

PRO-ACTIVE ACCOUNTING ACTIVITIES IN EUROPE (PAAinE)

**THE FINANCIAL REPORTING OF PENSIONS
FEEDBACK AND REDELIBERATIONS**

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The Financial Reporting of Pensions Feedback and Redeliberations

This report is part of Europe's 'Pro-active Accounting Activities in Europe' (PAAinE) initiative, which is a partnership between the European Financial Reporting Advisory Group (EFRAG) and European Standard-setters.

The development of this report has been led by the UK Accounting Standards Board (ASB) and sets out the ASB's recommendations on how a future accounting standard on pensions might be developed. The report also provides feedback on the ASB's redeliberations following a major consultation exercise on the discussion paper 'The Financial Reporting of Pensions' which was published in January 2008 as part of the Pro-Active Accounting in Europe (PAAinE) initiative.

The report has also been issued by the:

- *European Financial Reporting Advisory Group;*
- *the Conseil National de la Comptabilité (CNC), the French standard-setter;*
- *the Accounting Standards Committee of Germany, (ASCG) (Deutsches Rechnungslegungs Standards Committee (DRSC)), the German standard-setter; and*
- *the Organismo Italiano di Contabilità (OIC), the Italian standard-setter.*

who consider the publication of the report a useful contribution to the debate on the financial reporting of pensions but do not express a view as to the recommendations in the report.

This paper is available for downloading from the websites of the issuers. A limited number of copies will also be made available in printed form.

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1 Introduction

1.1 In January 2008, the discussion paper ‘The Financial Reporting of Pensions’¹ (DP) was published as part of Europe’s ProActive Accounting in Europe (‘PAAinE’) initiative, which is a partnership between the European Financial Reporting Advisory Group (EFRAG) and European standard-setters.

1.2 The development of the paper was led by the UK Accounting Standards Board (ASB). The views expressed in the DP were preliminary and represented the views of the ASB; other European standard-setters did not express any opinion.

1.3 This report sets out the ASB’s redeliberations informed by comments received from the consultation process. The objective of this report is to provide the International Accounting Standards Board (IASB) with recommendations on how it might develop a future financial reporting standard on pensions, following the outcome of a major consultation on the DP.

¹ The Discussion Paper can be accessed at <http://www.frc.org.uk/asb/technical/projects/project0065.html>.

2 Background

2.1 The objective of the DP was to take a fresh look at – and stimulate discussion on – the principles that might be reflected in future accounting standards on employment related pension benefits.

2.2 Comments were invited on the preliminary views set out in the DP. A total of 103 responses were received² and the ASB considers that this provides evidence that the DP fulfilled its objective of stimulating debate on the subject. The responses contained a variety of points of view and required careful consideration by the ASB.

2.3 The DP noted that in economies in which pension obligations are significant, it is important that there is a high degree of confidence in the financial reporting of pensions by employers and by pension plans.

2.4 Since embarking on this research project in October 2005, the recent financial crisis has refocused attention on the need for financial reporting to provide users of financial statements with an understanding of the risks an entity is exposed to. Since 2005, pensions have been affected by:

- (i) An increase in the number of defined benefit schemes closing to both new entrants and to future accruals in the UK³. As a consequence, the provision of defined benefit pensions is often no longer part of a wider human resource strategy to retain and recruit staff by employers. The main focus for many entities is now on risk management and funding the pension plan. As a consequence, it is the finance departments that take a more active role in the management of the pension plan.
- (ii) The UK AA corporate bond rate used to discount pension liabilities moving away from the underlying gilt rate and, for a period of time, reducing the level of reported liabilities and causing the funding position of many pension plans to appear stronger than the underlying economic reality⁴.
- (iii) European legislation regarding management and scheme funding has been strengthened⁵.

2.5 These events emphasise the need for clear and concise financial reporting of pensions. Over this time, however, the spread between AA corporate bonds and gilt yields has had the effect of significantly

² The responses can be accessed at <http://www.efrag.org/projects/detail.asp?id=70>.

³ PWC survey of 157 companies following Budget 2009: 96% of those surveyed said that defined benefits pension schemes are becoming increasingly unsustainable for UK employers.

⁴ The Pension Regulator: 'Scheme Funding: An analysis of recovery plans and clearance applications'.

⁵ Directive 2003/41/EC of the European Parliament and of the Council.

reducing UK pension liabilities reported in financial statements – to the extent that some have now called into question the reliability of the measure⁶.

2.6 There is no doubt that the IASB has a full and extensive agenda at this time and needs to focus its resources on priority issues. The IASB issued a discussion paper in March 2008 ‘Preliminary Views on Amendments to IAS 19 Employee Benefits’, which was focused on particular areas where IAS 19 might be improved in the short term. These improvements are being reconsidered at the moment and the IASB has agreed to extend the scope of the short-term project to include proposals to improve the disclosure requirements of IAS 19.

2.7 The ASB supports the IASB move to extend the scope of its current employee benefits project but retains the view that a more fundamental reconsideration of IAS 19 is required in the longer term.

⁶ The Pensions Regulator Scheme Funding – An analysis of recovery plans and clearance applications (December 2008).

3 Executive summary

3.1 The DP proposed some significant changes to the financial reporting of pensions from current accounting standards, some of which attracted considerable public debate. In July 2008, Ian Mackintosh, Chairman of the ASB, noted that:

“The responses contain a variety of points of view and will be a wonderful basis for redeliberating the original paper. We now need to consider the responses carefully to ensure the aim to develop sound proposals for the international community is fulfilled”.

3.2 Over the last year, the ASB has carefully considered the responses to the DP and has developed its thinking taking into consideration the views of respondents.

3.3 The preliminary views of the ASB were set out in the DP. A summary of responses and redeliberations is set out in section 4 of this report together with the ASB conclusions following redeliberations on its preliminary views.

3.4 Set out below is a précis of the ASB views following redeliberations:

3.4.1	<p><i>Liabilities to pay benefits (chapter 2 of the DP and paragraphs 4.5 to 4.25 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that recognition should be based on the principles of reflecting only present obligations as liabilities. ● The ASB affirms its view, on a majority basis, that the liability to pay benefits that is recognised (and the pension expense for each period) should be based on current salaries plus any future increases that are required by law or contract including other increases that are seen as non-discretionary, i.e. in respect of which there is a constructive obligation. ● The ASB formed the view that financial reporting for pensions should be based on the premise that a liability is owed to an individual employee – that is the unit of account should be at the level of the individual employee.
3.4.2	<p><i>Reporting entity considerations (chapter 3 of the DP and paragraphs 4.26 to 4.33 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that pension plans should be subject to the same principles of consolidation as are usually applied in determining whether one entity controls another. In affirming its view, the ASB acknowledges that further work is required to determine appropriate disclosures where it is deemed an entity has control of a pension plan.

<p>3.4.3</p>	<p><i>Recognition of pension assets and liabilities (chapter 4 of the DP and paragraphs 4.34 to 4.40 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that pension assets and liabilities should be recognised immediately, but acknowledges the recognition of the changes in assets and liabilities relating to pension benefits are inextricably linked to the presentation of those changes in the financial statements.
<p>3.4.4</p>	<p><i>Measurement of liabilities to pay benefits (chapter 5 of the DP and paragraphs 4.41 to 4.89 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that regulatory measures should not replace measures derived from general accounting principles used in financial reporting, but accepts that regulatory measures may provide useful information about the cash flows anticipated to fund future liabilities to pay pension benefits and, therefore, where appropriate, should be disclosed. ● The ASB's has clarified that in its view the future cash flows used to measure the liability to pay pension benefits should be: <ul style="list-style-type: none"> (a) explicit; (b) based on observable market prices that are adjusted to take into consideration entity-specific circumstances; (c) incorporate in an unbiased way all available information about the amount, timing and uncertainty of cash-flows arising from the contractual obligations; and (d) current – in other words, they correspond to conditions at the end of the reporting period. ● The ASB affirms its view that the liability to pay pension benefits should not be reduced to reflect an entity's credit risk. The ASB supports the IASB's decision in issuing a discussion paper on this topic and has responded to state that it does not support the inclusion of an entity's own credit risk in the measurement of liabilities unless, on initial recognition, the entity is party to an observable market transaction. ● The ASB affirms its view that it is not possible to make a reliable estimate of the risk arising from the size and variability of the liability to pay pension benefits. Consequently, the ASB affirms its view that users of financial statements are better served by disclosure regarding the sensitivity of assumptions than by adjusting the estimated cash flows, the discount rate or by inclusion of a risk margin.

	<p><i>Measurement of liabilities to pay benefits (continued)</i></p> <ul style="list-style-type: none"> ● The ASB, in considering concerns arising from the use of the AA corporate bond rate in the UK at this time, affirmed its view that the discount rate should reflect only the time value of money, and therefore should be a risk-free rate. In its view, the risk associated with the size and variability of the liability is more appropriately addressed through disclosure. ● The ASB, taking into consideration the concerns raised by respondents, has formed the view that, whilst its preliminary view that expenses of administering the plan’s accrued benefits is conceptually sound, as a matter of practicality (and taking into consideration the likely materiality of such expenses) that it would be more appropriate to expense the costs as incurred. ● The ASB has concluded that where employees have options to receive pension benefits in different ways, the liability should be reported at an amount that reflects the probability of the different outcomes.
3.4.5	<p><i>Measurement of assets held to pay benefits (chapter 6 of the DP and paragraphs 4.90 to 4.93 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that assets held to pay pension benefits should be reported at current values.
3.4.6	<p><i>Measurement of employer interests in assets and liabilities and similar entities (chapter 7 of the DP and paragraphs 4.94 to 4.97 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB clarified its view that if the contractual arrangements (and thereby the risks and rewards) result in a ‘net’ asset or liability being representative of the employer’s rights and obligations (where the trust is not consolidated because it is not controlled by the employer), the measurement of the net amount should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly, subject to reflecting the effect of any restrictions on the assets.
3.4.7	<p><i>Presentation in financial statements (chapter 8 of the DP and paragraphs 4.98 to 4.115 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that different components of changes in liabilities and/or assets should be presented separately.

