views on Amendments to IAS 19 Employee Benefits”: Comments from the British Accounting Association Special Interest Group in Financial Accounting and Reporting

The Financial Accounting and Reporting Special Interest Group (FARSIG) is a special interest group of the British Accounting Association. Its technical committee is charged with commenting on Exposure Drafts issued by standard setters on issues relating to financial accounting and reporting. Its views represent those of its members and not those of the BAA.

The British Accounting Association (BAA) is the representative body for UK accounting academics and others interested in the study of accounting and finance in the UK. The BAA Special Interest Group in Financial Accounting and Reporting is the BAA's designated group specialising in issues relating to financial reporting. This response has been formulated by Margaret Woods and Ken Peasnell with detailed comments from Mark Billings, Mike Jones, Pauline Weetman and Geoff Whittington, and has been approved by the Technical Committee of the Special Interest Group.

The comments below relate solely to the financial reporting of defined benefit pension schemes, and focus on issues surrounding the valuation and reporting of the liabilities of such schemes. As such, they directly address Questions 3 and 4 in the discussion paper. The authors do not wish to comment on the other questions raised.

Changes in the Value of Defined Benefit Obligations

The discussion paper proposes that entities should immediately recognise changes in the value of the defined benefit obligation. We agree with this proposal on the grounds that it enhances consistency across IFRS and additionally serves to enhance the scope for comparability of obligations across a range of reporting entities. Year on year changes in the value of a defined benefit obligation may, however, be difficult to interpret, given the problems surrounding its reliable measurement. The liability value is dependent upon a set of underlying assumptions, and any change in those assumptions will result in a potential change in the size of the obligation. For this reason we would suggest that additional qualitative and quantitative information may need to be provided to complement the reported valuation changes. More specifically, we would argue that quantitative assumptions should be benchmarked against a commonly used measure, and that assumptions about mortality or life expectancies be fully disclosed and also subject to sensitivity analysis.

It can be argued that the reliance of pension liability estimates on complex assumptions makes it necessary to provide readers with information about the sensitivity of the liability to variations in those assumptions. In taking a single estimate of the value of the defined benefit obligation, the company does not provide any indication of its ability to fulfil the obligation under changed circumstances, such

as an increase in life expectancy. Sensitivity analysis may provide a useful affirmation of the ability to honour commitments across of range of prudently selected scenarios.

In paragraph 2.8 of the discussion paper the Board observes that, in the light of the fact that post employment obligations are “more difficult to measure reliably than other obligations” it notes the relevance of disclosing “the risk of error surrounding their recognition and measurement.” The comments below focus on the disclosure implications of this observation, with specific reference to deferred benefit obligations.

As already noted, the scope for imprecision in the measurement of such liabilities is a consequence of the core assumptions which underpin the measurement process being potentially volatile, fundamentally uncertain (in the case of mortality forecasts) and non comparable. Consequently, we would ask that the IASB consider introducing a requirement for pension notes to include a sensitivity analysis which shows, both separately and cumulatively the impact of specified changes in the core assumptions. The case for such disclosures and possible suggested formats are as follows.

Mortality

The present value of the deferred pension liability is fundamentally dependent upon projected mortality rates, or life expectancies. As such, it is reasonable to assume that disclosure of the mortality assumptions is essential due to their material impact upon the valuation. The problem is that there is huge uncertainty in the mortality forecasts, which are also sensitive to geographic and occupational variation. As illustration of this, the recent trend of increased life expectancies for both males and females may be disrupted by the decline in public health levels due to growing obesity. This uncertainty is evidenced by the longevity fan charts constructed by Dowd et al (2008) that are reproduced below.

Fan charts are an established and respected tool used for showing possible ranges of forecast values. For example, the Bank of England published fan charts for inflation and GDP growth forecasts.

