

PRAG

PENSIONS RESEARCH ACCOUNTANTS GROUP

Please reply to:

Mr Z Fazal
C/O 187 Rednal Road
Kings Norton
Birmingham
B38 8EA

zahir.fazal@yahoo.co.uk

Ms M Sansom
ACCOUNTING STANDARDS BOARD
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

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Dear Michelle

Response to FRED 48 - The future of financial reporting in the UK and Republic of Ireland

The Pensions Research Accountants Group ("PRAG") is an independent research and discussion group for the development and exchange of ideas in the pensions field. Its efforts are concentrated mainly on the areas of reporting and accounting by pension schemes, but it has also produced reports on other matters when appropriate. There are over 400 members who work for pension funds, administrators, audit firms and other pension related professions.

Members of PRAG were invited to provide input to this response. A recurring theme, which is consistent with the view of the PRAG Executive, is that pension schemes are different to other entities and that the needs of the users of the financial statements are specific to the nature of the entity. Most notably, the financial statements are not usually distributed to members and the trustees rarely refer to the financial statements for governance purposes. This is consistent with a strong feeling by many in the pensions industry that the financial statements of pension schemes are essentially a stewardship document.

PRAG does, however, acknowledge that, as annual financial statements are required to comply with UK and European regulations, there does need to be an agreed accounting framework. This framework should be flexible to recognise the different types of pension arrangement and be proportionate to recognise the unique circumstances of pension schemes and the needs of the trustees and members.

As the authorised body for the Statement of Recommended Practice "Financial Reports of Pensions Schemes" ("the SORP") we undertake to ensure that there is adequate guidance

to enable meaningful financial information to be presented that demonstrates the proper stewardship of a scheme's assets by the trustees. The SORP should, therefore, provide detailed requirements for pension schemes which underlie principles set out in Financial Reporting Standards. On this basis, our view is that the final version of the UK Standard should provide broad principles and provide little detailed prescription for pension schemes.

Our responses to individual questions are made in this context.

Responses to consultation questions

Q4. Do you agree with the definition of a financial institution? If not, please provide your reasons and suggest how the definition might be improved.

The definition of Financial Institutions in the FRED includes retirement benefit plans (which are referred to as "pension schemes" in this response). PRAG recognises that a significant part of a pension scheme's operations relates to investments, but, PRAG does not believe that this justifies the inclusion of pension schemes in the definition of Financial Institutions.

We believe that pension schemes do not fall under any other recognisable definition of a financial institution. The members, trustees and sponsors of pension schemes have never regarded pension schemes as financial institutions and this is also, we understand, the case with regulators and legislators. We are also unaware of any definition of a financial institution that would include pension schemes. For example, Investopedia defines a financial institution as:

"An establishment that focuses on dealing with financial transactions, such as investments, loans and deposits. Conventionally, financial institutions are composed of organizations such as banks, trust companies, insurance companies and investment dealers. Almost everyone has dealt with a financial institution on a regular basis. Everything from depositing money to taking out loans and exchange currencies must be done through financial institutions"

The clear distinction is that pension schemes are not commercial organisations, focus on the provision of benefits to members and have a very different relationship with the members to that which financial institutions have with their shareholders and customers. We therefore emphasise that:

- pension schemes are fundamentally different from the other entities included in the definition;
- future accounting developments aimed at banks and insurance companies would automatically, and potentially inappropriately, apply to pension schemes;
- if pension schemes are regarded as financial institutions for accounting purposes this may set a precedent in other areas with unintended and potentially catastrophic consequences. For example, the application of Solvency II requirements;
- a number of disclosures required for financial institutions under the FRED are inappropriate for pension schemes, would add little value for the users of the financial statements and would incur additional costs in accounts preparation and audit.

We do accept that, due the significance of investments in pension scheme accounts, some of the disclosures for financial institutions are relevant to a pension scheme. Indeed, our initial analysis of the disclosures required for financial institutions under the FRED

indicates that many are already required by the current pensions SORP and disclosure regulations.

However, we emphasise that this is not true for all of the disclosure requirements and for many, whilst the principle is valid, the detail of the FRED for financial institutions would not be of value to all pension schemes' financial reporting.

For these reasons PRAG recommends an alternative approach..

By including pension schemes in the 'Specialised Activities' section, the FRED as currently drafted recognises that pension schemes have different accounting requirements from the generality of other reporting entities. PRAG proposes that investment related disclosures for pension schemes should be set out in this section.

We would therefore welcome the opportunity to discuss this alternative approach with the ASB and agree the investment disclosures that are appropriate for pension schemes.

Q6. The ASB is requesting comment on the proposals for the financial statements of retirement benefit plans, including:

- (a) Do you consider that the proposals provide sufficient guidance?**
- (b) Do you agree with the proposed disclosures about the liability to pay pension benefits?**

- (a) The guidance for pension schemes in the FRED is largely drawn from IAS 26 and includes a number of requirements for non-financial information to be included either in the financial statements or in a report alongside the financial statements. IAS 26 was issued over 20 years ago and appears to seek to provide guidance on not only the content of financial statements but also on accompanying reports which provide useful non-financial information on the arrangements of the pension scheme.

