

AN UNREAL NUMBER

How company pension accounting fosters an illusion of certainty

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Objectives

- Consider whether pension accounting is aligned with objectives of financial reporting:
 - Stewardship
 - Decision-usefulness
- Judged against 4 principles:
 - Disclosure
 - Measurement
 - Recognition
 - Consistency
 - Taken from the IASB's conceptual framework

A Brief History

- Three main pension accounting approaches:
 - cash accounting
 - actuarial-based pension accounting standards
 - SSAP 24
 - market-based pension accounting standards
 - FRS 17, SFAS 87 & 158 and IAS 19

From Gratuity to Guarantee:

the changing nature of the pension promise

- *Pensions as altruism*
- *Pensions as deferred pay:*
 - workers will not sacrifice wages in excess of the true value of the pension
- *Pensions as funding obligations:*
 - obligation arising from pension promise is restricted to payment of annual funding charge or contribution

From Gratuities to Guarantees:

the changing nature of the pension promise

- *Pensions as contingent claims:*
 - company put option
- *Pensions as guarantees:*
 - pension protection legislation:
 - increasingly affirmed deferred pay view of pensions
 - reduced or eliminated value of company's put option
 - Pensions Act 2004

Message 1

Pensions are deferred pay

A Range of Views

about pension assets & liabilities

- Company promises to pay DB pension regardless of investment performance of plan assets
- Might, therefore, think that both pension liability and pension assets would be included on company's balance sheet
- No pension accounting standard has ever adopted such an approach

A Range of Views

about pension assets & liabilities

- *Not ours, Guv*
- FRS 17 based on premise that separate pension fund changes nature of company's pension obligation:
 - because pension fund is controlled by trustees

A Range of Views

about pension assets & liabilities

- *Ours, but net*
- IAS 19 recognises recoverable plan surplus, rather than plan assets, as company asset:
 - *“plan assets reduce (but do not extinguish) an entity’s own obligation and result in a single, net liability”*

A Range of Views

about pension assets & liabilities

- *Ours, but offset*
- SFAS 87 regards liabilities and assets of DB plan as liabilities and assets of sponsoring company:
 - *“creating a separate legal entity does not change the nature of the employer’s obligation to pay promised benefits to retirees”*

A Range of Views

about pension assets & liabilities

- But SFAS 87 requires “*offsetting*”:
 - pension liabilities and plan assets are shown net on company’s balance sheet
 - “*even though the liability has not been settled, the assets may still be largely controlled and substantial risks and rewards associated with both of those amounts are clearly borne by the employer.*”

A Range of Views

about pension assets & liabilities

- So, market-based standards take differing views of ownership of liabilities and assets of DB pension plan
- But, for varying reasons, all three limit balance sheet recognition to plan surplus or deficit:
 - further analyses of plan assets and liabilities in footnotes

A Range of Views

about final salary pension obligations

- Market-based standards all view pensions as deferred pay
- But how much pay is deferred under a final salary plan?

A Range of Views

about final salary pension obligations

- Corporate accounting predicated on assumption that company is *going-concern*
- SFAS 87 asserts that the *going-concern* assumption, “*as applied to pensions, assumes that the plan will continue in operation and the benefits defined in the plan will be provided.*”

A Range of Views

about final salary pension obligations

- Thus defined, the accounting concept of pension plan as a *going-concern* is consistent with economic view of pension plan as an *implicit (long-term) contract*
- FASB concluded (and ASB and IASB agreed) that, from an accounting viewpoint, PBO better describes company's pension obligation

A Range of Views

about final salary pension obligations

- But when SFAS 87 issued, FASB decided recognising PBO in company's accounts would be too great a change from past practice
- So, SFAS 87 only required company's balance sheet to show minimum liability:
 - equal to any excess of ABO over value of plan assets

A Range of Views

about final salary pension obligations

- SFAS 158 amended SFAS 87 and removed this anomaly:
 - requires company to recognise, as an asset or a liability, difference between PBO and value of plan assets
- FRS 17 does likewise
- IAS 19 permits company's balance sheet to understate effect of PBO

Message 2

The pension obligation of company with final salary pension plan is best determined by reference to projected final salary

Spot the Conundrum

- Need to know current values of DB plan's assets and liabilities
- Asset's present value is sum of its discounted cash flows
- Liability's present value is sum of discounted cash flows required to settle it

Spot the Conundrum

- Pension plan asset cash flows are uncertain:
 - perhaps, too uncertain to include in the accounts?
- But their market value is objective and verifiable

