NAPF Securing the future of pensions

NAPF Response to the IASB Discussion Paper: Preliminary Views on Amendments to IAS 19 Employee Benefits

1 Introduction – about NAPF

1.1 The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,200 pension schemes with some 15 million members and assets of around £800 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

1.2 Our main concerns in responding to the Discussion Paper are twofold: to ensure that any new standard both provides meaningful information to investors and users of accounts and also does not cause employers to withdraw from offering good quality pensions for purely accounting reasons.

2 Summary and Recommendations

- The IASB's proposals on immediate recognition of all gains and losses arising from Defined Benefit plans, on changes in the presentation of pension cost in the income statement, and on 'contribution-based' pension promises and how they should be accounted for are premature. No decisions should be taken until after the IASB's full review of accounting for post-employment benefits is completed.

- While we recognise that accounting standards are moving towards the elimination of multiple recognition options, the removal of the option for deferred recognition of actuarial gains and losses must follow, rather than precede, a new standard on presentation. The option for deferral of actuarial gains and losses should not be removed until after an acceptable revised standard on financial statement presentation has been developed.

- Valuation changes arising from immediate recognition must not be taken through the profit and loss account. The volatility of the returns is likely to overwhelm the operating results, causing finance directors and company boards to withdraw from offering their employees good quality Defined Benefit pensions that are in fact affordable. We particularly oppose Approach 1, which would take all elements of pension income and cost through the profit and loss account.

- We strongly oppose the IASB's proposals on 'contribution-based' promises. They represent a fundamental change in pensions accounting and should be seen as out of scope in what is intended as an amending standard. Immediate problems in accounting for hybrid and cash balance schemes are more properly dealt with through an IFRIC interpretation.

3 NAPF Position on Key Issues

3.1 The bulk of the IASB's proposals – specifically those on immediate recognition in Defined Benefit plans, on changes in presentation in the income statement and on 'contribution based' promises – are premature and no decision should be made on them until after the completion of the IASB's full review of accounting for post-employment benefits. Their implications are wider than the IASB suggests.

3.2 *Recognition*

We recognise that accounting standards are moving towards the elimination of multiple recognition options; in particular, we recognise analysts' and users of accounts' dissatisfaction with the 'corridor' approach. The case has not, however, been convincingly made for the removal of all options for deferred recognition of actuarial gains and losses, which we believe should follow, rather than precede, a new standard on financial statement presentation. Any decisions on the options for deferral and changes to presentation in the income statement should await the outcome of the IASB's project on financial statement presentation. This will provide the necessary context for decisions on the options for deferred recognition of actuarial gains and losses and how the resulting returns are taken through the income statement. While we agree that delaying recognition of actuarial gains and losses is not in accord with the conceptual framework, we believe that the International Accounting Standards Committee (IASC)'s opinion at the time that IAS 19 was issued remains valid: that immediate recognition can only be achieved when fundamental issues relating to presentation in financial statements are resolved.

3.3 *Presentation of Pension Cost in the Income Statement*

3.3.1 We are very concerned about the impact on corporate decisions of taking valuation changes arising from immediate recognition through the profit and loss account. Finance directors' and company boards' concerns about the volatility of pension returns could cause companies to withdraw from offering their employees good quality Defined Benefit pensions that are in fact perfectly affordable. Over the past ten years many schemes in the UK have closed to new entrants and, more recently, a small number have closed to future accruals for existing members. The NAPF's 2007 Annual Survey showed that 30 per cent of Defined Benefit schemes in the private sector were open to new members and 70 per cent closed; five years earlier the position had been the opposite, with 70 per cent of schemes open and just 30 per cent closed. Pension schemes remain under pressure, not just from accounting changes but from regulatory changes from home and the EU.

3.3.2 Balance sheet figures are a snap shot at a point of time. Taking potentially large and highly volatile valuation changes (the difference between two point-in-time estimates) through the income statement as a measure of earnings or cost over the reporting period could dominate operating earnings and be extremely misleading. The long-term cash flow requirements to meet companies' pensions obligations, and hence the true liabilities, are essentially stable from one year to the next; their apparent volatility is a function of unreliabilities in the measurement process. While many investment analysts are used to adjusting reported income to obtain the underlying trend, recent corporate decisions on pensions suggest that finance directors and company boards would react to the apparent volatility in income (and, more specifically, in the profit and loss account) by reducing or closing their pension schemes, even when they are affordable. We would be particularly concerned about the adoption of Approach 1, which would take all changes in the value of plan assets through the profit and loss account.

3.3.3 How the various elements of the pension cost are taken through the income statement will play a vital role in avoiding misunderstandings about the nature of the different elements of pensions cost. Financial statements are unlikely to be useful for decisions unless material items with different predictive values are separated out. While we agree with the IASB that the distinction between income and capital returns must to some extent be arbitrary, we believe that there is predictive value in attempting to establish an underlying trend in income returns separate from market fluctuations. We understand the IASB's concerns about the use of expected returns, but believe that expected returns can give a good guide to management policy and thinking. They remain our preferred measure of interest income. We recognise that there have been misuses in some jurisdictions around the world where unrealistically high expected returns have been taken through the profit and loss account to boost reported profits, but we feel that such misuses should be tackled directly, whether through disclosure requirements or through the use of powers to call in accounts where unrealistically high expected returns have been used.

3.3.4 We feel that using market yields on high quality corporate bonds to impute interest income is worth consideration, particularly as it would be consistent with the treatment of interest cost.

3.4 *Contribution-Based Promises*

3.4.1 We strongly oppose the Board's proposals for the creation of a new category of 'contribution-based' promises. In attempting to clarify the boundary between Defined Benefit and Defined Contribution pensions, the Board has proposed changes that could have a dramatic impact on reported pension liabilities in many countries. We feel that the proposals will create more problems than they resolve and that they are likely to make the process of convergence more difficult. It is difficult to avoid the conclusion that they represent a fundamental change in pensions accounting and are out of scope in what is intended as an amending standard.