	<p><i>Presentation in financial statements (continued)</i></p> <ul style="list-style-type: none"> ● The ASB has decided not to affirm its view that the actual return on assets held to fund pension liabilities should be presented separately as financing income in the statement of comprehensive income. This is on the basis that, although this is a conceptually pure approach, it may not meet the needs of users. ● The ASB considers that further research is required in this area and alternative approaches should be evaluated before development of a new financial reporting standard.
3.4.8	<p><i>Disclosures in the employers' financial statements (chapter 9 of the DP and paragraphs 4.116 to 4.125 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view regarding the disclosures objectives for the financial reporting of pension as set out in the DP. The objectives are that: <ul style="list-style-type: none"> (a) financial statements contain adequate disclosure of the cost of providing pension benefits and any related gains, losses, assets and liabilities; (b) users of financial statements are able to obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those benefits; and (c) the funding obligations of the entity, in relation to liabilities to pay pension benefits, are clearly identified. ● The ASB noted it is important that management consider the disclosure objectives when preparing the financial statements to ensure that disclosures provide useful and cost-effective information.
3.4.9	<p><i>Accounting for multi-employer plans (chapter 10 of the DP and paragraphs 4.126 to 4.132 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that recognition and measurement principles as set out in chapters 4 to 7 should also apply in relation to multi-employer plans.
3.4.10	<p><i>Financial reporting by pension plans (chapter 11 of the DP and paragraphs 4.133 to 4.156 of this report)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that the objective of pension plan financial statements is to provide information about the financial position, performance and changes in financial position of a pension plan that is useful to members, and those who act in their interests, in making economic decisions and assessing the stewardship of trustees.

	<p><i>Financial reporting by pension plans (continued)</i></p> <ul style="list-style-type: none"> ● The ASB affirms its view that pension scheme financial statements should recognise the liability to pay future benefits but considers that a more detailed study of potential costs should be undertaken. ● The ASB agreed (by majority) that, conceptually, the employer’s covenant should be recognised as an asset in the pension plan financial statements but recognised that this can presents a number of serious practical difficulties. The alternative preferred is to require narrative disclosure of how the difference between the assets and liabilities will be funded.
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3.5 As is demonstrated from the analysis set out in section 4, many of the responses to the DP supported the preliminary views. There were, however, some areas that attracted debate and where opposition to the proposals was strong. Three particular areas are discussed below.

Measurement of liabilities to pay pensions benefits

3.6 It was proposed in the DP that the measure of liabilities to pay pension benefits should be a current value amount of future cash outflows expected to settle the liability when it falls due. Where the measure is derived from discounting future cash outflows, it should reflect the expected cash outflows (that are required to settle the liability as defined in the DP) discounted at a current market discount rate to reflect the time value of money.

3.7 Respondents to the DP were concerned with this proposal for several reasons; notably, many considered that the proposal did not reflect how risk should be taken into consideration.

3.8 The DP identified two types of risks that affect the liability to pay pension benefits; risk arising from the variability of the size of the liability to pay pensions benefits and risk that the reporting entity has insufficient cash flows to settle the liability (credit risk).

3.9 The preliminary views set out in the DP stated that risk arising from the size of the pension liability was very difficult to measure and it would be misleading to try and reflect the financial effect of such risk in a reported liability amount. It was therefore proposed that this risk should be addressed by disclosures regarding the assumptions that have been used to estimate the cash flows and the sensitivity of the liability to changes in those assumptions.

3.10 The ASB acknowledges the concern of some respondents to the DP that clarification is required as to whether and, if so how, risk should be addressed in the cash flows used to measure the pension liability. As part of its redeliberations, the ASB has sought to clarify how risk should be taken into account. The clarification notes that the cash flows should incorporate, in an unbiased way, all available information about the amount timing and uncertainty of cash flows arising from contractual obligations. The expected

value of the cash flows should be used, where the expected value is the probability-weighted average of the cash flow.

3.11 The ASB anticipates that by clarifying – firstly, the cash flows to be used in measuring the liability to pay pension benefits and secondly, by providing disclosures regarding the sensitivity of cash flows to the assumptions therein – that these clarifications explain the proposals for addressing the risk associated with the variability of the size of the pension liability.

3.12 In relation to credit risk, the majority of respondents agreed with the preliminary view in the DP that the liability should not be adjusted to take into account credit risk. A number of respondents noted that credit risk was an issue that should be considered at a conceptual level before being addressed by individual standards. The ASB agrees with this view and hence supports the IASB in issuing a discussion paper addressing this topic. The ASB has recently responded to the IASB's discussion paper⁷ and noted it does not support the inclusion of own credit risk in the measurement of liabilities, unless on initial recognition the entity is party to an observable market transaction.

3.13 In addition to the treatment of risks associated with pension liability, the ASB acknowledges the views of respondents who did not support the use of a discount rate that reflects the time value of money only: a risk-free rate. After considerable debate, the ASB can find no compelling reason to amend its preliminary view.

Presentation in financial statements

3.14 The DP proposed two significant changes from existing accounting standards to the presentation of changes arising from assets and liabilities to pay pensions benefits:

- (i) the ASB's preliminary view (which accords with its view regarding the recognition of liabilities to pay pension benefits and the assets held to fund those benefits) was that actuarial gains and losses should be presented in the profit and loss as part of other income; and
- (ii) the ASB also expressed the view that the actual return on assets should be presented in financing income and the expected return on assets should be disclosed but not recognised.

3.15 Respondents to the discussion paper broadly supported the preliminary views in the DP regarding recognition, but noted there is an inextricable link between recognition of liabilities to pay pension benefits and the assets held to fund those benefits with the presentation of changes arising from these assets and liabilities in the statement of comprehensive income. The ASB, in its redeliberations, accepted this point and agreed recognition required a satisfactory resolution for presentation.

⁷ The ASB response can be downloaded from www.frc.org.uk/asb/publications/asb_responses.cfm.

3.16 In relation to the preliminary view in the DP that the actual return on assets should be presented in financing income, two concerns were noted by respondents. Some respondents were concerned with the level of volatility that would be introduced into profit or loss; these respondents questioned the effect that adopting the preliminary view could have and suggested that it may affect a reporting entity's ability to raise finance. In essence, these respondents question the behavioural consequences that might occur as a consequence of the preliminary views set out in the DP.

3.17 Other respondents, in particular users of financial statements, considered that the preliminary view did not provide useful information. They noted that users of financial statements often use the expected return on assets to extrapolate and estimate future cash flows that may be required to fund the liability. Consequently, some users consider the preliminary view reduced the usefulness of information in the financial statements.

3.18 In contrast, other respondents agreed that the preliminary view was supported from a conceptual perspective but also understood the concerns regarding the short-term volatility being introduced into the profit and loss and the potential loss of information.

3.19 The ASB, in considering the views of respondents, noted that the IASB had in its discussion paper 'Preliminary Views on Amendments to IAS 19 Employee Benefits' outlined proposals for the presentation of changes in assets and liabilities held to fund pension benefits and had not received considerable support for its proposals. In view of this, the IASB concluded that further research should be undertaken in the area of presentation before a satisfactory solution could be found.

3.20 The ASB agrees that further research is required in this area but decided that, at this time, it could not undertake that research as it sought to respond to the consultation in a timely manner.

3.21 The ASB also noted a proposal for presentation that is based on the view that the pension deficit is a net liability and it is therefore wrong to present gross movements. Under this view, interest expense on the net deficit would be presented in financing income. This captures the interest cost on the liability and a return on assets at a rate equal to the discount rate. The remaining funding charge required to reconcile with the actual return on assets should be presented as a re-measurement item within the profit and loss.

Financial reporting by pension plans

3.22 The preliminary view in the DP was that financial statements for pension plans should provide information about the financial position, performance and changes in financial position of a pension plan that is useful to members and those who act in their interests in making economic decisions and assessing the stewardship of the trustees, and that the reporting required by IAS 26 did not achieve this.

3.23 A minority of respondents did not support the preliminary view and considered that pension plan financial statements were for stewardship purposes only. The ASB considered this view but could not find

a distinction between pension plan financial statements and other financial statements in terms of meeting the requirements for general purpose financial reporting, including stewardship requirements. Consequently, the ASB decided to affirm its preliminary view.

3.24 It was also proposed in the DP that the financial statements of pension plans should include the liability to pay future pensions. Respondents' views were divided on this matter.

3.25 The ASB, in referring to the view that pension plan financial statements were for stewardship purposes only, noted that, if the trustees are stewards of the pension plan, not recognising the liability suggested a disclaimer of responsibility on their part. In the ASB's view, stewardship requires the inclusion of the liability.

3.26 Some respondents suggested that users are not capable of understanding the liability and might be misled and/or unnecessarily alarmed by recognition of the liability. In considering this concern, the ASB noted that users' representatives (including trustees and the disclosures made by them in the financial statements) should explain and interpret financial statements.

3.27 A further concern raised by respondents was the costs associated with measurement and audit of the liability; these respondents suggested inadequate attention had been focused on assessing the possible costs and effects of the proposals in the DP.

3.28 The ASB affirmed its view that pension scheme financial statements should include the liability to pay future benefits and accepted that a more detailed study of potential costs should be undertaken.

3.29 The DP also proposed that, where an employer undertakes to cover all or part of a short fall in a pension plan, the plan should recognise an asset, reflecting its claim on the employer. The asset should be measured as the difference between the liability in respect of future benefits and the current value of assets available to pay those benefits. Where impaired, the amount reported as an asset should be reduced to its recoverable amount.

3.30 The analysis of respondents' views identified support for the principle that the financial statements of the pension plan should include an asset representing the employer's covenant; however, a number of respondents raised practical difficulties with the preliminary view.

