

Michelle Sansom, UITF Technical Director  
ASB  
5th Floor  
Aldwych House  
71-91 Aldwych  
London  
WC2B 4HN

**Hanson UK**  
Hanson House  
14, Castle Hill  
Maidenhead  
Berkshire  
SL6 4JJ  
Phone 01628 774100  
Fax 01628 774232

[www.hanson.com/uk](http://www.hanson.com/uk)

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Dear Ms Sansom

**‘Accounting implications of the replacement of the Retail Prices Index with the Consumer Prices Index for Retirement Benefits’.**

I am writing in response to your request for comments on the above abstract. The comments reflected in this letter are that of the author and are not to be taken as the views of either Hanson UK, HeidelbergCement Group or any other employee of these organisations.

As a senior finance professional within industry with responsibility for the financial reporting of five defined benefit pensions schemes under both FRS 17 and IAS 19 along with representing the Company in the triennial funding negotiations as well as recently providing the finance lead on a project to close the Schemes to future accrual I have strong views on this subject.

I am thankful that the UITF have sought to clarify the accounting treatment in this area as it was clear that guidance was needed to prevent companies from employing widely divergent accounting treatments. However, whilst accepting the need for the abstract and whilst in fact agreeing with much of it, I find myself strongly disagreeing with the proposed treatment where Scheme rules currently refer to statutory revaluation rather than a specific measure (RPI). I believe that the conclusion reached, being that any reduction in scheme liabilities should be recognised as an actuarial gain is highly questionable and that there are strong arguments to support the recognition of any such gains or losses in the profit and loss account.

P 7 of the abstract states:

*‘The UITF reached a [draft] consensus that if Scheme liabilities are not linked to at least RPI then a change to CPI is a change in the assumption about inflation used to measure the liabilities and represents an actuarial gain or loss in accordance with FRS 17.’*

This paragraph was seemingly arrived at using the rationale contained in A 10

*The UITF noted that a constructive obligation to the member for pensions linked to RPI could exist where the RPI is not embedded into the trust deed but where*

*associated literature made reference to the RPI or where the general understanding of scheme members was that increases would be calculated using the RPI. The nature of any constructive obligation to members could vary and would depend on a number of factors, including the nature and content of the communications with members. Consideration would need to be given to whether any associated literature made reference to the RPI or whether the general understanding of scheme members was that increases would be calculated using the RPI. However, a feature of a constructive obligation would be that the agreement of scheme trustees and/or members would generally be needed before any change could be made.*

It is the final sentence above which provides my key point of disagreement both in A 10 specifically and consequently in the conclusions of the draft abstract generally.

P 28 FRS 17 defines the meaning of a constructive obligation in this context as:

*'...publicly announced or awarded under an established practice that creates among employees a valid expectation of receiving...'*

Although the Government has never explicitly confirmed that statutory increases are based on RPI, it is clear that this is what the Government has actually been using since 1 January 1986 for statutory revaluation.

In my view, prior to the government announcement, employees expected to receive index-linking of their accrued benefits in line with RPI. The reaction of the major trade unions to the announcement also supports the argument that a valid expectation and a constructive (if not legal) obligation was in place and that they now see these changes as being a stealth cut in their members pensions.

As RPI has been used to determine statutory revaluation for a period of 25 years, this, for a significant number of scheme members, is all they have ever known, they have never received anything less than RPI so until the government announcement they clearly had a valid and justified expectation of receiving revaluation equal to RPI.

The draft abstract introduces a requirement which is not contained within FRS 17 which says that *'for a constructive obligation to exist then consent of the scheme trustees and /or members would generally be needed before any change could be made.'* It would seem to me that the abstract is effectively amending FRS 17 by introducing a new requirement rather than issuing an interpretation as to how to apply the current standard to the issue at hand.

I would be grateful if, when providing the final conclusions, the UITF could explain their thinking in this area and clarify whether this additional sentence would have the effect of more generally amending the requirements of FRS 17 going forward.

When determining whether or not a constructive obligation exists, I also find it helpful to look at the actions of the Trustees who, when compared to the scheme membership generally, have a better understanding of the legislative environment surrounding pensions. A look at the investment strategies of pension schemes demonstrates that Trustees also had an expectation that index-linking would be provided in line with RPI. Pension schemes have widely invested in a range of Liability Driven Investments (LDI) with a view of hedging exposure to RPI.

Also, in my experience, a majority of funding valuations and FRS 17 / IAS 19 inflation assumptions are based on market implied inflation which historically means RPI

given the fact that all index-linked Gilts provide inflation protection equal to RPI. Therefore, in my view, there are strong arguments to support the assertion that until the government announcement in July 2010, there was a widely held expectation amongst trustees, companies and members that index-linking in line with statute would in practice mean in line with RPI.

In my opinion, the change from RPI to CPI has been triggered by a specific event (the government announcement) and that event has effectively removed what was a constructive, if not legal obligation. As such, any gain or loss should be treated as a past service cost in the profit and loss regardless of whether the scheme rules refer to statutory revaluation or RPI. A specific event has ended a long standing established practice which gave members a valid expectation of receiving these benefits and as such there has been a marked change in the obligations in respect to past service and as such this should be recognised immediately as a past service credit.

To date, whether the scheme rules refer directly to RPI or more generally to statutory revaluation has had no bearing on the accounting for the scheme and as such it is illogical that it should have such a significant bearing at this stage. In practice, once members have had their indexation reduced to CPI from RPI whatever the scheme rules said originally has little ongoing relevance to the members once the change has been completed. With that in mind, the draft consensus as it stands at present also seems at odds with the concept of substance over form. In substance, if you were an affected scheme member it makes little difference whether you lost your entitlement due a piece of over-ride legislation (if indeed any is issued) or whether a long standing expectation based on 25 years of practice was broken by the government announcement. Substance over form should surely also suggest that tiny details hidden in the scheme rules should not alone determine material accounting treatments.

An approach of P+L recognition would be consistent with the definition of a constructive obligation / valid expectation contained within FRS 17 and would also be consistent with the current treatment of curtailment gains being recognised in the P+L upon a trigger event such as large scale redundancies or the closure of a scheme to future accrual. The government announcement is arguably a specific trigger event and, as such, any gain arising from any reduction in liabilities is closer in substance to a curtailment gain rather than an actuarial gain or loss triggered by everyday market movements

I trust you find these comments useful. I look forward to reading the UITF's conclusions in due course.

Yours faithfully

Ben Guyatt ACA  
Chief Accountant  
Hanson UK