ASPECTS OF ACCOUNTING FOR PENSION COSTS

ACCOUNTING
STANDARDS
BOARD

DISCUSSION PAPER

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Preface

In June 1995, the Accounting Standards Board issued a Discussion Paper 'Pension Costs in the Employer's Financial Statements' that set out two alternative approaches to pension cost accounting: an actuarial valuation approach and a market value approach. This further Discussion Paper describes the progress of the project since then, discussing in Chapter 1 the Board's reaction to international developments and setting out tentative decisions on two key aspects of pension cost accounting: (i) the measurement basis for assets held in a pension scheme and (ii) the discount rate to be applied to the pension liability.

The rest of the Discussion Paper focuses on two further key issues: (i) the recognition of actuarial gains and losses* and (ii) the treatment of past service costs. The Board has considered a number of ways of recognising actuarial gains and losses, some of which involve the use of the statement of total recognised gains and losses. This statement was introduced by the Board in FRS 3 'Reporting Financial Performance' in October 1992. Since then the Board has been developing its views on the role of the statement in conjunction with other accounting standard-setters internationally. Chapter 2 sets out briefly the Board's present thinking on this issue while Chapters 3 and 4 consider the options for actuarial gains and losses and past service costs in more detail.

* *Actuarial gains and losses comprise both experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred) and the effects of changes in the actuarial assumptions.*

The Board intends to issue a Discussion Paper on the role of the statement of total recognised gains and losses later this year. The Board recognises that issuing a Discussion Paper on pension costs before the general issues relating to the role of the statement of total recognised gains and losses have been debated is not ideal. On the other hand, the Board believes that it is important to give an indication of its thinking on pension cost accounting following the publication of International Accounting Standard (IAS) 19 (revised 1998) 'Employee Benefits'. It also believes that an example of how differing views on the role of the statement of total recognised gains and losses may affect accounting treatments in practice may be of help to those considering the general issues and that comments on the example may assist the Board in developing its subsequent Discussion Paper. The Board does not intend to finalise its views on pension cost accounting until it has considered the responses to the Discussion Paper on the role of the statement of total recognised gains and losses.

Invitation to comment

The Board would welcome comments on any aspect of the Discussion Paper. Respondents' views are especially sought on the matters set out below. It would be helpful if respondents could support their views with reasons and, where applicable, preferred alternatives. In addition to the discussion in the main text, a summary of the various possible treatments is given at Appendix B.

Q1 Do you agree with the Board's preliminary decisions on:

(a) the use of market values to measure pension scheme assets (paragraphs 1.8 - 1.15) and

(b) the use of the rate of return on matching assets to discount the pension liability (paragraphs 1.16 - 1.27)?

Chapter 3 sets out the following options for the recognition of actuarial gains and losses:

(a) spreading forward actuarial gains and losses in the profit and loss account (similarly to the SSAP 24 approach)

(b) immediate recognition of actuarial gains and losses in the profit and loss account, but presented on the face of the profit and loss account as a separate exceptional item

(c) immediate recognition of actuarial gains and losses in the statement of total recognised gains and losses

(d) immediate recognition of actuarial gains and losses in the statement of total recognised gains and losses with subsequent recycling of the gains and losses into the profit and loss account

Q2 Which of the options do you prefer, and for what reasons? If you prefer (a) do you favour the balance sheet presentation described at paragraph 3.2.6?

Q3 Are any of the options completely unacceptable to you and, if so, why?

Chapter 4 sets out the following options for the recognition of past service costs:

(a) recognise all past service costs immediately

(b) recognise past service costs relating to former employees immediately and spread forward those relating to current employees

(c) offset past service costs against any surplus funding them and recognise as a cost only any excess amount

Q4 Which of the options do you prefer, and for what reasons?

Q5 Are any of the options completely unacceptable to you and, if so, why?

Chapter 1: Development of the pensions project

1.1 The Board started a project on post-retirement benefits by requesting two reports on SSAP 24 'Accounting for pension costs': one from the Institute of Chartered Accountants in England and Wales and one from the Pensions Research Accountants Group. Both reports highlighted problems relating to the number of options SSAP 24 allows, the resulting flexibility and the fact that the disclosure requirements are insufficient to give a proper understanding of the options chosen or to ensure comparability between entities. The Board was also aware that the International Accounting Standards Committee (IASC) was about to start a project on employee benefits (including post-retirement benefits) and wished to develop its own thinking in order to be able to contribute fully to the international debate.

1.2 The Board issued a Discussion Paper 'Pension Costs in the Employer's Financial Statements' in June 1995. The Paper set out two alternative approaches to pension cost accounting: (i) an actuarial approach, which would retain the basic principles of SSAP 24 but restrict many of the options allowed under that standard and enhance the disclosure requirements, and (ii) a market value approach, the key feature of which would be to measure pension scheme assets at market value. Both approaches were based on the principle that the defined benefit liability is incurred as the employees provide service to the entity, not when any payments fall due.

1.3 Almost all of the responses to the Discussion Paper supported the actuarial approach. The main concerns expressed by respondents about market values were that:

- there is no market for pension commitments based on final salaries. Hence, using market values for assets is inconsistent with the basis of measurement for liabilities which is, of necessity, an actuarial valuation

- market values are not relevant to the measurement of a long-term net liability

- market values are too volatile.

Few comments were received on the other aspects of the market value approach.

1.4 A majority of the Board agreed with the respondents' views and work started on the preparation of a FRED based on the actuarial approach. However, the IASC project was moving in a different direction, as can be seen from the proposals in E54 'Employee Benefits', published in October 1996, and the subsequent standard IAS 19 (revised 1998), published in March 1998.

IAS 19 (revised 1998) 'Employee Benefits'

1.5 The requirements in IAS 19 (revised 1998) for defined benefit schemes are, like those in the Board's earlier Discussion Paper, based on the principle that the defined benefit liability is incurred as the employees provide service to the entity, not when any payments fall due.

1.6 There are, however, four main areas where IASC thinking has differed from the actuarial approach set out in the ASB Discussion Paper:

- IAS 19 (revised 1998) requires assets in a pension scheme to be measured at market value rather than an actuarial value as proposed under the actuarial approach.

- IAS 19 (revised 1998) requires the pension liability to be discounted at a risk-free rate rather than the rate of return on assets in the scheme as proposed under the actuarial approach.

- E54 proposed that (i) actuarial gains and losses up to 10 per cent of the greater of the gross value of the assets and liabilities in the scheme should not be recognised at all but (ii) to the extent that the actuarial gains and losses exceed the 10 per cent 'corridor' they should be recognised immediately. The actuarial approach proposed that all actuarial gains and losses should be recognised gradually over the remaining service lives of the employees. The approach in E54 has been amended and IAS 19 (revised 1998) not only allows actuarial gains and losses within a 10 per cent 'corridor' not to be recognised but also allows actuarial gains and losses exceeding the corridor to be spread forward over the remaining service lives of the employees.* The basis for conclusions published with the IAS, however, states that IASC may revisit this issue shortly.

- IAS 19 (revised 1998) requires past service costs to be recognised immediately the benefits are vested. The actuarial approach proposed that past service costs for current employees should be spread forward.

