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How to communicate reality?
The future of pension accounting

Wednesday 30 April 2008

WELCOME

Richard Gillingwater
Dean
Cass Business School

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Jeffrey Highfield
Chairman
PRAG

Agenda

Review of the ASB report by Andrew Lennard

Review of Pensions Institute report by David Blake

Formal responses from:

- **CBI by Neil Carberry**
- **NAPF by Nigel Peaple**
- **ABI by Michael McKersie**
- **Pensions Regulator by Phil Spary**

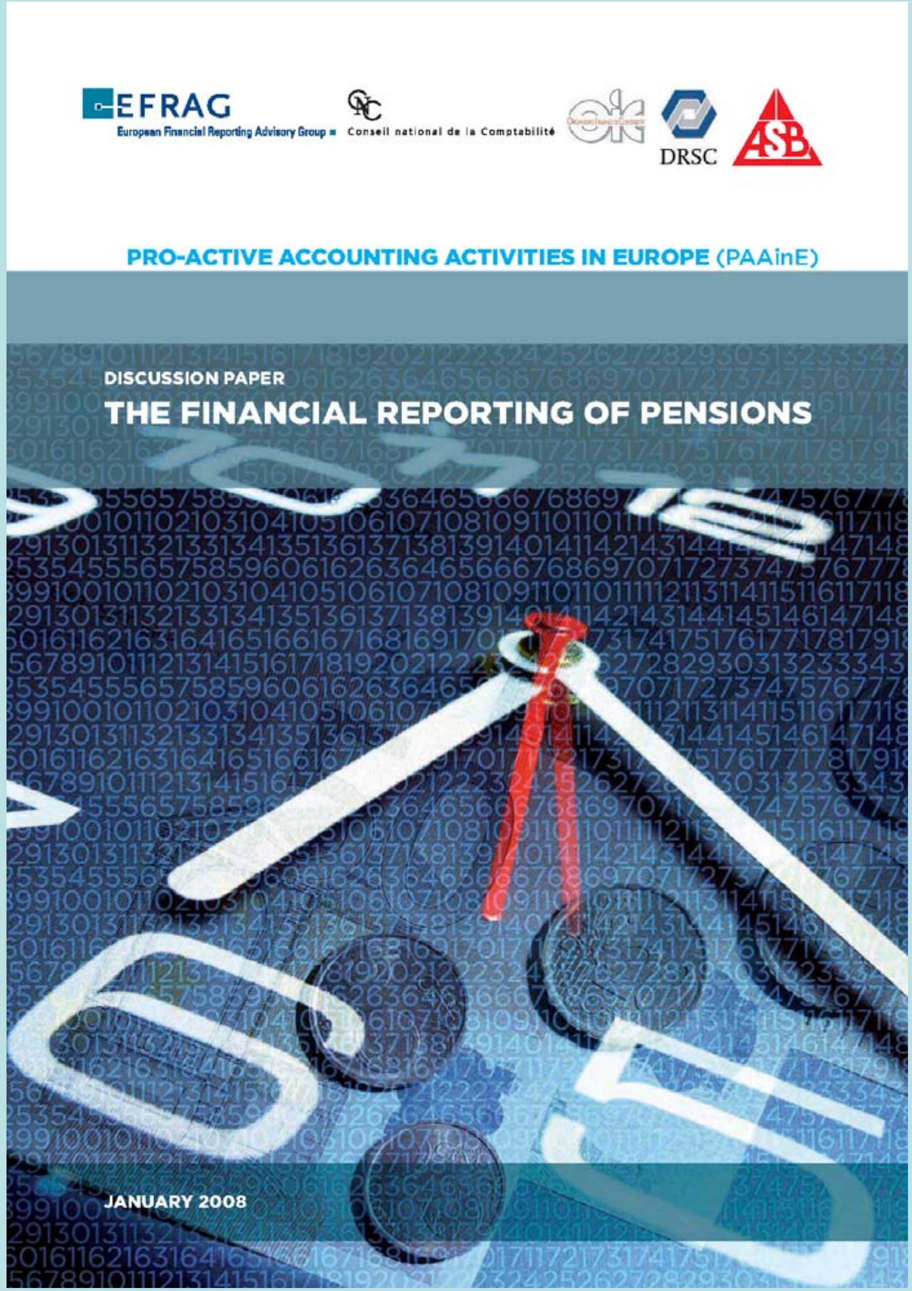
Panel discussion and Q&A chaired

by Crispin Southgate, Institutional Investment Advisors:

- **Andrew Evans, PwC**
- **Zaki Khorasanee, Cass Business School**
- **Andrew Lennard, ASB**
- **Fraser Low, Pensions Regulator**

ANDREW LENNARD

Director of Research
Accounting Standards Board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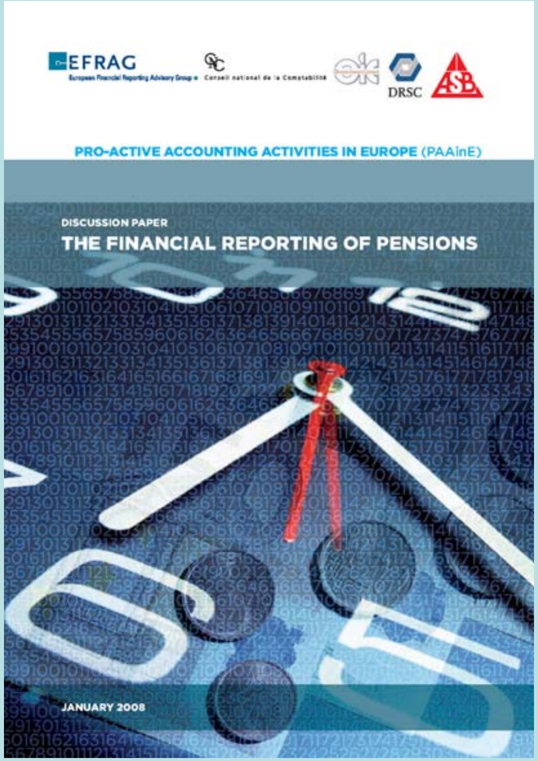
PRO-ACTIVE ACCOUNTING ACTIVITIES IN EUROPE (PAAinE)