3.31 The practical difficulties included a concern that trustees might not be able to measure the covenant. The ASB agreed that measuring the covenant requires assessment of the employing entity's creditworthiness. This assessment can be difficult to make and may give rise to considerable uncertainty in the amount recognised.

3.32 In addition, some ASB members did not support the preliminary view in the DP that a covenant necessarily gives rise to an asset. In their view, the employer's covenant may be no more than an assurance

and hence may not have the attributes of an asset. Schemes differ and whether future employer contributions are an asset may depend on individual facts and circumstances.

3.33 The ASB considered and affirmed an alternative approach; for trustees to provide disclosure regarding future contributions and the likelihood of those contributions being paid (i.e. narrative disclosure of how the funding gap would be bridged).

3.34 The ASB agreed (by majority) that, conceptually, the employer's covenant should be recognised as an asset in the financial statements of the pension plan but recognised that this could present a number of serious practical difficulties. The alternative preferred is to require narrative disclosure of how the difference between the assets and liabilities will be funded.

Conclusions

3.35 The ASB believes that the high response rate to the DP provides evidence that the DP achieved its objective of stimulating the debate on the financial reporting of pensions.

3.36 The responses also provided the ASB with a valuable opportunity to evaluate its preliminary views and develop its views with the ultimate aim of influencing the thinking of a future or revised accounting standard.

3.37 The ASB continues to support the IASB in its development of high quality understandable international financial reporting standards (IFRSs). The ASB hopes that the DP and the redeliberations following consultation will be a useful contribution to the debate on the financial reporting of pensions and assist the IASB in its thinking.

4 Summary of responses and redeliberations to the invitation to comment of the DP

4.1 This section of the report provides a summary of the preliminary views together with the invitation to comment set out in the DP (shown in the sections in *italics*). The aim of this section is to provide an overview of respondents' views to the invitation to comment and to detail the results of the ASB redeliberations.

4.2 Details of responses can be found in Appendix A of this report.

Chapter 1: Introduction

4.3 *The DP set out views on how pension arrangements including the obligation to provide pensions are best reflected in financial statements. It considered both the financial statements of the employer and those of a pension plan.*

4.4 *The DP identified that one of the perceived difficulties with existing pension standards is that they draw a sharp distinction between defined contribution and defined benefit plans. The DP took the approach of considering the fundamental principles, which are common to all pension plans.*

Chapter 2: Liabilities to pay benefits

4.5 *Liabilities, as defined in the Framework, arise when there is a present obligation to transfer economic benefits. This chapter set out views on which possible future pension benefits are (or are not) present obligations and should therefore be (or not be) reflected in the reported liability to provide pension benefits. The preliminary view in the DP was that:*

- (i) Pension obligations arise under employment contracts in which pension benefits are provided in exchange for services. It is at the time at which services are provided that a liability arises.*
- (ii) The liability that arises when service is provided includes, in addition to vested benefits, benefits in respect of services provided before vesting, because an employer cannot realistically avoid his promise (or can cancel it only on payment of compensation).*
- (iii) The liability that arises is often subject to a number of uncertainties, including those relating to future prices and other economic factors and demographic factors such as mortality: many of these clearly are relevant to the measurement of a liability, not whether it exists.*
- (iv) It is less clear whether some other factors, including benefits that the employer has discretion to vary and the level of future pensionable salaries, concern the measurement of a liability or its existence. There should be a clear principle that provides a basis for determining whether an entity has a liability for benefits that it might become committed to in the future:*

- (a) *Some believe the liability to pay benefits that is recognised (and the pension expense for each period) should include expectations of employees' pensionable salaries when they leave service.*
- (b) *Others (including the majority of the ASB's members) believe the liability to pay benefits that is recognised (and the pension expense for each period) should include only benefits to which the entity is presently committed (by legal or constructive obligation).*

Consequently, a liability in respect of pensions includes increases that are guaranteed by law or contract, and also those that an entity has a constructive obligation to give. However, only benefits to which the entity is presently committed to pay should be reflected in the liability: where the entity has genuine discretion to vary the amount of future benefit, this should not be reflected in the liability. The reported liability should also not reflect possible future changes to the entity's or the plan's financial position.

4.6 As the ASB was unable to reach a unanimous view prior to publication of the DP, it sought the views of respondents on whether liabilities to pay benefits should be based on expectations of employees' pensionable salaries when they leave service, or on current salaries.

Q1 Should a liability to pay benefits that is recognised be based on expectations of employees' pensionable salaries when they leave service, or on current salaries (including non-discretionary increases)?

4.7 As noted above, a majority of the ASB members consider that the liability to pay benefits should be based only on benefits that the entity is presently committed to pay. This preliminary view attracted some attention following the publication of the DP because it represented a significant change from the existing requirements in either IAS 19 'Employee Benefits' or FAS 87 'Employers' Accounting for Pensions'.

4.8 The analysis of responses to the DP revealed that views were divided with no overall consensus view emerging. There was a level of consensus amongst respondents when considered by category; for example, all accounting firms that responded to the DP considered the liability should be based on currently committed benefits (including non-discretionary increases); whereas most standard-setters considered the liability should be based on expectations of employees' pensionable salaries when they leave service.

4.9 Those that considered the liability should be based on expectations of employees' pensionable salaries when they leave service noted:

- (i) an employer who currently promises a pension equal to two per cent of final salaries should recognise a higher cost than an employer who promises a pension equal to two per cent of current salaries;
- (ii) the issue is not one of recognition but one of measurement;

- (iii) using salary at the reporting date without any inflation would be inconsistent with other assumptions; and
- (iv) in a final salary scheme, the employee earns a portion of the pension based on expected final salary in each period worked and not a portion of pension based on current salary.

4.10 In contrast, those respondents that considered the liability should be based on currently committed benefits salaries (including non-discretionary increases) noted:

- (i) the question in the DP should not address whether there is a constructive obligation to give pay increases but whether there is a constructive obligation to increase accrued pension benefits in line with future pay increases;
- (ii) liabilities based on current salaries are more consistent with the principle that a liability should only reflect the present commitment resulting from a legal or constructive obligation;
- (iii) the issue is not significant for a large proportion of UK schemes, where active members represent a diminishing proportion of the liabilities; and
- (iv) if the risk-free discount rate is applied as outlined in the DP, allowing for current salary would be appropriate as the proposals are generally consistent with a termination approach in measuring liabilities.

4.11 The views expressed by respondents were analysed by the ASB by considering the following questions:

- (i) Is there a constructive obligation to increase salaries?
- (ii) Is the issue one of recognition or measurement? and
- (iii) Is the number presented in the financial statements a faithful representation of the liability to pay pensions?

4.12 In considering the first question, it was noted that an employer is not under an obligation to increase an employee's salary at the present point in time and, consequently, no constructive obligation to increase salaries in the future currently exists. In forming its view, the ASB agreed with those respondents to the DP who noted the question was whether there is a constructive obligation to increase accrued pension benefits in line with future pay increases.

4.13 As to whether the issue is one of measurement or recognition, the ASB decided that it is first necessary to identify if a liability exists and only once the recognition criteria are met should the measurement criteria be considered. In the absence of a present obligation to be recognised, it was concluded there is no obligation to be measured.

4.14 As regards the presentation of amounts in the financial statements, it was considered that recognising current salaries in the liability to pay benefits produces a more informative profit and loss result. This is because the profit and loss result includes the pension earned in the year – including the increase in the value of the pension benefits arising as a consequence of the increase in salary during the year.

4.15 The ASB affirms its view, on a majority basis, that the liability to pay benefits that is recognised (and the pension expense for each period) should be based on current salaries plus any future increases that are required by law or contract including other increases that are seen as non-discretionary, i.e. in respect of which there is a constructive obligation.

4.16 *Chapter 2 of the DP also considered the issue of the unit of account for pensions. That is, should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? The DP noted it is clear that an employer can realistically avoid incurring an obligation, such as that for future salary increases to an individual employee, but it is doubtful whether the employer could realistically avoid it for the entire workforce.*

4.17 In the DP, the ASB did not express a preliminary view as to whether financial reporting should be based on the premise that a liability is owed to an individual employee or to the workforce as a whole but sought views on the topic.

Q2 Should financial reporting be based on the premise that a liability is owed to an individual employee or to the workforce as a whole? What consequences do you consider your view has for the recognition and measurement of pension obligations?

4.18 The analysis of comment letters did not reveal a consensus view on whether financial reporting should be based on the premise that a liability is owed to an individual employee or to the workforce as a whole. The review of responses suggested, however, that some respondents had answered the question ‘to whom does the employer owe the pension liability?’ rather than ‘should financial reporting recognise a liability where the unit of account is the individual employee or the workforce as a whole?’ The fact that respondents appeared to have responded to the questions in different ways may provide an explanation of why no consensus view emerged.

4.19 In analysing the responses, consideration was given to the view of some respondents that the liability is owed to the individual employee (because the workforce as a whole cannot be distinguished separately) but measurement could be based on the workforce as a whole applying a portfolio approach.

4.20 It was also noted that from a legal perspective the liability is owed to the individual employee and hence the unit of account should be that of the individual employee.

4.21 The ASB has formed the view that financial reporting should be based on the premise that a liability is owed to an individual employee – that is the unit of account should be the individual employee.

4.22 *The final topic addressed in chapter 2 concerned the requirements for attributing benefits to periods of service. The DP concluded that the present requirements in defined contribution plans and defined benefit plans are unsatisfactory because there is no clear principle behind them that can be applied consistently across the spectrum of benefits. The focus should shift from mechanisms that spread pension costs over employees' service lives to the principle of reflecting only present obligations as liabilities.*

4.23 Question 3 to the DP asked:

Q3 Do you agree that recognition should be based on the principle of reflecting only present obligations as liabilities?

4.24 A majority of respondents supported the preliminary view that recognition should be based on the principle of reflecting only present obligations as liabilities.