The approach in IAS 19 (revised 1998) is very similar in these respects to that in the US standard, FAS 87 'Employers' Accounting for Pensions', with the important exception that, under FAS 87, past service costs are spread forward.

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* *Methods that result in earlier recognition are also allowed, including immediate recognition of actuarial gains and losses both within and outside the 'corridor'.*

1.7 There is increasing pressure for accounting standards in the UK and the Republic of Ireland to be in line with international and overseas standards. The Board has, therefore, considered carefully the proposals in E54 and the resulting requirements of IAS 19 (revised 1998) and has consulted users, actuaries, preparers and auditors of accounts on an informal basis to assess the reaction in the UK. The results of these deliberations in relation to the measurement of scheme assets and the discount rate are set out below. The issues of actuarial gains and losses and past service costs are discussed in more detail in Chapters 3 and 4.

Market values for scheme assets

1.8 IAS 19 (revised 1998) requires assets in the pension scheme to be measured using market values. IASC has put forward the following arguments for using market values:

> (a) the use of market values enhances comparability between enterprises and reliability by diminishing the need for subjective estimates of long-term trends; in the absence of compelling evidence to the contrary, assumptions about future economic conditions should be based on current economic conditions.
>
> (b) market values are the best estimate of the future economic benefits associated with plan assets. Therefore, changes in market values of plan assets have a direct impact on the expected future cash outflows (in the form of contributions) of resources embodying economic benefits.
>
> **IASC Issues Paper 'Retirement benefits and other employee benefit costs' August 1995**

1.9 In contrast, the actuarial approach in the Board's Discussion Paper proposed that the assets should be measured at an actuarial value because market values reflect short-term fluctuations that are not a true reflection of the long-term cash flows that the assets will generate. As noted above, the use of actuarial values was supported by almost all respondents to the Discussion Paper and a majority of Board members.

1.10 However, the Board has had to recognise that the trend to market values is very strong internationally and that in other countries the actuarial profession is not always regarded with the respect that it commands in the UK. It was, therefore, always unlikely that IASC would change its proposals from market to actuarial values for pension scheme assets. Some members of the Board, in fact, agree with IASC that market values are the most objective and reliable measure of the scheme assets. The other members of the Board, although preferring actuarial values, would be prepared to move to market values in the interests of international harmonisation, for the following two reasons:

- If the liabilities are measured using the same assumptions that underlie the asset valuation (in particular, if an appropriate discount rate is used), the question of whether to use actuarial values or market values becomes less important—it is essentially a matter of choosing in which unit the net obligation should be expressed (actuarial values, which can be seen as long-term units, or market values, which can be seen as current units).

- Indeed, some actuarial valuations, for example those used for the minimum funding requirement and those used for transfer values, are already expressed in terms of market values of assets. In the light of international developments the actuarial profession is actively reviewing the possibility of extending this practice to valuations for financial reporting purposes because it is aware of the difficulties of explaining why actuarial values differ from market values and is conscious of the desirability of relating the actuarial assumptions adopted to current market conditions.

1.11 In general, market values fluctuate more than actuarial values. Whether this will result in volatility in the profit and loss account depends on how the use of market values for assets and market related discount rates affects the determination of the components of the pension cost and the way in which they are recognised.

1.12 The diagram opposite sets out, with simplifying assumptions, the key components of a pension scheme valuation using market values. Normal cost (ie excluding the effect of actuarial gains/losses and past service costs) consists of the accrual of an additional year's liability in respect of current service, plus interest on the opening amount of the actuarial liability, less the estimated long-term return on assets for the year.

Key components of a possible pension scheme valuation using market values*

		Total Pension Cost	
Source	**Basis of calculation**	**Normal cost**	**Actuarial gains/losses**
LIABILITY			
Projection of final pay	Estimated final pay at current prices (after adjusting for leavers) compounded at 'real' rate plus allowance for productivity		
Discounted	'Real' rate plus a margin		
= Actuarial liability			
	1/60th (say)	Service cost	
	'Real' rate plus margin	Plus interest	
	Adjustments to estimates eg - change in PV of final pay estimates; - change in discount rate since last valuation		Plus or minus adjustments to liability estimates
ASSETS			
Fund assets	Market value		
	Estimated long-term rate of return	Minus return on assets	
	Difference of estimate from actual		Plus or minus adjustments to estimate of return on assets

* *For simplicity the diagram makes no mention of pensions in course of payment or deferred pensions nor of past service costs.*

1.13 The first two items derive from the actuarial liability. As under any method of valuation, the level of service cost is influenced by the difference between the rate at which pay is projected to rise and the rate of interest at which the projection is discounted. A rise or fall in estimates of final pay that is not offset by a change in the discount rate therefore feeds through into a higher or lower service cost in respect of the current year, while the backlog effect on the opening actuarial liability is reflected as an actuarial gain or loss. Interest, on the other hand, is often a relatively stable component of normal cost, since a higher interest rate implies a correspondingly lower amount of the discounted liability to which it is applied.* The relevance of the interest rate lies not in the absolute amount of interest cost that it generates but in the relationship of this to other components of the valuation. This issue is discussed in paragraphs 1.16 - 1.27 below. The backlog effect on the actuarial liability of a change in the interest rate since the last valuation is reflected as an actuarial gain or loss.

1.14 While the actuarial liability and the costs derived from it depend on actuarial assumptions, albeit reflecting current long-term rates, the scheme assets are valued at current market prices. Normal cost, however, does not reflect the actual return on assets obtained in the year but rather an estimate of the current long-term return. The difference between the estimate and the actual return for the year is reflected as an actuarial gain or loss. Volatility of normal cost is mitigated to the extent that the estimated current long-term return reflects similar assumptions to those embodied in projections of final pay and in the interest rate at which the liability is discounted.

* *For example, if a projected liability of 100,000 is discounted over 15 years at 10 per cent rather than 5 per cent, the discounted liability will drop from 48,102 to 23,939. Interest cost on the liability will then change from 2,405 (5% x 48,102) to 2,394 (10% x 23,939).*

1.15 It is not, therefore, simply the case that using market values for assets introduces volatility into the profit and loss account. The volatility or otherwise of the pension figures depends on the interrelationship between the assumptions underlying all the components of the pension costs. Given this, the question is whether the use of actuarial values rather than market values is a sufficiently significant issue to warrant the UK treatment being different from international practice. The Board believes that it is not. The important issue is the way in which a market value approach is implemented. This view seemed to be generally accepted by most of those whom the Board has informally consulted on the IASC proposals, including those within the actuarial profession.

The discount rate for pension obligations

1.16 IAS 19 (revised 1998) requires pension obligations to be discounted at the market rate on high quality fixed-rate corporate bonds or government bonds with maturity consistent with the estimated maturity of the pension liability. This discount rate is chosen on the grounds that it reflects the time value of money but not the risks associated with a defined benefit obligation.

1.17 The Board disagrees with this approach. It believes that, to be consistent with the measurement of the assets in the scheme, the defined benefit obligation should be measured at fair value, which does reflect risk. However, this raises the question of how, in practice, the fair value can be estimated given that there is no active market for pension liabilities.

