

Technical Briefing Paper

The financial reporting of pensions

April 2008

In January 2008, the European Financial Reporting Advisory Group (EFRAG) published a Discussion Paper *The financial reporting of pensions* on behalf of the Pro-active Accounting Activities in Europe (PAAinE). The paper was developed by the UK standard-setter, the Accounting Standards Board (ASB).

A company's financial statement should provide full and transparent information on the extent of the company's exposure to pensions, including any deficit. But existing standards do not always achieve this as well as they might. Whilst standard-setters are addressing some of the issues that have arisen, the ASB believes that a fundamental review needs to be undertaken, and the paper aims to both stimulate the debate and influence the International Accounting Standards Board (IASB) as it reviews the current standard (IAS 19 *Employee Benefits*) governing pensions.

The Discussion Paper seeks to contribute to such a review by considering the accounting issues in the light of current and emerging accounting thinking. It seeks to develop principles that may be applied to pension plans of all kinds – without relying on the distinction between defined contribution (DC) plans and defined benefit (DB) plans which is a feature of existing standards and is troublesome to apply to hybrid plans.

The UK context

The ASB's standard on accounting for pensions, FRS 17 *Retirement Benefits*, was published in November 2000, although its requirements only become mandatory in full for accounting periods beginning on or after 1 January 2005. The implementation of FRS 17 gave rise to a number of comments about the accounting for pensions, particularly in respect of defined benefit pension arrangements, which have attracted a good deal of media attention.

The legal and regulatory environment for company pension schemes has also changed significantly since the publication of FRS 17, notably as a result of the Pensions Act 2004. Regulatory changes include a new statutory obligation on solvent companies to meet their pension obligations; the establishment of the Pension Protection Fund (PPF) to provide a partial safety net for employees whose employers are unable to meet their pension obligations; and the establishment of The Pensions Regulator (TPR), a regulator with significant powers. These changes could not have been anticipated when FRS 17 was developed and may have an effect on the relevant financial reporting.

The International context

Debate has also been stimulated by the move to International Financial Reporting Standards (IFRS). In many respects, the requirements of FRS 17 are similar to those of its international counterpart International Accounting Standard (IAS) 19 'Employee benefits'. But there are some issues that are addressed by IAS 19 and not by FRS 17, and there are a number of optional accounting treatments in IAS 19 the merit of which requires careful evaluation.

After considering the responses to the proposals in its discussion paper, EFRAG intends to issue a report setting out final recommendations for consideration by the IASB and FASB. The financial reporting of pensions is an IASB [agenda project](#), and they have recently issued a discussion paper, *Preliminary Views on Amendments to IAS 19 Employee Benefits*. A separate technical briefing paper is available on the ACCA website commenting on the key proposals of the IASB discussion paper.

Issues

Rather than seeking to improve existing accounting standards, the paper proposes a fundamental reconsideration of pension accounting. Consequently, some of the views in the paper differ markedly from existing standards on pensions. Some of the significant recommendations are outlined below.

One principle

A common set of principles for accounting for pensions should be applied to all pension arrangements, whether defined contribution (DC), defined benefit (DB) or the increasingly common 'hybrid' plans. The paper highlights the deficiencies in accounting for DC and DB plans on distinct principles, and especially the problems in applying these differing principles to hybrid plans.

Pension liability

Only benefits that the entity is presently committed (by legal or constructive obligation) to pay should be reflected in the liability. Where the entity has genuine discretion to vary the amount of future benefit, this is not reflected in the liability.

The focus should shift from mechanisms that spread pension costs over employees' service lives to the principle of reflecting only present obligations as liabilities. Therefore, if benefits are linked to employees' salaries at or near retirement or leaving service, expected future salary increases would only be reflected in the liability when increases are required by law or contract or are seen as non-discretionary. Under this approach, the pension expense and the pension liability is increased only when pensionable salaries actually increase. (The report notes differing views on this issue.)

Measuring the liability

Pension liabilities should be measured at a current value, defined as the settlement amount that reflects the cash outflows needed now or in the future to discharge the liability.

The liabilities should be measured by discounting future cash flows using a current market discount rate that reflects the time value of money only, that is, a risk-free rate. Risks, such as mortality risk, would be reported via disclosure.

Assets

Assets held to pay benefits should be reported at current values, as is consistent with current standards. However, current standards require the reporting of expected return of assets rather than the actual return. The paper proposes the expected return on assets should be provided by disclosure only, and that the actual return be reported as part of the profit or loss for the year.

Changes in measurement

Changes in the measurement of assets and liabilities relating to pension plans should not be deferred, such as by spreading them over the average remaining service lives of employees or by a 'corridor' approach (IAS 19) under which changes are not recognised at all unless they exceed a certain threshold. The paper therefore proposes all changes in the amounts of the pension deficits and surpluses should be reported in the period in which they arise.

Pension plan accounting

Regarding financial reporting by pension plans themselves, the paper suggests the IASB should consider withdrawing IAS 26 *Accounting and Reporting by Retirement Benefit Plans*. Instead, the standards for the general purpose financial reports of pension plans should be consistent with IFRSs in general. Thus, a plan's liability to pay benefits in the future should be measured using the same principles as an employer's liability.

Consolidation of pension plans

Current accounting standards require an employer to record a pension liability (the amount by which the liability to pay benefits exceeds the plan's assets) in respect of any guarantee it has given. This assumes that the plan is genuinely independent of the employer, for example where it is governed by Trustees who are bound to act in the interests of the members rather than the employer.



The paper argues that if the control rests with the employer, it should be consolidated in the employer's financial statements. This differs from current accounting standards which provide an exemption from the usual principles of consolidation for pension plans.

The Discussion Paper can be downloaded, free of charge, from the FRC website at:
<http://www.frc.org.uk/asb/technical/projects/project0065.html>

Comments on the Discussion Paper and responses to the specific questions raised in therein are requested by 14 July 2008 at: commentletter@efrag.org.

ACCA also welcomes members' comments on the paper. Please submit these via e-mail condocomments@accaglobal.com by Tuesday 1 July 2008.

This briefing paper contains information in a summary form and is of a general nature. It is not intended to address all of the issues of a specific entity and is not a substitute for detailed research or the exercise of professional judgement.

While every care has been taken in the preparation of this briefing paper, ACCA can not accept any responsibility for any loss occasioned by reliance on it.