4.25 **The ASB affirms its view that recognition should be based on the principle of reflecting only present obligations as liabilities.**

Chapter 3: Assets and liabilities – reporting entity considerations

4.26 *This chapter considered how obligations to provide pension benefits and assets held to pay such benefits should be reflected in the financial statements of an employer. It considered an employer's individual and consolidated financial statements. The preliminary views set out in the DP were:*

Individual financial statements:

- (i) If the employing entity is directly responsible for paying the benefits promised to employees, the liability must rest directly with the employing entity.*
- (ii) Where a pension is provided by a third party (such as an insurance company) some or all of the employer's present obligation to the employee is extinguished by transferring assets (i.e. paying agreed contributions) to that third party.*
- (iii) Where a fund of assets is established which is not transferred to a separate entity (i.e. it is simply a collection of assets of the employing entity):*
 - (a) the assets held in the fund are reported as assets of the employing entity in its individual financial statements; and*
 - (b) the obligation to pay benefits is a liability of the employing entity (i.e. it is not a liability of any other reporting entity).*

Where assets are transferred from the employer to an employer-sponsored plan:

- (i) If the employer has the legal or constructive obligation to pay benefits, it will have a liability to pay benefits and may have an asset, representing its right to reimbursement from the plan.*
- (ii) If the plan assumes the obligation to pay benefits and the employer has an obligation to make contributions to the plan to the extent that the plan's obligations cannot be met from its own assets, the asset or liability that is properly representative of the employer's rights and obligations is a net asset or liability that reflects its right to benefit from a surplus or its obligation to contribute to a deficit.*
- (iii) The reasons for the present requirement of IAS 19 to give a net presentation in some circumstances where the employer has a direct obligation to pay benefits do not seem to be convincing and should be reconsidered. A gross presentation would appropriately reflect the economic substance and be consistent with accounting principles that are applied elsewhere.*

The employer's consolidated financial statements:

- (i) There is no conceptual reason why financial reporting standards should provide an exemption from the consolidation of pension plans. Where a pension plan is part of a single economic entity (the group), then the usefulness of the information in the employer's financial statements is improved if the pension plan is consolidated.*
- (ii) Where it is determined that an entity does have control of the plan, then consolidation of the plan will result in the assets and liabilities of the plan being presented 'gross' in the employer's consolidated financial statements.*
- (iii) The notion of control (based on whether the employer has rights over the plan's assets and liabilities which give it access to the benefit of those assets and liabilities, and the ability to increase, maintain or protect the amount of those benefits) provides a suitable means to determine whether a plan should be consolidated.*
- (iv) Determination of this will require consideration of all relevant factors, including regulatory influences, and be based on the substance of the relationship between the employer and the pension plan.*
- (v) The application of the notion of control would result in some pension plans being consolidated into the group financial statements – whereas other plans an entity participates in might not be consolidated. It might be argued that this gives rise to inconsistency. However, if the criteria for consolidation are founded on appropriate principles, then the accounting treatment would reflect the economic substance of relationship between the entity and all its plans.*

4.27 In forming this view, it was recognised that removing the exemption from consolidation of pension plans represented a significant change from current practice and therefore views were sought on the preliminary view.

Q4 Do you agree that the consolidation of pension plans should be subject to the same principles as are usually applied in determining whether consolidation is appropriate?

4.28 The majority of respondents to question 4 supported the ASB's preliminary view; although some respondents (mainly actuaries and advisors) did not respond to this question as they considered it a technical accounting matter.

4.29 Whilst respondents supported the ASB's preliminary view, a concern was raised regarding whether the usefulness of financial statements would be improved if the assets and liabilities were consolidated. Those that raised this concern noted that users of financial statements are principally interested in the net position of the entity in relation to the pension plan and that applying general consolidation principles ignores the fact that assets in a pension plan are ring-fenced (separable from other assets) to meet obligations and may not be available to the employer's creditors, and/or that the employer's rights to assets is restricted to refunds of surpluses.

4.30 In considering the comments of respondents, it was noted by the ASB that only pension plans that are *controlled* by the reporting entity would be subject to consolidation and that many pension plans would not meet the test of control; for example, where rights to assets are restricted.

4.31 The ASB noted that in the circumstances that an employer has control of the pension plan, there is no distinction between the assets and liabilities pertaining to the pension plan and any other assets or liabilities of the entity.

4.32 It was also noted that an entity may wish to disclose the assets it had ring-fenced to fund pension liabilities. The ASB also noted that if an entity wished to it could provide additional disclosures to identify assets held to fund pension liabilities.

4.33 The ASB affirms its view that pension plans should be subject to the same principles of consolidation as are usually applied in determining whether one entity controls another. In affirming its view, the ASB acknowledges that further work is required to determine appropriate disclosures where it is deemed an entity has control of a pension plan.

Chapter 4: Recognition of pension assets and liabilities

4.34 *The DP noted that current standards may permit changes in the measurement of assets and liabilities relating to pension plans to be deferred, that is recognised prospectively over a period, such as the average remaining service lives of employees. Or a ‘corridor’ approach may be used, under which changes are not recognised at all unless they exceed a certain threshold.*

4.35 *Having considered the arguments that support deferral approaches, the DP concluded that such approaches do not provide sufficient justification for the balance sheet to portray assets and liabilities relating to pensions plans in a manner that is not representationally faithful. Accordingly, accounting standards should not permit these approaches, and all changes should be recognised immediately.*

4.36 The ASB sought the views of respondents to its preliminary view that the recognition of pension assets and liabilities that met the criteria for the recognition should be recognised and that deferral approaches did not provide transparent information.

Q5 Do you agree that changes in assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods, or left unrecognised provided they are within certain limits (a ‘corridor’) approach?

4.37 The review of responses demonstrated support for the proposal in the DP that assets and liabilities relating to pension plans should be recognised immediately, rather than deferred and recognised over a number of accounting periods, or left unrecognised provided they are within certain limits (a ‘corridor’) approach.

4.38 A number of respondents, whilst agreeing that changes in assets and liabilities relating to pension plans should be recognised immediately, noted that recognition was inextricably linked to the presentation of changes in the primary financial statements. These respondents considered that a solution to presentation of changes needed to be found.

4.39 The ASB was encouraged by the positive support for this proposal and considers that this level of support was a reflection of changes in opinion towards deferral approaches.

4.40 **The ASB affirms its view that pension assets and liabilities should be recognised immediately but acknowledges that the recognition of the changes in assets and liabilities relating to pension benefits is inextricably linked to the presentation of those changes in the financial statements.**

Chapter 5: Measurement of liabilities to pay benefits

4.41 Chapter 5 of the DP addressed the most controversial area in the financial reporting of pensions – the measurement of liabilities to pay benefits. The preliminary views may be summarised as follows:

- (i) A liability in respect of future pensions should be measured at a current value.
- (ii) A current value measure will be a 'settlement amount', reflecting a measure of the cash outflows (or other transfers of economic benefits) needed now or in the future to discharge the liability.
- (iii) If alternative means of settling a liability are currently available to an entity (i.e. it is within the employer's control to achieve them), the liability should be reported at the lowest amount of the available alternatives.
- (iv) Regulatory measures of liabilities to pay pensions should not replace measures derived from general accounting principles.
- (v) The objective of a current value measure of future payments of pension benefits is to reflect today's value of the future cash outflows expected to settle the liability when it falls due. This approach might be viewed as an 'entity-specific' measurement, because it aims to reflect not only the properties of the liability itself but also the relationship to its owner. Where this measure is derived from discounting future cash flows it should reflect:
 - expected value of cash flows (entity's best estimates) that would be admitted under the proposals in chapter 2;
 - current market discount rate to reflect the time value of money only, i.e. a risk-free rate.
- (vi) In theory, the liability should also reflect a margin for risk, but there is concern that some risks (for example, those relating to future changes in mortality) are 'unknowable' and therefore cannot be quantified. Accordingly, users are better served by disclosure about the sensitivities of the liability to changes in the assumptions that have been used in arriving at the best estimates.
- (vii) It is inappropriate for an entity's liability for pensions to be reduced to reflect its credit risk.
- (viii) Measurement of the liability should reflect expenses of administering the plan's accrued benefits.

Q6 Do you agree with the paper's views in the measurement of liabilities to pay benefits? In particular, 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?**

- **Information about the riskiness of a liability (i.e. the risk that the amount of pension benefits will differ from today's expectations) is best conveyed by disclosure rather than by adjusting the amount of the reported liability?**
- **The liability should not be reduced to reflect its credit risk?**
- **Expenses of administering the plan's accrued benefits should be reflected in the liability?**

4.42 The ASB noted the proposals set out in the DP for the measurement of liabilities to pay benefits generated considerable public debate and the comments received required careful evaluation.

Regulatory measures and financial reporting

4.43 The majority of respondents to the first sub-question above (which addressed regulatory measures) supported the preliminary view in the DP that regulatory measures should not replace measures derived from general accounting principles. Some respondents, however, considered that regulatory measures are useful to users of financial statements because often (albeit not always) regulatory measures focus on funding liabilities to pay future benefits and can therefore provide information about claims on an entity's resources.

4.44 This view stimulated the ASB to consider, in more detail, the relationship between the financial reporting of pensions, regulatory measures, and decision-making.

4.45 The DP noted that regulatory measures often consider the cash flows required to fund the pension liability and are not necessarily a measure of the liability to pay pension benefits. This view assumes that the focus of pension regulation is primarily to protect members and their benefits. In contrast, the role of financial reporting is the provision of useful information to users of financial statements.

4.46 In contrasting regulatory and financial reporting measures, it was noted that:

- (i) IAS 19 and FRS 17 provide a measure of the liabilities to pay pension benefits at the end of a reporting period. In contrast, regulatory measures (generally) focus on solvency and funding requirements. A regulatory measure will often be the amount of funding required for regulatory purposes of the liability to pay future benefits rather than an estimate of that liability. A regulatory measure may therefore provide information about the future cash flows required to fund the liability to pay future benefits. It is for this reason regulatory measures are important for decision-making, however;
- (ii) a regulatory measure may not be an approximation of the liability to pay future benefits because regulatory measures frequently make allowance for the returns to be earned from assets currently held to pay future benefits to be taken into consideration. Future returns do not affect the quantum of the liability that exists at the end of the reporting period.

