

“KEY PENSIONS ACCOUNTING AND REPORTING ISSUES FOR

TREASURERS”

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Introduction

Ladies and gentlemen, it is a pleasure to address you at this ACT Pensions Conference. I am Chief Executive of the Financial Reporting Council, the UK’s independent regulator responsible for promoting confidence in corporate reporting and governance. We have a broad range of responsibilities, including maintaining the Combined Code on Corporate Governance, monitoring compliance with the accounting and auditing requirements of the Companies Act and oversight of the accountancy and actuarial professions.

Most of our activities are undertaken by our six operating bodies, including the Accounting Standards Board (ASB). My remarks today, however, are personal reflections and do not necessarily reflect the views of the FRC Board or the ASB. Much of what I have to say is based on my practical experience as a finance director in dealing with pensions.

The topic which I have been asked to address is key pensions accounting and reporting issues for treasurers. I am not going to focus on the technical aspects of accounting for pensions; rather I am going to talk more about a subject which is closer to a treasurer's heart: cash-flows and risks. All of my remarks relate to defined benefit (typically, final salary) pension schemes rather than defined contribution schemes because it is in relation to defined benefit schemes that the most challenging accounting issues arise. I hope that my remarks will also be of interest to trustees of pension schemes, directors of companies which sponsor pension schemes and my friends in the actuarial profession.

I have organised my thoughts for today into five sections:

- The FRC's interest in pensions
- The pensions accounting challenge

- Discounting: theory and practice
- Some implications for pensions accounting and reporting
- Some implications for actuarial practice

The FRC's interests in pensions

I mentioned that the FRC's aim is to promote confidence in corporate reporting and governance. In support of that overall aim we have identified five major areas of activity into which our work can be conveniently categorised: corporate governance, corporate reporting, auditing and related services, actuarial practice and the professionalism of accountants and actuaries. Pensions touch all five of these areas, but those which are most relevant are corporate reporting and actuarial practice.

We are an outcomes-focused regulator and for each of the five major areas we have set out – in our Strategic Framework – the outcome which we believe that all those in the corporate reporting and governance supply chain should be working towards.

For example, the outcome which we have defined for corporate reporting is:

“Corporate reports contain information which is relevant, reliable, understandable and comparable, and useful for decision-making, including stewardship decisions.”

The outcome which we have defined for actuarial practice echoes the corporate reporting outcome:

“Users of actuarial information can place a high degree of reliance on its relevance, transparency of assumptions, completeness and comprehensibility.”

Each of these outcomes is easier to describe than to achieve. There are also a variety of ways in which the outcomes can be achieved in practice.

The Framework also explains that the responsibility for achieving these outcomes is shared between legislators, regulators, practitioners (eg company directors, pension trustees, auditors and actuaries) and the range of actors responsible for monitoring and enforcing standards.

The ASB has been very interested in pensions for many years. In 2000 it published FRS 17 which brought pensions deficits or surpluses onto

company balance sheets for the first time. In 2007 it published a non-mandatory Reporting Statement: Retirement Benefits – Disclosures which encouraged companies reporting under either IFRS or US GAAP to provide additional information about their pensions obligations. The ASB was stimulated to issue the Reporting Statement in response to calls by investors for improved disclosures, which led to a number of newspaper headlines, such as “Companies hide truth about pension deficits” from The Times in September 2006.

The ASB also published in January 2008, jointly with some other European standards boards, under the “Pro-Active Accounting in Europe” initiative, a major Discussion Paper on “The Financial Reporting of Pensions” which aimed to stimulate a “from first principles” debate about the way in which pensions are accounted for by both sponsoring companies and by pension schemes. The paper has achieved its aim in that we have had a very large number of very detailed responses to the Discussion Paper and the ASB is gradually working through its consideration of those responses. The ASB expects to issue a further paper later in 2009 setting out its views having taken careful account of the comments received.

The pensions accounting challenge

The challenge of giving a true and fair view of a company's financial position and results is an extremely demanding one. If you consider the challenge of providing a true and fair view - on paper - of one of your parents or children it can readily be seen how limited is the understanding of their skills and personalities that can be conveyed on paper. There are so many aspects of a human being that it is difficult to decide which aspects to attempt to capture and which techniques would be most appropriate. A photograph? A medical record? A school report? A letter in their own hand-writing? A greater depth of understanding could be conveyed by a video clip but even then it would fall a long way short of conveying the full complexities of those individuals. The choice of aspects and techniques might well depend on the intended use to which the information is to be put.

