BMS Finance Ltd
41-44 Great Queen Street
London WC2B 5AD
E info@bms-finance.com
P +44 (0)20 7092 6700
F +44 (0)20 7092 6701

Preliminary Views on Amendments to IAS 19 Employee Benefits

Comments from BMS Finance

Introduction

BMS Finance is a specialist financier – equity and mezzanine debt.

We focus on companies that have a significant pension scheme compared to the enterprise value of their core business. While the pension scheme may be in surplus, on an accounting basis, the size of the scheme is material for the prospects of the relevant group.

We work with a range of investors – private equity and public equity managers – to help companies address these issues.

As a result of our research and relationships we have a good insight into investors' views on the current accounting practise and their level of understanding of the potential impact of pension schemes on the future prospects of a company. We have set out our key findings below and then provided commentary on the suggested amendments.

Key Findings

Balance sheet

Investors have become more aware of the net pension surplus/(liability) as a result of it coming onto the balance sheet.

They understand that it will fluctuate with investment performance, which has resulted in finance directors appreciating the inherent risks and seeking to reduce this volatility.

The recent clarification on the circumstances in which a surplus can be recognised have been a further step forward.

Overall investors are comfortable with the balance sheet treatment of pension schemes and their impact on company valuation.

Profit and loss and STRGL

Investors understand the current service cost charge.

The other two elements are:

a) Changes in the underlying assumptions and actual investment performance; and

b) Interest on the assets and liabilities.

In the case of (a) we believe this should continue to remain outside the profit and loss, while still being reflected on a marked to market basis in the balance sheet.

We don't believe there is any benefit in reflecting the actual asset performance or changes in assumptions in the profit and loss statement. Given the large swings that are seen in financial markets we believe investors would seek to add back this item, so they can get a better understanding of the underlying performance of the business. This is particularly true as investors view pensions as a long term liability that will be volatile.

In the case of (b) we believe that the current treatment is poorly understood and is inconsistent with the balance sheet treatment of a pension scheme.

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On the latter point the balance sheet reflects the off-balance sheet nature of a pension scheme, which is wholly consistent with the legal position. Therefore the gross assets and liabilities are not consolidated.

In addition following the recent guidance under IFRIC14 a surplus may only be recognised if a company can show it has a right to such an asset – again wholly consistent with the legal position.

However the profit and loss account effectively consolidates the theoretical profit and loss account of the pension schemes gross assets and liabilities, which does not reflect the legal or economic reality. It can also result in the anomalous position of a balance sheet liability generating a profit rather than an interest charge, as detailed below.

Assumed asset return	6.8% - high equity weighting
AA bond yield	5.8%
Gross assets	£95m
Gross liabilities	£100m
Net deficit	£(5)m
Gross return	£6.46m
Gross interest	£(5.80)m
Net interest	£660,000 profit on a £5m debt

While this is not relevant for investors looking at EV to EBITDA or EBIT it is extremely important for investors who look at P/E ratios – predominantly public markets.

In addition we believe that this accounting treatment can encourage companies to continue to support investment strategies in their pension scheme with a high equity rating, even when from a risk basis this does not make sense for any of the parties involved. Effectively companies are being encouraged to hold equities due to an accounting standard rather than what makes sense to manage the scheme.

We believe the accounting treatment should be bought in line with the balance sheet treatment of the pension scheme. Therefore the interest charge should reflect:

a) whether the scheme is in deficit or surplus;

b) in the case of a deficit there should be a interest charge; and

c) in the case of a surplus whether the company has a right to receive the 'earnings', under the same guidance as IFRIC 14.

The interest rate should reflect the rate that the company can borrow at for a similar debt and in the case of a surplus the expected return on the assets. The interest rate used should be disclosed in the notes to the accounts and how it is calculated.

This would then allow the company to work with the scheme trustees to ensure the investment strategy is solely appropriate for the scheme, as it would have no direct impact on the P&L of the company, other than the rare occasion where a surplus is attributable to the company.