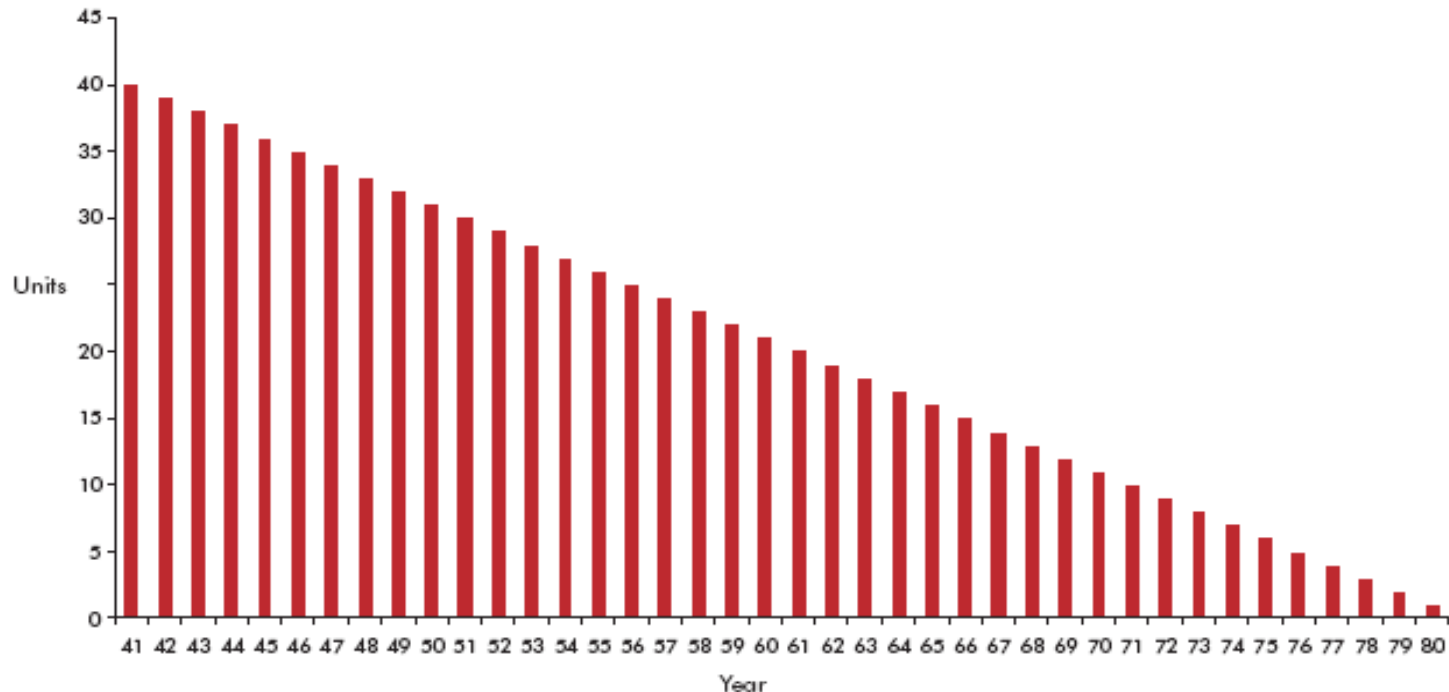
Spot the Conundrum

- Projected liability cash flows are also uncertain:
 - particularly those of final salary plan
- And no market value for pension liability

Message 3:

Report projected pension cash flows

Figure 1: pension liabilities by amount and due dates at end of year 40



Spot the Conundrum

- So, most useful information about DB plan's funded status is:
 - market, or fair, value of its assets
 - liability's projected cash flows
- But pension accounting standards require this information to be reduced to a single number

Spot the Conundrum

- Accounting standards do not have a “standard” discount rate for determining present values of future cash flows
- Decision-usefulness objective suggests use of discount rate on reference security to value pension liability
 - a reference security whose cash flows match those of pension liability in amount, timing and uncertainty.
- Stewardship objective suggests that reference security should be free of default risk

Spot the Conundrum

- But, market-based pension accounting standards mandate use of AA corporate bond yield as the discount rate for pension liabilities
- And they require market value of plan assets to be deducted from PV of pension liability to arrive at the single number measure of a pension deficit or surplus

Message 4

Stewardship objective suggests discounting pension liability cash flows at risk-free rate in a going-concern

An Illusion

- Uncertainty is the distinguishing characteristic of the final salary defined benefit pension obligation:
 - uncertainty as to ownership of pension assets and liabilities
 - uncertainty as to how much pay is deferred
 - uncertainty as to amounts and timing of future pension payments
 - uncertainty as to discount rate to be used to calculate their PV
 - uncertainty as to future cash flows of plan assets that will be used to settle those liabilities