1.18 One way of estimating the fair value is to look for assets that have an active market and are similar to the pension liability in that they react in the same way to changes in economic conditions. After all, if a liability were a promise to deliver a particular asset, the fair value of the liability would be the fair value of that asset. A pension liability is not a promise to deliver a particular asset but a promise to deliver a stream of cash flows. Nonetheless, like assets, its fair value is affected by the expected rate of improvements in productivity and general growth in the economy.*

1.19 This can be illustrated by noting that the fair value of a liability will normally equal the least cost to entities of discharging it. The entity could discharge the liability by either

(a) paying a third party now to take over the obligation, or

(b) investing in assets that it is reasonably certain will grow to match the amount due and using those assets to pay that amount at the due date.

For final salary pensions, there is generally no market in which the liability can be settled directly, so it is necessary to consider (b).

1.20 There are two ways in which an entity can fund a liability to achieve a reasonable level of certainty that the fund will be sufficient to meet the liability when it is due. One is to invest enough in risk-free assets, where the return is certain. However, the final amount of the liability is not known, so in order to be certain that the funds would be sufficient the amount invested would have to cover the highest possible liability.

* *The interrelationship between the liability and the economy can be expressed in statistical terms as the covariance between the liability and the market portfolio (scaled by the variance of the liability).*

1.21 Alternatively, an entity can invest in assets whose cash inflows match the amount and variability of the cash outflows of the liability. If such matching assets can be found, the need to increase the amount invested to cover the highest possible liability is greatly reduced—variation in the liability is already largely covered by variation in the matching assets. For example, salary rates are affected by growth in the economy and the resulting effect on the pension liability is traditionally covered by investing in the economy, ie by investing in a well-diversified equity portfolio.

1.22 Moreover, assets whose cash flows are subject to variability (such as those affected by real growth in the economy) generally give a higher rate of return than assets with fixed cash flows—they have to do so in order to compensate for the risk that generally arises from the variability. That risk is to some extent removed when the assets are used to fund matching liabilities because there is less variability in the net cash flows (which, at the extreme of a perfect match, will always be nil) but the higher rate of return still remains. The higher rate of return available on such matching assets means that, to cover a liability of any given expected value, a smaller investment need be made than would be required in risk-free assets. **The least cost for the entity, therefore, is to invest in matching assets, not in risk-free assets.**

1.23 Recording the liability at this least cost, ie at an approximation of the amount that would need to be invested in assets now, is equivalent to discounting the cash flows of the liability at the rate of return on such assets. This is similar to the method of valuing the liabilities traditionally used by actuaries in the UK, but with one crucial difference. Actuaries have tended to discount the cash flows of the liability using a discount rate based on the rate of return on the assets in the scheme. The Board believes that this approach needs to be refined so that it is not the rate of return on the actual assets in the scheme that is used but the rate of return on a portfolio of matching assets.

1.24 The actuarial profession is developing guidance on how to determine such a rate. It is expected that the appropriate rate will be:

(a) for current and deferred pensioners

- on fixed pensions, the rate of return on fixed interest bonds
- on index-linked pensions, the rate of return on index-linked bonds; and

(b) for current employees with a promise of final salary pensions, a rate that allows the implicit recognition of change in the economy through the incorporation of some element of expected equity return.

1.25 It is important to emphasise that the discount rate does not depend on how the liability is actually funded. The least cost of discharging a liability (ie its fair value) depends solely on the characteristics of the liability not on any assets used to fund it.

1.26 While the above specification for the discount rate for final salary pension liabilities may under some economic conditions result in discount rates that are not very different from the requirement in IAS 19 (revised 1998) to use a high quality corporate bond rate, the Board is opposed to the IAS 19 (revised 1998) requirements. It believes that the justification for the rate is unclear—a corporate bond rate does not reflect the risks relevant to the measurement of a final salary pension liability but instead reflects the irrelevant credit risk of the issuer of the bonds. Under different economic conditions, the IAS requirements may give a very different rate from that proposed by the Board and could lead to overstatement of the cost and liabilities of the pension and the introduction of false volatility into the financial statements.

1.27 Virtually all those whom the Board informally consulted in the UK were also strongly opposed to the IASC proposals relating to the discount rate.

Chapter 2: The role of the statement of total recognised gains and losses

2.1 The statement of total recognised gains and losses was introduced by the Board in FRS 3 'Reporting Financial Performance' in October 1992. It is a primary statement that complements the profit and loss account by showing all gains and losses recognised in the period.

2.2 At the time FRS 3 was issued, there were two commonly occurring items that fell to be recognised in the statement of total recognised gains and losses: revaluations of fixed assets and exchange gains and losses on overseas net investments. It had long been accepted that these items should not be shown in the profit and loss account for the period because they were gains and losses that were incidental to the entity's main activities.

2.3 FRS 3 also prohibited gains and losses that were recognised in the statement of total recognised gains and losses from being recognised a second time in the profit and loss account in subsequent accounting periods. This was consistent with the existing treatment of exchange gains and losses on overseas net investments in the UK and with the treatment of revalued fixed assets in the International Accounting Standard, IAS 16 'Property, Plant and Equipment'.

2.4 Since FRS 3 was issued, other standard-setters internationally have shown an interest in the statement of total recognised gains and losses and examined ways of developing the idea further. The G4+1* has issued a research study 'Reporting Financial Performance: Current Developments and Future Directions'† that sets out its interim views on reporting financial performance. Following this, the Board has begun a project to

* *The G4+1 comprises members of the standard-setting bodies in Australia, Canada, New Zealand, UK and USA, and of IASC.*

† *Published in January 1998*

consider the revision of FRS 3. This project is being taken forward on an international basis and it will be influenced by proposals put forward by the G4+1. Once a broad consensus has been reached internationally, the Board will produce a Discussion Paper on the revision of FRS 3, probably within the next twelve months.

2.5 The objective of the project is to decide how items of financial performance should be grouped, aggregated and formatted so as to provide the most useful information to the users of the financial statements. In the research study the G4+1 proposed that financial performance would be split into three parts: operating/trading activities, financing/treasury activities and 'other' gains and losses and expressed a preference among its members that these three sections should be shown in a single performance statement, rather than being split into a profit and loss account and a statement of total recognised gains and losses. A single performance statement is likely to remain the long-term aim. In the meantime, 'other' gains and losses would be shown in the statement of total recognised gains and losses.

2.6 Various options have been examined for distinguishing between gains and losses that would most usefully be reported under 'other' and those that should appear under operating/trading or financing/treasury activities. Distinctions that seem to have had some influence in the past have been 'realised' versus 'unrealised', 'certain' versus 'uncertain' and 'operating' versus 'holding' gains/losses. Distinguishing characteristics that might form the basis for a revised performance statement (or statements) are set out in the table opposite.

Characteristics typical of operating items	**Characteristics typical of 'other' gains and losses**
Operating activities	Non-operating activities
High predictive value	Less predictive value
Non-holding activities	Holding activities
Internal events (eg value adding activities)	External events (eg price changes)

It is not suggested that any one line in the above table should be used as a criterion to the exclusion of the others. Rather, items that predominantly have the characteristics listed on the left would tend to be reported as part of operations (or finance/treasury activities), whilst those whose characteristics were predominately those listed on the right would be reported as other gains and losses.

2.7 The approach can be illustrated in the treatment of revalued fixed assets. The revaluation of a factory is recognised in the statement of total recognised gains and losses because that gain is not directly attributable to the manufacturer's operating activities but arises from price increases. Depreciation, on the other hand, is recognised in the profit and loss account because it is an operating cost of manufacturing.