3.4.2 The Board's proposals are likely to lead to results that are arbitrary and which would be difficult to justify. They would result in some types of schemes that we would see as being Defined Benefit schemes being accounted for as contribution-based schemes. The Discussion Paper's chapter on measurement provides insufficient detail to allow an estimation of the impact of the proposals on individual schemes' reported liabilities. Perversely, efforts by scheme sponsors to reduce risk – for example by moving from final salary to career average benefits – could well lead to an increase in reported liabilities. We would draw your attention to the fact that the Accounting Standards Board (ASB)'s recent Discussion Paper on the financial reporting of pensions did not identify any concerns about accounting for career average plans or other schemes currently accounted for as Defined Benefit schemes.

3.4.3 Furthermore, the proposals seem to pre-empt the outcome of IASB's full review of pensions accounting, as once the fair approach proposed for accounting for these promises is adopted we find it difficult to see how standards setters will be able to consider dispassionately how best to account for pension promises more generally. We feel that the short-term clarifications that are needed in the meanwhile are best dealt with through the International Financial Reporting Interpretations Committee (IFRIC), rather than by an interim amendment to IAS 19.

3.5 *NAPF Response to ASB Discussion Paper*

We attach as Annex A our response to the ASB's Discussion Paper 'The Financial Reporting of Pensions', which goes into some of these issues in more detail. We also refer to specific paragraphs of this response in our answers to Questions 3 and 9.

4 Responses to Specific Questions Raised in the Discussion Paper

Scope of the Project

Q1 *Given the objective of the IASB project to address specific issues in a limited time frame, are there additional issues which you think should be addressed by the Board as part of this project? If so, why do you regard these issues as a matter of priority?*

No, we do not believe that there are additional items that should be addressed as part of this project.

Recognition and presentation of defined benefit promises

Q2 *Are there factors that the Board has not considered in arriving at its preliminary views? If so, what are those factors? Do those factors provide sufficient reason for the Board to reconsider its preliminary views? If so, why?*

While we agree that delayed recognition of actuarial gains and losses is not in accord with the conceptual framework, we believe that the IASC's opinion at the time that IAS 19 was issued remains valid: that immediate recognition can only be achieved when fundamental issues relating to presentation in financial statements are resolved[1].

Q3

(a) *Which approach to the presentation of changes in defined benefit costs provides the most useful information to users of financial statements? Why?*

(b) *In assessing the usefulness of information to users, what importance do you attach to each of the following factors, and why:*
   (i) *presentation of some components of defined benefit cost in other comprehensive income; and*
   (ii) *disaggregation of information about fair value?*

(c) *What would be the difficulties in applying each of the presentation approaches?*

Financial statements are unlikely to be useful for decisions unless material items with different predictive values are separated out. While we agree with the IASB that the distinction between income and capital returns must to some extent be arbitrary, we believe that there is predictive value in attempting to establish an underlying trend in income returns separate from market fluctuations.

We would be particularly worried about the adoption of Approach 1, which would take all changes in the value of plan assets through the profit and loss account. We are concerned that the operating and even financing results would be overwhelmed by the random noise in the actual returns and at the possible impact that this might have on decision-making. Taking potentially large and highly volatile valuation changes through the profit and loss account could dominate operating earnings and be extremely misleading, causing finance directors and company boards to withdraw from offering their employees defined benefit pensions that are in fact perfectly affordable. Our response to the ASB's Discussion Paper 'The Financial Reporting of

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[1] the IASC's opinion is referred to in paragraph 2.6 of the Discussion Paper, page 28.

Pensions', a copy of which we attach, set out our concerns in more detail – most particularly in paragraph 5.2 on pages 19-20.

Approaches 2 and 3 both achieve the objective of reporting interest income and expense in the same part of the financial statements and we concur with this approach. Various definitions of interest income are set out in Approach 3 with no preferred approach being put forward. We are surprised at the Discussion Paper's comments about the 'complexity' involved in implementing Approach 3, which seems to be very similar to current practice and should therefore be seen as well tried and understood. While we understand the IASB's concerns about the use of expected returns, expected returns can give a good guide to management policy and thinking. They remain our preferred measure of interest income. We recognise that there have been misuses in some jurisdictions around the world where unrealistically high expected returns have been taken through the profit and loss account to boost reported profits, but we feel that such misuses should be tackled directly, for example through regulatory bodies utilising disclosure requirements such as those required by FRS 17 (see our answer to Question 4, below) and by powers, such as those of the SEC in the United States, to call in accounts where unrealistically high expected returns have been used.

We do not agree with the use of dividends received on equity plan assets and of interest earned on debt plan assets for the measurement of interest income since it leads to a split of the total return on the assets which is capable of manipulation and reduces comparability of the results of corporate entities, one of the key objectives of investors.

We feel that using market yields on high quality corporate bonds to impute interest income is worth consideration, particularly as it would be consistent with the treatment of interest cost.

Q4

(a) How could the Board improve the approaches discussed in this paper to provide more useful information to users of financial statements?

(b) Please explain any alternative approach to presentation that provides more useful information to users of financial statements. In what way does your approach provide more useful information to users of financial statements?

We believe that improved disclosures not only provide useful information for users of accounts but also limit the opportunities for misuse by preparers. On expected returns, we would recommend the UK accounting standard FRS 17, which requires disclosure of assumptions about expected returns for each material asset class and a five-year historical record comparing expected and actual returns.

Definition of contribution-based promises

Recognition issues related to contribution-based promises

Q5 *Do you agree that the Board has identified the appropriate promises to be addressed in the scope of this project? If not, which promises should be included or excluded from the scope of the project, and why?*

In attempting to clarify the boundary between Defined Benefit and Defined Contribution pensions, the Board has proposed changes that could have a dramatic impact on reported pension liabilities in many countries. The proposals will create more problems than they resolve and are likely to make the process of convergence more difficult.

The proposals involve fundamental changes in accounting practice and therefore, as a matter of principle, are not appropriate for what is intended as an interim amending standard.

Q6 *Would many promises be reclassified from defined benefit to contribution-based under the Board's proposals? What are the practical difficulties, if any, facing entities affected by these proposals?*

If the Board's analysis of the impact of its proposals (through the fourteen examples of pension promises that it provides) is correct, the proposals would affect the majority of pension promises in some countries. Even in countries that are less affected, the proposals would create problems for firms seeking to reduce their pension risks – for example, by moving from final salary to career average benefits, which under the Board's proposals would be subject to a more onerous measurement requirement, possibly leading to an increased – rather than a reduced – reported liability despite the reduction in risk.

