



21 February 2008

ACA Sessional Meeting PAAinE Discussion Paper: Financial Reporting of Pensions

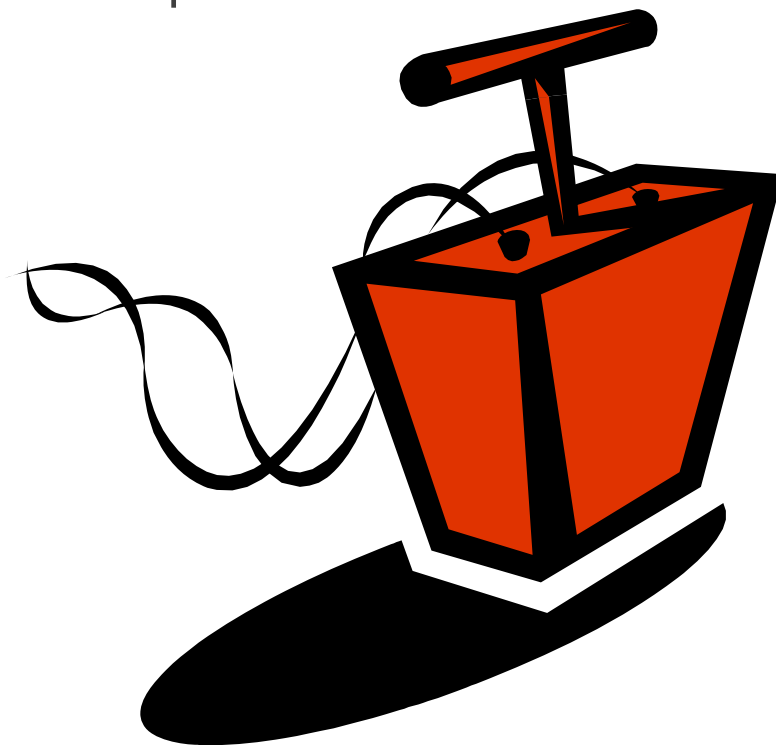
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How “explosive” is it?

- Wipe c. £100bn from UK corporate balance sheets
- Increase P&L volatility
- Accelerate the rush out of adequate DB pension provision
- Fails to consider wider social/economic/political implications

BUT

- Only preliminary views of ASB
- IASB is the decision maker



A call to get ARMED...

Attribution

Recognition

Measurement

Expense

Disclosure

...with clear principles

Attribution

When does an “accrued liability” exist?

- Liabilities should be accrued over the period that employees provide services to earn those benefits, in line with the benefit formula rather than on a straight line basis BUT with spreading over a vesting period
- E.g. DC scheme, 0% contribution for first 2 years, 10% contribution from year 3 onwards with a 20% extra contribution payable in year 3 conditional on the employee completing 2 years of service:

Year	Current Expense	New Expense
1	0%	10%
2	0%	10%
3	30%	10%

Attribution

Avoid “profit smoothing”

- Liabilities should be based on a present obligation, whether legal or constructive, and should not include future unvested changes such as future salary increases or discretionary benefits
- “Expected salary increases over an employee’s career are not reflected in financial statements by smoothing them over the employee’s service life and it is not clear why pension benefits should be treated differently.”
- No firm conclusion as to whether Career Average plans should attribute benefits according to the benefit formula rather than the current “Project and Prorate Approach”



Recognition

Immediately on the balance sheet

- Changes in assets and liabilities should not be subject to deferred recognition
- Gross presentation of assets and liabilities is generally appropriate except where the benefits are funded through a separate entity not controlled by the employer
- Entities controlled by the employer would be consolidated

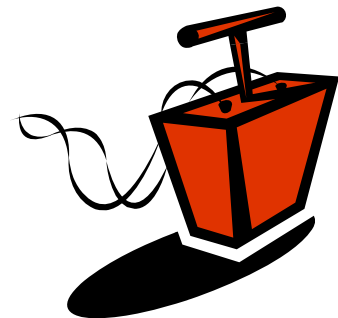


Measurement

The “explosive” question...