4.47 In considering the measurement of liabilities to pay pension benefits, it was concluded that the financial reporting of pensions should:

- (i) provide users of financial statements with a measure of the liabilities to pay benefits at the reporting date; and
- (ii) provide useful information about the claims on an entity's resources, that is, anticipated future cash flows.

4.48 **The ASB affirms its view that regulatory measures should not replace measures derived from general accounting principles used in financial reporting; but accepts that regulatory measures may provide useful information about the cash flows anticipated to fund future liabilities to pay pension benefits and, therefore where appropriate, should be disclosed.**

Discounted future cash flows

4.49 Having reaffirmed its view that the liability to pay pension benefits should be based on general accounting principles, the ASB returned to its preliminary views on the measurement of liabilities to pay future pension benefits.

4.50 The next sub-question asked whether respondents agreed the discount rate should reflect only the time value of money and therefore be a risk-free rate. The majority of respondents to the DP did not agree with this preliminary view.

4.51 Some of the reasons why respondents did not agree with the preliminary view include:

- (i) the discount rate should reflect the risks associated with the liability that is being measured; these include:
 - (a) an adjustment for variability in size (potentially increasing liability);
 - (b) adjustment for discretion of the employer (potentially reducing liability);
 - (c) adjustment for credit risk of employer; and
 - (d) adjustment for collateralisation of the liability.
- (ii) the proposals in the DP do not include a margin for risk at all, since the DP proposes using 'best estimate' rather than risk-adjusted gross cash flows. Respondents argued that this is inconsistent with the IASB's insurance project, which proposes that probability-weighted estimates should be used, and inconsistent also with the general principle that either the cash flows or the related discount rate (but not both) should be adjusted for risk;

- (iii) no further major changes to the accounting for pensions should occur until some of the general principles in accounting are addressed, for example, fair value, marking to market, recognition of gains and losses, allowance for credit risk; these areas should be resolved at the conceptual framework level;
- (iv) the use of a risk-free rate penalises entities with pension schemes because they would be required to record the pension liabilities at 'corporate value' whereas other forms of comparable debt are recorded at 'market value';
- (v) the behavioural consequences from using a risk-free rate are too significant to justify its use (that is, use of a risk-free rate could contribute to the closure of defined benefit pension schemes);
- (vi) the DP does not define what is meant by the 'risk-free rate'; and
- (vii) in some circumstances the risk-free rate might be higher than the current buyout rate.

4.52 The ASB noted that respondents were questioning the treatment of risk in measuring the liability to pay benefits. Recognising the link between the cash flows to be used in measuring the liability to pay benefits, the discount rate and the treatment of risk, it was decided redeliberations should first clarify the cash flows to be used.

4.53 To clarify the cash flows to be used, input was sought from the UK Board for Actuarial Standards regarding current procedures and methods used by actuaries to estimate future cash flows to pay pension benefits.

4.54 It was noted that currently:

- (i) actuaries, in making the funding calculations, use an undiscounted cash-flow model to establish the starting pension payment and then estimate how long that payment will continue;
- (ii) the actual calculation of the value of benefit is the sum of all the individual calculations of projected amounts adjusted for the discount factor and the probability of payment; and
- (iii) the cash-flow models capture a number of uncertainties (such as future salary, future inflation and longevity) but are not systematically risk-adjusted; for example, they do not take into account the risk of the distribution of deaths moving away from the norm or actions that management or trustees might take to reduce risk.

4.55 It was noted that limited guidance is currently provided in accounting standards for pensions on the cash flows to be used in measurement of the liability. The IASB in its Discussion Paper 'Preliminary Views on Insurance Contracts' (insurance DP) had provided in Appendix E further guidance for insurance contracts. The insurance DP noted that:

In estimating the current exit value of insurance liabilities, an insurer should develop estimates of cash flows that:

- *are explicit;*
- *are as consistent as possible with observable market prices;*
- *incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations;*
- *are current – in other words, they correspond to conditions at the end of the reporting period;*
- *exclude entity-specific cash flows. Cash flows are entity-specific if they would not arise for other entities holding an identical obligation.*

Explicit cash flows

4.56 The pension DP did not specifically address whether cash flows should be explicit. The ASB has decided that cash flows should be explicit, as it had formed the view that the unit of account for the liability to pay pensions should be the individual employee and that actuaries use estimates of individual pension benefits.

Observable market prices

4.57 The insurance DP proposed that inputs should be based on observable market prices. Respondents to the DP had, however, not questioned the use of the entity-specific approach proposed, whereas some respondents had questioned the proposals in the insurance DP.

4.58 The ASB noted an entity-specific approach, as proposed in the pension DP, would not permit management to ignore observable market data. It decided an entity should also use estimates that reflect all available internal and external data. The estimates should take into consideration the entity's specific circumstances.

Timing and uncertainty

4.59 In relation to timing and uncertainty associated with cash flows, the ASB clarified that in its view the expected present value of the cash flows should be used. The expected present value is the probability-weighted average of the present value of the cash flows.

4.60 The calculation of an expected value requires an entity to identify each possible scenario; determine the cash flows for that scenario; and make an unbiased estimate of the probability of that scenario. In the

case of a pension obligation, possible scenarios that need to be evaluated include retirement age, options to employees and life expectancy.

Currently available information

4.61 The DP proposed a current value measure and no evidence was advanced that cash flows should be based on anything other than using all currently available information about conditions at the end of the reporting period.

4.62 **The ASB has clarified that, in its view, the future cash flows used to measure the liability to pay benefits should be:**

- (a) **explicit;**
- (b) **based on observable market prices that are adjusted to take into consideration entity-specific circumstances;**
- (c) **incorporate, in an unbiased way, all available information about the amount, timing and uncertainty of all cash flows arising from the contractual obligations; and**
- (d) **current. In other words, they correspond to conditions at the end of the reporting period.**

4.63 IAS 19 requires an entity's best estimates of the variables that will determine the ultimate cost of providing post-employment benefits. The proposals set out above clarify the cash flows to be estimated in measuring the liability to pay benefits and specify the use of unbiased information. It is considered that current requirements do not sufficiently specify that cash flows should be free from bias and may therefore permit risk to be reflected in the cash flows in an unsystematic manner.

4.64 It is acknowledged that further guidance on the actual cash flows to be used in the measurement of liabilities to pay pension benefits would be required in a future financial reporting standard.

Information about the riskiness of the liability

4.65 Having clarified its views on the cash flows to be used in the measurement of the liability to pay benefits, the ASB reviewed its preliminary views regarding the treatment of risk associated with the pension liability.

4.66 The pension DP sought views as to whether respondents agreed that information about the riskiness of a liability (i.e. the risk that the amount of pension benefits will differ from today's expectations) is best conveyed by disclosure rather than by adjusting the amount of the reported liability. The majority of respondents agreed that information about the riskiness of a liability is best conveyed by disclosure rather than by adjusting the amount of the reported liability.

4.67 It was noted, however, that support for this preliminary view conflicted with the comments received from respondents regarding the preliminary view that the discount rate should only reflect the time value of money. It was considered that respondents had either not considered the inter-relationship between the preliminary view that the discount rate should only reflect the time value of money and therefore risk should be conveyed by disclosure only; or that respondents consider disclosure is always required to explain the sensitivities of assumptions used irrespective of how risk is approached in the measurement of the liability.

4.68 The pension DP identified two categories of risk: (i) the risk/variability of the size of the pension liability, and (ii) the risk that there are insufficient cash flows/assets in the company to pay pensions (credit risk).

4.69 In relation to credit risk, the pension DP proposes that the liability should not be reduced to reflect the credit risk of non-payment. The majority of respondents agreed with this proposal. Those respondents that did not agree with the proposal considered that the inclusion of credit risk would reflect an employer's ability to settle or transfer the pension liability. They also noted that, in the UK, enhanced transfer values and pricing of pensions in corporate transactions all suggest that liability valuations of less than a risk-free amount are from time to time accepted.

4.70 The ASB, however, agreed with those respondents that noted the treatment of credit risk should be considered at a conceptual level prior to consideration at a standards level. The ASB thus supports the IASB in its decision to issue a discussion document addressing credit risk in the measurement of liabilities.

4.71 The ASB affirms its view that the liability to pay pension benefits should not be reduced to reflect an entity's credit risk. The ASB supports the IASB's decision in issuing a discussion paper on this topic and has responded⁸ to state that it does not support the inclusion of an entity's own credit risk in the measurement of liabilities, unless on initial recognition the entity is party to an observable market transaction.

4.72 In relation to risk/variability of the size of the pension liability, the ASB noted the DP considers four options for incorporating risk:

- (i) reflect risk in the cash flows;
- (ii) add/deduct a margin for risk;
- (iii) reflect risk in the discount rate; and
- (iv) address risk only via disclosures.

⁸ The ASB response can be downloaded from www.frc.org.uk/asb/publications/asb_responses.cfm.

4.73 In relation to these four options, redeliberations have clarified that cash flows should be unbiased and therefore risk should not be incorporated in the cash flows.