Q7 *Do the proposals achieve that goal? If not, why not?*

Of the 14 examples of pension promise analysed in the Discussion Paper, six (numbers 5, 6, 7, 10, 13 and 14) involve a switch from IAS 19 Defined Benefit status to contribution-based status. We believe that the changes, whose impact will be significant for the schemes affected, are difficult to understand and will prove hard to explain; for example, it is difficult to see why final salary and career average schemes should be accounted for on a different basis, however hard one might try to distinguish them as representing a different balance of asset and salary risk.

Q8 *Do you have any comments on those preliminary views? If so, what are they?*

We believe that the proposed definitions and accounting methodology for contribution-based promises represent a fundamental change in pensions accounting and could have a dramatic impact in many countries. The effect of the change in definitions seems to be quite arbitrary, is difficult to understand and will prove hard to justify.

Measurement of contribution-based promises

Q9

(a) Are there alternative measurement approaches that better meet the measurement objectives described in this paper? Please describe the approaches and explain how they better meet the measurement objectives.

(b) To what extent should the effect of risk be included as a component of the measurement approach at this stage of the Board's post-employment benefit promises project? How should this be done?

We accept that there is a more immediate need to address accounting for Defined Contribution benefits with defined or guaranteed returns, but we believe that the Board's proposals for a new category of contribution-based promises are unnecessarily complex and fundamentally flawed. The proposed amendments to the definitions are difficult to understand and it appears that they will result in some types of schemes that we would see as being Defined Benefit schemes being accounted for as contribution-based schemes. We query the attempt to distinguish 'contribution-based' promises from Defined Benefit schemes on the basis of a distinction between 'asset' and 'salary' risk, which we do not believe is as clear as the Discussion Paper makes out; in particular we feel that some indices based on economic indicators (for example, inflation indices) are as relevant for salary risk as for asset risk. Furthermore, the chapter on measurement of contribution-based promises is unspecific on detail, with the result that it is difficult to work out how some schemes will be affected.

We suspect that the guarantees included in a number of Defined Contribution schemes that are of concern to the Board can be accounted as options on the basis of IAS 39 on financial instruments, as set out in the Discussion Paper on pages 90-91 in its discussion of the measurement of 'higher of' options. Any short-term clarifications that are needed are best dealt with through the International Financial Reporting Interpretations Committee (IFRIC), rather than by an interim amendment to IAS 19.

How best to account for risk is a difficult and complex subject and we believe that it is not an appropriate subject for an amending standard. It should await the more fundamental review that the Board is undertaking with FASB on pensions accounting. Our views on accounting for risk are set out in more detail in our attached response to the ASB's Discussion Paper 'The Financial Reporting of Pensions' (see in particular, paragraph 5.1 on pages 18-19). We believe that in the meanwhile the current requirement to discount Defined Benefit scheme liabilities at a good quality corporate bond rate adequately recognises that such risk is imperfectly but at least consistently measured in practice.

Q10

(a) *Do you agree that the liability for benefits in the payout and deferment phases should be measured in the same way as they are in the accumulation phase? If not, why?*

(b) *What are the practical difficulties, if any, of measuring the liability for a contribution-based promise during the payout phase at fair value assuming the terms of the benefit promise do not change?*

We agree that the liability for benefits in the payout and deferment phases should be measured in the same way as they are in the accrual phase. This seems a pragmatic approach to dealing with a contradiction that does not seem capable of resolution. We would, however, add that the inherent contradiction identified by the Board is evidence of the incoherence of the approach proposed and further reason for the proposals on contribution-based promises to be withdrawn.

Disaggregation, presentation and disclosure of contribution-based promises

Benefit promises with a 'higher of' option

Q11

(a) *What level of disaggregation of information about changes in the liability for contribution-based promises is useful to users of financial statements? Why?*

(b) *Do you agree that it is difficult to disaggregate changes in the contribution-based promise liability into components similar to those required for defined benefit promises? If not, why not?*

Q12 *Should changes in the liability for contribution-based promises (a) be presented in profit or loss, along with all changes in the value of any plan assets; or (b) mirror the presentation of changes in the liability for defined benefit promises (see Chapter 3)? Why?*

In answer to the above two questions, in principle presentation should be the same for Defined Benefit and contribution-based promises. We recognise that in practice some of the line items will be applicable for certain contribution-based promises, most obviously pure Defined Contribution schemes where the employer's contribution will be the only item accounted for.

Q13

(a) *What are the practical difficulties, if any, in identifying and measuring the 'higher of' option that an entity recognises separately from a host defined benefit promise?*

We suspect that it should not be too difficult to identify and measure 'higher of' options on the basis set out on pages 90-91 of the Discussion Paper.

(b) *Do you have any other comments on the proposals for benefit promises with a 'higher of' option? If so, what are they?*

We do not feel qualified to comment further.

Other matters

Q14 *What disclosures should the Board consider as part of that review?*

In reference to expected returns, we recommended in our answer to Question 4 the requirements of the UK standard FRS 17 for disclosure of assumptions about expected returns for each material asset class and five-year historical record comparing expected and actual returns.

The Accounting Standards Board in the UK recently issued best practice reporting guidelines for pensions. IASB should consider implementing several of these suggestions as additional requirements under IAS19 to enhance the information provided to investors. Specific examples of improved information for investors include:

- information to understand the future cash contribution requirements from the employer over longer periods than the one year presently required by IAS 19;
- disclosure of the longevity assumptions;
- disclosure of the sensitivity of the liabilities and costs to changes in the main assumptions; and
- disclosure of the employer's policy for managing pensions risk.

We would certainly welcome improved disclosures about mortality assumptions and feel that UK practice is moving in the right direction. We do not see the disclosures as being a matter for detailed prescription; we believe that analysts and users of accounts are looking for 'colour' and a view of management thinking, rather than the ticking off of prescribed requirements.

Q15 *Do you have any other comments on this paper? If so, what are they?*

As we have stated at various points in our response, we feel that the Board's proposed definitions of contribution-based promises and the accounting proposed for them represent a fundamental change in accounting practice and should await the full review of pensions accounting that is being undertaken by the Board and FASB. The proposals do not appear to be internally consistent and we feel that the remedy is likely to be worse than the problem that it is attempting to resolve. They should therefore be withdrawn. We likewise feel that the proposals on recognition should await the outcome of the Board's project on financial statement presentation.