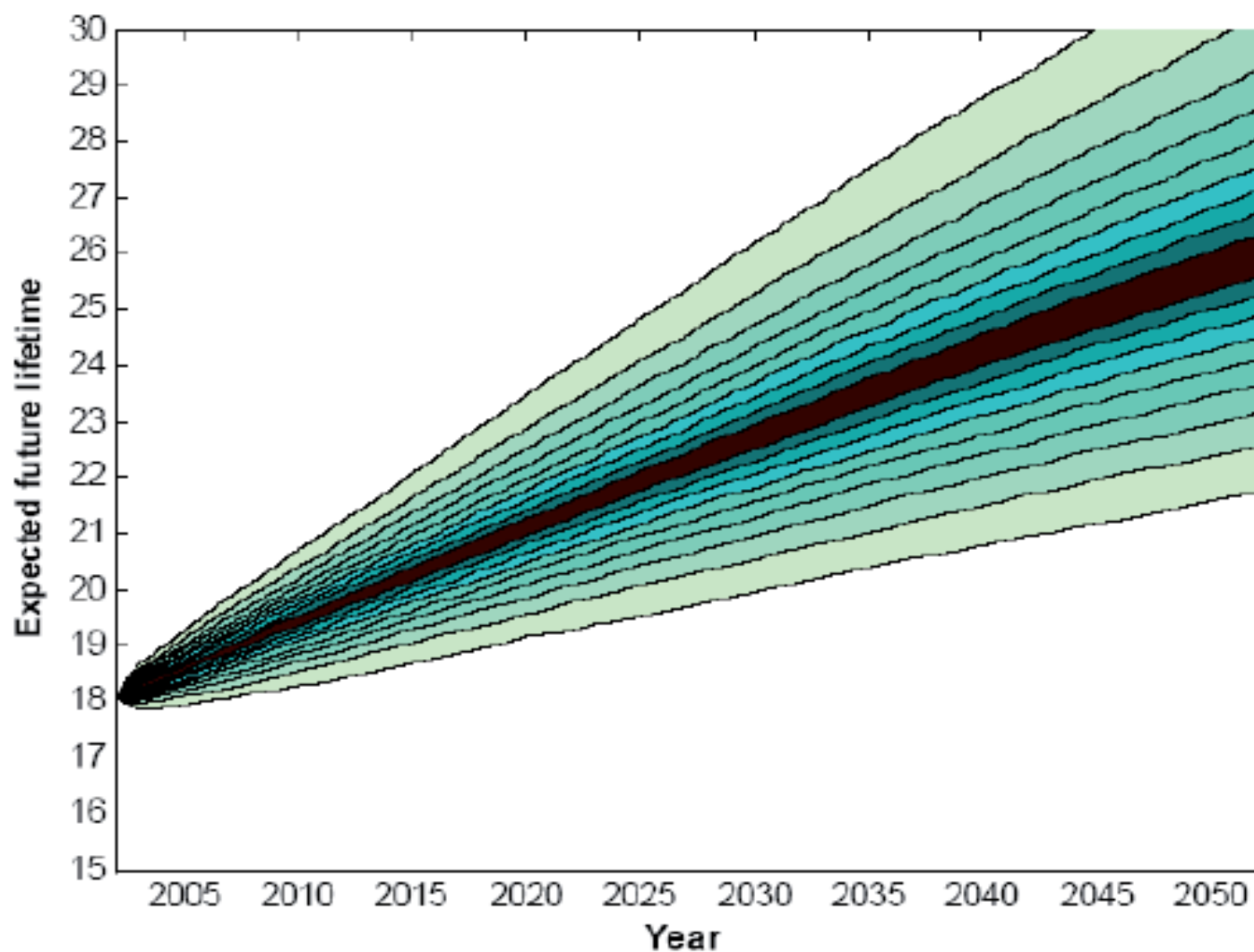
An Illusion

- Pension accounting standards create an illusion of certainty:
 - through their use of mark-to-models
 - by reliance on a single number (a “point estimate”) to measure funded status of DB plan

An Illusion

- But as Governor of BoE explains *“We do not say that in our view inflation will be 2%, or any other number. Such a statement is incoherent because a forecast is inherently probabilistic”*
- And UK Actuarial Profession no longer considers it possible to rely on a single projection of longevity:
 - recommends that actuaries using mortality projections should consider range of scenarios