2.8 The requirements in FRS 11 'Impairment of Fixed Assets and Goodwill' apply the operating/other split further. They are based on the principle that consumption of economic benefit should be shown as an operating cost like depreciation and that price fluctuations should be shown elsewhere. However, the FRS also recognises that in many cases it will be impossible to tell whether an impairment is caused by consumption of economic benefit or by a general change in prices. It therefore requires that:

(a) impairments that are clearly caused by the consumption of economic benefit should be reflected in the profit and loss account; and

(b) other impairments should be reflected in the statement of total recognised gains and losses to the extent that they reduce the carrying amount of the asset to depreciated historical cost or above and thereafter in the profit and loss account.

2.9 The above paragraphs summarise the way the role of the statement of total recognised gains and losses may develop, and how the treatment of fixed assets already reflects, to a large extent, the same principles. The next chapter considers how the statement might be used in the treatment of actuarial gains and losses arising in relation to pension costs.

Chapter 3: Actuarial gains and losses arising on defined benefit pension schemes

3.1 Introduction

3.1.1 Actuarial gains and losses arise from increases or decreases in either the market value of the assets in the pension scheme or the estimate of the defined benefit liability. Causes of actuarial gains and losses include:

- differences between the actual and expected returns on scheme assets
- the effect of changes in the discount rate applied to the liability
- unexpectedly high or low increases in salaries or the cost of other benefits, eg medical care
- changes in estimate of future increases in salaries or in the cost of other benefits.

3.1.2 The actuarial approach set out in the Board's earlier Discussion Paper on pension costs proposed to continue with the spreading approach used under SSAP 24 whereby actuarial gains and losses are recognised gradually over the service life of the employees. Under the alternative market value approach in that Discussion Paper, however, a different treatment was proposed. The profit and loss account would be charged with the cost of pensions earned in the period. Actuarial gains and losses would be recorded in the statement of total recognised gains and losses.

3.1.3 As mentioned earlier, E54 proposed a third treatment, that actuarial gains and losses should be recognised immediately in the profit and loss account to the extent that they exceeded 10 per cent of the greater of the value of the assets in the scheme and the value of the liabilities (the 'corridor'). Actuarial gains and losses of less than 10 per cent would not be recognised. It met substantial opposition in the responses to E54, and IASC reconsidered the issue. The approach adopted in IAS 19 (revised 1998) allows non-recognition of actuarial gains and losses within the 'corridor' and also allows gains and losses that exceed the 'corridor' to be spread forward over the remaining service lives of the employees.* However, the basis of conclusions published with IAS 19 (revised 1998) states that:

> The Board believes that the new IAS 19 is a significant improvement over the old IAS 19. Nevertheless, the Board believes that further improvement may be possible in due course. In particular, several Board members believe that it would be preferable to recognise all actuarial gains and losses immediately, outside the income statement, in a performance statement [the equivalent of the statement of total recognised gains and losses] or other statement showing changes in equity. However, the Board believes that such a solution is not feasible until the Board resolves various issues relating to the reporting of financial performance.† When the Board makes further progress with those issues, it may decide to revisit the treatment of actuarial gains and losses.
>
> **IAS 19 (revised 1998) Appendix 3, paragraph 2.**

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* *Methods that result in earlier recognition are also allowed, including immediate recognition of actuarial gains and losses both within and outside the 'corridor'.*

† *The ASB's views on these issues are further developed than those of IASC and are set out in Chapter 2.*

3.1.4 In order to examine the issues this chapter looks in more detail at four possible approaches:

(a)	• profit and loss account	– spreading forward of actuarial gains and losses (similar to the SSAP 24 approach)
	• balance sheet	– the pension asset or liability does not normally represent the current estimate of the surplus or deficit in the scheme
(b)	• profit and loss account	– immediate recognition of actuarial gains and losses as a separate exceptional item
	• balance sheet	– the pension asset or liability is the current estimate of the surplus or deficit in the scheme
(c)	• statement of total recognised gains and losses	– immediate recognition of actuarial gains and losses
	• balance sheet	– the pension asset and liability is the current estimate of the surplus or deficit in the scheme
(d)	• profit and loss account	– spreading forward of actuarial gains and losses recycled from the statement of total recognised gains and losses

• statement of total recognised gains and losses	- immediate recognition of actuarial gains and losses, which are subsequently recycled to the profit and loss account
• balance sheet	- the pension asset or liability is the current estimate of the surplus or deficit in the scheme.

3.2 Spreading forward actuarial gains and losses in the profit and loss account

Basis for approach

3.2.1 In this approach, actuarial gains and losses would be recognised gradually in the profit and loss account over the expected service lives of the current employees.

3.2.2 This approach is based on the view that changes in the net pension obligation are part of the operating cost of employing staff and should therefore be recognised in the profit and loss account. Because of the long-term assumptions involved in the valuations, there is always some uncertainty about the measurement and, hence, whether actuarial gains and losses arising from the valuations are true reflections of changes in the underlying net pension obligation.

3.2.3 This uncertainty does not form sufficient grounds for not recognising actuarial gains and losses at all. However, it is equally inappropriate to treat the actuarial gains and losses as wholly reliable measures. To do so by recognising them in full immediately would introduce false volatility into the financial statements, which would give a misleading picture of the pension cost.

3.2.4 Some mechanism is needed to cope with the inherent uncertainty in pension cost measurement and any such mechanism will inevitably be arbitrary to some extent. Spreading forward the actuarial gains and losses has the advantage that the gains and losses are recognised gradually over the period that the benefit is earned as the evidence of the probable future cash outflow builds up.

3.2.5 The Board does not favour combining this approach with a 'corridor' because it believes that the 'corridor' simply introduces additional complexity without advantages.

3.2.6 A possible variant on the spreading approach is to show in the balance sheet the latest surplus or deficit identified in the scheme, with a separately disclosed adjustment to bring it to the amount of the pension asset or liability that is recognised under the spreading approach.

Effect in practice

3.2.7 The practical effect of spreading the gains and losses forward can be illustrated by a simple example (ignoring the effect of interest and return on assets).

Example 1

Suppose an actuarial valuation indicated that there was a deficit of 50 in a pension scheme. The ongoing normal cost is 12 and the average remaining service life of the employees is ten years. Of the deficit 25 is funded in year 2 and 25 in year 3. Other contributions each year equal the normal cost.

The profit and loss account would show a charge of 17 for the next ten years. The balance sheet would show a pension liability or asset calculated as in the table below. The variant explained in paragraph 3.2.6 would require all three lines of the calculation to be shown.

	Year 1	*Year 2*	*Year 3*	*Year 10*
Deficit in scheme	(50)	(25)	0	0
Deficit not yet due for recognition	45	40	35	0
Pension (liability)/asset	(5)	15	35	0

Practical advantages and disadvantages

3.2.8 The practical advantages of a spreading approach are:

- it is consistent with IAS 19 (revised 1998) and FAS 87 (although both permit it to be combined with a corridor and IASC has already indicated that it might reconsider this issue once it has developed further its views on its equivalent to the statement of total recognised gains and losses).

- it is an approach with which preparers and users of financial statements are familiar.