DISCUSSION PAPER

THE FINANCIAL REPORTING OF PENSIONS

JANUARY 2008



The Future of Pensions Accounting

Andrew Lennard
ASB

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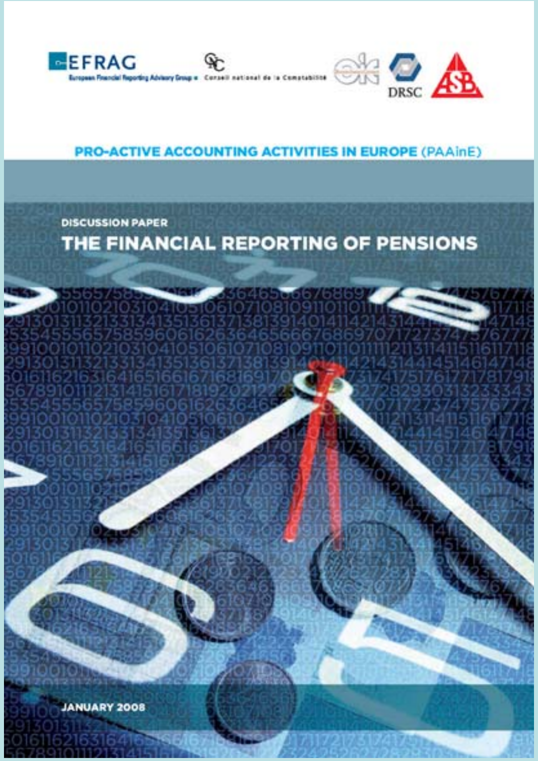
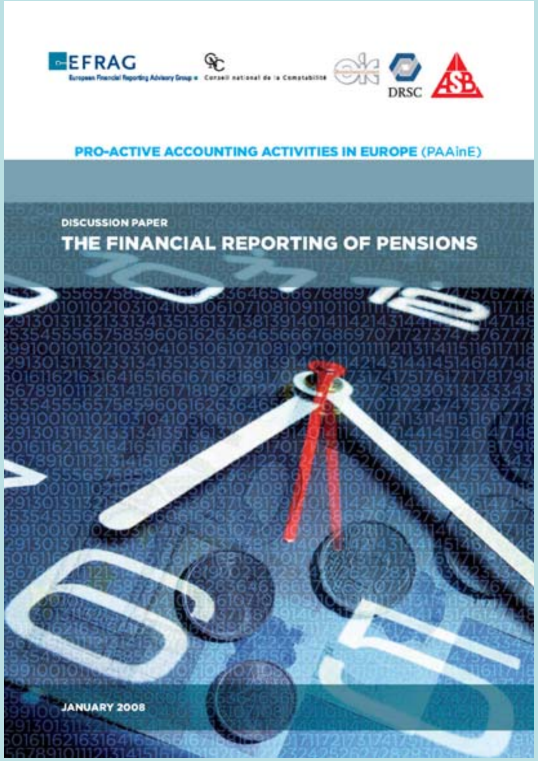


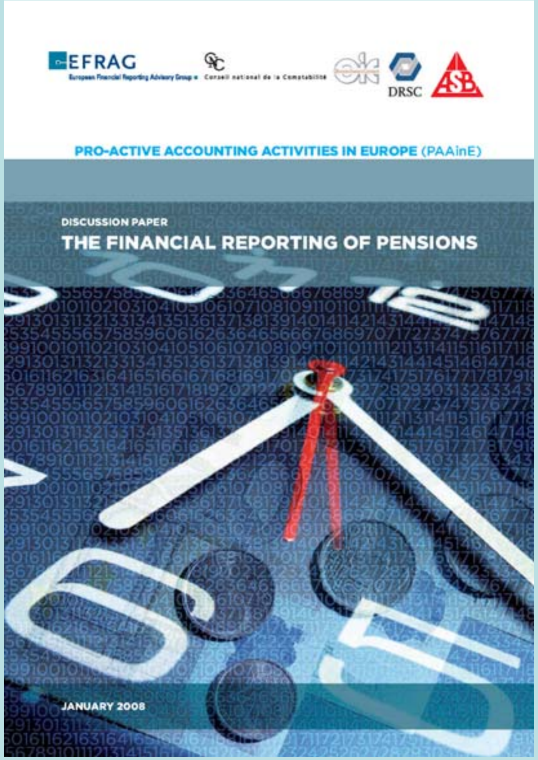
Why we did it

- **Pensions are important**
  - to companies
  - to employees
- **FRS17/IAS19 first generation**
  - Issues include:
    - —size of liability
    - —behavioural consequences
    - —hybrid plans (and some other issues)
- **Why are pensions different?**



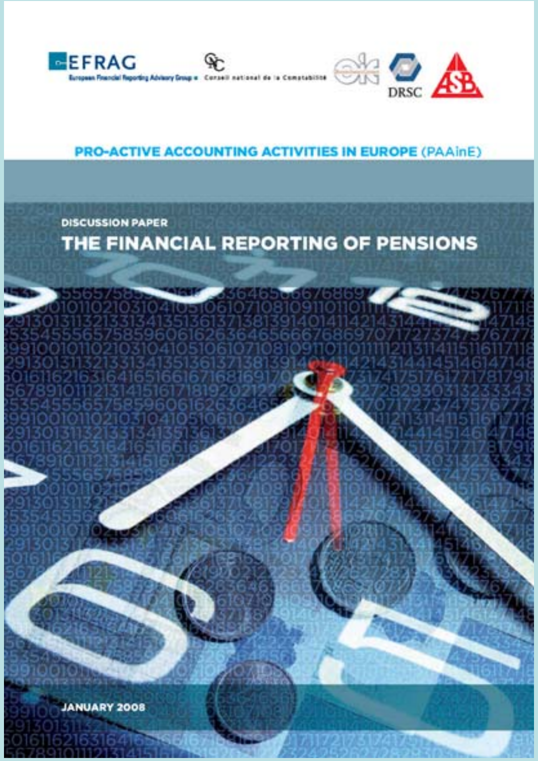
Objective of project

- Discussion Paper to inform the development of a new accounting standard that can be applied globally
- Encourage debate in Europe



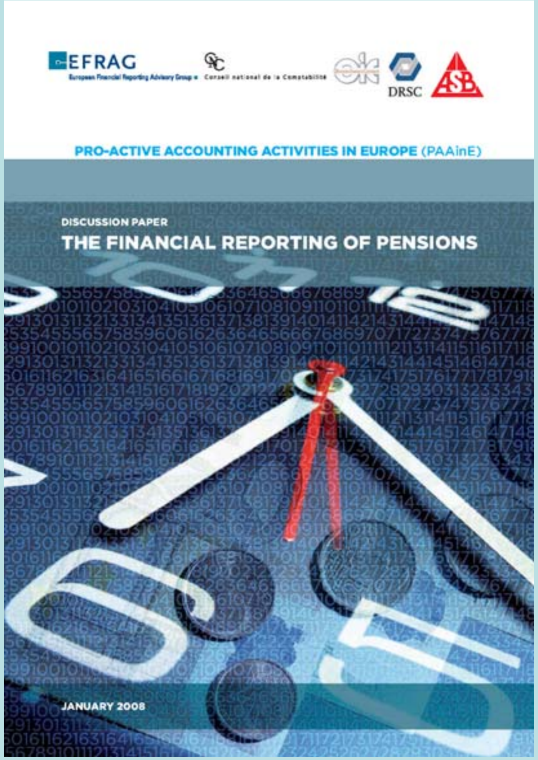
Chapter 1
Introduction

- **Back to basics – examine fundamental principles**
- **Informed by principles used elsewhere and in current thinking**
- **Same principles across spectrum of pension benefits**



