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**International  
Accounting Standards  
Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*

*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

## **INFORMATION FOR OBSERVERS**

**Board meeting:** 23 June 2006, London

**Project:** Pensions

**Subject:** ASB project on pensions accounting (Agenda Paper 11)

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## **1 Introduction**

1.1 The purpose of this session is:

- to inform IASB members of the work currently being led by the United Kingdom Accounting Standards Board (ASB) on accounting for pensions (and other post-retirement benefits) and;
- to obtain suggestions from IASB members and staff for changes in our approach; the issues to be addressed; any other aspects of the project that would improve the usefulness to IASB of the output of the project.

It is not expected that any technical decisions will be made at this session.

1.2 Like FASB – and as IASB is currently considering – the ASB's work has evolved into a two-stage process. ASB's first stage is represented by its work on disclosures, which is summarised in section 3 below. However, the main focus of this session will be on ASB's (relatively) longer-term work (referred to as 'the project').

1.3 The objective of the project is to develop a Discussion Paper, developed from first principles (a 'back-to-basics' approach) that will set out proposals for – and stimulate discussion on – the principles that might be reflected in a new accounting standard that would provide a successor to current standards, including IAS 19, FAS 87 and FRS 17.

1.4 The aim is not to simply present a neutral discussion of various views: the hope is that the paper will present solutions, and cogent argument in support of them. That said, it is clear that there are some issues – for example the extent to which (if any) the liability for pensions should reflect future salary increases – on which it will be best to present both sides of the argument as fully and impartially as possible.

1.5 The ASB has no plans to adopt a standard that would represent a 'UK solution'. Its aim is to contribute to an internationally-accepted standard on pensions accounting that will significantly improve the financial reporting secured by current accounting standards.

[Paragraphs 1.6 to 1.8 omitted from observer notes.]

## **2 Background**

2.1 Defined benefit pension schemes give rise to one of the largest obligations of companies and other entities that operate them. In several cases, reported deficits in pension schemes operated by UK listed companies are significant in relation to the companies' market capitalisation. Pension schemes can be more economically and politically significant than their sponsoring employer. Accounting for them has long been controversial owing to the size of the obligations and the uncertainties inherent in their measurement. The inexorable maturing of pension schemes in the next few decades will probably add to further problems.

2.2 Pensions accounting in the UK and Ireland has been improving. Financial Reporting Standard (FRS) 17 'Retirement Benefits', was published in November 2000. Although following a lengthy transitional period its requirements have only become mandatory in full for accounting periods beginning on or after 1 January 2005.

2.3 FRS 17 is perhaps the most 'modern' of the accounting standards on pensions, and has been the catalyst for a more informed debate regarding pensions issues. The large size of employers' pension obligations has meant that determining the appropriate method of accounting for them has been controversial. Now the obligations are visible in the accounts, they get noticed. FRS 17 (and IAS 19) continues to attract a good deal of high profile public comment. The following quote gives a flavour:

*"The idea that 30 years of retirement can be funded by a working life of 40 years is becoming increasingly un-sustainable at the current level of investment returns and contributions. Yet most corporate pension schemes continue to promise just that. One reason why there has been so little debate over the viability of these promises is that accounting rules obscure their true dimensions.*

*For example, UK corporate schemes are underfunded to the tune of £128bn, according to estimates by Mercer, a consultancy. This is just an accounting number, as those pension payments do not need to be made for many years. But the funding gap would be even bigger were the liabilities not discounted at an unrealistic rate."* ('Pension shocker for workers under 50', *Financial Times*, March 29 2005.)

2.4 The UK Accounting Standards Board (ASB) decided in October 2005 that it should undertake a research project into the financial reporting of pensions.

2.5 Around the same time, the European Financial Reporting Advisory Group (EFRAG) and European National Standard-Setters (NSS) agreed to work more closely together on 'Proactive Accounting Activities in Europe (PAAinE)', in order to improve the input from Europe to the global standard-setting process, to encourage the debate in Europe on accounting matters, and to educate the wider community on those matters. Accounting for pensions was selected as a PAAinE project, which the ASB is leading.

2.6 One of the main reasons for the project is that the landscape surrounding defined benefit pension schemes has changed significantly since IAS 19 and FRS 17 were developed, for example:

- (a) Liabilities have increased (because of falling long-term interest rates and rising longevity) faster than asset values. The appearance of large reported deficits in pension schemes operated by listed companies has

had socio-economic consequences (some have argued that the model has been damaging).