Annex A

NAPF Response to the ASB Discussion Paper: The Financial Reporting of Pensions

1 Introduction

1.1 The National Association of Pension Funds (NAPF) welcomes the opportunity to comment on the Accounting Standards Board (ASB)'s paper. A fundamental review of how to account for pensions is necessary given that existing standards not only remain a matter of controversy among pension professionals but are widely considered to have undermined good pension provision. However, the outcome of this current review must not further undermine good Defined Benefit pension provision or scheme sponsors' confidence in DB. Rather, it must provide a real world solution to the issue of accounting for pensions.

1.2 This paper:

- Outlines the impact of the ASB's proposals on DB pension schemes (section 3).
- Sets out the NAPF's views on the current approach to pensions accounting (section 4).
- Sets out the NAPF's views and recommendations on the key proposals in the ASB's paper (section 5).
- Responds to the ASB's specific questions (section 6).

About the NAPF

1.3 The NAPF is the leading voice of workplace pension provision in the UK. The NAPF represents over 2000 workplace pension schemes providing pensions for over 10 million working people. Our member schemes hold assets of around £800 billion and account for approximately one fifth of investment in the UK stock market.

2 Executive Summary and Recommendations

- The ASB's proposals are likely to further weaken DB provision in the UK, increasing reported scheme liabilities and undermining scheme sponsors' willingness to provide DB pensions. Like other regulators and standard setters, the ASB cannot operate in a vacuum, indifferent to the consequences of its actions. Instead it must offer a 'real world' solution to the issue of accounting for pensions that, on the one hand, takes account of the need (supported by the NAPF) for transparency, and on the other the need to maintain good quality DB pensions that provide valuable benefits to millions of working people.

- The ASB must revise its proposals, especially those relating to the use of a risk-free discount rate which will significantly increase reported DB scheme liabilities. Rather than a risk-free rate, the NAPF recommends a 'swaps plus' discount rate should be adopted. If 'swaps plus' is not considered appropriate, the current AA corporate bond discount rate should be retained.

- The use of actual rather than expected returns in the Income Statement is inappropriate as this would overstate the volatility of long-term pension costs. We are concerned that inclusion of actual returns in the Income Statement would dominate the operating and financing results. We recommend that the current practice of using expected returns is maintained.

- We agree that discretionary salary increases should be excluded from the calculation of liabilities.

- It is impractical and in some circumstances inappropriate to require employers providing pensions via multi-employer schemes to account for pensions in the same way as single employer schemes. The NAPF proposes that employers should continue to account only for their contributions to the scheme.

- The ASB's proposal that pension schemes should account for the liabilities on the same basis as the scheme sponsor misunderstands the purpose of pension scheme accounts, is likely to confuse scheme members and would add to scheme costs. The NAPF recommends that a summary of the scheme's funding position should be included in the scheme's annual report.

- We believe there are more fundamental issues that this review has failed to address, for example relating to the appropriateness of fair value accounting. Longer term, these issues will need to be examined. We have outlined our concerns on these issues in this response.

3 The Impact of the ASB's Proposals on DB Pension Provision

3.1 The ASB's proposals, and in particular the proposed move to a risk-free discount rate, are likely to further erode DB pension provision in the UK. And it is this – the practical effect – that is at the heart of the NAPF's concerns over the current proposals.

3.2 Over the past ten years many schemes have closed to new entrants and, more recently, to future accruals for existing members. The 2007 NAPF Annual Survey showed that 31 per cent of DB schemes in the private sector were open to new members and almost 70 per cent closed. Just five years previously in 2002 – the time FRS17 was being introduced – the situation was reversed, with 70 per cent of schemes open and just 30 per cent closed. Despite the high level of scheme closures, many millions of working people are continuing to save in open DB schemes. Some 63 per cent of workplace pension scheme members are still in open DB schemes[2]. Such schemes are providing valuable benefits to millions of working people.

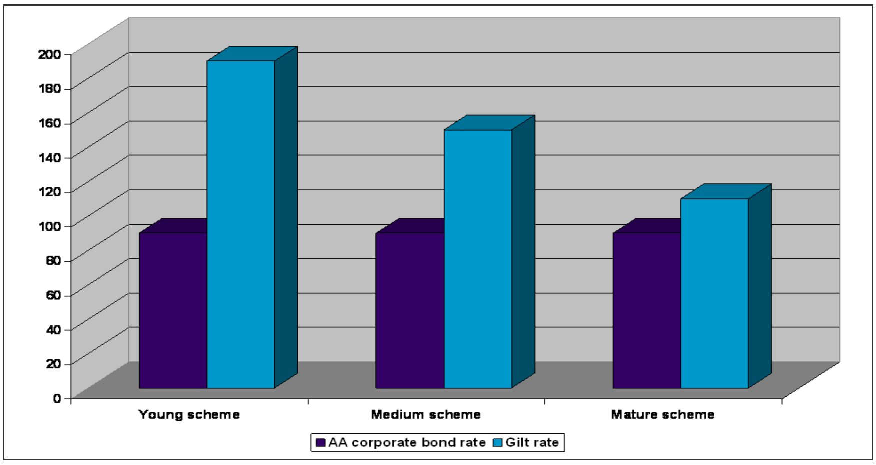
3.3 The practical effect of moving to a risk-free rate can be clearly seen from analysis undertaken for the NAPF by Punter Southall. It examines the situation of three schemes of differing maturities:

- the "young" scheme is one with a duration of 29 years;
- the "medium" scheme is one with a duration of 20 years; and
- the mature scheme has a duration of 12 years.

Each is assumed to have £100m of liabilities and figures are produced as at 31 December 2007.

3.4 As the figure below shows, moving to gilts as a basis for the discount rate would increase reported liabilities for schemes of all maturities, the less mature the scheme the higher the increase. The effect on a young scheme is very significant, more than doubling liabilities. Schemes of medium maturity would face a 60 per cent increase in liabilities and mature schemes would see liabilities rise by as much as 25 per cent.