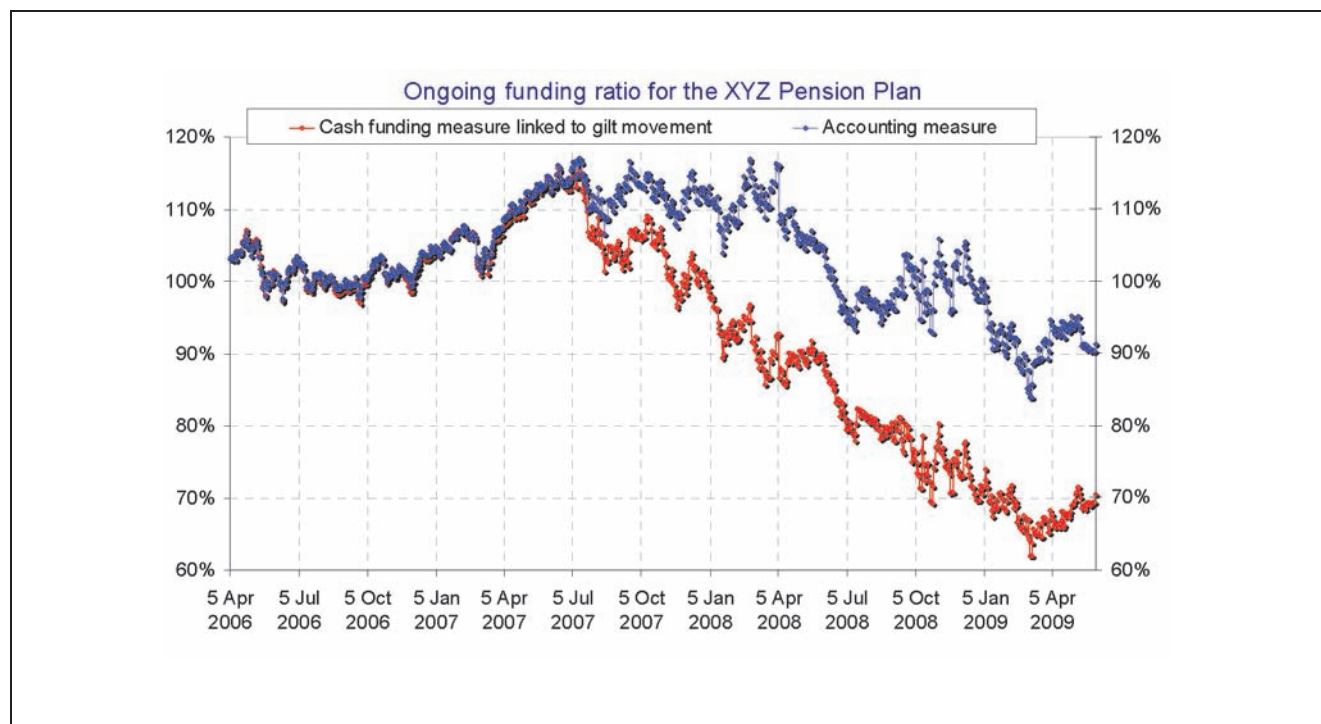
4.74 In relation to option 2 and 3, the ASB affirms its preliminary view that finding a risk margin for a pension liability or reflecting risk in the discount rate is very subjective.

4.75 **The ASB affirms its view that it is not possible to make a reliable estimate of the risk arising from the size and variability of the liability to pay pension benefits. Consequently, the ASB affirms its view that users of financial statements are better served by disclosure regarding the sensitivity of assumptions than by adjusting the estimated cash flows, the discount rate or by inclusion of a risk margin.**

4.76 As a result of reaffirming its view, the ASB considered that, rather than adjusting the discount rate for risk, it should take into consideration a concern that had been brought to its attention regarding the discount rate applied by IAS 19 (and FRS 17) subsequent to publication of the DP.

4.77 There is clear evidence that, in the UK, increases in the AA corporate bond rate have had the effect of significantly reducing the liabilities as measured in accordance with IAS 19. The ASB noted that had the discount rate been more closely linked to a risk-free rate, then the effect shown in the chart below would not have been so significant.

Source: Hewitt Associates Limited



4.78 Further, the ASB is aware that in countries where there is no deep and liquid market in high quality corporate bonds, entities are required to defer to the market yields (at the end of the reporting period) on government bonds. The consequence of this was that UK entities that report in accordance with IAS 19 could potentially show a lower pension liability to a comparable entity – due in part to the spread on corporate bonds.⁹

4.79 The ASB noted this concern for the discount rate currently prescribed by IAS 19. It also noted the ASB's rationale for the discount rate set out in Appendix IV to FRS 17 (namely, that the rate is justified on the grounds of the various options available to an employer to reduce benefits, or to refrain from increasing them and the uncertainty associated with the cash flows) is open to question now that corporate bond yields have moved away for government bond yields¹⁰.

4.80 The ASB, in considering concerns arising from the use of the AA corporate bond rate in the UK at this time, affirmed its view that the discount rate should reflect the time value of money, and therefore should be a risk-free rate. In its view, the risk associated with the size and variability of the liability is more appropriately addressed through disclosure.

4.81 The final sub-question relating to question 6 addresses the expenses of administering the pension benefits. The preliminary view in the DP was that:

- (i) expenses of administering the plan's assets are not present obligations;
- (ii) expenses of administering the plan's accrued benefits¹¹ should be included in the measurement of the liability and expenses of administering future benefits should be excluded; and
- (iii) views are divided as to whether measurement of the liability should reflect future levies.

4.82 The analysis of responses demonstrated that the majority of respondents agreed that expenses of administering the plan's accrued benefits should be reflected in the liability.

4.83 Whilst the majority of respondents agreed with the preliminary view, some respondents raised a concern regarding the practicalities of the proposals. Concerns regarding the practicalities were mainly received from preparers of financial statements.

⁹ In August 2009, IASB issued ED/2009/10 which contained proposals to eliminate the use of different rates by IAS 19.

¹⁰ Since this report was written, the gap between the corporate and government bond yields has narrowed and, although it has not closed completely, it is of less concern.

¹¹ Expenses of administering the plan's benefits are defined as all expenses that are not expenses of administering the plan's assets such as staff costs, trustees' remuneration, actuaries' and auditors' fees, legal and professional expenses.

4.84 In considering the concerns raised regarding the practicalities of proposals, it was decided that whilst the preliminary view in the DP was conceptually correct, it did not address the practical concerns noted by preparers of financial statements.

4.85 The ASB, taking into consideration the concern raised by respondents, has formed the view that, whilst its preliminary view that expenses of administering the plan's accrued benefits is conceptually sound, as a matter of practicality (and taking into consideration the likely materiality of such expenses), that it would be more appropriate to expense the costs as incurred.

4.86 Chapter 5 of the DP also discusses how employees' options regarding settlement should be viewed. One possibility is that the employer should report a liability that is based on the highest amount, until the employee elects to receive a lower amount. Another possibility is that the employer should report a liability that reflects the probability of different outcomes.

Q7 Where employees have options to receive benefits in different ways, should the liability be reported at the highest amount or at an amount that reflects the probability of different outcomes?

4.87 The analysis of responses illustrated that the majority of respondents considered that the liability should be reported at an amount that reflects the probability of different outcomes.

4.88 The ASB noted that it had not, in the DP, identified which of the options outlined above it preferred. Taking into consideration the support for reflecting the probability of different outcomes in the liability to pay benefits and the consistency between this view and its, now clarified, views regarding cash flows to be used in measuring the liability to pay benefits, the ASB decided that the liability should be reported at an amount that reflects the probability of different outcomes.

4.89 The ASB has concluded that, where employees have options to receive pension benefits in different ways, the liability should be reported at an amount that reflects the probability of the different outcomes.

Chapter 6: Measurement of assets held to pay benefits

4.90 This chapter set out the following views on the measurement of assets held to pay benefits:

- (i) Reporting assets held to pay benefits at current values provides more useful information than reporting them at historical measures. This is consistent with the views presented on measuring liabilities to pay benefits.
- (ii) The present requirement in pensions accounting standards that assets traded in active markets are measured at market values is well founded.

- (iii) *The role of investment strategy in meeting obligations to pay benefits requires explanation (rather than recognition) in financial statements.*
- (iv) *When an asset is not traded in an active market, a current value should be estimated using a valuation technique in accordance with the guidance in other accounting standards.*

Q8 Do you agree that assets held to pay benefits should be reported at current values?

4.91 The analysis of responses revealed strong support for the preliminary view that assets held to pay pension benefits should be measured at a current value.

4.92 The level of acceptance indicated very little debate regarding the measurement of assets held to pay benefits. There were, however, a few respondents who did not support the preliminary view and noted that assets are held to fund long-term liabilities and a long-term measure is more appropriate. The ASB had set out in the DP why it specifically considered a current value measure to be appropriate and that such a measure provides more decision-useful information.

4.93 **The ASB affirms its view that assets held to pay benefits should be reported at current values.**

Chapter 7: Measurement of employer interests in assets and liabilities of trusts and similar entities

4.94 *This chapter discussed the measurement of assets and liabilities shown in the sponsoring employer's financial statements when a separate trust or similar entity is established to hold assets to pay benefits. It concluded that:*

- (i) *If the employer has a direct obligation to pay benefits and a right to be reimbursed by a trust, its right to reimbursement should be measured on the same basis as the underlying assets held by the trust.*
- (ii) *If the contractual arrangements result in a 'net' asset or liability being representative of the employer's rights and obligations, the measurement of the net amount should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly, subject to reflecting the effect of any restrictions on the assets.*

Q9 Do you agree that a 'net' asset or liability should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly?

4.95 The majority of respondents agreed that a 'net' asset or liability should be based on the difference between the amount at which the assets and liabilities would be measured if they were measured directly.

4.96 A few respondents did not agree with the preliminary view and suggested whether the assets and liabilities were presented net or gross was related to whether the reporting entity controlled the trust or

similar entity. Whilst the relationship between this preliminary view and the views in chapter 3 is discussed in the chapter, the relationship is not specifically referred to in the invitation to comment of the DP.

4.97 The ASB clarified its view if the contractual arrangements (and thereby the risks and rewards) result in a ‘net’ asset or liability being representative of the employer’s rights and obligations (where the trust is not consolidated because it is not controlled by the employer), the measurement of the net amount should be based on the difference between the amounts at which the assets and liabilities would be measured if they were measured directly, subject to reflecting the effect of any restrictions on the assets.