3.2.9 The practical disadvantages are:

- unless the balance sheet figure is split into the two components described in paragraph 3.2.6 above, the balance sheet does not reflect the surplus/deficit according to the latest actuarial valuation. In particular, where, as in example 1, a deficit is funded more quickly than it is recognised, an asset will be recorded in the balance sheet even though there is no surplus (and may even still be a deficit) in the scheme—a result many find disturbing.

- spreading the gains and losses forward requires complicated and arbitrary rules.

- the above two points result in the reported figures being difficult to understand and regarded with suspicion by many users of accounts.

- it is inconsistent with FRS 7 'Fair Values in Acquisition Accounting', which requires a pension scheme surplus (to the extent recoverable) or deficit to be recognised as an asset or liability immediately. (However, there are other normally unrecognised assets and liabilities that are recognised as part of an acquisition, eg goodwill and some internally generated intangible assets.)

- it is inconsistent with the treatment of changes in estimate of other provisions which are recognised immediately in the profit and loss account (although this can be justified on the grounds of the uncertainty relating to the measurement of the gains and losses).

3.3 Actuarial gains and losses recognised immediately in the profit and loss account, but presented on the face of the profit and loss account as a separate exceptional item

Basis for approach

3.3.1 In this approach, actuarial gains and losses would be recognised immediately in the profit and loss account. However, if material, they would be presented on the face of the profit and loss account as a separate exceptional item after operating profit (like those items covered by paragraph 20 of FRS 3).

3.3.2 This approach reflects the view that the actuarial gains and losses are operating costs that belong in the profit and loss account and that the actuarial valuation is a sufficiently reliable measure for them to be reflected in the financial statements. However, the size of the actuarial gains and losses could overwhelm the operating profit figure, thereby distorting the picture of the other operating activities. It is therefore desirable to show them as an operating cost/credit separately from other operating profit.

3.3.3 Additionally, this approach has the advantage that operating profit reflects the best estimate of ongoing normal cost, which gives a better indication of future pension costs than would a figure that included the actuarial gains or losses, the future occurrence of which cannot be predicted.

Effect in practice

3.3.4 The practical effect of this approach can be illustrated using the same figures as in example 1 above.

Example 2

Suppose an actuarial valuation indicated that there was a deficit of 50 in a pension scheme. The ongoing normal cost is 12 and the average remaining service life of the employees is ten years. Of the deficit 25 is funded in year 2 and 25 in year 3. Other contributions each year equal the normal cost.

The profit and loss account would show a charge of 12 for the next ten years within operating profit and an exceptional loss of 50 in year 1. The balance sheet would show pension liabilities as follows:

	Year 1	*Year 2*	*Year 3*
Deficit in scheme	(50)	(25)	0

Practical advantages and disadvantages

3.3.5 The practical advantages of this approach are:

- the balance sheet reflects the surplus (to the extent that the entity will benefit from it) or deficit according to the latest actuarial valuation. This means that, unlike the spreading approach illustrated in Section 3.2, which is similar to that in SSAP 24, the balance sheet will never show an asset when there is a deficit in the scheme or a liability when there is a surplus in the scheme. There is also no need for complex reconciliations between the balance sheet figure and the surplus/deficit in the scheme.

- the reported figures are transparent and easy to understand.

- the method is consistent with FRS 7, which requires a pension scheme surplus (to the extent recoverable) or deficit to be recognised as an asset or liability immediately.

- the method is consistent with the treatment of changes in the estimate of other provisions.

3.3.6 The practical disadvantages are:

- the profit and loss account will contain potentially large and volatile figures, albeit disclosed separately.

- the volatility is significantly greater than that resulting from the minimum charge or credit permitted under both IAS 19 (revised 1998) and FAS 87.

3.4 Immediate recognition in the statement of total recognised gains and losses

Basis for approach

3.4.1 In this approach, actuarial gains and losses would be recognised immediately in the statement of total recognised gains and losses. They would not be recognised for a second time in the profit and loss account in a later accounting period. This would result in the profit and loss account showing the best estimate of the current pension cost based on market conditions at the balance sheet date (ie reflecting the market-based equivalent of the regular cost under SSAP 24 but excluding any variations from regular cost). Any restatement of the existing assets and liabilities at a subsequent balance sheet date would be reflected in the statement of total recognised gains and losses.

3.4.2 This approach is based on the view that changes in value of the net pension obligation are not operating costs for the period. They arise from external events and have little predictive value. Under the Board's developing views on the role of the statement of total recognised gains and losses, as set out in Chapter 2, they therefore belong in that statement rather than the profit and loss account.

3.4.3 As noted in Chapter 2, only two items are currently recognised in the statement of total recognised gains and losses: revaluations of fixed assets and exchange differences arising on overseas net investments. Some members of the Board believe that an analysis similar to that applied to revaluations of fixed assets can be applied to pension schemes. Just as manufacturers

are not in business in order to make gains or losses from owning factories, so most entities are not in business in order to make gains or losses out of the pension scheme, although both the factory and the pension scheme may be necessary to run the business. Actuarial gains and losses reflect changes in value of the pension scheme. They can arise on both the assets in the scheme or the liabilities and can be viewed as holding gains and losses similar to those arising from revaluations of fixed assets, as explained below.

3.4.4 Expected returns on the assets are incorporated in the ongoing cost of providing the pension, which is charged in the profit and loss account. Subsequent changes in the value of the pension scheme assets arising from unexpected changes in economic conditions are not directly attributable to the entity's core business. It is therefore appropriate that they should, like revaluations of fixed assets, be recognised in the statement of total recognised gains and losses.

3.4.5 Similarly, changes in the value of the pensions liability arising from additional service are charged to the profit and loss account in the period that the service is performed. Subsequent changes in the value of the liability are generally related to financial assumptions and are caused by general changes in economic conditions. These may be regarded as holding gains and losses to be recognised in the statement of total recognised gains and losses. They differ in this regard from many changes in estimate of other long-term provisions, which are more likely to be caused by a change in the underlying work that has to be done—eg for decommissioning costs, advances in technology may make cheaper methods available or, conversely, changes in environmental legislation may increase the amount of work to be done. In these cases the change in estimate arises from a change in substance of the provision rather than from general price fluctuations. There is, of course, not a perfect split between the two and both pensions and other provisions are affected by both types of change. Nonetheless, it is reasonable to categorise changes in pension liabilities as arising from price fluctuations and, therefore, reflect them in the statement of total recognised gains and losses.

3.4.6 A common concern expressed about this approach is that the changes in value of the pension assets and liabilities affect the amount of cash that will have to be paid out in relation to a pension. They should, therefore, be reflected in the profit and loss account at some time. Revaluations of fixed assets, on the other hand, do not affect the cash cost of the asset and hence do not need to be reflected in the profit and loss account.

3.4.7 It is true that the changes in value of the pension scheme assets and liabilities will affect the cash contributions whereas revaluations of fixed assets do not affect the amount that was paid for them. However, the total amount charged to the profit and loss account as depreciation on a revalued asset does not equal the cash paid for the asset. Each year is charged with an amount that reflects the use of the asset based on the revalued amount. This will be more than the cash cost where the asset has been revalued upwards. Similarly, with pensions the amount charged to the profit and loss account each year reflects the ongoing cost based on the latest valuation. The total charged over the life of the pension scheme may be more or less than the cash contributions depending on whether there have been actuarial gains or losses. An example illustrating the comparison between the treatment of the net pension obligation in this approach and revalued fixed assets is given in Appendix A.