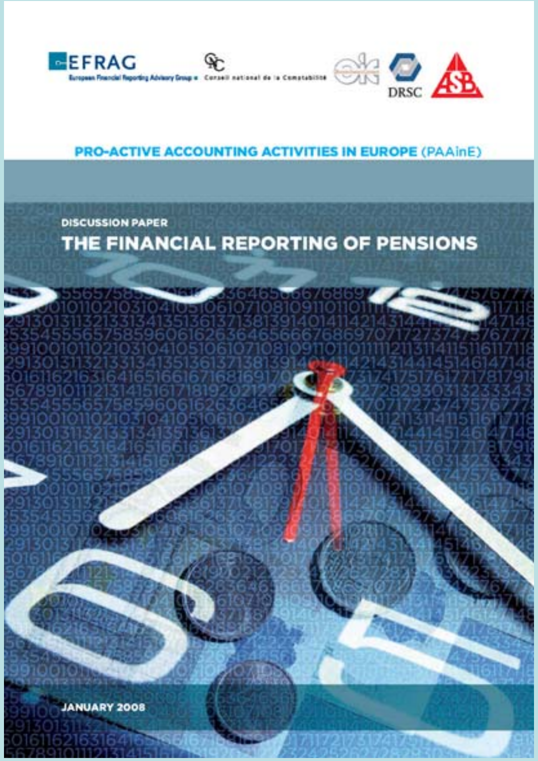
Chapter 2
Liabilities to pay benefits

- **Arise when service is given and a present commitment arises**
- **Includes constructive obligations**
- **Includes guaranteed increases**
- **Should projected salaries be reflected?**
- **Unit of account?**



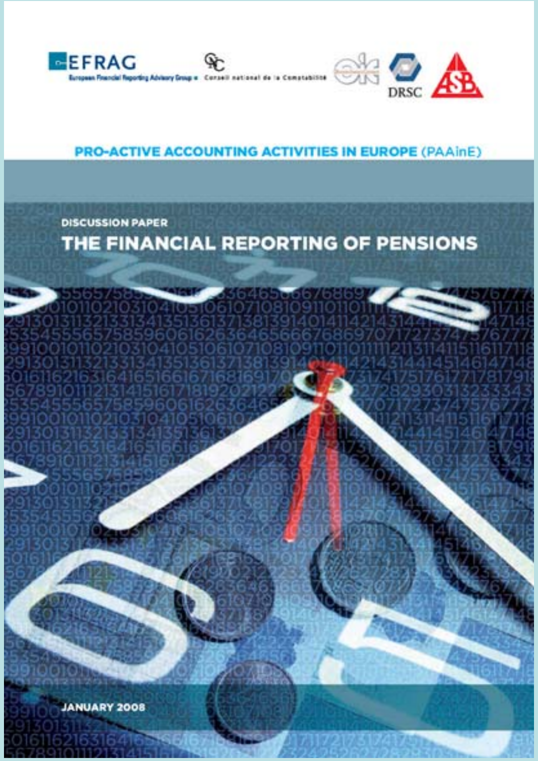
Chapter 3
Whose liability?

- **A separate entity may assume an employer's liability**
- **If employer has an obligation to make good, a 'net' presentation should be used**
- **Pension plans should be consolidated in the same circumstances as other entities**



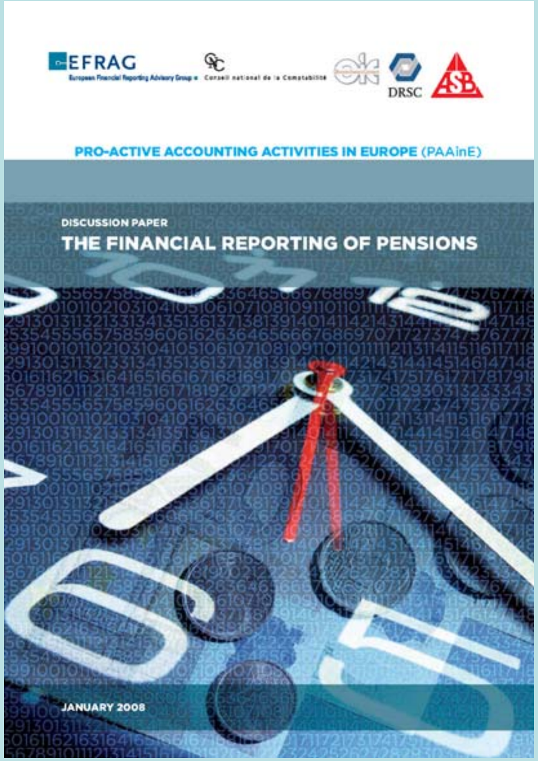
Chapter 4 Recognition of pension assets and liabilities

- No corridor or deferral mechanism—all changes in assets and liabilities recognised immediately



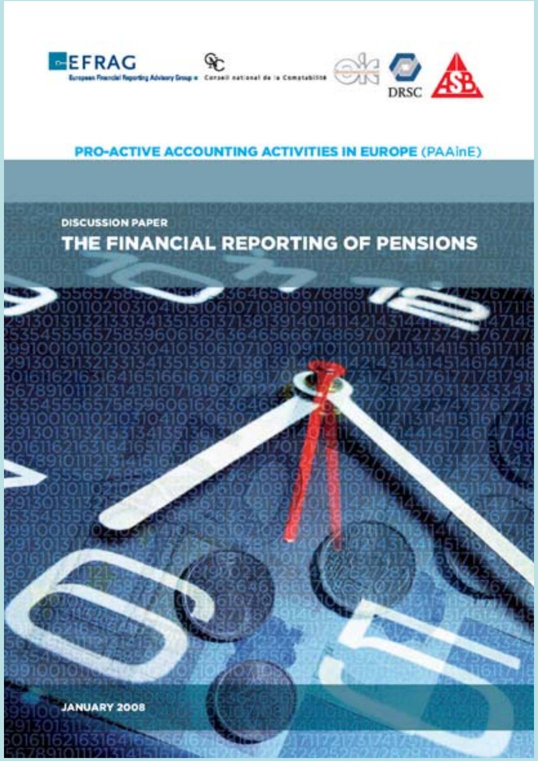
Chapter 5
Measurement of liabilities for benefits (1)