Fig 1: Pension Scheme Liabilities using AA Corporate Bond and Gilt Rates



Source: Punter Southall

[2] Pension Protection Fund and The Pensions Regulator 'Purple Book 2007', page 34.

3.5 The effect would be significant even in periods when corporate bond spreads over gilts were more normal. For a young scheme, it would have increased the liability by between 54 per cent and 68 per cent for the end-years 2004-2006, with smaller increases for medium and mature schemes (for a medium scheme the increase would have been between 32 per cent and 40 per cent, and for a mature scheme between 12 per cent and 15 per cent).

3.6 By themselves, the additional reported liabilities and the increased volatility in the income statement arising from the ASB's proposals would be significant and threatening to DB pensions. But the ASB's proposals are not the only pressures facing schemes:

- The Pensions Regulator (tPR) has recently produced guidance which states that schemes in a recovery period that fail to use long-cohort life expectancy projections will trigger further investigation by the Regulator. As we have made clear in our response to the Regulator, there is a risk that their guidance will become quasi regulation and trustees will move to use long-cohort regardless of their own scheme circumstances. Each additional year of life expectancy adds an additional 3 per cent to scheme liabilities. For FTSE 100 companies alone, this amounts to £12bn a year.

- From 2012, DB schemes that do not already use auto-enrolment will be required to auto-enrol their workers into a scheme, either Personal Accounts or their existing workplace scheme. If schemes auto-enrol at existing contribution rates, as it is hoped they will, the cost to schemes could be around £1bn a year leading to further upward pressure on liabilities.

- If the EU applies Solvency II capital requirements to UK DB pension schemes the effect on schemes would be significant: reported liabilities could rise by as much as 57 per cent, according to a study by the European Federation for Retirement Provision[3].

Taken in isolation, each of these events would be highly damaging to DB schemes. Taken together – and they would all come together around 2012/2013, along with the proposed changes to accounting standards – they are a mix toxic enough to kill off the UK's remaining DB provision.

3.7 Standard setters cannot operate in a vacuum, indifferent to the consequences of their proposals. They must take account of the wider environment in which scheme sponsors are operating and offer real world solutions. An increase in reported scheme liabilities is not just an accounting or

[3] European Federation for Retirement Provision 'IORP Directive – securing workplace pensions', May 2008, page 17.

actuarial convention. It affects scheme funding decisions and the willingness of employers to continue offering DB pensions.

3.8 To avoid doubt, we would emphasise that we are not suggesting that standards should be designed to produce results that are skewed in favour of keeping schemes open where they should not be kept open. Indeed, we agree that accounting standards should aspire to present economic substance fairly. However, it is precisely this criterion where the current environment has failed and why the recent proposals would be a further step in the wrong direction. Pensions accounting standards should be designed to reflect the true commercial impact of pension provision so that employers are not led by a distorted view of reality to close perfectly sound schemes.

4 The NAPF View on the Current Approach to Accounting Standards

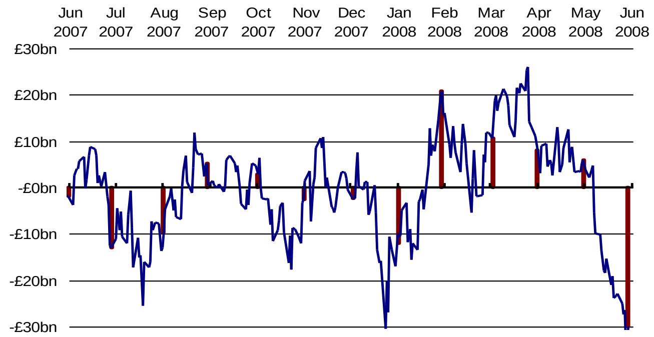
4.1 Standard setters must take note of the widespread concerns about the validity of the accounting framework and in particular the continued pressures towards "fair value" accounting. They should recognise the considerable uncertainties around the market and model-based measures that fair value accounting gives rise to, particularly when measuring very long term assets and liabilities. Clearly, it is reasonable to be concerned about a methodology that can give rise to very different figures over short periods of time without any significant change in the underlying cash flows. This is especially the case where there is already a history of decisions about pension provision and pension investment strategy being driven by accounting figures that do not properly reflect economic reality.

4.2 If implemented, the impact of the proposals will be that changes in balance sheet assets at fair value and liabilities between two dates will be immediately recognised in profit and loss, where the result will be likely to dominate other items. The consequence of this will be reported income and expenditure not representative of the true economic cost of running a pension scheme. Profits and losses will become distorted by changes in interest rates (in the case of liabilities) and by point-in-time market movements (in the case of assets). We believe that financial statements should be considered as a whole, and that the proposed balance sheet–centric approach is to the detriment of a true and fair view of profit and loss. As a portrayal of the financial disposition of companies, the profit and loss account gives a view at least as important as the balance sheet, and arguably more so. With the reported cost of providing pensions (gains and losses at fair value) so completely divorced from the economic substance of providing pensions (the regulatory position and long term funding rates), we question how it is possible for the profit and loss account to present financial performance fairly on this basis.

4.3 The issue of volatility, which must not be confused with the argument about cost measurement set out above, is also worth repeating. Pension scheme assets are held to meet long term liabilities and, although the investment management process involves switching between different asset classes and individual investments, schemes are seldom obliged to realise them in the short term to pay benefits. Indeed, only as a scheme matures will benefit payments exceed inflows from contributions and, even then, investment income (as opposed to change in value) will be sufficient to fund a material proportion of benefits. Further, during 2008 to date, equity markets have been moving up to 2 per cent in a single day over extended periods – evidence that sentiment and psychology can frequently influence market levels more than company fundamentals. Likewise, reported scheme liabilities are extremely sensitive to changes in the discount rate without there being any change in underlying cash flows. This volatility is compounded in the measurement of the scheme surplus or deficit, as being the difference between two large and volatile figures. Taking a value for the scheme surplus or deficit on this basis and putting it through the income statement is to take an unreal number and give it a prominence in the financial statements of the sponsoring employer that it does not deserve.