Effect in practice

3.4.8 The practical effect of immediate recognition in the statement of total recognised gains and losses can be illustrated using the same example again.

Example 3

Suppose an actuarial valuation indicated that there was a deficit of 50 in a pension scheme. The ongoing normal cost is 12 and the average remaining service life of the employees is 10 years. Of the deficit 25 is funded in year 2 and 25 in year 3. Other contributions each year equal the normal cost.

The profit and loss account would show a charge of 12 for the next ten years within operating profit and a loss of 50 in the statement of total recognised gains and losses in year 1. The balance sheet would show pension liabilities as follows:

	Year 1	*Year 2*	*Year 3*
Deficit in scheme	(50)	(25)	0

Practical advantages and disadvantages

3.4.9 The practical advantages of this approach are:

- as with immediate recognition in the profit and loss account, the balance sheet reflects the surplus (to the extent that the entity will benefit from it) or deficit according to the latest actuarial valuation, obviating any need for complex reconciliations and avoidance of figures in the balance sheet that lack any obvious meaning.

- the profit and loss account reflects the best estimate of the cost of employing staff in that year based on current market conditions.

- as a result of the above two points the reported figures are transparent and easy to understand.

- the method is consistent with FRS 7, which requires a pension scheme surplus (to the extent recoverable) or deficit to be recognised as an asset or liability immediately.

3.4.10 The practical disadvantages are:

- it is open to abuse through the use of assumptions that understate the estimate of the pension cost that is recorded in the profit and loss account. (This would be controlled by disclosure of a history (say of the last five years) of experience gains/losses recognised in the statement of total recognised gains and losses. A consistent record of experience losses would indicate that the assumptions on which the profit and loss account amounts were based were over-optimistic and that the regular cost should be increased.)

- the method is not consistent with changes in estimate of other provisions, which are recognised immediately in the profit and loss account (although this can be justified on the grounds that the changes arise from largely different causes, as discussed in paragraph 3.4.5 and the fact that for companies gains and losses in the pension fund are peripheral to their operating activities).

- the method is not consistent with IAS 19 (revised 1998) or FAS 87 (although IASC has indicated that it may consider this approach in the context of further developments in its views on its equivalent to the statement of total recognised gains and losses—see paragraph 3.1.3).

3.5 Immediate recognition in the statement of total recognised gains and losses with subsequent recycling

Basis for approach

3.5.1 In this approach, actuarial gains and losses would be recognised immediately in the statement of total recognised gains and losses. They would then be recognised for a second time (recycled) in the profit and loss account in a later accounting period.

3.5.2 This approach is based on a view similar to that underlying a spreading approach. Actuarial gains and losses are part of the operating cost of employing staff and therefore need to be recognised in the profit and loss account at some time. It is not appropriate to recognise them immediately in the profit and loss account because of the uncertainty surrounding their measurement. However, it is desirable for the balance sheet to reflect the outcome of the latest actuarial valuation, whether a surplus (to the extent that the entity expects to benefit from it) or a deficit, because, although it is not a precise or certain measure, it is the most up-to-date best estimate available.

3.5.3 This balance sheet presentation can be achieved by immediate recognition of actuarial gains and losses in the statement of total recognised gains and losses. With this approach, immediate recognition in that statement is not based on the view that the gains and losses are equivalent to those arising on the revaluation of fixed assets. Rather, the statement of total recognised gains and losses is used as a mechanism to cope with the uncertainty surrounding the pension cost measurement. From this point of view, recycling the gains and losses into the profit and loss account in subsequent periods is a natural consequence as subsequent valuations either confirm or reverse the amount of the gains and losses.

Effect in practice

3.5.4 The practical effect of immediate recognition of actuarial gains and losses in the statement of total recognised gains and losses followed by recycling can be illustrated using the same example as above.

Example 4

Suppose an actuarial valuation indicated that there was a deficit of 50 in a pension scheme. The ongoing normal cost is 12 and the average remaining service life of the employees is ten years. Of the deficit 25 is funded in year 2 and 25 in year 3. Other contributions each year equal the normal cost.

The profit and loss account would show a charge of 17 for the next ten years within operating profit. The statement of total recognised gains and losses would show a loss of 50 and a recycling adjustment (credit) of 5 in year 1 followed by recycling adjustments (credits) of 5 in the next nine years. The balance sheet would show pension liabilities as follows:

	Year 1	*Year 2*	*Year 3*
Deficit in scheme	(50)	(25)	0

Practical advantages and disadvantages

3.5.5 The practical advantages of immediate recognition of actuarial gains and losses in the statement of total recognised gains and losses followed by recycling are:

- as with the other approaches involving immediate recognition, the balance sheet reflects the surplus (to the extent that the entity will benefit from it) or deficit according to the latest actuarial valuation.

- it is less open to the abuse of undercharging the profit and loss account, since all gains and losses are reported in the profit and loss account at some time.

3.5.6 The practical disadvantages are:

- the same complicated and arbitrary spreading rules are required as for the spreading forward option, so the profit and loss account figures are still difficult to understand.

- it is inconsistent with FRS 7, which requires a pension scheme surplus (to the extent recoverable) or deficit to be recognised as an asset or liability on consolidation with no subsequent amortisation through the profit and loss account.

- it is not consistent with changes in estimate of other provisions, which are recognised immediately in the profit and loss account. Justification for the treatment rests on the uncertainties inherent in estimates of pension cost, yet the same treatment would not be accorded to other provisions whose estimates are subject to great uncertainty.

- it is inconsistent with IAS 19 (revised 1998) and FAS 87.

Chapter 4: Past service costs

4.1 Introduction

4.1.1 Past service costs arise when there is an increase in the benefits promised under the pension scheme. Some increases in benefits—in particular, cost of living increases—will have been included in the actuarial assumptions. If the cost of providing such benefits differs from what was assumed, the difference is treated as an actuarial gain or loss. The actuarial assumptions, however, do not reflect changes to the promised benefit itself, for example the creation of a pension benefit for a spouse where such a benefit did not previously exist. This chapter discusses the treatment of past service costs arising from this latter (and much rarer) type of change in benefits.

4.1.2 There are two factors that might be regarded as affecting the treatment of past service costs:

(a) whether they relate to current or to former employees; and

(b) whether they are funded out of a surplus in the pension scheme.

4.1.3 Present practice under SSAP 24 is that past service costs for current employees are spread forward in the profit and loss account. Past service costs for former employees are recognised immediately in the profit and loss account to the extent that they are not covered by a surplus in the scheme.

4.1.4 The actuarial approach set out in the earlier Discussion Paper also proposed that past service costs for current employees should be spread forward in the profit and loss account. However, for past service costs for former employees it proposed immediate recognition in the profit and loss account even if they were covered by a surplus in the scheme. The market value approach in the Discussion Paper proposed that all past service costs (ie those relating to both current and former employees and regardless of whether they were funded by a surplus) should be recognised immediately in the profit and loss account.