However, in the UK most of this information is required to be disclosed in a trustees' report under statute or the recommendations of the pensions SORP and therefore it is not required to be included in the FRED. It is also unclear what authority an accounting standard carries in relation to reports that do not form part of the financial statements. PRAG therefore recommends all references to disclosure of non-financial information are removed from the FRED and are instead included in the revision of the pensions SORP to the extent they are not required by statute.

PRAG also believes the guidance for pension schemes in the FRED could be streamlined. Detailed comments are set out in the appendix. We would be happy to discuss these comments further with the ASB if that would be useful.

- (b) The disclosures about the liability to pay pension benefits are largely drawn from IAS 26 with some tailoring to recognise existing reporting of actuarial information in UK pension schemes as recommended by the pensions SORP. However, the current drafting is not wholly consistent with either IAS 26 or current UK practice, which recommends disclosing the annual Summary Funding Statement (SFS) which is sent to all members and comments on the relationship between scheme assets and liabilities on an ongoing and buy-out basis.

There are also differences between disclosures under IAS 26 and the SFS, for example IAS 26 requires the disclosure of vested and non-vested benefits, and this is not required for SFS, and the SFS includes liabilities on a buy-out, or wind up, basis, and this is not required under IAS 26. Since SFS are already produced, sent to members and referred to in the pensions SORP PRAG recommends all references to

IAS 26 liability disclosures are removed and the FRED refers to disclosing the actuarial liability information contained in the SFS. PRAG notes that the SFS does not include the assumptions or methodology used to determine actuarial liabilities. This information is contained in the Statement of Funding Principles (SFP). The information in the SFP could also be usefully referred to in the FRED.

The FRED also allows the actuarial information to be included in a separate report alongside the financial statements or in the notes to the financial statements. It does not allow a third option of including actuarial liabilities in the net asset statement to create a balance sheet because the Disclosure Regulations do not permit this treatment, although this approach is allowed under IAS 26. PRAG agree with the approach taken in the FRED in relation to the disclosures about actuarial liabilities ie to include in a report alongside the financial statements or as a note to the financial statements, notwithstanding the comment above about the authority of an accounting standard over reports that do not form part of the financial statements.

We have also attached a number of detailed comments on the FRED.

As we have stated, we believe that there is an alternative approach to the inclusion of pension schemes in the final financial reporting standard. The approach we propose would not require significant change and we would welcome the opportunity to discuss our views with you.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Zahir Fazal', with a stylized flourish at the end.

Zahir Fazal
Chairman

Detailed comments

ED Reference	Comment
9.9 (b)/9.9A	<p>Consolidation</p> <p>Do the requirements of 9.9(b)/9.9 apply to pension schemes? ie if a pension scheme held a controlling interest in an entity which would require to be consolidated under current UK GAAP if it met the conditions in these sections could it not be consolidated and instead reported as an investment at fair value?</p> <p>This would be consistent with IAS 26 which requires all assets held to meet benefits to be reported at market value ie IAS 26 does not allow consolidation.</p> <p>PRAG believes it would be helpful to pension scheme accounting if 9.9(b)/9.9A applied to controlling investments held by pension schemes where they are held for investment purposes.</p>
9.10	<p>Special purpose entities</p> <p>Section 9.10 could contradict sections 9.(b)/9.9A for pension schemes. For example, if a pension scheme ‘controlled’ an investment fund eg a majority or 100% investor, would it have to consolidate under 9.10 even though its interest in the fund was purely for investment purposes?</p> <p>Also some pension schemes invest via ‘Common Investment Funds’ (“CIF”) which are typically set up under trust and manage investments for a number of pension schemes under the same employer on a pooled basis. Where a scheme had a majority investment would these be required to be consolidated? Currently the pensions SORP recommends detailed disclosure of underlying investments of the CIF in the notes to the pension scheme financial statements or attaching a copy of the CIF accounts to the pension scheme financial statements.</p> <p>PRAG recommends detailed guidance on applying the requirements of 9.10 is provided by the pensions SORP.</p>
Section 11 (11.5, 11.8 and 11.14(a)) Section 12 (12.3, 12.7) and 34.39	<p>Fair value of investments</p> <p>Section 11 requires debt instruments to be accounted for at amortised cost. Section 12 applies to all financial instruments not covered by Section 11 (ie Section 12 would not apply to debt instruments covered by Section 11) and requires financial instruments to be reported at fair value.</p> <p>Para 34.39 requires pension schemes to report assets available to meet benefits, which include debt instruments that meet the definition under Section 11, at fair value.</p>