4.4 The Punter Southall research described in Section 3 clearly shows the sensitivity of reported pension liabilities, and particularly very long term liabilities, to relatively small changes in the discount rate. The impact of this volatility on scheme surpluses and deficits when combined with the volatility in the measurement of scheme assets in response to market fluctuations is dramatic. This can be seen in a number of indices including the Pension Protection Fund's PPF 7800 Index, which gives a monthly estimate of the aggregate surplus/deficit of all the schemes in The Pensions Regulator/Pensions Protection Fund database on a discontinuance basis. Aon Consulting's Aon200 Index, tracking the aggregate FRS17/IAS19 surplus or deficit for the UK's 200 largest privately-sponsored pension schemes, gives a similar picture and is shown below for the twelve months to June 2008.

Aon200 Index - Total FRS17/IAS19 surplus (or deficit) for the UK's 200 largest UK privately-sponsored pension schemes



Source: Aon Consulting

4.5 One of the objectives of financial statements is, according to the IASB framework, that they should be relevant and that "Information has the quality of relevance when it influences the economic decisions of users". Because of the measurement problems arising from excessive reliance on market and fair values, the resulting figures are frequently a poor basis for decisions. A fair value approach to accounting is widely considered to have contributed to discouraging employers from continuing to provide defined benefit pensions and to the closure of many schemes to new entrants and to have distorted pension scheme trustees' investment decisions, encouraging them to adopt excessively cautious investment strategies that have increased the cost of pension provision.

4.6 Whilst we have reservations about the merits of fair value methodology in valuing pension assets and liabilities, we have structured the remainder of our response within the context of a fair value framework.

5 NAPF Response to the Key Proposals in the ASB Paper

This section sets out the NAPF's views on the five main proposals put forward by the ASB in its discussion paper.

5.1 *ASB Proposal: Pension liabilities should be discounted at the risk-free rate*

5.1.1 The choice of discount rate is necessarily arbitrary. We remain convinced, however, that a discount rate higher than the government bond or swaps rate is appropriate and that this can be justified both as a reflection of risk (for example, to reflect the discretion that scheme sponsors have to take action to mitigate the impact of their pension obligations) and by the fact that the assets held to fund the liability will grow at a higher rate than the risk-free rate.

5.1.2 We believe that:

- Scheme liabilities should be discounted at a rate that reflects risk – in particular the uncertainties inherent in the estimation of liabilities such as divorce rates, longevity, etc. and the opportunities available to companies to reduce or mitigate their liabilities, for example by making salary increases non-pensionable or by closing the scheme[4].

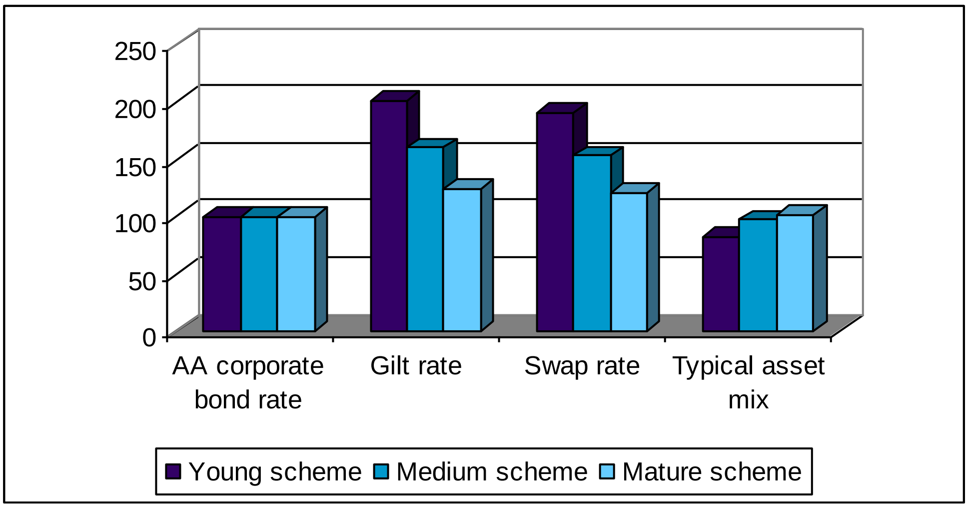
- Use of the risk-free rate is likely to be seriously misleading about the ability of the scheme to fund its liabilities, as it does not reflect the fact that scheme assets may be invested to earn a higher return than the risk-free rate. There are indications that buy-out firms are using a higher discount rate than the risk-free rate when assessing potential

[4] Specific actions taken by seven UK schemes to mitigate their liabilities are described in NAPF's Report 'All Change! Case studies from the changing world of occupational pensions', May 2007.

buy-outs and it seems counter-intuitive to report the liabilities at a level that would (on current pricing) be substantially greater than that at which they could be discharged in the market.

5.1.3 We therefore believe that standard setters must either retain the current requirement that the return on a good corporate bond is used to discount the liabilities or preferably, in view of the recent distortions caused by widening credit spreads, move to something similar but less liable to distortion, for example a swap rate plus an amount that could be seen as a long-term "sustainable" corporate bond spread. This could well be 1-2 percentage points (see Figure 2 below). The exact amount might be determined by accounting standard setters following consultation with market practitioners or delegated by them to preparers of accounts and the auditors' judgement. Our preference for the swap rate over a government bond rate is based on the fact that the swap market is more liquid, particularly at the long end, and is the mechanism by which pension funds tend to hedge their liabilities when they choose to do so.

Fig 2: Pension Scheme Liabilities using different discount rates, end-2007 (AA corporate bond rate = 100)



Source: Punter Southall

5.2 ***ASB Proposal: Actual rather than expected returns should be reported in the income statement***

5.2.1 We are extremely concerned about the potential impact of the Discussion Paper's proposal that actual, rather than expected, returns should be taken through the income statement. We are concerned that the operating and even financing results would be overwhelmed by the random noise in the actual returns and at the possible impact that this might have on decision-making. We have seen no evidence that analysts have expressed any wish to see actual returns shown (except as a note) in the income statement and believe that they would anyway strip this figure out in their analysis of the accounts.

5.2.2 Balance sheet figures are a snap shot at a point of time. Taking potentially large and highly volatile valuation changes (the difference between two point-in-time estimates) through the income statement as a measure of earnings or cost over the reporting period could dominate operating earnings and be extremely misleading. While many investment analysts are used to adjusting reported income to obtain the underlying trend, recent corporate decisions on pensions suggest that finance directors and company boards would react to the apparent volatility in income (and, more specifically, in the profit and loss account) by reducing or closing their pension schemes, even when they are affordable.