The longevity fan charts plot the 50 year profile of the anticipated shift in life expectancy for 65 year old males and females respectively by giving probability forecasts of future longevity: the darker the colouration, the more likely the outcome. The darker shading towards the middle of the chart therefore indicates the most likely outcomes as projected by the model; outcomes become less likely as they move away from the middle of the chart and their shading becomes lighter. The fan charts indicate that:

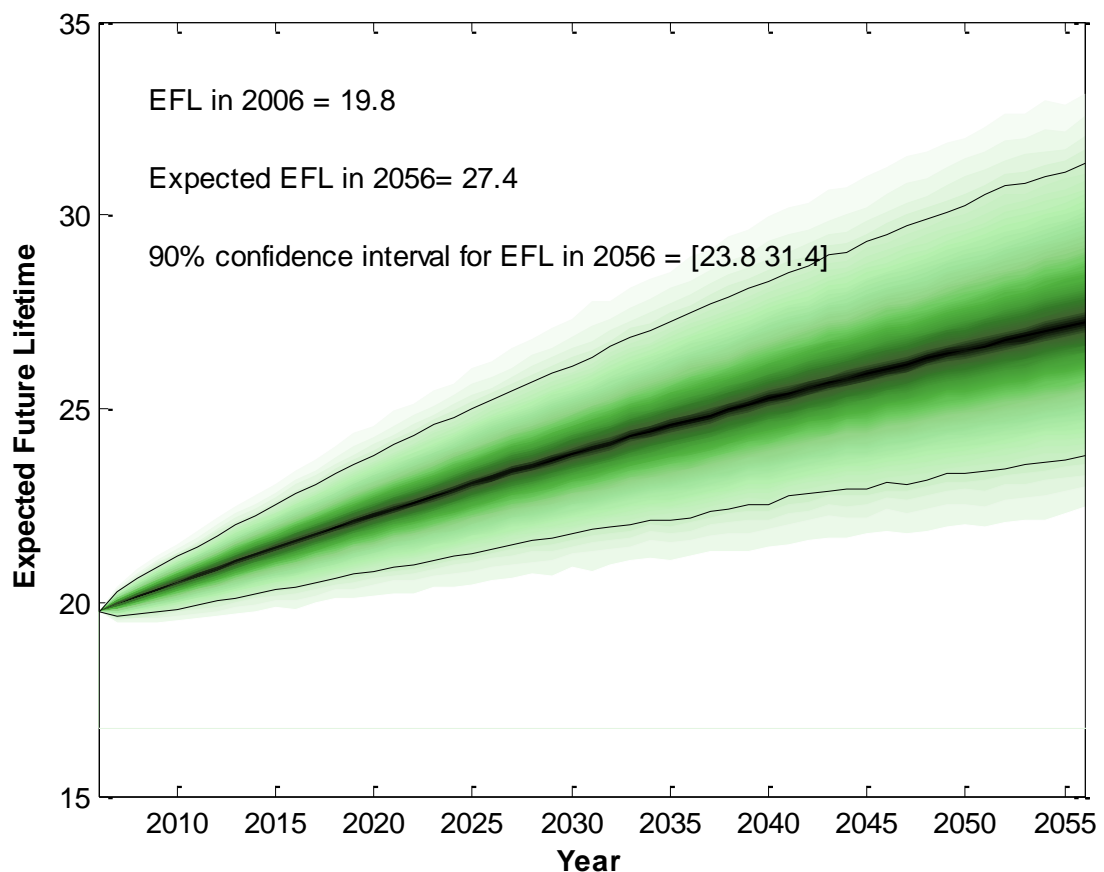
- For males, expected future lifetime is likely to rise by 38% by 2056
- For females, expected future lifetime is likely to rise by 19%
- In the longer term, male life expectancy overtakes that of females, reversing the current position
- Consequently, the costs of increased longevity are likely to rise accordingly

In addition, the two black lines superimposed on the charts mark the projected ‘risk bounds’ which give us a sense of the uncertainty in the projections. More precisely, they tell us that we can be 90% confident that:

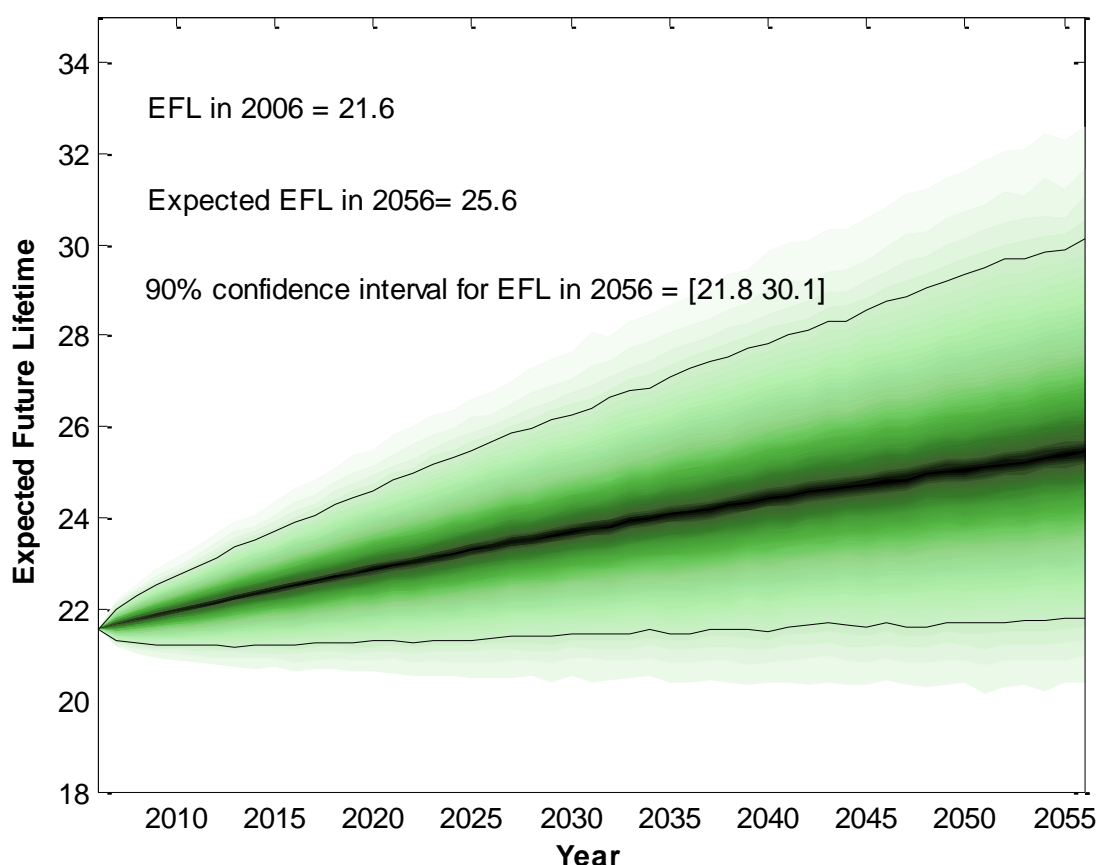
- The expected future life for 65 year old males in 2056 will be between 23.8 and 31.4 years
- The expected future life for 65 year old females in 2056 will be between 21.8 and 30.1 years

What is striking about these ranges is just how wide they are. Consequently, besides being likely to rise appreciably, future longevity is also very uncertain.

This suggests to us that there is a need to disclose the risks involved. In 2005, for example, ICI reported that its pension deficit of £470 million could in fact be £250 million higher if the mortality assumption was adjusted to take account of *known* increases in longevity. When liability measurements are so sensitive, it seems prudent to require disclosure of a variety of valuations based upon a standard range of variations in mortality assumptions. One such example would be disclosure of the impact of a one year improvement in life expectancy.



Longevity fan chart: England & Wales males (Source: “Facing Up to Uncertain Life Expectancy: The Longevity Fan Charts” by K. Dowd, D. Blake and A. J. G. Cairns, mimeo, Centre for Risk and Insurance Studies, Nottingham University Business School, June 2008)



Longevity fan chart: England and Wales females

Our suggestion to the Board on mortality disclosure therefore goes beyond that of the ASB (2007) and would provide users of the financial report with the scope to compare the sensitivity of funds across different reporting entities. Such a comparison would be further helped by the disclosure of any specific membership characteristics – such as an occupational bias impact on life expectancies – that might adversely affect the valuation of the defined benefit obligation.