Chapter 8: Presentation in the financial performance statement

4.98 This chapter considered how changes in the pension liabilities and in the assets held to fund those liabilities should be reported in the financial performance statement. It did not seek to address all the questions that are currently being debated in the context of financial statement presentation (such as whether measures of earnings should be presented), but built on the requirements of IAS 1 (revised September 2007) ‘Presentation of Financial Statements’. It assumed that, in the future, statements of financial performance will provide separate disclosure of the following:

- *operating activities;*
- *financing; and*
- *other financial performance.*

4.99 The paper considers the view that changes in liabilities and/or assets for a period should not be disaggregated, but favours an approach under which different components of the expense are presented separately (even where a ‘net’ asset or liability is reported in the balance sheet), as different components seem to have different drivers and predictive value.

Q10 Do you agree that different components of changes in liabilities and/or assets should be presented separately?

4.100 The majority of respondents agreed that different components of changes in liabilities and/or assets should be presented separately.

4.101 Many respondents expressed the view that the proposals regarding presentation of changes in liabilities to pay pensions and assets held to fund those liabilities need to be consistent with the IASB’s Financial Statement Presentation (FSP) project. The ASB accepted the view of respondents regarding consistency with proposals being made by the IASB but noted in January 2009 that the IASB had expressed a tentative view that any decision made in its limited scope project on IAS 19 should not be delayed by the FSP project.

4.102 The ASB affirms its view that different components of changes in liabilities and/or assets should be presented separately.

4.103 *The DP proposed that the changes in assets and liabilities should be presented as follows:*

- (a) *Service cost—within operating activities.*
- (b) *Finance cost of pensions—within financing.*
- (c) *Effect of change in the discount rate—within financing.*
- (d) *Actual return on assets—within financing.*
- (e) *Actuarial gains and losses—in the profit and loss account, within other financial performance.*

4.104 *These proposals represented a significant change from the requirements of current accounting standards relating to how the change in assets held to fund liabilities to pay benefits should be presented. An entity would no longer present the expected return on assets but would present, in financing costs, the actual return on assets. The DP acknowledged that this would introduce greater volatility into financial statements. The DP noted that since users of financial statements find the expected return on assets useful, it should be disclosed in the notes to profit and loss.*

4.105 *The proposals in the DP would also result in a difference to actuarial gains and losses. Current accounting standards include the effect of changes in the discount rate and the difference between the expected and actual return on assets. In accordance with the proposals set out in the DP, neither of these items would, any longer, form part of actuarial gains and losses.*

4.106 Recognising the significance of the changes proposed, the ASB sought views on its preliminary view.

Q11 Do you agree that the financial performance of an entity should reflect the actual return on assets, rather than the expected return, and that the expected return should be required to be disclosed?

4.107 The views of respondents were mixed; although some respondents agreed from a conceptual point of view, they also raised a concern regarding the introduction of volatility into the financial statements.

4.108 Some respondents expressed a concern as to the behavioural implications that might arise from including the actual return within financing costs. These respondents expressed a concern that volatility, arising from the inclusion of the actual return, may alarm investors and could affect the ability of the entity to raise finance in the capital markets or influence an entity regarding its choice of pension/post-employment benefits.

4.109 In considering the comments raised by respondents, the ASB acknowledged that its preliminary view was based upon a conceptually pure approach which did not necessarily best meet the needs of users. In particular, such an approach would emphasise the short-term volatility arising from changing pension asset values in a way which did not adequately reflect the indirect nature of the link between this volatility and the cash payments made by the company to the pension fund.

4.110 The ASB noted that the IASB had put forward three approaches to presentation in its discussion paper, 'Preliminary Views on Amendments to IAS 19 Employee Benefits'. The initial analysis of respondents' views suggested that no single approach had received a favourable view in contrast to other approaches.

4.111 The ASB decided that further work was required to find an acceptable solution to the presentation issue. Such work should focus on finding a new approach to the presentation of changes in assets and liabilities held to fund benefits and noted one recent alternative put forward. The significant features of the new approach include:

Value of the benefits promised in the current period – the service cost

The service cost is needed to measure the margins and profitability of current operating activities. This should equal the value of the benefits provided taking account of any guarantees given.

Funded status – the value of the total pension liability less assets set to one side to fund it

The pension liability is the aggregate value of the benefits currently promised but not yet settled. This should also take account of any guarantees given.

Cost of servicing the net pension liability – a net interest cost

If the pension liability exceeds related assets, then the difference is effectively the provision of finance by the employees to the business. There is an economic cost of this finance which should be recognised as an interest expense in the same manner as other debt service costs.

4.112 This approach is based on the view that the pension deficit is a net liability and it is therefore wrong to present gross movements on it – that is movements relating to assets and liabilities. Under this view, interest expense on the net deficit would be presented. This captures the interest cost on the liability and a return on assets at a rate equal to the discount rate. The remaining funding charge required to reconcile with the actual return on assets would be presented as a re-measurement item within the profit and loss.

4.113 The approach offers a number of advantages over the current reporting standard. It eliminates the expected return concept but allows users to assess the underlying performance of the reporting entity without further management adjustments to reported numbers in order to smooth asset returns. The

approach also captures the actual return on assets within the profit and loss statement rather than presenting the difference between expected and actual returns in other comprehensive income.

4.114 The ASB has decided not to affirm its view that the actual return on assets held to fund pension liabilities should be presented separately as financing income in the statement of comprehensive income. This is on the basis that, although this is a conceptually pure approach, it may not meet the needs of users.

4.115 The ASB considers that further research is required in this area and alternative approaches should be evaluated before development of a new financial reporting standard.

Chapter 9: Disclosures in the employer's financial statements

4.116 This chapter reviewed the disclosures that it would be appropriate for an accounting standard to require.

4.117 It was proposed in the DP that disclosures should provide information that explains the risks and rewards arising from the provision of pension benefits, having regard to the materiality of the amounts involved, such that:

- (i) financial statements contain adequate disclosure of the cost of providing pension benefits and any related gains, losses, assets and liabilities;*
- (ii) users of financial statements are able to obtain a clear view of the risks and rewards arising from liabilities to pay pension benefits and the assets held to fund those benefits; and*
- (iii) the funding obligations of the entity, in relation to liabilities to pay pension benefits, are clearly identified.*

4.118 The DP also noted that for practical reasons, an accounting standard would have to permit an employer to provide disclosure of information relating to its plans in aggregate; however, it would be reasonable to require separate information about surpluses and deficits. There is also a case for requiring specific disclosures for individual plans that are material to the group as a whole.

Q12 Do you agree with the objectives of disclosure that are identified in this chapter? Are there specific disclosure requirements that should be added to or deleted from those proposed?

4.119 In considering the views of respondents, it was noted that whilst the objectives for disclosures were generally agreed, there was concern regarding the volume and potential cost effectiveness of the proposals.

4.120 Some respondents argued that the volume of disclosures that is demanded by users of financial statements in relation to pensions was a consequence of the unfair accounting treatment of pensions in contrast to other liabilities. The respondents suggested that liabilities to pay future benefits appeared more risky when contrasted with similar liabilities such as bank loans and/or debt. It was noted that if liabilities

to pay benefits were treated more consistently and similarly marked to market, then arguably there would be a more balanced assessment of the need for disclosures.

4.121 In considering the view that the demand for disclosure was a consequence of unfair treatment of liabilities to pay pension benefits compared to other liabilities, the ASB noted that, unlike bank loans and debt (which measure repayment of a specified amount), liabilities to pay pensions arise from an employer receiving services today and promising to pay a future amount for an unspecified period of time (mortality risk) and are subject to greater uncertainty (i.e. variability as to the size of the pension liability).

4.122 Consequently, the ASB did not agree the demand for disclosures was a consequence of the unfair treatment of liabilities to pay pension benefit but arose due to the uncertainty surrounding the measure of the liability. It is the risk associated with the variability as to the size of the liability that also gave rise to the volume of disclosures.

4.123 In relation to the concerns raised by respondent regarding the volume of disclosures and thereby the costs effectiveness of the proposals, the ASB noted that this is not an easy issue to address because the volume of disclosures should correlate to the materiality of the liabilities to pay pensions benefits and the net assets of the reporting entity. It was therefore necessary for management to apply a level of judgement regarding the volume of disclosures provided.

4.124 The ASB noted that it had, in the DP, identified disclosure objectives with the aim of focusing attention on the objectives and providing the relevant useful information to users of financial statements, rather than focus on line-by-line disclosures.

4.125 The ASB affirms its view that the disclosures should provide information that explains the cost of providing pension benefits and related gains, losses and assets and liabilities, the risks and rewards arising from liabilities to pay benefits and assets held to fund those benefits together with the disclosures regarding the funding of those benefits. The ASB notes it is important that management considers the disclosure objectives when preparing the financial statements to ensure that disclosures provide useful and cost effective information.

Chapter 10: Accounting for multi-employer plans

4.126 *It was proposed in the DP that the recognition and measurement principles as set out in chapters 4 to 7 should also apply in relation to multi-employer plans. Accordingly, the pension liability of an individual employer will be a 'settlement amount' reflecting its expected future cash flows to the plan for settling its obligation for its former and current employees and any constructive obligation in respect of its share in the current under- or over-funding of the plan.*

4.127 *The following alternative approaches were considered as a surrogate for a settlement amount:*

- (a) *Proportionate share of collective pension asset or liability.*
- (b) *Reflect only the effect of recovery plans or asset refund plans.*
- (c) *Do not account for the employer's rights and obligations in respect of under- or over-funding.*

Q13 Do you agree that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan? How, in your view, should an accounting standard require that this be implemented in practice?

4.128 The review of responses suggested that a vast majority of respondents agreed that multi-employer plans should be reflected in an employer's financial statements using the same principles as those that apply to a single employer plan, however, in agreeing with the preliminary view, respondents also raised concern regarding the collection of the information required to achieve this. In some instances, respondents noted that it was not practical to obtain the information.