5.2.3 While we accept that the role of financial statements is to account for what has happened (rather than what one think might happen), putting actual returns through the income statement is likely to overwhelm operating profit in many cases and give a misleading view of the underlying earnings trend. We believe that the right approach is to continue to show expected returns but to provide enhanced disclosures of actual returns.

5.2.4 We recognise that there have been misuses in some jurisdictions around the world where unrealistically high expected returns have been taken through the profit and loss account to boost reported profits, but we feel that such misuses should be tackled directly, for example through regulatory bodies utilising disclosure requirements such as those required by FRS 17 and by powers, such as those of the SEC in the United States, to call in accounts where unrealistically high expected returns have been used. These include disclosure of assumptions about expected returns for each material asset class and a five-year historical record comparing expected and actual returns.

5.2.5 We also believe that how the various elements of the pension cost are taken through the income statement will play a vital role in avoiding misunderstandings about the nature of the different elements of pensions cost. We had understood that the accounting profession and standard setters had agreed that a move to taking actual returns through the income statement could not be introduced until after the implementation of a new standard on comprehensive income.

5.3 ***ASB Proposal: Consideration should be given to the exclusion of discretionary salary increases when calculating scheme liabilities***

5.3.1 While it can be argued that because pensions are deferred pay, an estimate of the total cost of the service should be allocated to the period in which it was delivered, we feel that there are stronger reasons to accept the general accounting principle that it is incorrect to account for future events over which one has discretion. We believe that ASB underestimates the extent to which employers have discretion to mitigate the impact of their pension liabilities, for example by increasing member contributions, raising normal retirement age or making future salary increases non-pensionable[5]. The trend towards greater use of incentive pay for senior executives also represents a move away from pensionable pay increases. Certainly inclusion of discretionary salary increases in the calculation of the liability would be inconsistent with a move to a risk-free discount rate, which implicitly excludes risks relating to future events.

5.3.2 The Punter Southall research undertaken for the NAPF suggests that exclusion of discretionary salary increases would reduce scheme liabilities by around 12 per cent for a young scheme.

5.4 *ASB Proposal: Employers in multi-employer schemes should account for their share of the scheme liability*

5.4.1 In some countries where DB pension provision is prevalent, for example in the Netherlands and in some UK schemes, multi-employer schemes operate on a risk-sharing basis. In such cases it would be incorrect for individual participating employers to account for their share of a liability that is not apportioned between them.

5.4.2 Even where there is only limited risk-sharing, it is difficult to see how employers can in practice reliably account for their share of the deficit except where the scheme is divided into sections that are separately accounted for. The Discussion Paper correctly identifies the problems in obtaining the necessary information for all three measurement methodologies that it proposes, but we fear that there will in many instances be no reasonable basis that could be consistently applied to determine an "allocation key" for calculating a proportionate share. The Discussion Paper suggests that the key could be based on contribution levels but in many multi-employer schemes this would be inequitable as between employers that have recently joined the scheme (and therefore not built up accrued benefits for their employees' past service) and employers with a longer record of involvement in the scheme, and between employers with a high proportion of active members and those with a high proportion of deferred and pensioner members.

5.5 *ASB Proposal: Pension schemes should account annually for the liabilities on the same basis as the scheme sponsor*

5.5.1 The ASB argues that scheme accounts are incomplete without inclusion of the liabilities and that this information would be useful to members, their advisers

[5] See Footnote 3 on page 6.

and representatives. Our view is that:

- The ASB has misunderstood the nature of scheme accounts – they are not "general purpose financial statements" for external decision makers but a statement of transactions and assets for stewardship purposes.

- It is difficult to see the benefits of including the liabilities in the accounts. Details of the liabilities on a regulatory funding basis are available to members through the Summary Funding Statement and the triennial valuation. Differences between the liabilities calculated on an accounting and funding basis, and between the liabilities as shown in the sponsor's accounts and in the scheme's accounts, would cause confusion and undermine member confidence in the scheme and in pensions in general.

- In view of the relationship between trustees and the scheme sponsor, and trustees' access to confidential information about the company, it would be unreasonable to expect trustees to comment publicly on the value of the sponsor covenant. It is possible that trustees would be unwilling to sign off such a valuation.

There would also be considerable additional costs in the ASB's proposal that the ASB has not fully considered – not only additional audit costs but actuarial and other advisory costs and additional management costs (sponsor and scheme) and additional time commitment for trustees.

5.5.2 In summary, it is difficult to see any genuine benefit in pension schemes accounting for the scheme liabilities in their annual report, which we see as unnecessary and a duplication of what is available in the scheme sponsor's accounts and certain to involve schemes in extra expense. Investors will continue to look to the scheme sponsor's accounts to assess the impact of the pension scheme on the sponsor's financial position, while scheme members would only be confused by discrepancies between the scheme's and the sponsor's accounts, whether the result of a different end-year or of different assumptions being adopted by the sponsor and the scheme trustees.

5.5.3 We believe, however, that it could be helpful to scheme members and their advisers to include, as a matter of course, a summary of the scheme's funding position, including the principal assumptions adopted, in the scheme's annual report. In some cases this information may best sit within the trustees' report. We would add that although European pension schemes include the scheme liabilities in their accounts, these are generally shown on a regulatory rather than on an accounting basis.

6 NAPF Responses to Specific Questions Raised in the Discussion Paper

Chapter 2: Liabilities to pay benefits

Q1 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)?

Current salaries, despite the paradox that indexed increases for deferred members required by law have to be recognised. While it can be argued that because pensions are deferred pay an estimate of the total cost of the service should be allocated to the period in which it was delivered, we feel that there are stronger reasons to accept the general accounting principle that it is incorrect to account for future events over which one has discretion. As we note in paragraph 5.3.1, employers have considerable discretion to mitigate the impact of their pension liabilities with the result that employees' expectations cannot be seen as a constructive liability on the employer.

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?

We have no doubt that the liability is owed to the individual employee. This is the legal position and we believe that it also reflects economic reality. As the Discussion Paper suggests, a consequence of this is that the accrued, rather than the prospective, benefit should be recognised.

Q3 Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?