- Regulatory measures are for funding, not accounting
- Lowest of available settlement alternatives:
  - usually current value of benefits to be paid
  - buy-out amount is typically higher
- Include expenses of administering accrued benefits



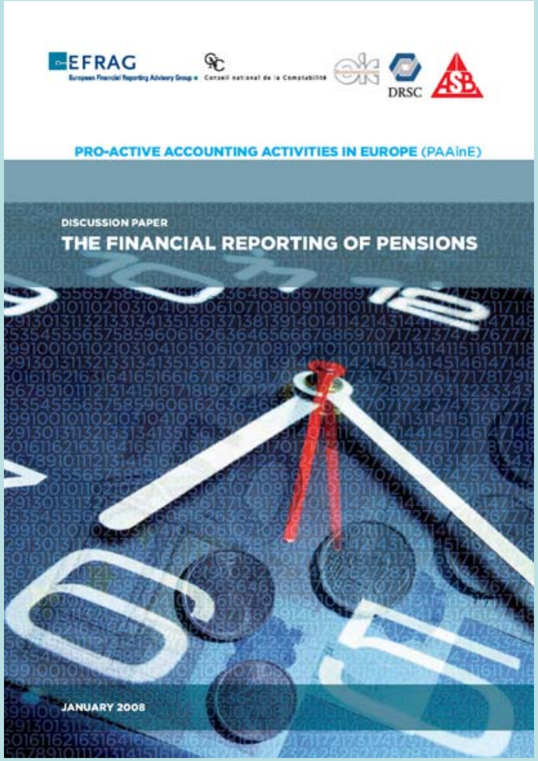
Chapter 5
Measurement of liabilities for benefits (2)

- Case for bond rate is not made
- Use risk free rate
  - objective is to reflect time value, not risks
  - risks reflected in the cash flows
  - are risks normally distributed?
  - transparency



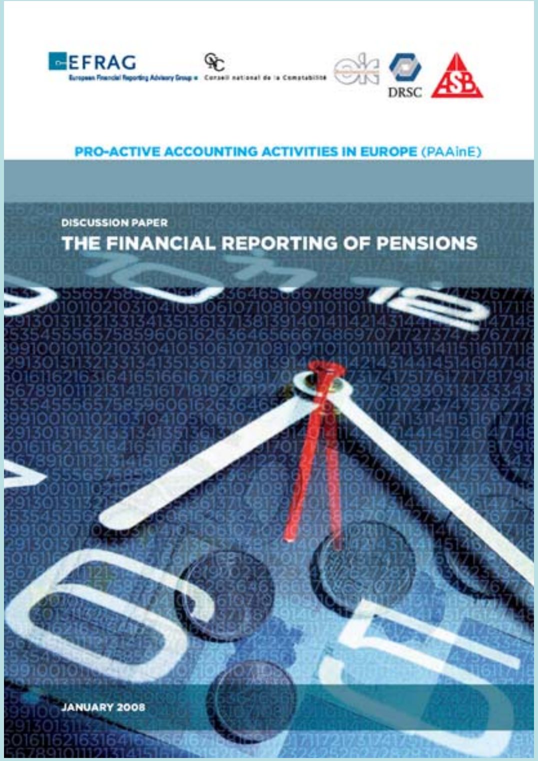
Chapter 6 Measurement of assets held to pay benefits

- **All assets held to pay benefits should be at current value**



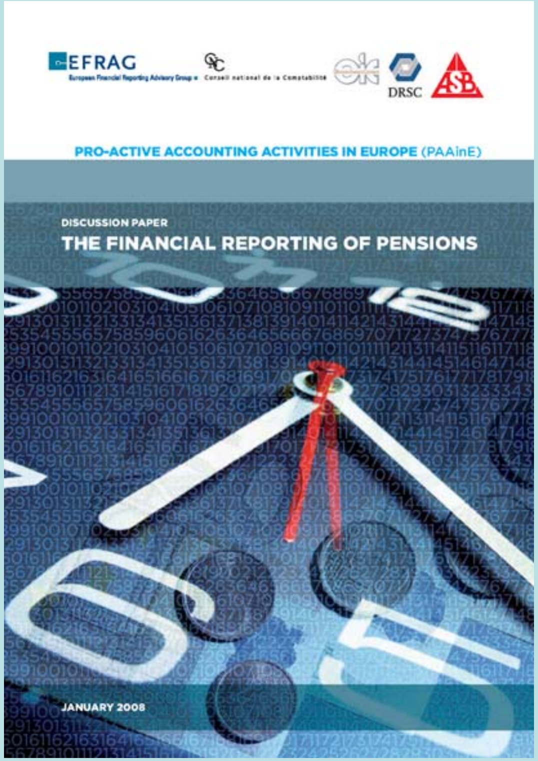
Chapter 7
Measurement of interests in trusts

- **‘Net’ measurement fairly reflects employer’s rights and obligations**



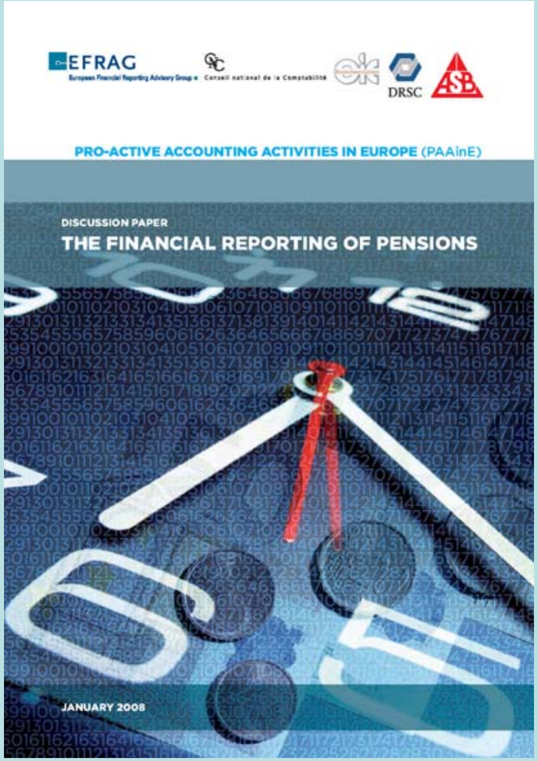
Chapter 8 Presentation in financial statements

- **<u>Operating</u>**
  Service cost
- **<u>Financing</u>**
  Interest on liabilities
  Effect of change in interest rate
  ***Actual* (not expected) return on assets**
- **<u>Other</u>**
  Remaining actuarial gains and losses