Salary Inflation

It would appear that the issue of whether or not salary growth rates should be included in the liability measurement is a matter which remains open to debate. As such, clearer regulatory guidance would aid both the comparability and reliability of liability measures. Additionally, however, the impact of including or excluding such growth is dependent in part upon the individual mix of scheme members in terms of the number of current employees, past employees and retired members. In a scheme where the average age is high, changes in salary growth rates may have only a limited impact upon the liability valuation, but the converse would be true where there are a large number of young employees.

We would therefore recommend that the Board introduces a requirement for companies to disclose the impact of a defined range of shifts (say 1% - 3%) in salary

growth rates upon the value of the pension liability. An alternative approach would be to also disclose the liability assuming a benchmark figure for salary inflation.

Price Inflation

The assumption about future price inflation is important for two reasons. Firstly, pension payments are commonly inflation linked, although the inflation growth rate may be capped under pension scheme rules. Secondly, it is reasonable to assume that the rate of price inflation will influence the company's assumed rate of salary inflation. Inflation therefore increases the cost of both current and future pension obligations.

The most common approach used by companies appears to be that inflation is assumed to be equal to the difference between the yields on fixed-interest and index-linked government bonds. Even though this assumption appears to be common, it would nonetheless be helpful for the user to better understand the scope for sensitivity of the liability arising from changes in the rate of inflation (and hence salary inflation). We would therefore recommend that the Board introduces a requirement for companies to disclose the impact of a specified range (say, 0.5% - 1.5%) of changes in inflation rates upon the value of the pension liability. An alternative approach would be to also disclose the liability assuming a benchmark figure for price inflation.

Discount Rate

The very long time horizon of some pension liabilities means that even small variations in the assumed discount rate used to derive their present value can lead to substantive changes in that value. The Pension Protection Fund, using a gilt based discount rate, has estimated that with interest rates low following the credit crunch, even a 0.3% rise in gilts yields will cause a 5.7% rise in average pension liabilities (*Financial Times*, 2008).

Variation in the discount rate is therefore a potentially useful tool for managers wishing to reduce the size of the pension liability, and the Pension Adviser Review found that in the fourth quarter of 2004 the assumed discount rate across all companies varied between 4.85% and 5.09% (Williams, 2005). Given that IAS 19 is currently rather imprecise in requiring the discount rate to equal the yield on 'high quality' corporate bonds, we would suggest that for the sake of comparability and prudence, the relevant rate should equal the risk free rate. The risk free rate would equal the rate of return on a long dated government bond.

Assuming risk aversion, it may be appropriate to use a risk adjusted discount rate, in which the discount rate is lowered to take account of the risk, but such adjustments are far from straightforward. Some risks, such as increased longevity, would increase the liability, whilst other risks – such as the risk of an employee leaving service – may reduce the forecast liability. The relative significance of “good” versus “bad” risks is largely unknown and so it is very difficult to justify a particular risk adjustment. It would be inconsistent with the conceptual framework's definition of liabilities to adjust the pension liabilities downward by including a default (employee) element in the discount rate. At the same time, it is not common practice to adjust liabilities to

reflect fundamental uncertainty, and there is therefore no obvious reason why we should do so with pensions.

Our support for the use of a risk free rate is thus based on the difficulties of applying a risk adjusted approach. Whilst it is acknowledged that adopting a risk free rate will give rise to complaints that liabilities are over valued, it will offer the benefit of a common benchmark for potential investors. Additionally, in order to take account of the sensitivity of the liability value to changes in the discount rate, we would suggest that the Board requires the disclosure of liability values across a specified range of discount values, perhaps plus or minus 0.5 per cent of the rate applied.

Overall Sensitivity

Some of the assumptions which underpin the measurement of the liability are interdependent and positively correlated. For the sake of completeness, therefore, if sensitivity disclosures are required, it makes sense to also require an estimate of the overall sensitivities, taking into account correlations between the relevant assumptions.

References

The Financial Times (2008), 'Pension deficits treble in a month', 15 January

Williams, P. (2005), 'Transparency in Pensions', *Accounting and Business*, October, pp. 18-20.

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