Yes. Specifically, discretionary future salary increases should be excluded.

Chapter 3: Assets and liabilities: reporting entity considerations

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?

We agree.

Chapter 4: Recognition of pension assets and liabilities

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?*

We accept the principle of immediate recognition – although not if the figure is to be shown in the income statement. As will be clear from what we have said in paragraph 5.2, we are extremely concerned about how these changes are reported and the unintended consequences in the form of the impact on pension provision if the changes have to be taken through the profit and loss account.

Chapter 5: Measurement of liabilities to pay benefits

Q6 *Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, do you agree that:*

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

  There are different views among our members about whether regulatory measures should replace measures derived from general accounting principles. Some accept that consistency requires that accounting values are based on general accounting principles and feel that, because of different regulatory requirements in different jurisdictions, investors' needs for comparability would also exclude the use of regulatory measures. Many NAPF members believe that regulatory or actuarial measures are in fact the most relevant way of determining the cost of pensions, and that an approach to profit and loss that is at least correlated in some way with the cashflows that will be required by regulation or prudent actuarial estimates of long term cost would help financial statements report the substance of operating a pension scheme and hence provide a more true and fair view of profit and loss.

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

  We do not agree. As we argue in paragraph 5.1, scheme liabilities should be discounted at a rate that reflects risk – in particular the uncertainties inherent in the estimation of liabilities and the opportunities available to companies to reduce or mitigate their liabilities, for example by making salary increases non-pensionable or by closing the scheme. Use of the risk-free rate is likely to be seriously misleading about the ability of the scheme to fund its liabilities, as it does not reflect that the fact that the scheme assets may be invested to earn a higher return than the risk-free rate. We therefore believe that standard setters should retain the current requirement that the return on a good corporate bond is used to discount the liabilities or, in view of the recent distortions caused by widening credit spreads, move to something similar but less liable to distortion, for example a swap rate plus an amount that could be seen as a long-term "sustainable" corporate bond spread.

- *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 do not agree. While we welcome meaningful disclosures about the risks inherent in the liability, we do not believe that these are inconsistent with the use of a discount rate that takes risk into account.

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

  We agree.

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

  We do not agree. We feel that it would be preferable to recognise expenses as they arise.

Q7 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?

We believe that the liability should be reported in a way that reflects the probability of different outcomes, as tax and other considerations mean that beneficiaries will not necessarily choose the option that is most costly to the scheme.

Chapter 6: Measurement of assets to pay benefits

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

We accept that, in the context of a fair value framework, assets held to pay benefits should be reported at current values. However, as we explained in section 4, we have reservations about the use of fair value for assets that are in effect fixed assets held for future growth and especially income generation. Given the opportunity afforded by the fundamental review, we suggest that some research into an alternative valuation method based on value in use might prove fruitful and ultimately result in a balance sheet position that more fairly represents the realities of pension provision.

Chapter 7: Measurement of employer interests in the assets and liabilities of trusts and similar entities

Q9 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?

We agree.

Chapter 8: Presentation in the financial statements

Q10 Do you agree that different components of changes in liabilities and/or assets should be presented separately?

We agree.

Q11 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?

We do not agree. We believe that the expected return should continue to be shown in the income statement with greater detail on actual returns in the notes. We would support a requirement to provide a five-year historical record comparing expected and actual returns in the notes to the accounts. As we have already explained in paragraph 5.2, we are concerned that the operating and financing results would be dominated by the random noise in the actual returns and at the possible impact that this might have on decision-making, and particularly on scheme sponsors' decisions about whether to continue providing good quality DB pensions for their staff.

Chapter 9: Disclosures in the employer's financial statements

Q12 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?

We believe that, where relevant, it would be appropriate to disclose details of alternative measures of pension liabilities, for example, regulatory and actuarial funding measures. As suggested in the Discussion Paper, this could be in the management commentary.

Chapter 10: Accounting for multi-employer plans

Q13 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?

As we have noted in paragraph 5.4, we find it difficult to see how sponsors' share of multi-employer schemes can be accounted for in practice except where the scheme is divided into sections that are separately accounted for. We feel that the proposal that the allocation key could be based on contributions would be inequitable between participating schemes with different membership profiles. Furthermore, we feel that, where there is genuine risk-sharing, it would be incorrect for individual employers to account for a liability that is not apportioned between them.

Chapter 11: Financial reporting by pension plans

Q14 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?

We do not agree. We believe that the ASB has misunderstood the nature of scheme accounts, which are not "general purpose financial statements" for external decision makers but a statement of transactions and assets for stewardship purposes. We find it difficult to see the benefits of including the employer's pension liabilities in the scheme accounts. Details of the liabilities on a regulatory funding basis, which we believe is what is of most concern to members, are available to members through the Summary Funding Statement and the triennial valuation. Including the liabilities in the accounts on an accounting basis would, as we have explained in paragraph 5.5.1, serve only to cause confusion and undermine members' confidence in the scheme and in pensions in general. We also believe that there would be considerable additional costs in the ASB's proposal – audit, actuarial and other advisory costs and management costs (for scheme and sponsor), as well as an additional time commitment for already hard-pressed trustees – that the ASB has not fully considered.

Q15 *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 do not agree. As we do not agree that the employer's pension liabilities should be included in the scheme's accounts, we feel that it would be inappropriate to recognise an amount that is potentially receivable under the employer's covenant.

General questions

Q16 *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.*

We hope that the ASB's consultation will lead to a framework that is applicable to all types of pension schemes. We would like to take the opportunity to say that we see no need for the proposals on "contribution-based" pension promises that the IASB has set out in its Discussion Paper on amendments to IAS 19, especially as these are presented as urgently required interim measures prior to a more full review of pensions accounting.

Q17 *Are there further specific issues relating to the cost and benefit of the proposals that should be taken account of in their further development?*

As a final comment, we would like to reiterate our concerns about possible unintended consequences of the ASB's Discussion Paper and their potential impact on pension provision. As we have already said in paragraph 3.6, standard setters cannot operate in a vacuum, indifferent to the consequences of their proposals. They must take account of the wider environment in which scheme sponsors are operating and offer real world solutions. An increase in reported scheme liabilities is not just an accounting or actuarial convention. It affects scheme funding decisions and the willingness of employers to continue offering DB pensions.