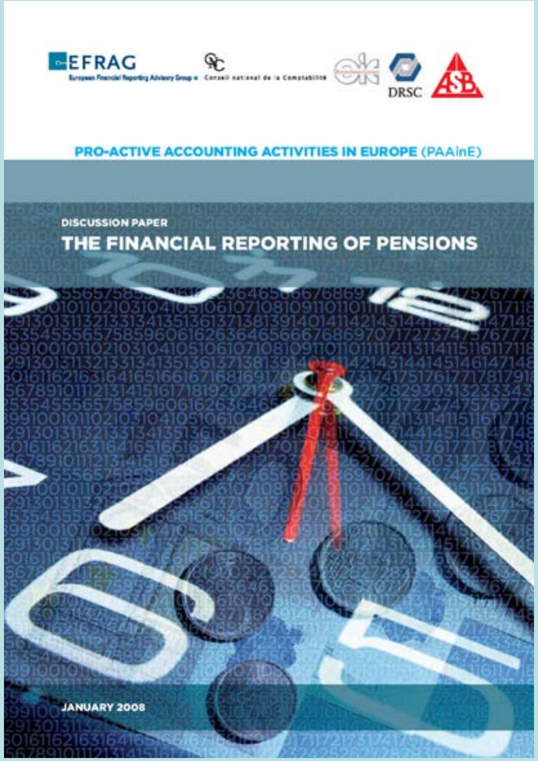
Chapter 9 Disclosures in financial statements

- Proportionate with objectives that focus on users' needs (some in management commentary)
- Information about amounts presented:
  - alternative measures of liabilities?
- Risks and rewards arising from assets and liabilities, including
  - relationship with trustees/managers of plan
  - investment strategies
  - expected return on assets
- Funding obligations



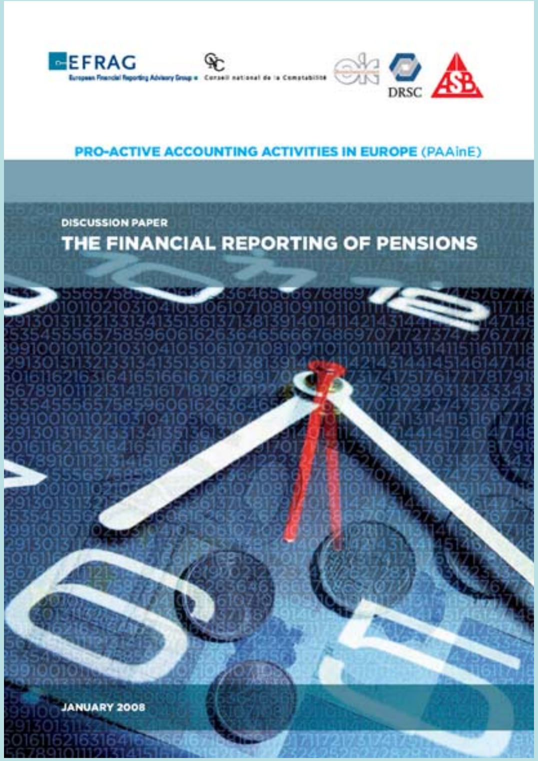
Chapter 10
Multi-employer plans

- In theory, use same recognition and measurement principles as single-employer plans
- Candidates for measurement:
  - current settlement amount
  - proportionate share of collective asset or liability
  - only recovery plans or premium reductions
  - no asset or liability



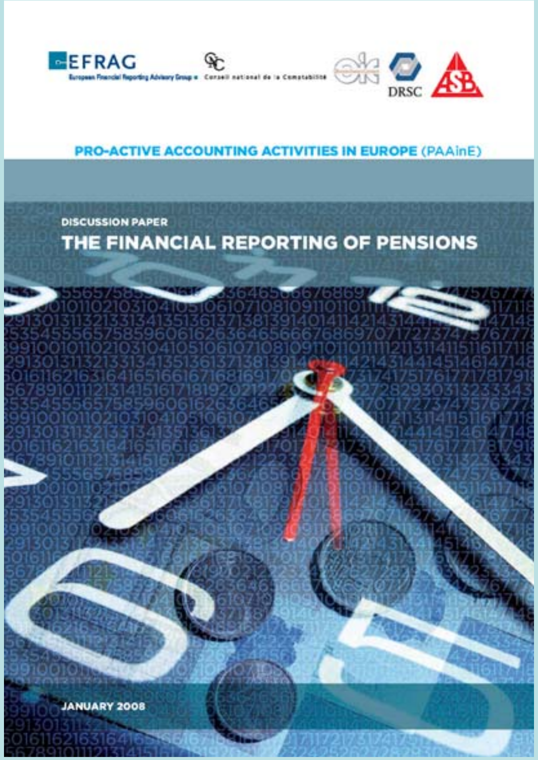
Chapter 11 Pension plans' financial reports

- Addresses general purpose financial statements
  - objective to provide information for members (and advisers)
- IASB should consider withdrawing IAS26
- Builds on rest of discussion paper:
  - assets
  - liabilities
- Report value of employer's covenant
- Additional discussion of investment strategy, employer's covenant and related party transactions