4.129 It was noted, however, that despite this concern, a number of respondents stressed the importance of requiring an entity to make every effort to obtain the data or make a calculation of an appropriate share or best estimate of its share of the assets and liabilities of the pension plan.

4.130 Those respondents that did not support the preliminary view considered that multi-employer plans were similar to state plans and that liabilities towards the plan were limited to current contributions payable. In these circumstances, it was proposed that disclosures were sufficient to explain the entity's position towards the plan.

4.131 In considering the views of respondents who did not support the preliminary view, the alternative approaches as a surrogate for the settlement amount were reviewed. The respondents to the DP favoured an approach based on the proportionate share.

4.132 In view of the support for the preliminary view, the ASB decided to affirm its view that recognition and measurement principles as set out in chapters 4 to 7 should also apply in relation to multi-employer plans.

Chapter 11: Financial reporting by pension plans

A standard for pension plans

4.133 *The ASB proposed in the DP that the IASB should consider withdrawing IAS 26, 'Accounting and reporting by retirement benefit plans'. The ASB considered the requirements for the financial reports of pension plans should be consistent with IFRS.*

The objective of financial reports of pension plans

4.134 *The ASB identified the objective for the financial reports of a pension plan to be the provision of information about the financial position, performance and changes in financial position of a pension plan that is useful to members and those who act in their interests, in making economic decisions and assessing the stewardship of the trustees.*

4.135 In reconsidering the preliminary views set out in the DP on the objectives of pension plan financial statements, the ASB noted that some respondents did not accept the view set out in the DP. These respondents considered that pension plan financial statements were for stewardship purposes only. These respondents also considered that the information needs of members were met in other ways, including regulatory reports.

4.136 One view analysed was whether financial statements of pension plans should be considered general purpose financial statements noting that while shareholders in a company each had the same interest in the company's financial statements, pensioners did not all have the same interest in the financial statements of pension plans. The interest of members was restricted to payment of individual pensions not the overall financial performance and stability of the entity.

4.137 The ASB considered, however, that pension plan financial statements were no different from other financial statements in terms of meeting the requirements for general purpose financial reporting, including the stewardship requirements. It was considered that if the financial statements were improved in the way recommended in the DP, then they should provide users with the information they need.

4.138 The ASB has decided to affirm its view that the objective of pension plan financial statements is to provide information about the financial position, performance and changes in financial position of a pension plan that is useful to members, and those who act in their interests, in making economic decisions and assessing the stewardship of trustees.

Assets available to pay benefits

4.139 *It was proposed in the DP that assets available to pay benefits should be stated at current value, which is market value where the asset is traded on a market.*

4.140 The ASB did not receive specific comments on this view and therefore affirms its view that the assets available to pay benefits should be stated at current value, which is fair value where the assets are traded on a market.

Liabilities to pay benefits

4.141 *It was also proposed that a financial reporting standard for pension plans should require financial statements to include the liability to pay future pensions.*

4.142 *In relation to the components of a plan's liability, it was proposed that it should be the same as those identified in chapter 3. A plan's liability in respect of future pensions should be measured according to the principles identified in chapter 5.*

4.143 Respondents' views were divided as to whether pension plan financial statements should include liabilities to pay pension benefits.

4.144 Among the matters raised by respondents was the concern that users were not be capable of understanding the liability so might be misled and/or unnecessarily alarmed. It was considered, however, that users' representatives should be able to explain and interpret financial statements and that plan's financial reports should include, in addition to the liability to pay benefits, disclosures that explained the liability.

4.145 A further concern raised by respondents was in relation to the costs associated with measurement and audit of the liability. Although cost was considered within the DP, respondents considered inadequate attention had been focused on assessing the possible costs and effects of the preliminary view.

4.146 In considering the balance between costs and the benefit of improving the quality of financial information currently provided by pension plan financial statements, a view was expressed that if financial statements do not recognise the liability to pay benefits, they are misleading and fail to provide useful information to users.

4.147 The ASB, in referring to the view that pension plan financial statements were for stewardship purposes only, noted that, if the trustees are stewards of the pension plan, not recognising the liability suggested a disclaimer of responsibility on their part. In the ASB's view, stewardship requires the inclusion of the liability.

4.148 It was, however, agreed that a fuller study of the cost of measuring the liability should be conducted.

4.149 The ASB affirms its view that pension scheme financial statements should recognise the liability to pay future benefits but considers that a more detailed study of potential costs should be undertaken.

The employer's covenant

4.150 *The DP proposed that where an employer undertakes to make payments to a plan to enable it to pay future benefits, then the plan should recognise an asset, reflecting its claim on the employer, based on the difference between its liability in respect of future benefits and the current value of assets available to pay those benefits. Where necessary, the amount reported as an asset should be reduced to its recoverable amount.*

4.151 The analysis of respondents' views identified support for the principle that the financial reports of the pension plan should include an asset representing the employer's covenant; however, a number of respondents raised practical difficulties with the preliminary view.

4.152 One difficulty foreseen by respondents was a concern regarding confidentiality; for example, where an employer's position is precarious, confirmation of this by the trustees impairing the covenant asset (where the trustees had confidential information) could exacerbate the problem and this might not be in the best interests of plan members.

4.153 The practical difficulties in measuring the covenant were considered. It was agreed that assessing the covenant requires assessment of the employing entity's creditworthiness. This assessment can be difficult to make and may give rise to considerable uncertainty in the amount recognised.

4.154 The ASB considered an alternative approach; for the trustees to provide disclosure regarding future contributions and the likelihood of contributions being paid (i.e. narrative disclosure of how the funding gap would be bridged). Under this approach, users can see the funding gap and the onus is placed on the trustees to explain how the funding gap will be addressed.

4.155 Some ASB members are opposed to the notion that there is, conceptually, an asset. In their view, the employer's covenant is no more than an assurance and may not have the attributes of an asset. In addition, they noted that schemes differ and whether the future contributions are an asset depends on the individual facts and circumstances.

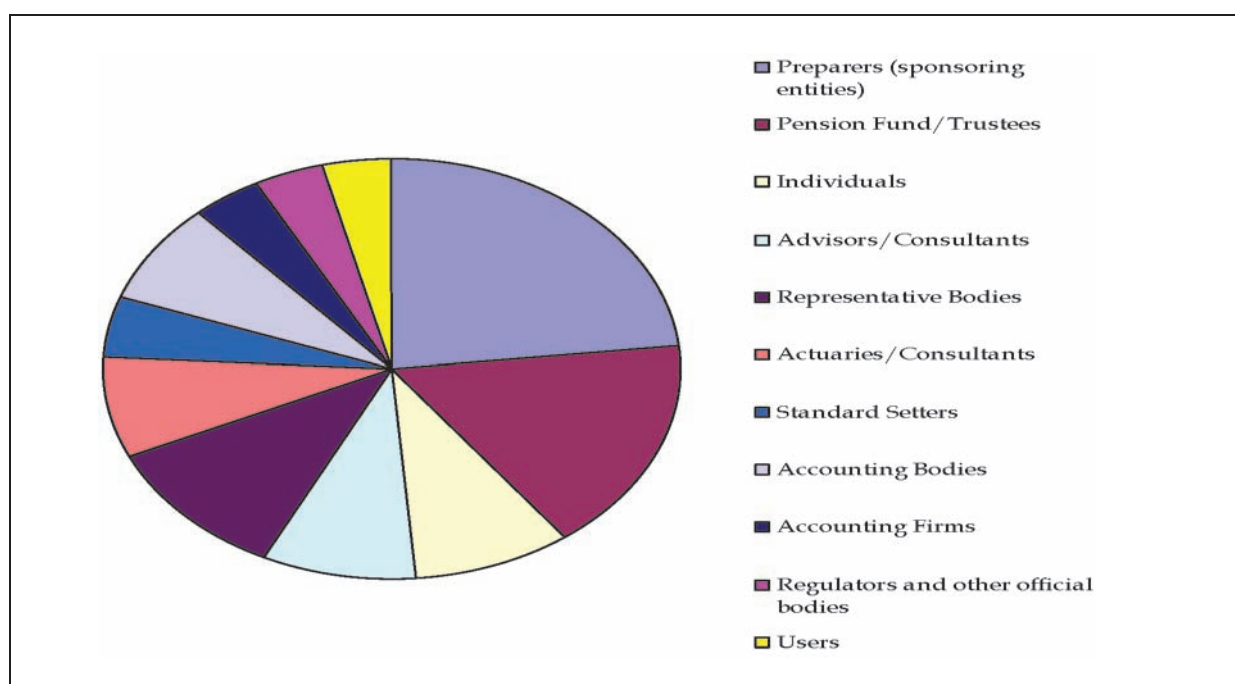
4.156 **The ASB agreed (by majority) that, conceptually, the employer's covenant should be recognised as an asset in the pension plan financial statements but recognised that this could present a number of serious practical difficulties. The alternative preferred is to require narrative disclosure of how the difference between the assets and liabilities will be funded.**

Appendix A – Overview of responses

A1 This appendix provides an overview of responses to the DP.

A2 Comments were invited on the preliminary views set out in the DP. A total of 103 responses were received. The responses contained a variety of views and were received by a cross-section of individuals and entities related to the pension industry.

Category of respondent	No.
Preparers (sponsoring entities)	24
Pension Fund/Trustee	17
Individuals	9
Advisors/Consultants	9
Representative Bodies	11
Actuaries/Consultants	8
Standard Setters	5
Accounting Bodies	8
Accounting Firms	4
Regulators and other official bodies	4
Users	4
	103



A3 Whilst the majority of responses were from the UK, 9 per cent of responses were received from respondents in Europe and a further 20 per cent from multinational organisations.

A4 The ASB has considered in its redeliberations the matters raised by respondents and section 4 of this report contains details and views formed following redeliberations.



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