Similar challenges arise in relation to accounting for pensions. I am proud to be a professional accountant but I am also very conscious that even properly prepared financial statements have considerable limitations.

The critics of accounting frequently seek to dismiss accounting as being:

- **Backward-looking**, despite the fact that many of the most critical decisions in preparing financial statements involve judgements about the likely course of future events (eg the collectability of debts, the saleability of inventory, etc). As we shall see, judgements about the likely course of future events are particularly important in accounting for pensions.
- **Based on an assumption of efficient markets.** This is not correct. Accounting does not assume that markets are efficient but it does assume, in relation to those assets which are required to be marked to market, that in most cases markets are more objective than company management. We can consider the extent to which users of corporate reports would find it more useful for management opinions rather than market values to be used in accounting for pensions.
- **A snap-shot.** This is a strength of accounting rather than a weakness. The long-run is made up of a series of short-runs and it useful to have feedback on the results of each short-run. This does not, however, imply that accounting encourages businesses to be managed for the short-run. I like the analogy of the 70 lap Formula 1 Grand Prix. It is useful for the drivers to know their lap times and how much fuel they have left at the end of each lap. But it would be very unwise for a

driver to conclude that his objective should be to drive a single lap in the fastest possible time without regard to its impact on his ability to finish the race. The operation of pension schemes is a long-term activity but information about short-term performance and current position is also likely to be valuable.

I am going to focus not on academic or theoretical points but on practical issues which are likely to be of particular interest to practitioners. I am very conscious here of JM Keynes' observation that "practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist."

The cash flows relating to defined benefit pension schemes typically stretch out for many years or even decades. In order to improve our understanding of the characteristics of a pension scheme for which we have to account we asked one of the firms of actuaries to send us, on an anonymised basis, a spreadsheet showing the best estimate of the benefits projected to be paid by a pension fund (AN Other Pension Scheme) of one of their clients. To simplify the discussion we have assumed that the scheme is closed to both

new entrants and to future accrual of service by existing members. This is progressively becoming the typical situation for UK pension funds.

The cash flows are shown on the chart (*chart 2*). The payments start relatively modestly, reach an annual peak after 47 years and finally end after 108 years. The total projected cash amount of benefits payable (what we might refer to as the “liabilities”) is £141 million.

The scheme is holding assets of £14m which are intended to be invested, earn returns and be used to pay these liabilities as they fall due. In the next chart (*chart 3*) I have added the projected evolution of the assets taking into account the expected investment returns, which are assumed to be 7% per annum, and the payment of benefits. The assets grow to just over £30 million in about 30 years’ time before gradually declining. Happily in this projection the last £ of benefits is paid by the last £ of assets. This illustrates the power of compound interest and the practical application of the economic theory of the time value of money.

The accounting challenge is how best to represent this picture in the financial statements of the sponsoring company and indeed in the financial

statements of the pension scheme itself: how do we compare a long-term *flow* of benefits with a current *stock* of assets? Unfortunately we cannot simply insert this chart into a balance sheet and we need to find a way of converting the picture on the chart into numbers. There is, however, no reason in principle why a chart like this could not be included in the financial review section of annual reports.

In this example, we can see that the assets are projected to be sufficient to meet the liabilities. Since we know that the best estimate of the liabilities is £141 million it could be argued that the value of the assets is also £141 million. We could refer to this value as the “future value of present assets”. The financial statements (*chart 4*) would then show a net pensions liability of zero, consisting of the value of future liabilities of £141 million less the future value of present assets of £141 million. This would mean that the impression given by the financial statements would be consistent with the expectation that the assets are sufficient to meet the liabilities. It would also deal with the points made by accounting’s critics in that the numbers would be forward- rather than backward-looking and would be based on the long-term rather than a snap-shot.

I am not sure how many of you treasurers here today are qualified accountants but I suspect that there are at least some of you who may have a slight sense of unease about the appropriateness of taking credit in today's financial statements for 100 years' worth of future investment returns. The sense of unease probably derives from a sense that accounting in this way is likely to be misleading because it does not take account of the risks to those future investment returns.