	<p>Clarification of how Sections 11 and 12 relate to para 34.39 is required.</p>
11.13, 12.12	<p>Transaction costs</p> <p>Both Sections 11 and 12 require initial measurement of financial instruments measured at fair value through profit and loss to exclude transaction costs ie to charge them to profit and loss account.</p> <p>Currently transaction costs are capitalised in pension schemes and disclosed in the notes to the financial statements under recommendation of the pensions SORP.</p> <p>Since pension schemes report all changes in market values through the revenue account, and not all investments in pension schemes are financial instruments, the requirement to account for transactions costs through the profit and loss account for financial instruments would appear to add little value. Also other investment types such as property, do not require initial measurement to exclude transaction costs.</p> <p>In addition, pension schemes do not have the same sensitivity as other entities as to whether the changes in value are realized or not.</p> <p>PRAG recommends the FRED makes it clear that initial measurement of financial instruments in pension scheme financial statements can include transaction costs in the guidance on retirement benefit plans.</p>
11.14	<p>Amortised cost and effective interest method</p> <p>Section 11 requires debt instruments to be reported at amortised cost using the effective interest method.</p> <p>Since pension schemes are required by 34.39 to report all investments at fair value through profit and loss presumably amortised cost and effective yield interest accounting will not apply.</p> <p>PRAG does not believe it is appropriate for amortised cost and effective yield interest accounting to apply to pension schemes and recommends the FRED makes this clear in the guidance on retirement benefit plans.</p>
11.27/34.22	<p>Fair value hierarchy</p> <p>The fair value hierarchy in 11.27 is not the same as the levelling wording used in IFRS 7 and this could be confusing if the intention is to achieve comparable disclosure.</p> <p>Clarification of the disclosure requirements in relation to fair value hierarchy disclosures is required.</p>

11.48A	<p>Credit risk disclosures regarding changes in fair value</p> <p>Section 11.48A requires certain reporting and risk disclosures for debt instruments. This appears to overlap with the financial instrument disclosures required by 34.17 to 34.30.</p> <p>For the reasons set out in PRAG's response to consultation questions detailed guidance on pension scheme financial risks should be included in the pensions SORP and not the FRED.</p>
34.31 – 34.36	<p>Retirement Benefit Plans – scope of standard</p> <p>There are various references to non-financial information being included in the financial statements or alongside the financial statements. This is as per IAS 26 but ignores the UK's statutory disclosure requirements and the recommendations of the pensions SORP. It is also questionable what mandate an accounting standard has over non-financial statement reports. Also if this information were included in financial statements it would increase audit scope and costs.</p> <p>The content of the standard could be streamlined as follows:</p> <ul style="list-style-type: none"> - The objectives of reporting for pension schemes in paragraphs 34.32 and 34.35 could be deleted. It is arguable whether these are complete and valid reasons. - The content of paras 34.22 and 34.35 overlap and could be combined with a requirement to separately report defined benefit and defined contribution arrangements as required by the pensions SORP - Para 34.34 includes a reference to 'funding policy'. A defined contribution scheme does not have a funding policy and therefore this should be removed. - Para 34.38 appears to be a repeat of a combination of 34.37 and 34.35. - Para 34.39 refers to 'profit and loss'. This is not relevant to pension schemes. - Para 34.40 (c) requires disclosure of 5% of any class or

	<p>type of security to be disclosed. This is not currently required by statute or the pensions SORP and may be impracticable for preparers of pension scheme accounts to obtain as well as adding to the cost of auditing the accounts. PRAG therefore recommends this is removed from the FRED.</p> <ul style="list-style-type: none"> - Para 34.44 – the reference should be to 34.42 - Para 34.46 – most of this information is required by statute. Certain information is not currently required to be disclosed such as a description of the retirement benefits promised to participants, a description of any plan termination terms. This information could be extensive depending on the size and complexity of the scheme and would therefore add to the cost of preparing the annual report. PRAG recommends detailed guidance on the provision of non-financial information such as that set out in paragraph 34.36 is left to the pensions SORP and removed from the FRED.
34.17-34.30	<p>Financial Institutions: Disclosures</p> <p>As noted above PRAG would welcome the opportunity to discuss appropriate investment risk disclosures with the ASB in the context of PRAG's alternative approach to investment disclosures for pension schemes. Notwithstanding this PRAG has the following comments on the current proposals.</p> <p>The risk disclosures required by paragraphs 34.23 to 34.30 will increase the cost of preparation of financial statements and the audit thereof with little additional benefit. The reasons for this are:</p> <ul style="list-style-type: none"> • For defined benefit schemes investment strategies and risk profiles are normally considered in the context of wider scheme risks including actuarial liabilities and employer covenant. Commenting on just investment risks would therefore add little value for the users of the financial statements. • For defined contribution arrangements scheme level investment risks are unlikely to be fully aligned with member level investment risks, which will depend on member investment choices, and their disclosure at scheme level will therefore add little value to the financial statements from a member perspective. <p>PRAG would also point out that in relation to the market risk sensitivity analyses required by 34.29 reference is made to the impact on profit and loss and equity. Pension schemes have neither of these items in their financial statements.</p>

34.41	<p>Statement of changes in net assets available for benefits (Fund Account)</p> <p>Included in this paragraph is the requirement to present:</p> <p>(i) profits and losses on disposal of investments and changes in value of investments</p> <p>As noted above, pension schemes do not have the same sensitivity as other entities as to whether the changes in value are realized or not. In lien with this, the current pensions SORP does not require a split between realized and unrealized changes in value. PRAG recommends that the current approach is maintained by including “total” at the beginning of the requirement.</p>
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