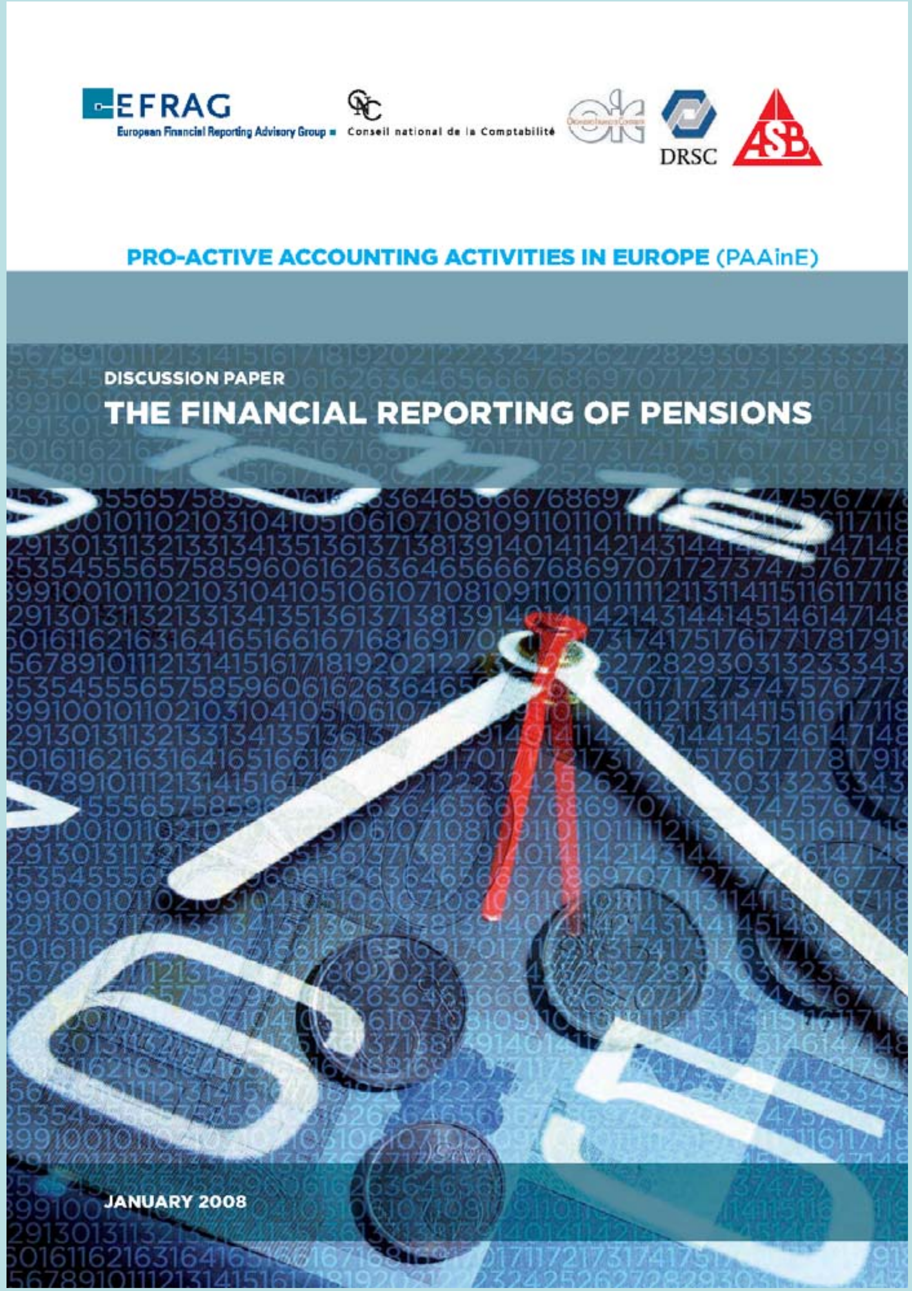
What we said—
Some key points

- **Discount at risk free rate**
- **Exclude future salaries(?)**
- **Present actual, not expected, return on assets**
- **No corridor or other deferrals**
- **Pension plans' own financial statements to include liability**



What we will do

- **Listen and analyse comments carefully**
- **Revise and refine proposals**
- **Present recommendations and findings to IASB**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DAVID BLAKE

Director

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AN UNREAL NUMBER
How company pension accounting fosters an illusion of certainty

David Blake
Zaki Khorasanee
John Pickles
David Tyrrall

Pensions Institute

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

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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 Gratuity to Guarantee:

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

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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

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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

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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?

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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."*

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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

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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

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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

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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?

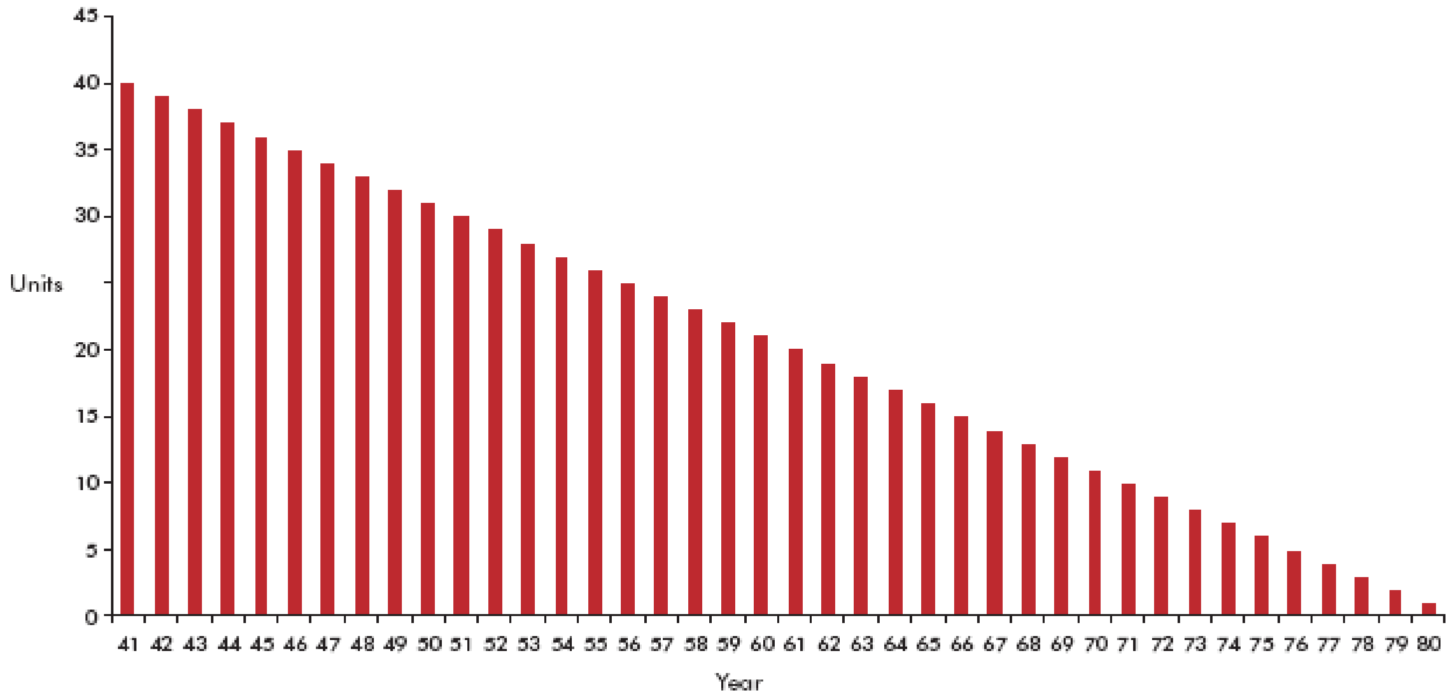
- But their market value is objective and verifiable

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



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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

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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

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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