So, if we are not comfortable with accounting on the basis of future values then let's compare the alternative of accounting on the basis of present values. It is generally accepted that the best measure of the present value of an asset is what someone would pay for it. Although there may be some complications if the scheme has chosen to invest in "alternative assets" for which a present value is not readily determinable, the present value of the assets is relatively straightforward.

The question of how to determine the present value of liabilities, particularly long-term liabilities such as pension benefits, is less straightforward to answer. One measurement basis which would have the advantage of being symmetrical with the basis for valuing the assets would be the amount which

you would need to pay someone to assume responsibility for the liability. In the case of pensions liabilities this is the “buyout” value. The market for pensions liabilities is neither deep nor liquid but it is generally possible to estimate the buyout value. Indeed, trustees are required to report an estimate of that value to members of the scheme each year, so we may expect that it is a number which is readily available at little or no extra cost for inclusion in financial statements.

Another measurement method, much used by actuaries, is to discount the future liabilities to a present value. It is common sense that an obligation to pay £10,000 in 20 years time is less onerous than an obligation to pay £10,000 today. (I would just observe in passing that the apparently symmetrical observation that an asset which we do not have to consume until 2029 must be worth more than an asset which we consume tomorrow would be regarded not as common sense but as nonsense.) The practical question is “how much less onerous?” We can use discounting to quantify how much less onerous the obligation is: the present value of £10,000 in 20 years, discounted at 4%, is £4,564, which certainly sounds less onerous!

The further into the future the payments the greater is the effect: the present value of £10,000 in 50 years, discounted at 4%, is £1,407, which is even more re-assuring.

Discounting dramatically shrinks the reported value of liabilities. It is like a magic financial telescope which is designed to be looked through the fat end. The purpose of a normal telescope is to make small things in the far distance appear larger. The magic discounting telescope has the opposite effect by making large things in the distance appear smaller.

It is quite something to find accountants – who are by tradition a cautious breed – happily taking a liability whose best estimate is £10,000 and recording it in the balance sheet at an amount of £1,407. And of course, the actuaries confirm that this is indeed the appropriate way of looking at this liability, which is very re-assuring.

However, we need to keep in mind that the view through the telescope is a distorted one as will be discovered, eventually, when one arrives at the future date. The payment in year 50 may appear to be only £1,407 but £10,000 is still likely to have to be paid.

The magic telescope also has a variable focal length which can be used to produce different results. If we increase the discount rate then we can make the liabilities appear even smaller. For example, the present value of £10,000 in 50 years, discounted at 7%, is £339, which is beginning to sound like a trivial sum. Of course, £10,000 will still have to be found in 2059.

The next chart (*chart 5*) illustrates the effect of discounting on our anonymous pension scheme. If we discount the liabilities at 4% then the reported present value is only £30 million.

The next chart (*chart 6*) shows that increasing the discount rate to 7% reduces the reported present value to £14 million. The magic telescope is a powerful one!

As you will all know, the choice made by the accounting standard setters is that it is more appropriate to represent pension liabilities on a present value basis rather than a future value basis, even though the two bases are economically and arithmetically equivalent.

The financial statements (*chart 7*) would then show a net pensions liability of zero, consisting of the present value of future liabilities of £14 million less the present value of assets of £14 million. This would also mean that the impression given by the financial statements would be consistent with the expectation that the assets are sufficient to meet the liabilities. However, we need to be clear that this mechanism also takes credit for 100 years of future investment returns, this time by reducing the value of liabilities rather than increasing the value of the assets.

Discounting: theory and practice

Discounting is a practical technique with a theoretical conceptual underpinning, the time value of money. The theory is only valid in the real world if two critical assumptions hold good. The first, assumption is that there is a financial asset which could be invested in which will generate certain returns which average out at 7% compound for 50 years and which can be converted into cash at the end of the 50th year. Second, and equally crucially, it assumes that one has £339 today which is available to buy this financial asset.

These theoretical assumptions are, of course, rebuttable in the real world in which treasurers have to work. I have scoured the market place for an asset which offers 7% compound, risk-free over 50 years. Perhaps anyone here today who knows where I could buy such an asset could let me know in the tea interval.

