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9 November 2010

Dear Michelle

Accounting implications of the replacement of the Retail Prices Index with the Consumer Prices Index for retirement benefits

This letter sets out the comments from Aon Hewitt on the information sheet No 90 issued by the UITF on 13 October 2010 that set out the proposed Abstract 'Accounting implications of the replacement of the Retail Prices Index with the Consumer Prices Index for Retirement Benefits'.

Pension scheme rules provide for increases to benefits that either refer to the Retail Prices Index (RPI) or more generally to increases required by legislation.

We agree that where pension scheme rules refer to the RPI then a rule change or over-riding legislation will be required before the Consumer Prices Index (CPI) will apply to the calculation of members' benefits. In this case, any change in benefit will give rise to a past service cost in accordance with FRS 17.

We believe the past service cost should be recognised when the amendment to the trust deed is executed or over riding legislation is passed (if later). Consultation is generally a requirement before any pension scheme rules can be changed so any consultation that is necessary would have occurred before the amendment to the rules.

In the second case, where pension scheme rules refer more generally to statutory pension increases, we believe that there is an established custom and practice of using RPI to calculate the increases applying to pensions.

In our view, this gives rise to a constructive obligation defined under FRS 12 as an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

The description of a constructive obligation in paragraph A10 applies a further criterion that the agreement of scheme trustees and/or members would generally be needed before any change could be made. This does not appear to be consistent with the treatment of other benefits that form a constructive obligation; for example discretionary pension increases or early retirement benefits on discretionary enhanced terms. Employers can typically change these benefits without the agreement of trustees and/or members.

We give two examples in the Appendix where, in our opinion, the Government announcement has given rise to a change in the constructive obligation but no consultation or agreement of trustees is required.

If it is intended that the accounting treatment should be different depending on the source of the change in the obligation then we feel that this should be clarified in the Abstract.

Where there is a change to the constructive obligation, we agree that an appropriate date of recognition would be the date that the obligation changed; 8th July 2010 (for private sector pension schemes) or 22nd June 2010 (for public sector pension schemes).

We ask the UITF to consider these comments and specifically clarify how the change should be accounted when there has been a change in the constructive obligation with no change in the Rules of the scheme. It would also be useful if the Abstract could consider the special situation of public sector schemes which have no trustees and where, in theory, Government could simply make changes to the regulations (although it usually does consult over any changes to the regulations). If these cases are addressed then we believe there will be less chance of misinterpretation of the Abstract to ensure it brings consistency in application for users.

Yours sincerely

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Enclosure

Appendix

Example 1

Scheme Rules set out that increases to pensions in deferment should be the statutory increases set by Government.

Although the Government has never explicitly confirmed that statutory increases are based on RPI, it is widely understood that the Government has been using this Index since 1 January 1986. In our view, employees would reasonably have expected indexation based on RPI to continue. We therefore believe the Government announcement relating to CPI is a change in the constructive obligation and should therefore be accounted for as a past service cost. Headlines in the press suggest that employees and unions view this change as a reduction in their benefit. However, in these circumstances, the Scheme Rules do not change and the agreement of the scheme trustees and/or members is not required (although scheme trustees may wish to notify members of the change out of best practice.)

Example 2

Regulations relating to public sector schemes set out that the Secretary of State shall in each tax year review the annual increases applying to benefits to maintain the purchasing power of public service pensions.

The regulations do not refer to RPI increases but more generally to increases in prices. However, it is hard to argue that in public sector schemes there has not been an established custom and practice of setting increases in line with the increase in the RPI and that this has created an expectation around future increases. For example, the Local Government Pension Scheme booklet did (until recently*) refer to increases in line with RPI and again headlines in the press suggest that public sector employees view this as a reduction in benefits. We therefore believe that there has been a change in constructive obligation when the CPI change was announced. However, again no change in the regulations is required nor is there a need to consult with members. Please note there are no trustees as such in public sector schemes so reference to "agreement with scheme trustees" in the Abstract is not applicable to public sector schemes.

* The Local Government Pension Committee produced a leaflet in August 2010 covering the changes to pension provisions announced by the Government in the June 2010 budget that may impact on members of the Local Government Pension Scheme (LGPS). This explained that, from April 2011, cost of living increases to pension in payment and to deferred pensions under the LGPS would be linked to the rise in the CPI, rather than the rise in the RPI.