Financial Reporting Council

FRC challenges the reporting of companies classifying pension liabilities as equity

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The Financial Reporting Council (FRC) warns Boards against entering into arrangements that turn pension obligations into equity instruments in their accounts. Several companies that used Scottish Limited Partnerships to achieve this outcome have taken steps to address the FRC's regulatory enquiries.

The Financial Reporting Review Panel (FRRP) of the FRC has, over recent years, considered several annual reports and accounts of companies which have put in place arrangements to provide additional collateral to their pension schemes in exchange for reduced annual contributions and a longer period to fund the pension scheme deficit.

The FRRP acknowledges the genuine commercial reasons for establishing such arrangements and has focused on companies that have reclassified pension liabilities as equity instruments.

Specifically, some of these arrangements, usually involving the establishment of a Scottish Limited Partnership which holds the collateral, have included additional features which appear to have been introduced in order to achieve an accounting outcome whereby the company's obligation to make future payments to its pension scheme is transformed into an equity instrument in the company's consolidated accounts. This has a favourable impact on financial solvency, gearing and reported comprehensive income notwithstanding that the company has retained the obligation to fund the pension deficit.

Following enquiries by the FRRP, each of the companies has revised either the arrangements or the amounts recognised with the result that the concerns of the FRRP have been addressed for the future from the date of the change.

Richard Fleck, Chairman of the FRC's Conduct Committee and chair of the FRRP said,

> *"The FRRP believes that it is important that companies and their advisers are aware that the FRRP will ordinarily open an enquiry into the financial reporting of any company in which material pension liabilities are reclassified from debt to equity."*

Notes to editors:

1. The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.
2. The Conduct Committee is a body authorised under the Companies Act 2006 ('the Act') to review and investigate the annual accounts and directors' reports of public and large private companies to see whether they comply with the requirements of the Act, including applicable accounting standards. Following implementation of the Accounting Regulation (EC) No. 1606/2002, this may mean compliance with UK or International Financial Reporting Standards.
3. Where breaches of the Act are discovered the Conduct Committee seeks to take corrective action that is proportionate to the nature and effect of the defects, taking account of market and user needs. Where a company's accounts or directors' report are defective in a material respect the Conduct Committee will, wherever possible, try to secure their revision by voluntary

means, but if this approach fails the Conduct Committee is empowered to make an application to the court under section 456 of the Act for an order for revision. To date no court applications have been made.

4. The Conduct Committee maintains a Financial Reporting Review Panel (FRRP). The Chairman is Richard Fleck and the Deputy Chairs are Joanna Osborne and Ian Wright. There are currently 24 other members drawn from a broad spectrum of commerce and the professions. Individual cases may be dealt with by a specially constituted Review Group of the FRRP.

Technical Notes to Editors

a. In these Technical Notes 'sponsor company' refers to the entity, or any other member of the group to which it belongs, that created the partnership.

b. The cases which have been of most concern to the FRRP contained a combination of the sponsor company being able to defer payments to its pension scheme whilst ring-fencing the cash that would otherwise have been paid. Deferral is possible only when the sponsor company has not paid a dividend to its own shareholders.

c. The classification of the liability to the pension scheme as an equity instrument, while at the same time recognising the pension scheme's entitlement as a plan asset, depends upon a series of linked steps, each of which requires considerable judgement, and where the failure of any one of the steps would lead to the classification of the obligation to the pension scheme as debt rather than as equity. In particular, the accounting treatment relies on the company concluding that:

i. the claim by the pension scheme on the partnership is readily transferable to a third party purchaser in the same form in which it existed at the balance sheet date, despite the fact that each arrangement is very specific to the parties involved and includes unique clauses that are likely to necessitate detailed negotiations with a third party purchaser and possible further undertakings by the sponsor company;

ii. a third party purchaser of the claim by the pension scheme on the sponsor company would pay the same amount for that claim as it would pay for a corporate bond issued by the sponsor company despite uncertainties over the timing or amount of cash flows in the claim and the unique terms and conditions of the claim; and

iii. the sponsor company's contractual right to require the deferral of any payments due to the pension scheme can be sustained in perpetuity despite the purpose of the partnership, the potential for cash being ring-fenced for transfer to the pension scheme, and the sponsor company's fiduciary obligation to the other partners in the partnership in the context of the obligation of the sponsor company to fund any deficit of the pension scheme.