I could buy a portfolio of AA corporate bonds yielding about 7% but if I did chose to hold them to maturity and then replace them with other bonds over the next 5 decades I would be fooling myself if I expected that there would be no defaults. To avoid disappointment (ie suffering a default and then having to put additional money into the pension fund at a later date) it would be sensible to build some defaults into my expected returns. It is difficult to predict the amount of defaults to allow for, but it would certainly be naïve to assume that the total expected return was equal to the current yield on the bonds. It could be argued that the best estimate of the total expected return after allowing for risk is the risk-free rate; certainly the use of the risk-free rate would ensure that investment outperformance is accounted for after, rather than before, it occurs.

There are other reasons why it is likely that in practice the average return on a portfolio of assets held in a pension fund will be less than the current bond yield. It is very common for pension trustees to want to “de-risk” the portion of the assets which relate to current pensioners, for example by holding gilts to match those payments or even to arrange for a buyout of those liabilities.

So what is the real world effect of lower returns? To illustrate this we have modelled the effect on our anonymous pension scheme of achieving returns of only 4%. This is shown on the next chart (*chart 8*). The assets do not grow as the returns are insufficient to pay the benefits after a few years and the assets are exhausted by year 27 leaving £117 million of benefits unpaid.

The second assumption (ie money is available now to invest in the pension fund) is also frequently rebutted, or at least partly rebutted, in practice. And the practical implications of this assumption being rebutted are considerable. This leads to the question: “What is the time value of money if you have no money?” This is not an academic riddle but is of real-world significance to any company with a deficit in their pension fund.

The next chart (*chart 8*) shows what will happen if our anonymous pension scheme is only 90% funded rather than 100% funded. If the opening assets are only £12.6 million rather than £14 million, the assets of the scheme grow to only about £23 million rather than £32 million and they start to decline about 10 years earlier. The result is that the assets are exhausted after year 46 leaving £77 million of benefits unpaid. An initial shortfall of £1.4 million grows over time to £77 million, once again illustrating the power of compound interest. It also illustrates how the view through the magic telescope can be misleading.

And this chart assumes 7% returns. I decided not to include the chart which shows the effect of both a funding shortfall and lower returns because it is too scary.

Each of these two scenarios could, of course, be rectified by the sponsoring employer injecting additional funds into the pension scheme. In the first scenario with returns of 4% rather than 7%, the additional amount required would be £16 million. It is no coincidence that this is the difference between the present value of the liabilities discounted at 4% (£30 million) and the present value discounted at 7% (£14 million).

In the second scenario, the additional amount required would be £1.4 million. It is no coincidence that this is the difference between the present value of the liabilities discounted 7% (£14 million) and the value of the assets.

However, these additional amounts are only correct if they had been injected at the valuation date. If the additional funds are injected at a later date then even larger amounts will be required because some investment returns which are assumed in the calculations will not in fact be generated.

We can illustrate this by reference to the previous example of the present value of £10,000 in 50 years discounted at 7%. If I do not have £339 to invest today then I will miss out on the £24 of returns which I expected to earn in the first year. In the second year, even if I then find the £339 to invest, I will miss out on a further £2, which is the expected return on the £24 missing returns in the first year, leaving a cumulative shortfall of £26 after two years. By year 50 I shall find that I only have £9,300 rather than the £10,000 I had originally assumed in my theoretical discounting

calculation. If it took me to the beginning of the third year to find the £339 to invest I would arrive at year 50 with only £8,700.

This illustrates that a short time lag in investing can give rise to a significant shortfall compared to the amount I need to pay my obligation in year 50.

This is very relevant to judging the prospects for success of pension deficit recovery plans. Let's take an example of a fund with a deficit of £10 millions and assume that we have an objective of clearing the deficit over a 10 year period. A naive observer might think that the problem will be solved by paying £1m per annum for 10 years. Unfortunately, due to the effect of "missing" investment returns, this strategy would still leave the fund with a deficit of £5m at the end of the 10 years, even assuming annual investment returns of 7%. The deficit can be predicted to take 17 years to clear with annual payments of £1m. Alternatively, annual payments of £1.5m are needed to clear the deficit within 10 years. These are further illustrations of the impact of the time value of money.

Some implications for pensions accounting and reporting

There are a wide range of sincerely held views about the merits of different accounting methods, and judgments have to be made as to which methods best meet the needs of the constituencies that have to apply them, audit them and make decisions based on them.