Q6 Do you agree that:

- Regulatory measures should not replace measures derived from general accounting principles?
- The discount rate should reflect the time value of money only, and therefore should be a risk-free rate?
- The liability should not be reduced to reflect its credit risk?
- Information about the riskiness of a liability is best conveyed by disclosure rather than by adjusting the reported liability amount?
- Expenses of administering the plan’s accrued benefits should be reflected in the liability?



Measurement

Discount Rate – some arguments for and against use of Credit Risk

For:

- A pension scheme is like a bond
- Current accounting requirements for bonds allow for credit risk
- The value of a pension promise to employees reflects the credit risk in the amount promised [?]

Against:

- A Company cannot settle or transfer liabilities in a way that reflects its credit risk (assuming it continues as a going concern)
- Difficult to measure credit risk and account for changes in credit risk
- Much of the credit risk for funded liabilities is taken out by collateralisation [?]

Wider social/economic issue:

- Risk-free rates will deter DB pension provision and lead to switches from equities to fixed interest investments

Expense

ASB wants volatile pension assets to hit P&L

ASB propose that Pension Expense in P&L account should be presented as:

- Service cost – within operating activities
- Interest on (gross) liabilities – within financing
- Effect of change in discount rate – within financing
- Actual return on assets – within financing
- (Other) Actuarial gains and losses – within other financial performance

Expected return on assets required as a disclosure item.



Expense

A personal alternative proposal

Pension Expense in P&L account should be presented as:

- Service cost – within operating activities
- Interest on net liabilities (i.e. discount rate applied to funded status and expected cashflows) – within financing

Below the line SoRIE should be presented (without recycling) as:

- Effect of change in discount rate
- Asset gain or loss (from actual return relative to discount rate)
- Effect of change in assumptions
- Effect of liability experience

Note: assumes a SoRIE still exists

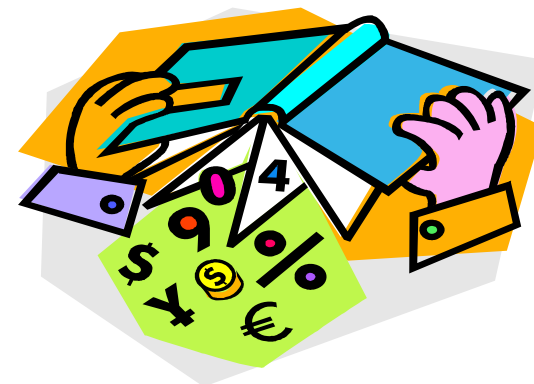
Disclosures

Company Accounts

Extensive additional disclosures proposed:

- Sensitivity analysis
- Alternative measures of pension liabilities (e.g. buyout?)
- Liability profile (actives/deferreds/pensioners)
- Investment strategy – asset allocation, exposure to risk
- Trustee powers – e.g. unilateral right to trigger windup
- Funding obligations – agreed funding principles, regular/special contributions

Should disclosures depend on materiality?





Disclosures

Financial Reporting by Pension Plans

- Pension plan accounts should reflect their obligation to pay benefits on the same measurement and recognition bases as an employer's accounts (i.e. using a risk-free discount rate)
- Pension plan accounts should reflect an asset in respect of their claim on the employer to fund benefits
- Consideration should be given to disclosures in respect of:
 - Investment strategy
 - Employer's covenant
 - Related party transactions

Concluding thoughts...

- ASB discussion is a helpful contribution to the debate
- Attribution, Recognition and Disclosure ideas are useful
- Personally, not convinced that the accounting principles suggested for Measurement and Expense are clear enough to justify:
 - Wiping c. £100bn from UK corporate balance sheets
 - Increasing P&L volatility
 - Accelerating the rush out of adequate DB pension provision



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