4.1.5 Internationally, E54 proposed immediate recognition for past service costs for former employees and asked commentators to choose between immediate recognition and spreading forward for current employees. The resulting standard, IAS 19 (revised 1998), requires that all past service costs should be recognised in the profit and loss account immediately the benefits have vested.

4.1.6 In the responses to the Board's Discussion Paper there was substantial support for the proposal that past service costs for current employees should be spread forward and substantial opposition to the proposal that past service costs for former employees funded out of a surplus in the scheme should be recognised immediately. This chapter, therefore, looks in more detail at the following options:

(a) recognise all past service costs immediately (the method required under IAS 19 (revised 1998) and proposed under the market value approach in the Discussion Paper)

(b) recognise past service costs relating to former employees immediately and spread forward those relating to current employees (the Discussion Paper's actuarial approach)

(c) offset past service costs against any surplus funding them and recognise as a cost only any excess amount (an alternative suggested by many respondents to the Discussion Paper).

The preference of a majority of the Board is to follow the international consensus and adopt option (a).

4.2 Recognise all past service costs immediately

4.2.1 With this approach, all past service costs would be recognised in the profit and loss account as soon as the benefits have vested. Most increases in benefit in the UK vest immediately and the past service costs would therefore be recognised immediately.

4.2.2 There are two aspects to this approach:

(a) the increased liability arising from the enhanced benefits is recognised immediately in the balance sheet; and

(b) the increase in the liability is recognised as an operating cost in the profit and loss account.

4.2.3 Immediate recognition of the increased liability in the balance sheet reflects the view that the commitment to increase benefits is known with certainty to have resulted in a greater liability—there is not the uncertainty associated with actuarial gains and losses, which may or may not reflect a change in the underlying net obligation, to justify delayed recognition. Further, the liability relating to current as well as former employees increases immediately. If an employee left the day after the increased benefits were awarded, the transfer value would reflect those increased benefits—no further service from the employee would be required to earn them and there would be no reason to defer the recognition of the increased liability.

4.2.4 Recognition of the increase as an operating cost in the profit and loss account, whether or not it is covered by a surplus in the scheme, reflects the view that the funding of the pension scheme does not affect the cost of the increased benefits to the company. The fact that the operating cost may be funded out of a surplus in the scheme does not mean that the entity does not bear a cost—the surplus will have been recognised because it is expected to provide benefits in the form of reduced future contributions or refunds, benefits that are no longer available if the surplus has been used to pay for past service costs.

4.2.5 It therefore follows that the entity should record an operating cost relating to the enhanced benefits regardless of whether it is funded by a surplus or of how any surplus that may exist is recognised. The emergence of a surplus and the enhancement of benefits are events that, although they may sometimes be linked, are of a different type—one is a holding gain or change in estimate resulting from events external to the scheme and one an operating cost resulting from a management decision directly related to the scheme.* If the surplus is recognised as a holding gain in the statement of total recognised gains and losses (Sections 3.4 and 3.5 above), that does not mean that the cost of the enhanced benefits ceases to be an operating cost and instead becomes a holding loss. Similarly, if some of the surplus is unrecognised because it is being spread forward as a change in estimate (Section 3.2 above), that does not reduce the operating cost that should arise in the profit and loss account. The reason for spreading forward any surplus is uncertainty whether it exists. Using the surplus to offset past service costs would imply that the uncertainty has suddenly been removed—an assumption that is inconsistent with the whole basis for spreading forward recognition of surpluses and deficits.

4.2.6 In some circumstances, part of a pre-existing surplus may be unrecognised on the grounds that it is too large to be recovered in full via reduced contributions or a refund. If past service costs are funded out of a surplus that is unrecognised in the financial statements for this reason, then it is appropriate that the costs be offset against the unrecognised surplus and only any excess cost recognised as a cost in the profit and loss account.

Effect in practice

4.2.7 The effect of this approach can be illustrated by two simple examples.

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* *Enhancements of benefits in relation to past service costs can be distinguished from salary increases that give rise to actuarial losses that are recognised as holding losses. Salary increases are largely driven by prevailing economic conditions, enhancements of benefits arise from specific management decisions in the period in relation to the scheme.*

Example 5

Suppose an entity awarded an increase in benefits relating to past service to both current and former employees. The costs are 20 for current employees and 35 for former employees. There is a surplus in the scheme of 40, from which the entity expects to benefit and which is being recognised under one of the options in Chapter 3.

Costs of 55 are recognised in the profit and loss account in the year.

Example 6

As example 5, but the surplus in the scheme is 90, of which only 40 is expected to provide benefits for the entity, resulting in 50 being unrecognised.

A cost of 5 is recognised in the profit and loss account in the year.

Practical advantages and disadvantages

4.2.8 The practical advantage of immediate recognition of past service costs in the profit and loss account is that it is simple to apply and easy to understand. Further, it produces consistent treatment of past service costs across entities regardless of the financial position of their pension schemes. It is also consistent with the IASC approach and the Board's approach to other provisions where a present obligation exists. The practical disadvantage is that it is claimed that it will inhibit entities from awarding increases in benefits.

4.3 Recognise past service costs relating to former employees immediately and spread forward those relating to current employees

4.3.1 This approach is similar to the one discussed above in that the recognition of past service costs is not affected by their funding. For past service costs for former employees, it adopts exactly the same approach as that above, ie recognises them immediately in the profit and loss account. However, past service costs for current employees are spread forward.

4.3.2 Those who support this approach do so on the following grounds. For current employees, enhanced benefits may be calculated in relation to past service but the cost is essentially a cost of granting benefits to an existing group of employees in exchange for their services in the future. The commitment to pay someone for services in the future is not recognised immediately, but as the services are performed. Former employees give no service in the future and, hence, the cost of their enhanced benefits is recognised immediately.

Effect in practice

4.3.3 The effect of this approach can be illustrated by a simple example.

Example 7

Suppose an entity awarded an increase in benefits to both current and former employees. The costs are 20 for current employees and 35 for former employees. There is a surplus in the scheme of 40, from which the entity expects to benefit and which is being recognised under one of the options in Chapter 3. The average remaining service life of the employees is ten years.

Costs of 35 (relating to former employees) and 2* (relating to current employees) are recognised in the profit and loss account in the year. A further cost of 2 per year relating to current employees will be recognised for the next nine years.

* *This assumes a straight-line method of spreading forward for simplicity. If the proposal in this section were adopted the Board might conclude that an alternative method such as percentage of pay was more appropriate.*

Practical advantages and disadvantages

4.3.4 The practical advantage of this approach is that it is not thought to inhibit entities from awarding enhanced benefits to current employees, though it may have a restraining effect on the (much rarer) cases when awards—other than cost of living upgrades—to former employees are under consideration. The disadvantages are that it is inconsistent with both IASC and the Board's approach to other provisions in that no liability is recognised even though a present obligation exists. Further, as with a spreading approach to actuarial gains and losses, complex and arbitrary rules are needed to govern the method of spreading forward.

4.4 Offset past service costs against any surplus funding them and recognise as a cost only any excess amount

4.4.1 This approach reflects the view that the entity bears an operating cost only to the extent that enhanced benefits cannot be funded out of a surplus in the scheme. It is pointed out that that amount is, after all, the extent of the additional cash contributions that will be required over time. The treatment is also justified on the grounds that it follows from the requirements limiting the recognition of a surplus—a surplus should be recognised only to the extent that the entity will benefit from it through reduced contributions or refunds. A surplus used to benefit the members of the scheme should not be recognised as a gain (or an asset) of the entity, nor does its use constitute an operating cost of the entity.