For example, there is intense interest in the accounting standards rules regarding the discount rates and the illustrations which I have given today help to explain why this is the case. We can debate from now to eternity what discount rate should be applied to pension liabilities and no doubt some people will feel more comfortable with one rate compared to another. In particular some people may be comforted by availing themselves of the most powerful magic telescope which their actuaries can justify. But the choice of discount rate does not affect the underlying cash flows and it is to them that we must look.

However, I personally draw a number of conclusions from this analysis.

First, there is a high probability of further shortfalls emerging in cases where there is already a deficit in the pension scheme because the liabilities have been reduced to take credit for the returns on non-existent assets.

Second, the higher the rate used to discount pensions liabilities the greater the risk of shortfalls emerging at a later date.

Third, the greater the delay in addressing pensions deficits the greater the amount which will ultimately be required to address them.

Fourthly, companies should consider whether the disclosures which they are currently making about the likely future cash flows associated with their pension obligations, even if those disclosures fully comply with existing accounting standards, are adequate to convey a balanced and realistic view of the risks which they face.

One of the criticisms that is sometimes levelled at accounting is that it influences decisions, that people make decisions on the basis of accounting information. This is a surprising criticism: the purpose of accounting is to be useful for decision-making!

It may be that a better appreciation of the limitations of current accounting standards for pensions will increase awareness of the risks which companies are exposed to. In some cases this may accelerate a re-evaluation by companies of whether those are risks which they continue to be prepared to run. But what better reporting of pensions cannot be fairly accused of is increasing the risks: the risks are already there.

Some implications for actuarial practice

I expect that what I have had to say today will not come as much news to actuaries – although it may be somewhat of a surprise to some of their clients. We at the FRC are thinking about whether there is more that we need to do to increase the likelihood that our actuarial practice outcome (“Users of actuarial information can place a high degree of reliance on its relevance, transparency of assumptions, completeness and comprehensibility.”) is achieved.

The Board for Actuarial Standards has this outcome very much in mind as it undertakes its overhaul of the current suite of actuarial guidance notes.

One of the new actuarial standards will be a Standard on Reporting Actuarial Information. In March of this year BAS published an Exposure Draft of that Standard which contained a number of requirements which are of relevance to the issues which I have discussed today.

For example, it proposed that actuarial reports “shall include an indication of the nature of any future cash flows being quantified, including their timing”. The draft standard then gives actuaries considerable discretion as to how to meet this obligation but notes that charts or diagrams could be used.

The proposed standard also requires that an actuarial report “that includes the results of calculations that are performed at regular intervals shall include an indication of the projected results from future corresponding calculations.” This requirement would apply to actuarial valuations of pension funds and the information provided for the purposes of annual financial statements.

The BAS is now carefully considering the responses to the consultation on the Exposure Draft and expects to issue a final Standard in the next few months.

Conclusion

My conclusion is therefore that whilst the existing pensions accounting standards perform a very useful function of drawing attention to the importance of pensions assets and liabilities, by their very nature they are imperfect and incomplete sources of information. My contention is that corporate treasurers – and indeed pension trustees – should focus their attention on developing a better understanding of the cash-flows in the pension scheme.

This matters more now than it did even five years ago because of the establishment by the government of the Pensions Protection Fund: trustees of pension funds (and, indirectly, the directors of sponsoring companies) are now legally responsible (via the mandatory PPF levy) not only for the liabilities of their own schemes but for the unpaid liabilities of those pension

schemes which are not competent – or lucky – enough to meet their liabilities.

I quote from an article written by George Schwartz in the Sunday Times 60 years ago:

“The accountant is not a popular figure in life. If economics is the dismal science, accountancy is the dismal practice. A hollow groan goes up when [a proposal] for a beautiful scheme is followed by the accountant’s observations.”

He went on to say:

“... some unpleasant facts can emerge when proper accounts are kept. But ... still more unpleasant facts eventually emerge when proper accounts are not kept.”

Generally speaking accounting serves business people and their investors very well as a source of information for decision-making. But I hope that my remarks today have illustrated how accounting has real limitations when it is called upon to account today for liabilities which stretch for decades into the future.

Users of accounting information need to recognise these limitations. Firstly, it would be unwise to base a decision solely on accounting information; it should be one of many inputs to decision-making. Secondly, it is important that people who chose to rely, even in part, on accounting information take appropriate care to understand the basis on which the financial statements have been prepared. Corporate treasurers have the skills and experience to help directors of sponsoring companies and pensions trustees address the limitations of pensions accounting.