(b) Recent changes to the UK regulatory environment have made the pension obligation harder to avoid, including:

- a statutory funding objective arising from the European Pensions Directive,
- a statutory obligation on solvent companies to meet their pensions obligations, and
- the establishment of a pensions regulator with significant powers to ensure that companies are able to meet those obligations, for example by imposing additional contributions.

(c) Accounting measures are being used by UK regulators for funding purposes.

(d) Companies are taking actions to close defined benefit schemes to new employees or to restrict future service benefits for existing employees.

2.7 When the ASB announced the project, it published a list of troublesome issues that it wished the project to address:

- How is the relationship between an employer and a pension scheme best reflected in the employer's financial statements?
- How should the employer's liability in respect of pensions be quantified? In particular:
  - What is the most appropriate actuarial method?
  - Should the employer's liability reflect future salary increases?
  - What discount rate should be used to translate future cash flows into a realistic present value?
- What is 'the expected return on assets', and how (if at all) should it be reflected in the employer's financial statements?
- What is the impact on financial reporting of pension fund regulation arrangements?

- Are the disclosures required by current accounting standards appropriate? (see 2 below)

The research will also cover the financial reports of pension schemes, including consideration of whether requirements for the accounts of pension schemes secure adequate reporting of liabilities to pay pensions.

### **3 Pension disclosures**

3.1 The ASB decided to carry out a ‘fast-track’ review of the disclosure requirements for defined benefit schemes in the light of concerns expressed by commentators that financial statements do not contain sufficient information to allow their users to adequately assess the risks arising from defined benefit schemes. This review is distinct from the wider research project and is focused on short-term improvements to the disclosure requirements in FRS 17, giving particular consideration to the recent changes made in the UK regulatory regime.

3.2 The exposure draft published on 31 May proposes an amendment to FRS 17, which replaces the disclosures required by FRS 17 with those of IAS 19. This achieves convergence between the FRS 17 and IAS 19 in relation to disclosures.

3.3 The exposure draft also proposes additional disclosures which address:

- i the relationship between the entity and trustees (managers) of the defined benefit scheme;
- ii the principal assumptions used to measure scheme liabilities;
- iii the sensitivity of scheme liabilities to changes in the principal assumptions used to measure the scheme liabilities;
- iv how the liabilities arising from defined benefit schemes are measured;
- v the future funding requirements to the defined benefit scheme; and
- vi the nature and extent of the risks arising from the assets held by the defined benefit scheme.

3.4 These additional disclosures are set out in a draft Reporting Statement which is designed as a formulation of best practice for all UK entities who have defined benefit schemes; it is intended to be persuasive rather than mandatory.

## **4 Approach to the project and project plan**

### *Advisory Groups*

4.1 To assist in its research in the UK, the ASB has formed a Pensions Advisory Panel (the Panel), with nineteen members who provide a variety of expert perspectives on pensions accounting, including those of actuaries, trustees, the preparers, auditors and users of financial statements and regulators. The role of the Panel is to ensure that a number of knowledgeable points of view are fully considered.

4.2 In addition, a European Working Group has been set up under EFRAG's PAAinE arrangements to bring broad European experience to the project.

4.3 Details of the membership of both the Panel and the Working Group are on the ASB website at [www.frc.org.uk/asb](http://www.frc.org.uk/asb) [remainder of sentence omitted from observer notes]. The views of Panel and working group members are being fully reported to and debated by the ASB.

### *Approach to the project*

4.4 Both the Panel and the Working Group have strongly supported the proposed 'back to basics' approach of examining the fundamentals of pensions accounting in the context of the IASB's conceptual framework.

4.5 Our discussions have also reflected the emerging conceptual framework on issues such as:

- the definitions of assets and liabilities
- boundary of the reporting entity
- the meaning of control

4.6 One effect of this approach is that some of the discussion inevitably relates to a conceptual basis that is a moving target; nevertheless, the project

team believes that the new thinking should be reflected and that it would not be sufficient to rely on the old definitions. A by-product of this approach is that we might discover whether it produces any strange answers.