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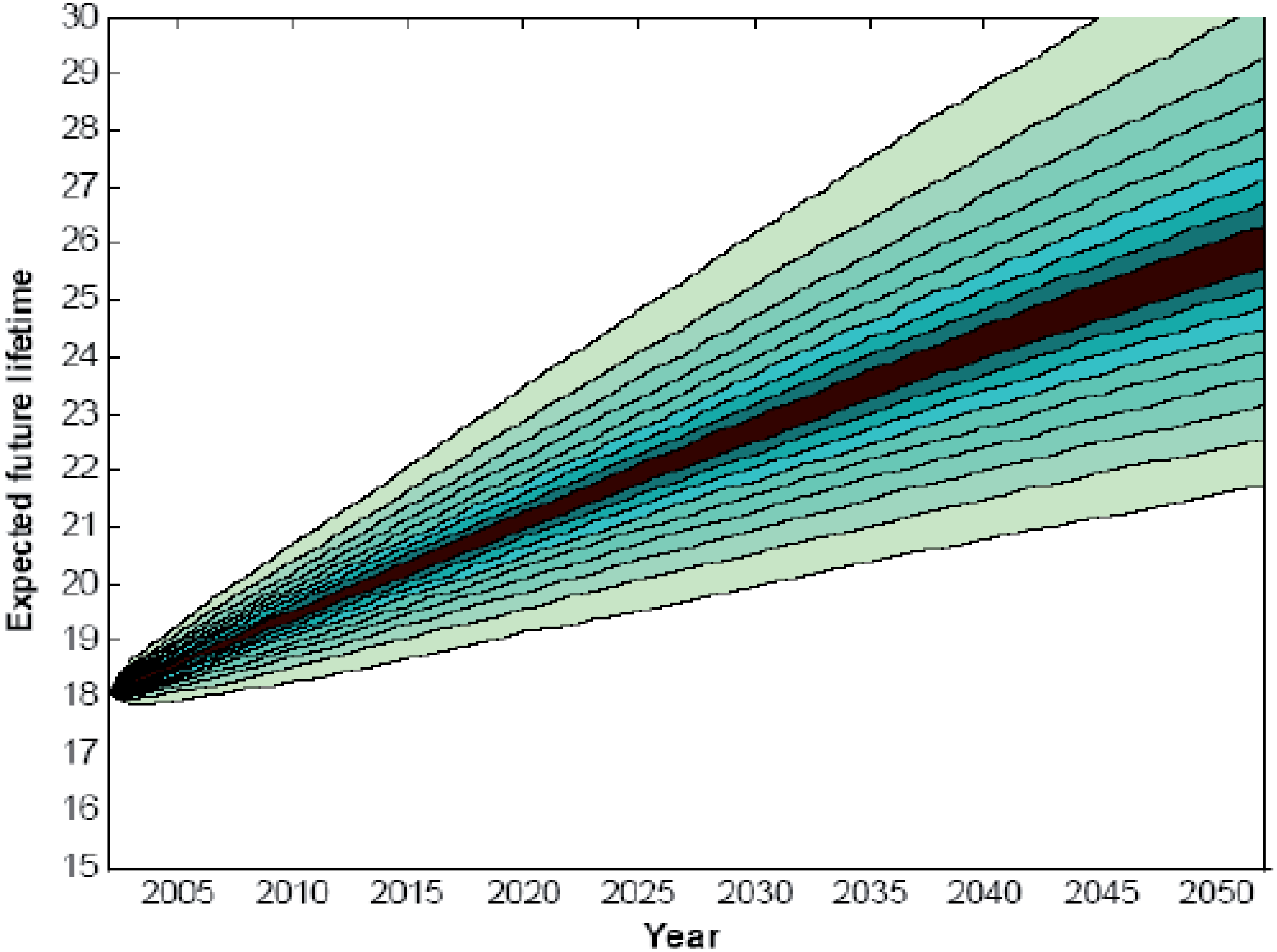
An Illusion

- 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



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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

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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

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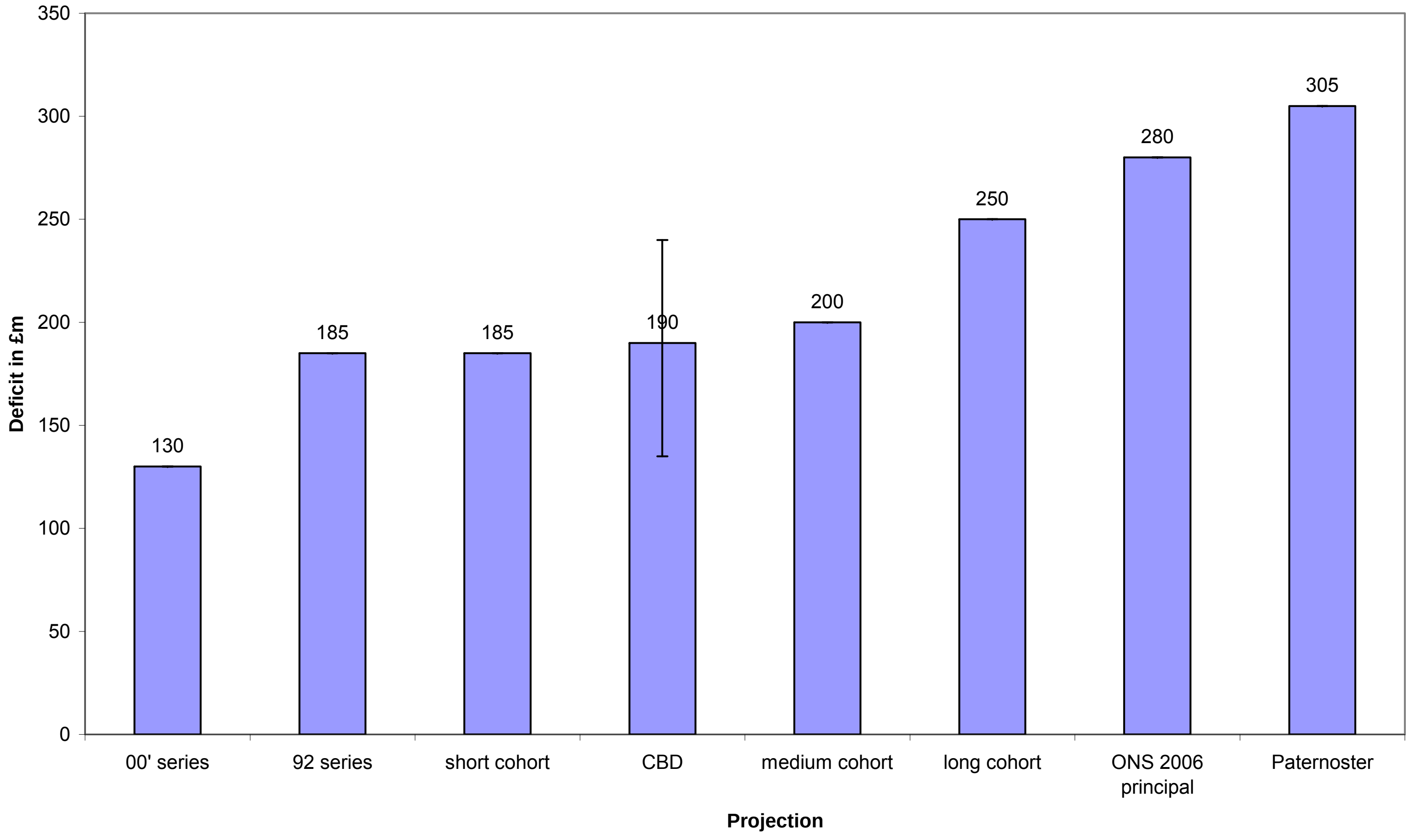
Comparison of pension deficit using different mortality assumptions