Figure 4: longevity fan chart for 65-year old males starting in 2002



Message 5

The “single number” required for the DB pension surplus/deficit on a company’s balance sheet cannot convey useful information about distribution of range of outcomes, particularly over life expectancy

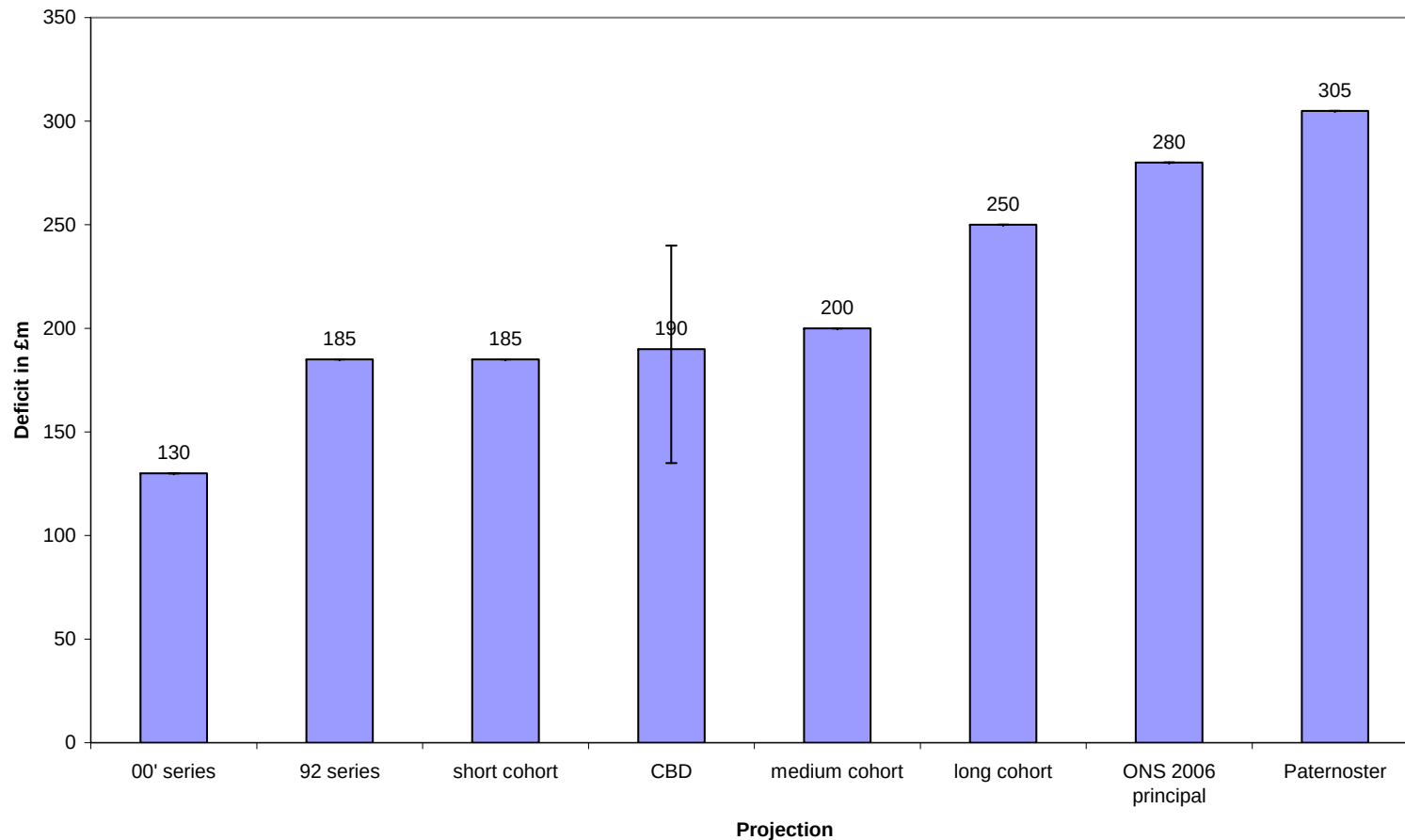
Conclusion

- Despite evolution towards principled pension accounting, unease persists
- Although uncertainty permeates DB pension obligation, pension accounting standards measure the funded status of DB plan with a single “unreal” number

Conclusion

- If pension accounting is to help fulfil the objectives of financial reporting, it needs to develop valuation methods that can measure the uncertainties inherent in DB obligation

Comparison of pension deficit using different mortality assumptions



And avoid this?

CHANGES IN FTSE100 PENSION DEFICIT