[Paragraph 4.7 omitted from observer notes]

## **5 Issues considered to date**

5.1 Agenda paper 11A [omitted from observer notes\*] is a draft of a discussion summary – covering issues that have been considered to date – which the ASB intends to publish on its website.

5.2 Discussions have focussed on:

- defining the benefits that are within the scope of the project
- defining the liability that arises from the obligation to deliver benefits
- defining the liability when a separate fund is established.

5.3 The approach has been to steer the discussions through fundamental issues (examining them from first principles) in a logical way to provide the building blocks for a discussion paper.

### ***Defining the benefits***

5.4 A pension is simply a form of deferred remuneration given in exchange for an employee's services. Pensions are the most significant form of deferred remuneration and will thus be the main focus of the project. However, if the principles of accounting for pensions are sound, they should also be appropriate for other forms of benefits which are payable after the service has been provided.

### ***Defining the liability***

5.5 The key issues considered are when an obligation to deliver benefits meets the definition of a liability and what future events should be reflected in the measurement of that liability. The groups have been readdressing these issues with particular attention on how to account for increases to benefits that are discretionary and how to account for the effects of future increases in salaries when benefits are linked to future salaries.

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\* The draft discussion summary is omitted from observer notes. It is expected that the summary will be posted to the ASB website around 30 June 2006.

5.6 Issues that are causing difficulty include:

- the boundary of constructive obligations
- the emergence of 'stand-ready' obligations and their implications for the recognition versus measurement debate (if we can predict and measure a future cash flow, should we book it?)
- does discretion matter and, if so, what does it mean?

5.7 The following caption attempts to summarise the discussions in a nutshell:

#### **What is included in pension liabilities?**

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- Vested benefits are in
- Guaranteed increases in vested benefits are in
- Unvested benefits are in (?)
- Possible future changes to benefits are out (?)
- Right to join a plan after a period of service is a stand ready obligation
- Does discretion matter?
  - some believe all *expected* payments should be in
  - others believe only *legal or constructive* obligations should be in
- Future salary increases – in or out?
  - view that final salary pension promise is more valuable (PBO)
  - view that it is a reward for *future* service (ABO)
  - view that some inflation should be reflected
- Future administration expenses of plan?

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## *Separate funds*

5.8 The groups have discussed the assets and liabilities that arise (both in individual entities' and consolidated accounts) when separate vehicles (eg trusts) are involved. In these circumstances, the employee has a right to receive benefits, irrespective of how the arrangement is funded. A corresponding obligation exists amongst the providers of the benefits. A question that goes to the heart of the asset and liability 'offsetting' issue is how that obligation is shared.

5.9 This issue has been approached by addressing the following questions:

- is the vehicle a separate entity or is it part of the employing entity?
- if the vehicle is a separate entity, what assets and liabilities arise in each entity?
- if the vehicle is a separate entity, should it be consolidated by the employing entity (the analysis has considered whether the control test that the IASB is developing in its project on consolidation can be applied to pension plans)?

5.10 Further attention will be given to assessing similarities and differences between retirement benefit trusts (and similar entities) and special purpose entities that are addressed in other accounting literature.

## **6 Next steps**

6.1 In the initial part of the project we have considered *what* should be reflected in the measurement of liabilities.

6.2 The next steps will include addressing *how* assets and liabilities should be measured.

6.3 One of the main criticisms of the use of the AA corporate bond rate to measure liabilities is that it is arbitrary. Many viewpoints are being considered:

- On the view that pension liabilities are like debt, some argue that the 'AA' bond approach understates the liability because it fails to take account of either the degree of collateralisation (funding) of the debt or the credit quality of the employer.

- The AA corporate bond rate is an inappropriate measure of the risks specific to the liability.
- Some believe the AA corporate bond rate overstates the liability, arguing for the rate of return on assets or WACC.
- Some argue for the amount the entity would pay to transfer the liability to a third party.
- One effect of the present model is that deriving a value for the employer's interest in the fund based on measuring the assets and liabilities of the fund separately (ie assets at fair values and liabilities discounted at a risk-free or risk-adjusted rates) tends to give rise to 'structural deficits' on employers' balance sheets when funds are invested in higher return investments. It is claimed that a scheme that is considered to be adequately funded on a cash flow basis will appear to be underfunded on a balance sheet basis. Some argue that the accounting measurement is driving economic decisions and that alternative models should be considered.