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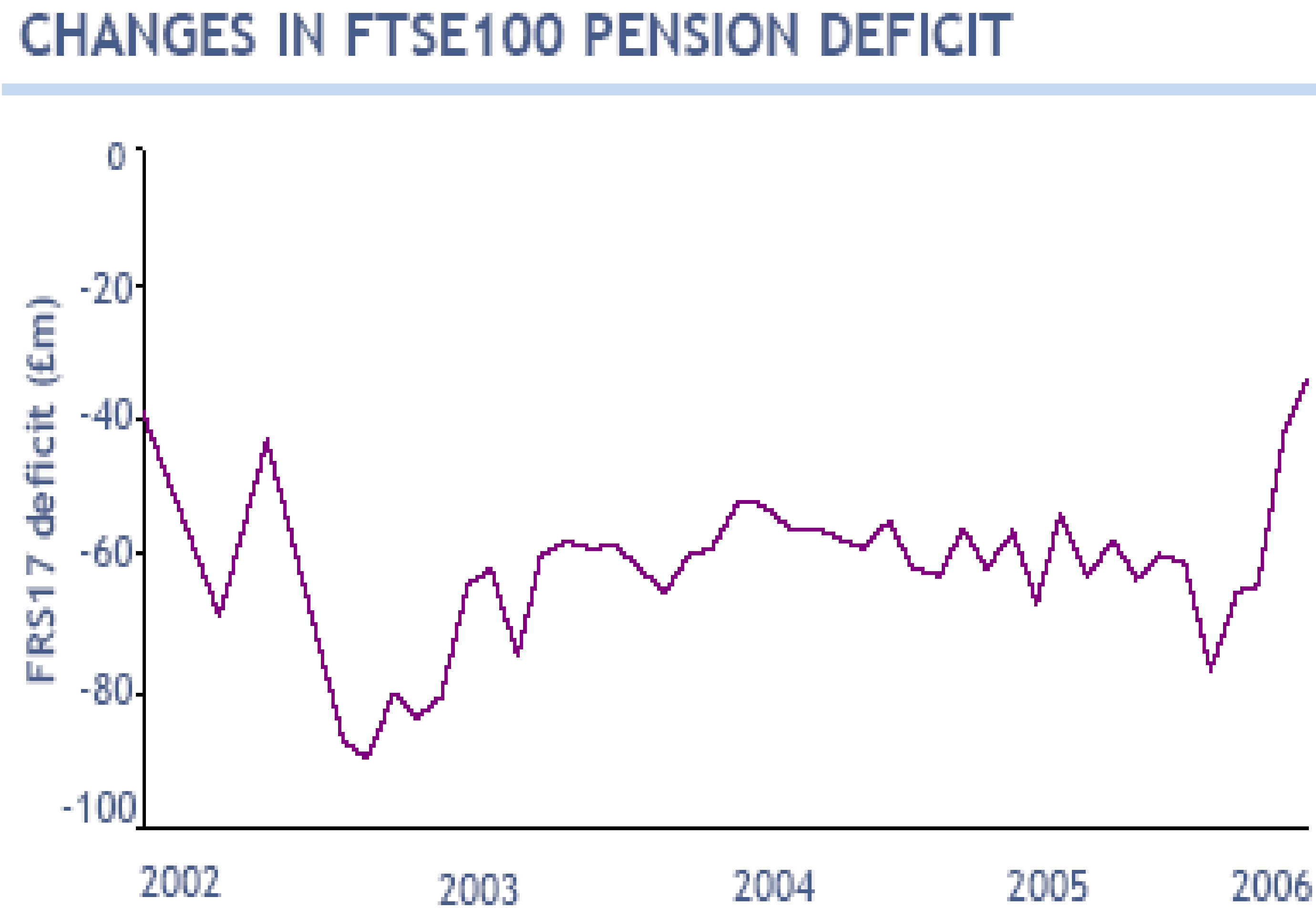
And avoid this?



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Association of British Insurers

The Future of Pension Accounting

Cass Business School Seminar 30 April 2008

Michael McKersie
Assistant Director, Capital Markets
Association of British Insurers

Fair Values

- Fine for the asset side of the pension scheme
- Not so good for the liabilities

Which is a problem because we are interested in the net position**!**

Pensions as a Special Type of Insurance Risk

- The particular nature of pension liabilities:
  - •Investment risk
  - •Inflation risk
  - •Longevity risk

We need to understand how these work out in combination and to recognise

- The very long and uncertain direction of the liabilities
- FRS17/IAS19 does not fully achieve this.

- Pension Liabilities are not Fixed-Interest in Nature
  - The biggest problem with the existing accounting
- A risk-free discount rate does not/cannot exist
  - the biggest problem with the proposed accounting

- We need a methodology that gives the right shape to the liabilities just as much as the right size!
- We need the right kind of prudence.

- Is future salary growth a present liability for the scheme?
- The impact of regulators: Perhaps this cannot decrease the cost but are we sure it doesn’t increase it?

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PHIL SPARY

the Pensions Regulator

The Pensions Regulator

The Pensions Accounting Debate

Phil Spary
30 April 2008

Key issues for TPR……

- Primarily the impact on scheme accounting
  - Contractual obligation
  - Member understanding (decision usefulness)
  - Robust disclosure (stewardship)
  - Balanced with cost?
- For the sponsor
  - Transparency
  - Behavioural implications
  - Comparability

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Risks - built around 4 principles

Measurement	*Liabilities - reliably measuring the cost of service* *Assets – fair valuing*
Recognition	*Including those items which have a cost or value – but when, now or later?*
Disclosure	*Transparent reporting of the pension obligation*
Consistency	*Comparability*

The Pensions Regulator

In summary……

- We welcome and support a ‘root and branch’ review of pensions accounting
- We will watch with interest as the corporate debate gains momentum
- We intend to take an active role in the review of pension scheme accounting
- We look forward to a well informed discussion

The Pensions Regulator

PANEL and Q&A

chaired by Crispin Southgate, Institutional Investment Advisors

Andrew Evans, Partner, PwC
Dr Zaki Khorasanee, Cass Business School
Andrew Lennard, ASB
Fraser Low, the Pensions Regulator

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