4.4.2 This approach will result in differing treatments depending on what approach is adopted for the recognition of the actuarial gain giving rise to the surplus, as follows:

- If actuarial gains and losses are spread forward in the profit and loss account (the first option in Chapter 3), past service costs will be offset against any surplus that has not yet been recognised in the profit and loss account. Any costs not covered by the surplus will be recognised immediately in the profit and loss account.

Example 8

Suppose an entity awarded an increase in benefits to both current and former employees. The costs are 20 for current employees and 35 for former employees. There is a surplus in the scheme of 40, which arose two years ago and from which the entity expects to benefit. It is being spread forward in the profit and loss account—8 has been recognised and 32 has yet to be recognised.

Costs of 23 (20+35-32) are recognised in the profit and loss account in the year. There is no further surplus to amortise through the profit and loss account in subsequent periods.

- If actuarial gains and losses are recognised immediately in the profit and loss account (the second option in Chapter 3), past service costs will also simply be recognised immediately in the profit and loss account.

Example 9

Suppose an entity awarded an increase in benefits to both current and former employees. The costs are 20 for current employees and 35 for former employees. There is a surplus in the scheme of 40, from which the entity expects to benefit and which has been recognised in the profit and loss account.

Costs of 55 are recognised in the profit and loss account in the year. If the surplus arose in the same year as the additional benefits were awarded the net cost recognised would be 15.

- If actuarial gains and losses are recognised in the statement of total recognised gains and losses, the use of the surplus to fund past service costs would be recognised in the statement of total recognised gains and losses and any excess cost in the profit and loss account.

Example 10

Suppose an entity awarded an increase in benefits to both current and former employees. The costs are 20 for current employees and 35 for former employees. There is a surplus in the scheme of 40, from which the entity expects to benefit and which was recognised in the statement of total recognised gains and losses two years ago.

Costs of 15 are recognised in the profit and loss account in the year and a loss of 40 in the statement of total recognised gains and losses.

- Finally, if the surplus is originally recognised in the statement of total recognised gains and losses and then recycled into the profit and loss account (the fourth option in Chapter 3), the use of the surplus to fund past service costs would be recognised in the statement of total recognised gains and losses to the extent that the gain arising on recognition of the surplus had not yet been recycled. Any excess would be recognised in the profit and loss account.

Example 11

Suppose an entity awarded an increase in benefits to both current and former employees. The costs are 20 for current employees and 35 for former employees. There is a surplus in the scheme of 40, from which the entity expects to benefit and which was recognised in the statement of total recognised gains and losses two years ago. The remaining service life of the employees is ten years and 8 of the 40 has been recycled into the profit and loss account.

Costs of 23 (20+35-32) are recognised in the profit and loss account in the year and a loss of 32 in the statement of total recognised gains and losses. There is no further gain to be recycled into the profit and loss account in subsequent years.

Practical advantages and disadvantages

4.4.3 The practical advantage of offsetting the past service costs against the surplus is that it reflects in the profit and loss account the amount that many view as the true cost to the entity of increasing the benefits. The disadvantages are that it is inconsistent with IASC's approach and that past service costs will be treated differently from entity to entity depending on the financial position of the pension scheme, leading to a lack of comparability.

Appendix A:

Comparison of immediate recognition of actuarial gains and losses in the statement of total recognised gains and losses with the treatment of revalued fixed assets

A1 Suppose an entity has a policy to revalue assets to their replacement cost and it has an asset with a five-year life and a cost of 100 which was revalued to 90 (replacement cost of 150 less depreciation of 60) at the beginning of year 3. Straight-line depreciation for the first two years would be 20 per year and for the last three years 30 per year, totalling 130 over the full five years. Note that this is not equal to the cash cost of 100 or the replacement cost of 150. However, each year **is** charged with the current cost of the use of the fixed asset.

A2 The same analysis can be applied to pensions. Suppose a pension based on final salary in five years' time is expected to be 500. The expected normal charge, interest charge and cash contributions are as follows (based on interest at 6 per cent and annual cash contributions equal to the normal charge):

Year	*1*	*2*	*3*	*4*	*5*	*Total*
Cash contribution	75	79	84	89	94	421
Normal charge	75	79	84	89	94	421
Interest	5	9	15	21	29	79

At the beginning of year 4, an actuarial valuation shows an increased expected pension of 600 and better than expected investment returns giving rise to a net surplus in the scheme of 100 (loss on the liabilities of 53—because of the increase in the expected pension from 500 to 600—and gain on assets of 153).

A3 The surplus of 100 is recognised immediately in the statement of total recognised gains and losses, the normal charge and interest in years 4 and 5 increase and the cash contributions fall as follows:

Year	*1*	*2*	*3*	*4*	*5*	*Total*
Cash contribution	75	79	84	**7**	**113**	**358**
Normal charge	75	79	84	**107**	**113**	**458**
Interest	5	9	15	**26**	**34**	**89**
STRGL				**(100)**		**(100)**

A4 The total normal charge plus interest does not equal the 600 due to be paid out, nor does the total normal charge equal the total cash contributions, just as the total depreciation did not equal the replacement cost of the asset. However, the normal charge for each year **does,** like depreciation, represent the increase in the liability arising from the service provided by the employee in the year. In addition, the total normal pension cost (458) less the gain recognised in the statement of total recognised gains and losses of 100 equals the total cash contributions (358). Finally, the timing of the funding/recovery of any deficit/surplus may be very different from the timing of the funding of the ongoing normal charge. Recognising any surplus/deficit separately from the normal charge provides more useful information for predicting future cash flows than does mixing them together. In the above example the cash contribution of 7 in year 4 equals the ongoing cost of 107 (recorded in the profit and loss account) less the recovery of the surplus (via a pensions holiday) of 100 (recorded in the statement of total recognised gains and losses).

Appendix B:

Summary of possible treatments discussed in the Paper

	Profit and loss account	Statement of total recognised gains and losses	Balance sheet
Actuarial gains and losses			
(a) Spread as in SSAP 24 (Section 3.2)	smoothed charge/credit	N/A	not necessarily latest deficit/surplus
(b) Immediate recognition exceptional item (Section 3.3)	immediate charge/credit	N/A	latest deficit/surplus
(c) Immediate recognition in the statement of total recognised gains and losses (Section 3.4)	—	immediate charge/credit	latest deficit/surplus
(d) As (c) with recycled charge/credit to the profit and loss account (Section 3.5)	smoothed charge/credit	immediate charge/credit plus transfer to the profit and loss account	latest deficit/surplus

	Profit and loss account	Statement of total recognised gains and losses	Balance sheet
Past service costs			
(a) Immediate recognition of all costs (Section 4.2)	immediate charge/credit	N/A	true liability
(b) Former employees	immediate charge/credit	N/A	true liability
Current employees (Section 4.3)	smoothed charge/credit	N/A	not true liability
(c) Offset costs against surplus			
either	offset then charge excess	N/A	liability as for actuarial gains/losses
or (Section 4.4)	N/A	offset then charge excess	liability as for actuarial gains/losses

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